



Australian Energy Market Commission

Rule Determination

Transmission network replacement and reconfiguration

Rule Proponent

Stanwell Corporation Ltd

1 March 2007

Signed:

A handwritten signature in black ink, which appears to read 'John Tamblyn', is written over a horizontal dotted line. The signature is fluid and cursive.

**John Tamblyn
Chairman**

For and on behalf of

Australian Energy Market Commission

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy market. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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1. Summary

On 17 May 2006 Stanwell Corporation Ltd ('Stanwell') submitted a Rule change proposal ('the Proposed Rule') with the Australian Energy Market Commission ('the Commission') to address concerns that transmission network service providers ('TNSPs') are able to undertake reconfigurations of the transmission network without considering potential third party impacts. Stanwell argued that by not considering third party impacts, there was significant potential for inefficient investments to occur. For this reason, the rule change proposed by Stanwell was believed to promote the National Energy Market ('NEM') objective.

The Commission has determined not to make the Proposed Rule or another Rule, and, in accordance with section 102 of the National Electricity Law ('NEL') the Commission makes this Rule determination and sets out its reasons for not making the Rule proposed by Stanwell.

The Commission had previously released a draft Rule determination and draft Rule that modified a number of elements of the proposed Rule put forward by Stanwell, and outlined its reasons for that decision. Following further analysis and consideration of issues raised in submissions on the draft Rule, the Commission's final decision is not to proceed with the draft Rule, and not to make the proposed Rule put forward by Stanwell. The Commission is not satisfied that the proposed Rule of Stanwell satisfies the Rule making test or promotes the NEM objective.

In brief, the Rule proposed by Stanwell had three elements. First, it required a TNSP to undertake the Regulatory Test for all reconfiguration investments. Second, if the Regulatory Test is passed, the Rule proposed that any third parties negatively affected by the reconfiguration would be entitled to compensation. Third, it required a TNSP to provide information to the market when proposing to undertake a reconfiguration of the network.

The proposed amendments to the Rules as proposed by Stanwell were argued to result in:¹

- (a) a decrease in the risks associated with investments in generation facilities, thereby improving incentives for efficient generation investment;
- (b) more transparent decisions regarding replacement or reconfiguration of transmission networks to promote efficient network planning decisions; and
- (c) the recognition that the costs incurred or profit foregone by generators as a result of network reconfiguration should be compensated to ensure that efficient investments are not deterred.

¹ Stanwell Corporation Rule Change Proposal, 17 May 2006, p4

In relation to the Rule proposed by Stanwell and subsequent release of a draft Rule determination and draft Rule, the Commission sought submissions and has considered the issues raised in conjunction with undertaking its own analysis. In total the Commission received 13 submissions in response to the first and second round consultations.

Under the Rule making test in section 88 of the NEL, the Commission must be satisfied that if a Rule is to be made, it will or is likely to contribute to the achievement of the national electricity market objective, namely:²

The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

As a result of its consideration and analysis, the Commission is not satisfied that the Rule proposed by Stanwell would, or is likely to, promote the NEM Objective. In addition, the Commission is not satisfied that the making of another Rule in this instance, would, or would be likely, to promote the NEM Objective.

The Commission has therefore decided not to make the Rule proposed by Stanwell or any other Rule. The main reasons for this decision are that:

- the Commission has been persuaded by arguments made in submissions that the matters raised in the draft Rule determination are best dealt with in a specific review of the application of the Regulatory Test rather than in the particular context of the Rule proposed by Stanwell;
- the appropriate threshold for application of the Regulatory Test would be best considered by the Commission through a Rule change proposal directly related to that matter. The Commission notes that it has received correspondence from the Energy Transmission Network Owners Forum (ETNOF) that it intends to submit a Rule change proposal on this issue³ ; and
- the proposed informational requirements developed in the draft Rule should also be considered in the context of a wider review of the provision of information in relation to the application of the Regulatory Test, and were ancillary to the Rule proposed by Stanwell.

The Commission believes that a targeted review of the application of the Regulatory Test, in light of the recommendations arising from the Energy Reform Implementation Group's consideration of similar issues, is more likely to result in amendments to the National Electricity Rules that would promote the NEM Objective.

² Section 7, NEL.

³ In a letter dated 17 February 2007, ETNOF advised the Commission that it intends to lodge a Rule change proposal addressing the issues of the Regulatory Test thresholds and the publication of information in Annual Planning Reports.

2. Stanwell's Rule Proposal

On 17 May 2006, Stanwell Corporation lodged a Rule change proposal with the Commission seeking the establishment of a "comprehensive inter-participant framework for addressing network replacement or reconfiguration".⁴ Under this proposal, the Regulatory Test would be extended to apply to any proposed reconfiguration or replacement of network assets not captured by the definition of augmentation under the Rules.⁵ In addition, affected third parties would be entitled to be compensated for foregone revenue as a result of the reconfiguration or replacement.

The Proposal was intended to address what Stanwell believed was a gap in the Rules regarding transmission investments. Under the National Electricity Rules, TNSPs are required to undertake the Regulatory Test when making transmission asset investments that constitute an augmentation of the network; however Stanwell indicated that this same requirement is not applied to reconfiguration or replacement of network components or assets. Stanwell's proposal was concerned with ensuring that networks and network users are presented with accurate signals when making locational decisions, and addressing what it perceived to be an asymmetric risk faced by generators arising out of potential reconfiguration decisions by TNSPs.

2.1. Request to Expedite the Rule Change

In a letter of 2 June 2006, Stanwell requested that the Rule change proposal be handled as a matter to be expedited under section 96 of the NEL on the basis that:

- the Rule change is urgently required because it has an existing generation asset that in the very near term may, as a result of a foreshadowed network reconfiguration, become unable to provide system restart ancillary service payments; and
- the Rule change is non-controversial as
 - it will not impose an unreasonable burden on TNSPs;
 - any TNSP costs would be recoverable through the revenue cap and/or positive pass through mechanism; and
 - the proposal is likely to lower electricity costs where risks in the electricity supply chain are reduced.

