Ref 2/370/2

Submission on ACCC Issues Paper – Review of the Regulatory Test

As a Transmission Network Service Provider, Powerlink strongly supports the Commission's stated objective of ensuring the Regulatory Test does not result in a complex and lengthy process that delays the development of regulated investment.

We therefore welcome the current review of the Regulatory Test, and are pleased to offer comments on the issue paper dated 10 May 2002 for consideration by the ACCC. In response to this review, Powerlink would like to emphasise two important messages to the Commission, viz:

- **The reliability augmentation stream of the Regulatory Test should be maintained in its present form; and**

- **The market benefit stream of the Regulatory Test needs to be broadened to allow other benefits to be captured in the economic evaluation in some circumstances.**

The reliability augmentation stream of the test was designed to ensure TNSPs are required to undergo a rigorous and public investment assessment process without it imposing impossible barriers to TNSPs in terms of being able to meet statutory designated reliability standard obligations. By the Commission's own admission[1] this particular stream of the test is working well. Therefore the reliability stream should not be changed. It needs to be pointed out here that should the Commission contemplate any changes to the reliability stream of the test, such changes will need to be mirrored by corresponding changes to TNSP's statutory obligations.

The market benefit stream of the regulatory test is seen to be working less effectively. This is not surprising when one remembers that economic evaluation rules for a complex infrastructure investment process have been limited to a subset of benefits purely for the purpose of "administrative simplicity". This is hardly the recipe for sound and prudent investment in Australia's electricity industry infrastructure.

In this submission, Powerlink has developed an administratively sound process which will allow the full extent of market benefits to be enveloped within a market benefit regulatory test evaluation.

Our comments are organised into broad areas as follows:

(1) Reliability Augmentations
(2) Competition Impacts of Network Investment
(3) Relationship with Role of Networks and Network Investment
(4) Non-Network and Unregulated Network Alternatives
(5) Other Issues

[1] Page 5 of the ACCC's Issues Paper – "To date, most augmentations that have been undertaken by TNSPs are reliability driven…"

(1) RELIABILITY AUGMENTATIONS

Comment 1: No negative inferences about the Regulatory Test should be drawn from the fact that the majority of applications to date have been for reliability-driven augmentations.

The ACCC issues paper notes that most augmentations to date that have been undertaken by TNSPs have been reliability driven. It indicates that this has been criticised by some parties, who apparently have attributed negative connotations to the fact that relatively few market driven augmentations have occurred.

Powerlink considers there is a simple reason for this outcome in Queensland. The Queensland region is experiencing very high load growth, averaging nearly 4% (higher in some localised areas). This has been occurring consistently for at least the last ten years. The primary reason for nearly all capital expenditure undertaken and planned by Powerlink is to maintain reliability of supply to Queensland customers in the face of this high growth rate.

Powerlink would also offer the comment that most transmission augmentations historically have been required to meet reliability standards. In Queensland's case, there has always been a focus on deferring investment as long as possible to minimise costs. Many years ago, when all investment was centrally planned, the Queensland Electricity Commission (Powerlink's predecessor) operated Swanbank Power Station out of merit order (based on short run marginal cost of operation which was known at the time) to address limitations in the transmission grid between Central and Southern Queensland. As the duration this was required was relatively short this was considered economic compared with investing in a new transmission line. Historically, very few augmentations were implemented on the basis of achieving lower delivered energy costs to consumers or what would now be referred to as market benefit. Almost all augmentations were implemented to satisfy reliability requirements. As such there should be no concern that the majority of augmentations evaluated under the Regulatory Test are applied to the reliability stream of the test.

Comment 2: Drawing a relationship between forecast capital expenditure, and whether the Regulatory Test impedes investment is not appropriate.

The ACCC issues paper notes that TNSPs have forecast capital expenditure programs of over $2 billion over the next four to five years and a similar amount for DNSPs. The ACCC have inferred from this that the regulatory test itself does not impede necessary network investment. This reasoning is flawed – in a practical sense, these two matters are not necessarily linked. In making this link the ACCC appears to have overlooked the obligation to supply placed on most TNSPs. This obligation gives rise to a continuing need to invest in the network.

