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Mr Sebastian Roberts
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Dear Mr Roberts

REVIEW OF THE REGULATORY TEST – DRAFT DECISION

NRG appreciates this opportunity to comment on the ACCC's draft decision on the review of the regulatory test for network augmentations, following consultations on this issue throughout 2002 and 2003.

At a broad level, NRG Flinders supports continuing efforts to seek to more closely align and integrate the framework for the regulation of transmission revenues embodied in the (Draft) Statement of Principles for the Regulation of Transmission Revenues, and the processes governing the regulatory approval of network augmentations embodied in the Regulatory Test.

It is essential that these arrangements operate in an integrated and complementary manner if the desired regulatory outcomes are to be achieved in a consistent manner across the NEM. However, to this end, it is acknowledged that many of the linkages between the frameworks are being addressed through a separate, parallel consultation.

1. Minor Amendments

NRG Flinders continues to support the principle of seeking to align the Regulatory Test with the Code. To this end, a number of minor clarifications are proposed, noting that the more substantive issues of refurbishment and replacement expenditure, and asset thresholds, have been deferred pending the completion of the concurrent review of the capital expenditure framework. However, the ACCC's view that the augmentation component of any replacement or refurbishment project should be subject to the Regulatory Test is supported.

2. Definitional Amendments

The ACCC has proposed to amend and clarify a number of the terms and definitions used in the Regulatory test. NRG Flinders offers the following comments.

In respect of alternative projects for non-reliability augmentations, the ACCC has accepted that it is inappropriate to exclude an alternative project on the basis that is does not have an identifiable proponent. While the existence of a proponent provides a useful indicator, it should not be the sole determinant of the practicability of a project, or else the test becomes open to gaming and interested TNSPs have an automatic right of veto. The proposed amendment is therefore supported to reflect the position that the existence of a proponent is a sufficient but not necessary condition to demonstrate the practicability of a project.

The ACCC has proposed to amend the definition of market benefits and costs to clarify the list of non-exhaustive benefits and costs that may be taken into account. The ACCC has reaffirmed its position that externalities should continue to be excluded from consideration, and that the assessment should be limited to those who produce, distribute and consume electricity in the NEM. This position is supported.

In terms of benefits, it is noted that the Commission proposes to remove references to VoLL generation to avoid the potential for double counting of benefits. However, it would appear that the proposed definition still leaves scope for double counting of benefits, as it includes both reductions in involuntary supply interruption and deferral of reliability plant. It would be desirable to remove any scope for double counting in this respect.

In terms of costs, it is noted that the ACCC has maintained the position that wealth transfers should rightly be excluded from the concept of net market benefit. However, it is noted that the issue of allowable costs is considered separately in the context of the current review of the capital expenditure framework.

The ACCC has proposed to adopt definitions of committed and anticipated projects for application within the test, consistent with the definitions used by NEMMCO. This should assist in ensuring consistency between the application of the Test and NEM planning processes. The ACCC has also proposed to refine and broaden the definition of anticipated projects. NRG Flinders believes the expanded definition should help to ensure that legitimate anticipated projects are not unreasonably excluded from the assessment.

In relation to VoLL, the ACCC has proposed to expand the measure of reliability benefit by introducing an additional Value of Customer Reliability (VCR) measure into the test, based on the view that marginal values for foregone energy greatly exceed VoLL for some customer groups. In doing so, it has recognised that this position represents a trade off between the two key principles of market efficiency and competitive neutrality that underpin the Regulatory Test.

However, the amendment proposed appears to allow for the use of either VoLL or VCR, at the discretion of the applicant. This appears to violate the principle of competitive neutrality entirely, without achieving a balance between the two objectives. It is unclear how non-regulated options driven by an investment signal capped at VoLL are in a position to compete with regulated options valued against a much higher measure. To enable regulated and non-regulated capacity investments to compete on an even-handed basis, it would appear inappropriate to include the level of VCR as a potential measure of benefit, at least for non-reliability projects.

