POWERLINK QUEENSLAND

RESPONSE TO: ACCC DRAFT DECISION

REVIEW OF THE REGULATORY TEST FOR NETWORK AUGMENTATIONS

23 April 2004

General Comments

The main area of uncertainty that remains following the Draft Decision on the Regulatory Test is associated with the ACCC's proposed approach to the inclusion of 'competition benefits' in the analysis of augmentation options. Powerlink understands the ACCC has engaged consultants to apply the methodology to 'real world' examples, including a potential upgrade to the transfer capacity of the Queensland-New South Wales Interconnector (QNI). Powerlink has offered its assistance in this process if required, and looks forward to the outcome. At this stage, Powerlink reserves its judgement on this aspect of the Draft Decision, until we have a better understanding of how the proposed modelling for evaluating competition benefits will be applied in practice.

In relation to other areas of the Draft Decision, Powerlink welcomes the ACCC's retention of the two limbs of the regulatory test for reliability augmentations and market benefit augmentations. Retention of the "reliability limb" of the test is absolutely essential to enable TNSPs to meet mandated reliability standards. Most TNSPs face onerous financial liabilities and exposures, including loss of licence, if they fail to meet those standards.

The recognition by the ACCC of the need to have regard to the obligations imposed on NSPs to meet network performance requirements is critical. The most common driver for transmission investment is the need to maintain a reliable supply to load centres in the face of persistent load growth. It is important that the regulatory framework enable the TNSP to respond in a timely manner to ensure reliability of supply is maintained.

This point is covered more comprehensively in Powerlink's submission to the accompanying ACCC paper on proposals to alter the capital expenditure framework used in setting a TNSPs revenue. Powerlink has not made any comments in this submission on the type of projects the Regulatory Test applies to, or the thresholds for new small and large projects. We agree with the ACCC that further discussion on these issues should be deferred until the outcomes of the ACCC review of the capex framework are known.

Option 1 - Minor Amendments

Powerlink supports the principle of making minor amendments to address inconsistencies between the Regulatory Test and the relevant sections of the National Electricity Code. It is important that all potential conflicts between the Regulatory Test and the Code are removed, and that duplication of Code requirements is avoided. Powerlink considers that the proposed changes to the wording of the Regulatory Test achieve this outcome and aid clarity, and therefore it supports the proposed changes.

Option 2 – Definitional Changes

The Draft Decision proposes that the ACCC amend and define certain terms in the Regulatory Test. Powerlink's views on the proposed changes are set out below:

Alternative Projects and Need for Proponent

The definitions proposed in the Draft Decision related to alternative projects appear to address Powerlink's concerns raised in the previous consultation phase – that is, it is essential the definition does not give rise to unintended difficulties in applying the Regulatory Test to reliability augmentations.

We strongly support the need for a proponent for solutions to meet a reliability need. This derives from the statutory requirement of the TNSP to meet mandated reliability standards and the liabilities and exposures it faces if it does not. For a non-network solution to be a viable substitute for a network augmentation to maintain reliability, there must be a proponent who is prepared to undertake the solution or there will be adverse reliability consequences for customers. In addition, it is important that a proponent exists that will accept liabilities and exposures to the extent that the TNSP suffers a loss due to the failure of the non-network solution to deliver. Powerlink also supports the proposed requirement that for all reliability augmentations, an alternative project must meet all necessary reliability obligations and be technically feasible.

For non-reliability augmentations, the proposed definition of an alternative project relates to the delivery of similar outcomes in a similar timeframe and determining whether an alternative project is commercially and technically feasible. While Powerlink understands the reasons for stipulating that "absence of a proponent will not exclude a project from being an alternative project" for a market benefit augmentation, we have some concerns as to the practical outcomes of this approach.

For example, what happens if no proponent comes forward for a non-reliability augmentation, even if that option is demonstrated to have the highest net market benefit following an application of the ACCC Regulatory Test? A situation may arise where a network option delivers positive net market benefits, but ranks second behind a hypothetical 'proponent-less' option. If no proponent comes forward to implement the best-ranked option, the market would not receive the benefits associated with either the best-ranked or second-best option. The regulatory risk to a network owner would preclude it being willing to proceed with an option which did not deliver the highest net market benefits and therefore which did not pass the Regulatory Test. Powerlink suggests some clarification be added to the Regulatory Test to cover this situation. It would be helpful if the Test stated that the highest-ranked option that provides positive net market benefits and which has a proponent satisfies the Regulatory Test, should no proponent be able to be identified for higher-ranked options following completion of the analysis and publication of the results.

