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9 October 2006

Dr John Tamblyn,
Australian Energy Market Commission,
PO Box H166,
Australia Square, NSW 1215.

Dear Dr Tamblyn,

**RE: Comments on Draft Rule Determination – Reform of the Regulatory Test
Principles**

The Regulatory Test controls the development of regulated network service infrastructure in the Australian National Electricity Market.

As a company with a keen interest in infrastructure development Energy Solutions Australia Pty Ltd is therefore pleased to contribute to the above consultation.

Please do not hesitate to contact me should you have any queries regarding this submission.

Regards,

Dr. A. Cook
Managing Director

THIS SUBMISSION HAS BEEN MADE ELECTRONICALLY AND THEREFORE HAS NO SIGNATURE

1.0 Background

On 12 October 2005 the Ministerial Council on Energy (MCE) submitted a proposal to the Australian Energy Market Commission (AEMC) to implement new Regulatory Test principles for new network service investment.

After extensive public consultation and internal deliberation the AEMC gave notice on 21 September 2006 under section 99 of the National Electricity Law (NEL) of the making of a Draft Determination¹ and Draft Rule² related to that proposal.

This submission provides comments on one specific aspect of the Draft Determination viz the selection of alternative options to the proposed network service investment.

2.0 The Regulatory Test

The Regulatory Test³ assesses regulated network service investment proposals in order to determine whether they are eligible to be subject to the regulation and pricing arrangements in Chapter 6 of the Rules. Therefore network service investment decisions proceed only if they satisfy the Regulatory Test i.e. the Regulatory Test is the mechanism used to assess the economic efficiency of network service investment decisions.

The Regulatory Test is a cost benefit analysis with two limbs:

- a reliability limb, which assesses so called ‘reliability augmentations’ required to meet the ‘*minimum network performance requirements as set out in Schedule 5.1 of the Code or in relevant legislation, regulations or any statutory instrument of a participating jurisdiction*⁴’; and
- a market benefits limb, which assesses all other ‘market driven augmentations.’

The Regulatory Test compares the proposed network service investment against ‘*all other reasonable network and non-network alternatives to address the identified constraint or inability to meet the network performance requirements*⁵.’

The Rules do not define what constitutes an ‘*alternative*’ however the ACCC has stated:

- for a reliability augmentation an alternative is required to:
 - have ‘*a clearly identifiable proponent*⁶’; and
 - be practicable i.e. ‘*it is technically feasible.*’

¹ AEMC, *Draft Rule Determination, National Electricity Amendment (Reform of the Regulatory Test Principles) Rule 2006 (Draft Determination)*, 21 September 2006

² AEMC, *Draft Rule, Draft National Electricity Amendment (Reform of the Regulatory Test Principles) Rule 2006 (Draft Rule)*, undated

³ ACCC, *Review of the Regulatory Test for Network Augmentations (Regulatory Test)*, 11 August 2004

⁴ Regulatory Test, page 7

⁵ The Rules, Clause 6.6.6(b)(1)(3)

⁶ The Regulatory Test, page 8

- for a market driven augmentation an alternative is required to:
 - be genuine i.e.
 - *‘deliver[s] similar outcomes to those delivered by the option being assessed; and*
 - *become[s] operational in a similar timeframe to the option being assessed⁷; and*
 - be practicable i.e.:
 - technically feasible; and
 - *‘commercially feasible, which is to be demonstrated by determining whether an objective operator, acting rationally according to the economic criteria prescribed by this test, would be prepared to construct or provide the alternative option⁸.’*

With reference to commercial feasibility the Regulatory Test states:

‘The existence of a genuine proponent for the alternative option should be taken into account when determining practicability, however, absence of such a proponent will not exclude a project from being an alternative option for the purposes of the regulatory test⁹.’

3.0 The Identification of Alternative Options

This section first outlines the AEMC’s proposed approach to the identification of alternative options. It then identifies issues with that approach.

