

Major Energy Users Inc

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Dr. John Tamblyn
Chairman
Australian Energy Market Commission
P O Box H166
Australia Square
NSW 1215

Dear Dr. Tamblyn,

MEU's Views on Regulatory Test Principles

It is disappointing that the AEMC has again failed to properly understand what the MEU proposes in its recommendations to the AEMC.

In this case regarding the Regulatory Test (RT), contrary to the suggestion in the draft determination, we did not propose that the RT should not be based on a cost benefit approach, in fact we strongly support such an approach. What we did recommend was that the RT cost benefit analysis should include, in its calculation 'consumer benefits' which would result from the network augmentation proposed. The simple fact is that 'consumer benefits' have been explicitly excluded in the implementation of the RT, notwithstanding views to the contrary. The MEU's submission did not seek to have 'consumer benefits' given primacy over efficient investment – what the MEU states is that the 'consumer benefits' should be included as an element in the cost benefit analysis. By excluding this benefit from the cost benefit analysis, the AEMC has valued the investments made by electricity supply entities **above** those of consumers – it is a consistent failure of the AEMC and others to exclude investments made by consumers within the context of the electricity market.

Indeed, despite the range of views put forward by the MEU, the only issue taken up by the AEMC, totally misrepresents MEU's views. Reference to the ACCC's recourse to the 'Code' is insufficient reason to dismiss the MEU's views on consumer benefits, as the Code as written tended to support the primacy of the electricity supply industry over the interests of consumers. In fact, the new Rules clearly detail that the electricity supply industry is a service to consumers and this is clearly stated in the NEL objective.

The NEL objective refers to 'the long term interest of consumers'. That is the objective that should guide the AEMC in implementing the RT and incorporating consumer benefits as one criterion in the cost benefit analysis. The MEU has not suggested that it be the only criterion – that is a straw man set up in the AEMC draft determination and, as in other reviews, raises the issues for the AEMC to address.

The draft determination makes reference to the objective and takes from this that the objective specifies "efficient investment" as the key element of the objective. The AEMC draft determination refers to the ACCC draft determination with regard to version 2 of the RT. The ACCC is quoted as stating that (page 49)

"...lower prices [for consumers] are not an objective ..."

and the AEMC accepts this view. What is not even debated is that the ACCC determination was made in reference to the Code (which as stated earlier) tends to support the interests of the electricity supply side entities. Under the new Rules, it is

"...the long term interests of consumers with respect to price, quality, reliability and security of supply of electricity ..."

which is the focus of the objective, not efficient investment in the electricity supply arrangements as is implied by the AEMC (page 51)

"The NEM objective specifies "efficient investment" as one of the key elements..."

"Efficient investment" and "efficient use" are only tools needed to ensure that the sometimes competing four outcomes (price, quality, reliability and security) for consumers can be balanced.

The AEMC has elected only to examine the outcomes from efficient investment from the view point of the electricity supply side by neglecting to assess the impact of the decision on efficient investments made by consumers, and totally ignoring the outcomes for efficient use of the electricity system.

The AEMC assumes that by the inclusion of consumer benefits in the cost benefit analysis that this will most likely result in economically suboptimal outcomes by the discarding of superior outcomes, and quotes NERA as saying so, thus gaining support for its view.

The AEMC makes no attempt to verify whether this assumption is correct; nor does it assess the impact of increased reliability and more efficient use of electricity to support its rejection of the viewpoint made by every consumer response to the RT review. The AEMC failed to examine the approach of the AER which has been examining developing tools to assess the cost impacts of congestion. The AER in its investigations, effectively uses the "consumer

benefit" (i.e. the difference in cost between dispatch of the lowest cost generation and the cost resulting from dispatch of out-of-merit order generation due to the constraint) as the basis for its calculation of its indicators of the cost of congestion. Appendix B provides extracts of the AER decision, demonstrating that the AER approach does exactly what MEU proposed to the AEMC.

In fact, intuitively the AEMC assumption can be shown to be totally incorrect, and attached (appendix A) is an example of why this assumption is incorrect.

In its submission to the AEMC, the MEU provided a number of views which support the inclusion of the consumer benefit in the cost benefit analysis. These included the following observations which were **totally ignored** by the AEMC in the draft determination.

