

Australian Energy Market Commission

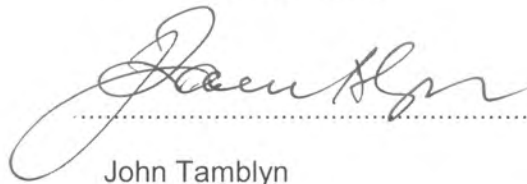
Draft Rule Determination

Draft National Electricity Amendment (Transmission network replacement and reconfiguration) Rule 2006

Proponent: Stanwell Corporation Ltd

Date: 26 October 2006

Signed:

A handwritten signature in black ink, appearing to read 'John Tamblyn', is written over a horizontal dotted line.

John Tamblyn

Chairman

For and on behalf of:

Australian Energy Market Commission

Commissioners: Tamblyn

Woodward

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1. Summary

On 17 May 2006 Stanwell Corporation Ltd ('Stanwell') lodged a Rule change proposal ('the Proposed Rule') with the Australian Energy Market Commission ('the Commission') to address concerns regarding the scope for transmission network service providers ('TNSPs') to reconfigure the transmission network, without consideration of third party impacts. Stanwell argued that there was significant potential for inefficient investments to be made in these circumstances, justifying the introduction of the proposed rule to further promote the National Energy Market ('NEM') objective, which, amongst other things, requires the promotion of efficient investment.

In brief, the Proposed Reconfiguration Rule has three elements. First, the Proposed Rule requires a TNSP to undertake the Regulatory Test for all reconfiguration investments. Second, if the Regulatory Test is passed, any third parties that are negatively impacted from the reconfiguration would be entitled to compensation. Third, the Proposed Rule provides for a TNSP to provide information to the market when it is proposing to undertake a reconfiguration of the network.

The Rule Change has been proposed by Stanwell in order to:¹

- (a) decrease the riskiness of already risky investments in establishing, maintaining and expanding generation facilities such that generators have an incentive to behave efficiently;
- (b) ensure that decisions regarding replacement or reconfiguration of transmission networks are transparent so as to promote efficient network planning decisions; and
- (c) ensure that the costs incurred or profit foregone by generators as a result of network reconfiguration are recognised and compensation is payable as a result, in order to ensure that efficient investment is not deterred.

The Commission sought submissions on the Proposed Rule and has considered the issues raised in conjunction with undertaking its own analysis. As a result of this analysis, the Commission has determined to proceed with a Draft Rule which accepts Stanwell's fundamental proposal that the Regulatory Test should be applied to network reconfigurations, but implements a number of modifications to the proposal. These modifications include extension of the proposal to include network replacements and an increase in the threshold for affected projects. The Draft Rule also excludes Stanwell's proposal that a compensation regime be introduced for market participants affected by reconfiguration or replacement decisions.

The Commission believes that the Draft Rule will promote the NEM Objective and this Draft Determination outlines in detail the Commission's reasons for its approach in the Draft Transmission Network Replacement and Reconfiguration Rule.

¹ Stanwell Corporation Rule Change Proposal, 17 May 2006, p4

2. Stanwell's Rule Proposal

On 17 May 2006, Stanwell Corporation lodged a Rule Change Proposal with the AEMC seeking the establishment of a "comprehensive inter-participant framework for addressing network replacement or reconfiguration".² Under this proposal, the Regulatory Test would be extended to apply to any proposed reconfigurations or replacements of network assets not captured by the definition of augmentation under the Rules. In addition, affected third parties would be entitled to be compensated for foregone revenue as a result of the reconfiguration or replacement.

The Proposal is intended to address what Stanwell believes is a gap in the Rules regarding transmission investments. Under the National Electricity Rules, TNSPs are required to undertake the Regulatory Test when making transmission asset investments that constitute an augmentation of the network; however this same requirement is not applicable to reconfiguration or replacement of network components or assets. Stanwell's proposal is concerned with ensuring that networks and network users are presented with accurate signals when making locational decisions, and addressing what it perceives to be an asymmetric risk faced by generators arising out of potential reconfiguration decisions by TNSPs.

2.1. Request to Expedite the Rule Change

In a letter of 2 June 2006, Stanwell requested that the Rule change proposal be handled as a matter to be expedited under section 96 of the NEL on the basis that:

- The Rule change is urgently required because it has an existing generation asset that in the very near term may, as a result of a foreshadowed network reconfiguration, become unable to provide system restart ancillary service payments; and
- The Rule change is non-controversial as
 - it will not impose an unreasonable burden on TNSPs;
 - any TNSP costs would be recoverable through the revenue cap and/or positive pass through mechanism; and
 - the proposal is likely to lower electricity costs where risks in the electricity supply chain are reduced.

The Commission considered Stanwell's request and concluded that, while Stanwell may be adversely impacted if the proposed network reconfiguration proceeds, the situation does not represent an imminent threat to the wholesale exchange or the safety, security or reliability of the national electricity system..

The Commission also concluded that the Rule was not non-controversial because:

- the process is likely to increase the regulatory burden on TNSPs due to the increased requirement for the application of the Regulatory Test;

² Stanwell Corporation Rule Change Proposal, 17 May 2006, p1

- the proposed regime for the provision of compensation to adversely affected participants would likely be controversial as it is contrary to the principle of open access; and
- the inclusion of a compensation regime had the potential to raise, rather than lower, electricity costs depending on the relative size of the compensation compared to the reduction in risks to the supply chain.

Consequently, the Commission concluded that it was not appropriate for the Rule Change to proceed under an expedited process.

