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Mr Michael Rawstron
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

Dear Michael

ACCC Review of Regulatory Test

Thankyou for the opportunity to comment on the Commission's issues paper on the review of the regulatory test. CS Energy believes that transmission infrastructure is the key facilitator of competition in the National Electricity Market. A robust transmission system maximises competition between generation sources to provide the best possible prices for consumers and also minimises trading risks for generators (both physical and financial) reducing risk premiums in end use prices.

Principles of the Regulatory Test

The current regulatory test was developed to encompass the principles of economic efficiency and competitive neutrality and is based on a cost benefit analysis. Presumably the test aims to prevent network owners from over-investing or gold plating their networks and inflicting excessive costs on users who were not a party to the decision to build. Competitive neutrality provisions aim to level the playing field between network investment and non-network alternatives such as generation, demand side or unregulated network investment. The current regulatory test fails to achieve these aims and is biased towards under-investment or investment later than required, reducing competitiveness in the market.

In calculating benefits, only cost savings are considered and not pool price outcomes. Analysis of investments to date, for example QNI, shows that the benefits in terms of reduced pool price outcomes are many times the cost savings, which would have been used in the regulatory test. Although it is difficult to predict pool price outcomes as they depend on participant behaviour, it is clear that the existing test is overly conservative, underestimating benefits to customers and preventing economic investment from occurring.

Competition benefits

The issues paper raises the question of whether competition benefits should be included and how they should be measured. Competition benefits should be included but quantifying them is difficult as they depend on participant behaviour. Reserve margins between available generation and demand at a particular load centre are a good indicator of competitiveness. Transmission investment improves reserve margins through

increased capacity and lower constraints increasing the quantity of available generation at a load centre. The commission should consider using reserve margin as a proxy for competition benefits.

Optimisation out of the Asset Base

CS Energy believes the risk of optimisation is a real concern for regulated transmission owners and is an impediment to investments proceeding in a timely manner. From a competitive neutrality perspective it could be argued that optimisation should occur because non-regulated alternatives such as generation are also exposed to the risk of their assets being stranded. However non-regulated investors have access to market returns whereas regulated investment is restricted to a regulated rate of return.

Our view is that regulated business should receive low returns commensurate with low levels of risk. This should achieve the lowest transmission costs for the market. To achieve this aim, we see two alternate ways of handling the issue of optimisation. One option would be to reduce the return on assets to values just above prevailing cash rates and abolish optimisation of assets. Another option would be for the return on assets to be maintained at current levels and reduce returns on optimised out assets to cash cost only, not zero.

The objective of the tests would be to secure greater asset investment under the same revenue cap.

Maintaining the integrity of Regional Structure

The design of the National Electricity Market is a regional model with pricing regions incorporating a regional reference node and interconnectors joining the nodes allowing competition between regions. CS Energy supports the current model as it avoids the risks and complexity associated with a fully nodal model and still provides adequate locational pricing that is predictable and easy to understand.

NEMMCO have identified some problems with the representation of transmission constraints under the existing model particularly where constraints within a region interact with interconnector constraints. Consultations are underway on how these issues should be handled but CS Energy believes that the proposals to date are only stopgap measures. There are two solutions to this issue, creation of additional regions or investment in transmission to remove the constraints. The creation of additional regions has been canvassed well but the alternative of transmission investment has not been given due consideration.

Creation of additional regions does cause additional costs and increases risks associated with financial trading which are reflected in end-use prices. Transmission investment also imposes additional costs on the market but proves other benefits in terms of improved competition and reduced electrical losses.

The current regulatory test is lacking in that the benefit of maintaining the integrity of the regional model is not considered. CS Energy believes that solving these constraint issues is an important benefit and should be factored into the regulatory test.

Conclusion

The principles of economic efficiency and competitive neutrality as a basis for the regulatory test are sound, but CS Energy believes that consideration of process issues in formulation of the regulatory test have resulted in a test that is overly conservative and

grossly underestimates the benefits associated with new transmission investment. This has resulted in required investment being not occurring or being delayed reducing market efficiency and competition.

We believe the regulatory test should be changed to properly consider all the benefits of transmission investment.

Experience to date has shown that benefits from transmission investment have proved to be many times those that would be calculated by the regulatory test. The cost to energy consumers of under-investment is far greater than the costs that would occur through over-investment so the test should result in more rather than less transmission investment. The new regulatory test should aim to reduced regulated risk so that extra investment can occur, but reduce returns so that an additional cost burden is not carried by customers.

Yours sincerely

A.G. Bellas
CHIEF EXECUTIVE

Enquiries: Ron Roduner
Telephone (07) 3222 9361
Facsimile (07) 322 9343