Major Energy Users Inc.

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Mr Tom Leuner
General Manager
Markets
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Dear Mr Leuner

AER Guidelines for draft RIT-T and application guidelines

The MEU has reviewed the draft RIT-T and the application guidelines developed by the AER. The MEU appreciates that the AER has made considerable effort to develop these and the MEU congratulates the AER on the of clarity of the work.

It was in the examination of the examples provided that the MEU identified a serious concern, which has continued throughout the development of the Regulatory Test in all of its guises. The basis of this continuing concern is that the provision of a network asset could result in either increased prices for consumers or cause a reduction in electricity prices. In this regard, it should be noted that it is consumers that pay for the bulk of all transmission costs with generators only paying for (shallow) connection to the shared network.

When there is congestion within a region there is no regional price differential that occurs so any augmentation that occurs will have a modest effect on the regional price. Congestion within a region causes generators to be dispatched out of merit order leading to an increase in the regional electricity price, even though the SRMC of the "out-of-merit order" dispatched generator might be lower than that of the generator that would otherwise be dispatched. This means that the regional marginal price for the region is higher than it need be, even though the "disorderly" dispatched generator might have a lower SRMC. As section A8 of the guidelines observes, strategic bidding by a generator needs to be assessed and accommodated in the competition benefits. The AER notes (page 70) that the RIT-T can account for this:

> "Therefore, to the extent a *credible option* attenuates the incentives for a generator to engage in disorderly bidding, the calculation of that *credible option*'s *market benefit* could include the *market benefit* arising from more cost-reflective generator bidding."

So effectively the guidelines recognise that the benefit of an intra-regional augmentation could lead to a reduction in disorderly (strategic) bidding and this can be included in the competition benefits. The AER goes on to note, however, that including the impact of disorderly bidding is complex and therefore might not be appropriate for the majority of assessments.

Yet despite this, the same effect is not permitted for inclusion when the assessment of an inter-regional connection is made. This is despite the fact that a very clear price signal is provided by inter-regional price differentials.

Consumers continued to be confused as to why the regional price differentials cannot be used to demonstrate the benefits of augmentation of inter-regional connections. Even though consumers pay for the augmentation, the AER continues to assert that the price reductions a region sees, when stronger interconnection is implemented, are considered a "transfer of wealth" and therefore not a market benefit.

The electricity market is designed to allow investment in networks if it provides a net benefit. Surely then, consumers should be permitted to invest in inter-regional connections if this increases generator competition. Strong competition should deliver consumers with the best outcome, and strengthening inter-regional connections is one way.

Conversely, generators are permitted to price higher than their SRMC and are able to do this because there is reduced competition caused by congestion. Generators are not required to contribute to augmentations so they are not being required to contribute to the increased competition.

Thus on the one hand generators are able to benefit from congestion, yet on the other, consumers are not permitted to see the benefits of increased competition the investment that they fund will achieve. This is a singularly one sided view.

The MEU considers that the AER should introduce the benefits that a consumer sees from "its investment" included in the guidelines.

In reviewing the examples provided in the guidelines, the MEU identified some aspects which might lead to inappropriate outcomes.

Example 23
This example seems to indicate that investment would be permitted (all other things being equal) as the cost of the augmentation would result in less involuntary load shedding. The example shows this quite clearly. Yet when the actuality of the impact is assessed, in lieu of 1 MW of involuntary load shedding

and the investment in the augmentation, the spot price for all consumers would increase to $100/MWh from $10/MWh.

If this example was implemented, this would provide a transfer of wealth from consumers to the 200 MW generator of $18,000/hr, which is not an efficient outcome, as the 200 MW generator has done nothing to warrant this increase in revenue. Overall, the cost to consumers would be $20,100/hr and the market would incur a net increase in operating costs of $2,100/hr plus the cost of the capital to provide the new generator which would cost ~$100,000/MW[1].

This example seems to miss the real costs involved.

Example 28
This example highlights the core issue consumers have with the AER approach to competition benefits.

Using the Biggar example, the base case sees the dispatch costs as $6,900/hr, even though the spot price is "strategically" set at $100/MWh. The base load generator is a dominant generator and must be dispatched. It uses its dominant position to set the spot price and optimises its revenue, and forces less thermally efficient plant to be dispatched.

In this example, the base load generator SRMC is $10/MWh and as it sells 60 MW, its costs are $600/hr, yet it gets paid $6,000/hr because it has the ability to set the spot price by economic withdrawal of capacity. All other generators receive their SRMC. Because the base load generator is using its market power consumers pay $20,000/hr for power.

If the dominant generator had bid at its SRMC, the spot price would have been $50/MWh set by the mid merit generator, and consumers would have paid $10,000/hr (200 MW*$50/MWh), which is half the cost they are paying.

Consumers then invest in an interconnector to a region where the spot price is $12/MWh and this can provide 2/3rd of the consumer demand. Biggar sees that this option is credible based on a net benefit of $4,680/hr.

With the interconnector, the base load generator is no longer a dominant generator and must offer its capacity at its SRMC because it must dispatch a minimum of 60 MW. Consumers have paid for the interconnector and benefit by paying only $2400/hr for power. Consumers see a benefit of $17,600/hr

If the base load generator had bid its capacity at SRMC, and not used its position of dominance to set the spot price, it would be marginal whether the investment to build the interconnector would be viable.

By excluding the market signals (as provided by the spot price) the AER has excluded a clear benefit seen from the viewpoint of consumers who are

[1] This is the cost used by the Reliability Panel for new generation when assessing MPC

required to pay for the network investment. Essentially consumers see that their investment in the interconnector has increased competition. Yet the AER guideline sees that the benefit accruing to consumers see is just a transfer of wealth and must therefore be discarded.

However, the spot price is intended to send investment signals. The higher the spot price, the greater the incentive to invest in more generation – this is a statement made by the AEMC Reliability Panel when deciding whether to increase the MPC. As an interconnector is a surrogate generator located at the border of a region, why is the market signal disregarded in this case when it is an interconnector, but seen as appropriate when applied to investment in generation?

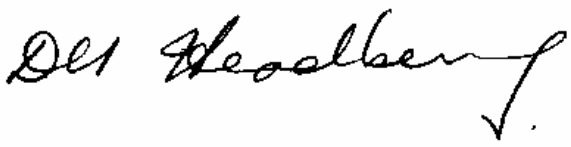
Pragmatically, the AER guideline reduces the incentive to augment interconnectors and mutes market signals.

Another issue which the MEU has identified is that whilst the RIT-T applies to both intra-regional networks and inter-regional connectors, there seems to be a dearth of proposals from TNSPs for inter-regional connection. Has the AER sought to assess this issue? What are the constraining factors? Are the guidelines disincentivising the building of inter-regional connectors? Consumers see that stronger inter-regional connection provides two major benefits to consumers – firstly, they increase competition between generators causing more competitive pricing in each region and, secondly, they provide greater reliability in supply.

We would therefore like to see the guidelines provide an incentive to TNSPs to augment inter-regional connection rather than focus their capex on intra-regional augmentations. There is obviously a clear disincentive for TNSPs to want to augment inter-regional connectors due to the need to liaise with another TNSP and that this introduces complexities. But surely the response should be to seek to minimise these disincentives

The AER should review the guidelines to ensure there is no explicit or implicit disincentive to augment inter-regional connectors.

Yours sincerely



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