2.2. Summary of the Rule Proposal

Under Stanwell's revised proposal:

- (a) The Regulatory Test must be undertaken not only in the context of augmentation of the network but also where there is a network reconfiguration with a value greater of \$10 million, or where a network user has identified themselves as being financially disadvantaged by the proposed reconfiguration in the order to \$1 million or more. The application of the Regulatory Test would encompass consultation procedures.
- (b) Compensation would be payable to generators where they incur cost or forgo profit as a result of a network reconfiguration, unless this is accounted for under an existing agreement between the TNSP and the affected party.
- (c) A mechanism would be implemented which allows TNSPs to recoup the cost of the compensation payable as a result of network reconfiguration via the TNSP revenue cap calculation and in-period via a "positive pass through" mechanism.

2.3. Key Issues Addressed by the Proposal

Stanwell has identified three specific issues that it seeks to address in the Rule Change Proposal.

2.3.1. Location decisions

The location of a generation investment impacts considerably on the profitability of the investment. Given the long-run nature of generation investments and their high cost, location decisions are therefore of critical importance.

Location impacts on generator profitability because of the features of the transmission network where it is connected. These features include its capacity, reliability and the effective cost of evacuating power through the network.

Stanwell believes that the NEM Objective will be promoted by providing generators and network users with accurate market signals to allow decisions about the location of generation investment and large load investment to be made efficiently. The Proposed Rule is designed to allow generators and other third parties to manage the risks that arise from decisions by TNSPs to replace or reconfigure the transmission network.

2.3.2. Mitigation of risk

The second issue identified by Stanwell relates to the risks that may arise from a reconfiguration for generators. The first relates to a reconfiguration that results in the reclassification of previously shared network assets as connection assets. In accordance with the requirements in the Draft Revenue Rule, this may allow the TNSP to seek to recover the costs from an individual generator.

The second relates to a reconfiguration where a generator loses the ability to provide services, such as system restart, or its ability to maintain a level of reliability of supply as a result of the loss of access to points of access. In this circumstance a reconfiguration creates significant risks on the revenue of a generator.

As the issue of reclassification of shared network assets is addressed as part of the current review of Transmission Revenue and Pricing (Chapter 6), Stanwell's proposal focuses on an approach to mitigate the risks arising from a reconfiguration that impacts on generator revenue.

2.3.3. Asymmetrical application of the Regulatory Test

The final issue identified by Stanwell relates to the asymmetric application of the Regulatory Test.

A fundamental principle underpinning Stanwell's proposal is ensuring that the same decision making standards apply to significant new investments to augment the network and significant investments to reconfigure the network. In the absence of this symmetrical application of the Regulatory Test, Stanwell believes that network owner and operator incentives are distorted. The age profile of transmission networks assets, as well as factors such as shifts in usage, changes in terrain or variations in land use and network routing controls have the potential to result in an increasing number of large scale transmission investments by TNSPs that are not captured by the definition of augmentation under the current Rules.

Stanwell is of the view that a detailed assessment of total costs and benefits of any significant investment, including impacts on third parties, is required to ensure optimal network planning decisions. On the basis that the role of the Regulatory Test is to promote efficient network planning decisions with respect to whether expenditure is warranted or net beneficial; and which project should be pursued or preferred, application of the Regulatory Test to network reconfigurations would promote the NEM Objective.

2.4. Related Rule change proposals

The Commission is currently considering a Rule change proposal submitted by the Ministerial Council on Energy (MCE) to develop a framework in the Rules for the making of the Regulatory Test. A draft Rule and determination was released on 21 September 2006 and submissions are due to close on 3 November 2006.

The key elements of the draft Regulatory Test Principles Rule are:

- An improved governance structure for the Regulatory Test;

- Clearer objectives for the Regulatory Test;
- Improved certainty for the application of the Regulatory Test; and
- Improved procedural requirements in the making of the Regulatory Test by the AER.

In reviewing the proposed Rule, the Commission has taken into consideration its approach to the draft Regulatory Test Rule.

The Commission believes that the proposed Rule seeks to extend the scope and application of the Regulatory Test, rather than addressing the framework for the making of the Regulatory Test. Any implications for the framework for the Regulatory Test arising from this Rule proposal will be considered in the context of each Draft Rule.

3. Draft Rule determination

The Commission has determined in accordance with section 99 of the NEL to make the Draft Rule. A draft of the Rule to be made (the Draft Rule) is attached to this determination.

This determination sets out the Commission's reasons for making 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; 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 applied the statutory Rule making test and, for reasons set out in chapter 4 of this draft Rule determination, is satisfied that the draft Rule is likely to contribute to the achievement of the NEM objective.

3.1. The Commission's power to make the Rule

The Commission is satisfied that the Rule to be made falls within the subject matters for which the Commission may make Rules as set out in section 34 and Schedule 1 of the NEL.

The proposed Rule does appear to be within the matters set out in NEL s.34(1), as it does relate to:

- (a) the operation of the national electricity market;
- (b) the operation of the national electricity system for the purposes of security and reliability of that system; and
- (c) the activities of persons participating in the national electricity market or involved in the operation of the national electricity system.

The proposed Rule changes also appears to fall under a number of subject matter items under Schedule 1 of the NEL including: 10 (disconnection of transmission systems), 12 (expansion of the transmission system), 13 (network access) and 15 (regulation of revenues earned by TNSPs).

3.2. Assessment of the Draft Rule: the Rule making test and the National Electricity Market objective

The Rule making test requires the Commission to be satisfied that a Rule that it proposes to make will contribute to the NEM objective. The test requires the Commission to

consider the implications of the proposed new Rule, for efficient investment in, and efficient use of, these electricity services, in respect of specified elements which have an impact on the long term interests of end users of electricity.

The Rule making test states:

“(1)The AEMC may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity market objective.

(2) For the purposes of subsection (1), the AEMC may give such weight to any aspect of the national electricity market objective as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.” (s.88 NEL)

The NEM objective is at the centre of the Rule making test, and is set out in s. 7 of the NEL:

“The national electricity market objective 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.”

