

18 June 2002

Mr Michael Rawstron
General Manager
Regulatory Affairs- Electricity
Australian Competition and Consumer Commission
PO box 1199
Dickson ACT 2602
Electricity.group@accc.gov.au

Dear Mr Rawstron,

REVIEW OF THE REGULATORY TEST

Origin Energy Limited (Origin) thanks the Australian Consumer and Competition Commission (ACCC) for the opportunity to provide a submission to the above review.

Origin is vertically integrated in the competitive sectors of the NEM with both retail and generation assets and is therefore focused on examining issues from an overall market efficiency perspective. While we believe it is possible to have network investment taking place on a fully decentralised basis, the current masking of price signals in the NEM means private investment initiatives may not always be forthcoming. Nevertheless, Origin is confident that improved transmission pricing arrangements and the implementation of an appropriate cost recovery regime will increasingly lead to market driven investments in the network.

However, while acknowledging a current role for a regulatory test, Origin believes it is crucial that all relevant costs and benefits are sufficiently considered in such a test and that it is administered in a transparent and impartial manner. Otherwise, in our view, excessive regulated expansion of the network will be encouraged,

detering private investment solutions, and increasing costs and risks to consumers.

Costs and benefits

A major concern that Origin has with the regulatory test is that it ignores important costs and benefits.

For example, a key difference between regulated and non-regulated network alternatives is their risk and financing arrangements. Non-regulated investments are privately funded and the investment and operational risks are borne by the investors. Moreover, because market network service providers (MNSPs) derive revenues from energy flows across their lines it is rational for them to ensure lines are available at times when flows are at their peak and for outages to be scheduled accordingly. They also have strong incentives to provide firm financial hedges across the links so as to maximise the value of the capacity. Such features of non-regulated links provide for a natural alignment between the behaviour of market network providers and its impacts on the energy market.

However, no such incentives presently exist for regulated links, principally because there is a clear separation between those who undertake the investment, the state based transmission providers (TNSPs), and those who pay for it and bear the risk (the end use customers). Further, once incorporated into the regulatory asset base TNSPs receive a fixed income stream regardless of line availability, the timing of outages, or the firmness of associated hedges until the next pricing reset.

While the ACCC has sought to impose an incentive regime and is currently looking at measures to transfer some of the risk back to TNSPs, we believe the administrative and transactions costs of such regulatory measures ought to be recognised in the regulatory test.

Further, Origin is also concerned that the regulatory test takes insufficient account of key environmental benefits associated with local generation options. Such options provide important advantages in addressing environment externalities compared to network augmentation. For instance, the latter has significant negative environmental impacts (land clearing etc), while also favouring remote coal fired generation over less emissions intensive local generation and demand side management options. However, such costs do not appear to have been explicitly recognised in the regulatory test to date. As a result, greater benefits are

attributed to augmentations than a rigorous and valid cost-benefit analysis would allow, therefore advantaging regulated expansion of the network.

Network and distributed resources package

Origin believes that the 'Network and distributed resources package' recently authorised by the ACCC may lead to a biased and incorrect application of the regulatory test. This stems from the fact that the ACCC has devolved responsibility for administering the regulatory test from NEMMCO to TNSPs themselves. This appears to be contrary to good corporate governance and economic efficiency, given that under the test TNSPs are required to evaluate investment alternatives that are in competition with their own proposals. Moreover, because most TNSPs are also the network owners they have clear incentives to favour their own regulated network expansion options over others.

While the ACCC has put a number of measures in place to address these issues, including optimisation, a new dispute resolution framework, and information disclosure provisions (for which we applaud the ACCC), we do not consider these measures to be sufficient.

First, the effectiveness of optimisation in influencing the behaviour of TNSPs is in question given that the ACCC also allows for the accelerated depreciation of under-utilised assets. Further, problems with information asymmetry and the general uncertainty of relevant parameters make optimisation somewhat contentious and ineffectual. It is also a retrospective process occurring up to five years after the investment has taken place, in which case it is too late to reverse the damaging effects of inefficient network expansion or deferred generation development. Once implemented regulated network investment is sunk and permanently alters the opportunity for non-regulated alternatives to come forward.

