ELECTRICITY TRANSMISSION NETWORK owners

Application of Regulatory Test to Network Replacement and Reconfiguration

Response to AEMC Draft Rule Determination

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1. Introduction

The Electricity Transmission Network Owners' Forum (ETNOF) welcomes this opportunity to comment on the Australian Energy Market Commission's (the "Commission") Draft Determination[1] on the Stanwell proposal to address network replacement and reconfiguration investments (the Stanwell proposal).

This submission covers three propositions contained in the AEMC's draft decision, they are:

- the need to extend the clause 5.6.6 Regulatory Test consultation process to all large network investments, and where ETNOF proposes a less heavy handed solution that still achieves the Commission's objectives;
- the appropriateness of the proposed threshold for large network investments; and
- the Commission's decision to reject Stanwell's proposal for the payment of compensation to third parties affected by reconfiguration investments, which is supported by ETNOF as being consistent with the established market design principles.

2. Replacement and Reconfiguration Investments

The Commission has stated its concern that there is a "lack of sufficient incentives for efficient replacement and reconfiguration investment as provided for in the Chapter 6 framework." The Commission then goes on to conclude that this concern is most conveniently addressed by applying the Regulatory Test processes set out in clause 5.6.6 of the Rules to all network investments over $35 million (large network investments) as well as to augmentations. ETNOF submits that such an approach is too heavy handed and is disproportionate in terms of achieving the Commission's objectives.

Specifically, ETNOF believes that the Commission's objective can be met through an alternative requirement that ensures that only those large network investments for which non-network solutions are realistic options are subjected to the clause 5.6.6 Regulatory Test consultation process. This submission proposes an approach that achieves this without need for all major network projects to be subjected to the clause 5.6.6 process.

Before detailing our proposal, it is worth considering the type of investments that the Commission is proposing to be covered by the Regulatory Test. The majority of the capital expenditure that would now be captured by the expanded scope of the Regulatory Test involves the replacement of existing assets with their modern day equivalent.

Such like-for-like replacement of elements in an existing network has no detrimental impact on network users because it does not change the capability of the network to deliver energy. Rather, the decision to undertake such replacements is normally driven by deterioration in the asset's condition which undermines the ability of the asset to meet the performance required by network users in terms of capacity, reliability, safety and environmental criteria.

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[1] AEMC, *Stanwell Proposal: Draft Rule Determination*, 26 October 2006.

ETNOF believes that the existing regulatory regime already provides strong disciplines for the good practice replacement of ageing assets. This is because the need for the services in question can be clearly informed by historical data, that is, as to whether they are provided at an efficient level or not, keeping in mind that the intention of replacement is like-for-like replacement, not increased service level.

Utilisation information would be expected to be a key determinant of TNSPs in formulating plans to optimally meet performance obligations, and also for the AER in reviewing these in setting an *ex ante* capital expenditure allowance. Under the new Chapter 6 rules for setting transmission revenues one of the factors that the AER is to have regard to in approving a TNSPs capital expenditure estimate is the demand for services. Under the approval process there is considerable incentive on TNSPs to satisfy the AER that the expenditure is prudent, and as we note, history must be compelling. Scenario analysis of uncertain future needs which is a feature of analysis under the Regulatory Test is unnecessary.

ETNOF therefore concludes that the proposal to apply the Regulatory Test to pure replacement projects would serve no useful purpose and instead would overlay existing review processes and be detrimental to the delivery of critical infrastructure.

ETNOF notes that the AEMC's decision to extend the Regulatory Test process to all large network investments seeks to increase:[2]

> *"…incentives in addition to those provided through the Chapter 6 framework to ensure that replacement expenditure is undertaken at least cost, and because of the need to consider alternative non-network options in place of network replacement investments."*

ETNOF recognises and supports the validity of these objectives. Nevertheless, it is the collective experience of ETNOF that most opportunities for efficient non-network alternatives arise from the ability to defer incremental network augmentations. The value of such deferral is often magnified because augmentations are typically lumpy, and so utilisation of these incremental assets in the early years is often below its long term optimal level.

In contrast the possibilities for efficient non-network alternatives to replacement investments are limited. This is because a common characteristic of assets scheduled to be replaced is they generally have a high level of utilisation, as they are old, and demand for services has grown during their lifetime. Therefore, replacements cannot be deferred by incremental non-network solutions. Further, replaced assets are commonly part of a larger network asset of which only a portion is replaced at any one time, which limits the benefits from non-network alternatives.

Notwithstanding the limited scope for non-network alternatives for existing assets, many large replacement projects (e.g. substation or line replacement projects) are already covered by the existing 5.6.6 process. Large replacement projects often involve some opportunity to enhance network capability. Where the value of the augmentation component of such projects falls within the threshold that defines a *new small transmission network asset*, these large replacement projects are already included in the Annual Planning Report process. Furthermore, under the current Rules those large replacement projects with enhancements of more than $10 million would already trigger a full Regulatory Test.

