

23-2-2005

AEMC
PO Box H166
Australia Square NSW 1215

Dear Dr. Tamblyn,

This submission represents the views of the following companies, "The Group" that include

- TRUenergy;
- International Power;
- Loy Yang Marketing Management Co; and
- NRG Flinders
- AGL

The "Group" welcomes the opportunity to comment on the MCE proposed 'Rule' change to reform the Rules regarding the regulatory test for new transmission investment.

In the Rule Change Application, the MCE presents three arguments to support its Rule Change Proposal:

- it will increase the *stability* of the Regulatory Test ("the Test"), by providing greater policy guidance to the AER;
- it will increase the *robustness* of the Test by providing greater clarity and removing ambiguity; and
- it will increase investor *certainty* by clarifying how the Test results will be used by the Regulator

The combined effect is argued to be to improve the efficiency of transmission investment, providing long-run benefits to the consumer.

The group supports these objectives however believe that there is an alternative. The group is of the view that these objectives would be best met by including the entire Regulatory Test in the National Electricity Rules (Rules). We believe that this has the merits of establishing the stability that the MCE seeks, whilst avoiding the problems we foresee associated with designing and introducing Test principles. Our submission presents the arguments for including the test in the Rules

In case the AEMC does decide that the MCE approach of adopting principles is still required, we believe a number of changes are required to improve the implementation. Firstly, the drafted principles need some revision to improve clarify and to better reflect the test principles and the NEM objective. We present and discuss alternative drafting and describe some possible improvements to the proposed governance arrangements for the new principles and guidelines.

We would welcome the opportunity to discuss this submission with you in the future. Further information or clarification on this submission should be directed to Con Noutso, at TRUenergy on telephone 86281240.

Yours Sincerely

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**National Electricity Amendment
(Reform of the Regulatory Test
Principles)
Rule 2005**

Submission to AEMC

-from-

**TRUenergy
NRG Flinders
International Power
Loy Yang Marketing Management Co
AGL**

February 2006

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1. Introduction

1.1. *Scope and Purpose*

This submission represents the views of the following companies, “The Group”:

- TRUenergy;
- International Power;
- Loy Yang Marketing Management Co; and
- NRG Flinders
- AGL

The Group owns the majority of Victorian and South Australian generation capacity and will be approaching this review with prime consideration of the interplay between the regulated transmission network and the competitive national electricity market.

1.2. *The Case for Change*

In the Rule Change Application, the MCE presents three arguments to support its Rule Change Proposal:

- it will increase the *stability* of the Regulatory Test (“the Test”), by providing greater policy guidance to the AER;
- it will increase the *robustness* of the Test by providing greater clarity and removing ambiguity; and
- it will increase investor *certainty* by clarifying how the Test results will be used by the Regulator

The combined effect is argued to be to improve the efficiency of transmission investment, providing long-run benefits to the consumer.

In principle these are valid arguments but, against the historical facts, they are less compelling, because:

- the Test has only been changed once in its 6-year history¹ – there is no historical evidence of instability;
- much of the historical concern about Test robustness relates to Version 1 of the Test, and has been addressed by the changes made by the ACCC (in 2004) in promulgating Version 2;

¹ The Regulatory Test was first promulgated by the ACCC in December 1999 and was revised in 2004. The previous investment test – the “customer benefit test” - was not governed by the NEM economic regulator and so is not relevant to this submission.

- to the extent there is uncertainty about how the Test results will be used, these are matters for the design of TNSP revenue regulation (currently being reviewed by the AEMC) and not for the Test itself; and
- there are no identified and potentially economic transmission investment projects – that we are aware of – that are languishing as a result of shortcomings in the design or application of the Test.

On the other hand, we recognize that the Test governance arrangements create the potential for instability – for example if the AER chose to become more active on the Test design than its ACCC predecessor. Indeed, we referred to this concern in a submission to the AEMC Chapter 6 Review² noting that, whilst the design of the Test had the potential to substantially impact the NEM, market participants had little say on its development. The issue for us, of course, is certainty for investors in the unregulated market; an issue that is all too easily forgotten in the focus on TNSPs.