The Commission considered Stanwell's request and concluded that, while Stanwell may be adversely impacted if the proposed network reconfiguration proceeds, the situation does not represent an imminent threat to the wholesale exchange or the safety, security or reliability of the national electricity system.

The Commission also concluded that the Rule was not non-controversial because:

⁴ Stanwell Corporation Rule Change Proposal, 17 May 2006, p1

⁵ Stanwell submitted a number of modifications to its proposal on 10 July 2006, including the narrowing of the applicability of the Rule change to network reconfigurations only.

- the process is likely to increase the regulatory burden on TNSPs due to the increased requirement for the application of the Regulatory Test;
- the proposed regime for the provision of compensation to adversely affected participants would likely be controversial as it may be regarded as contrary to the principle of open access; and
- the inclusion of a compensation regime had the potential to raise, rather than lower, electricity costs depending on the relative size of the compensation compared to the reduction in risks to the supply chain.

Consequently, the Commission concluded that it was not appropriate for the Rule Change to proceed under an expedited process.

2.2. Summary of the Rule proposed by Stanwell

The amendments to the Rules proposed initially by Stanwell, and as subsequently revised by them, required:

- (a) the Regulatory Test to be undertaken where there is a proposed network reconfiguration with a value greater than \$10 million, or where a network user has identified themselves as being financially disadvantaged by the proposed reconfiguration in the order to \$1 million or more;
- (b) the payment of compensation to generators where they incur costs or forgo profits as a result of a network reconfiguration, unless this is accounted for under an existing agreement between the TNSP and the affected party; and
- (c) the implementation of a mechanism that allows TNSPs to recoup the cost of the compensation payable as a result of network reconfiguration via the TNSP revenue cap calculation and in-period via a “positive pass through” mechanism.

2.3. Key issues in relation to the Proposal

Stanwell identified three specific issues that it sought to address in the Rule change proposal.

2.3.1. Location decisions

The location of a generation investment impacts considerably on the profitability of the investment. Given the long-run nature of generation investments and their high cost, location decisions are therefore of critical importance.

Specific features of the transmission network where a generator is located can impact on its overall profitability. These features include its capacity, reliability and the effective cost of evacuating power through the network.

Stanwell argued that the NEM Objective would be promoted by providing generators and network users with accurate market signals to allow decisions about the location of generation investment and large load investment to be made more efficiently. The Rule proposed by Stanwell was designed to allow generators and other third parties to manage the risks that arise from decisions by TNSPs to replace or reconfigure the transmission network.

2.3.2. Mitigation of risk

A second issue identified by Stanwell related to the risks for generators arising from a reconfiguration of the transmission network. The first risk related to a reconfiguration that results in the reclassification of previously shared network assets as connection assets. Stanwell argued that, in accordance with the requirements in the Draft Revenue Rule⁶, this may allow the TNSP to seek to recover the costs of a network reconfiguration from an individual generator.

The second risk related to a reconfiguration where a generator loses the ability to provide services, such as system restart, or its ability to maintain a level of reliability of supply as a result of the loss of access to points of access. In these circumstances a reconfiguration is argued to create significant risk for the expected revenue for a generator.

As the issue of reclassification of shared network assets is addressed as part of the current review of Transmission Revenue and Pricing (Chapter 6), Stanwell's proposal focused on an approach to mitigate the risks arising from a reconfiguration that impacts on generator revenue.

2.3.3. Asymmetrical application of the Regulatory Test

The final issue identified by Stanwell related to the asymmetric application of the Regulatory Test.

A fundamental principle underpinning Stanwell's proposal was ensuring that the same decision making standards apply to significant new investments to augment the network and significant investments to reconfigure the network. In the absence of this symmetrical application of the Regulatory Test, Stanwell believed that network owner and operator incentives are distorted. The age profile of transmission networks assets, as well as factors such as shifts in usage, changes in terrain or variations in land use and network routing controls had the potential to result in an increasing number of large scale transmission investments by TNSPs that are not captured by the definition of augmentation under the current Rules.

Stanwell was of the view that a detailed assessment of the total costs and benefits of any significant investment, including impacts on third parties, was required to ensure optimal network planning decisions. On the basis that the role of the Regulatory Test is to promote efficient network planning decisions with respect to whether expenditure is warranted or net beneficial; and which project should be pursued or preferred, application of the Regulatory Test to network reconfigurations was therefore argued by Stanwell as promoting the NEM Objective.

2.4. Related Rule changes

The Commission has recently completed its consideration of a Rule change proposal submitted by the Ministerial Council on Energy (MCE) to develop a framework in the

⁶ The Commission subsequently made the Transmission Revenue Rule on 16 November 2006.

Rules for the making of the Regulatory Test. A Rule determination and the National Electricity Amendment (Reform of the Regulatory Test Principles) Rule 2006 No.19 was made on 30 November 2006.

The key elements of the Regulatory Test Principles Rule are:

- an improved governance structure for the Regulatory Test;
- clearer objectives for the Regulatory Test;
- improved certainty for the application of the Regulatory Test; and
- improved procedural requirements in the making of the Regulatory Test by the AER.

In making its decision to not make the Rule proposed by Stanwell, or another Rule, the Commission considered that there was merit in a more focused review of the application of the Regulatory Test, particularly in relation to some of the issues identified by Stanwell, and issues identified in a recent report by the Energy Reform Implementation Group.⁷

⁷ See discussion in Energy Reform Implementation Group Discussion Paper, November 2006

3. Rule determination

The Commission has determined not to make the proposed Rule put forward by Stanwell or any other Rule, and, in accordance with section 102 of the National Electricity Law ('NEL') the Commission makes this Rule determination and sets out its reasons.

On balance the Commission was not satisfied that, under section 88 of the NEL, the Rule proposed by Stanwell will, or is likely to, contribute to the achievement of the NEM objective and therefore does not satisfy the statutory Rule making test.

In addition, the Commission is not satisfied that the making of another Rule in this instance, would, or would be likely, to promote the NEM Objective.

