



Australian Energy Market Commission

**Draft Rule Determination**

**Draft National Electricity Amendment (Transmission Last Resort Planning) Rule 2006**

Rule Proponent  
Ministerial Council on Energy

23 November 2006

Signed:

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For and on behalf of  
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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy market. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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# 1. Summary

On 5 October 2005 the Commission received a Rule change proposal from the Ministerial Council on Energy ('MCE') requesting that the Commission make a Rule to provide it with a Last Resort Planning Power ('LRPP').

The Proposed Rule has three main elements:

- First, it provides the Commission with a power to direct a Registered Participant to undertake the Regulatory Test for a potential transmission network project.
- Second, it requires the Commission to seek advice from a panel of industry representatives, including a representative of the National Electricity Market Management Company ('NEMMCO'), and have regard to specific information, when identifying a potential transmission network project that may become the subject of a direction.
- Third, it provides a process that the Commission must follow in exercising the LRPP, including the issuing of a notice of direction, statement of reasons for its decision and providing for circumstances where a directed party fails to comply with a notice issued in accordance with the Proposed Rule.

The Commission published the Rule proposal in accordance with section 95 of the National Electricity Law ('NEL') and the closing date for submissions on the Rule Proposal was 24 February 2006. The Commission received 10 submissions at this stage of consultation.

Given the interrelationship between the LRPP Rule proposal and other Rule proposals under consideration by the Commission (for example the Transmission Revenue Rule Proposal, the Congestion Management Rule and the Regulatory Test Rule Proposal) the Commission decided to issue a notice under section 107 of the NEL extending the publication of the Draft Determination and Draft Rule to 23 November 2006.

The proposed Rule provides the Commission with the power to direct a party (for the purposes of the Rule a registered participant) to undertake the Regulatory Test in relation to an identified new network investment. It should be noted that the power is not intended to apply to non-network projects, (for example generation or demand side projects). However, there remains scope to assess non-network projects as viable alternative options to a proposed transmission investment as part of the usual application of the Regulatory Test.

In developing the Draft LRPP Rule the Commission has been mindful of its current work to develop a Congestion Management Regime. The Commission considers that the LRPP is an important and complimentary part of the

Congestion Management Regime being developed by the Commission as part of its Congestion Management Review, and will form part of the overall strategy to manage transmission constraints. The Draft LRPP Rule is however not considered by the Commission to limit the options that it may consider in the context of the Congestion Management Review. It is possible that as a result of that Review, the Commission may propose amendments to the LRPP Rule.

The Commission is also mindful of the work of the Energy Reform Implementation Group (ERIG) who are examining the possibility of a national planning approach to transmission. The Commission notes that the ERIG review may ultimately also propose policy initiatives which result in the need for changes to the LRPP Rule.

In considering the LRPP Rule proposal the Commission has identified issues that it seeks comment on from interested stakeholders to assist in its analysis. These issues include:

- whether the Commission should have the flexibility to direct parties to undertake the Regulatory Test in relation to an identified project, or direct parties to identify a project and then undertake the Regulatory Test in relation to that project;
- whether the LRPP Rule provides for directed parties to be able to recover the costs of undertaking the Regulatory Test. If so, how should the directed parties (transmission network service providers ('TNSP's') and non-TNSP's) be able to recover these costs; and
- whether the Commission should be required to seek advice directly from NEMMCO, in addition to the Reliability Panel, when identifying a project that will be subject to a LRPP direction.

The key elements of the Draft LRPP Rule are:

- **Provision of a LRPP to the Commission.** The Draft Rule provides the Commission with a LRPP to direct registered market participants to undertake the Regulatory Test for identified potential transmission projects within the national transmission flow paths and between regions, or to direct a party to identify a potential transmission project for the purpose of subsequently undertaking the Regulatory Test.
- **Inclusion of a purpose clause.** The Draft Rule expresses the purpose of the LRPP - to ensure timely and efficient inter-regional transmission investment for the long term interests of consumers.
- **Requirement to develop a LRPP Guideline.** The Draft Rule requires the Commission to develop a guideline to provide information on its proposed approach to exercising the LRPP.

- **Guidance on the exercise of the LRPP.** The Draft Rule requires the Commission to exercise the LRPP in accordance with the published guideline and consistent with the purpose included in the Draft Rule.
- **Formal procedures.** The Draft Rule requires the Commission to seek advice from the Reliability Panel when identifying a potential transmission project and have regard to the Annual National Transmission Statements ('ANTS') produced by NEMMCO, and the likely costs of the directed party applying the Regulatory Test.

The Commission is particularly mindful that the final LRPP Rule may be amended in the future as a consequence of the Commission's review into Congestion Management.

The Commission considers that the Draft Rule satisfies the statutory requirements provided for in the NEL.

Submissions on the Draft Rule Determination and Draft Rule should be received by 29 January 2007.

Submissions can be sent electronically to [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au) or by mail to;

Australian Energy Market Commission  
PO Box H166  
Australia Square NSW 1215  
Fax (02) 8296 7899

Under section 101 of the NEL, any interested person or body may request that the AEMC hold a hearing in relation to the Draft Rule Determination. Any request must be received by 30 November 2006.

## 2. The MCE's Rule Proposal

On 5 October 2005 the Commission received a Rule change proposal from the Ministerial Council on Energy ('MCE') requesting that the Commission make a Rule to provide for a LRPP. The Proposed Rule seeks to ensure that appropriate consideration is given to transmission investment in circumstances where existing incentives to undertake transmission investment may be lacking. These circumstances may arise where a potential transmission investment results in inter-regional benefits, which would result in positive net benefits to the market as a whole, but which is not economic for any one Network Service Provider operating in one region of the market.

In the remainder of this chapter the MCE Proposed LRPP Rule is summarised. In addition the context for the Proposed Rule is explained, including a discussion of the incentive problem that the Proposed Rule is seeking to address.

### 2.1. Summary of the Rule Proposal

The Proposed Rule would give the Commission the power to direct a market participant to undertake the Regulatory Test<sup>1</sup> in relation to an identified new transmission network investment. The power cannot be used to direct the Regulatory Test to be undertaken for non-transmission projects such as generation or demand side projects. However, because the Regulatory Test provides for an assessment of non-network alternative options, non-network options can be indirectly included in the assessment process arising from the exercise of the proposed LRPP.

The Proposed Rule provides for a process that the Commission would be required to follow in exercising the LRPP. The proposed process requires the Commission to:

- establish and seek advice from a panel of industry representatives prior to exercising the LRPP and when identifying a potential transmission project for the application of the LRPP. The Proposed Rule requires a representative of NEMMCO be included on the panel of industry representatives to provide technical support;
- give notice in writing to direct the relevant party to apply the Regulatory Test for the potential transmission project. The notice may specify one or more of the alternative projects that the directed party must consider when applying the Regulatory Test to the potential transmission projects

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<sup>1</sup> The Regulatory Test is provided for in Rule 5.6.5A and requires a Network Service Provider to undertake a cost benefit analysis of a proposed large network investment, prior to undertaking the investment to ensure that all alternative non-network options are also considered and that efficient transmission investment occurs.

and/or the timeframe in which the Regulatory Test must be carried out;  
and

- publish a statement of its reasons for exercising the LRPP at the same time it issues the notice.

The Rule also requires that the Commission must have regard to:

- the latest two ANTS;
- whether the potential transmission project has previously been subjected to the Regulatory Test and if so, when the Test was carried out and the results of the application of the Test; and
- the likely costs of the directed party in applying the Regulatory Test to an identified potential transmission investment.

The party directed by the Commission in accordance with the Proposed Rule must comply with the notice including any requirements in the notice for consultation, publication of results, and timeframes. Where a directed party fails to comply with the terms of a notice the Proposed Rule allows the Commission to engage a party other than the directed party to apply the Regulatory Test to the potential transmission investment.

The Proposed Rule requires the directed party to publish a report setting out the results of the application of the Regulatory Test to the potential transmission investment. Following the publication of the report any registered market participant may apply to the AER for a determination as to whether the potential transmission project satisfies the Regulatory Test. The AER must use the findings and recommendations of the report and any other material it considers relevant when making its determination.

The MCE outlines in the Rule proposal a number of factors that it considers are relevant to the use of the LRPP. These include that the LRPP:<sup>2</sup>

- *“is expected to be exercised rarely;*
- *is to be exercised only where normal market arrangements have failed to provide efficient and timely incentives for the assessment of transmission projects which might be expected to satisfy the Regulatory Test;*
- *does not extend to directing actual investment to occur; and*
- *only applies to national transmission flow paths under the ANTS that lie between Regional Reference Nodes (ie transmission networks that directly impact inter-regional transfers)”.*

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<sup>2</sup> MCE Rule Proposal p3.

