NRG Flinders Operating Services Pty Ltd
Adelaide Office
168 Greenhill Road
Parkside SA 5063

GPO Box 2535
Adelaide SA 5001
Australia

Telephone (+61) 8 8372 8777
Facsimile (+61) 8 8372 8666

28 March 2003

Mr Sebastian Roberts
A/General Manager
Regulatory Affairs – Electricity
ACCC
PO Box 1199
Dickson ACT 2606

Email: electricity.group@accc.gov.au

Dear Mr Roberts

REVIEW OF THE REGULATORY TEST – DISCUSSION PAPER

NRG appreciates this opportunity to offer the following comments on the options the ACCC has put forward in the above discussion paper to revise the regulatory test, following initial consultation on this issue in mid-2002.

1. Minor Amendments

The minor modifications the ACCC has identified to revise and update the regulatory test to ensure consistency with recent Code changes are accepted and supported. NRG Flinders also welcomes the comments the ACCC has made to clarify the operation of its optimisation policy, particularly the intention to assess the prudence of refurbishment and replacement expenditure against criteria similar to the regulatory test, given that this expenditure is not otherwise subject to such scrutiny.

2. Definitional Amendments

NRG Flinders is also supportive of the majority of the definitional amendments that the ACCC has put forward in an attempt to clarify and define aspects of the regulatory test.

In particular, it has been proposed that the existence of a proponent would be sufficient but not necessary as an indicator of the viability of an 'alternative project'. In the absence of a proponent, it would need to be established that an alternative is both a substitute and is practicable in terms of its technical and commercial feasibility.

This approach offers greater clarity as to when an alternative should be recognised as valid, given the potential risks of gaming that the ACCC has highlighted with respect to incumbent TNSPs.

However, significant questions still remain over the ability to demonstrate that an alternative is technically feasible in the absence of any support from the relevant TNSP for that option. Similarly, it remains an open question as to how it would be possible to establish that a project is commercially feasible if the TNSP denies its consent for that project (noting that there appears to be no guaranteed right of access to TNSP assets under the transmission access arrangements). Consequently, greater guidance may be necessary on these points if the suggested changes are to serve the purpose of clarifying the operation of the test to reduce the present uncertainties.

In identifying project costs for the purposes of the regulatory test, the ACCC has highlighted several cost elements that should be identified as typical examples, including capital costs, O&M costs, network losses, ancillary service costs and testing costs.

However, to ensure the integrity of the test, it would also be necessary for the ACCC to hold the proponent to account for the costs identified during the regulatory test in subsequently determining the regulatory value of an approved asset. While the ACCC is required to take the costs identified during the regulatory test into account in setting regulated value, it would be worth clarifying that no costs in excess of those assessed during the application of the test would be considered by the ACCC in setting regulated asset value. This would place greater discipline on the costs identified during the course of the assessment.

The proposal to adopt the criteria for 'committed project' status used by NEMMCO ensures consistency between the application of the test and IRPC planning processes. However, noting that in some instances projects may be undertaken on balance sheet, the requirement for financing contracts to be signed may present a barrier for such projects in demonstrating committed status. A letter of commitment from the governing body could perhaps be taken as sufficient evidence of commitment in this instance if all other criteria are met.

The ACCC has proposed to apply consistent criteria for 'anticipated project' status, with the proviso that the relevant actions must be in progress in order to meet the criteria. Whilst at first glance this approach seems reasonable, it may be difficult in practice to evidence the fact that actions are 'in process'. Additional clarification (and/or examples) may therefore be required. A lack of clarity on this issue could result in legitimate anticipated projects being overlooked.

The additional information the ACCC has proposed to require of reliability driven augmentations is supported. Together with the clearer application of optimisation policy, this should serve to increase transparency and scrutiny in the delivery of these projects.

It is noted that the discussion paper does not directly address the application of the 'market failure' test and the timing issues associated with the approval of regulated projects. Whilst the present test prevents a project being approved more than 12 months in advance of scheduled construction and prevents a project being approved within 18 months of the need having been made known to the market, no specific checks or balances are applied to the length of the

construction timeframe, which could take an indefinite period. As a result, a project could potentially be approved many years in advance of its optimal timing on the basis of an extended construction period, effectively 'freezing out' alternative investment options during this time.

This appears to undermine the intent of the existing timeframes to ensure that regulated investments are undertaken as a last resort only, in the event that no unregulated options emerge in sufficient time to address the identified need. To ensure this market failure aspect of the test operates as intended, the ACCC may therefore wish to consider applying greater discipline to construction timeframes, such as a 'reasonableness' or 'verifiable' requirement, in addition to adopting the position that an approved market benefits project will not be considered for inclusion in the regulated asset base in advance of its optimal timing.

3. Competition Test

In considering potential measures of competition benefit, it is important to take into consideration any offsetting impacts that may also result from a regulated investment. For instance, while a new interconnect may offer competitive benefits to the importing region in the form of an additional source of supply, conversely the exporting region will experience an effective increase in total demand and therefore a corresponding tightening of its supply-demand balance. Clearly only the net benefit of this competitive impact is relevant to consider in applying the regulatory test.

In terms of the specific options identified, the "market simulations" model appears to suffer from the primary disadvantage that it is almost totally reliant on modelling assumptions and inputs. The inherent uncertainty of predicting competitor responses and interactions in even the short term would appear to render any estimation of potential competitive benefits in the medium or long term almost meaningless. In addition, the inability to capture interactions within the contract market obscures the estimation of the actual benefits likely to materialise even further. Consequently, this method might be regarded as heavily speculative and open to dispute. A number of other options suffer from similar shortcomings.

With respect to "Powerlink's public benefits competition test", practical factors appear to rule out consideration of this option, as noted by the ACCC. Similarly, the "Stanwell competition index", as the ACCC notes, relies on qualitative and subjective measures, which appear to rule out further consideration of this option also.

The (adjusted) "Herschmann-Herfindahl index" method offers some attractions, but is also heavily dependent on the assumptions adopted. The "residual supply analysis" model appears to have some merit, but is perhaps more useful in providing a snapshot of potential market benefit at a particular point in time. The ability to accurately model benefits into the future again appears to be solely dependent on the reliability of input assumptions.

"Commercial benefits analysis" offers some advantages, including its reliance on objectively measurable interregional settlements surpluses. However, as noted by the ACCC, this method is backward looking only, and does not necessarily provide an indication of the extent to which a

new or expanded interconnect would reduce interregional price separation. In addition, this test can only be applied directly to regions between which an existing interconnection exists.

In summary, whilst some of the options identified for measuring competitive benefit offer the advantage of measurable and analytically appealing techniques, no single option appears to provide a robust, objective and defensible method. The methods at best become increasingly reliant on forecast modelling inputs and assumptions into the future, introducing subjectivity and therefore scope for dispute into the regulatory test. At this stage, it is not clear that the addition of such a feature would add any value to the application of the regulatory test, particularly as a binding and mandatory element.

4. Conclusion

NRG Flinders would favour the adoption of options 1 and 2, with the inclusion of the various additions and clarifications outlined above. These options improve the consistency of the test with the current Code, and clarify its application in key areas. However, significant questions remain over the value of introducing a competitive benefits test into the test at this time. None of the potential options identified to date appear to provide a sufficiently objective, robust and defensible method, and appear prone to the pitfalls of modelling assumptions, subjectivity and dispute. NRG Flinders would not therefore support the adoption of option 3 at this time.

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

Reza Evans
Manager
Regulation and Market Development