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Dear Dr Tamblyn

**National Electricity Rules – Rule Change Application  
Reform of the Regulatory Test Principles**

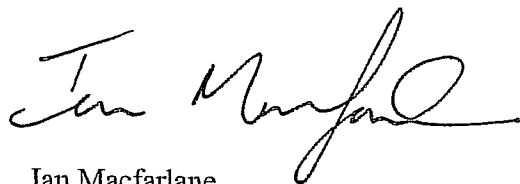
In accordance with s.91 of the *National Electricity Law* (NEL), the Ministerial Council on Energy (MCE) requests the Australian Energy Market Commission (AEMC) to make a Rule to implement new *regulatory test* principles.

In the December 2003 MCE report to the Council of Australian Governments (COAG), the MCE adopted four key principles to underpin transmission policy in the National Electricity Market (NEM). Within these principles the MCE agreed to a package of transmission reforms, including reforms to the *regulatory test*. The May 2005 MCE Statement on NEM Electricity Transmission draws together the various elements of the MCE Transmission Reform program including, proposed *regulatory test* principles.

Further to the guidance provided in the above documents, a description of the proposed rule, statement of the issues concerning the existing rules, and how the proposed rule addresses those issues consistent with the NEM objective is at **Attachment A**. A draft of the proposed rule is at **Attachment B**.

The MCE would be pleased if you could have these matters considered by the AEMC. For further details, please do not hesitate to contact Loretta Boman on (07) 3225 8207.

Yours sincerely



Ian Macfarlane

## Rule change request on regulatory test principles

### Role of the regulatory test in the Rules

Network investment in the National Electricity Market (NEM) is subject to regulatory oversight to ensure that investment is least-cost and competitively neutral. The regulatory framework and associated processes are set out in the National Electricity Rules (the Rules). The *regulatory test* is part of this framework.

Clause 5.6.5A of the Rules requires the Australian Energy Regulator (AER) to:

- (a) promulgate the *regulatory test*;
- (b) have regard to the need to ensure that the *regulatory test* is consistent with the basis of asset valuation determined by the AER; and
- (c) have regard to the obligations imposed on network service providers to meet network performance requirements, in developing and maintaining the *regulatory test*.

The *regulatory test* is used to evaluate proposed new regulated transmission investment (with an expected value in excess of \$1 million or another threshold agreed by the AER) against all other reasonable network and non-network alternatives, including but not limited to interconnectors, generation options, demand side options, market network service options and options involving other transmission and distribution networks. *New transmission network investment* is deemed to satisfy the *regulatory test* if it maximises the Net Present Value (NPV) of the market benefits (or in the case of reliability augmentations, finds the least cost solution) having regard to a number of alternative projects, timings and market development scenarios. Transmission augmentations, which meet this standard should be added to the proponent's regulated asset base.

The overarching objective of the regulatory test is to deliver efficient transmission investment through application of a net economic benefits test, not simply more transmission regardless of the economics.

### Background to policy position

Since its first application in 1997, the test for regulated network investment (now the *regulatory test*) has undergone a process of more or less continuous revision and reform.

Early versions of the test as articulated in version 1.0 of the National Electricity Code (the Code) were conceptually flawed. The test specified in the Code was known as the "Customer Benefits" test and focused on "Customer Benefits" rather than net market benefits (based on the sum of both consumer and producer surpluses). As a consequence the Customer Benefits Test was found to be highly volatile, but more relevantly, poorly specified the nature of the public benefits of augmentation. Following recognition that the interpretation of the Customer Benefits Test was leading to undesirable outcomes, the Australian Competition and Consumer Commission (ACCC) was asked to review and, in 1999, revised the Customer Benefits Test to the *regulatory test*.<sup>1</sup> The *regulatory test* now focused on the concept of net

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<sup>1</sup> Australian Competition And Consumer ACCC, "Regulatory Test for New Interconnectors and Network Augmentations", 15 December 1999.

public benefits, rather than net customer benefits and on economic cost savings, rather than (potentially distorted) pool price outcomes.

The process under which the *regulatory test* has been applied has also been substantially revised. In February 2002 the ACCC issued a final determination regarding Code changes sought by NECA – the Network and Distributed Resources (NDR) package. The NDR Code changes significantly modify the processes surrounding the application of the *regulatory test*.

Under the arrangements in place from December 1999 to February 2002, the concept was for a degree of centralised oversight of network investment across the NEM. Under these arrangements, the Inter-regional Planning Committee (IRPC) and NEMMCO were responsible for the evaluation of the technical and economic merit of inter-regional augmentations. The NDR Code changes move away from these centralised arrangements and place greater reliance on individual TNSPs – as proponents of the project – for planning and investment decision-making. In particular, the TNSPs are now responsible for undertaking the economic assessment of the project. That is, the proponent now applies the *regulatory test*, and subsequently makes an application for regulated status to the ACCC.

