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**Draft-Rule Determination: National Electricity Amendment (Reform of the
Regulatory Test Principles) Rule 2006**

Please find attached a copy of "The Group's" submission to the Commission's invitation for comments on the Draft-Rule Determination - Reform of the Regulatory Test Principles. "The Group" consists of:

- TRUenergy
- International Power
- Loy Yang Marketing Management Co.
- Flinders Power

Further information or clarification on this submission should be directed to Mr Con Noutso, Manager Regulation (Access), at TRUenergy on telephone (03) 8628-1240 or at con.noutso@trueenergy.com.au

National Electricity Amendment Reform of the Regulatory Test Principles

Draft Rule Determination

A. Introduction

The Group welcomes the opportunity to respond to the Australian Energy Market Commission's (the Commission) Draft-Rule determination on the reform of the regulatory test principles. The regulatory test remains the most controversial regulatory instrument applied through the National Electricity Rules (the Rules). The Australian Competition and Consumer Commission's (ACCC) continued attempts to improve the regulatory test in the past few years provide clear evidence of this. Whilst the Group supports the Commission's attempts to reform the regulatory test, the changes proposed must be carefully designed to ensure the outcomes provide benefits to all market participants. In light of these comments, the Group has concerns regarding some of the outcomes of the Commission's Draft Rule Determination – National Electricity Amendment (Reform of the regulatory Test Principles) Rule 2006.

The Group's position on the Draft-Rule is;

1. The regulatory test as it exists and in its entirety, should be migrated to the National Electricity Rules - "Rules". The test would be more likely to be applied in accordance with the black letter law if this policy was adopted. The inclusion of high-level regulatory test principles in the Rules may give Transmission Network Service Providers (TNSPs) greater discretion in applying the regulatory test opening the way for TNSPs to "game" the test through favourable interpretations of these broad principles.
2. Although the Group does not believe "reliability based" assessments are necessary to the development of a reliable and efficient transmission system, it accepts other regulatory instruments such as jurisdictional license conditions mandate these. Therefore, the specification of the two limbs of the regulatory test should continue to be maintained.
3. The Group would be concerned if the AEMC were to propose broadening the reliability limb of the regulatory test such that investment that was not least cost could be promoted.
4. The Group has previously supported changes to the market benefits limb of the regulatory test to avoid the uncertainty regarding the definition of what might be considered "genuine" or "practicable" when considering alternative options. However, we are concerned that the changes made to the regulatory test to substitute these terms with terms like "more likely alternatives" that hope to improve the clarity of the test, may in fact contravene some of the key principles of the regulatory test to be embedded in the Rules.

B. The regulatory test as it exists should be migrated to the Rules

The Group had previously supported the idea of migrating the regulatory test in its entirety to the Rules and considered this approach identical to the MCE proposal. The regulatory test was a 7- page document, which in substance already contains a set of high-level principles. The Commission disagreed with this proposal and determined it should embed a set of high-level regulatory test principles in the Rules.

The Group remains concerned that including a set of high-level principles in the Rules will give TNSPs greater discretion in how the regulatory test is applied. It also requires the Australian Energy Regulator (AER) become a market rule maker as well as regulator. Even the details of the regulatory test are too significant and controversial to be promulgated by a network regulator. Our view is the regulatory test should be applied in accordance with the black letter law. The inclusion of regulatory test principles in the Rules might open the way for TNSPs to further "game" the test, making it much more difficult for generators to plan their investments. Designing the regulatory framework to include the regulatory test in the Rules provides increased certainty and transparency in applying the regulatory test for all market participants.

C. The specification of the two limbs of the regulatory test should continue to be maintained

The Group supports the Commission's decision to support the specification of two limbs to form part of the regulatory test. Note our view that N-1 reliability investments are not really necessary, but we agree with the Commission that:

1. The MCE proposal specifies the 'limbs' of the test in the Rules reflecting a significant component of the MCE proposal. The Group agrees that any move away from the MCE's proposed approach would be a significant change in the scope of the proposal and potentially represent a divergence from the agreed MCE policy.
2. An assessment of the appropriateness of the reliability and market benefits test limb of the current test is beyond the scope of the current Rule change proposal.

The Group remains concerned that the reliability limb of the regulatory test is applied in a less transparent way compared with the market benefit limb. It strongly believes that many investments justified by TNSPs under the reliability limb of the regulatory test are un-necessary and inefficient. It remains concerned TNSPs continue to use their own interpretation of the reliability standards in their relevant jurisdiction to continue to justify building in-efficient transmission.

The extent of this inefficiency is usually limited to a small sub jurisdictional area. It would be particularly dangerous if the AEMC were to propose an approach that leads to "reliability" and "market benefits" being combined such that very large projects with NEM wide impacts were promoted partly on the basis of local reliability standards. For example, we would not support a third limb of the regulatory test.

D. The Commission's approach to addressing concerns regarding the assessment of alternative options under the market benefits limb is inconsistent with efficiency & competitive neutrality

The Commission's proposed approach to addressing concerns regarding the assessment of alternative options under the market benefits limb of the regulatory test may breach the regulatory test principles of competitive neutrality and efficiency which are to be included in the Rules. The requirement for the regulatory test to take the form of an assessment of the proposal against the "likely alternatives", rather than an assessment against all "genuine" & "practicable" alternatives results in some alternatives or scenarios that could have been considered being simply overlooked.

