23 April 2004

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

Email: electricity.group@accc.gov.au

Our ref: BN008/0005/0082

Dear Mr Roberts,

REVIEW OF THE REGULATORY TEST FOR NETWORK AUGMENTATION

We refer to the request for submissions on the above Draft Decision ("Decision") released by the Australian Competition and Consumer Commission ("Commission") for comment by 23 April 2004. We thank you for the opportunity to comment and ask that you accept this letter as Ergon Energy Pty Ltd's ("Ergon Energy") submission on the Report.

Ergon Energy supports the proposal in Option 1 and 2 to increase alignment between the National Electricity Code (Code) and the Regulatory Test and to provide further certainty via definitional changes. We have focussed our comments on competition benefits, in particular the unique features of the electricity market that require special consideration when modelling competition benefits.

1. Option 1 – Alignment of the Regulatory Test and the Code

Ergon Energy supports the proposed amendments outlined in Option 1 of the Decision as they provide further consistency between the Regulatory Test and the Code. To ensure consistency is maintained in the future, Ergon Energy recommends that the Regulatory Test is periodically reviewed in the context of further Code changes to ensure that consistency between the Regulatory Test and the Code continues to be maintained.

2. Option 2 – Definitional Changes

Ergon Energy supports amendments to the Regulatory Test that will ensure certainty for market participants resulting from the consistent application of the test. We agree

however that it is important to strike a balance between clear definitions and overly prescriptive criteria.

3. Competition Benefits

Ergon Energy supports more prescriptive guidelines in relation to the correct application of competition benefits within the Regulatory Test such that a common methodology can be applied to all transmission augmentations. Having said that it is important that any guidelines are clear and are not overly subjective so that they are prone to dispute, delaying necessary investment.

Ergon Energy supports the inclusion of competition benefits in the Regulatory Test. If not for the complexity involved, Ergon Energy would advocate the use of general equilibrium modelling to determine the full extent of competition benefits, however in light of the difficulties with this approach we support a partial equilibrium model. If a jurisdiction considers that new network investment will deliver general equilibrium benefits and these are not sufficiently accounted for in the regulatory test, the jurisdiction may still fund the augmentation outside the network service providers revenue cap. Accordingly a partial equilibrium model will not necessarily stifle investment where competition benefits cannot be proved under this model.

We suggest an amendment to paragraph (b) of the definition of "Competition Benefits". Paragraph (b) refers to the change in competition benefits resulting from bidding that reflects any "market power" in the augmented network. We suggest that "market power" should be amended to "revised bidding strategy" or some similar wording, as whether or not market power will in fact exist or be exercised will depend on the circumstances.

3.1 Modelling Competition Benefits

Any mechanism utilised in the National Electricity Market (NEM) to measure competition benefits must be capable of identifying the parties whose behaviour the network investment is capable of modifying as well as quantifying the benefits that are alleged to result. Ergon Energy acknowledges that this is a sophisticated task. The measures traditionally applied to assess the state of competition within a market (eg Herfindahl-Hirschman), fail to recognise that in the case of electricity, there need not be a direct correlation between market share and the ability to set or influence price. The unique characteristics of the electricity market such as those outlined below should therefore be recognised in the development of an appropriate competition measure.

3.1.1 Repeat Auction

The main problem with the development of a model of supply-side behaviour is the inability to account for the dynamic aspects of the market which result from the repeat auction process. For example competition models are usually based on the presumption that players act unilaterally (ie that there is no explicit or tacit collusion). In dynamic markets of repeated interaction however, firms develop "learned behaviours", leading them to compete less aggressively with one another (ie through price-cutting) and resulting in higher prices. The dynamic nature of the electricity market and the repeat auction process will therefore need to be captured under any proposed competition model.

3.1.2 Inelastic Demand Curve

The ability to effectively model supply-side behaviour is particularly relevant to the electricity industry where there is a highly inelastic demand curve, making the demand side of the market at times totally irrelevant in terms of the effect they have on suppliers' actions and strategies. High inelasticity of demand contributes significantly to a generator's ability to influence prices. That is, the inelasticity of demand ensures that at times the supply-side can withhold capacity or raise prices, without incurring any loss of profits.

3.1.3 Access to Data

Many simulations rely heavily on access to a greater quality of information than that to which electricity market regulators historically have access. In particular, most simulations are not based on data that allows for an accurate measurement of marginal costs at different levels of production due to information inaccessibility and instead, are based upon average variable costs or the costs of the last generator dispatched to meet demand. The difference between average variable and marginal cost is quite distinct. There is a need to ensure therefore that the competition measure is supported by powers that allow access by the regulator to all data necessary to the development of accurate marginal cost functions.

Ergon Energy would be pleased to discuss this submission. Should you require clarification on any point in our submission please do no hesitate to contact me on (07) 3228 8134 or Michael Callow on (07) 3228 8259.

Yours sincerely,

Rebecca Myers
Manager Regulation