New South Wales
TREASURY

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Dear Mr Rawstron

Review of the Regulatory Test

The New South Wales Government (Government) appreciates the opportunity to make a submission to the Australian Competition and Consumer Commission (Commission) regarding the Commission's review of the regulatory test.

As you would be aware, the Government, through the Minister for Energy, is a party to the current application brought by Murraylink Transmission Corporation (MTC) in relation to NEMMCO's determination on the SNI Interconnector. The Government believes that the MTC application is an attempt to frustrate SNI by inappropriately extending the intended scope of the regulatory test. The present review presents an opportunity to put beyond doubt the intended application of the test.

New South Wales believes that the regulatory test is cumbersome and complex. Most importantly, the current test entrenches an administered form of competition between regulated and non-regulated solutions, whereas the NEM objectives call for light-handed regulation and competitive market forces wherever possible. The Government proposes to address this shortcoming by substantially simplifying the regulatory test to reinstate the importance of competitive processes in guiding investment decisions and reducing the reliance on administered solutions where competitive processes can operate. This submission does this by focussing on a key issue in the regulatory test – the nature of alternative projects that must be considered when assessing a proposed augmentation.

Purpose and form of the regulatory test

The Commission makes clear in section 3 of the discussion of the original test that the market benefit test:

- "Embodies the principle of competitive neutrality, which is important for encouraging competition in the generation of electricity and the supply of energy services; and
- "Is also largely consistent with the standard principles used in economic cost benefit studies. These studies are used to guide public decision-making towards economically efficient outcomes, often in the context of market failures."

In addition, the Commission said:

> "… the Commission has accepted the argument that the regulatory test include the principle of maximising prospective benefits over costs. This principle has two implications. First, regulated network investments should be compared against competing options (eg generation, demand side and non-regulated alternatives). Second, the regulated network investment should be commissioned at a time that maximises the net benefits to the community and not simply at that time when the net benefits to the community first become positive. Consequently, in the context of assessing regulated network investments, the cost/benefit framework will be required to work much harder than is normally the case."

This extract raises important policy issues. In particular, the Government disagrees, in principle, that the regulatory test should involve the first modification to standard cost benefit analysis outlined above, that is, comparison with hypothetical competing alternatives.

Comparison of proposed augmentation net market benefit

According to the above extract reproduced from section 3 of the Commission's discussion of the test, the regulatory test presently requires comparison of a proposed augmentation with non-regulated alternatives. The SNI dispute has raised the issue of whether a proposed augmentation ought to be compared against alternative *regulated* options. That matter is dealt with below in the section entitled "Nature of alternative options".

However, in looking at the regulatory test from first principles, it is not clear why a proposed augmentation should be compared against *any* alternative options, *so long as* the market has been given a reasonable amount of time to come up with a solution *and* the proposed augmentation has a positive net market benefit on its own merits.

In the Government's view, the development of the market occurs over two stages. First, following the publication or identification of an impending constraint or reliability problem in a NEMMCO or TNSP planning document, or in documents such as the New South Wales Statement of System Opportunities, the market is free to respond without pre-emption by a regulated investment. The regulatory test presently gives the market a minimum of six months from the date of publication of a potential constraint or reliability problem to respond via an embedded generator, DSM, market network service or other non-regulated option prior to a regulated option being assessed. If the market does respond in some way, then the response should either obviate the need for a regulated option or could be counted as "committed" or "anticipated" in the subsequent assessment of the regulated option. This first stage can thus be regarded as *competition by non-regulated alternatives for the market opportunity*, which has been identified in published documents.

It is only if the market does not respond (or does not respond adequately) that the second stage of market development takes place. This second stage can be characterised as *competition for regulated projects* under the auspices of the regulatory test. The whole purpose of the regulatory test is to allow for regulated provision of network solutions where the market has collectively been unable or unwilling to address an identified problem or opportunity. To require the test to not only assess the net benefits of the regulated option, but

to require a re-appraisal against non-regulated alternatives that have already had an unhindered opportunity to respond causes two main problems:

- It encourages opportunism or "gaming" of the test by persons who have an interest in preventing or deterring a regulated network augmentation. Such persons can propose non-regulated projects for comparison with the regulated augmentation option without any requirement to make a serious commitment to the project; and

- If a TNSP finds that an embedded generation or DSM option is more net beneficial than the proposed regulated augmentation, it effectively puts TNSPs into the business of developing non-network alternatives. This would be likely to have the effect of deterring agents in the market from engaging in serious consideration of these options in the first stage of market development, which is the appropriate time for consideration of non-regulated options. The Government submits that this would actually lead to a greater reliance on regulatory processes, in contrast to the direction that the NEM should take.

