



Australian Energy Market Commission

Rule Determination

National Electricity Amendment (Transmission Last Resort Planning) Rule 2007

Rule Proponent
Ministerial Council on Energy
8 March 2007

Signed:



.....
John Tamblyn
Chairman
For and on behalf of
Australian Energy Market Commission

Commissioners
Tamblyn
Carver
Woodward

Inquiries

The Australian Energy Market Commission
PO Box H166
Australia Square NSW 1215

E: aemc@aemc.gov.au

T: (02) 8296 7800

F: (02) 8296 7899

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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 5 October 2005 the Commission received a Rule change proposal from the Ministerial Council on Energy (MCE) requesting that the Commission make a Rule to provide it with a last resort planning power (LRPP).

In accordance with sections 102 and 103 of the National Electricity Law (NEL) the Commission has decided to make a LRPP Rule (Rule to be made) and associated Rule determination. This Rule determination outlines the Commission's reasons for its decision. The Rule will be made under s 103 on 15 March 2007 and commence operation on the same date.

The Commission published the Rule proposed by the MCE in accordance with s 95 of the National Electricity Law (NEL). The closing date for first round submissions on the Rule Proposal was 24 February 2006. The Commission received 10 submissions at this stage of consultation.

Given the interrelationship between the LRPP Rule proposal and other Rule proposals under consideration by the Commission at the time (for example the Transmission Revenue Rule Proposal, the Congestion Management Review and the Regulatory Test Rule Proposal) the Commission decided to issue a notice under s 107 of the NEL extending the publication of the Draft Determination and Draft Rule to 23 November 2006.

The Commission published its draft Rule determination and draft Rule for consultation on 23 November 2006. Four submissions on the draft Rule determination were received by the close of consultation on 29 January 2007. On 15 February 2007 the Commission gave notice under s 107 of the NEL that it would extend the time for preparing the determination until 8 March 2007.

The proposed Rule provided the Commission with the power to direct a party (for the purposes of the Rule a registered participant) to undertake the Regulatory Test in relation to an identified new network investment. The power was not intended to apply to non-network projects (for example generation or demand side projects). However, there remained scope to assess non-network projects as viable alternative options to a proposed transmission investment as part of the usual application of the Regulatory Test.

The Commission considers that the LRPP is an important and complimentary part of the regime being developed by the Commission as part of its Congestion Management Review, and will form part of the overall strategy to manage transmission constraints. The Commission does not, however, consider the LRPP limits the options that may be considered by the Commission in the context of the Congestion Management Review. It is possible that as a result of that Review, the Commission may propose amendments to the LRPP Rule.

The Commission is also mindful of the work of the Energy Reform Implementation Group (ERIG) who examined the possibility of a national planning approach to transmission. The Commission notes that the ERIG review has recently finalised its report and may ultimately also propose policy initiatives that require amendments to the LRPP Rule.

In considering the Rule proposed by the MCE, the Commission invited comment in its draft Rule determination from interested stakeholders on the following issues:

- whether the Commission should have the flexibility to direct parties to undertake the Regulatory Test in relation to an identified project, or direct parties to identify a project and then undertake the Regulatory Test in relation to that project;
- whether the LRPP Rule should provide for directed parties to recover the costs of undertaking the Regulatory Test and, if so, how should the directed parties (transmission network service providers (TNSPs) and non-TNSPs) be able to recover these costs; and
- whether the Commission should be required to seek advice directly from NEMMCO, in addition to the Reliability Panel, when identifying a project that will be subject to a LRPP direction.

The LRPP Rule has largely enhanced the framework established in the Draft Rule, with some minor modifications. The key elements of the Rule made by the Commission are:

- **Provision of a LRPP to the Commission.** The Rule provides the Commission with a LRPP to direct registered participants to undertake the Regulatory Test for identified potential transmission projects within the national transmission flow paths and between regions, or to direct a party to identify a potential transmission project for the purpose of subsequently undertaking the Regulatory Test;
- **Inclusion of a purpose clause.** The Rule expresses the purpose of the LRPP - to ensure timely and efficient inter-regional transmission investment for the long term interests of consumers;
- **Inclusion of matters to consider in determining whether to exercise the LRPP.** In deciding whether or not to exercise the LRPP, the Commission must:
 - identify a constraint problem within the national transmission flow paths;

