TXU

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Mr John Cosgrove
Commissioner
Productivity Commission
Locked bag 2 Collins Street East Post Office
MELBOURNE VIC. 8003

Dear Mr. Cosgrove,

Following your discussion with Con Noutso from TXU on 28 May 2001, we submit further details of TXU's experience with attempts to extend gas networks to Barwon Heads, as evidence that the National Third Party Access Code (NTPAC) for natural gas pipelines fails to provide appropriate incentives to invest in essential infrastructure, especially in marginal projects eg new areas.

TXU Networks sought a variation to its access arrangements[1] to clarify how exogenously driven investments would be treated by the ORG across regulatory periods, and to provide certainty that the cost of financing (WACC) would be reimbursed for any investment in unforseen capital expenditure.[2] TXU argued that in the absence of such certainty access to and expansion of the gas distribution system, in excess of the amounts forecast at the beginning of the access arrangement period, will be postponed.

The ORG denied the request for the variation sought on the basis that it considered it was inconsistent with the 'price path' approach that is required for incentive regulation in Victoria.[3] The ORG also expressed concern as to whether an amendment to the current access arrangement is the appropriate mechanism for dealing with the approach to be taken for incentive mechanisms to be applied at the next gas price review.

1 The proposed revision is contained in TXU's submission to the ORG on the 27thn of June , 2000.

2 Unforseen capital expenditure refers to investments in projects that were not identified or forecast at the time of approval of the access arrangement.

3 P.16 ORG's draft decision delivered Nov. 10, 2000 clearly states
" While the proposed revision would appear to provide greater certainty for investors it would reduce the incentives for the service providers to minimise the cost of providing distribution services. That is, the effect of the proposed revision suggest that TXU would be guarantee a return on any 'exogenously driven' investments undertaken on an ex-post adjustment. By its nature, this would be more reflective of a 'cost of service' approach to regulation (as described in section 8.3(b) of the Code) rather than the 'price path' approach adopted in relation to the current access arrangements and required by the tariff order.

Because of the ORG's decision TXU deferred the investment in Barwon Heads. The main influences were :

a) The uncertainty about the return

TXU sought a formal variation to its access arrangements in relation to financing costs associated with the supply of gas to Barwon heads.[4] More specifically, the variation would allow TXU to be reimbursed for the incremental financing costs incurred during the current regulatory period by including this amount in the calculation of tariffs to apply from the next regulatory period.

b) The incentive mechanism

The 'price path' approach to incentive regulation applied by the ORG would

(i) Deny TXU the cost of capital (WACC) for unforseen capital expenditure incurred for undertaking projects that were not included in the original access arrangement like Barwon heads.

(ii) Penalise TXU by applying the 'price path' approach to incentive regulation implying unforseen capital expenditure was inefficient under the 'price path' approach to incentive regulation adopted by the ORG.

c) The ORG's failure to consider the possibility that 'greenfield' projects like Barwon Heads may have higher risk associated with investing in them.

The risks associated with reticulation of 'greenfield' projects are simply higher than the risks associated with expanding a gas distribution system that has established markets. TXU contend it should be compensated for this risk of reticulating 'greenfield' projects in the form of a higher cost of capital (WACC).

The ORG argued that in applying the 'price path' approach to incentive regulation it was expected that utilities would undertake some projects that earn returns above their cost of capital (WACC) whilst undertaking other projects that would earn returns below these levels.[5]

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4 Application for revision to Access arrangements - TXU Networks (Gas) Pty. Ltd. 27 June 2000. P. 3 of the submission clearly states

" The proposed revision is to provide certainty that the cost of that the cost of financing will be reimbursed to the service provider for investment in unforseen exogenously driven capital expenditure until such time as the investment cam be included in the capital base , and hence in future reference tariffs. TXU contends that in the absence of that certainty, access to and expansion of the gas distribution network in excess of the forecast amounts will be stifled or at best postponed.

5 Application for revision of TXU Networks (Gas) Pty. Ltd. Gas Access Arrangement – Final Decision . P. 13 states

" Again its inevitable that the incentives provided under such a regime are unlikely to provide the regulated entity with a commercial incentive to undertake efficient investments in all instances. Such incentives normally are designed to make certain investments projects profitable on average, and to reflect benchmarks about costs, customer usage and other matters. In practice a number of projects are likely to generate high returns to the entity, but others will generate returns lower than its cost of capital. Accordingly, regulators would expect regulated entities to accept the 'swings and roundabouts' inherent in such an incentive regime, and to meet the expectations of service provision during the period, ,rather than cherry picking the projects that deliver above required returns, but refusing to undertake marginally unprofitable projects. "

TXU believes that the ORG's position on this issue is commercially unrealistic. TXU would only undertake projects where it believed it would earn at minimum its required cost of capital (WACC) over the life of the project.

TXU has strong concerns that the ORG's interpretation of the NTPAC will prevent investment in marginal projects. The costs of failing to invest in essential infrastructure in these areas are likely to be larger than the costs of monopoly pricing to the community.

For further enquires regarding this issue please contact Mr Con Noutso on 03-96794242.

Yours sincerely

PETER MAGARRY
General Manager
TXU Networks