Despite these reforms, the Ministerial Council on Energy (MCE) recognised inefficiencies in transmission planning and investment and in its December 2003 report to the Council of Australian Governments, adopted the following principles to underpin transmission policy in the NEM:

- The transmission system fulfils three key roles — it provides a transportation service from generation source to load centre, facilitates competition, and ensures secure and reliable supply.
- There is a central and ongoing role for the regulated provision of transmission, with some scope for competitive (market) provision.
- Transmission investment decisions should be timely, transparent, predictable and nationally consistent, at the lowest sustainable cost.
- The regulatory framework should maximise the economic value of transmission, including through the efficient removal of regional price differences in the operation of the NEM.

Using these principles, the MCE agreed to a package of reforms in electricity transmission, including reforms to the *regulatory test*, taking account of the ACCC's review of the *regulatory test*.

In August 2004, the ACCC published its decision which promulgated changes to the *regulatory test*. The three sets of changes included:

- Modification to the *regulatory test* (version 1) to ensure consistency between it and the Code.
- Introduction of a number of definitions to be used by TNSPs when applying the *regulatory test* to ensure its consistent application across the NEM.
- Introduction of competition benefits, which captures the efficiency benefits of increased competition between generators.

### **Statement of issues concerning the existing Rules**

The application of the *regulatory test* has been the most disputed matter in the Code (before conversion to the Rules). It was the subject of the only matter to be brought before the

National Electricity Tribunal, and subsequently to a Supreme Court and Court of Appeal. Among the matters disputed were the nature of the *regulatory test* itself and the methodologies used to ascribe economic benefits to transmission investment.

Also, there was no policy guidance to the ACCC for promulgating the *regulatory test*.

As a consequence of this lack of clarity on the application of the *regulatory test* and consequent disputes, potentially economic transmission investment was either delayed or not made.

Further, the initial *regulatory test* excluded the benefits of competition facilitated by transmission investment. Consequently, transmission investment which may have been economically justified may not have proceeded because those investments did not pass the *regulatory test*.

Many of the ambiguities of the *regulatory test* and inconsistencies between the *regulatory test* and the Rules have been highlighted in the ACCC Discussion Paper on the Review of the Regulatory Test (5 February 2003).

The emphasis of this proposed Rule change is on improving the overall regulatory settings and establishing a streamlined process that helps to maximise the net economic benefit to all those who produce, consume and transport electricity in the *market*.

The *regulatory test* principles have been developed by the MCE. The focus has been on establishing appropriate principles to be followed by the AER and proponents. The high level principles will codify the policy requirements that the *regulatory test* must meet, while leaving sufficient discretion with the AER to promulgate the *regulatory test* and perform its role as regulator. The challenge in setting the principles is to strike a balance such that the AER is not both rule maker and rule enforcer with respect to the *regulatory test*.

The high level principles in the Rules and the *regulatory test* promulgated by the AER using those principles will provide the framework for the evaluation of proposed new regulated network investment.

However, this framework alone may not ensure consistent outcomes of efficient network investment when the *regulatory test* is applied by different parties. The framework needs to be supported by detailed guidelines for the application of the *regulatory test*, to be developed by the AER.

It is expected that the *regulatory test* principles and these detailed guidelines will complement each other.

Consideration was given to including a highly prescriptive *regulatory test* in the Rules. This approach was however discarded as it would go beyond setting policy requirements and would leave the Network Service Providers (NSP) and the AER with little discretion in applying the test.

### **Description of proposed Rule**

The proposed Rule replaces clause 5.6.5A of the Rules and introduces a suite of principles that the AER must adopt in promulgating the *regulatory test*.

The proposed Rule should contain a set of *regulatory test* principles that will provide minimum coverage guidelines for the AER to apply in promulgating the *regulatory test*. The principles are intended to ensure the *regulatory test* is promulgated in a manner which provides a level of certainty to NSPs in undertaking new network investment, while leaving sufficient discretion with the AER to promulgate the *regulatory test* and perform its role as regulator.

