Review of the National Access Regime
Productivity Commission
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Dear Sir / Madam

Legislation Review: Clause 6 of the Competition Principles Agreement and Part IIIA of the Trade Practices Act 1974 – Review of the National Access Regime – Position Paper

TransGrid would like to thank the Productivity Commission for the opportunity to comment on this particular Position Paper.

In relation to efficient infrastructure investment, we commend the Productivity Commission's findings and proposals for placing greater emphasis on the incentives to invest in essential infrastructure. The issues raised are particularly pertinent for electricity transmission investment, as the processes and regulatory environment are very complex and time-consuming.

Recent US National Energy Policy (NEP) developments support the Productivity Commission's position. The absence of transmission investment was a significant factor in the Californian electricity market fiasco, which clearly influenced the proposed NEP. As part of the ongoing effort to implement a key recommendation of the NEP, Secretary of Energy Abraham (May 29, US-time) called for a transmission infrastructure that ensures reliable electricity supplies. Highlighting the problems presented by a lack of a reliable transmission infrastructure during a visit to Con Edison's Sprain Brook Substation in New York, Abraham said, "Investment in new transmission capacity has failed to keep pace with growth in electricity demand and with changes in the industry's structure. If we remove the transmission constraints across the country, like those present in New York, the result will be lower prices and improved reliability."

The Secretary noted that, in some cases, transmission constraints exist because of a lack of economic incentive. The NEP proposes a solution by encouraging the Federal Energy Regulatory Commission to develop incentive rates to promote transmission expansion. In other cases, the problem is the siting process itself. The NEP proposes legislation providing for federal transmission siting, as under current law, transmission siting is a state function.

A complicating factor in transmission investment decision making in Australia is a belief by some that the market can deliver more efficient outcomes than regulated processes, which has resulted in a crude regime for unregulated transmission development operating in parallel with regulated transmission development. This, in turn, has led to competing and overlapping processes that complicate the delivery of efficient infrastructure, in a way not seen anywhere in the world. It is a clear example of the dangers of pursuing competition at the expense of efficiency, a concern raised by the Commission's Position Paper.

Despite the potential merits, a coherent framework for market driven transmission investment has not yet been achieved anywhere in the world. This is because of well established market failures in infrastructure development, including the need to capture economies of scale and the significant transaction costs in bringing together potential beneficiaries of "common good" style developments. Electricity transmission systems are (because of the laws of physics) much more physically integrated than other infrastructure networks.

For example a transmission development in Sydney can deliver benefits to the interconnection capability between Victoria and South Australia. To assist the Commission with this issue we refer the Commission to an Electricity Journal article (published by Elsevier Science Inc), entitled *"Transmission Investment: Obstacles to a Market Approach*" by Lisa Cameron (pp.25-38, March 2001).

While efforts to develop a market-based regime are essential this must not be at the expense of efficient outcomes, and with full recognition of potential market failures. In this regard TransGrid notes the view recently annunciated by the National Competition Council that the processes for handling both regulated and unregulated interconnects have been unsatisfactory, and that it will be giving priority attention to these arrangements in its current third tranche review of Competition payments to the States.

Contemporary overseas academic research recently published also supports the Productivity Commission's position on inadequate transmission investment and that the high social cost of setting returns on equity too low will more than likely outweigh the costs of setting returns too high. By way of example we refer the Commission to the article in the Electricity Journal, "*Assessing the Cost of Capital for a Standalone Transmission Company*" by Michael Cragg, William Lehr and Ron Rudkin (pp.80-88, January/February 2001)

We would also like to re-iterate in this submission that the on-going disincentives for efficient investment in new transmission infrastructure, under the current national transmission access arrangements are of particular concern to TransGrid. One example of the sub optimal outcomes resulting from these disincentives to invest is that surplus thermal generation capacity in NSW is not reaching supply-strapped Victoria and South Australia.

Attempts to streamline the process for transmission infrastructure investment have failed for the following key reasons:

1. The ability of upstream and downstream market participants to influence the investment and pricing arrangements under the National Electricity Code (NEC) with the objective of minimising competition in their markets. There is also scope for affected parties to "game" the current inter-regional planning process for approving new interconnectors.

2. Failure of industry regulators to recognise the relative economic impacts of transmission, in the emphasis they are placing upon developing market rules. Typically, transmission costs make up only about 7% of an end use customer's electricity bill, whereas wholesale electricity generation represents typically about 45% of the same bill. An investment in transmission infrastructure can deliver direct savings in generation infrastructure, as well as enhancing wholesale market competition in electricity generation. It is worth noting that the ACCC regulatory test that is used to determine the relative economic merits of a regulated transmission investment proposal has limited consideration of market power in upstream or downstream markets.

3. Failure of industry regulators and participants to fully recognise the need to match accountability for outcomes with responsibility for decision making. Much of the ultimate decision making power in relation to transmission investments resides with third parties, while leaving the commercial and service level accountabilities with transmission service providers.

Current disincentives to regulated transmission investment include low regulated rates of return, high levels of commercial risk arising from, among other matters, regulatory uncertainty, and evolving service standards. Rules for adjustments to regulated income associated with inefficient investment are unclear and there is no scope for the establishment of regulatory principles that have precedent value. There is also limited development of incentives aimed at emulating the efficiency drivers that would result from competitive markets for provision of essential infrastructure.

In summary, based on TransGrid's experience with the National Electricity Market access regime, and the accounts provided in numerous submissions to the original Productivity Commission Issues Paper, there are still major unresolved issues in developing the best framework for ensuring the economic development of essential infrastructure. Material referred to in this submission essentially endorses the findings in the Commission's Position Paper.

I trust that this letter is of assistance to the Productivity Commission and look forward to further involvement in this important project. Furthermore, please be advised that this submission can be made available for public scrutiny, and as such is not commercially sensitive.

Should you wish to discuss any of the matters raised in this submission, please feel free to contact me on (02) 9284 3434 or via e-mail: phil.gall@tg.nsw.gov.au

Yours sincerely

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