- undertake all reasonable inquiries to be satisfied that no current Regulatory Test is being undertaken in relation to the identified problem;
 - consider other options that could address the identified problem, and be satisfied that these options are unlikely to address the problem;
 - be satisfied that the problem may have a significant impact on the efficient operation of the market; and
 - be satisfied that the problem is unlikely to be addressed but for the exercise of the power.
- **Requirement to develop LRPP Guidelines.** The Rule requires the Commission to develop a guideline to provide information on its proposed approach to exercising the LRPP and specific matters that must be included in the guidelines;
 - **Guidance on the exercise of the LRPP.** The Rule requires the Commission to exercise the LRPP in accordance with the published guidelines and consistent with the purpose included in the Rule;
 - **Advisory role of the Inter-Regional Planning Committee.** The Rule requires the Commission to seek advice from the Inter-Regional Planning Committee when identifying a potential transmission project and have regard to the Annual National Transmission Statements (ANTS) produced by NEMMCO. The Commission also has the power to request NEMMCO to appoint additional expertise from other non-transmission sectors to the IRPC.

As noted above, the Commission is mindful that the LRPP Rule may be amended in the future as a consequence of the Commission’s Congestion Management Review or the recommendations of ERIG.

The Commission considers that the Rule satisfies the rule making test provided for in s 88 of the NEL.

In addition, the Commission is preparing a draft of the LRPP Guidelines, which it will publish for consultation after the commencement of the Rule. The draft Guidelines will provide guidance to market participants concerning the manner in which the Commission proposes to exercise the LRPP, including specific matters which the Commission intends will limit its exercise of the power. As required by the LRPP Rule, the Commission will release the draft Guidelines for public consultation in accordance with the transmission consultation procedures provided for in Part H of Chapter 6A of the Rules.

2. The MCE's Rule Proposal

On 5 October 2005 the Commission received a Rule change proposal from the Ministerial Council on Energy (MCE) requesting that the Commission make a Rule to provide for a last resort planning power (LRPP). The Proposed Rule sought to ensure that appropriate consideration is given to transmission investment in circumstances where existing incentives to undertake transmission investment may be lacking. These circumstances may arise where a potential transmission investment results in inter-regional benefits that could result in positive net benefits to the market as a whole, but which is not economic for any one Network Service Provider operating in one region of the market to undertake.

This chapter summarises the LRPP Rule proposed by the MCE and explains the context for the Proposed Rule, including the incentive problem that the Proposed Rule seeks to address.

2.1. Summary of the Rule Proposal

The intention of the Proposed Rule was to give the Commission the power to direct a market participant to undertake the Regulatory Test¹ in relation to an identified new transmission network investment. The power did not extend to directing that the Regulatory Test to be undertaken for non-transmission projects such as generation or demand side projects. However, because the Regulatory Test provides for an assessment of non-network alternative options, non-network options can be indirectly included in the assessment process arising from the exercise of the proposed LRPP.

The Proposed Rule also set out a process the Commission would be required to follow in exercising the LRPP. The proposed process required the Commission to:

- establish and seek advice from a panel of industry representatives prior to exercising the LRPP and when identifying a potential transmission project for the application of the LRPP. The Proposed Rule requires a representative of NEMMCO be included on the panel of industry representatives to provide technical support;
- give notice in writing to direct the relevant party – the directed party – to apply the Regulatory Test for the potential transmission project. The purpose of the notice was to specify one or more of the alternative projects

¹ The Regulatory Test is provided for in Rule 5.6.5A and requires a Network Service Provider to undertake a cost-benefit analysis of a proposed large network investment prior to undertaking the investment to ensure that all alternative non-network options are also considered and that efficient transmission investment occurs.

that the directed party must consider when applying the Regulatory Test to the potential transmission projects and/or the timeframe in which the Regulatory Test must be carried out; and

- publish a statement of its reasons for exercising the LRPP at the same time it issues the notice.