The Commission has applied the Rule making test to the Draft Rule, as modified by the outcomes of analysis and discussion in Chapter 4.

3.3. Summary of the Modified Rule Proposal

The Commission has accepted Stanwell’s fundamental proposal that the Regulatory Test should be applied to network reconfigurations, as it promotes greater certainty and reduces the asymmetry in application of the Regulatory Test. However, in preparing its Draft Rule determination, the Commission has decided to make a number of modifications and amendments to the proposal.

The Commission’s Draft Rule incorporates the following modifications:

- The Draft Rule extends the proposal to also require the Regulatory Test to be applied to replacement investment;
- The Draft Rule amends the threshold for the application of the Regulatory Test for reconfiguration and replacement investment to the mid-point of \$25 million to \$50 million. The Commission is specifically seeking feedback from market participants on the appropriate threshold for network reconfigurations and replacements to be subject to the Regulatory Test.
- The Commission does not support the inclusion in the Rules of a requirement for compensation to be paid to network participants affected by reconfigurations or replacements. The Commission has taken the view that whether compensation should be payable under the terms and conditions of a connection agreement is a matter for commercial negotiation between the relevant parties. The Commission’s draft decision is therefore to not accept the Proposed Rule as it relates to the payment of compensation to third parties

affected by a proposed reconfiguration or replacement that has passed the Regulatory Test.

- The Commission agrees that consultation with market participants is vital in the context of network reconfigurations and replacements, as it is with network augmentations under the Regulatory Test. Appropriately, the information disclosure and consultation requirements of the Regulatory Test as provided in section 5.6.6 of the Rules will also apply to reconfiguration and replacement expenditure above the draft proposed \$35 million threshold.³

These modifications are discussed in greater detail in Chapter 4 of this Draft Determination.

3.4. Assessment against the NEM Objective

The Commission is satisfied that a modified version of the Rule change proposed by Stanwell will more effectively contribute to the NEM objective by promoting efficient investment in both transmission and generation, thereby contributing to the long term interests of consumers through reliability and price of electricity services.

Efficient investment in the NEM relies in part on maximising transparency, particularly for planning purposes, and ensuring the clarity of locational signals. Clearer location signals work to ensure that generation investment is made where it will serve the long term interests of consumers with respect to price, quality, reliability and security of supply.

The Regulatory Test plays a significant role in this clarification of locational signals, which are in turn a factor in ensuring a reliable and secure supply to consumers. The Draft Rule will, by broadening the application of the Regulatory Test to all large scale transmission investments work to reduce the degree of unmanageable or unforeseen risk that transmission and generation investments are subject to. This will reduce the degree to which investment may be discouraged by these risks, and will address any concern that investment may be subject to the negative impacts of arbitrary and economically irrational reconfiguration and replacements at a later date.

Furthermore, requiring the application of the Regulatory Test to reconfigurations and replacements ensures the consideration of the wider market benefits and costs that may arise from these kinds of investments that would not otherwise be considered. In the case of large reconfiguration or replacement investments, this could have significant effects on the long term interests of market participants. In terms of the NEM objective, this ensures that all significant network investments will automatically take into consideration a range of factors which have an impact on the price, quality, reliability and security of the supply of electricity to consumers. The concurrent implementation of the information disclosure and consultation requirements of the Regulatory Test will further enhance transparency within the market and the reliability of the NEM.

³ The \$35 million threshold has been derived from the midpoint of the range of \$20 million to \$50 million for the purposes of further consideration by market participants.

Symmetrical application of the Regulatory Test reduces the potential distortion of incentives for transmission investment by ensuring that non-network options are considered as potential alternatives to all large network investment proposals, not just augmentations. Furthermore, the Draft Rule engages with questions of market design and definition that are implicit in the Stanwell proposal and that arise out of the issue that the proposal is intended to address.

The Commission's decision not to institute a compensation regime for network reconfigurations and replacements in the Rules places the onus on the parties to a connection agreement to negotiate suitable outcomes on a commercial basis. This will contribute to active competition in the market, which in turn promotes efficient investment in, and use of, the network.

3.5. Consultation process

3.5.1. Submissions received

A section 95 notice relating to the Rule change proposal was issued by the Commission on 15 June 2006, inviting submissions from interested parties. First round submissions were due to close on 17 July 2006; however, due to a submission from Stanwell on 10 July 2006 proposing a number of amendments to its proposal, first round consultation was extended until 31 August 2006. The Commission received five submissions from:

- National Generator Forum (NGF);
- The Group;
- EnergyAustralia (EA);
- Electricity Transmission Network Owners Forum (ETNOF); and
- VENCORP.

There was no clear consensus view amongst respondents, with submissions relatively evenly split for and against the proposal. Specific concerns were raised by all submissions about the applicability, implementation and implication of the proposal. Respondent views are discussed in greater detail as part of the Commission's analysis of the key issues in Chapter 4

3.5.2. The public hearing

No requests were made for a public hearing in relation to this proposal, and no public hearing has been held to date.

4. Commission's analysis of the Proposed Rule

In summary, the Stanwell Rule change proposal seeks to improve investment certainty for market participants, and in particular generators, by requiring TNSPs to apply the Regulatory Test when undertaking proposed network reconfigurations, provide compensation if the Regulatory Test is satisfied, and also undertake appropriate consultation with affected market participants.

At a broad level, the Proposal seeks to provide location based incentives by ensuring that TNSPs undertake rational reconfiguration investments. It also seeks to address a concern that inefficient reconfiguration investment decisions are likely to be made within the current Rules because the Rules do not require TNSPs to consider third party impacts that may arise from reconfiguration investments.