The Proposed Rule however, does not provide for these factors to be explicitly considered when deciding whether to exercise the LRPP.

The power has also been limited to national transmission flowpaths between regional reference nodes.

The MCE has outlined that it intends to amend the NEL to provide a civil penalty for any failure to comply with a direction from the Commission in accordance with the exercise of the Proposed LRPP. An appropriate Regulation prescribing the relevant provision as a civil penalty provision is anticipated to be made in due course.

## **2.2. Context for the requirement of a Last Resort Planning Power**

In its Rule proposal the MCE notes that robust and effective transmission planning processes are integral to the realisation of a national grid as a platform for a competitive NEM.

According to the Rule proposal, current market arrangements and regulatory processes for inter-connector development may not deliver timely and adequate levels of transmission investment as there are no specific requirements that ensure an inter-regional network investment is committed. This is more the case for inter-regional assets as the potential investment is likely to require co-ordination between the effected jurisdictional networks which have caused delays to the application of the Regulatory Test for otherwise potentially economic projects.

Furthermore, the MCE indicates that a key concern with the current framework for the regulation of TNSP's is the incentives for appropriate investment in transmission networks. In its Rule proposal the MCE state that the National Electricity Code provided for state based transmission network planning and investment and, as a result, was relatively piecemeal in nature. This lack of national consistency in planning arrangements is seen as a potential impediment to efficient network investment, particularly between state jurisdictions. Importantly, the Electricity Code provided TNSP's with no obligation to maintain efficient transfer capacity between jurisdictional regions.

The motivation underlying the MCE's LRPP Rule proposal is to provide a mechanism whereby interconnector investment occurs in a timely way, and that an adequate level of inter-regional investment is undertaken. As an inter-regional transmission asset is likely to have a material inter-network impact, a potential investment is likely to require co-ordination between the affected jurisdictional networks. This necessary co-ordination has resulted in significant delays, particularly with undertaking the Regulatory Test, for what are otherwise economically beneficial interconnector projects.

To partly address this issue the MCE, in its 2003 report to the Council of Australian Governments ('COAG'), endorsed a new National Electricity Market (NEM) transmission planning process to improve consistency and transparency surrounding interconnector development, thereby improving the economic efficiency of interconnector projects.

Part of this new process was the development of the Annual National Transmission Statement (ANTS), which is published annually by NEMMCO. The ANTS provides information on the major national transmission flow paths, forecasts interconnector constraints, and identifies options to relieve transmission constraints.

Despite these improved arrangements relating to information provision, the MCE identify in its Rule proposal that the Rules do not provide particular requirements or standards for inter-regional investments (unlike intra-regional investment) which is mostly undertaken to comply with reliability standards). In addition, any inter-regional investment requires a proponent as the obligation for assessing whether a new interconnector satisfies the Regulatory Test for transmission investment resides with the proponent (usually a jurisdictional planning body). As inter-regional assets will have a material inter-network impact, a potential investment is likely to require the consent of both jurisdictions of the impacted networks. This need for co-ordination, while necessary, has prevented and delayed the Regulatory Test being applied to potentially economic inter-regional investment.

Against this background, the MCE's proposal provides the Commission with a LRPP, which allows the Commission to direct TNSP's to undertake the Regulatory Test for potential investments that address constraints affecting major national flow paths when normal market arrangements fail to promote efficient and timely investment to address material network congestion. The Proposed Rule requires the results from the Regulatory Test to be published to inform potential investors about whether an economically viable project exists. While the Rule Proposal does not provide a power to direct a TNSP to undertake an identified investment, by requiring the Regulatory Test to be undertaken, valuable information will be provided to potential investors who may then undertake the investment.

### **2.3. Problems with the incentives in the current Rules**

The Rule proposal states:<sup>3</sup>

*"The LRPP will compliment the ANTS regional boundary arrangements, the regulatory test and congestion management arrangements in encouraging*

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<sup>3</sup> MCE Rule Proposal p7.

*efficient and timely investment in the NEM. When normal market arrangements fail to promote efficient and timely investment to address material network congestion, the LRPP will require the regulatory test to be undertaken."*

*"The requirement that any direction is subject to the cost/benefit process (ie regulatory test), ensures the overarching objective of delivering efficient transmission investment, not simply more transmission regardless of the economics. The regulatory test requires evaluation of non-network options as well as, an important part of the economic efficiency discipline."*

Under the existing market Rules there are few incentives for TNSP's to undertake efficient discretionary investments, particularly when they are not required to meet reliability standards, even though the investment may improve the overall performance of the network, thereby delivering overall market benefits.

There are a number of reasons for the lack of incentives including:

- the focus of TNSP's on within jurisdictional investments, particularly relating to meeting reliability standards;
- the market benefits limb of the Regulatory Test being relatively more difficult to satisfy compared with the reliability limb; and
- non-profit related factors impacting on TNSP's investment decisions.

## **2.4. Economic Problem leading to the need for a Last Resort Planning Power**

The problem that the Rule proposal is seeking to address is the lack of incentives for market participants to make inter-regional investments when they are required. There are a number of identified causes for this lack of incentives, and the Rule proposal provides a framework in the Rules to ensure that appropriate inter-regional investments are examined.

A key reason for the lack of inter-regional investment is problems of co-ordination between jurisdictionally based TNSP's. This in turn leads to delays in the provision of inter-regional investment. The lack of co-ordination arises because TNSP's focus their capital investment programs on meeting their reliability requirements within their area of operations. Inter-regional investment usually has benefits outside of a particular TNSP's jurisdiction meaning that for any one TNSP the benefits may not outweigh the costs, while for the market as a whole there may be positive net benefits.

While the current Rules do provide for a TNSP to recover the costs of investment where the Regulatory Test is satisfied, these costs would only be recovered from a segment of beneficiaries, rather than all beneficiaries because the TNSP can only service customers within its own area of operations. There are provisions in the Rules for jurisdictions to recoup these costs where benefits accrue across

jurisdictions, however in practice, this has rarely occurred and cannot be relied upon to address the incentive problem.

In considering the problem raised by this Rule Proposal, it is necessary to evaluate whether the lack of incentives for inter-regional investment arising within the current Rule framework is sufficient to justify regulatory intervention of the form of the proposed LRPP. In particular, the proposed LRPP Rule needs to be evaluated in light of the incentives anticipated to be created by Rule changes currently being considered by the Commission. These interactions are outlined in the following section.

## **2.5. Related rule change proposals and reviews**

In considering the Proposed Rule the Commission has been mindful that other rule change proposals and reviews are currently being analysed by the Commission and the results of these processes are likely to impact on investment incentives and the operation of the proposed LRPP.

The related rule change proposals and reviews include the:

- Congestion Management Review;
- Transmission Revenue Rule; and
- Reform of the Regulatory Test principles Rule Change.

In addition, ERIG is also considering the problem of investment incentives in the context of the current energy market reforms and is likely to make recommendations relevant to the Proposed LRPP Rule in the near future. ERIG has recently released its November 2006 Discussion Paper.

### **2.5.1. Congestion Management Review**

Transmission network congestion occurs when the available network capacity cannot accommodate the dispatch of the least-cost combination of available generation to meet demand across the network. Congestion management is therefore necessary to maintain the physical and operational security of the power system and has important implications for the spot prices, the degree of competition, the bidding incentives for market participants and the level of price and volume risk borne by participants. In the long term, the manner in which congestion is managed affects the investment decisions of new generators, load, network service providers and the opportunities for alternative energy sources.

The review requires the Commission to examine the feasibility of a constraint management regime as a mechanism for managing material congestion issues, until those issues can be addressed through investment or a region boundary change. The Commission is also required to take into account the relationship between a constraint management regime, constraint formulation, region

boundary review criteria and review triggers, the ANTS flow paths, the LRPP, the Regulatory Test and TNSP revenue and price regulation arrangements.

Currently there are three broad categories of arrangements to manage congestion. These are:

- Rules governing dispatch, including the way the power system is represented in the NEM dispatch engine;
- TNSP incentives, including short term arrangements to promote network availability and long term incentives for transmission investment; and
- Rules governing pricing and settlement, including the way prices are determined and settlement is carried out for each participant in the event of congestion within or between regions.

The proposed MCE staged approach to Congestion Management sees the LRPP as an interventionist step to stimulate investment when normal market arrangements fail. Where infrastructure investment is not stimulated as a result of the LRPP being exercised, the next step in a potential congestion management regime would be a boundary change.

The congestion management review recommendations are likely to impact on the underlying incentives for inter-regional investment in a number of ways with implications for the requirement for a LRPP.

An effective congestion management regime through changes to infrastructure investment incentives is likely to improve the way congestion is managed, which impacts on the identification and timing of inter-regional investments. This might lead to a greater focus by TNSP's to undertake inter-regional investment to resolve congestion issues, leaving limited circumstances in which a LRPP directive would be required.