1.3. Options for Change

To the extent that there is potential for Test instability, we agree that the MCE’s proposal, to develop Test principles and include these in the Rules, is one way to mitigate this. On the other hand, in our experience, designing principles is always problematic. They need to be specific enough to go beyond mere “motherhood” statements, but not so detailed that they encroach upon (or even supersede) the rules that they are intended to govern. And most importantly, one must resist the temptation to create novel principles that were never in the minds of the original designers³.

In our view, the MCE, in drafting principles, has failed to avoid these pitfalls. This is not intended to be a harsh criticism; developing principles is never easy. In the light of such difficulties, we offer an alternative approach: to include the Test, in full as it stands, in the Rules. We believe that this has the merits of establishing the stability that the MCE seeks, whilst avoiding the problems associated with designing and introducing Test principles. This proposal is presented and discussed in section 2, below.

Finally, in case the AEMC does decide that the MCE approach of adopting principles is still required, we believe a number of changes are required to improve the implementation. Firstly, the drafted principles need some revision to improve clarity and to better reflect the test principles and objectives. We present and discuss alternative drafting in section 3. Secondly, section 4 describes some possible improvements to the proposed governance arrangements for the new principles and guidelines.

² AEMC Review of the Electricity Transmission Revenue and Pricing Rules, Response to the Revenue Requirements Issues Paper: November 2005. Note that, although AGL was not in the group that made this submission, it supports those elements of the submission that are referred to in this document

³ If the MCE desire is really to change the Test (and we do not believe that it is), they should do this directly by proposing a new Test rather than through novel Test principles

2. Include the Test in the Rules

2.1. *Our Proposal*

Our proposal is straightforward: the Test, as it exists and in its entirety, should be migrated to the Rules. We believe that this will deliver the stability that the MCE seeks, whilst avoiding the problems that are likely to arise under the MCE proposal. These problems – and the reasons why our proposal avoids them – are set out below.

2.2. *Governance Concerns*

We believe that the MCE proposal will introduce new complexity and uncertainty into the arrangements under which the Test – and hence transmission investment – is governed. Consider the “governance hierarchy” for the Test that the MCE proposal would establish:

- at the top sits the *NEM objective*, which both the AEMC and AER must promote;
- next come the *Test Principles*, governed by the AEMC through the Rules change process;
- next comes the *Test* itself, promulgated by the AER in accordance with the principles;
- below this the MCE proposes to introduce “*Test guidelines*”, also to be promulgated by the AER, although the change process is not specified⁴; and
- finally, a TNSP wishing to invest must make sense of the above and develop and apply a *detailed methodology* to evaluate its proposed project.

If, at any stage, an aggrieved party believes that any of these governance “layers” is inconsistent with a layer above it in the hierarchy, they may potentially initiate a change or dispute process, the specifics of the process depending upon the layer in dispute.

Indeed, to take just one layer, we anticipate that, whatever the final Test principles look like, it will be at least arguable that the existing Test violates one or more of these. The MCE notes, cryptically, that “the new principles will not require the AER to change the current Test”. We are not sure whether this is from a legal or an economic perspective, but we imagine that some doubt would exist either way⁵. Good regulatory practice would suggest that the first thing the AER should do if/when the principles are implemented is to undertake a consultation process to

⁴ considered further in section 4.2, below

⁵ And, if this doubt did not exist, it would likely be because the Test principles were so broad and ambiguous that they place no constraint on current or future Test design and so would achieve little.

see if stakeholders believe that the current Test aligns with the principles and make any necessary changes. Thus, Test stability is already compromised.

Our proposal avoids the need for principles, thus at least removing one layer and removing the source of instability described above. We accept that there may still be some need for guidelines, and we think that these should be promulgated by the AER, as the MCE proposes. The scope and content of these guidelines would be specified in the Test and would be drafted to minimize ambiguity and potential for dispute.

2.3. Test Change Process

We believe that the major advantage of our proposal is that it would bring to bear – through the AEMC Rule Change process – the combined wisdom of NEM participants and ensure that all interests are represented when any future changes to the Test are made. Any person could propose a change to the Test and the sole criterion in its assessment (by the AEMC) would be promotion of the NEM objective. At first sight, one might argue that this potentially compromises Test stability. We would argue otherwise. The AEMC Rule Change process has been carefully designed to trade-off stability against innovation and improvement⁶.