The Proposed Rule also required that the Commission have regard to:

- the latest two Annual National Transmission Statements (ANTS);
- whether the potential transmission project has previously been subjected to the Regulatory Test and if so, when the Test was carried out and the results of the application of the Test; and
- the likely costs of the directed party in applying the Regulatory Test to an identified potential transmission investment.

A party directed by the Commission in accordance with the Proposed Rule would be required to comply with the notice including any requirements in the notice for consultation, publication of results, and timeframes. Where a directed party fails to comply with the terms of a notice the Proposed Rule allowed the Commission to direct a party other than the initially directed party to apply the Regulatory Test to the potential transmission investment.

The Proposed Rule required the directed party to publish a report setting out the results of the application of the Regulatory Test to the potential transmission investment. Following the publication of the report any registered market participant could apply to the AER for a determination as to whether the potential transmission project satisfies the Regulatory Test. The AER was then required to use the findings and recommendations of the report and any other material it considers relevant when making its determination.

The MCE outlined in its proposal a number of factors that it considers are relevant to the exercise of the LRPP. These include that the LRPP:²

- *“is expected to be exercised rarely;*
- *is to be exercised only where normal market arrangements have failed to provide efficient and timely incentives for the assessment of transmission projects which might be expected to satisfy the Regulatory Test;*
- *does not extend to directing actual investment to occur; and*
- *only applies to national transmission flow paths under the ANTS that lie between Regional Reference Nodes (ie transmission networks that directly impact inter-regional transfers)”.*

² MCE Rule Proposal, p3.

The Proposed Rule however, did not provide for these factors to be explicitly considered when deciding whether to exercise the LRPP.

The power was also limited to national transmission flowpaths between regional reference nodes.

The MCE outlined that it intended to amend the NEL to provide a civil penalty for any failure to comply with a direction from the Commission in accordance with the exercise of the LRPP. An appropriate Regulation prescribing the relevant provision as a civil penalty provision is anticipated to be made in due course.

The MCE considers that its proposal would contribute to achieving the NEM Objective by promoting efficient investment and efficient use of electricity services, which would in turn promote the long-term interests of end users by ensuring a safe, secure and reliable electricity supply.

2.2. Context for the requirement of a Last Resort Planning Power

In its Rule proposal the MCE notes that robust and effective transmission planning processes are integral to the realisation of a national grid as a platform for a competitive NEM.

The MCE considers that current market arrangements and regulatory processes for inter-connector development may not deliver timely and adequate levels of transmission investment as there are no specific requirements that ensure an inter-regional network investment is committed. This is more the case for inter-regional assets as the potential investment is likely to require co-ordination between the effected jurisdictional networks which have caused delays to the application of the Regulatory Test for otherwise potentially economic projects.

Furthermore, the MCE indicates that a key concern with the current framework for the regulation of TNSPs is the incentives for appropriate investment in transmission networks. In its Rule proposal the MCE state that the National Electricity Code provided for state-based transmission network planning and investment and, as a result, was relatively piecemeal in nature. This lack of national consistency in planning arrangements is seen as a potential impediment to efficient network investment, particularly between state jurisdictions. Importantly, the Electricity Code did not oblige TNSPs to maintain efficient transfer capacity between jurisdictional regions.

The motivation underlying the MCE's Rule proposal is to provide a mechanism whereby interconnector investment occurs in a timely way and that an adequate level of inter-regional investment is undertaken. As an inter-regional transmission asset is likely to have a material inter-network impact, a potential investment is likely to require co-ordination between the affected jurisdictional

networks. This need for co-ordination has resulted in significant delays, particularly in undertaking the Regulatory Test, for what are otherwise economically beneficial interconnector projects.

To partly address this issue the MCE, in its 2003 report to the Council of Australian Governments (COAG), endorsed a new National Electricity Market (NEM) transmission planning process to improve consistency and transparency surrounding interconnector development, thereby improving the economic efficiency of interconnector projects.

Part of this new process was the development of the Annual National Transmission Statement (ANTS), which is published annually by NEMMCO. The ANTS provides information on the major national transmission flow paths, forecasts interconnector constraints, and identifies options to relieve transmission constraints.