Market Benefits & Costs

The Draft Decision proposes to modify the Regulatory Test to include non-exhaustive lists of potential market benefits and costs that may be assessed in the analysis.

Powerlink sees few issues associated with these changes, provided they remain as indicative lists to be assessed based on relevance and materiality, rather than mandatory items to be included in each analysis.

However, Powerlink considers that further clarity is required regarding the treatment of losses due to power flows on the network. At present, network losses appear in both the list of potential costs and in the list of potential net market benefits, which may give rise to confusion. Powerlink considers that it is essential that differences in the cost of losses be able to be included in an evaluation of options to address reliability requirements (which suggests that losses should be in the 'cost' list). The difference in losses due to power transfer for options, both network and non-network, to address reliability requirements can be quite significant, particularly in transmission networks which cover large geographical distances and where customer loads are remote from power generation sources.

Market Development Scenarios & Definition of 'Committed Projects'

(i) Identification of Projects

Powerlink suggests that the existing wording in the Regulatory Test, which has not been changed in the Draft Decision, be changed to insert the words 'technically feasible' as follows: "market development scenarios should include … any other technically feasible projects identified during the consultation process". Experience with the Regulatory Test has shown that occasionally projects which are technically infeasible are put forward during the consultation process by parties without detailed technical knowledge of the electricity system. It is important that the Regulatory Test allows these infeasible options to be excluded from the analysis; otherwise outcomes which make no practical sense could result.

(ii) Commitment Status of Projects

Powerlink reaffirms its view that a regulated network augmentation cannot be considered 'committed' until it has satisfied the Regulatory Test. Among other issues, funding approval is not likely to be given by a TNSP's Board until regulatory requirements are met.

However, we accept the ACCC's view that passing the Regulatory Test may not always mean that a network augmentation will definitely be constructed, as other factors may also be relevant.

Applying the definition of 'committed projects' based on NEMMCO's relatively strict criteria used in the Statement of Opportunities (SOO) to regulated network investments will mean that future network augmentations that have not yet passed the Regulatory Test will almost always fall into the category of 'anticipated projects' or 'modelled projects'. This will occur even if such augmentations have a very high probability of being implemented once regulatory processes are complete. At this stage, Powerlink cannot foresee any major practical pitfalls associated with this outcome, as the level of certainty of an anticipated project is considered when developing market development scenarios. However, it is noted that this could give rise to different perceptions on the part of market participants and interested parties, in relation to the commitment status of network projects.

Discount rate

The Draft Decision proposes to include a formula for calculation of the discount rate to be used in the Regulatory Test. This is to be a "discount rate appropriate for the analysis of a private enterprise investment in the electricity sector".

Powerlink considers that a formula should not be included, as it adds little value, and indeed could lead to additional confusion about the parameters assumed. As long as a commercial discount rate is assumed, the discount rate selected is not likely to be of great significance because:

- It is the ranking of alternative projects which is important in the Regulatory Test, rather than the absolute NPV value; and
- When carrying out the Regulatory Test, sensitivity analysis examining changes in parameters including the discount rate is required.

Should a formula be incorporated in the Regulatory Test, Powerlink's preference is for a pre-tax nominal WACC (Ke/(1-t*(1-y))*E/V + Kd*D/V) as it is difficult to determine the tax position of each project in advance. However, we agree with the ACCC that the important issue is to maintain consistency between the choice of discount rate and the cashflows that it is applied to.

Cost of Supply Reliability

The Draft Decision suggests that the Regulatory Test be altered so that in determining the market benefit, "reasonable forecasts of the value of energy to electricity consumers as reflected in either the level of VoLL and/or VCR" should be considered. In reaching this conclusion, the ACCC appears to have missed the point of earlier responses to the consultation on the review of the Regulatory Test. VoLL as it is defined in the Code is NOT a measure of the value of energy to customers – it therefore should not feature in the Regulatory Test at all in this context.

The Reliability Panel has specifically made the point in its determinations that the $10,000 per MWh set by the Reliability Panel is not a measure of the value of reliability to customers. Indeed, in its discussions on the matter, the Panel members believe that the label "VoLL" is misleading, and that what the Panel is setting is a "market price cap", which balances a range of factors. In essence, the setting of this "market price cap" derives from a starting position of "theoretically, there shouldn't need to be a price cap" but then applies "real world" considerations of having a cap. The cap is designed on one hand to be high enough to encourage (peaking) generation investment but on the other hand not so high that it falls outside the availability (depth and liquidity) of the hedging instruments through which market participants manage price risk.

