

1st April 2003

Mr Sebastian Roberts
A/g General Manager
Regulatory Affairs-Electricity
Australian Competition and Consumer Commission
By Email: Electricity.group@acc.gov.au

Dear Sebastian

**Edison Mission Energy Australia Ltd Supplementary Submission to
ACCC Discussion Paper – Review of the Regulatory Test**

Please find attached our supplementary submission to the *ACCC Discussion Paper – Review of the Regulatory Test*.

Edison Mission Energy Australia Limited (EME) is making a joint submission in relation to this review with a number of other market participants. This submission is a supplementary submission to the joint submission and is intended specifically to deal with EME's position on the inclusion or otherwise of so called "competition benefits" into the Regulatory Test. This in our view is necessary as it appears the ACCC has misinterpreted our position on this issue in our earlier response.

I apologise for the slight delay in provision of this submission. Should you have any questions regarding the submission, please contact Terry Killen, on (03) 96966477.

Yours sincerely

Paul Hyslop
Regional Vice President
Marketing and Trading

ACCC Review of Regulatory Test

Edison Mission Energy Australia Limited Submission

Edison Mission Energy Australia Limited (EME) is making a joint submission in relation to this review with a number of other market participants. This submission is a supplementary submission to the joint submission and is intended specifically to deal with EME's position on the inclusion or otherwise of so called "competition benefits" into the Regulatory Test and is necessary as it appears the ACCC has misinterpreted our position on this issue in our earlier response.

The ACCC in their discussion paper claimed that EME believed that competition benefits should be included in the Regulatory Test. This is a misinterpretation of EME's position, possibly as a consequence of the fact that EME's position was taken from a series of answers to questions that the ACCC had asked in its Issues Paper. The remainder of this submission seeks to clarify EME's position.

In its submission to the ACCC dated 14th June 2002, EME made the following statement in relation to the question, "Should the test be altered to reflect greater competition in a region from the introduction of network investment?"

EME sees some benefits in including competition as part of the test, as it reflects some of the benefits that entrepreneurs would be able to access. However, as issues of wealth transfer do not enhance the economic efficiency of the NEM, but rather forecast winners and losers, any such approach including competition aspects must be undertaken rigorously in order to avoid any arbitrary assessment by proponents. If the analysis is arbitrary proponents would be incentivised to game the outcome in favour of their proposed investments which would likely lead to massive over-investment in networks. In addition as the long term benefits are very uncertain, the test should only capture benefits that are forecast in the first five years.

In order to ensure a rigorous analysis, the test should use the same approach as is to be used for the "beneficiary pays" test as is currently under development by NECA and the industry.

The following points are noted as being significant in our response:

- EME considered the potential inclusion on the basis of competitive neutrality – i.e. to ensure that all investments are treated on an equivalent basis.
- Wealth transfers do not fundamentally enhance economic efficiency with the implication that wealth transfer benefits should not be claimed as "public good" which would then be socialised.
- Any assessment of competition benefits must be undertaken rigorously (envisioned the same approach as to be used for beneficiary pays when it is developed) which should include Monte Carlo and scenario based pool modelling to demonstrate the benefits delivered to individual participants.

- Long term competition benefits are highly uncertain. Only the near term benefits that can be demonstrably captured from participants (through some form of contract – including transfer of property rights) should be included – EME suggested a natural limit of five years be imposed on any negotiations¹

EME provided *qualified support* for the concept of including competition benefits and hence should not be lumped, as the ACCC has done, with the other participants that have provided no qualification to their position. EME’s aim in providing this *qualified support* is to ensure that practical, alternative market-based network investment options are given appropriate consideration and are fairly assessed alongside the regulated proposals. As market-based options rely entirely on their ability to capture economic rents in the market, EME was simply acknowledging the fact that the capacity of regulated investments to do this should also be considered.

In its submission EME particularly stressed the need to reconcile competition benefits with economic efficiency (noting that many competition benefits are in fact simply wealth transfers). This is important because by including competition benefits, the Test must ensure that proponents do not double count benefits in order to justify what would otherwise represent a negative net benefit.

EME linked the inclusion of competition benefits with the beneficiary pays approach that is currently being developed by NECA. Although not spelt out in its response to the ACCC Issues Paper, in its responses to NECA on the beneficiary pays issue, EME has clearly expressed the following views about the operation and workability of any Beneficiary Pays scheme:

1. The Beneficiary Pays scheme should emulate commercially negotiated outcomes.
2. The Beneficiary Pays scheme should require NSPs to clearly and unambiguously demonstrate to each relevant participant the extent and certainty of any benefits ascribed to each participant (individual participant by individual participant). This would in our view require substantial pool modelling using, at a minimum, Monte Carlo and scenario based approaches covering the full range of potential outcomes. We note that failure to reach agreement with each participant on the level of benefits so ascribed will only lead to intractable and long running disputes and will not result in a workable scheme for allocating costs. EME in particular totally rejects the NSP’s predilection for a simple “crank the handle” approach to Beneficiary Pays as any such approach would be largely arbitrary and would not lead to agreement and acceptance by each participant.
3. Beneficiary Pays must include the transfer of property rights to individual Participants in accordance with the proportion of benefits ascribed (at a minimum a portion of any settlements residue but preferably a firmer interlocational hedge).

Hence in relation to the Beneficiaries Pays methodology, EME envisages NSPs marketing the benefits of new investments to the relevant participants in order to get their agreement to pay, and in the process would provide a portion of the property rights that are associated with the new investment. The portion of the benefits negotiated as property rights will then need to be subtracted from the total benefits calculated as they will have been captured by the specific beneficiaries and should not be double counted. The loss of benefits will be offset by specific revenues from the specific participant beneficiaries. It should be noted that the resulting

¹ An equivalent degree of uncertainty applies to spot prices and it is noteworthy that very few (if any) hedge contracts are written beyond five years forward.

investment looks very much like a hybrid investment (part willing investor, part regulated). While the “crank the handle” approach to Beneficiary Pays appears to be favoured by NSPs, such an approach is clearly problematic and unworkable, as individual participants that do not agree with the benefits so calculated, will exercise every right at their disposal to oppose the calculation, where it makes commercial sense to do so.

Thus in supporting consideration of a “competition test” EME envisages obligations being imposed on NSPs to actually demonstrate that they have captured these benefits through commercially negotiated arrangements with the participants identified as beneficiaries of increased competition. This would be consistent with maintaining competitive neutrality between regulated and entrepreneurial investments. EME does not countenance “crank the handle” type calculations being carried out that simply sum up arbitrarily assessed wealth transfers which add nothing to the NEM in terms of economic efficiency.

In summary, to clarify EME’s position, it supports appropriate consideration of competition benefits in the Test to the extent necessary to ensure that NSP’s have an incentive to act entrepreneurially and seek out prospective beneficiaries to assist with the funding of new investments, rather than simply rely on the regulatory test which ultimately leads to some form of socialisation of the costs with all its attendant inefficiencies. In addition, EME is concerned to ensure that competing, unregulated investment options are given proper consideration in the application of the Test. EME does not support inclusion of a competition benefits test through a “crank the handle” arbitrary assessment as a means of applying a ‘public good’ argument to justify new regulated investments, when they would otherwise fail the remaining provisions of the Test.