ETNOF acknowledges the importance of ensuring the market is properly informed of new transmission investments. It therefore proposes that all projects over $35 million be included

2 AEMC, *Stanwell Proposal: Draft Rule Determination*, 26 October 2006, pp 17-18.

in the Annual Planning Report process set out in clause 5.6.2A, whether they have an augmentation component or not.

Employing the Annual Planning Report process avoids the unnecessary administrative burden of undertaking a the full 5.6.6 process, while ensuring that all market participants are informed of upcoming major transmission investments. Furthermore, by requiring the prior disclosure of an intention to invest in a large network investment, potential non-network alternatives can make themselves known to the TNSP and so be included in the economic analysis that is undertaken so as to ensure the delivery of an efficient network investment.

Once a TNSP is made aware of the potential for non-network alternatives to reduce expenditure on reconfiguration or replacement projects, it has a strong incentive through the current *ex ante* capital expenditure framework to pursue these non-network opportunities.

ETNOF submits that this alternative approach would provide a “safety net” by enhancing the disclosure of information to market participants. It would ensure that interested parties are informed of all large network investments, permitting them to assess the potential impact of the investment on their own operational and investment decisions and by allowing them to raise alternative non-network options.

ETNOF submits that including projects over $35 million in the Annual Planning Report provides a more appropriate balance between the regulatory compliance costs and associated benefits in terms of improved investment decisions.

3. Threshold for Application of Clause 5.6.6

The Commission has invited submissions regarding the appropriate values for the various thresholds for the Regulatory Test. A consequence of the Commission’s draft Rule is it creates the following thresholds, ie:

- New Large Transmission Network Asset:
  - $35 million in network investments; or
  - $10 million in augmentation investments.
- New Small Transmission Network Asset:
  - $1 million in augmentation investments.

An analysis of the appropriateness of these thresholds requires one to ascertain the expected benefits from undertaking either the Regulatory Test or Annual Planning Report processes in terms of identifying efficient non-network options and transparency of information. These benefits must then be weighed up against the expected administrative burden that would arise from the need to apply the Regulatory Test or Annual Planning Report process.

To determine an economically efficient threshold level would at a minimum require a cost-benefit analysis that considers:

- the minimum efficient scale for non-network options to displace network investments;
- the extent that the current threshold captures routine and uncontroversial transmission investments in the Annual Planning Report;

- the likelihood that non-network investments are identified through the Regulatory Test consultation process; and

- the expected administrative workload of various thresholds.

ETNOF intends to undertake this analysis and submit a Rule Change Proposal for further consideration by the Commission in the New Year.

As an interim measure ETNOF supports a $35 million threshold for including large network investments in the Annual Planning Report process. A $35 million threshold ensures that specialist resources are not diverted from assessing investments where non-network solutions are a realistic option. The additional burden associated with a lower threshold could potentially result in a consultancy hiatus which would disrupt the meeting of critical capital expenditure needs and service dates.

4. Compensation

ETNOF would observe that the AEMC's decision to reject the Stanwell proposal for the payment of compensation to third parties affected by reconfiguration investments is consistent with established market design principles.

AEMC has correctly identified that common carriage is a foundation principle of transmission regulation. The Stanwell proposal takes an individual participant benefit/cost perspective, which departs from the regimes underlying concept that the evaluation of regulated network investment should be on the basis of a net economic benefit to all market participants, and does not have as a principal purpose the identification and evaluation of where those benefits (or costs) fall. The current decision framework for new transmission investment requires that the gains accrued by the winners (improved loss factors, improved supply reliability) exceed the losses suffered by the losers. In no part of the existing NEM framework for network investment is there any provision for redistribution of wealth from the winners to the losers, either by compensating losers, or by seeking equivalent payments from winners.

The Stanwell proposal would involve a fundamental shift in the operation of the regulated transmission network and, in the opinion of ETNOF, such a policy decision is more appropriately raised within a wider forum such as the congestion management review.

5. Conclusion

In assessing the Commission's Draft Determination, ETNOF believes that:

- The national electricity market objectives are better achieved by requiring that large network investments are covered by the Annual Planning Report, rather than the full Regulatory Test process.

- A interim threshold of $35 million is appropriate until a detailed assessment of the efficient threshold levels can be undertaken in the new year.

- AEMC's decision to reject Stanwell proposal for the payment of compensation to third parties affected by reconfiguration investments is correct and consistent with the accepted principle of common carriage, and any shift in policy position is more appropriately addressed in say the congestion management review.