The AEMC should draft Rules to capture the following policy intent:

1. The *regulatory test* must have as its purposes the identification of *new network investment* or non-network alternatives that:
  - (i) maximise the net economic benefit to all those who produce, consume and transport electricity in the market; or
  - (ii) in the event the option is necessitated to meet the service standards linked to the technical requirements of Schedule 5.1 of the Rules or in applicable regulatory instruments, minimise the present value of the costs of meeting those requirements.
2. The *regulatory test* must be used by NSPs in the assessment of all new network investment in accordance with the Rules and with a level of analysis commensurate with the scale and size of the new network investment.
3. The *regulatory test* must be based on the principles of cost-benefit analysis as a means of economic discipline, thus satisfying the overarching objective to deliver efficient transmission investment, not simply more transmission regardless of the economics.
4. The *regulatory test* must ensure that all genuine and practicable alternative options to proposed *new transmission network investment* are evaluated by NSPs without bias, regarding: energy source; technology; ownership; the extent to which the *new transmission network investment* or the non-network alternative enables intra-regional or inter-regional trading of electricity; whether the new network investment or non-network alternative is intended to be regulated; or any other factor. This is to ensure NSPs do not favour network-only investment, and that the most efficient solution for the NEM as a whole is progressed rather than the investment that is internally most efficient for the NSP.
5. To allow NSPs to recover the efficient costs of maintaining a secure and reliable power system for end-users, the *regulatory test* must reflect the requirement for NSPs to meet network performance standards linked to the technical requirements of Schedule 5.1 of the Rules or in applicable regulatory instruments, while minimising the present value of the costs of meeting those requirements.
6. To promote confidence in the *regulatory test*, and minimise avenues for legal dispute, the *regulatory test* must be transparent, robust, defensible and capable of consistent application.
7. The *regulatory test* must be consistent with the basis of asset valuation determined by the AER for the purposes of clause 6.2.3 of the Rules to ensure internal consistency within the Rules.

The proposed Rule should allow the AER to vary the *regulatory test* from time to time, but only if the AER meets certain requirements prior to the variation to ensure investment certainty in the NEM. Requirements at a minimum should include the AER publishing a notice of its intention to review or amend the *regulatory test*; inviting submissions and publishing draft and final decisions.

The proposed Rule should also impose an obligation on the AER to publish guidelines for the application of the *regulatory test*. This will clarify how the *regulatory test* should be applied and ensure it is applied consistently by all parties. The proposed Rule should also set out the various factors that the AER must address in the *regulatory test* or the associated guidelines and should include at a minimum:

1. The classes of possible benefits that may be included as benefits, and classes of possible benefits that may not be included as benefits.
2. The method or methods permitted for estimating the magnitude of the different classes of benefits.
3. The classes of possible costs that may be counted as costs, and classes of possible costs that may not be included as costs.
4. The method or methods permitted for estimating the magnitude of the different classes of costs.
5. The appropriate method and value for specific inputs, where relevant, for determining the discount rate to be applied.

The proposed Rule should require the AER to address the extent to which it uses the results of an application of the *regulatory test* by a NSP, in determining what new network investment or non-network alternative options will be included in the regulated asset base of the NSP for future revenue cap decisions.

To facilitate the transition from current *regulatory test* arrangements to the proposed Rule (new principles), and to provide certainty to *Registered participants* and the AER, the AEMC should consider transitional arrangements for the new principles. The new principles will not require the AER to change the current *regulatory test* and will only apply when the AER chooses to change the *regulatory test*.

The proposed Rule should contain such other necessary consequential changes that the AEMC deems necessary in order to achieve the proposed reforms.

A draft of the proposed Rules to be made is contained in Attachment B.

## **How the proposed Rule is likely to contribute to the achievement of the national electricity market objective**

### Promoting Efficient Investment

The proposed Rule change will promote efficient investment through the provision of a robust and stable framework for the economic evaluation of network investment against alternatives, or where the network investment is required to meet network performance standards, that the investment is made at least cost. The framework will be robust because the parameters and methodologies used in the analysis will be required to be clearly defined. The combination of principles, and guidelines will provide greater clarity for the application of the *regulatory test* and reduce the scope for dispute.

The proposed Rule change will increase certainty for investors because the AER will be required to address the extent to which it will use the results of the *regulatory test* to include investment in the regulated asset base in future regulatory decisions.

The proposed Rule change will promote efficient investment because potential investment will be evaluated through a stable framework over time, which can only be changed through a consultative and transparent process.

The proposed Rule change will promote efficient and timely investment in transmission which will facilitate competition between generators and provide improved price signals for the location of new generation investment.

#### Long term benefit to customers

Most network investment is undertaken to maintain network performance requirements, including reliability standards. Consequently, if the proposed Rule change promotes efficient investment in the manner described above, the long term interests of consumers of electricity will be promoted in respect to reliability and security of supply. Also, the reliability and security of the national electricity system will be enhanced.

