

# **Energy Solutions Australia Pty Ltd**

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Mr Sebastian Roberts,  
General Manager,  
Regulatory Affairs – Electricity,  
ACCC,  
PO Box 5203,  
Melbourne, Vic 3001.

Dear Mr Roberts,

**RE: Comments on Draft Decision ‘Review of the Regulatory Test for network augmentations’**

Energy Solutions Australia Pty Ltd is pleased to contribute to the above consultation.

The Regulatory Test controls the development of regulated network services in the Australian National Electricity Market (NEM). The Regulatory Test therefore plays a key role in the NEM in defining the appropriate interaction between the competitive market and the non-competitive market i.e. the regulated sector. On that basis it is critical to ‘get right’ the Regulatory Test.

Please do not hesitate to contact me should you have any queries regarding this submission.

Regards,

Dr. A. Cook  
Managing Director

THIS SUBMISSION HAS BEEN MADE ELECTRONICALLY AND BEARS NO SIGNATURE

## 1.0 Background

On 5 February 2003 the Australian Competition and Consumer Commission (the ACCC) released a Discussion Paper<sup>1</sup> in which it outlined three options for the development of the Regulatory Test. The options considered included:

- Option 1, which involved maintaining the current Regulatory Test with minor modifications to ensure consistency between the Regulatory Test and the National Electricity Code (the Code);
- Option 2, which provided a number of definitions to be used by transmission and distribution businesses when applying the Regulatory Test in an attempt to define and clarify elements of the Regulatory Test, and ensure a nationally consistent application; and
- Option 3, which considered ways of ensuring the Regulatory Test included the benefits of increased competition.

The ACCC has now published its Draft Determination<sup>2</sup> on the above matters, and Energy Solutions Australia Pty Ltd (ESA) is pleased to provide feedback.

This submission considers each of the options in turn.

## 2.0 The Draft Determination and Option 1

The Draft Determination notes that *'all parties who made submissions in response to this section of the Discussion Paper agree with the principle of aligning the regulatory test with the code. Therefore, the Commission proposes amending the regulatory test along the lines raised in its Discussion Paper'*. ESA supports this approach.

ESA's only additional comments on Option 1 relate to the reliability limb of the Regulatory Test.

ESA supports the submissions of VENCORP and Gallagher and Associates that the ACCC should consider eliminating the reliability limb of the Regulatory Test. It is noted that the ACCC also gives in principle support for this view viz *'the Commission supports the views expressed by VENCORP that all transmission investment be undertaken with reference to its economic need'*. However, the ACCC then goes on to argue that eliminating the reliability limb would be inconsistent with its Clause 5.6.5A obligations. ESA disagrees with this position.

Anecdotal evidence is that 80% of network augmentations are reliability based. This is not surprising given that the reliability limb provides an 'easy' approval path. Opportunities for potential misuse of the reliability limb stem from the fact that the jurisdictional requirements referred to in Clause 5.6.5A are not at all clear, and indeed can lead to perverse outcomes when considered on a national basis.

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<sup>1</sup> ACCC, *Discussion Paper, Review of the regulatory test*, 5 February 2003 (**Discussion Paper**)

<sup>2</sup> ACCC, *Review of the Regulatory Test for network augmentations, Draft Decision*, 10 March 2004 (**Draft Determination**)

It should also be noted that the Clause 5.6.3(l) Code obligation on the Inter-Regional Planning Committee (IRPC) to develop ‘*an objective set of criteria for assessing whether a proposed new small network asset or new large network asset is a reliability augmentation*’ commenced in May 2003. Almost 12 months later, ESA understands that the IRPC effort is stalled, and that the matter is not being progressed. This leaves the Regulatory Test with an approval limb which is ill-defined and with the very real potential for inefficient outcomes. It should come as no surprise that this limb is the chosen approval limb for the majority of network augmentations proposed by Transmission Network Service Providers (TNSPs).

As the transmission regulator the ACCC has a responsibility to act to restore the appropriate and intended checks and balances on the application of the Regulatory Test. Elimination of the reliability limb of the Regulatory Test is an appropriate response for the ACCC to take.

### **3.0 The Draft Determination and Option 2**

The Draft Determination states in part that ‘*taking into account the views raised by interested parties, the Commission considers that it is appropriate to amend and define particular terms used in the regulatory test which it considers will provide greater guidance to Network Service Providers (NSPs)*’. ESA agrees with this conclusion in the expectation that it will lead to greater consistency in the application of the Regulatory Test across the NEM. This in turn will lead to more efficient outcomes, which should be less open to disputes and delay.

ESA’s comments on specific definitions are as follows.

#### **3.1 Alternative Projects**

The ACCC has concluded that:

- For a reliability augmentation there is a need for an alternative project ‘*to have a clearly identifiable proponent*’ in order to ensure that statutory obligations imposed on TNSPs are met; whereas
- For a non-reliability augmentation, an alternative project does not need to have a ‘*clearly identifiable proponent*’.