A TNSP develops a capital expenditure forecast based on the transmission works it considers necessary to meet its Code and statutory obligations. However, each augmentation is required to be separately assessed under the Regulatory Test no more than 12 months prior to the start of construction. It therefore does not naturally follow that all augmentation proposals which make up the capital expenditure forecast can satisfy the Regulatory Test when the separate project-by-project assessment is made.

Comment 3: There are few incentives to propose 'market benefit' type augmentations.

Another reason for the majority of augmentations being reliability driven may be the lack of incentive to propose 'market benefit' type augmentations. A TNSP is not required to invest in such assets, meaning the financial return must be sufficient to justify the effort required to satisfy regulatory and other requirements, and the regulatory risk associated with potential optimisation at a later date.

It is Powerlink's view that the signals we are receiving are driving us to underbuild, or build only where required to satisfy our obligations. The more difficult it is to justify an augmentation through the regulatory processes (ie – if delays of years and high legal costs such as has been observed for interconnectors such as SNI become the norm), the less likely these investments will be attractive to a TNSP.

The issues paper identifies that one of the aims of the Regulatory Test is to prevent overbuilding by transmission companies. We suggest the ACCC perhaps needs to also give some consideration to measures to prevent underbuilding – due to the potential for very high cost impacts on the market.

Comment 4: It is essential that reliability augmentations still be assessed using a defined time-limited and outcome-oriented process which allows TNSPs to meet their service obligations.

Powerlink strongly believes that the distinction between reliability-driven and other augmentations in the existing Regulatory Test must be maintained. The reasons for the initial adoption of this approach have not changed.

The whole point of distinguishing between reliability and other augmentations in the ACCC Regulatory Test was to allow an NSP to meet its Code obligations. The Regulatory Test contains 'a cost minimisation test for augmentations in order for networks to meet their service standard obligations as specified in Schedule 5.1" (Executive Summary, ACCC Regulatory Test for New Interconnectors and Network Augmentations, 15 December 1999.).

Perhaps it is worth revisiting part of the basis behind the introduction of this test. It was based on Ernst & Young's assessment that " a way of measuring reliability benefits is to consider the cost of alternatives required to maintain the same level of reliability, or more specifically to look at how much cheaper (or more expensive) it is to maintain reliability at the agreed standard".[2] In essence, the benefits of the reliability augmentation are inherent in the standards in the Code, and should not have to be reassessed. The existing Regulatory Test follows this rationale. The Regulatory Test is based on the assumption that meeting the service standard is the benefit of the proposed augmentation, and that the benefits of all alternatives which meet that standard are the same and only costs need to be considered. The Regulatory Test preamble notes "the cost effectiveness criterion will be equivalent to the market benefits criterion where the various options provide a very similar level of benefits (ie – the service standard requirement) so the assessment of benefits is no longer a distinguishing element of the test".

The assumption of benefit is the only difference between reliability and other augmentations in the Regulatory Test – for a reliability augmentation, the benefits

[2] Ernst & Young "Review of the Assessment Criterion for New Interconnectors and Network Augmentations – Final Report to Australian Competition and Consumer Commission March 1999."

need not be quantified. In all other ways, the two paths of the Regulatory Test are the same. For example, a proponent must evaluate non-network alternatives, must consider possible market development scenarios and use commercial discount rates for both reliability and market-benefit type augmentations.

It is essential that the regulatory processes provide the ability for TNSPs to carry out augmentations necessary to satisfy code obligations and licence conditions related to continuity and quality of supply. Powerlink considers that maintaining the existing approach to reliability augmentations is the most appropriate way of achieving this.

Comment 5: Steps are underway as required by the Network and Distributed Resources Code changes to develop criteria for reliability augmentations to prevent incorrect classification by a TNSP. No further action is appropriate as part of the Regulatory Test review.

Powerlink would challenge any suggestion that TNSPs implement reliability augmentations because they have an incentive to do so or because the test is less onerous. By definition, these types of augmentations are implemented because they are required to satisfy TNSP network performance obligations. The reliability 'path' of the Regulatory Test has been used in most applications of the Regulatory Test to date because this is the path designated for assessing augmentations where a TNSP must act to meet relevant standards.