It would be possible, of course, to design and implement a similar Test change process under AER governance. Whilst this could address some of our concerns, we believe that such an approach would still be inferior to our proposal because:

- it would require the extra effort and cost of designing and establishing the AER change process;
- it would be at odds with the AER's culture and role, which is to *determine* economic regulation and not to sit in judgement on other people's regulatory suggestions.
- it would contravene a guiding principle in the recent MCE governance reforms: that rule making and rule enforcement should be separated

In summary, we believe that AEMC – rather than AER - governance will lead to improved stability and effectiveness of Test design.

2.4. Degree of AER Discretion

The broader issue of “prescription versus discretion” for the AER has been raised by the AEMC in its chapter 6 review. Whilst it may not be a case that “one size fits all”, we would think that the AEMC should decide upon its approach in the broader context before ruling on the Test in particular.

Notwithstanding this, we would note that the current Test is in any case probably closer in nature to “principles” than it is to “prescription”⁷. It only runs to 7 pages, which is fairly economical and high-level and comparable (say) to the AER's Statement of Regulatory *Principles* (26 pages). So, if one were to rename the Test to become “Test Principles” (and rename the “Test Guidelines” to be “the Test”),

⁶ although, admittedly, only time will tell how well it achieves this goal

⁷ which, incidentally, is the source of the MCE's concern about Test robustness

our proposal becomes identical to the MCE proposal. In this view, our proposal is very much in the spirit of the MCE approach and the fundamental point of difference is not over whether or not “Test principles” should be established in the Rules but over the *level* at which these principles should be established.⁸

2.5. Summary

In summary, we propose that – to deliver the MCE’s objective of improved Test stability – the Test in its entirety is brought into the Rules and becomes subject to the AEMC Rule change process. The advantages of this approach over the MCE proposal are:

- it avoids the need to create new Test principles, which may or may not align with the existing Test and the philosophy underlying it, potentially creating new sources of instability and uncertainty;
- it places the Test under AEMC governance and, in particular, the AEMC Rule change process, which has been carefully designed to allow full market scrutiny of proposed changes and to combine stability with the opportunity to innovate and improve where this promotes the NEM objective;
- it avoids the necessity of designing and establishing a new or revised Test change process under the AER and the potential for such a process to clash with the AER’s primary role and culture of economic regulation of TNSPs; and
- since the current Test is in any case expressed at a fairly high level, our approach is broadly consistent with the spirit of the MCE proposal

Under our proposal, the new governance ‘hierarchy’ becomes:

- the *NEM objective*, which both the AEMC and AER must promote;
- the *Test*, promulgated by the AEMC in accordance with the *NEM Objective*;
- *Test guidelines* promulgated by the AER; and
- TNSP *detailed methodology* to evaluate its proposed project.

We recommend that the AEMC considers this approach.

⁸ In this view, a “middle way” might exist between the two proposals, whereby part of the existing Test is considered to be “principles” and included in the Rules and the remaining part is considered to be procedural detail and remains with the AER. Whilst we would not rule out supporting such an approach, we would note that it will face the problem of deciding what is principle and what is practice.

3. Enhancing the Test Principles

3.1. *Our Concerns with the Draft Principles*

In this section we present the changes we would like to see to the drafting of the Test principles, should principles be included in the Rules as the MCE has proposed⁹. These changes address some concerns we have with the MCE principles which are:

- it misrepresents the purpose and scope of the Test, giving it an apparently far greater role than its current one;
- it does not refer to the problem of the moral hazard that arises because a TNSP profits from an investment but does not suffer the financial consequences if it turns out to be uneconomic or inappropriate¹⁰, creating a bias towards overinvestment which the Test has been designed to counteract; and
- that the potential for a TNSP to exhibit bias against certain investment options in the Test arises not just through its evaluation methodology but also in its choice of options to be evaluated¹¹

Below, we expand on these concerns and propose ways of addressing them. We also suggest some additional enhancements to clarify the drafted principles.

3.2. *Purpose of Test*

The MCE's Draft Principle 1 states that the Test "has as its purposes the identification of [economic] new network investment or non-network alternatives". In fact, it does nothing of the sort:

- it does not identify network investments: this is done through the TNSP network planning and ANTS processes described in the Rules;
- it does not identify unregulated non-network alternatives. This is done by potential investors in the unregulated market: eg generation planning functions

In fact, the Test purpose is to *evaluate* proposed *regulated* investments, against alternatives, to see whether they are likely to be economic.