3.1 The Proposed Approach

The Draft Determination proposes that the Regulatory Test *‘should take the form of an assessment of the proposal against the likely alternative or alternatives, rather than an assessment against all genuine and practicable alternatives¹⁰.’*

This is reflected in the Draft Rule as follows:

‘...the regulatory test must:

- (1) be based on a cost-benefit analysis of the future were the new investment to take place, compared to the likely alternative outcome or outcomes, were the new network investment not to take place;*
- (2) ensure that the determination of the likely alternative outcome is informed by a consideration of all genuine and practicable alternative options¹¹,*

⁷ The Regulatory Test, page 8

⁸ The Regulatory Test, page 8

⁹ The Regulatory Test, page 8

¹⁰ The Draft Determination, page 5

¹¹ Draft Rule, Clause 5.6.5A(c)

Genuine and practicable alternative options are to be identified through a process which requires the Network Service Provider (NSP) to:

‘publicly request information as to the identity and detail of alternative options to the proposed new network investment¹².’

This is further elaborated in the Draft Determination:

‘.....the NSP should be required to issue a request for information (RFI) to identify possible alternatives to a proposed transmission augmentation. This could include:

- *Local Generation;*
- *Demand Side Management;*
- *Non-electricity alternatives; or*
- *An alternative network upgrade¹³.’*

At the close of the RFI process the NSP *‘collects all the information from the RFI and then makes an assessment as to which of these options, or another option or options based on its own analysis, should be considered likely alternatives¹⁴.’*

The AEMC has further proposed that in order to reduce gaming:

‘Rather than simply being required to prove that their alternative is genuine and practicable, a proponent of an alternative project will have to provide evidence that their project is likely to proceed but for the proposed network augmentation. This should result in higher hurdle for alternative projects, which should limit the ability of a project which is purely speculative or unlikely to proceed, from being used to block a proposed transmission augmentation¹⁵.’

The AEMC considers that its proposed approach will assist to establish *‘a streamlined process that helps to maximize the net economic benefit to all those who produce, consume and transport electricity in the market¹⁶.’*

3.2 Issues with the Proposed Approach

Three issues arise with the proposed approach:

- It is the NSP who makes the decision regarding which *‘genuine and practicable alternative options’* are to be considered *‘likely alternative(s)’*, and the NSP has a conflict of interest.

¹² The Draft Rule, Clause 5.6.5A(d)(2)

¹³ The Draft Determination, pages 55 and 56

¹⁴ The Draft Determination, page 58

¹⁵ The Draft Determination, page 59

¹⁶ The Draft Determination, page 7

- The Regulatory Test is unavoidably and inherently circular, and alternative options may only be identified part way through its application. Any such alternative options also need to be considered in the Regulatory Test's application.
- That the AEMC is proposing a '*higher hurdle for alternative projects*' ignores the economic efficiency objective of the Regulatory Test and the practical experience to date of gaming not by proponents of alternative projects but by the NSPs themselves.

Each of these issues is considered in turn.

3.2.1 The Selection of Likely Alternatives

The requirement to '*publicly request information*' on alternative options is a sensible and practical approach. Indeed some network owners e.g. Powerlink Queensland already follow that approach.

However, the AEMC has already noted that:

- '*.....NSPs lack a commercial incentive to consider potentially cheaper network solutions and/or an engineering preference exists for NSPs to invest in more complex solutions*¹⁷;' and
- there is a role for '*the Test prevent[ing] a TNSP introducing bias through its selection of alternative options*¹⁸.'

There is therefore a real danger in giving NSPs carte blanche discretion to eliminate '*genuine and practicable alternative options*' from consideration. It is noted that CRA (i.e. the AEMC's consultant) agrees with this position:

*'...the objective of achieving efficient investment outcomesrequire[s] an obligation on NSPs to assess all investment alternatives.....In the absence of such a requirement, NSPs may give preference to an investment option that would increase their asset base or otherwise suit their commercial interests, rather than reflect the public interest in an option that is efficient*¹⁹.'

