



24 February 2006

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Dear John

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

United Energy Distribution (UED) welcomes the opportunity to make this submission on the Rule change proposal relating to new principles that the Australian Energy Regulator (AER) must adopt in promulgating the Regulatory Test under the National Electricity Rules.

As a general comment, UED strongly supports Rule changes that are aimed at clearly setting out the principles that must be adopted by the AER in implementing and administering the regulatory framework described in the Rules. In this context, UED is generally supportive of the proposed Rule change; however the company considers that the Rule change proposal could be further clarified:

- to include a provision in Rule 5.6.5A that, subject to the revenue determination provisions set out in Chapter 6 of the Rules, establishes a clear linkage between the Regulatory Test and the inclusion of the associated new investment into the regulatory asset base; and
- to clarify that the Regulatory Test is to be applied to transmission networks only.

The company's reasons for its position on these two matters are set out under separate headings below.

### **Linkage between Regulatory Test outcomes and regulated revenue**

Attachment A of the Ministerial Council on Energy's (MCE) Rule Change Application sets out, amongst other things, the rationale for the proposed Rule changes. Page 1 of Attachment A states:

"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."

This passage establishes a clear and logical linkage between the Regulatory Test and the level of regulated revenue that a Transmission NSP should be permitted to recover.

To date, there has not been a clear linkage in the Rules between the Regulatory Test and the revenue setting rules. This weakness has been addressed during the AEMC's present review of Chapter 6 of the Rules. Accordingly, the AEMC's *Transmission Revenue Rule Proposal Report* states on page 56:

"In relation to determining forecasts of future capital expenditure, the Rules provide for a presumptive approval of capital expenditure for reliability augmentations, projects that are required to meet regulatory obligations and projects that have satisfied the Regulatory Test."

UED considers that there would be some benefit in strengthening the linkage between the Regulatory Test and the revenue setting Rules, by including a statement in clause 5.6.5A to the effect that, subject to the revenue determination provisions set out in Chapter 6 of the Rules, the costs of transmission augmentations which satisfy the Regulatory Test are to be added to the proponent's regulated asset base. We suggest that this principle be incorporated into the first paragraph of clause 5.6.5A.

In making this suggestion, we note that the regulatory provisions governing New Facilities Investment in the National Gas Code (sections 8.15 to 8.17) explicitly provide for the regulatory asset value to be increased in recognition of additional capital costs incurred in constructing new facilities for the purpose of providing services. UED considers that this is an area in which there would be considerable merit in establishing greater consistency between the rules governing new investment in the gas and electricity network sectors.

### **Application of the Regulatory Test to distribution network investment**

The Regulatory Test is designed to address issues that are considered to be specific to electricity transmission. In particular:

- The Regulatory Test encompasses a consideration of "competition benefits". These benefits consist of wider economic benefits associated with the efficient removal of regional price differences in the operation of the National Electricity Market (NEM). Such benefits may be attributable to investment in increased inter-regional transmission capacity which facilitates greater competition between generators in different regions.
- Electricity transmission investment is centrally planned, however it takes place within a market environment in which there may be economically viable alternatives to transmission development. These alternatives may include demand-side response or local generation. The Regulatory Test is designed to ensure that viable alternatives to transmission investments are considered as part of the centrally-administered investment decision process, and that transmission development only proceeds if it is the most efficient option.
- The development of transmission networks can have a material impact on spot market prices, and on the distribution of wealth amongst wholesale market participants. The Regulatory Test provides a transparent and consultative framework for centrally-planned transmission investment decision-making. It is also designed to provide investment decision signals that reflect the net benefits (ie ignoring wealth transfers) of particular investment alternatives.

As already noted, Attachment A of the MCE's Rule Change Application sets out, among other things: the role of the Regulatory Test in the Rules, the background to the policy position adopted by the MCE, and a statement of issues concerning the existing Rules. The discussion in Attachment A is focused (solely) on *transmission* issues. It seems clear that the intended application of the Regulatory Test is to be limited to transmission investment. This inference is borne out by the MCE's recent consultation paper on the establishment of a national regulatory framework for energy distribution and retailing<sup>1</sup> which stated:

"The formal application of the regulatory test for electricity distributors is an onerous requirement, given the relative size of the majority of distribution investments." (page 23)

The MCE consultation paper proposes that:

- The current provisions in the National Electricity Rules relating to the form of regulation - including the requirement on distributors to apply the Regulatory Test - will be replaced with new proposed Rules relating to the form of regulation (see pages 23 and 24).
- Proposed new distribution network expansion rules – to be applied on a national basis - will replace the regulatory test for distributors (see page 41).

On the basis of the foregoing discussion, we understand that it is the MCE's intention that Distribution NSPs would not be required to apply the Regulatory Test. However, the drafting of the proposed new clause 5.6.5A of the Rules (set out in Attachment B of the MCE's Rule Change Application) is written in a way which makes the Regulatory Test applicable to both Transmission and Distribution NSPs.

In view of the current status of the MCE's work in establishing a national regime for energy network regulation, it would be inappropriate for Rule changes to be made to clause 5.6.5A now without clarifying that the Regulatory Test is to be applied to transmission investment only. UED therefore submits that the proposed new clause 5.6.5A should be drafted so as to limit its application to transmission investment only.

Should you have any questions in relation to the above, please contact Siva Moorthy, Network Regulation Manager on (03) 8544 9442.

Yours sincerely

**Julie Buckland**  
Manager Regulatory and Government Relations Group

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<sup>1</sup> *Public Consultation on a National Framework for Energy Distribution and Retail Regulation*, Prepared by NERA Economic Consulting and Gilbert + Tobin May 2005