In making this Rule determination the Commission has taken into account:

- its powers under the NEL to make Rules;
- Stanwell's Rule change proposal and proposed Rule;
- submissions received; and
- the Commission's own analysis as to whether a Rule to be made would, or would be likely, to contribute to the achievement of the national electricity market objective so that it satisfies the statutory Rule making test.

These matters are discussed below. A detailed discussion of the Commission's reasons for the Rule determination is provided in section 4.

3.1. Commission's power to make the Rule

The Commission is satisfied that the subject matter of the Rule as proposed by Stanwell falls within the scope of the Commission's Rule making powers as set out in section 34 and Schedule 1 of the NEL.

Specifically, the proposed Rule would fall within the matters set out in section 34(1) of the NEL, as it relates to:

- (a) the operation of the national electricity market;
- (b) the operation of the national electricity system for the purposes of security and reliability of that system; and
- (c) the activities of persons participating in the national electricity market or involved in the operation of the national electricity system.

The Rule as proposed also falls within a number of subject matters in Schedule 1 of the NEL, specifically: Item 10 (disconnection of transmission systems), Item 13 (network access) and Item 15 (regulation of revenues earned by TNSPs).

3.2. Assessment against the national electricity market objective

The Rule making test as provided in section 88 of the NEL requires the Commission to be satisfied that a Rule that it proposes to make will contribute to the NEM objective. The test requires the Commission to consider the implications of any potential Rule that would amend the National Electricity Rules, for efficient investment in, and efficient use of, electricity services, in respect of specified elements which have an impact on the long term interests of end users of electricity.

The Rule making test states:

“(1) The AEMC may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity market objective.

“(2) For the purposes of subsection (1), the AEMC may give such weight to any aspect of the national electricity market objective as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.” (s.88 NEL)

The NEM objective is at the centre of the Rule making test, and is set out in section 7 of the NEL:

“The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.”

The Rule proposed by Stanwell sought to achieve two outcomes. First to provide improved locational signals for investment in generation, and second, to better manage the risks associated with generation investment. The Rule as proposed would have required TNSPs to apply the Regulatory Test to proposed reconfiguration investments and required the payment of compensation where generators were adversely affected by the investment.

As indicated in the draft Rule determination, the Commission believes that the Regulatory Test plays a significant role in clarifying locational signals, which are in turn a factor in ensuring a reliable and secure supply of electricity to consumers. In the draft Rule determination the Commission indicated that it believed, at that time, that the modified solution put forward in the draft Rule would reduce the degree of unmanageable or unforeseen risk that transmission and generation investments are subject to by broadening the application of the Regulatory Test to all large scale transmission. This was believed to reduce the degree to which investment may be discouraged by these risks, and would have potentially addressed any concerns that investment may be subject to the negative impacts of arbitrary and economically irrational reconfiguration and replacements at a later date.

On the basis of submissions received in relation to the draft Rule determination and associated draft Rule, the Commission has formed the view that there remains a need for further debate and analysis before it is clear that the NEM Objective is or is likely to be promoted by a wider application of the Regulatory Test, as presented in the draft Rule. The Commission’s reasons for this conclusion are that:

- the Commission has been persuaded by arguments made in submissions that the matters raised in the draft Rule determination are best dealt with in a specific review of the application of the Regulatory Test rather than in the particular context of the Rule proposed by Stanwell;
- the appropriate threshold for application of the Regulatory Test would be best considered by the Commission through a Rule change proposal directly related to that matter. The Commission notes that it has received correspondence from the Energy Transmission Network Owners Forum (ETNOF) that it intends to submit a Rule change proposal on this issue⁸ ; and
- the proposed informational requirements developed in the draft Rule should also be considered in the context of a wider review of the provision of information in relation to the application of the Regulatory Test, and were ancillary to the Rule proposed by Stanwell.

In particular, a number of submissions indicated that there were likely to be significant distortions arising from a change in the threshold for the application of the Regulatory Test for large proposed reconfiguration and replacement investments without a subsequent change to the threshold for application of the test to new augmentations.

While the Commission acknowledged in the draft Rule determination the potential for distortions to arise, the wider benefits from applying the Regulatory Test more broadly were considered, at that time, to outweigh these costs. It became apparent however that the Commission had underestimated the likely distortions associated with a staged change to the threshold, and therefore considers the appropriate way forward is for a more targeted and specific consideration of the appropriate threshold for the Regulatory Test, as proposed by ETNOF.

While the Commission is not satisfied that the Rule proposed by Stanwell satisfies the Rule making test and promotes the NEM Objective, this should not be taken as precluding future Rule change proposals satisfying the Rule making test. A future specific review would provide the opportunity for a more detailed consideration of possible enhancements to the application of the Regulatory Test. This is consistent with issues identified by the Energy Reform Implementation Group and issues raised in submissions to the Commission's recent consideration of the Regulatory Test Principles Rule.

In light of the concerns raised in a number of submissions and its own assessment, the Commission has decided not to proceed with the making of the draft Rule, (or any further modified version) and, for the reasons set out above, finds that the Rule making test has not been satisfied by the making of the draft Rule in this particular context.

⁸ In a letter dated 17 February 2007, ETNOF advised the Commission that it intends to lodge a Rule change proposal addressing the issues of the Regulatory Test thresholds and the publication of information in Annual Planning Reports.

The Commission therefore concludes that neither the Rule proposed by Stanwell, nor the draft Rule contained in the draft Rule Determination, should be made.

3.3. Consultation process

3.3.1. Submissions received

A section 95 notice relating to the Rule change proposal was issued by the Commission on 15 June 2006, inviting submissions from interested parties. First round submissions were due to close on 17 July 2006; however, due to a submission from Stanwell on 10 July 2006 proposing a number of amendments to its proposal, first round consultation was extended until 31 August 2006. The Commission received five submissions at this stage of the consultation process, from:

- National Generator Forum (NGF);
- The Group;
- EnergyAustralia (EA);
- Electricity Transmission Network Owners Forum (ETNOF); and
- VENCORP.