Powerlink would also make the point that VCR is not a defined code term. It would seem better to require general consideration of information regarding *"reasonable forecasts of the value of electricity to consumers"* in this section of the Regulatory Test. The Regulatory Test does not specify how to calculate other elements in this section, such as demand forecasts or the efficient operating costs of supplying energy. Powerlink considers it is better that the Test remain silent, rather than using VoLL which is inappropriate in this context, or VCR, which does little to aid clarity as it is not a clearly defined term or dollar value.

Deletion of bias towards unregulated transmission

Powerlink supports the removal of the 'market failure test' (note (7)) from the Regulatory Test. We consider that this is in line with the decision of the NEM policy body, the Ministerial Council of Energy, at its December 2003 meeting to remove existing biases in favour of unregulated transmission investment.

Sensitivity Analysis

The Draft Decision proposes to modify the Regulatory Test so that:
"appropriate sensitivity analysis must be conducted on, but not be limited to, the following…".

The list includes market benefit assumptions, generator bidding behaviour etc. Some of these are not relevant to reliability augmentations. In some cases (eg– for small network augmentations less than $10M in cost), the materiality of some aspects of the sensitivity studies may not justify the level of analysis required. It is suggested that the wording be modified to:

"sensitivity analysis appropriate to the size and type of project should be carried out on, but not be limited to, the following…:

Option 3 - Competition Benefits

The proposed changes to the Regulatory Test clarify that, in determining the market benefit of a network augmentation, the analysis may include competition benefits. This is a positive step forward.

The approach the ACCC intends to adopt is to allow only 'economically efficient' benefits to be included in a Regulatory Test evaluation (ie – gross competition benefits arising from wealth transfers from customers to generators remain excluded). The ACCC believes that 'competition' benefits can be defined by considering the effect of the augmentation on a generator's bidding behaviour. The Commission considers that market modelling is the only appropriate method to calculate these competition benefits, and proposes to engage a consultant to do further work on modelling approaches.

The Ministerial Council of Energy, as the policy-making body for the NEM, recommended at its December 2003 meeting that "a new regulatory test for transmission to include the full economic benefits of increased competition be implemented in July 2004". It will therefore be necessary for the MCE to determine whether the ACCC's proposal relating to competition benefits satisfies the policy decision the MCE has taken.

It is Powerlink's understanding that the MCE Standing Committee of Officers (SCO) is unable to provide advice to the MCE on this matter, as the issue of competition benefits is inconclusive at this point. We understand the SCO has signalled its intention to monitor the outcome of the ACCC's proposal to engage a consultant to evaluate several 'real world' examples through the proposed method of calculating competition benefits, and subsequently advise the MCE.

Powerlink is uncertain at this stage whether the approach to competition benefits outlined in the ACCC's Draft Decision will effectively capture the relevant benefits of transmission augmentations in increasing competition. We welcome indications in the Draft Decision that:

- Pool price impacts of a transmission augmentation will be able to be captured to some degree in the Regulatory Test analysis. We draw this inference from the section where the ACCC quotes Professor Littlechild who states that "the benefit of competition is then presumably the greater output that is induced by the lower prices, valued at the difference between price and marginal cost. This is the so-called 'welfare triangle'."

- the benefits of a transmission augmentation in reducing market power will be able to be recognised: "Competition benefits are defined to be the difference arising between the following two network scenarios:
  - the 'augmented network' with bidding assumed to be the same as in the status quo network
  - the 'augmented network' with bidding which accurately and fully reflects any market power in the augmented network."

At this point, it is not clear how the proposed approach will be applied, and whether the additional benefits that will be able to be included in the Regulatory Test analysis will be significant.

The ACCC has engaged consultants to conduct modelling on designated projects. Powerlink understands the ACCC intends to apply the proposed approach to potential augmentations that could deliver increases in inter-regional transfer capacity, such as a future QNI Upgrade or Yass-Wagga connection. Powerlink is happy to cooperate with the ACCC's consultants as they work through an assessment of the competition benefits that could be included in a future Regulatory Test assessment for a QNI Upgrade. Until this is done, Powerlink reserves its position on this aspect of the Draft Decision. We look forward to providing further comment when we have a better understanding of how the proposed approach to evaluating competition benefits will be applied in practice.

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