The regulatory test, as presently drafted, does not comply with the principles espoused in the Commission's discussion above. It actively discourages regulated network solutions, even where they are found to be net beneficial and where no market-driven project has been seriously considered.

The regulatory test should restrict attention to the net market benefits or otherwise of the proposed augmentation, after allowing sufficient time for the market to provide alternative solutions. This would properly place the emphasis on competitive processes and competition for market solutions *prior to the time that that a regulated solution is considered*, rather than relying on the regulatory process to later "manage" competition into place. Experience has shown that attempts to manage competition in this way are unsatisfactory. If the Commission believes that the test does not give adequate opportunity for the market to respond to a proposed problem, then this should be addressed by an extension to the minimum time period between publication of the problem and the application of the test to a proposed augmentation, rather than by forcing the proponent to compare the augmentation against hypothetical alternatives. In this context, the Government would be willing to support an extension of the minimum time period between publication of a need and application of the test from six months to one year.

Nature of alternative options

If the Commission does not accept the Government's arguments for a restriction of the regulatory test to an assessment of the net benefits of the proposed augmentation in question, the Government submits that, at the least, the nature of the competing alternatives to be compared needs to be clarified. This is an issue that has been raised in the current SNI application by MTC.

In short, it should be put beyond doubt that "alternative projects" means "alternative non-regulated projects" or at least "alternative projects that do not involve regulated augmentation of the proponent's network". The basis for this interpretation is clear in a number of the Commission's statements, as well as in the Code.

Regulatory test context

To repeat part of an extract from section 3.2 of the test, the Commission states that it has:

"…accepted the argument that the regulatory test include the principle of maximising benefits over costs. This principle has two implications. First, regulated network investments should be compared against competing options (eg generation, demand-side and non-regulated alternatives)."

The clear inference to be drawn from this paragraph is that the "competing alternatives" are non-regulated.

Further, note 7 of the test clearly indicates that in assessing net market benefit, the goal is to avoid distorting *unregulated* alternatives, rather than ensuring, through the application of the regulatory test, that the proposed augmentation is itself the optimal regulated option:

"In determining the market benefit, the proposed augmentation should not pre-empt or distort potential unregulated developments including network, generation and demand side developments."

Previous Code context

The ACCC's authorisation of the Code discusses the Commission's concerns with network service providers focussing on *regulated network* solutions to constraints or reliability problems. For example, the Commission wrote:

"The process surrounding the establishment of an interconnector should be open to affected and interested parties. The process for approving a regulated interconnector should not crowd-out more economic alternatives which do not have the advantage of a guaranteed return."
(Section 5.5.1, Decision, Application for acceptance, National Electricity Market Access Code, 16 September 1998)

Indeed, the Code itself strongly indicates that NEMMCO is to consider only non-regulated alternatives to a proposed regulated augmentation. Prior to the recent network and distributed resources (NDR) Code changes, clause 5.6.5(k)(1) stated that NEMMCO must:

"…consider the practical alternatives to *augmentation* including, but not limited to, *generation,* demand side options and market network service provider options;"

The Government notes that this clause does not say "the practical alternatives to ***the*** *augmentation*". Rather, the clause just refers to alternatives to network augmentation in general. This suggests that in applying the regulatory test under the previous version of the Code, NEMMCO was not required to consider alternative forms of regulated augmentation to the proponent's network in assessing the proposed augmentation. This interpretation is consistent with the Government's understanding that the Code was not designed to provide the opportunity for NEMMCO to "step into the shoes" of the proponent and to nominate a fundamentally different regulated project. Unless such a reconfigured project had the full support of the proponent, such a process would raise fundamental questions regarding the allocation of commercial risk in network investments. Moreover, the test puts pressure on the

proponent to carefully consider its regulated proposal in any case, because to the extent that doubts have been raised regarding the 'validity' of all elements of the regulated option, the Commission will have a heightened sensitivity to the appropriateness of the augmentation when undertaking its regulatory reset.