In response to the draft Rule determination and draft Rule the Commission received a further eight submissions from:

- EnergyAustralia;
- Electricity Transmission Network Owners Forum;
- National Generators Forum;
- Powerlink;
- Stanwell Corporation;
- Queensland Department of Mines and Energy; and
- Flinders Power.

No requests were made for a public hearing in relation to this proposal, and no public hearing has been held to date.

There was no clear consensus view amongst respondents, with submissions relatively evenly split for and against the proposal. Specific concerns were raised by all submissions about the applicability, implementation and implication of the proposal and the draft Rule. Respondent views are discussed in greater detail as part of the Commission's analysis of the key issues in Chapter 4.

A notice under section 107 of the NEL was published by the Commission on 11 January 2007 extending the period for assessment of the proposal by the Commission. This extension was sought to allow the Commission sufficient time to undertake a comprehensive assessment of the issues raised by the proposal and in submissions.

4. Commission's analysis of the Proposed Rule

In summary, the Rule change proposed by Stanwell sought to improve investment certainty for market participants, and in particular generators, by requiring TNSPs to apply the Regulatory Test when undertaking proposed network reconfigurations, provide compensation if the Regulatory Test is satisfied, and also undertake appropriate consultation with affected market participants.

The Commission finds, however, that it is not clear that the enhancements to the proposed Rule outlined in the draft Rule determination satisfy the Rule making test, and has therefore decided to not make the proposed Rule, or any other Rule based on the proposed Rule. This chapter outlines the Commission's reasons for this decision in relation to each of the issues.

At a broad level, the proposed Rule sought to provide location based incentives by ensuring that TNSPs undertake reconfiguration investments that take into consideration the potential impacts on third parties, including generators. It also sought to address a concern that inefficient reconfiguration investment decisions could be made within the current Rules because there is no requirement in the Rules for TNSPs to consider third party impacts that may arise from reconfiguration investments.

By requiring TNSPs to undertake the Regulatory Test for reconfiguration investments in combination with taking into consideration the costs of third parties, Stanwell argued that the NEM objective would be promoted because the Test ensured that TNSPs considered the wider market benefits and costs that may arise from a network reconfiguration. In the absence of applying the Regulatory Test, a TNSP would undertake a reconfiguration investment if its private economic benefits are maximised given the costs of the investment and its regulatory obligations. The incentive to invest efficiently arises from the economic regulation framework as developed by the Commission in its recent review of the economic regulation of transmission services and subsequent Rule changes.

In making its decision on the proposed Rule, a key issue for the Commission was whether the problem identified by Stanwell was sufficient to justify some form of regulatory intervention in the Rules. This required consideration of the incentives within the current Rules for efficient investments arising from reconfigurations, as well as an assessment of whether the costs of implementing the proposed regime were justified by the potential benefits to market participants.

As a result of consultation following the release of the Commission's draft Rule, and further internal analysis, the Commission has concluded that there are issues arising out of the changes to the Regulatory Test framework as contained in the draft Rule that require focused consultation and analysis and as such would be best considered as part of a specific Rule change proposal or review.

Reconfiguration investments generally arise when an asset requires replacement and a TNSP identifies more efficient asset configurations to deliver required system performance associated with the particular asset. The incentive to invest efficiently

arises from the provisions in Chapter 6A of the Rules as applied by the AER that require total forecast capital expenditure to be efficient. An alternative configuration may be more efficient because of changes in the use of the network or environmental factors since it was originally built.

Unlike new network augmentations that are required to satisfy the Regulatory Test, reconfigurations are not currently required to undergo any mandated test prior to the investment being undertaken. This does not imply however that there is no regulatory constraint placed on TNSPs with regard to reconfiguration investments. Just as for the general capital expenditure program, these investments must satisfy requirements of the Rules, in particular that the expenditure is efficient to meet regulatory requirements. If the reconfiguration expenditure is not efficient, some or all of it will be excluded by the regulator in the building block calculation used to estimate the TNSPs maximum allowed revenue for the purposes of its revenue cap.

The Commission is however concerned about a possible lack of sufficient incentives for efficient replacement and reconfiguration investment under the Chapter 6A framework, as identified in the Stanwell proposal. Unlike the reasoning of Stanwell where the scope for inefficiency arises because TNSPs are not required to have regard to the negative impact of proposed reconfiguration investments on identified third parties, the Commission's concerns are regarding:

- the potential for investment distortions to arise because the Regulatory Test is only applied to new large augmentations, rather than all proposed large network investments; and
- a lack of incentives for TNSPs to consider alternative non-network options when proposing to replace or reconfigure the existing transmission network.

While this led the Commission to conclude for the purposes of the draft Rule and draft Rule determination that there was merit in applying the Regulatory Test to proposed reconfiguration and replacement investments, following an examination of issues raised in submissions, it is no longer clear that the NEM Objective would or would be likely to, be satisfied by extending the application of the Regulatory Test in this manner at this time. The Commission believes that a more focused consultation on, and assessment of, the operation of the Regulatory Test than is afforded by this Rule proposal would be a more appropriate forum in which to consider these issues. For this reason, the Commission has decided that the Rule proposed by Stanwell does not satisfy the Rule making test, and has therefore not made the proposed Rule.

The remainder of this chapter examines the main elements of the Stanwell proposal in greater detail, given the Commission's view that the current regulatory framework does not create appropriate incentives for efficient reconfiguration and replacement investment.

4.1. Application of the Regulatory Test to reconfiguration investments

In its Rule change proposal, Stanwell argued that the Regulatory Test should be applied to transmission network reconfigurations as well as network augmentations in order to address its concerns about third party impacts arising from reconfiguration investments.

Stanwell's original proposal required the Regulatory Test to be applied to distribution networks and the replacement of network elements; however this aspect of the proposal was amended following consultation with the market by Stanwell. Undertaking the Regulatory Test in these circumstances would, in Stanwell's view, ensure that the costs and benefits to affected network users, such as generators, are taken into consideration by the TNSP when making a decision regarding a network reconfiguration project.