ESA disagrees with the conclusion regarding reliability augmentations.

Firstly, ESA is of the view that it is the fact that the reliability limb provides an ‘easy’ approval path that is responsible for 80% of network augmentations being reliability based. With none of the intended and appropriate checks and balances on the reliability limb in place (refer to Section 2.0), the ACCC’s Draft Determination has the effect of making the reliability limb appear an even easier approval path. In that case the Draft Determination has the very real potential of ensuring that the 80% figure will increase to 100%.

Second, ESA does not understand why the time constraints associated with reliability augmentations do not permit consideration of alternative projects that do not have clearly identifiable proponents. The main pressure that reliability augmentations impose on TNSPs is to ensure that an augmentation is in place by the appropriate in-service date. It should be a simple matter for any commercially focused developer to work backwards from that in-service date to develop a schedule which includes a time period for the assessment of alternative projects that do not have clearly identifiable proponents. After all, reliability augmentations should not suddenly appear out of nowhere, catching the TNSP by complete surprise. Rather, the additional reporting requirements imposed on TNSPs by the Network and Distributed Resources Code changes require that TNSPs provide the market advance notice of all augmentations in order to give the opportunity for competitive market solutions to develop.

Requiring reliability augmentations to have clearly identifiable proponents provides a mechanism for TNSPs to limit the range of alternative projects. This in turn means that TNSPs can then make decisions based on subjective preferences, rather than forcing them to make decisions solely on the basis of the economic rationality that derives from the Regulatory Test.

A compromise approach that both focuses on the TNSP's obligations and the economic rationality imposed by the Regulatory Test is for the ACCC to require TNSPs to consider all alternative projects (irrespective of whether they have a proponent). If the preferred project from the Regulatory Test does not have a proponent, the TNSP should be required to publicize the project to the market and to wait for a specific fixed period to see whether a proponent emerges. Should a proponent not emerge within the specified fixed period, the TNSP should be permitted to develop the highest ranked project with a proponent. Such an approach would not jeopardize the need for TNSPs to meet reliability obligations.

Any proposal (such as a reliability based proposal) which unilaterally passes a large proportion of the investment risk back to consumers deserves close attention from the ACCC.

### 3.1.1 The Proposed Definition

ESA notes that the ACCC's proposed amendment to the wording of the Regulatory Test for 'Other Augmentations' states in part:

*'Commercial Feasibility,*

*a) Commercial feasibility will be demonstrated by determining whether **an objective NSP** in the position of a proponent acting rationally in the National Electricity Market would have a sufficient economic incentive to construct the alternative project.'* [emphasis added]

This wording closely reflects that used by the Supreme Court of Victoria in its SNI versus Murraylink decision. However, the Court's actual wording referred to 'an objective operator' rather than to 'an objective NSP'. In so doing the Court commented that the subjective preferences of NSPs may not be in accordance with the economic rationality that derives from the Regulatory Test, and cast doubt on the objectivity of NSPs. ESA suggests that it is more appropriate for the Regulatory Test to exactly reflect the wording used by the Court, and that the Regulatory Test therefore should read as follows:

*'Commercial Feasibility,*

*a) Commercial feasibility will be demonstrated by determining whether **an objective operator** in the position of a proponent acting rationally in the National Electricity Market would have a sufficient economic incentive to construct the alternative project.'*

### **3.2 VoLL**

The ACCC has proposed to amend the Regulatory Test to give TNSPs a choice as to whether to use the Value of Lost Load (i.e. VoLL, presently set at \$10,000/MWhr) or the alternative Value of Customer Reliability (i.e. VCR, presently set at \$30,000/MWhr).

ESA agrees with other parties that using the VCR introduces a bias towards regulated projects, and that this is a backwards step inconsistent with a preference for market based solutions. Section 4.0 of this submission highlights that only a bias towards competitive solutions is consistent with national competition policy objectives.

### **3.3 Market Benefits**

The ACCC's Draft Determination includes a non-exhaustive list of permitted benefits. Given the present uncertainty and disagreement in the market regarding the appropriateness of including competition benefits (and even on the definition of competition benefits), ESA is concerned that under the present drafting all competition benefits could be inappropriately included. ESA therefore suggests that the definition of market benefits include text to specifically exclude competition benefits that are wealth transfers.

If after further consultation the ACCC decides that it is appropriate to expand the permissible benefits, then the wording in the Regulatory Test can be easily modified as appropriate.

### **3.4 Committed/Anticipated Projects**

The ACCC has defined a committed project as one requiring *'the financing arrangements for the proposal, including any debt plans, must have been conducted and contracts executed'*. This definition does not take into account NRG Flinders' concern that such a definition may present difficulties for on balance sheet projects.