By requiring TNSPs to undertake the Regulatory Test for reconfiguration investments in combination with taking into consideration costs of third parties Stanwell argues the NEM objective will be promoted because the Test ensures that TNSPs consider the wider market benefits and costs that may arise from a network reconfiguration. In the absence of applying the Regulatory Test, a TNSP will undertake a reconfiguration investment if its private economic benefits are maximised given the costs of the investment and its regulatory obligations. The incentive to invest efficiently arises from the economic regulation framework as provided by the current Chapter 6 Rules and the AER's SRP and, after 1 January 2007, by the incentive framework developed by the Commission in the Revenue Rule.

A key preliminary issue for the Commission was whether the problem identified by Stanwell is sufficient to justify some form of regulatory intervention in the Rules. This requires consideration of the incentives within the current Rules for efficient investments arising from reconfigurations.

Reconfiguration investments generally arise when an asset requires replacement and a TNSP identifies more efficient asset configurations to deliver required system performance associated with the particular asset. The incentive to invest efficiently arises from the provisions in Chapter 6 of the Rules as applied by the AER that require total forecast capital expenditure to be efficient – Draft Rule 6A.6.7. An alternative configuration may be more efficient because of changes in the use of the network or environmental factors since it was originally built.

Unlike new network augmentations that are required to satisfy the Regulatory Test, reconfigurations are not currently required to undergo any mandated test prior to the investment being undertaken. This does not imply however that there is no regulatory constraint placed on TNSPs with regard to reconfiguration investments. Just as for the general capital expenditure program, these investments must satisfy requirements of the Rules, in particular that the expenditure is efficient to meet regulatory requirements. If the reconfiguration expenditure is not efficient, some or all of it will be excluded by the regulator in the building block calculation used to estimate the TNSPs maximum allowed revenue for the purposes of its revenue cap.

The Commission is however concerned about the lack of sufficient incentives for efficient replacement and reconfiguration investment as provided for in the Chapter 6

framework and identified by Stanwell. Unlike the reasoning of Stanwell where the scope for inefficiency arises because TNSPs are not required to have regard to the negative impact of proposed reconfiguration investments on identified third parties, the Commission's concerns are regarding

- the potential for investment distortions to arise because the Regulatory Test is only applied to new large augmentations, rather than all proposed large investments; and
- a lack of incentives for TNSPs to consider alternative non-network options when proposing to replace or reconfigure the existing transmission network.

For this reason, the Commission's draft view is that it is appropriate to consider some form of regulatory obligation on TNSPs to ensure efficient replacement and reconfiguration outcomes. This is likely to result in TNSPs making efficient replacement and reconfiguration investment decisions after considering non-network options, thereby providing better generation investment signals compared with current arrangements.

The Commission recognises that the draft Rule represents a significant extension to the scope and application of the current Regulatory Test. The Commission, however, believes that the issues arising out of the proposal are important enough to warrant the consideration of the proposed extension to the Regulatory Test. In light of the Commission's current consideration of a draft Rule relating to the regulatory Test principles as proposed by the MCE, the Commission is seeking comments from stakeholders on any inconsistencies or unexpected implications arising this draft Rule or the Regulatory Test principles draft Rule.

The remainder of this chapter examines the main elements of the Stanwell proposal in greater detail, given the Commission's view that the current regulatory framework does not create appropriate incentives for efficient reconfiguration and replacement investment.

There are three key elements of the Proposed Reconfiguration Rule:

- application of the Regulatory Test to proposed reconfiguration investments;
- the payment of compensation to third parties affected by a reconfiguration investment; and
- the imposition of market information disclosure obligations on TNSPs.

The Commission has considered each of these elements in detail, and the reasons for its Draft Rule are outlined below.

4.1. Application of the Regulatory Test to reconfiguration investments

In its Rule change proposal, Stanwell suggests that to address its concern about third party impacts arising from reconfiguration investments, the Regulatory Test should be applied to transmission network reconfigurations as well as network augmentations.

Stanwell's original proposal required the Regulatory Test to be applied to distribution networks and the replacement of network elements; however this aspect of the proposal was amended following consultation with the market by Stanwell. Undertaking the Regulatory Test in these circumstances would, in Stanwell's view, ensure that the costs and benefits to affected network users, such as generators, are taken into consideration by the TNSP when making a decision regarding a network reconfiguration project.

The Commission has decided for the Draft Rule to accept Stanwell's Proposed Rule to provide in the Rules for the Regulatory Test to apply to all large reconfiguration investments. In addition, it believes that the original proposal had sufficient merit such that the Regulatory Test should also apply to large replacement investments, to ensure that replacement expenditure is also undertaken efficiently.

As outlined above, the Commission believes there is significant scope for inefficient replacement and reconfiguration investment due to the Regulatory Test only applying to new augmentation investments, and a lack of regard by TNSPs for alternative non-network options when considering proposed replacement and reconfiguration investments.

In addition, the Commission believes there is merit in amending the applicable threshold for determining what constitutes a large investment for the purposes of applying the Regulatory Test. While the Commission believes it is beyond the scope of this Rule change Proposal to amend the threshold of \$10 million applied for large augmentation investments, it believes it is able to apply a higher threshold to replacement and reconfiguration investments. For the purposes of the Draft Determination the Commission believes the threshold should be in the range of \$25 million to \$50 million.

While applying a different threshold for replacements and reconfigurations compared with new augmentations may lead to distortions in the classification of investment by TNSPs in order to avoid the application of the Regulatory Test, the Commission believes that the definitions in Chapter 6 are sufficiently clear that the scope for these distortions is limited. The Commission is seeking particular feedback from interested parties on this draft threshold in submissions, and would welcome the opportunity to further consider the applicable threshold for the application of the Regulatory Test to augmentation investments.