In terms of the market failure test, the ACCC has identified that the requirement within the Regulatory Test for an 18-month minimum period between announcement of the proposal and the commencement of construction has lead to unintended confusion. However, the ACCC has proposed to remove Note (7) in its entirety from the Test, effectively removing the market failure test altogether.

Given the removal of this clause, it would appear that a replacement clause is required to ensure that the original intent of the provision is met, and ensure that regulated options do not unnecessarily pre-empt market driven capacity development. To this end, the ACCC may wish to consider including a clause that specifies a maximum lead-time between the commencement of the regulatory approval process and the timing of the underlying need being considered (eg 3-5 years). This will ensure that regulated developments continue to be undertaken only in instances where market driven solutions do not emerge in a sufficient timeframe.

3. Competition Test

In considering the question of explicitly recognising "competition benefits" in the Regulatory Test, the ACCC has determined that any such benefits must be limited to those arising from increases in efficiency from transmission augmentation, excluding wealth transfers within and between groups from the assessment. This position is consistent with the stated objectives of the National Electricity Code.

The ACCC has also determined that the Regulatory Test should continue to consider only those benefits and costs arising directly in the electricity market. This is also supported, as no compelling case has been offered to suggest the Test should be extended beyond these costs and benefits.

In considering potential methods for the calculation of competition benefits, respondents have highlighted the deficiencies inherent in the various approaches. It is also noted that the ACCC's consultants (Farrier Swier) have concluded that all options available (with the exception of market modelling) are not helpful in view of their weaknesses and shortcomings. In light of this, the ACCC has recommended against the use of all other methods. This conclusion appears sound.

Consequently, as its preferred methodology, the ACCC has recommended the use of market simulation modelling as the only practical method. The recommended approach involves an assessment of the incremental benefits involved in moving from status quo bidding to a pattern of bidding that recognises the full extent of market power in an augmented scenario.

In considering the merits of this approach, it is important to ensure at a minimum that any revised approach under the Regulatory Test:

- Calculates benefits limited to those who produce, distribute and consume electricity in the NEM;

- Captures only benefits and costs that can be measured in terms of financial transactions in the market;

- Avoids the potential for double counting of benefits under the Test;

- Captures only net efficiency impacts, not gross benefits or wealth transfers; and

- Minimises the scope for subjectivity, uncertainty and disputation.

NRG Flinders does not believe that sufficient evidence has been offered at this time to demonstrate that these conditions are adequately addressed under the enhanced methodology proposed. In particular, it appears that the favoured methodology suffers from a heavy reliance on subjective assumptions and modelling inputs, and requires proponent TNSPs to form judgements on market power and bidding behaviour in the market.

It is also unclear that the approach would identify only those benefits additional to those captured under other elements of the Test. The methodology would therefore appear to require further refinement and clarification before its introduction into the Test, particularly as part of the base case assessment.

More broadly, it is unclear that the approach confines itself purely to efficiency impacts within the market. To the extent that the method departs from pure efficiency benefits and captures broader deemed pool price benefits from modelled bidding behaviour, it must rely on the implicit assumption that favourable wholesale price movements automatically translate into price benefits for end users. However, the extent to which any modelled price benefits will ultimately be translated into benefits for end users will be dependent on the level of competition in the retail sector, and will be influenced heavily by complex interactions in the contract market and the forward contract position of market players, which can never be known.

4. Conclusion

In summary, NRG Flinders is broadly supportive of the minor amendments and definitional amendments proposed to the Regulatory Test, subject to the qualifications above, and noting that various substantive issues have been deferred to the separate consultation on the capital expenditure framework.

However, NRG Flinders remains unconvinced that the refined methodology for the measurement of "competitive benefits" would add value to the Regulatory test at this time, and believes further justification and refinement is warranted before the chosen approach could form a worthwhile addition to the Test.

Should you have any queries in relation to this submission, please feel free to contact Simon Appleby on (08) 8372 8706 or myself on (08) 8372 8726.

Yours sincerely

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