Similarly the Congestion Management Review could conclude that the time involved in invoking the LRPP may unduly delay the initiation of a boundary change as the ultimate solution for the management of congestion, raising questions about the efficacy of a LRPP.

Irrespective of the implications for the incentives for inter-regional investment arising from the Congestion Management Review, the Commission considers that the LRPP is likely to provide a useful additional mechanism for ensuring that potentially efficient inter-regional investments are examined and considered.

The Commission considers that the LRPP is complimentary to the Congestion Management Review and will form part of the overall strategy to manage transmission constraints. The Commission is mindful however that, following the completion of the Congestion Management Review, the Commission may

make recommendations to amend the LRPP Rule. This would be in accordance with the comprehensive review into incentive mechanisms, and arrangements for managing physical and financial trading risks associated with material network congestion that form the terms of reference of that review. The Commission's Draft Determination and Rule to accept a LRPP should therefore not be considered as limiting the options that the Commission will be considering as part of its recommendations for the Congestion Management Review.

## **2.5.2. Impact of the Transmission Revenue Rule**

The Commission has finalised the Transmission Revenue Rule, which is anticipated to be released by the end of November. The incentive package created in the Revenue Rule enhances the previous framework and includes the following elements;

- the incentive power for capital expenditure efficiencies has been increased by allowing the retention of any additional depreciation allowances in addition to return on capital, if a TNSP underspends relative to its forecast expenditure, and vice versa;
- inclusion of a separate contingent projects regime for capital expenditure for specific large projects triggered by particular events, with an associated incentive mechanism similar to that applicable to other capital expenditure;
- the removal of ex-post reviews of the prudence of actual capital expenditure before it is rolled into the TNSP's regulatory asset base;
- an increase in the service performance incentive cap from one percent to five percent of regulated revenue;
- the formalisation of cost pass through arrangements;
- removing the scope for the AER to re-optimize the regulatory asset base, thereby reducing the risk of regulatory asset stranding; and
- scope for a TNSP to seek to re-open the revenue cap in genuine force majeure circumstances.

The Commission considers that, in combination, these mechanisms provide a balanced package of incentives for TNSP's to invest in and operate their networks efficiently while maintaining the quality and reliability of transmission services. While incentive properties of each element of the suite of incentive mechanisms are important, it is essential to maintain the overall balance of incentive measures.

The Commission however does consider that under the current market arrangements there are few incentives for TNSP's to undertake efficient discretionary investments that are not related to its reliability standards, but which could provide net market benefits through improved performance of the network. Indeed, where there is an investment that is not required for reliability

reasons, a TNSP has a financial disincentive to invest in the project. This is because the TNSP is able to obtain a benefit from deferring the expenditure until the end of a regulatory control period.

If market benefits were considered as part of a contingent project regime, the financial disincentive would be removed as the TNSP could obtain a benefit from minimising the costs of the project. However, the TNSP is still indifferent to the timing of the project and the benefits that undertaking it earlier may have for the performance of the system. In addition, this would not capture projects that fall under the contingent projects threshold.

Some submissions to this Rule proposal have contended that the Commission should focus on providing sufficient incentives for market participants to undertake infrastructure investment that is for a market benefit, rather than introduce a LRPP.

However, the Commission considers that the current incentive framework is unlikely to create the positive incentives necessary to resolve the inter-regional transmission investment problems identified above. This suggests a prima facie case for inclusion in the Rules of a positive incentive to encourage inter-regional investments. The Commission also considers that it is unlikely that the changes to the Transmission Revenue and Pricing Rules arising out of the Commission's review into these matters will create the requisite positive incentives to ameliorate the need for a LRPP.<sup>4</sup>

### **2.5.3. Development of the Regulatory Test Rule**

The MCE has submitted a Rule proposal to the Commission to provide a framework within the Rules for the making of the Regulatory Test by the AER. The Commission published its Draft Determination and Rule in September 2006.

The Regulatory Test is part of the regulatory framework for assessing proposed new network augmentation investment within the Rules. The Test recognises the existence of a unique market failure arising from the vertically separated industry structures operating within the NEM. The market failure arises because new network augmentation investments can have significant external impacts on many, unidentifiable up and down stream market participants, such that ordinary commercial negotiation to resolve these external impacts is not feasible. In addition, there may be scope for non-network solutions to meet reliability requirements, however there is likely to be little or no incentive for TNSP's to consider these alternative options when evaluating a proposed network investment.

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<sup>4</sup> The Commission recognises that there is scope in the current Rules for jurisdictions to negotiate interregional TUOS payments, however, as evidenced through existing practice, this has not been sufficient to solve the incentive problem on its own.

To resolve these market failures the Regulatory Test requires a TNSP to consider any wider market benefits and costs, and alternative non-network options, thereby ensuring that efficient augmentation investments are made.

The key elements of the Draft Regulatory Test Rule are:

- the provision of an improved governance structure for the Test within the Rules. The Commission has adopted the MCE's proposal for Regulatory Test principles to be incorporated into the Rules, to provide an improved framework for its operation;
- explicit guidance on the objectives for the Test. The Commission has determined that the Test principles should provide seven key objectives: economic efficiency, reliability, predictability, competitive neutrality, proportionality, consistency and transparency;
- improved certainty in the application of the Test. The Commission has addressed concerns regarding the assessment of alternative options under the current market benefits limb of the Regulatory Test by proposing a two stage process. First, by requiring a TNSP to publish a request for information on potential alternative options and second, requiring that the 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 practical alternatives.

The Commission considers that this approach addresses the MCE's concerns regarding the potential for economic transmission investments to be deferred and reduces the scope for gaming of the Test. Critically, the Commission is of the view that this approach will reduce the risk of the project being justified as maximising net market benefits, yet failing to be constructed, resulting in sub-optimal outcomes for the market as a whole.

These changes to the framework for the making of the Regulatory Test may improve the current incentive for TNSP's to focus on reliability investments, because the reliability limb of the Test is relatively easier to undertake. By making the market benefits limb simpler, through the provision of an information mechanism for alternative projects and requiring the comparison of the proposed investment against likely alternatives, there should be greater incentives for market participants to undertake the Regulatory Test for inter-regional investments.

The Commission considers that substantive changes to the Regulatory Test to address an apparent bias towards the reliability limb of the test may provide further incentives for market participants to undertake the Test for market benefits purposes. The ERIG is considering these issues and the Commission

acknowledges the recent discussion paper released by ERIG that raises an option to reform the Regulatory Test, in part to address this concern. The option involves replacing the current Regulatory Test and assessment process with a two stage process for identifying and evaluating proposed transmission investments.<sup>5</sup>

The Commission considers that while there are more incentives for market participants to undertake the Regulatory Test through the changes described above, there is still a requirement for an LRPP to address the delays in undertaking the Regulatory Test in regards to interconnectors, in the absence of further reforms to the Regulatory Test.

#### **2.5.4. Energy Reform Implementation Group Review**

In regard to electricity transmission ERIG is reviewing the potential for achieving a fully national transmission network including a truly national approach to the future development of the electricity network, the legitimate commercial interests of asset owners, and the need to promote investment that supports the efficient provision of transmission services. ERIG recently released a number of discussion papers outlining initial views in relation to market structures, transmission and energy financial markets.

A key consideration of ERIG is the need for a national approach to transmission planning including a national planning function. ERIG has identified that inter-regional transmission augmentation can be more complex and costly than intra-regional transmission augmentations as two or more transmission companies need to co-ordinate the project.

ERIG has also commented that the current regulatory arrangements do not provide the appropriate incentives on owners to invest in a timely and economically efficient manner where the investment decision is made by the owner of the monopoly asset and conversely that uncoupling of responsibility for making decisions about the timing and nature of transmission development from grid ownership diminishes accountability over investment decisions and will increase the risk to customers of poor investment decisions.

Recommendations arising from the ERIG review are likely to impact on the need for, and best approach to, the LRPP. The final ERIG recommendations are not expected until early 2007, and will need to be reviewed by the Council of Australian Governments ('COAG') before any resulting decisions for changes to

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<sup>5</sup> Energy Reform implementation Group, November 2006, p139 which indicates that the 2 stage process should be determined on the basis of a set of overall national efficiency objectives which would effectively integrate the two limbs of the current Regulatory Test and seek to develop the network in a manner that maximises net market benefits whilst ensuring that customer reliability standards are maintained.

policy, legislation or Rules are made, and action undertaken to implement them. The ERIG November 2006 Discussion Paper has however raised the possibility of (amongst other changes) a national planning model for the NEM.

The Commission acknowledges that if a national planning model were implemented then the LRPP Rule will need to be re-examined. Depending on the governance arrangements that are adopted, the LRPP may potentially be more appropriately held by a new planning body. As an interim measure, as these policy issues are being developed the LRPP Rule, as considered in this Determination, is a sensible approach given the current regulatory framework.