The remainder of this section outlines issues raised in submissions and the Commission's detailed reasons for its Draft Rule.

4.1.1. Submissions

In considering the application of the Regulatory Test to replacement works, the Energy Transmission Network Owners Forum (ETNOF) indicates in its submission that:⁴

Replacement capital expenditure is currently subject to review by the AER in determining a revenue cap for the TNSP, and is subject to regulatory incentives aimed at encouraging efficient expenditure. Furthermore, such expenditure is

⁴ ETNOF submission, 31 August 2006, p. 4

subject to normal project approval and governance procedures within the business.

For this reason, and because asset replacements have no impact on participants, ETNOF argue that there is no need to apply the Regulatory Test to replacement expenditure. This is particularly because ETNOF considers the costs associated with applying the Regulatory Test to outweigh any potential benefits:⁵

The proposal to require public consultation on the application of the regulatory test for all network replacements and reconfigurations would impose a significant additional regulatory compliance burden upon TNSPs, with no additional benefit to end-users. The cost of this additional burden would be borne by end-users through regulated charges.

EnergyAustralia raises a number of concerns with the application of the Regulatory Test to reconfiguration investments. First, it is concerned by the potential delays that may arise in transmission investment from a requirement to undertake the Regulatory Test for network reconfigurations. This is considered to be a particular problem because the threshold of \$10 million is likely to capture most reconfiguration investments.

Second, EnergyAustralia believes that the problem identified by Stanwell, being how generators mitigate the risks arising from reconfiguration in their investments, is best resolved through the negotiation of a connection agreement.

The National Generators Forum however claims that “[p]ractical experience amongst members of the NGF is that this is very difficult to negotiate deep connection rights in a connection agreement”.⁶

Other submissions, including from the NGF and VenCorp agree with the principle that third party impacts should be considered as part of the reconfiguration investment framework, but do not comment on the appropriateness of applying the Regulatory Test for this purpose.

4.1.2. Commission’s analysis

The key motivation for the Rule change proposal from Stanwell is to provide a mechanism whereby a TNSP is required to consider the impacts on third parties of a proposed reconfiguration investment. The Regulatory Test, which requires the TNSP to consider the benefits and costs arising from a network investment, is therefore potentially a convenient mechanism to use to achieve this outcome.

It is important however, to consider the purpose underlying the application of the Regulatory Test to determine whether it can be appropriately applied to the problem identified by Stanwell.

⁵ ETNOF submission, 31 August 2006, p. 5

⁶ National Generators Forum submission, 30 August 2006, p. 3

The Regulatory Test was originally designed to address concerns regarding the lack of incentives by TNSPs to consider alternative non-network investments that may be more efficient to network investments, and to thereby ensure efficient investments are undertaken. It also ensures that, for non-reliability investments, the overall market benefits exceed the costs, because of the diffuse impacts a network augmentation investment can have on both up and down stream users. This is particularly important due to the difficulty in determining the impact of an augmentation network investment on particularly users.

For a reconfiguration investment however, affected parties are likely to be relatively easily identified, due to the tendency of reconfiguration investments to be localised to a particular segment of the network. This suggests that the commercial negotiation and arbitration framework provided for in the Rules might be able to ensure that an efficient outcome occurs. There are two reasons why this might not, in practice, be true:

First, there is no positive incentive in the Rules for a TNSP to negotiate with an affected third party user when a reconfiguration is proposed; and

Second, there are potentially insufficient incentives on TNSPs to ensure that a proposed reconfiguration is the most efficient approach to providing required network services, particular due to a lack of regard for non-network options.

A lack of an incentive to negotiate means that negotiation is unlikely to lead to an efficient outcome. Similarly, for negotiation to deliver an efficient outcome, any proposed reconfiguration should be the TNSP's least cost option, taking into consideration non-network alternative options. To the extent that it is not the least cost option, negotiation may not result in efficient reconfiguration investment.

To ensure that reconfigurations are, in practice, efficient investments in the long-term interests of consumers, the Commission believes there is merit in requiring the Regulatory Test to be applied to proposed reconfigurations.

Similarly, the Commission considered whether there were any reasons to not also apply the Regulatory Test to replacement investments given its views about the benefits for the promotion of the NEM objective.

In amending its original proposal Stanwell indicated:

Stanwell no longer considers that it is necessary for the Regulatory Test to be applied where there is like for like replacement of the network, because this would not adversely affect network users in the way that a re-configuration might. Further, we recognise that such a broad approach would result in compliance costs for network businesses.⁷

The Commission however believes that the application of the Regulatory Test for like for like replacement capital expenditure is necessary even though like for like replacement expenditure does not impact on third parties. This is because it provides incentives in addition to those provided through the Chapter 6 framework to ensure that replacement

⁷ Supplementary submission from Stanwell, 10 July 2006, p. 3

expenditure is undertaken at least cost, and because of the need to consider alternative non-network options in place of network replacement investments. The need to consider alternative options is particularly relevant as significant transmission replacement investments are anticipated over the coming years as many transmission assets begin reaching the end of their economic lives. In the Commission's view, the positive benefits arising from the improved replacement decisions will outweigh any costs arising from the need to apply the Regulatory Test to these investments.

Finally, the Commission considered the relevant threshold for the application of the Regulatory Test for reconfiguration and replacement investments, in line with the concerns raised by EnergyAustralia. The Regulatory Test currently applies to large new transmission investments in excess of \$10 million.⁸

The Commission was concerned that the current \$10 million threshold is too low for any network investment, having been originally implemented in 1999, and the costs associated with transmission investment having increased since that time.

The Commission believes that an appropriate threshold is likely to be within the range of \$20 million to \$50 million. In the absence of a basis for an appropriate threshold the Commission has notionally used a Regulatory Test threshold of \$35 million, being the midpoint of the identified range, for reconfiguration and replacement investments in the Draft Rule. The Commission would welcome submissions specifically addressing the appropriate value for the threshold.