The remainder of the drafting of principle (1) is untidy in that it partly duplicates principle (5). We therefore suggest the following drafting:

⁹ Noting that, notwithstanding the exact drafting of the principles, our preference is still for the entire Test to be incorporated into the Rules as discussed in the previous section.

¹⁰ as a normal, unregulated investor would

¹¹ as was seen most starkly in the evaluation of SNI

“[the Test must] have as its purpose the evaluation of proposed new regulated investments to see whether they are likely to maximise the net economic benefit to all those who produce, consume and transport electricity in the market”

3.3. *Moral Hazard*

The Test has been included in the NEM arrangements to prevent the uneconomic investment that would otherwise likely arise as a result of moral hazard. For unregulated investors there is no moral hazard and, of course, no Test¹². It is surprising that the MCE principles do not refer to this: it is the Test’s “raison d’etre”.

Of course, moral hazard was recognised by the Test designers, who recommended a number of Test requirements to address it, such as that:

- the TNSP use a commercial rate for discounting future cash flows: a TNSP would otherwise be inclined to use its (much lower) regulated WACC;
- only benefits that “that can also be captured by non-regulated alternatives” should be included¹³;
- timing constraints should be imposed on when the Test can be undertaken, relative to market need and expected construction¹⁴; and
- the proposed project must satisfy a high burden of proof that it was economic: ie it had to *maximise* net benefit in a majority of scenarios.

We would note that some of these requirements have been lost or diluted in Version 2 of the Test: for example by deleting clause 7 and including explicit “competition benefits” which would generally not be available to non-regulated alternatives.¹⁵ Nevertheless, we believe the principle should be clearly established to prevent further dilution. We propose the following principle:

“[The Test must] recognise that the adverse financial impact of any inefficient regulated investment is primarily borne by non-regulated sectors of the NEM and not by the proponent, and reflect this in the level of prudence and caution to be used in:

- estimating future costs and benefits and the uncertainty associated with these;
- setting the rate at which these are discounted;
- deciding which alternative options are evaluated;
- choosing the timing of the Test in relation to that of the proposed investment; and
- determining whether net economic benefit is maximised”.

¹² this is not to say that there is never uneconomic investment

¹³ see the Review of the Assessment Criterion for New Interconnectors and Network Augmentation Final Report, Ernst and Young, March 1999: recommendation on P53

¹⁴ These were set out in Clause 7 of version 1 of the Test, although they do not appear in version 2.

¹⁵ Perhaps, with effective principles in place based on the original design work, this watering down may have been avoided. Alternatively, a more open and consultative change process, anchored by the NEM objective, may also have prevented it.

3.4. *TNSP Bias*

A TNSP has many incentives to be biased in its evaluation of its favoured project against alternatives. Of course, it wants its favourite to “get up” and, if this is not possible, at least find an “economic” project that helps its bottom line rather than that of its competitors (eg MNSPs or local generation).

We are pleased, then, to see that the MCE has proposed a “competitive neutrality” principle, which at least should ensure that the Test does not allow the TNSP to be biased in evaluating its option against a range of alternative options which are identified and modelled.

But this begs a bigger question: how does the Test prevent a TNSP introducing bias through its selection of alternative options? As the SNI process demonstrated, simply requiring that all “genuine” and “practicable” options are evaluated is insufficient, since this leaves plenty of room for interpretation, and therefore potential dispute, which, ultimately, may have to be decided in the courts (as was SNI).

This ambiguity in the Test has been addressed in Version 2, which provides some guidelines for interpreting the meaning of “genuine” and “practicable”. But suppose, hypothetically that the AER decided to delete these new interpretations from the Test. Such a move would be unhelpful, arguably in violation of the NEM objective, but not in violation of principle 4 or any other. A new principle is needed.

Crafting an appropriate principle is not easy, but we have attempted this (below) by turning around the burden of proof: requiring a TNSP to show that an identified option¹⁶ is either impractical or “ungenuine”, before excluding it from the Test evaluation, rather than the other way around. Thus, a new principle should state:

“[The Test must] ensure that all identified options are either evaluated, or are demonstrated to be:

- impractical;
- frivolous or poorly defined;
- not able to provide a substitute for all or some of the services provided by the proposed investment; or
- likely to provide costs and benefits similar to another, evaluated option.”