Despite these improved arrangements relating to information provision, the MCE identify in its Rule proposal that the Rules do not provide particular requirements or standards for inter-regional investments (unlike intra-regional investment) which is mostly undertaken to comply with reliability standards. In addition, any inter-regional investment requires a proponent, as the obligation for assessing whether a new interconnector satisfies the Regulatory Test for transmission investment resides with the proponent (usually a jurisdictional planning body). As inter-regional assets will have a material inter-network impact, a potential investment is likely to require the consent of both jurisdictions of the impacted networks. This need for co-ordination, while necessary, has prevented and delayed the Regulatory Test being applied to potentially economic inter-regional investment.

Against this background, the MCE's proposal provides the Commission with the LRPP, which allows the Commission to direct TNSPs to undertake the Regulatory Test for potential investments that address constraints affecting major national flow paths when normal market arrangements fail to promote efficient and timely investment. The Proposed Rule required the results from the Regulatory Test to be published to inform potential investors about whether an economically viable project exists. While the Rule Proposal did not provide a power to direct a TNSP to undertake an identified investment, requiring the Regulatory Test to be undertaken will provide valuable information to potential investors who may then undertake the investment.

2.3. Problems with the incentives in the current Rules

The Rule proposal stated:³

³ MCE Rule Proposal, p7.

“The LRPP will compliment the ANTS regional boundary arrangements, the regulatory test and congestion management arrangements in encouraging efficient and timely investment in the NEM. When normal market arrangements fail to promote efficient and timely investment to address material network congestion, the LRPP will require the regulatory test to be undertaken.

The requirement that any direction is subject to the cost/benefit process (ie Regulatory Test), ensures the overarching objective of delivering efficient transmission investment, not simply more transmission regardless of the economics. The regulatory test requires evaluation of non-network options as well as an important part of the economic efficiency discipline.”

The MCE was concerned that under the existing market Rules there are few incentives for TNSPs to undertake efficient discretionary investments, particularly when they are not required to meet reliability standards, even though the investment may improve the overall performance of the network, and deliver overall market benefits. There are a number of reasons for the lack of incentives, including:

- the focus of TNSPs on within jurisdictional investments, particularly relating to meeting reliability standards;
- the relative difficulty of satisfying the market benefits limb of the Regulatory Test compared with the reliability limb; and
- non-profit related factors impacting on TNSPs investment decisions.

2.4. Economic problem leading to the need for a Last Resort Planning Power

The problem that the MCE sought to address with this proposal is the lack of incentives for market participants to make inter-regional investments when they are required. The MCE identified a number of causes for the absence of incentives, and the Rule proposal provided a framework to ensure that appropriate inter-regional investments are examined.

A key reason for the lack of inter-regional investment is that delays in investment are caused by problems of co-ordination between jurisdictionally based TNSPs. The lack of co-ordination arises because TNSPs focus their capital investment programs on meeting their reliability requirements within their area of operations. Inter-regional investment usually has benefits outside of a particular TNSP’s jurisdiction, meaning that for any one TNSP the benefits may not outweigh the costs, while for the market as a whole there may be positive net benefits.

While the current Rules do provide for a TNSP to recover the costs of investment where the Regulatory Test is satisfied, these costs would only be recovered from

a segment of beneficiaries, rather than all beneficiaries because the TNSP can only service customers within its own area of operations. There are provisions in the Rules for jurisdictions to recoup these costs where benefits accrue across jurisdictions, however in practice, this has rarely occurred and cannot be relied upon to address the incentive problem.

In considering the problem sought to be addressed by this Rule Proposal, it is necessary to evaluate whether the lack of incentives for inter-regional investment arising within the current Rule framework is sufficient to justify regulatory intervention of the form of the proposed LRPP. In particular, the proposed LRPP Rule needs to be evaluated in light of the incentives anticipated to be created by Rule changes currently being considered by the Commission. These interactions are outlined in the following section.

2.5. Related rule change proposals and reviews

In considering the Proposed Rule the Commission has been mindful that it is currently analysing a range of issues in relation to the Congestion Management Review that are related to the LRPP Rule. In particular appropriate arrangements to manage network congestion are likely to impact on investment incentives and the operation of the proposed LRPP.