- Generation is intended to be subject to competition. This applies not just within a region but nationally. By viewing the "transfer of wealth" issue as it is, this implicitly assesses the issue on a regional basis, with regional generation being provided a commercial benefit at the expense of generation in another region. It also limits interstate trade in electricity.
- Inter-regional price differentials occur when the interconnector is constrained. This requires high price region generators the opportunity to be dispatched out of merit order to relieve a constraint. This is not efficient, and it is the consumer benefit which provides the magnitude of the cost of out-of-merit dispatch.
- Economic efficiency for a consumer is increased when consumers can increase a cost in one area to achieve a larger cost saving in another area. This can only apply when the consumer benefit is included in the cost benefit analysis for future augmentations.

The MEU is again **disappointed** that the AEMC has not carried out a proper assessment of the specific issues we raised in response to the request for submissions. It is disappointing that the only two consumer submissions have been given such inadequate and unbalanced treatment in the draft determination. The AEMC has accordingly relied on assertions and assumptions based on the superseded Code which does not stand up to more rigorous analysis.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark Gell', written in a cursive style.

Mark Gell
Chairman

Appendix A

An example using inter-regional augmentation

Assume that there is a price differential between two regions. The reason for the price differential applying is that the high price region has insufficient generation, and/or that the existing generation is more expensive than in the low price region.

There are a number of outcomes which can flow from this scenario – the consumers in the high price region will move to the low price region (this would be a very inefficient use of resources), new generation will be established in the high price region (but why build new generation when existing but undispachable generation is available in an adjacent region?), or augmentation will occur at the regional boundary and available generation in the low priced region can be dispatched.

The RT as currently applied only recognises the “transfer of wealth” applying between the generator and consumer within the high priced region, effectively implying that the NEM is not national and was never intended to be. The assessment of economic efficiency needs to include the benefit between dispatching the generation in the low priced region and the generation in the high priced region, and incorporating the differential in value to both by dispatching the lower price generator first. See for example the way AER calculates the Total Cost of Congestion (TCC) which it uses to measure the impact of congestion in the network.

The current RT is based on the assumption that the “loss of wealth” by the generator in the high priced region is offset by the “increase in wealth” by the consumer in the region, i.e. that there is a net zero benefit within the region.

This approach therefore excludes the “increase of wealth” which would go to the generator in the lower priced region to partly offset the “loss of wealth” applying to the generator in the high priced region. The only assessment of the benefit between the two generators is the inter-regional price difference, which is what the consumer sees.

Without including the consumer benefit of augmenting the inter-regional connection in the cost benefit analysis, there is no inclusion of the benefit that increased competition between generators will deliver, and the lower cost generation could continue to be displaced by higher cost generation. If the consumer benefit is included in the cost benefit analysis, it provides an estimated value of what this increased competition between generators will deliver by the augmentation of the interconnection.

Thus, a more efficient outcome is the result.

Appendix B

Extract from the AER Decision “Indicators of the market impact of transmission congestion” 9 June 2006 (pages 5 and 6)

“The AER’s decision is to publish the following as indicators of the market impact of transmission congestion:

.. The **total cost of constraints (TCC)**. The TCC estimates how much benefit the market would receive if all transmission constraints were removed. It does this by modelling how much the cost of generation would be reduced if all transmission limits were increased until they no longer affect the dispatch of generation.

.. The **outage constraint cost (OCC)**. The OCC is similar to the TCC but only estimates the benefit to the market by removing all transmission outage constraints (but retaining other causes of congestion such as system normal constraints). The AER has included this indicator because retailers, generators and other traders are particularly interested in the TNSPs’ management of outages. If the impacts of the outages are not predictable or notified well in advance then it can be difficult for traders to manage the associated risks.

.. The **marginal cost of constraints (MCC)**. The MCC estimates how much benefit the market would receive if a transmission constraint was marginally reduced. It does this by modelling how much the cost of generation would be reduced if the transmission limit was increased by one megawatt. The MCC identifies particular elements of the transmission network that have binding limits that cause generation to be dispatched out of merit order.”