Where this involves *interconnector development*, efficient investment can increase system security by allowing reserves to be shared between regions. This creates an efficiency benefit by potentially reducing region specific reserve requirements.

Where a particular transmission investment option is the most effective means of facilitating competition (for example, by promoting competition between generators) the new *regulatory test* arrangements will enable the identification and approval of that option. As such, competitive transmission investment options will proceed and the long term interests of consumers of electricity will be promoted in respect to the price of the electricity that they consume. Where transmission investment is not the most efficient means of facilitating competition, the new *regulatory test* arrangements will help to identify it as such in the long term interest of consumers.

#### **Power to make the Rule**

The AEMC has the power to make the requested rule under s 34(1)(a) and s.34(1)(b) of the NEL. It also falls clearly within the head of power in clause 12 of Schedule 1 of the NEL relating to the augmentation or expansion in the capacity of transmission systems and distribution systems which is given effect by s. 34(2) of the NEL.

## Proposed replacement of clause 5.6.5A of the National Electricity Rules

### Replacement of clause 5.6.5A

Delete the existing clause 5.6.5A and replace it with the following.

#### 5.6.5A Regulatory Test

The *AER* must promulgate the *regulatory test* for *new network investment* in accordance with the principles set out in this clause 5.6.5A. The principles are intended to ensure the *regulatory test* is promulgated in a manner which provides a level of certainty to *Network Service Providers* in undertaking *new network investment*.

- (a) The *regulatory test* or any amended *regulatory test* under this clause 5.6.5A must:
- (1) have as its purposes the identification of *new network investment* or *non-network* alternatives that:
    - (i) maximise the net economic benefit to all those who produce, consume and transport electricity in the *market*; or
    - (ii) in the event the option is necessitated to meet the service standards linked to the technical requirements of schedule 5.1 or in *applicable regulatory instruments*, minimise the present value of the costs of meeting those requirements;
  - (2) be used by *Network Service Providers* in the assessment of all *new network investment* in accordance with the *Rules* and with a level of analysis commensurate with the scale and size of the *new network investment*;
  - (3) be based on the principles of cost-benefit analysis;
  - (4) ensure that all genuine and practicable alternative options to proposed *new network investment* are evaluated by *Network Service Providers* without bias, regarding:
    - (i) energy source;
    - (ii) technology;
    - (iii) ownership;
    - (iv) the extent to which the *new network investment* or the *non-network* alternative enables *intra-regional* or *inter-regional* trading of electricity;
    - (v) whether the *new network investment* or *non-network* alternative is intended to be regulated; or
    - (vi) any other factor.



- (5) reflect the requirement for *Network Service Providers* to meet *network* performance standards linked to the technical requirements of schedule 5.1 or in *applicable regulatory instruments*, while minimising the present value of the costs of meeting those requirements;
  - (6) be capable of consistent application; and
  - (7) be consistent with the basis of asset valuation determined by the *AER* for the purposes of clause 6.2.3.
- (b) The *AER* may amend the *regulatory test* from time to time, only if it:
- (1) *publishes* a notice of its intention to review or amend the *regulatory test*;
  - (2) invites and considers submissions from *interested parties*;
  - (3) *publishes* a draft decision in relation to the review or proposed amendments to the *regulatory test*; and
  - (4) *publishes* a final decision, setting out any proposed amendments to the *regulatory test* and its reasons for the final decision.
- (c) The *AER* must *publish* guidelines for the application of the *regulatory test*. The guidelines must be *published* at the same time that the *AER* promulgates the *regulatory test* or subsequently amends the *regulatory test*.
- (d) The *AER* must ensure that in relation to the principles of cost benefit analysis referred to in clause 5.6.5A(a)(3), the *regulatory test* or any guidelines for the application of the *regulatory test* address, as a minimum, the following factors:
- (1) the classes of possible benefits that may be included as benefits, and classes of possible benefits that may not be included as benefits;
  - (2) the method or methods permitted for estimating the magnitude of the different classes of benefits;
  - (3) the classes of possible costs that may be counted as costs, and classes of possible costs that may not be included as costs;
  - (4) the method or methods permitted for estimating the magnitude of the different classes of costs; and
  - (5) the appropriate method and value for specific inputs, where relevant, for determining the discount rate to be applied.
- (e) The *AER* must ensure that the *regulatory test* or any guidelines for the application of the *regulatory test* address the extent to which the *AER* will use the results of an application of the *regulatory test* by a *Network Service Provider* in determining what *new network investment* or *non-network* alternative options will be included in the regulated asset base of the *Network Service Provider* for future *revenue cap* decisions.