NDR Code changes

Following the NDR Code changes, the Code now requires an applicant to provide an application notice that sets out, *inter alia*:

"all other reasonable network and non-network alternatives to address the identified constraint or inability to meet the network performance requirement… These alternatives include, but are not limited to, interconnectors, generation options, demand side options, market network service options, and options involving other transmission and distribution networks;" (clause 5.6.6(b)(1)(iii))

The Government submits that this requires consideration of all alternatives that *do not involve regulated augmentation of the proponent's network*. This inference can be drawn by the words "…options involving other transmission and distribution networks". If it were intended that an applicant consider alternative configurations of regulated augmentations to its own network, presumably the relevant words would have instead read "…and other regulated network options". Further, the use of the words, "…include, but are not limited to…" suggests that the other (unnamed) alternatives also do not involve regulated augmentations to the relevant proponent's network.

The rationale for limiting consideration of alternative options to options not involving the proponent's network is consistent with the rationale for the NDR Code changes. The NECA Code Change Panel wrote in its December 2000 report on these changes:

"The Code changes propose to remove the responsibility from NEMMCO for determining whether proposed interconnectors meet the regulatory test. This current responsibility places NEMMCO in a role akin to that of a regulator without any of the regulatory powers. This inconsistency leads to uncertainty for NSPs. Any determination by NEMMCO that a proposed augmentation ought to be part of the regulated asset base for revenue setting purposes could be overturned by the regulator." (Appendix 1, page 3)

The NDR Code changes lend further weight to the arguments outlined above. The changes are designed to avoid the conflict between NEMMCO's assessment role, which may lead to granting regulated status to a proponent's proposal, and subsequent regulatory review by the Commission. The current regulatory test places responsibility with the proponent for presenting the "best" regulated alternative, and for this alternative to be assessed against competing non-regulated alternatives. The NDR Code changes further clarify the operation of the regulatory test by placing the full responsibility for the assessment of the regulatory option with the proponent, recognising the risk that the regulator may subsequently revise the treatment of the regulated asset in the proponent's asset base.

ACCC Draft Statement context

Section 3.4 of the ACCC's Draft Statement of Principles for the Regulation of Transmission Revenues (May 1999) makes clear that where a TNSP's assets become redundant, these will

generally be removed from the TNSP's asset base through the regulatory optimisation process (pages 50-51).

Consequently, the TNSP will be financially accountable for poor investment decisions, *ex post*, whether or not the initial decision to invest was prudent *ex ante*. Whilst this imposes some risks on a TNSP, the Government accepts that such 'optimisation' risk is part and parcel of being a regulated entity, so long as such risks are considered in the setting of its weighted average cost of capital. However, financial accountability for investment decision-making implies that TNSPs must have full responsibility for developing their own regulated investment proposals, if principles of good governance are to be observed. This means that a TNSP must not be asked by an unaccountable party (such as NEMMCO previously or an interested market participant now) to reconfigure a regulated augmentation proposal to the satisfaction of that other party. It is one thing for third parties to offer insights or suggestions, but ultimately, the TNSP must have sole and complete discretion as to the regulated proposal it wishes to subject to the regulatory test. Separation of responsibility and accountability in this context (or indeed, in almost any context) creates serious governance problems. This is why the NDR Code changes remove the Inter-Regional Planning Committee (IRPC) from the role of economic evaluator of a regulated proposal and place the responsibility on the proponent to not only develop regulated investment proposals, but also to apply the regulatory test.

Hence, the regulatory test or the discussion surrounding the test should confirm that it requires maximisation of net market benefit (or minimisation of cost for reliability augmentations) from the perspective of ensuring that NSPs consider *all reasonable and timely alternatives to regulated augmentation of its network(s)*.

Alternative regulated augmentation proponents

The Government understands that, particularly following the NDR Code changes, it is (and perhaps was) potentially possible for any person to register as a TNSP and propose a regulated augmentation to another TNSP's network. Therefore, one argument against restricting the consideration of alternative options to options outside the proponent TNSP's network is that a third party may wish to propose an alternative regulated augmentation to the proponent's network.