¹⁶ which could be identified by anyone during the Test consultation process

3.5. *Other Enhancements*

The header paragraph to the proposed new clause 5.6.5A expresses an “intention” to provide a level of investment certainty to NSPs. We would seek to remove this drafting for two reasons:

- it does not seem necessary to state an intention, and seems likely only to cause additional confusion. If the intention is not clear from the principles themselves, then perhaps the drafting of the principles should be improved; and
- the drafted intention is misleading and misconceived, as it ignores investment certainty for the remaining (unregulated) 90% of the market, which is equally important and relevant.

We think that the first part of principle 2 (ie the use of the Test) is unnecessary since this is already required elsewhere in the Rules. However, we agree with the sentiment in the second part of principle 2 and consider that this could be better captured as follows:

“[the Test must] be able to be undertaken at a cost that is commensurate with the likely magnitude of the costs and benefits associated with the proposed investment”

Principle 3 could be enhanced by including “established” before “principles”, to prevent a TNSP developing its own economic theory of cost-benefit.

As noted earlier, principle 5 partly duplicates principle 1. Its wording could be taken to imply (as could the wording of principle 1 part (ii)) that benefits are irrelevant in relation to reliability-driven augmentation. We do not think this should be the case. We think our proposed wording of principle 1 removes this suggestion. Principle 5 can be simply stated in a similar way to the equivalent principle in the current rules (5.6.5A(c)): thus

“[the Test must] reflect the network performance obligations of Network Service Providers imposed under the Rules or in applicable regulatory instruments”

Whilst we would agree with the sentiment in principle 6, the current drafting lacks clarity. We suggest:

“[the Test must] be capable of consistent application in that two persons independently evaluating through the Regulatory Test the same proposed investment at the same time would be likely to obtain the same test result”

We would also question whether the current Test accords with this principle. That the MCE has proposed that additional Test guidelines are required suggests that it believes that it does not. To address this uncertainty, we would suggest that principle 6 – indeed all of the principles – should relate to the Test *and any associated guidelines* taken together.

Finally, principle 7 – that the test must be *consistent* with regulatory asset valuation – echoes an existing Test principle (Rules clause 5.6.5A(b)) but goes some way beyond it. We agree with the need for consistency, but would argue that this should be achieved primarily in the design of revenue regulation, not in the design of the Test. The tail should not wag the dog. Indeed, a situation could arise where the necessity of the Test to align with regulatory asset valuation may conflict with the other Test principles. Recognising that a similar principle already exists, we do not propose removing principle 7, but instead propose redrafting it as follows:

“[The Test must] to the extent possible without breaching any of the previous principles, be consistent with regulation of network service providers by the AER pursuant to the Rules”

3.6. Summary

A consolidated list of revised principles, making all of the changes suggested above, is included in Appendix 1. We recommend to the AEMC that, if it is in favour of having Test principles, it consider the draft principles that we have proposed.

4. Other Improvements

As noted above, we believe that our proposal, as described in section 2, will be more effective in addressing the MCE's stated concerns that the MCE approach. However, if the MCE approach is adopted, we believe that there are some detailed improvements that could be made. These are presented and discussed in this section.

4.1. *Test change process*

This is described in proposed clause (b) of the MCE's draft Rules. We think this process could be improved by a specific requirement on the AER to demonstrate how its proposed changes are in accordance with the new Test principles. A similar requirement is placed on Rule change proposers and the AEMC in relation to Rule changes and the NEM objective. The requirement would apply to the AER's "notice of intention" and also to the draft and final decisions¹⁷.

4.2. *Guidelines change process*

It is unclear how the guidelines will be changed. In the MCE's current drafting, there is no requirement on the AER to undertake *any* consultation on the Test guidelines, let alone demonstrate that they are consistent with the Test and the Test principles. We believe these requirements should be included. It is also unclear to us whether guidelines can be changed between changes to the Test. We think this should be allowed.

4.3. *Consistency between Test and NSP Regulation*

The intended meaning of the MCE's draft clause (e) is unclear to us, but it seems to relate to a need to ensure a clear nexus between the Test and TNSP regulation – in particular, asset valuation. We agree wholeheartedly with this sentiment; it is something that we have promoted in our submission¹⁸ to the AEMC Chapter 6 review.