ESA notes the ACCC's suggestion that '*a letter of commitment from the governing body could perhaps be taken as sufficient evidence of commitment if all other criteria are met*', and suggests that the definition should be amended to include this option.

### **3.5 Market Failure Criterion**

The ACCC has proposed to delete note (7) from the Regulatory Test, on the basis that this will '*avoid confusion*' associated with it. ESA disagrees with this proposal.

Firstly, the ACCC has stated that the Draft Determination '*only deals with the mechanics of the regulatory test. The framework in which the regulatory test operates and its use by the Commission in setting a Transmission Network Service Provider's (TNSP) revenue is the subject of another paper<sup>3</sup>....*'. However, deletion of note (7) is not an issue related only to the '*mechanics of the regulatory test*'. Rather, deletion of note (7) has far reaching consequences regarding the framework '*in which the regulatory test operates*' and therefore on the ACCC's own criterion any discussion regarding the deletion of note (7) has no place in the Draft Determination.

Second, the ACCC has raised that Powerlink has commented that note (7) '*is biased towards non-regulated interconnectors*'. Powerlink is incorrect. Note (7) explicitly states:

*'the proposed augmentation should not pre-empt nor distort potential unregulated developments including network, generation and demand side developments'*

That is, the bias is collectively towards all '*unregulated developments*'. Deletion of note (7) therefore raises issues relating to the framework in which the Regulatory Test operates, and indeed extends to the very foundation of the NEM, with the key question being:

*'Are regulated network services an equally valid investment to market based investments?'*

The answer to this question should be a resounding 'NO'. This position is also supported by other parties. For example:

- This view was also articulated by NSW Treasury in a submission to the ACCC on the role of the Regulatory Test:

*'In the Government's view, the development of the market occurs over two stages. ... This first stage can thus be regarded as competition by non-regulated alternatives for the market opportunity...*

*It is only if the market does not respond (or does not respond adequately) that the second stage of market development takes place. This second stage can be*

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<sup>3</sup> Draft Determination, page 1

*characterised as competition for regulated projects under the auspices of the regulatory test<sup>4</sup>.*

- The list of objectives of the transmission revenue regulatory regime contained in Clause 6.2.2 of the Code places an obligation on the ACCC, in administering the transmission revenue regulatory regime, to seek to achieve:

*‘(h) promotion of competition in upstream and downstream markets and promotion of competition in the provision of network services where economically feasible’.*

Deletion of note (7) from the Regulatory Test is incompatible with this obligation.

- This view was also enunciated by the ACCC itself in the Regulatory Test which stated:

*‘the Commission has based the regulatory test on the traditional cost-benefit analysis framework but with a number of clarifications to limit any adverse impacts that regulated network investments might have on the competitive processes in the contestable parts of the industry<sup>5</sup>’*

That is, the ACCC recognised that the market should be competitive, that the regulated sector could impact adversely on the competitive market, and that controls needed to be introduced to limit the adverse impacts.

The Commission further discussed this issue when it first authorized the National Electricity Code:

*‘The Commission is concerned with the extent to which the [Code] provisions may be arrangements which protect NSPs and other network users from potential externalities, create a barrier to market entry, and limit contestability of network augmentation. All of these may limit competition for augmentation and may increase costs to network users<sup>6</sup>’.*

On that basis ESA concludes that the Regulatory Test is not designed to promote the development of regulated network investment in the context of alternative market based investment opportunities in the NEM. New regulated investment is not an equally valid alternative to a market-driven option. Rather, new regulated investment is to proceed only where there is a clearly demonstrated market failure. To this end, it is entirely

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<sup>4</sup> Letter from K Cosgriff (NSW Treasury) to M Rawstron (ACCC) (undated) page 2

<sup>5</sup> ACCC, *Regulatory Test for New Interconnectors and Network Augmentations*, 15 December 1999, (**Regulatory Test**), executive summary, page 2

<sup>6</sup> ACCC, *Determination: Applications for Authorisation – National Electricity Code*, 10 December 1997, page 146

appropriate that the Regulatory Test contains market failure criterion provisions and that regulated network services should only be permitted to proceed when that market failure has been proved. It is therefore incorrect that the ACCC should delete note (7) simply to ‘*avoid confusion*’ associated with it.

#### **4.0 The Draft Determination and Option 3**

ESA understands that there are still outstanding issues associated with the inclusion of competition benefits in the Regulatory Test, and that further work needs to be undertaken before the ACCC makes a final decision in this area.

As a general comment, ESA supports only the inclusion of competition benefits which are not wealth transfers.

#### **5.0 Conclusion**

Ensuring that the Regulatory Test is properly framed is essential to the efficient and effective operation and development of the National Electricity Market. While the Draft Determination goes some way towards facilitating an efficient and effective framework, there is still outstanding issues, some of which are detailed in this submission.