The Network and Distributed Resources Code change package provides for measures to ensure TNSPs do not incorrectly classify augmentations when carrying out the Regulatory Test assessment. The development of criteria to determine whether an augmentation is a reliability augmentation is the role of the IRPC, the Reliability Panel and individual jurisdictions. It should not also be a matter open for consideration by the ACCC in the Regulatory Test review. Whether an augmentation is reliability-driven is also disputable under recent Code changes. Powerlink considers that this provides sufficient checks and balances to ensure appropriate assessments are made.

(2) COMPETITION IMPACTS OF NETWORK INVESTMENT

Comment 1 –The lack of recognition in the Regulatory Test of the competitive impacts of network investment will lead to uneconomic investment. In some cases, the Regulatory Test prevents regulated network investment from being proposed as an option to address wholesale market inefficiencies.

Powerlink's main criticism of the market benefit stream of the Regulatory Test is that it does not allow benefits associated with increased competition on the supply side to be included in the analysis. As acknowledged by the ACCC in its issues paper, network investment can have a major impact on competition in a region, either by reducing generator market power or reducing prices.

Powerlink raised this issue when the Regulatory Test was first developed, and it is now being recognised as a flaw in the current test by other market commentators.

It is important to be aware that competition issues exist within regions as well as inter-regionally. Binding intra-regional transmission constraints can have a major impact on generator bidding and may result in increased market power for generators on the downstream side of the constraint. This risk is evident in several areas within Queensland.

This is a very real economic issue, with generator bids during instances of binding network constraints often being significantly above the generator fuel cost differential which can validly be included in a Regulatory Test assessment. This sends inappropriate market signals, with local retailers being driven by price to undertake potentially inefficient investments.

For example, the installation of peaking plant in South East Queensland is being considered by retailers to address the network transfer limit known as the Tarong Limit – in a situation where Queensland faces an abundant supply of low cost power in other areas of the state.

The Regulatory Test review by the ACCC should not be concerned with whether the installation of such plant is appropriate or cost-effective, or with barriers to fully funded options or other alternatives. It should not be concerned with issues of region boundaries, as recent Code changes have removed the distinction between assessing inter-regional augmentations and intra-regional augmentations under the Regulatory Test.

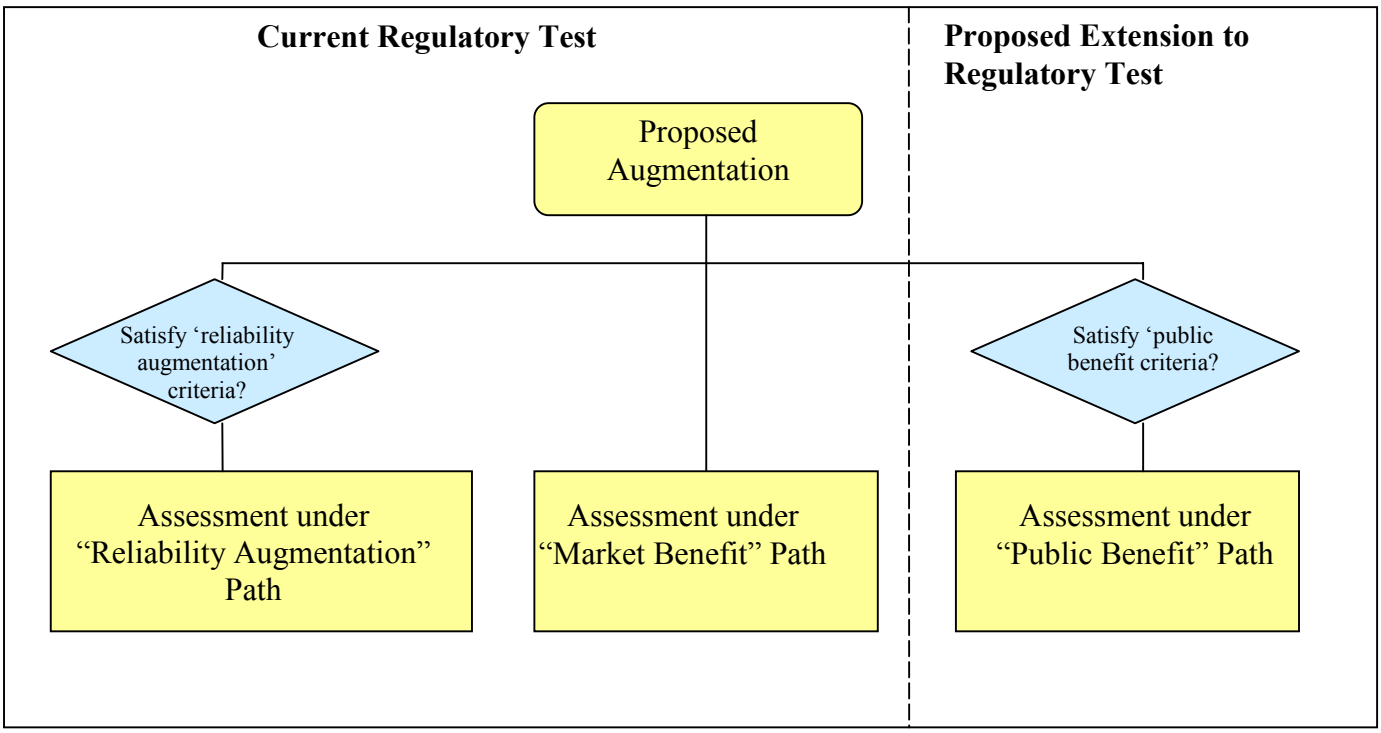
What the ACCC review should and must consider is whether the current form of the Regulatory Test prevents regulated network investment from being considered alongside these alternatives as a potential option. Powerlink contends that the existing Regulatory Test can clearly prevent a TNSP from proposing a regulated solution to overcome network constraints that are impacting on the market.