The Commission believes that it is beyond the scope of this Rule change proposal to consider the threshold for the Regulatory Test applied to new large augmentation network investments of \$10 million, and has therefore retained that threshold. There is however no apparent policy reason for providing a difference in the threshold between reconfiguration, replacement and new augmentation investments for the application of the Regulatory Test. The Commission invites market participants to consider the relevant threshold for the Regulatory Test for new augmentation investments and, if necessary, submit a Rule Change Proposal for further consideration by the Commission.

4.1.3. Commission's draft decision

The Commission's draft decision is:

- acceptance of the proposal to apply the Regulatory Test to reconfiguration investment;
- extension of the proposal by also requiring the Regulatory Test to be applied to replacement investment; and
- amending the threshold for the application of the Regulatory Test for reconfiguration and replacement investment to \$35 million.

⁸ Chapter 10, National Electricity Rules, definition of *new large network transmission asset*.

4.2. Payment of compensation to affected third parties

In its Rule change proposal Stanwell suggests that where a reconfiguration project satisfies the Regulatory Test then compensation should be paid by the TNSP to any adversely affected network users. This compensation would be for any additional cost or forgone revenue that results from the network reconfiguration. The proposal also allows for the TNSP to recover the cost of any compensation paid from network users via increases to the revenue cap.

In its proposal, Stanwell argues that the payment of compensation to network users who have reasonably relied on the existing configuration of the network in making investment decisions would lead to greater certainty and hence more investment efficiency.

The Commission has decided to not allow for the payment of compensation to affected third parties arising from a reconfiguration or replacement investment. An overview of submissions and the Commission's detailed reasons for this decision are outlined further in this section.

4.2.1. Submissions

The NGF and the Group support Stanwell's proposal of compensation to network users affected by a reconfiguration of the network. They consider that generators make investments on the basis that the capability of the network will remain constant, or improve, over time. Therefore, network users that are adversely affected by a network reconfiguration that reduces the network capability should receive compensation payments.

EnergyAustralia and ETNOF identify the payment of compensation as an issue about property rights, indicating that it amounts to a form of firm access.

Issues surrounding open access arrangements of the market are currently being debated as part of more broad-scale reviews of economic regulation and congestion management. As we discuss below, the Rule change establishes a right for a generator to seek compensation as a results of a network change that modifies its ability to evacuate power to the shared network. This would set a dangerous precedent for market impacts resulting from all network augmentations. [EnergyAustralia]⁹

it is a fundamental principle of the market that access to the transmission network is provided on a non-firm basis; indeed the market provides no firm transmission rights to any participant. Contrary to this principle, the Stanwell proposal provides an implied property right which ETNOF believes would be better and more fully considered as part of the AEMC congestion management review. [ETNOF]¹⁰

⁹ EnergyAustralia submission, 30 August 2006, p. 2

¹⁰ ETNOF submission, 31 August 2006, p. 4

They argue that firm access is inconsistent with a framework for negotiated access such as exists in the Rules. Under this framework, compensation would be included as an element in contractual negotiations.

EnergyAustralia also considers that the flow of compensation is in the wrong direction. That is, if a project is justified under the Regulatory Test, the TNSP should be compensated to the extent that the TNSP undertakes an alternative option at the request of a market participant.

EnergyAustralia questions the impact of establishing a precedent for the payment of compensation to an incumbent generator in this context – if compensation is paid in this context, what would prevent compensation being paid to an incumbent generator that loses revenue as a result of an augmentation that benefits the market as a whole. EA considers there to be “endless” potential opportunities for a TNSP to compensate “disgruntled market participants”.

4.2.2. Commission’s analysis

Assuming a general principle that compensation is only paid where rights are taken away, the payment of compensation to affected network users would imply that the user has some form of access right. This is contrary to the regulatory transmission framework which is based on the principle of common carriage.

In the case of network access being reduced as the result of a network reconfiguration, the absence of guaranteed access rights under the Rules implies that the payment of concomitant compensation under the Rules would not be appropriate. Network users that are considering a long term investment that is reliant on firm access should negotiate this access with the TNSP and any costs factored into the investment decision. It should be noted, however, that Stanwell is referring specifically to the loss of revenue it receives under a contract for the provision of system restart services, rather than any impairment of its ability to provide generation.

The Commission believes that there are other factors that can reduce the capability of generators to access the network including:

- network overloading due to load growth;
- entry of new generators that compete for access to the network;
- reducing network capability due to new larger loads and generators that increase the severity of the worst credible contingency; and
- re-rating of transmission elements due to changes in operating practices such as premature aging of transformers and methodology for determining the thermal ratings of transmission lines.

At present generators are not sheltered from these risks and, therefore, the Commission believes that generators should not be protected from the similar risk of network reconfiguration. In effect, these are business specific rules that should be taken into consideration as part of generation investments.

In addition, the Commission considers that the payment of compensation is unlikely to be in the interests of end users in many instances. For example, in the Stanwell case, reconfiguration would mean that Kareeya is unable to provide its system restart ancillary service and this service would need to be obtained from an alternative source. If Stanwell is compensated for its lost revenue then in effect end users pay for the service twice.

Finally, if compensation was to be payable to generators affected by a reconfiguration, it would seem appropriate that the compensation be symmetrical. In other words, if a network reconfiguration benefited a particular generator, that generator should contribute to the reconfiguration investment in line with the benefits it receives. In this way, the incentives arising from reconfiguration investments would be balanced.

Determining the level of compensation, positive or negative, to an affected network user is likely to be contentious, as has been emphasised in a number of submissions. Stanwell's proposed Rule does not provide any indication of how compensation is to be calculated, but it has indicated support for the development of compensation guidelines by the AER, or recourse to a dispute resolution process.