In addition, ERIG is also considering the problem of investment incentives in the context of the current energy market reforms and is likely to make recommendations relevant to the Proposed LRPP Rule in the near future. ERIG released its Discussion Paper in November 2006 which addresses this issue.⁴

2.5.1. Congestion Management Review

Transmission network congestion occurs when the available network capacity cannot accommodate the dispatch of the least-cost combination of available generation to meet demand across the network. Congestion management is therefore necessary to maintain the physical and operational security of the power system and has important implications for the spot prices, the degree of competition, the bidding incentives for market participants and the level of price and volume risk borne by participants. In the long term, the manner in which congestion is managed affects the investment decisions of new generators, load, network service providers and the opportunities for alternative energy sources.

The review requires the Commission to examine the feasibility of a constraint management regime as a mechanism for managing material congestion issues, until those issues can be addressed through investment or a region boundary change. The Commission is also required to take into account the relationship

⁴ Energy Reform Implementation Group, *Discussion papers*, November 2006, available at http://www.erig.gov.au/assets/documents/erig/ERIG_Discussion_Papers20061117171022.pdf.

between a constraint management regime, constraint formulation, region boundary review criteria and review triggers, the ANTS flow paths, the LRPP, the Regulatory Test and TNSP revenue and price regulation arrangements.

Currently there are three broad categories of arrangements to manage congestion. These are:

- Rules governing dispatch, including the way the power system is represented in the NEM dispatch engine;
- TNSP incentives, including short term arrangements to promote network availability and long term incentives for transmission investment; and
- Rules governing pricing and settlement, including the way prices are determined and settlement is carried out for each participant in the event of congestion within or between regions.

The proposed MCE staged approach to congestion management sees the LRPP as an interventionist step to stimulate investment when normal market arrangements fail. Where infrastructure investment is not stimulated as a result of the LRPP being exercised, the next step in a potential congestion management regime would be a boundary change.

The Congestion Management Review recommendations are likely to impact on the underlying incentives for inter-regional investment in a number of ways with implications for the requirement for a LRPP.

An effective congestion management regime, brought about through changes to infrastructure investment incentives, is likely to improve the way congestion is managed, which is also likely to impact on the identification and timing of inter-regional investments. This might lead to a greater focus by TNSPs to undertake inter-regional investment to resolve congestion issues, leaving limited circumstances in which a LRPP directive would be required.

Similarly, the Congestion Management Review could conclude that the time involved in invoking the LRPP may unduly delay the initiation of a boundary change as the ultimate solution for the management of congestion, raising questions about the efficacy of a LRPP.

Irrespective of the implications for the incentives for inter-regional investment arising from the Congestion Management Review, the Commission considers that the LRPP is likely to provide a useful additional mechanism for ensuring that potentially efficient inter-regional investments are examined and considered.

The Commission considers that the LRPP is complimentary to the Congestion Management Review and will form part of the overall strategy to manage transmission constraints. The Commission is mindful that, following the

completion of the Congestion Management Review, the Commission may make recommendations to amend the LRPP Rule. This would be in accordance with the comprehensive review into incentive mechanisms, and arrangements for managing physical and financial trading risks associated with material network congestion that form the terms of reference of that review. This Rule Determination and the Rule to be made adopting the LRPP should therefore not be considered as limiting the options that the Commission will be considering as part of its recommendations for the Congestion Management Review.

2.5.2. Impact of the Transmission Revenue Rule

The Commission published the Transmission Revenue Rule on 16 November 2006.⁵ The incentive package created in the Revenue Rule enhances the previous framework and includes the following elements:

- the incentive power for capital expenditure efficiencies has been increased by allowing the retention of any additional depreciation allowances in addition to return on capital, if a TNSP underspends relative to its forecast expenditure, and vice versa;
- inclusion of a separate contingent projects regime for capital expenditure for specific large projects triggered by particular events, with an associated incentive mechanism similar to that applicable to other capital expenditure;
- the removal of ex-post reviews of the prudence of actual capital expenditure before it is rolled into the TNSPs regulatory asset base;
- an increase in the service performance incentive cap from one percent to five percent of regulated revenue;
- the formalisation of cost pass through arrangements;
- removing the scope for the AER to re-optimize the regulatory asset base, thereby reducing the risk of regulatory asset stranding; and
- scope for a TNSP to seek to re-open the revenue cap in genuine force majeure circumstances.