### 3. Draft Rule Determination

The Commission has determined in accordance with s.99 of the NEL to make the Draft Rule attached to this Draft Determination (Appendix A). The Draft Rule contains some amendments to the Proposed Rule put forward by the MCE. A summary of the differences between the Proposed Rule and the Draft Rule is included in Section 5 of this Draft Rule Determination.

#### 3.1. Commission's power to make Rule

The MCE's Rule change proposal seeks to provide the Commission with a LRPP. The Commission is satisfied that the Draft Rule falls within the subject matter for which the Commission can make Rules set out in s.34 of the NEL. Specifically, the Draft Rule relates to the following items under schedule 1 of the NEL:

- the Proposed Rule is covered by s.34, as it relates to the regulation of both the operation of the NEM and the regulation of the activities of persons including registered participants participating in the NEM or involved in the operation of the national electricity system;
- Item 12 of schedule 1 of the NEL also states that the *"augmentation or expansion in the capacity of transmission systems and distribution systems"* is an allowable subject matter for the National Electricity Rules.

Under s.88 of the NEL, the Commission is only able to make Rules if:

*"It is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity market objective."*

The National Electricity Market objective, as set out in s.7 of the NEL, is to:

*"Promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system."*

This Draft Determination sets out the Commission's reasons for making the Draft Rule. In developing the Draft Rule the Commission has taken into account:

- the Commission's powers under the NEL to make the Rule;
- the proponent's Rule change proposal and proposed Rule;
- submissions received;
- relevant Ministerial Council of Energy ("MCE") statements of policy principles; and

- the Commission's analysis as to the way(s) in which the Draft Rule will, or is likely to, contribute to the achievement of the National Electricity Market objective so that it satisfies the statutory Rule making test.

The Commission has examined the Draft Rule and assessed it against the statutory Rule making test. The Commission is satisfied that the Draft Rule is likely to promote the NEM Objective. Section 4 presents the Commission's reasoning as to the issues raised by the MCE's proposal and how it satisfies the NEM objective and the statutory Rule making test.

### **3.2. Assessment against the NEM Objective**

The Commission is satisfied that the modified version of the Rule change proposed by the MCE will effectively contribute to the promotion of the NEM Objective. In reaching this view, the Commission has assessed the submissions as they relate to the need for a LRPP within the overall incentives for inter-regional investment within the rules.

The LRPP seeks to address a concern that the current incentive framework leads to insufficient investment in inter-regional transmission assets, and therefore results in inefficient transmission investment. The lack of incentives for inter-regional transmission investment arises because the benefits from inter-regional investments are shared between each region, such that it would not be economic for an individual TNSP to undertake the investment.

By directing that the Regulatory Test be undertaken, the resulting information is anticipated to increase the likelihood that an inter-regional investment that delivers positive market benefits will be undertaken. This will result in more efficient transmission investment, that is beneficial to the market as a whole. By implication the LRPP will therefore promote the NEM Objective.

The Draft Rule also provides for a transparent and clear process for exercising the LRPP, directly in the Draft Rule and by a requirement to develop and publish a LRPP Guideline. In addition, the Draft Rule clarifies the purpose for the LRPP to provide additional guidance for the exercise of the discretion inherent in the LRPP. All of these enhancements are expected to improve the operation of the LRPP compared against the MCE Proposed Rule and are therefore also considered to promote the NEM Objective.

### **3.3. Consultation on the MCE proposal**

The MCE submitted its proposal to the Commission on 5 October 2005. On 20 December 2005, the Commission commenced consultation under s.95 of the NEL on the proposal. Consultation closed on 24 February 2006. Given the interrelationship between the LRPP Rule proposal and other Rule proposals under consideration by the Commission, it was decided to issue a notice under

s.107 of the NEL extending the publication of the Draft Determination and Draft Rule until 23 November 2006.

The Commission received 10 submissions at the first round of consultation, which are available on the Commission's website. The Commission received submissions from:

- AGL;
- CS Energy;
- Energy Retailers Association of Australia ('ERAA');
- Ergon Energy;
- National Generators Forum ('NGF');
- Powerlink Queensland;
- TransGrid;
- "The Group" - TRUenergy, International Power, Loy Yang Marketing Management Co, NRG Flinders and AGL;
- VENCORP; and
- NEMMCO

## 4. Commission's analysis of the Proposed Rule

In summary the Proposed Last Resort Planning Power Rule has three key elements:

- First, it provides the Commission with a power to direct a Registered Participant to undertake the Regulatory Test for a potential transmission network project.
- Second, it requires the Commission to seek advice from a panel of industry representatives, including a representative of NEMMCO, and have regard to specific information, when identifying a potential transmission network project that may become the subject of a direction.
- Third, it provides a process that the Commission must follow in exercising the LRPP, including the issuing of a notice of direction, statement of reasons for its decision and providing for circumstances where a directed party fails to comply with a notice issued in accordance with the Proposed Rule.

The Proposed Rule gives the Commission significant discretion to exercise the LRPP. No specific guidance is provided in the Draft Rule to assist the Commission in deciding whether to exercise the LRPP, apart from requirements to seek advice and refer to specified information. The Proposed Rule also does not provide guidance on the approach to the identification of, nor appointment to, the required industry panel.

There are a number of issues that the Commission has examined in detail in developing the Draft Rule. These were:

- who should exercise the LRPP?;
- guidance on the exercise of discretion to use the LRPP; and
- the appropriateness of the proposed LRPP process.

In addition to these general issues, the Commission also examined a number of issues raised in submissions including:

- whether the LRPP should be limited to investments relating to transmission flow paths; and
- who should bear the costs of undertaking the Regulatory Test following a direction in accordance with the LRPP?

This chapter details the Commission's analysis and reasons underlying its Draft LRPP Rule in relation to each of the issues identified above.

## 4.1. Who should exercise the LRPP?

The Rule proposal provides the power for the Commission to exercise the LRPP. From a practical perspective the Rule proposal envisages that the Commission would independently identify and determine whether there might, at any particular time, be a need to exercise the proposed power.

The Commission has examined whether it is the most appropriate entity to have the LRPP, given the need to obtain sufficient information to independently determine whether the LRPP should be exercised. It has concluded that it is appropriate for the LRPP to reside with the Commission, so long as the Rule also provides for the development of a LRPP Guideline that includes a process for market participants to request that the Commission consider an identified potential transmission project.

### 4.1.1. Submissions

A number of submissions commented on whether the LRPP should reside with the Commission compared with other alternatives. A number of submissions argued that the AER was a more appropriate entity to exercise the LRPP.

AGL said:<sup>6</sup>

*“There are a number of related issues in the Rules that relate to network investment, disputes over the application of the regulatory test and payments for regulated assets. The overseeing body for these areas is the AER not the AEMC. Matters of system standards and reliability are also specifically assigned to the Reliability Panel rather than generally to the AEMC. It is not, therefore obvious why the AEMC is given this power rather than the AER or possibly the Reliability Panel.”*

*“AGL considers that the correct role of the AEMC is the assessment of Rules and assessment of the operation of the market and that the LRPP should lie with the AER.”*

The Group and the NGF said:<sup>7</sup>

*“[the Rule proposal] expands the regulatory powers of the AEMC in a way not envisaged in the development of the new NEM governance arrangements, and thus increases regulatory risk, at two levels:*

- Specifically, it increases uncertainty associated with transmission investment, as affected parties will have to second guess not just the likely response of a TNSP to an identified investment project but also the likely response of the AEMC if the TNSP’s response is inaction;”*

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<sup>6</sup> AGL Submission, 24 February 2006, p2

<sup>7</sup> The Group Submission, February 2006, p4 ; NGF Submission, 23 February 2006, p4.

- *“Philosophically, it challenges and upsets the established governance principles of AEMC as “rule maker” and AER as “enforcer” by creating a precedent for the AEMC awarding itself new “executive” regulatory powers on the basis that these promote the NEM objective.”*

#### **4.1.2. Commission’s analysis**

The Commission considers that it is capable of exercising the LRPP as proposed by the MCE, given its Rule making functions and powers conferred under section 29(1) of the NEL.

Section 34 of the NEL provides for the subject matter over which the Commission may make those Rules. Section 34(3)(c)(i) of the NEL provides that the Commission may make Rules that:

*“(c) confer functions or powers on, or leave any matter or thing to be decided by –  
The AER, the AEMC, NEMMCO or a jurisdictional regulator; ...”*

Section 34(d) provides that the Commission may make Rules that:

*“confer rights or impose obligations on any person or a class of person (other than the AER, the AEMC or a jurisdictional regulator)”*

These sections of the NEL allow the Commission to make a Rule that provides the Commission with a power to direct market participants such as the LRPP.