In undertaking the Commission's proposed approach, a possible outcome is that the project that might be defined as the most efficient project under the current test is not considered a "likely alternative". This outcome cannot be reconciled with the requirement of the regulatory test principles embedded in the Rules that require the regulatory test deliver competitive neutrality and economic efficiency. In fact, the Commission's Draft-Rule explains on page 43 that the objective of achieving competitively neutral and efficient investment outcomes in applying the regulatory test would require an obligation on NSPs to assess all investment options whether they are network or non-network options. It further explains that in the absence of such a requirement, NSPs may give preference to an investment option that would increase their asset base or suit their commercial interests, rather than reflect the public interest in an option that is most efficient. The Commission's proposed changes to the regulatory test proposed couldn't guarantee there would not be a bias towards network developments given fewer alternative options will be considered.

In the Draft-Rule, the Commission claimed that the Group supports the approach of changing the words "genuine" and "practical" to "likely" under the market benefits limb of the regulatory test by way of principle. The Group's concern in this regard was that the existing definitions were insufficiently broad allowing a TNSP to interpret this clause in any manner it sort fit. The Group never supported the principle of narrowing this definition in the manner the Commission has done, especially given the significance this change would have.

An assessment of the implications of the Commission's proposed approach to determining the "likely alternative" projects proves it is difficult to reconcile the revised approach with the regulatory test principle of competitive neutrality and economic efficiency. These implications include:

1. Potential to reduce gaming

The Commission argues the new test will change the scope for regulatory gaming. Rather than the NSP determining which projects meets the hurdle of being sufficiently "genuine" or "practicable", and then assessing all the of them against the proposed project, it is an assessment of which project or projects are "likely alternatives" in the absence of the proposed project. Rather than simply being required to prove that their alternative is "genuine" and "practicable", a proponent of an alternative project will have to provide evidence that their project is likely to proceed but for the proposed network augmentation.

The Group's view is that this proposal will limit the scope of projects that could be assessed by the TNSP to determine which project maximises the market benefits. Accordingly, it could contravene the principle of competitive neutrality. Furthermore, whilst it is claimed to reduce the scope for proponents of speculative projects in effect reducing gaming, it might actually amount to making the test far easier for TNSPs to game.

2. More predictable outcomes and greater certainty for NSPs

The Commission believes the changes to the test will result in more predictable outcomes for TNSPs, and therefore greater certainty for NSP investment decisions, by reducing the possibilities of gaming and the costs of assessing unlikely alternative projects.

The Group's view is that this proposal creates a bias in terms of favouring the TNSPs proposal as it limits other projects that might deliver greater market benefits. Accordingly, it might actually lead to an inefficient investment (compared to alternative investment options not considered) being undertaken. Of greater impact than NSP certainty is merchant and consumer certainty that the most efficient projects are being promoted.

3. Address the issue of nothing being built if the transmission option is rejected

The Commission argues that as a result of this change, proposals that are unlikely to proceed will not be considered as an alternative, and therefore will not be considered as part of the formal test assessment.

The Group's view is that it is not the intention of the market benefits limb of the regulatory test to ensure that transmission projects are built. The regulatory test, in accordance with the regulatory principles, has at its core competitive neutrality and economic efficiency. The changes to the test being considered cannot guarantee that the test will deliver these two key regulatory principles. The changes increase the probability that something gets built, which is inconsistent with the key objectives of the regulatory test principles embedded in the Rules. Accordingly, we question whether the changes to the regulatory test represent the right changes!

4. Lower costs

The Commission argues that the assessment process will be simpler and fewer unlikely alternative options will be subjected to a full cost benefit analysis under the test.

The Group's view is an amended regulatory test that does not consider all the alternative options cannot guarantee the alternative option to be developed is competitively neutral or efficient. Accordingly, it fails to achieve its primary objective.

5. Most 'efficient' project may not be likely

The Commission notes that in undertaking the Commission's proposed approach, a potential outcome is that the project that has been defined as the most efficient project under the current regulator test may not be considered a likely alternative under the new Rules for the regulatory test.

The Group's view is that the Commission's proposed approach to the regulatory test is inconsistent with the principle of economic efficiency to be embedded in the Rules, especially when the Commission admits that the most efficient project under its revised approach may not be likely to be considered a likely alternative.

E. Conclusion

The Group welcomes the Commission's attempts to reform the regulatory test principles. The application of the regulatory test has been consistently disputed in applying the Rules and any improvements to the application of the test would be welcome. However, we caution against any changes the regulatory test that may actually weaken it by threatening its core principles of competitive neutrality and economic efficiency. Hence, any changes to the test need to be very carefully considered. Accordingly, we re-emphasize:

1. Our support for migrating the regulatory test to the Rules
2. Maintaining the specification of two limbs to form part of the regulatory test
3. Warn against broadening the reliability limb of the regulatory test
4. Remain concerned at the Commission's changes to the market benefits limb of the regulatory test on the basis the changes breach competitive neutrality and economic efficiency principles to be included in the Rules.