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Mr Michael Rawstron
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Dear Mr Rawstron

REVIEW OF THE REGULATORY TEST

NRG Flinders is pleased to offer the following comments in response to the ACCC's Issues Paper concerning the review of the Regulatory Test under the National Electricity Code.

For convenience, the following comments follow the headings adopted in the Paper, and generally attempt to address the questions raised, together with related issues.

Maximising Net Benefits

NRG Flinders does not consider that the current test, requiring the maximisation of market benefits, represents too high a hurdle. The alternative approach of adopting a target NPV rate appears overly simplistic and fails to maximise the potential value of a regulated investment to the market among available alternatives. If anything, it would appear that the test as presently framed allows for the consideration of a wider range of benefits than might be appropriate. The requirement for a proposed augmentation to demonstrate greater market benefit (and/or lower cost) than alternatives in most but not all scenarios also provides for a relatively generous threshold.

It may be possible to draw a distinction between the treatment of DNSPs and TNSPs for the purposes of the test, but only to the extent that the projects in question are not substitutes for each other. In the case of main system augmentation, a given project may have both distribution and transmission network alternatives. In areas of substitutability, it is therefore essential that equitable and consistent treatment applies.

It is considered that reliability driven augmentations need to be more tightly defined, and accordingly should be required to meet certain conditions in order to avoid the full application of the regulatory test. Notwithstanding the separate approval criteria, the same level of scrutiny should apply to these projects to allow for robust debate of the alternatives to ensure the most appropriate and cost effective solution is ultimately implemented in response to a particular requirement.

Competitive Impacts of Network Development

In considering potential competitive impacts, it must be remembered that a network investment provides transfer capacity only and does not in itself create additional energy. For this reason, network developments, and interconnects in particular, provide a potential increase in the level of competition only, to the extent that sufficient generation is present to enable the transfer of additional energy. Even if such capacity is present initially, it can not be assumed that sufficient capacity will be available indefinitely into the future to support the same level of transfer and competitive benefit.

These factors will impact on the estimation of any competitive benefit. All other things being equal, a new transmission line linking regions clearly offers less competitive benefit than a new generator of the same capacity within the importing region. NRG Flinders would have serious misgivings over the use of purported competitive benefits to justify marginal investments, particularly given the subjectivity of these assessments.

Similarly, estimation of reserve sharing and reliability benefits must be linked to the levels of capacity known to be available. Estimation of such benefits beyond reasonable forecasting timeframes is of questionable value, and places reliance on speculative assumptions over future levels of excess capacity in adjoining regions. At best, only probabilistic assumptions can be adopted in seeking to measure the future value of an interconnect in providing effective capacity to meet peak demands.

Such assessments should also be framed to avoid sensitivity to assumptions over the future level or mix of generation investment. In the case of an interconnect, the valuation of unserved energy at VoLL is highly dubious, in the presence of future generation alternatives.

It is also important to focus only on the incremental benefits offered by a network augmentation. There is a clear distinction between the impacts of an initial interconnect linking adjoining regions, with its associated competitive and reserve sharing benefits, as compared with the impact of subsequent interconnections. The marginal value of each new link will clearly diminish as the number of interconnects increases.

To produce meaningful estimates of the expected price benefits of an interconnector requires assumptions to be made over the bidding and contracting behaviour of all participants in the affected regions. While examination of past behaviour may provide some guide, it fails to capture the response of the market to the new link. Historic bidding analysis also loses its relevance if

extrapolated into the future, given the dynamic nature of the market environment. These factors should limit the reliance placed on any modelling of potential price benefit. It should also be recognised that an interconnect is likely to have offsetting price effects in the exporting and importing regions, both of which must be captured.

Clearly, unregulated network investments fall outside the scope of the regulatory test. Proponents of these projects bear the market risk associated with their investment and are not entitled to a regulated return, and therefore do not need to satisfy the regulatory asset test.

Nevertheless, for regulated and unregulated investments to coexist in the NEM, it is essential that the two forms of investment are treated on an equivalent basis in terms of the benefits ascribed to them. This is necessary to avoid regulated investments duplicating and rendering pre-existing unregulated investments unviable, which would threaten the basis of future unregulated network investment in the NEM.

Equitable treatment is also essential if the ‘market failure’ test is to be applied on a meaningful basis, to give priority to market driven investments before considering regulatory alternatives. The operation of this test should also be clarified if it is to have maximum impact in practice. For example, in the event that an unregulated project achieves committed status in sufficient time prior to the approved commencement date of a regulated alternative, there is an argument that the regulated status of the regulated link should lapse.

Conversely, an unregulated development must be commercially committed before it can be assumed to proceed. Commitment criteria modelled on those applied by NEMMCO might be considered for inclusion in the regulatory test, but should make appropriate allowance for committed investments that occur on balance sheet and do not require external financing.

Timing issues associated with the application of the market failure test should also be resolved. While the regulatory test requires that a proposed augmentation must not be approved more than 12 months in advance of the construction date, it is silent on the construction timeframe that should reasonably be allowed.

Network and Distributed Resources Code Change Package

The practice of excluding externalities from consideration (eg environmental costs) is supported. Until such costs are internalised (eg through some form of emissions trading regime, carbon tax or other policy response) these should be excluded. It is not the role of the regulated network test to resolve these broader policy issues.

Nevertheless, there would be value in providing greater guidance on the costs and benefits that may be included within the regulatory test to provide for greater consistency across the market and increase certainty for market participants. This is particularly relevant to ensuring competitive neutrality between alternative forms of investment, particularly in regions of the NEM in which transmission planning is not independent of network ownership.

A more explicit market test period might be a useful addition to the test. While the Regulatory Test presently prevents a regulated development receiving approval within 18 months of the need for augmentation being made known to the market, this might be considered a limited timeframe in which to bring a market driven investment to commitment stage, particularly recognising that consultation on regulated options may be in progress at the same time. Clarifying the application of the market failure test, as above, would provide an effective lead time of up to 30 months. However, it may be worthwhile considering a more extended timeframe, at least for non-reliability projects.

Terms which may require definition within the test include ‘unforeseen circumstances’ resulting in project delay (note 7b) and ‘material impact’ requiring republication of information (note 9).

Other Issues

The use of a discount rate for regulated investments applicable to an equivalent private investment in the electricity sector is appropriate, consistent with the uniform treatment of regulated and unregulated projects.

It might also be expected that any reasonable investment would deliver a sizeable proportion of its benefits in the initial years of the project. It appears questionable that a project could be justified on the basis of net benefits that were weighted heavily in future years of the forecast period, recognising the increasing uncertainty attached to any estimates of benefits and costs into the future. A requirement that a given proportion of net benefits should be realised within a reasonable forecast timeframe (eg 5 years) might therefore be considered.

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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