The Commission also has a power under section 29(2) that provides that:

*“the AEMC has power to do all things necessary or convenient to be done for or in connection with the performance of its functions”*

The Commission considers that while the NEM governance arrangements contemplated a separation between the Rule making, regulation and enforcement functions, the Commission does not consider that conferring the LRPP with the Commission is contrary to those arrangements.

The Commission disagrees with the views expressed by AGL that the LRPP should reside with the AER or the Reliability Panel. The LRPP constitutes a direction to institute a regulatory process, (the application of the Regulatory Test), rather than the oversight of the Regulatory Test, which the AER will continue undertake as its regulatory function. The Commission further believes that it would be inappropriate for the AER to have the power to make the Regulatory Test, arbitrate disputes arising from its application, and direct parties to undertake the Test. Proper principles of regulatory governance would require these functions to be split. To provide the AER with a power of direction as well as regulatory and arbitration functions would inappropriately provide the AER

with significant influence over the behaviour of market participants in relation to transmission infrastructure development.

The Commission also notes that the Reliability Panel, which is a constituent part of the Commission, currently possesses similar powers of direction.

The Commission also believes that the insertion of an objective and the publishing of guidelines on the exercise of the discretion, as outlined in section 4.2 below, will minimise any concerns that market participants may have over the exercise of the LRPP by the Commission.

The Commission is mindful that in identifying a project which may lead to an LRPP direction, the Commission proposes to be advised by the Reliability Panel as the relevant industry representative panel. Submissions have pointed out that the Reliability Panel has the necessary technical expertise, and NEMMCO has membership on the Panel. Given a requirement in the Proposed Rule to seek expert technical advice prior to exercising the LRPP, the Commission believes that it will be able to effectively exercise the LRPP as required.

#### **4.1.3. Commission's draft decision**

The Commission has decided that it is appropriate for the LRPP to be conferred on itself, subject to requirements to seek industry advice prior to the exercise of the power, and given the development of guidelines to provide transparency and certainty about the Commission's approach to exercising the power.

## **4.2. Guidance on the exercise of discretion by the Commission**

In line with the Commission's approach in developing the Transmission Revenue and Pricing Rules, the Commission believes it is appropriate to provide guidance for the exercise of its discretion arising from the LRPP Draft Rule. This provides greater transparency and certainty as to the likely exercise of the LRPP amongst market participants.

The Commission's approach in the Draft Rule is to provide that the exercise of the LRPP must be in accordance with guidelines developed by the Commission, and is consistent with a clause within the Draft Rule detailing the purpose for the LRPP.

By the inclusion of a purpose clause in the Draft Rule, and a requirement for the exercise to be undertaken in accordance with guidelines, the Commission is seeking to improve the certainty and transparency of the application of the LRPP. This is considered by the Commission to be an enhancement to the MCE Proposed Rule. These enhancements are not considered to reduce the "*flexibility*

*[of the Commission] to respond to a policy direction from the MCE or autonomously on the basis of market information such as through the ANTS or as otherwise obtained.”<sup>8</sup>*

#### **4.2.1. Submissions**

A number of submissions expressed concern about the proposed Rule having no constraint on the power to exercise the LRPP. Due to a lack of constraint, there is concern that the LRPP may be used more widely than anticipated by the MCE.<sup>9</sup>

TransGrid and Powerlink indicated that<sup>10</sup>:

*“There are no safeguards in the proposed Rule to avoid more widespread use of the last resort planning power than intended by the MCE. It is stated several times in the preamble that this power is to be applied to inter-regional issues and is expected to be exercised ‘when normal market arrangements fail to promote efficient and timely investment to address material network congestion’.”*

Submissions also suggested that limitations should be placed on the use of the LRPP.

AGL said:<sup>11</sup>

*“While the MCE has suggested that there will be limited circumstances when a party other than the TNSP will be directed, the Rule does not limit the LRPP. AGL therefore considers that a directed party should be able to reject the direction if they:*

- *Lack the technical capability;*
- *Are unable to complete the work in a reasonable time; or*
- *Have a conflict of interest.”*

The Group said:<sup>12</sup>

*“AEMC should explicitly be restricted to using the LRPP only in relation to investment projects which have been identified through the ANTS process and which have a high likelihood of being economic;”*

In regard to publishing guidelines the Group said:<sup>13</sup>

*“the AEMC should be required to develop and publish guidelines describing when and how it proposes to use the LRPP – and of course adhere to these;”*

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<sup>8</sup> MCE Rule Proposal, p4.

<sup>9</sup> TransGrid Submission, 24 February 2006, p8; Powerlink Submission, p3.

<sup>10</sup> Ibid.

<sup>11</sup> AGL Submission, 24 February 2006, p2.

<sup>12</sup> The Group Submission, February 2006, p5

<sup>13</sup> Ibid.

*“These guidelines should specifically allow and encourage a voluntary response to the identified investment need, from either regulated or non-regulated investors;”*

#### **4.2.2. Commission’s analysis**

The Commission is mindful that an open-ended discretion to exercise the LRPP provides considerable flexibility to respond to MCE policy initiatives or changes in market requirements. However, the Commission believes that the benefit from providing flexibility to the Commission in the exercise of its discretion needs to be balanced against the need to provide certainty and transparency to market participants.

To achieve this balance the Commission has included in the Draft Rule a requirement that the LRPP can only be exercised:

- in accordance with guidelines to be developed by the Commission; and
- consistent with the purpose of the LRPP as defined in the Draft Rule.

The development of a LRPP guideline by the Commission will provide greater certainty to market participants as to the approach the Commission will undertake in considering whether to exercise the LRPP. The guideline is likely to detail the factors the Commission will take into consideration in exercising the LRPP, greater detail surrounding its process for exercising the LRPP and the regard it will have to advice provided by the industry panel.

The Commission has placed a requirement in the Draft Rule to develop the guidelines by 1 January 2008. In addition, the Draft Rule requires the Commission to follow the transmission consultation procedures developed for the Transmission Revenue Rule.

The Commission considers that requiring the exercise of the LRPP to be consistent with a proposed purpose clause for the LRPP further assists with providing a framework for the exercise of the LRPP discretion. The purpose for the LRPP as provided in the Draft Rule is as follows:

*“the purpose of the last resort planning power is to ensure timely and efficient inter-regional transmission investment for the long term interests of consumers.”*

#### **4.2.3. Commission’s draft decision**

The Commission has decided to include in the Draft LRPP Rule a statement of the purpose for the LRPP and a requirement for the Commission to develop guidelines to outline its proposed approach to exercising the LRPP.

### **4.3. Appropriateness of the proposed LRPP process**

The proposed LRPP Rule provides discretion to the Commission to determine who to direct to undertake the Regulatory Test, to define the relevant project, and to set timeframes associated with undertaking the Test. Each of these elements are discussed further below.

#### **4.3.1. Who should be directed to undertake the Regulatory Test**

The Commission is provided with reasonable discretion in the Proposed Rule to determine who should be directed to undertake the Regulatory Test. This is because the Proposed Rule refers to any market participant being able to be directed to undertake the Regulatory Test.

While it is anticipated that directed parties would be TNSP's, and in some situations generators (ie where improving generation capacity may be the most market effective solution) or planning bodies. Other market participants could also possibly be directed to undertake the Regulatory Test, particularly if the party initially directed fails to comply with the notice to undertake the Test.

The Rule proposal provides the Commission with discretion over who it may direct to conduct the Regulatory Test. The MCE states that it is normally expected that the Commission would direct TNSP's to conduct the Regulatory Test. The Rule proposal however acknowledges that there are circumstances where the Commission may wish to direct other parties to undertake the Regulatory Test for example where there may be a conflict of interest.

The Commission has decided to not specify in the Draft Rule a specific approach to the selection of the party whom is directed in accordance with the LRPP. The Commission believes that this issue can more appropriately be considered in the context of developing the LRPP guideline.

The Rule proposal does not specify whether the Commission can direct more than one party to jointly undertake the Regulatory Test. Infrastructure investment projects for interconnectors may affect parties in each of the affected regions. It may therefore be appropriate in some circumstances for the Regulatory Test to be undertaken jointly between two or more parties. The Draft Rule provides the Commission with scope to direct more than one party to undertake the Regulatory Test as deemed necessary.

The remainder for this section provides the reasons for this draft decision.

##### **4.3.1.1. Submissions**

Most submissions received by the Commission commented on the issue of who should be the directed party. Particularly in light of the fact the Rule proposal

(and similarly the Draft Rule) contained no provisions for cost recovery by directed parties.

The majority of submissions favoured the proposition that the TNSP or jurisdictional planning body from the jurisdiction that is most affected by the need for additional transmission investment infrastructure or most significantly contributes to the constraint in question, should be the directed party in the first instance.