Therefore as a first preference NSPs should be required to consider all genuine and practicable alternative options. If however the AEMC decides to permit NSPs to eliminate alternative options from consideration then it needs to provide specific guidance as to how that is to be achieved.

The Regulatory Test itself uses the following criterion to determine commercial feasibility:

¹⁷ The Draft Determination, page 25

¹⁸ The Draft Determination, page 53

¹⁹ CRA, *Principles for the Regulatory Test, Final Report*, September 2006, page 16

‘...is to be demonstrated by determining whether an objective operator, acting rationally according to the economic criteria prescribed by this test, would be prepared to construct or provide the alternative option.’

The AEMC needs to give consideration to extending this criterion more generally to the filtering of ‘*genuine and practicable alternatives*’ by the NSPs.

In summary, employing an up-front RFI process will inevitably lead to some streamlining in the application of the Regulatory Test. However, that streamlining should not be at the risk of compromising the adequacy of the assessment process.

Finally, it is noted that the Group’s submission to the AEMC states in part:

‘As the SNI process demonstrated, simply requiring that all “genuine” and “practicable” options are evaluated is insufficient, since this leaves plenty of room for interpretation, and therefore potential dispute, which, ultimately, may have to be decided in the courts (as was SNI)²⁰.’

This statement is incorrect. SNI was assessed under the Regulatory Test version 1, whereas it was only in the Regulatory Test version 2 that the ACCC provided guidance on what constituted an alternative and introduced the terms ‘*genuine*’ and ‘*practicable*.’

3.2.1 The Regulatory Test’s Unavoidable and Inherent Circularity

Requiring all alternatives to be identified up-front through an RFI will deliver a more streamlined process.

However, the MCE has also stated regarding the new Regulatory Test principles:

‘The overarching objective of the Regulatory Test is to deliver efficient transmission investment through application of a net economic benefits test, not simply more transmission regardless of the economics²¹.’

The Draft Rule does not satisfy this criterion. In particular, requiring all alternative options to be identified up-front ignores that the application of the Regulatory Test plays a major role in informing the market regarding (efficient) alternatives.

CRA has aptly expressed this as follows:

‘...the act of determining that an interconnection proposal satisfies the regulatory test favourably alters conventional perceptions of the project’s practicability. Projects that would be utterly impractical without regulatory protection, perhaps because of overwhelming transaction costs, can become

²⁰ The Draft Determination, page 53

²¹ Letter from MCE to J. Tamblyn (AEMC), undated, page 1

practical if they are deemed fit to be regulated. What matters is how large the net market benefit is likely to be, as the magnitude of the net market benefit determines the value/merit of overcoming any of the (typically fewer) remaining obstacles to implementation.

*Practicability is an economic concept that, when applied to regulated investments, can be substantially achieved by a finding that a project – that can otherwise be legally implemented – passes the regulatory test. **It is crucial to recognize the existence of inherent and unavoidable circularity with respect to the overall evaluation process.** Practicability is not strictly an exogenous factor to be assessed by NEMMCO or the IRPC - .it is a characteristic that is substantially conferred by a favourable determination²².’ [emphasis added]*

That is, a Regulatory Test assessment may very well highlight alternatives that the market as a whole may not be aware of at the time when the network owner makes its public request for information.

A practical example of a Regulatory Test assessment identifying alternative options occurred in the evaluation of the proposed SNI interconnection, when the USNI alternative was identified. In fact USNI was shown to deliver greater benefits than SNI itself. It is therefore crucial that if the Regulatory Test is not simply to deliver ‘*more transmission regardless of the economics*’ that alternatives identified during the assessment process should be included.

The AEMC needs to ensure that alternative options identified through the Regulatory Test assessment process are also considered.

3.2.3 A Higher Hurdle for Alternative Projects

A higher hurdle for alternative projects assumes that there is an issue with the market attempting to game the application of the Regulatory Test. However, in the most controversial case to date it was an NSP and others (rather than the market) that misapplied the Regulatory Test. In particular, with regards to NEMMCO’s approval of SNI²³:

- SNI only ‘passed’ the Regulatory Test because the Inter-regional Planning Committee, NEMMCO and the National Electricity Tribunal all ruled out Unbundled SNI as a practical alternative.