The Commission considers that, in combination, these mechanisms provide a balanced package of incentives for TNSPs to invest in and operate their networks efficiently while maintaining the quality and reliability of transmission services. While incentive properties of each element of the suite of incentive mechanisms are important, it is essential to maintain the overall balance of incentive measures.

⁵ *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No 18.*

The Commission, however, does consider that under the current market arrangements there are few incentives for TNSPs to undertake efficient discretionary investments that are not related to its reliability standards, but which could provide net market benefits through improved performance of the network. Indeed, where there is an investment that is not required for reliability reasons, a TNSP has a financial disincentive to invest in the project. This is because the TNSP is able to obtain a benefit from deferring the expenditure until the end of a regulatory control period.

If market benefits were considered as part of a contingent project regime, the financial disincentive would be removed as the TNSP could obtain a benefit from minimising the costs of the project. However, the TNSP is still indifferent to the timing of the project and the benefits that undertaking it earlier may have for the performance of the system. In addition, this would not capture projects that fall under the contingent projects threshold.

Some submissions to this Rule proposal have contended that the Commission should focus on providing sufficient incentives for market participants to undertake infrastructure investment that is for a market benefit, rather than introduce a LRPP.

However, the Commission considers that the current incentive framework is unlikely to create the positive incentives necessary to resolve the inter-regional transmission investment problems identified above. This suggests a prima facie case for inclusion in the Rules of a positive incentive to encourage inter-regional investments. The Commission also considers that it is unlikely that the changes to the Transmission Revenue and Pricing Rules that arose from the Commission's review into these matters will create the requisite positive incentives to ameliorate the need for a LRPP.⁶

2.5.3. The Regulatory Test Rule

The MCE submitted a Rule proposal to the Commission to provide a framework within the Rules for the making of the Regulatory Test by the AER. The Commission published its Rule determination and associated Rule in November 2006.

The Regulatory Test is part of the regulatory framework for assessing proposed new network augmentation investment within the Rules. The Test recognises the existence of a unique market failure arising from the vertically separated industry structures operating within the NEM. The market failure arises because new network augmentation investments can have significant external impacts on many unidentifiable up and down stream market participants, such that

⁶ The Commission recognises that there is scope in the current Rules for jurisdictions to negotiate interregional TUOS payments, however, as evidenced through existing practice, this has not been sufficient to solve the incentive problem on its own.

ordinary commercial negotiation to resolve these external impacts is not feasible. In addition, there may be scope for non-network solutions to meet reliability requirements, however there is likely to be little or no incentive for TNSPs to consider these alternative options when evaluating a proposed network investment.

To resolve these market failures the Regulatory Test requires a TNSP to consider any wider market benefits and costs, and alternative non-network options, thereby ensuring that efficient augmentation investments are made.

The key elements of the Regulatory Test Rule are:

- an improved governance structure for the Test within the Rules. The Commission has adopted the MCE's proposal for Regulatory Test principles to be incorporated into the Rules, to provide an improved framework for its operation;
- explicit guidance on the objectives for the Test. The Commission has determined that the Test principles should provide seven key objectives: economic efficiency, reliability, predictability, competitive neutrality, proportionality, consistency and transparency;
- improved certainty in the application of the Test. The Commission has addressed concerns regarding the assessment of alternative options under the current market benefits limb of the Regulatory Test by proposing a two stage process: first, by requiring a TNSP to publish a request for information on potential alternative options and second, requiring that the Test should take the form of an assessment of the proposal against the likely alternative or alternatives, rather than an assessment against all genuine and practical alternatives.

The Commission considers that this approach addresses the MCE's concerns regarding the potential for economic transmission investments to be deferred and reduces the scope for gaming of the Test. Critically, the Commission is of the view that this approach will reduce the risk of the project being justified as maximising net market benefits, yet failing to be constructed, resulting in sub-optimal outcomes for the market as a whole.

