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1 November 2006

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Dr J ~~Tamblyn~~  
Chair  
Australian Energy Market Commission  
PO Box H166  
Australia Square NSW 1215

Dear Dr Tamblyn

**RE: Draft Rule - Reform of the Regulatory Test Principles**

The AER welcomes this opportunity to comment on the AEMC's Draft Rule Determination on the MCE's proposal to include a suite of principles in the National Electricity Rules (the Rules) on the regulatory test.

The AER notes the intent of the Draft Rule is to guide the AER in promulgating the regulatory test.

The Draft Rule also broadens the AER's responsibilities in relation to the Regulatory Test. The Draft Rule requires the AER to issue guidelines to assist in the application of the test and formulate a consultation process for the request for information on alternative options.

Whilst the AER generally supports the Draft Rule, it suggests further consideration be given to the proposed approach for assessing alternatives under the regulatory test. The AER is concerned that, as it stands, the proposed process for evaluation of options is open to gaming by the NSP to exclude possible network options from the final assessment.

The regulatory test currently requires the consideration of alternative options, and defines these as ‘genuine’ and ‘practicable’.

The AEMC’s Draft Rule adopts a ‘counterfactual’ approach involving a consideration of ‘likely alternatives or outcomes’ should the new network investment not take place. Whilst the determination of a likely outcome is to be informed by a consideration of all genuine and practicable options, the proposal limits the options that a network service provider (NSP) must consider in its regulatory test assessment to those that are ‘likely alternatives’.

The AER understands that this approach is intended to reduce the possibility of an option satisfying the regulatory test but not being built. In particular, the AEMC is concerned with minimising regulatory gaming opportunities that may arise from the delays associated with considering or waiting for the construction of unlikely non-network options.

The AER suggests that a better means to address this problem would be to allow the NSP to assess the likelihood of a *non-network option* but require the NSP to include in its final regulatory test analysis *all genuine and practicable network options*. This would address issues of information asymmetry and maintain transparency in the final analysis of alternative projects.

The AER is concerned that the type of assessment proposed by the Draft Rule may be affected by the actions of the self-interested proponent. This is acknowledged in the AEMC’s Draft Determination which states:

While a proponent would not be required for a project to be considered as a potentially likely alternative, the absence of a proponent could be one of the factors to be assessed in determining which alternative option or options are likely in the absence of the proposed project. A specific case may be an alternative project that the NSP would be the proponent for. In this case one of the factors that the assessment would consider would be whether the NSP would be likely to be a proponent of the project in the absence of its proposed project.<sup>1</sup>

Whilst the AEMC’s approach would address potential delays caused by vexatious generation options, it leaves the process open to gaming by the NSP, which also has a self-interest, to exclude possible network options from the final assessment. The AER considers that it is inappropriate for the NSP to be able to affect the regulatory test analysis by omitting a genuine and practicable option on the basis that it prefers not to build it.

Left unaddressed, this aspect of the AEMC’s proposed approach may potentially shift the emphasis of the regulatory test from finding the most efficient investment option to what is probable by providing the NSP with discretion to dismiss lesser-preferred network options as unlikely. This would undermine the completeness of the

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<sup>1</sup> AEMC 2006, *Reform of the Regulatory Test Principles*, Draft Rule Determination, 21 September 2006, p 58

consideration of network options in the final regulatory test analysis and decrease the transparency of the process.

This matter aside, the AER supports the Draft Rule including the transitional arrangements proposed to deem the current regulatory test compliant with the principles until end 2007 on the basis that the regulatory test be repromulgated by January 2008.

Please contact Gavin Fox on (02) 6243 1249 if you wish to discuss any of the matters raised in this submission.

Yours sincerely

A handwritten signature in cursive script, appearing to read 'Steve Edwell'.

Steve Edwell  
Chairman