CS Energy said<sup>14</sup>:

*“It is appropriate that the AEMC has suitable discretion and breadth of choice in selecting the appropriate party to undertake the Regulatory Test. The most appropriate parties would usually be TNSP’s and planning bodies who are most affected by the potential project and have the expertise to effectively and efficiently undertake the regulatory test required. If the AEMC identifies good reasons that the most affected party should not be directed then the next most affected party should be directed and so on. There is no justification that, for example, the AEMC might reasonably direct a generator, retailer or MNSP. The proposed Rule should be amended to place appropriate limits on the AEMC’s range of choices.”*

NEMMCO said<sup>15</sup>:

*“[The transmission planning body for any region connected by the national transmission flow path that would be augmented by the project to which the regulatory test is to be applied] should be the directed party – otherwise another TNSP should be the directed party. Only when all these avenues have been exhausted should the AEMC resort to directing other parties to run the Regulatory Test.”*

Ergon Energy said<sup>16</sup>:

*“The ‘directed party’ should be a transmission network service provider (TNSP). TNSP’s are appropriately equipped to efficiently act on a LRPP direction given their experience in undertaking the regulatory test and access to relevant data. By only engaging TNSP’s it should ensure LRPP assessments are conducted efficiently and in a timely manner.”*

Powerlink said<sup>17</sup>:

*“Powerlink also believes that the Rules should require that the directed party is the most likely proponent of any notional augmentation, ie the body (or bodies)*

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<sup>14</sup> CS Energy Submission, 24 February 2006, p1.

<sup>15</sup> NEMMCO Submission, 24 February 2006, p2

<sup>16</sup> Ergon Energy Submission, 24 February 2006, p1.

<sup>17</sup> Powerlink Submission, 24 February 2006, p4.

*whose network most significantly contributes to the constraint in question. Such Network Service Providers have the experience of carrying out regulatory tests and would have relevant expertise and local technical data to undertake the regulatory test assessments effectively and efficiently. It would appear inappropriate to engage a third party registered participant to undertake such assessments and in so doing incur the unrecoverable costs of complying with the direction."*

The NGF said<sup>18</sup>:

*"it is the NGF's view that generators should be excluded from being directed because the Rule is directed primarily at correcting for failures of the regulated investment process which, as the MCE proposal notes, could be due to":*

- *"The failure of the TNSP's regulatory or policy framework;*
- *TNSP's or jurisdictional planning bodies that do not behave rationally;*
- *The TNSP's or jurisdictional planning bodies not undertaking the regulatory test because they believe that the particular investment would not pass the test.*

*"None of these failures are due to any action or inaction on the part of generators, furthermore this is an area where generators are unlikely to have sufficient expertise or resources to carry out the assessment. The inclusion of generators as a class only for the purpose of addressing conflicts of interests is therefore unlikely to be helpful.*

*"In addition the application of costs and penalties to a generator as a Directed participant will not achieve the MCE objective of establishing appropriate incentives for participants that are in fact responsible for applying the Regulatory Test (eg transmission network service providers).*

*"Other ways of addressing the issue are:*

- *The power to direct should only apply to those participants undertaking regulated investment, this is consistent with the MCE view that "it is expected that the AEMC normally would direct the TNSP's", or alternatively,*
- *If generators are directed to undertake the test they should be compensated with full cost recovery for so doing."*

The Group said<sup>19</sup>:

*"the Rules should make clear which party or parties may be directed using the LRPP. One would expect that this would be only the TNSP or TNSP's with transmission franchises in the location of the investment project."*

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<sup>18</sup> NGF Submission, 24 February 2006, p4.

<sup>19</sup> Group Submission, February 2006, p5.

In relation to the possible direction of third party's the Group submitted that<sup>20</sup>:

*"We have previously suggested to the AEMC that any suitably qualified third party should be entitled to:*

- *Request that a TNSP submit an identified project to the Test, so long as the TNSP's direct costs are covered;*
- *Itself submit an identified project to the Test where the relevant TNSP has declined to do so; and*
- *Develop an efficient project which a TNSP has declined to develop, and receive regulated revenue for that project on the same terms as those for a TNSP."*

*"We believe that such enhanced contestability will encourage a TNSP to develop economic projects and, where it declines to do so, will allow a third party to develop the project itself. Importantly, this is achieved without increasing the scope of regulatory intervention or the level of regulatory risk."*

VENCORP said<sup>21</sup>:

*"VENCORP believes that the rules should be amended to identify the relevant TNSP (ie the TNSP whose region the potential transmission project may be constructed within) as the directed party in the first instance".*

*"In accordance with the proposed Rules, if the party first fails to undertake or complete the project the AEMC may then direct a second party to undertake the regulatory test. The process the AEMC would use to select and engage the second party under clause 5.6.5B(g) is not specified and requires clarification."*

The ERAA said<sup>22</sup>:

*"the ERAA is concerned that the proposal under consideration allows the AEMC to direct any registered participant to undertake the regulatory test. This could potentially lead to the situation where a business with no experience in and no desire or capability to invest in transmission is directed under the LRPP...*

*...TNSP's are also best positioned to act on a positive outcome from the regulatory test due to their primary roles as providers of transmission network infrastructure in the NEM."*

#### 4.3.1.2. Commission's analysis

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<sup>20</sup> Group Submission, February 2006, p6.

<sup>21</sup> VENCORP Submission, 24 February 2006, p1.

<sup>22</sup> ERAA Submission, 24 February 2006, p1.

For interconnectors that operate between regions, the Commission considers that it may be difficult to identify one party to undertake the Regulatory Test. There may be affected parties in either of the affected regions, or more than one affected party in a region. In these circumstances it would make sense for each of the directed parties to jointly undertake the Regulatory Test. In some circumstances it may be the case that different parties may individually undertake the Regulatory Test in regards to the same identified transmission project.

The Commission has therefore provided in the Draft Rule for the direction to undertake the Regulatory Test to apply to one or more parties. The Commission considers that whether, in the particular circumstances where the LRPP is exercised, the parties are directed to jointly or individually undertake the Regulatory Test, would be decided on a case by case basis and how the direction would operate in a practical sense would be a matter for the directed parties to determine.

In regards to who should be directed to undertake the Regulatory Test the Commission considers that in most instances, either a TNSP or jurisdictional planning body would be directed to undertake the Regulatory Test in accordance with the LRPP Rule.

The Commission however does not believe that it is either necessary or appropriate to include in the Draft Rule specific requirements on who should be directed to undertake the Regulatory Test following a decision to exercise the LRPP. In particular, the Commission believes that these details relate to the implementation of the LRPP and are therefore more appropriately addressed within the guidelines. Many of the comments made in submissions will therefore be relevant to the development of the LRPP guideline.

Similarly, the process by which a market participant may propose a potential transmission project for consideration by the Commission for the exercise of the LRPP as suggested by the Group, need not be specified in the Rule. How the Commission identifies potential transmission projects for further consideration can be developed in greater detail in the LRPP guideline. Interested stakeholders will have an opportunity to comment on these guidelines in accordance with the guideline consultation requirements specified in the Draft Rule.

#### 4.3.1.3. Commission's draft decision

The Commission has decided that the LRPP Rule should provide for the Commission to be able to direct more than one party to undertake the Regulatory Test.

In regards to the question of who should be directed to undertake the Regulatory Test the Commission has decided to not provide criteria in the Draft Rule

specifying who should undertake the Regulatory Test if directed to in accordance with the Draft Rule. These matters are considered by the Commission to be issues of implementation best left to formulation through the development of the LRPP guidelines.

#### **4.3.2. Identification of the relevant project and the role of the industry panel**

Under the Proposed Rule, the Commission must identify potential transmission projects with the assistance and advice from a panel of industry experts. The proposed Rule does not specify how these experts should be appointed, who should be appointed, or who should appoint the panel. It does provide that a representative from NEMMCO must be on the panel.

The Commission has the power to appoint the panel pursuant to section 39 of the NEL, which allows the Commission to appoint committees to assist it with the performance of its functions. The Commission has decided however that it is unnecessary to appoint a new specific industry panel to advise it for the LRPP. The Commission has instead decided for the Draft Rule to provide for the Reliability Panel to act as the industry panel for the purposes of providing advice on the LRPP. The Reliability Panel has already been established under section 38 of the NEL, and clause 8.8 of the Rules. The conduct, representation, and funding of the Reliability Panel have already been provided for in the NEL and the Rules. The Commission is interested in receiving submissions related to this draft decision.

The proposed Rule also provides the Commission with the power to specify alternative projects to be considered when undertaking the Regulatory Test. This power represents an extension to the Regulatory Test process where the proponent identifies viable alternatives. The directed party therefore is not only directed to undertake the Regulatory Test in regards to a certain transmission project but may also be directed on which alternative options it must also consider.