These changes to the framework for the making of the Regulatory Test may improve the current incentive for TNSPs to focus on reliability investments, because the reliability limb of the Test is relatively easier to undertake. By making the market benefits limb simpler by providing an information mechanism for alternative projects and requiring the comparison of the proposed investment against likely alternatives, there should be greater incentives for market participants to undertake the Regulatory Test for inter-regional investments.

The Commission considers that changes to the Regulatory Test to address an apparent bias towards the reliability limb of the test may provide further incentives for market participants to undertake the Test for market benefits purposes. The ERIG is considering these issues and the Commission acknowledges the discussion paper released by ERIG that raises an option to reform the Regulatory Test, in part to address this concern. The option involves replacing the current Regulatory Test and assessment process with a two stage process for identifying and evaluating proposed transmission investments.⁷

The Commission considers that while there are more incentives for market participants to undertake the Regulatory Test through the changes described above, there is still a need for a LRPP to address the delays in undertaking the Regulatory Test in regards to interconnectors, in the absence of further reforms to the Regulatory Test.

2.5.4. Energy Reform Implementation Group Review

ERIG has recently completed its review of the potential for achieving a fully national electricity transmission network including a truly national approach to the future development of the electricity network, the legitimate commercial interests of asset owners, and the need to promote investment that supports the efficient provision of transmission services. In November 2006, ERIG released a number of discussion papers outlining its initial views in relation to market structures, transmission and energy financial markets.⁸

A key consideration of ERIG is the need for a national approach to transmission planning, including a national planning function. ERIG has identified that inter-regional transmission augmentation can be more complex and costly than intra-regional transmission augmentations as two or more transmission companies need to co-ordinate the project.

ERIG has also commented that the current regulatory arrangements do not provide the appropriate incentives for owners to invest in a timely and economically efficient manner where the investment decision is made by the owner of the monopoly asset and, conversely, that uncoupling of responsibility for making decisions about the timing and nature of transmission development from grid ownership diminishes accountability over investment decisions and will increase the risk to customers of poor investment decisions.

⁷ Energy Reform Implementation Group, November 2006, p.139, which indicates that the 2 stage process should be determined on the basis of a set of overall national efficiency objectives which would effectively integrate the two limbs of the current Regulatory Test and seek to develop the network in a manner that maximises net market benefits whilst ensuring that customer reliability standards are maintained.

⁸ Energy Reform Implementation Group, *Discussion papers*, November 2006, available at http://www.erig.gov.au/assets/documents/erig/ERIG_Discussion_Papers20061117171022.pdf.

Recommendations arising from the ERIG review are likely to impact on the need for, and best approach to, the LRPP. The final ERIG recommendations are expected during 2007, and will need to be reviewed by COAG before any decisions for changes to policy, legislation or Rules are made, and action undertaken to implement them.

The ERIG Discussion Paper has, however, raised the possibility of a national planning model for the NEM. The Commission acknowledges that if a national planning model were implemented, the LRPP Rule will need to be re-examined. Depending on the governance arrangements that are adopted, the LRPP may be more appropriately held by a new planning body. As these policy issues are being developed, the Commission considers that the LRPP Rule is a sensible approach given the current regulatory framework.

3. Rule Determination

The Commission has determined in accordance with s 102 of the NEL to make this Rule determination (Attachment A) and will make the attached Rule under s 103 on 15 March 2007. The Rule to be made contains some amendments to the Proposed Rule put forward by the MCE. A summary of the differences between the Proposed Rule and the Rule to be made is included in section 6 of this Rule determination.

3.1. Commission's power to make the Rule

The MCE's Rule change proposal seeks to provide the Commission with a LRPP. The Commission is satisfied that the Rule falls within the subject matter for which the Commission can make Rules set out in s 34 of the NEL. Specifically, the Rule relates to the following items under Schedule 1 of the NEL:

- the Proposed Rule is covered by s 34, as it relates to the regulation of both the operation of the NEM and the regulation of the activities of persons including registered participants participating in the NEM or involved in the operation of the national electricity system;
- Item 12 of schedule 1 of the NEL also states that the "*augmentation or expansion in the capacity of transmission systems and distribution systems*" is an allowable subject matter for the National Electricity Rules.

Under s 88 of the NEL, the Commission is only able to make Rules if:

"It is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity market objective."