Second, while Origin acknowledges the attempt by the ACCC to increase transparency, we believe the new information requirements are unlikely to solve the problem of asymmetric information, because ultimately TNSPs control what information is released and, disturbingly, are responsible for evaluating the alternatives to their own proposals. Given that TNSPs have greater knowledge and resources in respect of network issues, and the incentive to bring these to bear,

Origin remains unconvinced that the new arrangements would significantly reduce the potential for TNSPs to influence the regulatory test to their own ends.

In Origin's view, this issue cannot be solved unless an independent third party controls responsibility for network investment and the application of the regulatory test. Ideally, such a third party would have no ownership rights over the network, but its sole function would be to plan the expansion of the network on a nationally integrated basis and competitively tender for least cost solutions to network problems. The absence of network ownership rights would eliminate the perverse incentives for emphasising network augmentations over generation and demand side management options. Recent views put forward for a 'national transmission planner' by the ACCC and others, provides an appropriate prototype for such a body. The implementation of such a model would provide market participants with far greater confidence that the regulatory test had been applied correctly and impartially.

Other Issues

Origin also wishes to briefly comment on some other issues the ACCC have put forward for discussion.

- First, Origin does not believe the current hurdle of 'maximising net market benefits' is too high, as this is more likely to result in the least cost solutions to network problems being implemented. Any lowering of this hurdle would be inconsistent with principles of economic efficiency and would favour regulated investment options.
- Origin also does not agree with introducing the concept of competitive benefits into the regulatory test. This would rely on observing pool price outcomes. However, given the very low price elasticity of demand for electricity, lower prices will largely reflect wealth transfers rather than any increase in social surplus. There are therefore no 'net market benefit' grounds for considering such benefits (since they focus on individual benefits), while they provide regulated network investments with an advantage over non-regulated alternatives.

- In respect of the appropriate discount rate Origin considers it imperative that a commercial rate continues to be used in order to maintain equivalence between regulated and non-regulated options.
- We applaud the current provision 7 (c) in the regulatory test which provides a specified time period in which non-regulated options are allowed to come forward to address any network problems. Origin strongly believes that the application of the regulatory test should only occur as a last resort, where a demonstrable market failure has occurred. But as we have argued in this submission, such a provision depends critically on the timely and fair disclosure of information by TNSP and we do not have confidence that the appropriate incentive framework is in place for this to occur.
- Origin does believe there is scope for changing requirements in respect of reliability augmentations, as it is very difficult for private investment options to compete with these. Origin notes that the test for such augmentations does not require 'net market benefits' to be maximised, nor is it subject to dispute by market participants. It is therefore not surprising, as the ACCC itself acknowledges, that most proposed augmentations put forward by TNSPs have been for reliability purposes. While ideally there should be no distinction made between reliability and non-reliability proposals (particularly given the recent increase in VOLL), this issue, as most other issues related to the monopoly power of TNSPs, would disappear with an appropriately constructed governance framework separating planning from ownership and allowing for the unbiased tendering of network solutions.

Conclusion

In failing to consider some of key benefits of non-regulated network and generation alternatives the regulatory test inadvertently favours regulated investment options. Contributing to this process, in our view, are regulatory arrangements that do not sufficiently constrain a TNSPs ability to abuse its monopoly power.

Origin has outlined in this submission the costs and benefits that it believes should be included in the regulatory test. In addition, we have put forward a view



as to the appropriate governance framework necessary to ensure that the regulatory test is applied in a transparent and impartial manner.

If you wish to discuss any of these issues further please do not hesitate to contact Con Van kemenade on (02) 9220 6278 or Mark Landis on (03) 9652 5569

Yours Sincerely,

(sgd) Mark R. Landis for

Tony Wood
General Manager Public & Government Affairs