The Commission's draft Rule and associated draft Rule determination accepted an enhanced version of Stanwell's proposal that broadened the application of the Regulatory Test to both reconfiguration and replacement investments. Given its preliminary view to extend the application of the Regulatory Test to potential reconfiguration and replacement investments, the Commission's draft Rule determination highlighted concerns that the current threshold for the application of the Regulatory Test of \$10 million was too low for current network investment. Reflecting this, the draft Rule proposed a revised threshold of \$35 million for the application of the Regulatory Test to reconfiguration and replacement investments, and invited submissions specifically addressing the appropriateness of this threshold.

Having considered first and second round submissions in response to these specific issues, the Commission has decided not to accept, at this time, Stanwell's proposal that applying the Regulatory Test to all large reconfiguration investments promotes, or is likely to promote, the NEM Objective.

However, as noted above, the Commission is of the view that the issue of possible inefficient replacement and reconfiguration investment due to the Regulatory Test only applying to new augmentation investments, and a lack of regard by TNSPs for alternative non-network options when considering proposed replacement and reconfiguration investments is worthy of further consideration, but should be subject to a more focused consultation and assessment process. In addition, the Commission believes there is merit in assessing the applicable threshold for determining what constitutes a large investment for the purposes of applying the Regulatory Test. However, this would also be more appropriately undertaken in the context of Rule change proposal specifically addressing the thresholds applicable to the Regulatory Test. The Energy Transmission Network Owners Forum (ETNOF) has indicated in its second round submission to the Commission, and in correspondence received subsequently, that it intends to submit a Rule change proposal on this issue.

The remainder of this section outlines issues raised in submissions and the Commission's reasons for its decision to not make the proposed Rule.

4.1.1. Submissions

In considering the application of the Regulatory Test to replacement works, the Energy Transmission Network Owners Forum (ETNOF) indicated in its first round submission that:⁹

⁹ ETNOF submission, 31 August 2006, p. 4

Replacement capital expenditure is currently subject to review by the AER in determining a revenue cap for the TNSP, and is subject to regulatory incentives aimed at encouraging efficient expenditure. Furthermore, such expenditure is subject to normal project approval and governance procedures within the business.

For this reason, and because asset replacements have no impact on participants, ETNOF argued that there is no need to apply the Regulatory Test to replacement expenditure. This is particularly because ETNOF considered the costs associated with applying the Regulatory Test to outweigh any potential benefits:¹⁰

The proposal to require public consultation on the application of the regulatory test for all network replacements and reconfigurations would impose a significant additional regulatory compliance burden upon TNSPs, with no additional benefit to end-users. The cost of this additional burden would be borne by end-users through regulated charges.

ETNOF's second round submission argued that analysis of the appropriate, economically efficient thresholds to apply to various aspects of the Regulatory Test requires careful consideration of a broad range of issues. ETNOF states that "the Stanwell proposal would involve a fundamental shift in the operation of the regulated transmission network and... such a policy decision is more appropriately raised within a wider forum".¹¹ ETNOF indicated that it intends to undertake an analysis of these issues and submit a Rule change proposal for further consideration by the Commission.

EnergyAustralia raised a number of concerns with the application of the Regulatory Test to reconfiguration investments. First, it is concerned by the potential delays that may arise in transmission investment from a requirement to undertake the Regulatory Test for network reconfigurations. This is considered to be a particular problem because the threshold of \$10 million is likely to capture most reconfiguration investments.

Second, EnergyAustralia believed that the problem identified by Stanwell, being how generators mitigate the risks arising from reconfiguration in their investments, is best resolved through the negotiation of a connection agreement.

The National Generators Forum however claimed that "[p]ractical experience amongst members of the NGF is that this is very difficult to negotiate deep connection rights in a connection agreement".¹² The NGF reiterated this view in its second round submission.

EnergyAustralia's second round submission maintained its objections to the proposed broader application of the Regulatory Test, primarily on the grounds that such a change would have serious implications for the operation of the overall incentive framework and should therefore not be considered without subjecting it to a specific consultative process. In EnergyAustralia's view, the draft Rule would introduce a number of

¹⁰ ETNOF submission, 31 August 2006, p. 5

¹¹ ETNOF second round submission, 21 December 2006, p. 5

¹² National Generators Forum submission, 30 August 2006, p. 3

“inconsistencies which cannot be justified”¹³ into the Rules framework. EnergyAustralia further argued that the regulatory burden created by the Rule Proposal would exceed any perceived benefit, and therefore would not promote the NEM objective.

This view was echoed by the Queensland Department of Mines and Energy, which expressed strong concerns regarding the potential negative impact on network service providers and customers, as the draft Rule would “impose a substantial procedural burden on Powerlink, significantly increase the time between identifying a project and completing it and increase the risk that the project will not be completed in sufficient time to maintain reliability of supply”.¹⁴

Other submissions, including from the NGF and VenCorp agreed with the principle that third party impacts should be considered as part of the reconfiguration investment framework, but do not comment on the appropriateness of applying the Regulatory Test for this purpose.

4.1.2. Commission’s analysis

The key motivation for the Rule change proposal from Stanwell is to provide a mechanism whereby a TNSP is required to consider the impacts on third parties of a proposed reconfiguration investment. The Regulatory Test, which requires the TNSP to consider the benefits and costs arising from a network investment, is therefore potentially a convenient mechanism to use to achieve this outcome.

It is important, however, to consider the purpose underlying the application of the Regulatory Test to determine whether it can be appropriately applied to the problem identified by Stanwell.

The Regulatory Test was originally designed to address concerns regarding the lack of incentives by TNSPs to consider alternative non-network investments that may be more efficient to network investments, and to thereby ensure efficient investments are undertaken. It also ensures that, for non-reliability investments, the overall market benefits exceed the costs, because of the diffuse impacts a network augmentation investment can have on both up and down stream users. This is particularly important due to the difficulty in determining the impact of an augmentation network investment on particularly users.

