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13th June 2002

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Dear Michael

Review of Regulatory Test

Snowy Hydro Trading Propriety Limited (SHT) advocates that efficient transmission investment will play a critical role in the development of National Electricity Market. As a general principle, we believe that market based mechanisms will deliver the most efficient market outcome. Hence the need for a regulated interconnector may indicate market failure.

It is our view that regulated interconnectors must not be able to create a barrier to entry for a non-regulated interconnector. The assessment of SNOVIC by the IRPC offers some pertinent observations which will be used to provide context to the review of the regulatory test.

Executive Summary

In summary we believe that:

1. The test must be assessed by an independent third party such as the ACCC. Otherwise this is open to gaming by the TNSP;
2. The benefits of a regulated investment by default accrues to customers. Hence, customers must pay for the regulated investment costs;
3. The test must be more prescriptive thereby removing subjectivity and hence manipulation of key inputs to derive certain biased outcomes;
4. Market disruption costs associated with the implementation of the regulated projects are ultimately passed through to end customers and hence must be incorporated into the net benefits calculation.

Assessment of the Test

It is very important that an independent body such as the ACCC remains the body assessing the application of the Regulatory Test. This is essential to ensure that objectivity is retained since both TNSPs and DNSPs are incentivised to increase the size of their asset base and hence inappropriately apply or manipulate the test. It is pertinent to remember that capital spent on regulated investments are ultimately funded by end customers and hence commitment to this expenditure must be treated with the highest degree of scrutiny.

SHT is therefore concerned to see comments such as, “ the Commission relies on TNSPs applying the regulatory test correctly in their assessment of network investment. However, the Commission is able to retrospectively review actual network investment at the commencement of each revenue rest and determine whether the augmentation has been assessed against the criterion set out in the regulatory test¹.” Retrospectively, assessing the appropriateness of investments is treating the symptom and not addressing the original cause. Further to this what recourse is available to customers for inappropriate investments? Hence, SHT believes that the onus is on an independent body such as the ACCC to thoroughly assess the application of the regulatory test and approve/disapprove the project accordingly.

Market Responses

SHT's premise is that the market will deliver the most efficient outcomes. With this in mind, the onus must be on TNSPs to identify potential future network constraints and to make this information available to the market. Market Participants must then be given a sufficient amount of time to assess the viability of privately funded alternatives to alleviate the potential constraint. If market Participants don't respond to address the constraint then it is clear indication that there are no benefits likely to accrue to the Participant by addressing the constraint. Hence, the benefits must default to customers and therefore any regulated transmission project subject to meeting the requirements of the regulatory test must be funded by market customers.

Consistent with these views the test should still be assess on maximizing market benefits with a number of possible alternative projects. This is necessary to ensure that there is an optimum outcome with the view that customers wear the risk of a stranded asset. SHT believes the discount rate should be no less than the hurdle rate for private investors since the cost of the project resides with customers. A discount rate less than a private investment rate would skew the solution of the transmission constraint in favour of regulated projects.

Subjectivity of the Test

The latitude offered by the test gives the proponent advocating a project a great amount of leeway in its application of the test. The cliché “garbage in, garbage out” is very relevant in this regard. For instance:

- The assessment performed by Roam Consulting for the IRPC revealed that the majority of the SNOVIC savings was derived from the deferral of investment in new generation infrastructure. This “reliability entry” capacity deferral constituted upto 85% of SNOVIC total benefit. SHT's concern is that the methodology applied by the IRPC resulted in the development of an excessive amount of reliability entry capacity with upto 2500MW of plant modeled in SRMC scenarios. Conversely, no market entry plant appeared to be modeled. This is in stark contrast to reality as all new capacity development in the NEM have been market driven as opposed to no reliability entry plant been contracted through the reserve trader mechanism.

¹ Issues paper, Review of the regulatory test, page 5.

- The IRPC assumed that the capacity benefits delivered by the interconnector is always equal to its nominal capacity for the life of the asset. This assumption is grossly invalid when there are insufficient spare generation capacity in the exporting region. For instance this assumption is violated because in NEMMCO's Statement of Opportunities 2001 the NSW demand is forecasted to exceed the installed generation capacity in summer 2006/2007.
- Roam Consulting's forecast of average pool prices in all NEM regions escalated from approximately \$33/MWh in 2003/04 to over \$60/MWh in 2012/13. Clearly, this is not reflective of expected market price outcomes under a competitive market environment.

These three specific examples raised above illustrate that the application of the Regulatory Test is opened to a lot of subjectivity and hence political manipulation. Clearly, there needs to be greater transparency in the methodology used to assess the cost-benefit analysis. SHT advocates that the Test must be made more prescriptive to ensure that there is a consistent application. Further to this the key assumptions in the test must be made transparent to the market and a process must be established to allow Participants to critique the validity of the assumptions. This process was clearly lacking in the application of the SNOVIC test.

Incorporation of Market Disruption Risks

There is the serious and imminent risk of market disbenefit to Participants with market disruptions to allow the implementation of regulated transmission investments. For instance, the proposed scope of works for the SNOVIC project includes outages of transmission lines during peak working hours. The period where these outages take place will result in increased costs to Market Participants as they hedge their respective positions. These hedging costs will be ultimately passed through to end customers.

Further to this Market Participants factor in potential project delays and as a result prudently manage these risks through contracts. These hedging costs must also be factored into the net benefits test as a risk premium.

It is our view that those in the best position to manage the risk must be accountable for any adverse outcomes. Compensation to affected Participants must include direct losses associated with a variation in generation, hedging compensation, variable costs incurred, and any consequential losses.

Ultimately, customers are likely to be the most adversely affected by any price increase during a proposed outage period and the period of uncertainty surrounding the project completion. In summary, it is our view that the cost of the project outages to market Participants needs to be incorporated in the analysis as a risk premium which would reduce the net benefit calculation.

If you have any enquiries in relation to this submission then please contact myself on (02) 9278-1862.

Yours faithfully,

Kevin Ly
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