TransGrid's Response to the Queensland Competition Authority Issues Paper

Electricity Distribution Determination of Prescribed Services – May 2000

The scope for TransGrid to comment on regulation of distribution is limited because of the fundamental differences between distribution and transmission functions. TransGrid's primary experience is with the regulation of transmission. Areas of difference between transmission and distribution include:

1. The costs of transmission are typically 5 to 7% of an end users total electricity bill compared with 10 to 60% in the case of distribution.
2. Distribution companies directly serve large numbers of diverse end use customers.
3. Transmission service failures are very rare but can have geographically widespread impacts.
4. Transmission has a vital role in facilitating wholesale electricity market competition both within and across national market regions.
5. Transmission performance can impact on the integrity of the overall interconnected power system.

Despite these differences some general comments on the Queensland Competition Authority's (QCA) Issues Paper can be made.

It is pleasing to see that the QCA is considering the nature of the incentives imposed by the regulatory regime. In TransGrid's view these should produce similar incentives for regulated monopolies as those faced by businesses operating in competitive markets. For example above average performers in terms of service delivery and efficiency should receive and keep above average returns.

We do not accept the proposal contained in the paper that regulated returns should be set at low levels to encourage regulated businesses to move prescribed services into unregulated environments. Among other matters returns set below a firm's weighted average cost of capital simply encourage the firm not to invest in prescribed services at all – an entirely inappropriate outcome for essential infrastructure.

In determining an appropriate return for prescribed services the capital asset pricing model provides a useful basis for determining a company's weighted average cost of capital. While it is true that businesses in competitive markets face greater income volatility than regulated businesses, and hence more risk, regulated businesses can face asymmetric risks that also affect the viability of an investment. If income from a regulated investment is expected to reduce over time because of asymmetric risks this can also affect the cost of capital in the early years of these investments. It is often the regulatory regime itself that introduces asymmetric risks resulting in situations where regulated businesses can sometimes face more significant commercial risks than unregulated businesses.

Asymmetric risks facing regulated network businesses in Australia include:

1. Removal of value from the regulated asset base before capital invested in these assets has been fully recovered by the asset owner. This comes about because of 'asset optimisation' associated with the optimised deprival value methodology that applies under the Australian National Electricity Code.
2. Increasing levels of liability to customers and other parties as a result of supply interruption or failure to meet inferred supply standards. In recent years the liability exposure of network businesses has been growing as a result of regulatory changes.
3. Regulatory risk. Each decision of the ACCC in relation to businesses that it regulates has produced a lower rate of return to the owners than the preceding decision. In the UK

there have been very significant downward adjustments of regulated revenue at regulatory resets for regulated network businesses.

In summary, the QCA may be able to subject some aspects of typical distribution businesses to competitive environments resulting in minimising the need for regulatory oversight. However, some elements of natural monopoly are inevitable and these will need thoughtful regulation. This regulation should provide appropriate incentives to improve service and efficiency. Above all there needs to be an appropriate rate of return on invested capital to ensure that investment in essential service provision is not stifled by inappropriate commercial incentives.