It would be obvious to all observers that if every retailer takes action to install peaking plant to hedge their pool price exposure in a situation where Queensland has plentiful generation capacity, the customer will pay the price of this inefficiency.

However, if a TNSP knows that the only way to justify an augmentation to overcome a constraint is to include benefits associated with reduced generator market power, and this is not allowable under the Regulatory Test, no such augmentation will be proposed. This is clearly not an appropriate outcome as it restricts potentially economic solutions from consideration.

<u>Comment 2:</u> Powerlink suggests the Regulatory Test be altered to add a 'third path' to allow competition and a range of other benefits to be included under some circumstances.

Proposed Alteration to Regulatory Test



It is one matter to recognise that the failure to include competition benefits in the Regulatory Test is a real issue, causing inefficient investment signals and resulting in higher market costs than would otherwise occur.

However, Powerlink accepts that finding an appropriate solution is difficult. This is, after all, why the initial drafting of the Regulatory Test excluded such benefits.

Powerlink suggests that this could be addressed in a workable manner as outlined below:

- The Regulatory Test could be expanded to include an optional 'public benefit test'. This would provide the option to incorporate competition and other benefits under certain special circumstances. It would not open up each application of the Regulatory Test to the volatility inherent in any consideration of pool price outcomes and 'strategic bidding' assumptions.

- This 'public benefit test' would not need to be prescriptive, but could indicate a range of benefits that a proponent may use in the Regulatory Test assessment. These could comprise the inclusion of actual pool price outcomes in the analysis, the consideration of 'strategic bidding' scenarios, and consideration of potential major load development scenarios. The analysis could also be allowed to take account of assumptions about the likely wholesale cost of generation (that may not be reflective of the marginal cost of the relevant generators).

- This would bring significant volatility to the test (the reason this type of test was moved away from when the existing Regulatory Test was developed) and increase the likelihood of disputes. Powerlink would definitely not recommend this approach be used for assessment of all network investments. However, we consider it may be appropriate in some cases where the benefits are significant and relatively clear-cut.

- Powerlink suggests a structure where the 'public benefit test' can only be applied in three circumstances:

  (a) where historical evidence exists that wholesale prices have been significantly above marginal costs. This would only allow 'after the fact' augmentations to address situations where network constraints have actually resulted in high market costs. However, this would be a better situation than presently exists, where these types of competition benefits can never be explicitly recognised in the Regulatory Test.