However, we do not think that this is something that the Test or the Test principles can really address. It really lies in the domain of Chapter 6, and is hopefully being addressed currently by the AEMC. We therefore see no need for the proposed clause (e).

¹⁷ If our proposal were adopted, it would similarly be necessary to establish an AER change process under which the AER would demonstrate that its proposed Test guidelines are in accordance with the Test.

¹⁸ AEMC Review of the Electricity Transmission Revenue and Pricing Rules, Response to the Revenue Requirements Issues Paper: November 2005.

5. Conclusions

The MCE has expressed concern about the stability and robustness of the Regulatory Test and its governance. In our view, to the extent that evidence supporting such concerns has been seen historically, the problems have already been addressed by changes to the Test design. Thus, the case for change at this time is not compelling.

On the other hand, we recognise that existing Test governance is weak and that future problems could potentially arise. However, we believe that this weakness could be best addressed by incorporating the entire Test – as it currently exists – into the Rules, rather than just a set of “Test principles” as the MCE has proposed.

Our approach has the merit of simplicity, as it avoids the need to define new Test principles and the problems that may arise if these are seen to be inconsistent with the current Test. It also allows best use to be made of the existing AEMC change process, which has been recently and carefully designed to effectively trade off stability against improvement and innovation, whilst ensuring all changes promote the NEM objective. Under the MCE proposal, a new AER change process would need to be designed.

On the other hand, we agree with the MCE that there may be a need to develop detailed “Test guidelines” to ensure clarity and robustness and agree that these should be developed and promulgated by the AER.

If, on the other hand, Test principles are to be introduced, it is vital that they clearly and comprehensively articulate the underlying objectives and philosophy of the Test. This philosophy does not appear in the Test itself, but can be found in the papers and reports that were developed and discussed prior to the initial promulgation of the Test.

In our view, the MCE’s draft principles do not capture or represent the Test philosophy and objectives. In particular, they fail to recognise why the Test is needed: that the nature of TNSP regulation – and the moral hazard that it creates – gives rise to an institutional bias in favour of *regulated* investment and that a regulatory test hurdle (hopefully) restores neutrality and so promotes economic efficiency. We have proposed revised principles which we believe better capture the Test philosophy and so will promote economic efficiency, in line with the NEM objective.

Appendix: Proposed Test Principles

The regulatory test or any amended test, taken together with any guidelines for the application of the test, under this clause 5.6.5A must:

1. have as its purpose the evaluation of proposed new regulated investments to see whether they are likely to maximise the net economic benefit to all those who produce, consume and transport electricity in the market;
2. recognise that the adverse financial impact of any inefficient regulated investment is primarily borne by non-regulated sectors of the NEM and not by the proponent, and reflect this in the level of prudence and caution to be used in:
 - (i) estimating future costs and benefits and the uncertainty associated with these;
 - (ii) setting the rate at which these are discounted;
 - (iii) deciding which alternative options are evaluated;
 - (iv) choosing the timing of the Test in relation to that of the proposed investment; and
 - (v) determining whether net economic benefit is maximised;
3. be able to be undertaken at a cost that is commensurate with the likely magnitude of the costs and benefits associated with the proposed investment;
4. be based on established principles of cost-benefit analysis;
5. ensure that all identified options are either evaluated, or are demonstrated to be:
 - (i) impractical;
 - (ii) frivolous or poorly defined;
 - (iii) not able to provide a substitute for all or some of the services provided by the proposed investment; or
 - (iv) likely to provide a level of net benefit which is similar to or less than another, evaluated option;

6. ensure that the methodology used by a TNSP to evaluate the costs and benefits of an option is unbiased in relation to the following attributes of that option:
 - (i) energy source;
 - (ii) technology;
 - (iii) ownership;
 - (iv) location;
 - (v) scale;
 - (vi) regulatory status; or
 - (vii) any other factor;
7. reflect the network performance obligations of Network Service Providers imposed under the Rules or in applicable regulatory instruments;
8. be capable of consistent application, in that two persons independently undertaking the Regulatory Test for the same proposed investment at the same time would be likely to obtain the same test result; and
9. to the extent possible without breaching any of the previous principles, be consistent with regulation of network service providers by the AER pursuant to the Rules.