For a reconfiguration investment, however, affected parties are likely to be relatively easily identified, due to the tendency of reconfiguration investments to be localised to a particular segment of the network. This suggests that the commercial negotiation and arbitration framework provided for in the Rules might be able to ensure that an efficient outcome occurs. There are two reasons why this might not, in practice, be true:

- First, there is no positive incentive in the Rules for a TNSP to negotiate with an affected third party user when a reconfiguration is proposed; and

¹³ EnergyAustralia, second round submission, December 2006, p. 9

¹⁴ Queensland department of Mines and Energy, 10 January 2007, p. 2

- Second, there are potentially insufficient incentives on TNSPs to ensure that a proposed reconfiguration is the most efficient approach to providing required network services, particularly due to a lack of regard for non-network options.

Without sufficient incentives to negotiate, that negotiation is unlikely to lead to an efficient outcome. Similarly, for negotiation to deliver an efficient outcome, any proposed reconfiguration should be the TNSP's least cost option, taking into consideration non-network alternative options. To the extent that it is not the least cost option, negotiation may not result in efficient reconfiguration investment.

To ensure that reconfigurations are, in practice, efficient investments in the long-term interests of consumers, the Commission believes there are arguments for broadening the application of the Regulatory Test beyond proposed new network augmentation investments to capture proposed large reconfiguration and replacement investments. However, in light of views raised in submissions, the Commission is persuaded of the view that this Rule change proposal is not the appropriate forum in which to consider this issue and has therefore decided not to extend the application of the Regulatory Test at this time.

Finally, the Commission considered in the draft Rule determination the relevant threshold for the application of the Regulatory Test for reconfiguration and replacement investments, in line with the concerns raised by EnergyAustralia. The Regulatory Test currently applies to large new transmission investments in excess of \$10 million.¹⁵

The Commission's draft determination outlined its concerns that the current \$10 million threshold is too low for any network investment, given the increase in costs associated with transmission investment since the threshold was originally implemented in 1999. The draft Rule determination concluded that an appropriate threshold is likely to be within the range of \$20 million to \$50 million. In the absence of a basis for an appropriate threshold the Commission notionally used a Regulatory Test threshold of \$35 million, being the midpoint of the identified range, for reconfiguration and replacement investments in the draft Rule and invited submissions on this specific issue.

Consideration of submissions on this issue, as well as further internal analysis, has led the Commission to conclude that the introduction of changes to the thresholds under the Regulatory Test requires further discussion and more focused consultation in the context of the operation of the Regulatory Test as a whole. Furthermore, the introduction of a tiered or staggered threshold is of sufficient concern, particularly amongst some respondents, from a procedural point of view to conclude that, without the benefit of additional consultation, it is not certain that the NEM Objective would be promoted by the draft Rule. The Commission believes that a focused review that is able to properly address the consequences of a change to the Regulatory Test thresholds and the potential for distortionary impacts is more likely to result in an outcome which promotes the NEM objective.

¹⁵ Chapter 10, National Electricity Rules, definition of *new large network transmission asset*.

4.1.3. Commission's decision

The Commission's decision is to not accept the proposal from Stanwell to apply the Regulatory Test to all large reconfiguration investments.

4.2. Payment of compensation to affected third parties

In its Rule change proposal Stanwell suggested that where a reconfiguration project satisfies the Regulatory Test, then compensation should be paid by the TNSP to any adversely affected network users. This compensation would be for any additional cost or forgone revenue that resulted from the network reconfiguration. The proposal also allowed for the TNSP to recover the cost of any compensation paid from network users via increases to the revenue cap.

In its proposal, Stanwell argued that the payment of compensation to network users who have reasonably relied on the existing configuration of the network in making investment decisions would lead to greater certainty and hence more investment efficiency.

Stanwell's response to the Commission's draft Rule determination, which rejected the implementation of a compensation regime under the Rules, proposed an alternative process, whereby connection agreements that do not provide for compensation would be subject to a limited reopening and amendment process. In addition, the revised compensation regime would require TNSPs and generators to negotiate in good faith on the issue of compensation in future connection agreements in accordance with guidelines devised by the AEMC.

The Commission has concluded that neither of the two compensation regimes proposed by Stanwell would satisfy, or would be likely to satisfy, the NEM Objective. An overview of submissions and the Commission's reasons for its decision are outlined further in this section.

4.2.1. Submissions

First round submissions from the NGF and the Group supported Stanwell's proposal of compensation to network users affected by a reconfiguration of the network. They considered that generators make investments on the basis that the capability of the network will remain constant, or improve, over time. Therefore, they argued that network users that are adversely affected by a network reconfiguration that reduces the network capability should receive compensation payments.

The NGF's second round submission expressed support for Stanwell's alternate proposal of a limited reopening regime for connection agreements, on the basis that connection agreements have not, or are not, negotiated taking into consideration the effects of reconfigurations or replacements.

EnergyAustralia and ETNOF identified the payment of compensation as an issue about property rights, indicating that it amounts to a form of firm access.

Issues surrounding open access arrangements of the market are currently being debated as part of more broad-scale reviews of economic regulation and

congestion management. As we discuss below, the Rule change establishes a right for a generator to seek compensation as a results of a network change that modifies its ability to evacuate power to the shared network. This would set a dangerous precedent for market impacts resulting from all network augmentations. [EnergyAustralia]¹⁶

it is a fundamental principle of the market that access to the transmission network is provided on a non-firm basis; indeed the market provides no firm transmission rights to any participant. Contrary to this principle, the Stanwell proposal provides an implied property right which ETNOF believes would be better and more fully considered as part of the AEMC congestion management review. [ETNOF]¹⁷

They argued that firm access is inconsistent with a framework for negotiated access such as exists in the Rules. Under this framework, compensation would be included as an element in contractual negotiations.