  (b) Where market power occurs or will occur. This would necessitate a definition of when market power arises. ABARE discussed this in their paper reviewing the Californian electricity market and defined it as follows:

  "Generators are defined to have market power if they can profitably increase the price they receive for their supply by reducing the amount of electricity on offer to the market or by raising the minimum price at which they are willing to offer electricity. This behaviour is profitable for the generator if the increase in the market price is sufficient to more than offset any reduction in revenue from units that are not dispatched despite having a production cost below the market price."[3]

  (c) Where overcoming a particular network limitation is considered sufficiently important by one or more jurisdictions. This category could be determined by a jurisdiction to be 'in the state's interest', or if multiple jurisdictions are impacted such as in the case of an interconnector, 'in the national interest'.

  Note that Powerlink is not suggesting that a jurisdiction rule that a specific network augmentation is in the state or national interest – the jurisdiction/s would instead declare that action is required to address a particular network limitation 'in the state's interest'. The most appropriate network or non-network alternative would be determined through market processes including the Regulatory Test assessment process. However, such a declaration by a jurisdiction could provide a valid trigger for a broader 'public benefit' assessment where competition or other benefits are allowable in the Regulatory Test economic analysis.

  Powerlink understands that the US Department of Energy wants to develop a method for identifying and addressing so called "national-interest" transmission bottlenecks. Their study found that interregional transmission congestion cost consumers hundreds of millions of dollars annually, and that relieving bottlenecks in four regions (California, PJM, New York and New England) alone could save consumers US$500 million annually[4].

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[3] Californian electricity market reform: An Australian perspective – ABARE current issues – August 2001, by Anthony Swan and Christopher Short

[4] Fortnightly's GridWeek Letter No. 15 May 10, 2002.

(3) ROLE OF NETWORKS AND NETWORK INVESTMENT

Comment 1: Broader issues relating to the role of networks, pricing and market design are more appropriately matters to be addressed by COAG and the NEM Ministers Forum.

The Commission's introduction to the Regulatory Test issues paper contained information and comments on the role of networks, transmission pricing etc. While this is useful background, Powerlink considers it is important not to cloud the review of the Regulatory Test with such issues. The Regulatory Test refers to the economic evaluation of corrective action to address network limitations. Impacts on the Regulatory Test of any changes in policy framework should be addressed separately, once outcomes of the wider COAG review process are known.

Comment 2: The Regulatory Test is an impediment to investment – but the impact differs according to the type of project.

Powerlink considers that the Regulatory Test and associated parts of the National Electricity Code are a significant (in some cases insurmountable) hurdle for investment designed to address network constraints that may be causing high market impacts.

Proposed new interconnectors have suffered enormous delays through the Regulatory Test assessment process. In addition to this, it is Powerlink's view that cases exist where intra-regional augmentations that could deliver economic benefits are not being proposed. This latter situation is caused partly by the requirements of the Regulatory Test (see section on competition impacts of network investment), and partly by other regulatory signals which are driving TNSPs to 'underbuild'.

In terms of investment required to satisfy network performance requirements and technical standards, Powerlink's view is that the Regulatory Test does not prevent such investment. The potential exists for the associated Code requirements to dramatically impede necessary investment through delays and disputes, but there appears to be sufficient mechanisms in the Regulatory Test itself to allow a TNSP to invest so as to satisfy its obligations.

(4) NON-NETWORK AND UNREGULATED ALTERNATIVES

Comment 1: The bias towards unregulated network investments needs to be removed from the Regulatory Test.

Powerlink's primary comment in this area is that the bias towards unregulated network investments should be removed from the Regulatory Test. There presently exists a requirement in the Regulatory Test that 'new interconnectors must not be determined to satisfy this test if start of construction is within 18 months of the project's need first being identified' in a public report.

NEMMCO's report quoted in the issues paper found that the Regulatory Test should be modified to not unduly favour non-regulated solutions. Powerlink would agree that there is no valid reason for continuing this approach. Other mechanisms such as the new requirement for NEMMCO to carry out and publish an annual interconnector

review will provide greater information to market participants and interested parties. The Regulatory Test requires that all alternatives be considered on an equal basis in terms of benefits associated with them, so bias towards one form of investment is not justified.