Whilst the Government acknowledges that it is possible for third parties to propose and develop augmentations to another TNSP's network, the Government believes that there are good reasons why consideration of such alternative regulated options are, and should remain, excluded from the application of the regulatory test to the original proposed augmentation.

First, as far as the Government is aware, no third party has ever spontaneously proposed and developed a regulated augmentation to another TNSP's network. The Government understands that third party augmentations have only ever been the result of a specific tender process initiated by the jurisdictional TNSP (or in Victoria's case, VENCorp). Therefore, given that regulated augmentations are only intended to be developed where the market has failed to provide a non-regulated project, it would seem a highly risky strategy – from either a reliability or maximising market benefit point of view – to treat hypothetical regulated alternatives as practicable without a proponent having being identified.

Second, if a third party proposes a regulated augmentation before the TNSP to whose network the augmentation relates proposes an augmentation, then the third party is free to assess the proposed augmentation under the regulatory test itself. In other words, the limiting of the test to comparison of regulated projects with alternatives to regulated augmentation of the relevant TNSP's network does not create a barrier to a third party proposing a regulated option. The contestability of regulated projects allows a market for the regulated project to be nurtured, whereby the party that proposes and assesses a regulated augmentation first can apply the test with the protection that if the project passes the regulatory test, it cannot be imitated by another party. Once the test has been successfully applied to a regulated project, that project should be regarded as "committed" or "anticipated" and a follower proponent would have to take the project into account in assessing its own regulated option, if it chose to continue with the assessment. Other possible indicia of "committed" status could be undertaking an Environmental Impact Study or commencement of physical construction. It would be useful if the Commission could provide some guidance to proponents in this regard.

If a proponent were forced to compare a proposed regulated augmentation against other feasible regulated augmentations to its network, it would be in the interests of any potential proponent to "free-ride" on the first proponent's augmentation proposal and follow with its own regulated augmentation proposal by making minor changes to the first proposal. This could harm the incentives for any potential proponent to develop a regulated augmentation proposal in the first place, to the detriment of the market as a whole.

Therefore, the Government submits that there are two types of markets that the regulatory test framework creates, if modified in accordance with this submission. First, there is the market for a non-regulated solution, for which there is a substantial amount of published information and free entry. If that market fails to deliver an adequate response, then there is a market for a regulated solution, for which there is also free entry and a property right, as it were, for being the first to propose a regulated augmentation. If the regulatory test attempts to manage competition into either or both of these stages, it will undermine the vigour of competition in the relevant stage(s) and cause greater, rather than less, reliance on regulated developments, or alternatively, may frustrate the overall development of interconnection investment.

Conclusion

The New South Wales Government strongly submits that the regulatory test should be changed to require a proponent of a proposed regulated augmentation to only determine whether the proposal has a positive net market benefit across a majority of likely scenarios. The requirement to compare the proposed augmentation with other hypothetical projects should be dropped. It could potentially lead to gaming and delays and put TNSPs in the central planner-type position of developing non-network alternatives. Rather, the market should be allowed to work freely without agents being able to fall-back on the regulatory test process to force consideration of non-regulated solutions. This change should stimulate competition for a non-regulated solution. In this context, the Government would agree to a lengthening of the minimum time between publication of the need for a solution and application of the regulatory test from six months to one year.

If the Commission is unwilling to revise and simplify the test in the suggested manner, the Government suggests that the Commission make clarifying comments to the effect that the test requires comparison of the proponent's regulated option only against non-regulated options, or at most, those options that do not involve regulated augmentations to the

proponent TNSP's network. The alternative of forcing proponents to assess an augmentation proposal against all non-regulated *and regulated* options would be likely to diminish the incentive for regulated options to come forward, to the detriment of the market. The approach suggested by the Government is consistent with other commentary in the test, the wording of the test itself and the Code before and after the NDR changes. However, even this is definitely a second-best solution, which will not maximise the competitiveness of the market. In the Government's view, the simplest and best solution is to make the regulatory test consistent with standard cost-benefit analysis by requiring only a net market benefit from a proposed regulated augmentation to be found.

Please contact me on (02) 9228 5442 if you wish to discuss this submission.

Yours sincerely

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