²² Murraylink Transmission Company v National Electricity Market Management Company, Victorian Supreme Court, No 8359 of 2002, 24 July 2003 (**The Decision**), <http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/vic/VSC/2003/265.html?query=murraylink> , clause 29

²³ Further details can be obtained from the paper by Professor S. Littlechild, *Regulated and Merchant Interconnectors in Australia: SNI and Murraylink Revisited*, CMI Working Paper 37, 13 January 2004

- The Victorian Supreme Court identified significant issues with the application of the Regulatory Test to SNI such that there is considerable doubt as to whether SNI actually passed the Regulatory Test.
- Alternative 1 in the application by Murraylink Transmission Company Pty Ltd to the ACCC for regulated status was essentially SNI (or at least the interconnector portion extending from Buronga to Monash, and excluding the Monash – Robertstown portion). The ACCC found that SNI:
 - would have cost several times as much as was previously estimated (\$245 million versus an estimated \$110 M);
 - would not have been the most cost effective routing; and
 - did not pass the Regulatory Test (costs of \$245 M versus benefits in the range \$170 – 220 M).

The challenge to NEMMCO’s approval of SNI was therefore beneficial to the market because it prevented an inefficient regulated interconnector from proceeding. In that case the delay in SNI (due to litigation) actually improved rather than reduced the efficient use of resources.

The SNI example suggests that rather than focusing on higher hurdles for alternative projects the AEMC needs to focus on deterring inefficient network services by NSPs. In that respect it is noted that the major deterrent to inefficient network services (the risk of stranding) was recently removed. Other parties are of a similar view regarding the role of stranding in ensuring efficient network investment. For example, the Energy Users Association of Australia and the Energy Action Group have jointly stated:

‘We object strongly to any proposals that would provide regulated networks with ‘protection’ from ‘stranding’ (i.e. poor investment decisions) and effectively pass these costs on to end users²⁴.’

3.3 Recommendations

It is recommended that:

- The public request for information as set down in Clause (d)(2) of the Draft Rule will deliver a more streamlined process, and therefore is a sensible approach.
- The AEMC should require NSPs to consider all genuine and practicable alternative options. If however the AEMC decides otherwise then it needs to provide specific guidance as to how ‘likely’ alternatives are selected from ‘genuine and practicable’ alternatives, rather than simply stating that *‘this phase will no doubt require the application of some judgment²⁵.’*
- The AEMC needs to clarify that alternative options which only become apparent during the Regulatory Test assessment need to be considered.

²⁴ Joint submission by EAG and EUAA to the AEMC Transmission Revenue Review, *Response to AEMC Draft Rule Change Proposals Electricity Transmission Revenue Requirements*, April 2006, page 30

²⁵ The Draft Determination, page 58

- The AEMC should give consideration to dissuading gaming of the Regulatory Test by NSPs through the re-introduction of stranding for inefficient network investments. This is a more urgent priority than consideration of a higher hurdle for alternative options.

4.0 Conclusions

The AEMC has provided for the streamlining of the application of the Regulatory Test through two mechanisms:

- NSPs being required to issue a request for information (RFI) in order to identify ‘*genuine and practicable*’ alternative options up-front; and
- permitting NSPs to only consider a subset of the ‘*genuine and practicable*’ alternative options i.e. ‘*likely*’ alternative options.

The requirement to issue an RFI is a sensible and practical approach to streamlining. However, permitting NSPs to only consider ‘*likely*’ alternative options runs the risk of compromising economic efficiency objectives and the development of ‘*more transmission regardless of the economics.*’ NSPs should therefore be required to consider all ‘*genuine and practicable*’ alternatives. This includes those identified up-front through the RFI and also those identified through the discovery process associated with the application of the Regulatory Test. The AEMC should also give consideration to the re-introduction of asset stranding in order to deter inefficient network investments.