Estimating the lost revenue over the life of the replacement assets is likely to be impractical and affected network users would not have the correct incentives to disclose their true costs. This could lead to inefficient investment decisions. Any benefits from compensating affected generators are likely to be outweighed by the burden on the TNSP in assessing the level of compensation and in risk to the network user in terms of the uncertainty of the compensation that would apply. However, in contrast negotiated network access provides a mechanism for the affected users to accurately value the impact different reconfiguration options and hence is more likely to lead to an efficient outcome.

For all of these reasons, the Commission has decided to reject the proposal for inclusion in the Rules for the payment of compensation to affected third parties arising from the passing of the Regulatory Test for a reconfiguration or replacement investment.

4.2.3. Commission's draft decision

The Commission's draft decision is to not accept the Proposed Rule as it relates to the payment of compensation to third parties affected by a proposed reconfiguration or replacement that has passed the Regulatory Test.

4.3. Information disclosure requirements for TNSPs

Under the Rule change proposal, TNSPs would be required to publish the details of proposed reconfigurations as part of its annual planning report prior to undertaking a reconfiguration. The required information proposed comprises:

- the month and year in which the proposed reconfiguration will become operational;
- the purpose of the reconfiguration;
- the total cost of the proposed reconfiguration;

- other reasonable network and non-network options to the reconfiguration;
- an explanation of the ranking of reasonable alternatives to the project including non-network alternatives. This ranking is to be undertaken in accordance with the principles contained in the Regulatory Test; and
- whether the proposed reconfiguration will have a material inter-network impact, assessed having regard to the objective set of criteria published by the Inter-regional Planning Committee (if such criteria have been published).

Upon notification of the planned reconfiguration, affected participants (specifically a market participant that will incur a cost, or forgo revenue, in excess of \$1 million) must make themselves known to the TNSP proposing the reconfiguration.

The TNSP is required to consult with affected participants and provide a “reasonable opportunity” for affected participants to make written submissions in relation to the proposed reconfiguration. The TNSP is obligated to consider matters raised in submissions from affected parties and make appropriate amendments. The TNSP must reissue the details of the proposed reconfiguration incorporating agreed amendments if material changes to the proposed reconfiguration occur as a result of the consultation process. The AER, in making its revenue cap determination for the TNSP, is required to take into account matters raised in the consultation process for the proposed reconfiguration.

In light of the Commission’s draft decision regarding the Rule proposal relating to the payment of compensation for third parties affected by a reconfiguration or replacement investment, many of the information disclosure proposals are no longer necessary. The Commission believes that the information disclosure requirements surrounding the application of the Regulatory Test currently provided in the Rules are sufficient for the application of the Test to proposed reconfiguration and replacement investments.

The remainder of this section outlines the Commission’s reasons for this draft decision and provides an overview of submissions in relation to information requirements.

4.3.1. Submissions

In general, there was broad recognition and support for the provision of information about proposed reconfiguration investments if there were likely to be third party impacts.

However VENCORP expressed concerns that the requirement to publish notification on the annual planning report prior to commencing work could lead to unnecessary delays to a project for third parties.¹¹ VENCORP suggested that notification of a reconfiguration could be undertaken through the annual planning report, or via publication of a notice to stakeholders (similar to the process currently in place for funded augmentations).

¹¹ VENCORP submission, 1 September 2006, p. 1.

The NGF was supportive of the consultation obligations included in the proposal, arguing that it was likely to lead to better investment decisions across the NEM:¹²

The NGF believes that because of the obligations the Rule change places on NSPs to consult in relation to network reconfigurations the consequent improved communications are likely to lead to better investment decisions all round.

NGF is also of the view that the improved communication between the generator and TNSP would avoid the situation that Stanwell (and Powerlink) currently itself in.

Finally, ETNOF argues that it would be impractical to apply a public consultation process to the large number of replacement projects that are anticipated due to the age of the network. In ETNOF's view, reconfigurations are relatively rare, and are the result of detailed network planning assessments.

4.3.2. Commission's analysis

There is clear merit in implementing processes that improve communication between market participants, particularly regarding changes to the network with potential third party impacts. It is important, however, to remain mindful of the possible additional regulatory burden that the imposition of additional reporting and consultation requirements could create for TNSPs.

In principle, the Commission believes that there are three circumstances that justify the inclusion of an information disclosure requirement relating to network reconfigurations or replacements:

- where there is potential for interested market participants to be unaware of a proposed reconfiguration or replacement investment;
- where there is scope for a reconfiguration to have significant third party impacts;
or
- there is potential for non-network alternative options to be considered.

The process proposed by Stanwell, and in particular the consultation process, does create substantial additional regulatory obligations on TNSPs. The amount of information required in an annual planning report regarding the proposed reconfiguration will result in material additional costs for the TNSP. If the age of the network is taken into consideration, it is not unrealistic to expect the number of reconfigurations and replacements to increase markedly in the near future.

Requiring the publication of some information regarding proposed network reconfigurations would be of benefit by improving the information available to market participants when making operational or investment decisions. Information provided to the market could comprise:

¹² NGF submission, 30 August 2006, p. 2

- the month and year in which the proposed reconfiguration will become operational;
- the purpose of the reconfiguration;
- the assets affected by reconfiguration
- the total cost of the proposed reconfiguration;

VENCorp's concern regarding the possibility that the publication and consultation process proposed by Stanwell could delay projects is valid. The Commission agrees with this concern and has therefore provided for TNSPs to notify the market of proposed reconfigurations via a notice published on the NEMMCO website, in addition to publication in the annual planning report. This would result in information being available to the market in a more timely fashion, particularly with regard to urgent reconfiguration work.