EnergyAustralia also considered that the flow of compensation is in the wrong direction. That is, if a project is justified under the Regulatory Test, the TNSP should be compensated to the extent that the TNSP undertakes an alternative option at the request of a market participant. EnergyAustralia's second round submission elaborated on this point, arguing that a "TNSP and its customers should not be liable for these commercial outcomes", just as a "TNSP does not receive revenues from generators who may have benefited commercially from a network configuration to meet reliability requirements".¹⁸

EnergyAustralia questioned the impact of establishing a precedent for the payment of compensation to an incumbent generator in this context – if compensation is paid in this context, what would prevent compensation being paid to an incumbent generator that loses revenue as a result of an augmentation that benefits the market as a whole? EnergyAustralia considers there to be "endless" potential opportunities for a TNSP to compensate "disgruntled market participants".

EnergyAustralia and ETNOF's second round submissions both supported the Commission's decision to reject the implementation of a compensation regime, reiterating points made in their initial submissions. ETNOF argued that the Stanwell proposal "takes an individual participant benefit/cost perspective, which departs from the regime's 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."¹⁹

¹⁶ EnergyAustralia submission, 30 August 2006, p. 2

¹⁷ ETNOF submission, 31 August 2006, p. 4

¹⁸ EnergyAustralia second round submission, December 2006, p. 5

¹⁹ ETNOF second round submission, 21 December 2006, p. 5

4.2.2. Commission's analysis

Assuming a general principle that compensation is only paid where rights are taken away, the payment of compensation to affected network users would imply that the user has some form of access right. This is contrary to the regulatory transmission framework which is based on the principle of common carriage.

In the case of network access being reduced as the result of a network reconfiguration, the absence of guaranteed access rights under the Rules implies that the payment of concomitant compensation under the Rules would not be appropriate. Network users that are considering a long term investment that is reliant on some form of firm access should negotiate this access with the TNSP and any costs consequently factored into the investment decision. It should be noted, however, that Stanwell is referring specifically to the loss of revenue it receives under a contract for the provision of system restart services, rather than any impairment of its ability to provide generation.

The Commission believes that there are other factors that can reduce the capability of generators to access the network including:

- network overloading due to load growth;
- entry of new generators that compete for access to the network;
- reducing network capability due to new larger loads and generators that increase the severity of the worst credible contingency; and
- re-rating of transmission elements due to changes in operating practices such as premature aging of transformers and methodology for determining the thermal ratings of transmission lines.

At present generators are not sheltered from these risks and, therefore, the Commission believes that generators should not be protected from the similar risk of network reconfiguration. In effect, these are business specific risks that should be taken into consideration as part of generation investments.

In addition, the Commission considers that the payment of compensation is unlikely to be in the interests of end users in many instances. For example, in the Stanwell case, reconfiguration would mean that the Kareeya power station is unable to provide its system restart ancillary service and this service would need to be obtained from an alternative source. If Stanwell is compensated for its lost revenue then in effect end users pay for the service twice.

Finally, if compensation was to be payable to generators affected by a reconfiguration, it would seem appropriate that the compensation be symmetrical. In other words, if a network reconfiguration benefited a particular generator, that generator should contribute to the reconfiguration investment in line with the benefits it receives. In this way, the incentives arising from reconfiguration investments would be balanced.

Determining the level of compensation, positive or negative, to an affected network user is likely to be contentious, as has been emphasised in a number of submissions. Stanwell's proposed Rule does not provide any indication of how compensation is to be calculated, but it has indicated support for the development of compensation guidelines

by the AER, or recourse to a dispute resolution process. Stanwell's submission in response to the draft Rule proposed that the AEMC develop guidelines for the negotiation of the issue of compensation within future connection agreements.

Estimating the lost revenue over the life of the replacement assets is likely to be impractical and affected network users would not have the correct incentives to disclose their true costs. This could lead to inefficient investment decisions. Any benefits from compensating affected generators are likely to be outweighed by the burden on the TNSP in assessing the level of compensation and in risk to the network user in terms of the uncertainty of the compensation that would apply. However, in contrast negotiated network access provides a mechanism for the affected users to accurately value the impact different reconfiguration options and hence is more likely to lead to an efficient outcome.

The Commission is of the view that the reasons articulated above apply equally to Stanwell's further proposal as outlined in its submission in response to the draft Rule. Stanwell argued for the introduction of a regime to allow for the reopening of connection agreements, and a requirement that TNSPs and generators negotiate in good faith on the payment of compensation when negotiating new connection agreements.

In the Commission's opinion, this additional proposal does not necessarily eliminate the problems arising out of the imposition of an inappropriate compensation regime upon market participants as would be the case with the regime initially proposed by Stanwell. Without further consultation, it is difficult to assess whether the development of guidelines for the negotiation of particular aspects of connection agreements would be considered by market participants too great an intrusion upon commercial practices. Similarly, the development by the AEMC of guidelines governing this aspect of connection agreement negotiation would require some form of further consultation.

For all of these reasons, the Commission has decided to reject the proposal for inclusion in the Rules for the payment of compensation to affected third parties arising from the passing of the Regulatory Test for a reconfiguration or replacement investment.

4.2.3. Commission's decision

The Commission's final decision is to not accept the elements of the Rule proposed by Stanwell as it relates to the payment of compensation to third parties affected by a proposed reconfiguration or replacement that has passed the Regulatory Test. The Commission has also decided not to accept Stanwell's revised proposal for the introduction of Rules permitting the limited reopening of connection agreements for the purposes of negotiating compensation arising out of network reconfigurations or replacements.

4.3. Information disclosure requirements for TNSPs

Under the Rule change proposal, TNSPs would be required to publish the details of proposed reconfigurations as part of its annual planning report prior to undertaking a reconfiguration. The required information proposed comprises:

- the month and year in which the proposed reconfiguration will become operational;

- the purpose of the reconfiguration;
- the total cost of the proposed reconfiguration;
- other reasonable network and non-network options to the reconfiguration;
- an explanation of the ranking of reasonable alternatives to the project including non-network alternatives. This ranking is to be undertaken in accordance with the principles contained in the Regulatory Test; and
- whether the proposed reconfiguration will have a material inter-network impact, assessed having regard to the objective set of criteria published by the Inter-regional Planning Committee (if such criteria have been published).

