Reference No: M02/3373

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Dear Mr Roberts

Thank you for this opportunity to comment on the Commission's document, "Discussion Paper – Review of the regulatory test" (ACCC paper).

New South Wales has had a long history of interest in the development of the Regulatory Test. Following NEMMCO's original Riverlink determination, the 'Customer benefits' test in the Code was removed and replaced by the Commission's present Regulatory Test. It is appropriate that the Test is revisited again in light of recent experience of its application, including the SNI dispute.

The Ministry of Energy and Utilities (Ministry) is conscious of the consequences of uncertainty and potential shortcomings in both the Regulatory Test and indeed the entire network planning and investment regime. In relation to the Regulatory Test, the Ministry's policy objective is to support changes to the Test that promote regulatory certainty and consistency and efficient market outcomes.

In pursuit of these objectives, the Ministry has comments on the following topics raised in the ACCC paper:

- Competition benefits;
- Definition of 'alternative projects';
- Optimisation risk;
- Thresholds for 'small' and 'large' network investments;
- Use of VoLL.

Competition benefits

The centrepiece of the NEM reforms involved the development of the interconnection capacity between the States as a way of broadening and deepening competition between generators. Therefore, in principle, benefits to the market that flow from increases in competition should be able to be included in the Regulatory Test assessment framework. The question is how such benefits should be calculated.

The Ministry is fundamentally supportive of an approach that includes 'competition benefits' in the Regulatory Test in so far as competition brought about by network investment increases overall economic welfare. The Ministry does not believe that it is appropriate for a regulatory agency such as the ACCC to develop an instrument based on income transfers that have the effect of promoting the interests of some stakeholders (eg customers) above those of others (eg generators). If this should happen, then it is a matter for Governments to determine outside of the present Regulatory Test consultation process.

'Alternative projects'

The Commission has proposed that the only criteria for an 'alternative project' under the Regulatory Test are that the project is a 'substitute' and 'practicable' or alternatively that it has 'a clearly identified proponent'. In relation to the proponent criterion, the ACCC paper expressed concern that if it were a *necessary* criterion, it would allow TNSPs to game the Test by only putting forward their preferred projects.

Whilst not suggesting that the need for a proponent is a necessary criterion for all projects, it is not necessarily negative for TNSPs to (only) put forward their preferred augmentation for comparison against unregulated options. The basis for this argument is that it is the TNSP who faces the risk of optimisation if it develops a regulated asset and so the TNSP should have the ability to select which regulated project(s) to put forward for assessment under the Regulatory Test.

This approach provides the TNSP with an incentive to fully utilise its market intelligence to determine whether a proposed project is likely to be 'used and useful' well into the future. By taking the decision about alternative projects out of the TNSP's hands – and given that disputes over the Regulatory Test are likely to end up with the Commission – the ACCC would effectively be replacing the long term judgements of the TNSP with the Commission's own. This signals a move by the Commission away from incentive-based regulation, which relies on a scheme of *ex post* regulatory measures to create incentives on TNSPs to act efficiently in the first instance, towards an *ex ante* regime that involves the regulatory agency effectively prescribing investment decisions for or on behalf of the TNSP.

Optimisation risk

If the Commission denies the discretion of a TNSP to select its preferred regulated augmentation to its network, then the TNSP should be protected from optimisation risk for any project that subsequently passes the Regulatory Test. This protection should apply for the foreseeable future at the time of the decision, suggesting at least 10 years. It would not be reasonable for the Commission to require the TNSP to consider augmentations the TNSP did not wish to undertake, for one of those augmentations to pass the Test and then for the Commission to later optimise the asset. This would place the TNSP in a 'no-win' position.

The Commission may take the view that the 'commercial feasibility' criterion protects a proponent being forced to consider a project that involves unacceptable optimisation risk. However, if it is ultimately the Commission (and not the TNSP) that decides whether a project is commercially feasible, then it is not appropriate for that

project to be subject to optimisation as this subjects the TNSP to risks arising from decisions outside its control.

If the Commission does insulate projects that have passed the Regulatory Test from optimisation (regardless of their later utilisation), then it should be acknowledged that what the Commission has done is transfer the risks of future asset redundancy from TNSPs to customers. If an asset passes the Regulatory Test and is insulated from optimisation, but years later is found to be underutilised, then customers will continue to pay inflated TUoS charges in relation to that asset.

The ACCC paper does acknowledge that the issue of optimisation risk requires further clarification and says that the matter will be dealt with further in the finalisation of the Statement of Regulatory Principles. However, in the Ministry's view, the interpretation and application of the Regulatory Test is intimately related to the nature and extent of optimisation risk. The Ministry would therefore recommend that the Commission to clarify its approach to optimisation – at least for assets that pass the Regulatory Test – as part of the present consultation process.

Thresholds for new 'small' and 'large' network assets

The Ministry supports an increase in the value thresholds for new 'small' and 'large' network assets. In light of the fact that even a single transformer can cost well over $1 million and a single phase shifting transformer can cost in the vicinity of $20 million (see Saha Energy report on Murraylink conversion application), the Ministry proposes that the thresholds for new small and large network assets be raised to $5 million and $25 million respectively. It seems unlikely that a regulated network project of any substance would cost less than $5 million and just as unlikely that a significant augmentation would cost less than $25 million.

Use of VoLL

The Ministry notes the Commission's view that the value of electricity under the Regulatory Test should be 'VoLL', presently $10,000/MWh. However, this is intended to be a cap on dispatch prices in the NEM, rather than an accurate measure of the value of unserved energy to customers. To the extent that the prescribed level of VoLL understates the value of unserved energy to customers, the Commission's approach is likely to lead to inefficient underinvestment, to the detriment of efficiency and reliability. The Ministry therefore supports the use of an alternative measure of the value of unserved energy in the Regulatory Test where this has been independently and transparently derived.

Please contact either Peter Staveley (9901 8842) or Jonathan Wills (02 9901 8657) should you wish to discuss this submission.

Yours sincerely

(SGD B K STEFFEN)
(11 April 2003)

Brian Steffen
Director-General