##### **4.3.2.1. Submissions**

A number of submissions received by the Commission expressed concern about the MCE's Proposed Rule in relation to the requirement for the Commission to identify the potential transmission project and the role of the expert panel in this assessment.

NEMMCO indicated that<sup>23</sup>:

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<sup>23</sup> NEMMCO Submission, 24 February 2006, p3.

*“Considerably more study is required to refine conceptual augmentations published in the ANTS to projects able to be assessed under the regulatory test. This work is generally performed by the relevant TNSP’s. The Panel would need to have access to information held by TNSP’s to ensure any project put forward is sufficiently developed to allow assessment under the regulatory test. This information may also include information regarding the feasibility of the project (for example, information regarding existing easements, etc). Consideration should be given to providing means of ensuring the Panel has access to the required information.”*

They suggest that the task of identifying the potential transmission project is likely to be involved and require detailed information. It is for this reason that a number of TNSP’s indicate in their submissions that it would be impractical and inappropriate for the Commission to identify specific transmission projects.<sup>24</sup>

For example Powerlink believes:<sup>25</sup>

*“that it is impractical to require the AEMC to identify actual projects and determine whether they would alleviate the forecast constraints. This is a very resource intensive exercise in inter-regional planning which the AEMC should not be expected to undertake before exercising the last resort planning power.”*

*“Powerlink proposes that the AEMC should be able to exercise the power based on constraints identified in the ANTS, while leaving it to the directed party to identify the options to be assessed.*

*“Powerlink believes that the use of the term project should be replaced, as it is misleading regarding the purpose of the Regulatory Test. The Regulatory Test is not applied to a primary project, but to a range of options with a recommended new asset being the outcome of the test. A single project is only arrived at after the Regulatory Test is completed, when an application to establish a new large network asset is made, ie the outcome of the Regulatory Test must not be pre-empted.”*

VENCorp comments on the scope and role of the panel of industry representatives as provided in the Proposed Rule. In particular they indicate that<sup>26</sup>:

*“First the draft Rules are unclear on how the industry –panel is to be funded and, as previously stated VENCorp believes this should be clarified.”*

*“Second, the discussion paper indicates that the representatives should be registered participants and include NEMMCO. The Rules however are silent on which participants and participant categories are represented on this Panel.*

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<sup>24</sup> Powerlink Submission, 24 February 2006, p3; TransGrid Submission, 24 February 2006 p9.

<sup>25</sup> Ibid.

<sup>26</sup> VENCorp Submission, 24 February 2006, p2

*Arguably, the panel should not be limited to Registered Participants, as there “may be a requirement for specialist skills (eg economic, engineering) that do not lie with a registered participant, or for which the AEMC wishes to have independent advice. Therefore VENCORP believe that the membership of this industry panel should be clarified within the Rules.*

*“Third the proposed Rules are silent on how the panel should conduct itself or provide advice to the AEMC. VENCORP suggests that industry and participants could be consulted on establishing a Terms of Reference for the panel, which should also be embedded in the Rules.”*

#### 4.3.2.2. Commission’s analysis

The submissions in relation to the requirement for the Commission to identify a specific potential transmission project for the exercise of the LRPP raise a fundamental question about the role of the power in the overall regime for the management of transmission congestion.

The Proposed Rule envisages that the Commission identify a specific potential transmission project. A reason why the Proposed Rule requires the Commission to identify the specific project could be because allowing a directed party to identify the project to address a particular transmission problem may result in projects that are likely to fail the Regulatory Test being identified. In essence, the fact that the LRPP is being exercised suggests that there are insufficient incentives on a TNSP to undertake the Regulatory Test to identify the most efficient investment to resolve the identified inter-regional congestion problem. It would therefore be inappropriate for the LRPP to simply ask the directed party to identify the most efficient investment solution, in the absence of specific guidance from the Commission.

The difficulty with this approach however, as NEMMCO identify, is that the Commission may lack sufficient information and technical expertise to scope and specify a potential transmission project. To ensure that the Commission is sufficiently informed and provided with technical expertise to identify and scope a potential transmission project, the Commission would need to rely on advice from technical experts through the proposed advice from the industry panel, and also any other technical assistance it would require.

In considering these points the Commission is of the view that a flexible approach would be the most suitable way forward. It would appear in some instances the best approach would be for the Commission to identify particular projects whereas in other instances it may be more appropriate for the directed party to undertake the identification process and then apply the Regulatory Test.

The Commission therefore considers that the Draft LRPP Rule should provide the Commission with the power to both direct parties in relation to a project

identified by the Commission, or direct parties to identify a project and then undertake the Regulatory Test. The Commission is seeking comments on the appropriateness of this approach from interested stakeholders.

The proposed LRPP Guideline would provide greater detail as to the approach the Commission would take to the identification of the potential transmission project for the purposes of exercising the LRPP.

The Commission is also mindful of the need to maximise its own efficiency in its operations and has therefore decided to provide for the Reliability Panel as the requisite industry panel for the purposes of providing advice on the exercise of the LRPP. The Reliability Panel satisfies the Proposed Rule requirement that NEMMCO be involved in providing advice to the Commission in relation to the LRPP.

Under the NEL, the Commission is required to establish a Reliability Panel where its requisite composition is set out in the Rules (Chapter 8). Sections 34 and 38 of the NEL specifically allow the AEMC to make Rules that confer functions on the Reliability Panel. The Reliability Panel has statutory functions and powers under the NEL and the Rules including to provide advice in relation to the safety, security and reliability of the national electricity system.

The Reliability Panel has been set up to provide technical and expert advice on particular aspects of the market as the Commission considers necessary. Providing reports and information to the Commission on the safety, security and reliability of the market is an existing requirement on the Reliability Panel. As such, by giving the role of technical advisor to the Reliability Panel in the context of the LRPP, the Commission is drawing on a well established and tested advisory structure that is already in existence.

To facilitate the operations of the Reliability Panel as the provider of advice in accordance with the Draft LRPP Rule, the Commission intends to develop in the LRPP Guideline the terms of reference for the Panel in relation to this new role.

The Reliability Panel currently carries out functions that require technical expertise of the sort needed to advise the Commission in relation to an identified project. The panel draws on both the experience of its members and on technical subcommittees that it is able to engage to source this expertise and is therefore capable of conducting the analysis required by the draft LRPP Rule.

The Rule proposal provided for a representative from NEMMCO to be on the proposed industry panel. As the Reliability Panel includes a member of NEMMCO, by using the Reliability Panel as the industry panel this requirement is satisfied. There may however be some merit in the Commission being required in the Rule to obtain advice from NEMMCO, independently from the Reliability Panel. The Commission is seeking comments on whether the Commission be

required in the Rule to seek advice from NEMMCO in addition to seeking advice from the Reliability Panel when identifying a project or transmission constraint for the exercise of the LRPP.

#### 4.3.2.3. Commission's draft decision

The Commission has decided to maintain a requirement in the Draft Rule for the LRPP to provide for a direction to undertake the Regulatory Test for a potential transmission project and has also decided to clarify the scope of the Rule proposal to allow the Commission to direct a party to identify a transmission project and then undertake the Regulatory Test. The Commission has also decided to provide for the Reliability Panel as the requisite entity that the Commission must seek advice from when identifying a potential transmission project for the purposes of the LRPP. The Commission is seeking comment from interested stakeholders on whether the LRPP Rule should require the Commission to seek advice from NEMMCO in addition to the Reliability Panel prior to exercising the LRPP.

### 4.3.3. Timeframes and conduct

The Rule proposal provides the Commission with the power to set timeframes for the completion of the Regulatory Test. Currently the proposed Rule provides that where the timeframe is not met the Commission has the power to direct another party to undertake the Regulatory Test. The proposed Rule otherwise does not provide any consequences associated with a directed party not subsequently undertaking the Regulatory Test. This is likely to mean that there is insufficient incentives on the initially directed party to comply with the Commission's timeframes. The MCE's intention is to introduce civil penalty's in the future to prevent breaches of timeframes.

#### 4.3.3.1. Submissions

A number of submissions indicated that the Proposed Rule does not provide any guidance on the timeframe that a directed party should undertake the Regulatory Test for the purposes of a notice issued in accordance with the LRPP.<sup>27</sup>

NEMMCO indicates that<sup>28</sup>:

*"Some projects may be more advanced than others in terms of their specification of scope, impact on network limitations and costs, as well as in assessments of feasibility. Consideration should be given to all of these aspects in the establishment of the timeframe. NEMMCO suggests Rules require the AEMC*

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<sup>27</sup> NEMMCO Submission, 24 February 2006, p4; TransGrid Submission, 24 February 2006, p8; Powerlink Submissions, 24 February 2006, p4.