Upon notification of the planned reconfiguration, affected participants (specifically a market participant that will incur a cost, or forgo revenue, in excess of \$1 million) were proposed to make themselves known to the TNSP proposing the reconfiguration.

The Rule proposed that the TNSP be required to consult with affected participants and provide a “reasonable opportunity” for affected participants to make written submissions in relation to the proposed reconfiguration. The TNSP would have been obligated to consider matters raised in submissions from affected parties and make appropriate amendments. The TNSP would subsequently be required to reissue the details of the proposed reconfiguration incorporating agreed amendments if material changes to the proposed reconfiguration occur as a result of the consultation process. The AER, in making its revenue cap determination for the TNSP, would have been required to take into account matters raised in the consultation process for the proposed reconfiguration.

The Commission’s draft decision was to apply the information disclosure requirements provided in Rule 5.6.6 to large reconfiguration and replacement investments, in place of adopting the information disclosure and consultation regime proposed by Stanwell. The Commission believed at the time of making the draft Rule that the information disclosure requirements surrounding the application of the Regulatory Test currently provided in the Rules were appropriate and sufficient for the application of the Test to proposed reconfiguration and replacement investments, in light of the decision to reject the proposed compensation payment regime.

In the Commission’s view, the information provisions were a consequential element of the Rule proposed by Stanwell. Given its decision not to accept the other two key aspects of the Rule proposal, the Commission is not convinced that implementing a new information disclosure and consultation regime, or modifying the current Annual Planning Report process, is appropriate without undertaking specific consultation on that as a stand alone issue.

The Commission notes that it has received notification from ETNOF expressing its intention to submit a Rule change proposal addressing information disclosure in the Annual Planning Report.

The remainder of this section outlines the Commission’s reasons for its decision and provides an overview of submissions in relation to information requirements.

4.3.1. Submissions

In general, there was broad recognition and support for the provision of information about proposed reconfiguration investments if there were likely to be third party impacts.

However VENCORP expressed concerns that the requirement to publish notification on the annual planning report prior to commencing work could lead to unnecessary delays to a project for third parties.²⁰ VENCORP suggested that notification of a reconfiguration could be undertaken through the annual planning report, or via publication of a notice to stakeholders (similar to the process currently in place for funded augmentations).

The NGF was supportive of the consultation obligations included in the proposal, arguing that it was likely to lead to better investment decisions across the NEM:²¹

The NGF believes that because of the obligations the Rule change places on NSPs to consult in relation to network reconfigurations the consequent improved communications are likely to lead to better investment decisions all round.

NGF is also of the view that the improved communication between the generator and TNSP would avoid the situation that Stanwell (and Powerlink) currently itself in.

ETNOF argued in its first round submission that it would be impractical to apply a public consultation process to the large number of replacement projects that are anticipated due to the age of the network. In ETNOF's view, reconfigurations are relatively rare, and are the result of detailed network planning assessments. In its second round submission, ETNOF expressed support for the Commission's draft decision on information provision, and proposed extending the provision to include all projects over \$35 million, in order to avoid the administrative burden associated with undertaking a full Regulatory Test process.

4.3.2. Commission's analysis

While there is clear merit in implementing processes that improve communication between market participants, particularly regarding changes to the network with potential third party impacts, there are important considerations regarding the possible additional regulatory burden that the imposition of additional reporting and consultation requirements could create for TNSPs.

In principle, the Commission believes that there are three circumstances that justify the inclusion of an information disclosure requirement relating to network reconfigurations or replacements:

- where there is potential for interested market participants to be unaware of a proposed reconfiguration or replacement investment;

²⁰ VENCORP submission, 1 September 2006, p. 1.

²¹ NGF submission, 30 August 2006, p. 2

- where there is scope for a reconfiguration to have significant third party impacts; or
- there is potential for non-network alternative options to be considered.

The process proposed by Stanwell, and in particular the consultation process, does create substantial additional regulatory obligations on TNSPs. The amount of information required in an annual planning report regarding the proposed reconfiguration will result in material additional costs for the TNSP. If the age of the network is taken into consideration, it is not unrealistic to expect the number of reconfigurations and replacements to increase markedly in the near future.

Requiring the publication of some information regarding proposed network reconfigurations could be of benefit by improving the information available to market participants when making operational or investment decisions. However, the Commission believes that this additional information, and the associated potential burden upon TNSPs, should be considered within a Rule change proposal focusing on the information required under the Regulatory Test or the Annual Planning Report process, rather than consequential to the Rule proposed by Stanwell.

The Commission's approach in the draft Rule was to adopt the current information requirements provided for the application of the Regulatory Test. The Commission took the view at the time that there did not appear to be any justification for a different regime for large reconfiguration or replacement investments, particularly given its decision not to implement any form of compensation regime (and its specific information disclosure requirements).

The Commission's final decision to not accept Stanwell's proposed Rule regarding the extension of the Regulatory Test removes the main rationale for the inclusion of this particular information disclosure framework with regard to reconfiguration and replacement investments. In the Commission's view, introducing additional information disclosure and consultation requirements not directly resulting from the implementation of Stanwell's proposal should not be undertaken without the benefit of focused consultation on the range of options available, and the potential costs and benefits.

4.3.3. Commission's decision

The Commission has decided not to accept the information disclosure aspects of the Stanwell proposal.

4.4. Other issues raised in submissions

The Commission received a late submission from Flinders Power in response to the draft Rule. The submission raises the issue of the possible reallocation of shared system costs to connection costs as a result of reconfiguration projects and the risk that this could lead to unwarranted increases in prescribed transmission entry charges for connected generators.

The Commission notes the issue raised by Flinders Power regarding the reclassification of connection assets, and appreciates the circumstances surrounding the late submission.

However, the Commission is of the view that it is not appropriate to address the issues raised by Flinders Power in the context of the Stanwell Rule proposal.

End of Rule Determination