In light of the Commission's concerns regarding distortions arising from the application of the Regulatory Test to only augmentation investments, the Commission's draft approach has been to simply adopt the current information requirements provided for the application of the Regulatory Test. There does not appear to be any justification for a different regime for large reconfiguration or replacement investments.

In considering the information disclosure requirements, the Commission can see some merit in the current requirements for small augmentation investments as provided in Rule 5.6.6A being also applied to small replacement and reconfiguration investments. The Commission has decided to not include provisions in the Draft Rule to achieve this outcome because it believes it is beyond the scope of this Rule change Proposal, as the Proposal does not address informational requirements for small reconfiguration or replacement investments. The Commission does however welcome submissions or views on the appropriateness or otherwise of applying Rule 5.6.6A to proposed small reconfiguration and replacement investments.

4.3.3. Commission's draft decision

The Commission has decided in the Draft Rule to apply the information disclosure requirements provided in Rule 5.6.6 to large reconfiguration and replacement investments.

5. Differences between the Proposed Rule and the Draft Rule

5.1. Proposed “reconfiguration” definition

As noted in this draft Rule determination the Commission has decided that in addition to the Regulatory Test applying to network reconfigurations, it should also apply to network replacements. In making this modification to Stanwell’s proposal, the Commission considers it more appropriate to capture the inclusion of reconfigurations and replacements within the current definition of “new large transmission network asset”. Instead of adopting Stanwell’s proposed definition for reconfiguration, the Commission has extended the definition of new large transmission network asset in the Draft Rule to include any investment in any transmission asset over \$35 million. The Commission considers this approach achieves the Commission’s objective to ensure consistency in application of the Regulatory Test whilst adequately capturing reconfigurations and replacements for the purposes of the Regulatory Test.

5.2. Proposed addition to “affected participant” definition

The Commission has not adopted Stanwell’s proposal in this regard. This is linked to the Commission’s decision on Stanwell’s proposal of compensation for network reconfigurations. Given the Commission’s decision to not accept the compensation component of the proposal, the amendment to affected participant is a consequential change of the compensation component that is no longer necessary.

5.3. Proposed new clause 5.6.6C

From the Commission’s perspective, this clause seeks to apply the Regulatory Test provisions to reconfigurations and to also place similar reporting obligations on reconfigurations in the Annual Planning Report.

As the Commission has extended the definition of new large transmission network asset, the Commission considers the effect of Stanwell’s proposed new clause 5.6.6C is adequately covered by clause 5.6.6 which deals with applications for new large transmission network assets, which, with the new definition of new large transmission network assets will ensure reconfigurations and replacements fall within the scope of the Regulatory Test.

In relation to the Annual Planning reporting requirements, the Commission has modified the requirements in clause 5.6.2A to include new large transmission network assets. Currently the requirements only apply to augmentations. The Commission considers this inclusion ensures that the current effect of clause 5.6.2A relating to small AND large augmentations is maintained whilst also ensuring it applies to reconfigurations and replacements.

5.4. Proposed clause 5.3.4B

The Commission has not included this clause in the Draft Rule as it relates to compensation for network reconfiguration which is an aspect of the Stanwell proposal that the Commission has not adopted.

5.5. Proposed schedule 6.2(3)

The Commission has not adopted this clause in its Draft Rule as it relates to the compensation component of the Stanwell proposal.

5.6. Proposed change to definition of “Pass through event” and “network reconfiguration event”

The Commission has not adopted either of the proposed changes in the Draft Rule as they relate to the compensation component of the proposal.

5.7. Proposed change to Chapter 6 Rules

The Commission has not addressed the proposed change to Chapter 6 Rules as the proposed change relates to the compensation component of the Draft Rule.

5.8. Draft Rule 11.5

The Commission has included savings and transitional arrangements to ensure that the definition of new large transmission network asset that currently applies to the regulatory test will encompass the new definition of new large transmission network asset in order that reconfigurations and replacements are included. Clauses have also been included in the Draft Rule to preserve the current meaning of new large transmission network asset for certain jurisdictional derogations.

5.9. No consequential change to clause 5.6.3

The Commission has not made consequential changes to this clause which deals with the Inter-Regional Planning Committee. The Commission is of the view that where the clause refers to the defined term of new large transmission network assets, the new definition which encompasses reconfigurations and replacements should apply from the commencement date of this Rule. For this reason, no consequential amendment was required. Clause 5.6.3 also refers to augmentations. The Commission considers that the references to augmentations in this clause should still only apply to augmentations and should not be extended to include reconfigurations and replacements as they are reflected in the new definition of new large transmission network asset.

6. Savings and Transitional Arrangements

The new definition of new large transmission network asset requires the Commission to ensure appropriate transitional arrangements are in place. The Commission considers the key savings and transitional arrangement to relate to ensuring the regulatory test as made by the AER captures the new definition and, in doing so will capture reconfigurations and replacements. The Commission has achieved this purpose by ensuring that the new definition applies as the old definition of new large transmission network asset applied for the regulatory from the commencement date of this Rule.

The Commission considers that the current clause 5.6.6 of the Rules which deals with applications for new large transmission network assets will not require savings and transitional arrangements. The Commission's view in this regard is premised on the fact that the new definition is an extension of the old definition so that where applicants under clause 5.6.6 have relied upon the meaning of the old definition the substance of the old definition has not changed for the purposes of clause 5.6.6.

The Commission has also included transitional arrangements in relation to certain jurisdictional derogations contained in Chapter 9. The Draft Rule includes clauses to ensure that those derogations are not affected by the extension to the definition of new large transmission network asset.

The Commission invites comment on any other outstanding savings and transitional arrangements that have not been captured in the Draft Rule.

Attachment 1: Draft Rule