<sup>28</sup> NEMMCO Submission, 24 February, 2006, p4.

*take advice from relevant parties such as the directed party and the panel of industry experts when deciding the timeframe."*

VENCorp believes that the timeframe established by the AEMC for the directed party to carry out the Regulatory Test should be reasonable and therefore believes that clause 5.6.5B(e)(ii) should be amended to – "*a reasonable timeframe in which the regulatory test must be carried out by the directed party.*"<sup>29</sup>

#### 4.3.3.2. Commission's analysis

The Commission believes that timeframes are essential in any process as it provides incentives for the timely completion of the required task. These timeframes should however be appropriate to the specific circumstances arising in respect of a particular proposed exercise of the LRPP.

The Commission believes that it is therefore appropriate for the notice directing a party to undertake the Regulatory Test to provide a timeframe within which it should be completed. While the Commission intends to include in the LRPP Guideline the factors that it would take into consideration in deciding on the appropriate timeframe, the factors outlined by NEMMCO relating to the scope of the potential project, its anticipated impact and likely costs and benefits are likely to be a starting point.

#### 4.3.3.3. Commission's draft decision

The Commission intends to provide further guidance within the LRPP guideline on the factors to be considered when deciding on the timeframe for completion of the directed Regulatory Test for an identified potential transmission project. The Draft Rule provides a requirement that the notice issued directing a party should specify this timeframe.

## **4.4. Limiting the LRPP to National Transmission Flow Paths**

In line with the Proposed Rule, the Draft LRPP Rule is limited to only apply to investments relating to constraints within the national transmission flow paths between regional reference nodes as defined in the Rules. This recognises that the purpose of the proposed LRPP is to address concerns regarding the incentives for investment within these national transmission flow paths between regions, rather than investments within a region.

### **4.4.1. Submissions**

AGL indicated in its submission that the LRPP should not be restricted to inter-regional links. Its view is that all major flow paths identified by the ANTS should be subject to this power since they impact on the efficient operation of the

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<sup>29</sup> VENCORP Submission, 24 February 2006, p4

market and therefore the long term interests of customers in terms of price and reliability.

#### **4.4.2. Commission's analysis**

The Commission believes that the LRPP should be limited to investments to relieve constraints within the national transmission flow paths between regions as proposed by the MCE. While intra-regional congestion can contribute to inter-regional congestion the Commission considers that the Congestion Management Review will examine this matter and recommend appropriate responses. In the meantime the Commission considers that limiting the LRPP to national transmission flowpaths is appropriate as this recognises the underlying incentive problem that the Rule proposal is seeking to address.

#### **4.4.3. Commission's draft decision**

The Commission has accepted the MCE Proposal to limit the application of the LRPP to investments relating to constraints within the national transmission flow paths between inter-regional reference nodes.

### **4.5. Recovery of the costs associated with a LRPP direction**

An issue raised in a number of submissions was whether a directed party should be able to recover the costs associated with undertaking the Regulatory Test.

The Commission has decided that it is unnecessary for the Draft Rule to provide separate provisions for the recovery of the costs associated with undertaking the Regulatory Test. The undertaking of the Regulatory Test as directed by the LRPP, if the directed party is a TNSP, is part of the normal business operations for a TNSP. These costs would therefore be included in regulated costs passed onto prices paid by network users.

If the directed party is not a TNSP however, some consideration would need to be given to the costs of undertaking the Regulatory Test by that party. This would best be resolved on a case by case basis. The Commission will develop some guidance on this issue in the context of developing the LRPP Guideline.

The Draft Rule provides for the Commission to take into consideration the costs of undertaking the Regulatory Test prior to exercising the LRPP.

#### 4.5.1. Submissions

A number of submissions were received in relation to who should bear the costs of undertaking the directed Regulatory Test. In general, submissions supported the directed party being able to recover the costs associated with the direction.<sup>30</sup>

NEMMCO indicated that<sup>31</sup>:

*it supports the MCE's proposal that costs of undertaking the Regulatory Test should be borne by the directed party to the extent that the directed party is the relevant TNSP. However, NEMMCO believes that requiring a directed party who is not the relevant TNSP to bear the costs of the application of the Regulatory Test would not be appropriate.*

TransGrid indicated that<sup>32</sup>:

*it needs to be made clear within the Rule that all reasonable costs imposed on TNSP's by this process are to be passed through as adjustments to regulated revenue caps. To do otherwise would be inconsistent with NEL provisions entitling TNSP's to a reasonable opportunity to recover costs associated with meeting a service obligation.*

#### 4.5.2. Commission's analysis

While the MCE Proposed Rule does not provide for the recovery of costs associated with a direction in accordance with the Proposed Rule, it envisages in the Rule proposal that these costs would be borne by the directed party.<sup>33</sup>

For a directed TNSP, these costs would be part of the ordinary operations of the business and could therefore be included in regulated revenue caps. The costs associated with fulfilling a direction are unlikely to be so large as to justify a direct pass through of these costs into regulated charges during a regulatory control period.

For a directed registered participant that is not a TNSP, the Commission is required in the Draft Rule to consider the costs associated with undertaking the directed Regulatory Test prior to exercising the LRPP. However, the Commission would also need to consider issues associated with cost recovery in these circumstances. One option is that this be undertaken on a case by case basis, guidance for which can be outlined in the LRPP guideline.

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<sup>30</sup> NEMMCO Submission, 24 February 2006, p3; Powerlink Submission, 24 February 2006, p4; TransGrid Submission, 24 February 2006, p8,9; AGL Submission, 24 February 2006, p2; NGF Submission 23 February 2006, p6;; VENC Corp Submission, 24 February 2006, p2,3.

<sup>31</sup> NEMMCO Submission, 24 February 2006, p3.

<sup>32</sup> TransGrid Submission, 24 February 2006, p9.

<sup>33</sup> MCE Rule Proposal p6,7.

The Commission invites submissions on the issue of whether provisions for cost recovery are appropriate for party's directed to sit the Regulatory Test. The Commission is interested in comments as to whether these provisions be made part of the LRPP Rule or be included in the guideline. The Commission is also seeking comments on the appropriate approach to recovery of costs for both directed TNSP's and non TNSP's, in the event that provisions for cost recovery are considered appropriate.

#### **4.5.3. Commission's draft decision**

The Commission has decided to not specify in the Draft Rule the approach to recovery of the costs of a direction in accordance with the LRPP. The Commission is seeking comments on whether it is appropriate for provision for the recovery of costs be included in the LRRP Rule, or in the guideline for exercising the LRPP. The Commission is also seeking comment on the appropriate mechanism to recover the costs for directed TNSP's and directed non-TNSP's.

## 5. Differences between the Proposed Rule and the Draft Rule

The Commission has largely adopted the substance of the MCE's proposed Rule subject to some modifications, enhancements and minor editorial drafting amendments. The Commission has included the provisions dealing with the LRPP in clause 5.6.4. The key differences between the Proposed Rule and the Draft Rule are that the Draft Rule contains:

- the inclusion of a purpose clause which expresses the purpose of the LRPP (to ensure timely and efficient inter-regional transmission investment for the long term interests of consumers). This aids in guiding the discretion of the Commission in exercising the LRPP.
- Requirement to develop LRPP guidelines to provide information on the Commission's proposed approach to exercising the LRPP, and a requirement that the Commission exercise the LRPP in accordance with the published guidelines. The guideline is required to be developed in accordance with the transmission consultation procedures recently introduced into the Rules by the National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18. The first LRPP guidelines should be in place by 1 January 2008.
- A requirement that the Commission seek the advice of the Reliability Panel when identifying a potential transmission project. The requirement has removed the specific additional requirement for NEMMCO to be part of the group providing advice as NEMMCO is a required Reliability Panel member under the Rules.
- Inclusion of the Commission's power to direct a Registered Participant to identify a potential transmission project where the Commission cannot or does not identify a specific transmission project. The Commission is required to take into account the same matters that it must consider when exercising the LRPP.
- Requirement on the Commission to publish annually a report which documents the matters that the Commission has considered during the year in deciding whether to exercise the LRPP.
- Modifying the LRPP to allow the Commission to direct one or more Registered Participant to apply the Regulatory Test.

- The Commission may also include consultation and publication requirements on the Registered Participant in addition to the consultation and publication requirements under the Regulatory Test.
- The Commission removed the proposed clause that requires the Commission to consider whether the potential transmission project has previously been subjected to the Regulatory Test. The Commission considers that such a requirement will be difficult to apply.
- The proposed Rule also included provisions that required the directed party to publish a report regarding the application of the Regulatory Test and also to seek a determination from the AER that the project satisfies the Regulatory Test. The Commission has decided not to adopt these clauses as the Commission considers that the current reporting provisions in the Rules and the Regulatory Test already adequately address this issue.

# **Attachment 1: Draft Rule**