Comment 2: Early disclosure of information should be encouraged to provide sufficient time for non-network alternatives to come forward. Prescriptive time periods should not be adopted as they will not be appropriate in all circumstances.

A market test period, in which unregulated alternatives are given a specified time to respond, should not be introduced into the test. This leads to an unnecessary bias towards non-regulated investments, and a prescriptive approach which may result in undesirable outcomes.

The issue of sufficient time for non-network alternatives can be better addressed via other means. One of the primary objectives behind the Network and Distributed Resources code changes was to increase requirements for information disclosure about future network limitations and Regulatory Test assessments. The Code changes incorporate many prescriptive requirements to make it obligatory for TNSPs to provide greater information via the Annual Planning Reports and as part of individual consultation processes for proposed large network assets.

In addition to this, Powerlink has voluntarily adopted a process where it discloses greater information about limitations which may give rise to the need to develop new major network assets. Our general approach is to provide an early information paper to Code Participants and interested parties regarding the nature of the future limitation, well before analysis of potential solutions has been completed.

Together with the Code changes, this extends the time available for proponents to develop non-network alternatives and increases transparency.

Comment 3: Powerlink is concerned about the lack of competition in the provision of non-network alternatives. This can lead to the opportunity for supposedly competitive options to extract 'monopoly rent'.

In most cases, intra-regional network limitations are localised issues. The reality is that grid support is nearly always required from a specific local area. Often only a single existing generator or group of generators owned by one participant, has the technical capability to provide grid support to overcome the local network limitation.

Recent Code changes require TNSPs to disclose the costs of their transmission augmentation proposals to the market prior to initiating consultation processes. Powerlink considers that this is not appropriate in terms of achieving the most cost-efficient outcome. It is akin to an auction where the reserve price is known and there is only one bidder....clearly the buyer will bid just above the reserve price even if they were willing to pay significantly more.

Powerlink does not believe it is the ACCC's intention that market-based solutions to transmission network limitations be provided at only $1 less than the cost of a transmission augmentation. Money paid under a grid support arrangement consists of regulated funds. It is appropriate that there be some clear mechanism to ensure non network solutions are provided on a competitive basis, linked perhaps to the disclosure of the costs of the participant actually providing the grid support service. If there is no competition in the provision of the non network solution consideration

should be given to regulation of the service being provided to avoid any risk of monopoly rents. Powerlink suggests that this issue be considered as part of the Regulatory Test review.

(5) OTHER ISSUES

Comment 1: Recent Code changes have considerably increased the transparency of the process, and no further oversight is considered necessary.

Comment 2: Pricing and beneficiaries pays are an allocation mechanism. They should not be considered in the Regulatory Test assessment of the most economically efficient investment.

The Regulatory Test is a test to determine whether an investment is economically efficient and should therefore be allowed into the regulated asset base of a TNSP.

This should not be confused with proposals to change how the cost of regulated transmission is allocated between market participants via a form of beneficiaries pays. The investment decision should not be impacted by the cost allocation process – this would invite disputes from parties who do not wish to pay for an economically efficient investment.

It should be considered from the opposite viewpoint – that is, the beneficiaries pays mechanism should be developed so as to align with the Regulatory Test, not vice versa, and with the true (not theoretical) beneficiaries of an investment.

Comment 3: Powerlink considers the entire regulatory process for new network investments is too long and unwieldy, and that it may act as an impediment to necessary and worthwhile investment.

Powerlink's view is that the timeframes for assessment of network investments under Code requirements associated with the Regulatory Test are far too long. We also have stated in numerous forums and reviews that we consider opening the dispute process to all interested parties has the potential to result in significant delays to essential and worthwhile investments.

Powerlink considers that these issues are outside the scope of the present Regulatory Test review, given the acceptance of the Network and Distributed Resources Code changes. However, our concern remains that the regulatory process, of which the Regulatory Test is a part, may hinder the ability of TNSPs such as Powerlink to meet service obligations. We would request that the ACCC carefully consider any alterations to the Regulatory Test that it may propose as a result of this review in the light of these concerns.

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