The National Electricity Market objective, as set out in s 7 of the NEL, (NEM 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."

This Rule determination sets out the Commission's reasons for making the Rule. In developing the Rule, the Commission has taken into account:

- the Commission's powers under the NEL to make the Rule;
- the proponent's Rule change proposal and proposed Rule;
- submissions received;

- relevant Ministerial Council of Energy (MCE) statements of policy principles; and
- the Commission’s analysis as to the way(s) in which the Rule will, or is likely to, contribute to the achievement of the National Electricity Market objective so that it satisfies the statutory Rule making test.

The Commission has examined the Rule and assessed it against the statutory Rule making test. The Commission is satisfied that the Rule is likely to promote the NEM Objective. Section 5 presents the Commission’s analysis of the issues raised by the MCE’s proposal and how it satisfies the NEM objective and the statutory Rule making test.

3.2. Assessment against the NEM Objective

The Commission is satisfied that the Rule proposed by the MCE (and as modified by the Commission) will effectively contribute to the promotion of the NEM Objective. In reaching this view, the Commission has assessed submissions from stakeholders in the context of the overall incentives for inter-regional investment within the Rules.

The LRPP seeks to address a concern that the current incentive framework leads to insufficient investment in inter-regional transmission assets, and therefore results in inefficient transmission investment. The lack of incentives for inter-regional transmission investment arises because the benefits from inter-regional investments are shared between each region, such that it would not be economic for an individual TNSP to undertake the investment.

The Commission anticipates that the information that is generated by directing a market participant to undertake the Regulatory Test will increase the likelihood that an inter-regional investment that delivers positive market benefits will be undertaken. This will result in more efficient transmission investment that is beneficial to the market as a whole. By implication, the LRPP will therefore promote the NEM Objective.

The Rule to be made also provides for a transparent and clear process for exercising the LRPP, both by addressed procedural matters directly in the Rule and by requiring to develop and publish a LRPP Guideline. Procedural matters addressed in the Rule to be made include the process surrounding the issue of a direction notice and annual reporting obligations on the Commission.

In addition, the Rule to be made clarifies that the purpose of the LRPP is to provide additional guidance for the exercise of the discretion inherent in the LRPP. It also gives the Commission guidance about the circumstances in which it is appropriate to exercise the LRPP by prescribing a number of matters to which the Commission must have regard when it is considering exercising the LRPP. The Commission expects that each of these features will improve the

operation of the LRPP and improve the efficiency of the NEM, thereby promoting the NEM Objective.

The appointment of the IRPC as the advisory panel to the Commission in relation to matters concerning the exercise of the LRPP will assist the Commission to exercise the power in a manner that promotes efficient investment.

In combination, the Commission considers that the Rule to be made promotes the NEM Objective.

3.3. Consultation on the MCE proposal

The MCE submitted its proposal to the Commission on 5 October 2005. On 20 December 2005, the Commission commenced consultation under s 95 of the NEL on the proposal. Consultation closed on 24 February 2006. Given the interrelationship between the LRPP Rule proposal and other Rule proposals under consideration by the Commission, it was decided to issue a notice under s 107 of the NEL extending the time for publication of the draft Rule determination and draft Rule until 23 November 2006.

The Commission received 10 submissions at the first round of consultation, which are available on the Commission's website. The Commission received submissions from:

- AGL;
- CS Energy;
- Energy Retailers Association of Australia (ERAA);
- Ergon Energy;
- National Generators Forum (NGF);
- Powerlink Queensland;
- TransGrid;
- "The Group" - TRUenergy, International Power, Loy Yang Marketing Management Co, NRG Flinders and AGL;
- VENCORP; and
- NEMMCO.

The Commission did not receive a request for a pre-determination conference.

Public consultation on the draft Rule Determination and draft Rule commenced on 23 November 2006 and closed on 29 January 2007. The Commission received 4 submissions:

- TRUenergy;
- TransGrid;
- VENCorp; and
- Powerlink.

On 15 February 2007, the Commission gave notice under s 107 of the NEL extending the period of time for preparation of the Rule determination until 8 March 2007.

4. LRPP Guidelines

Clause 5.6.4(o) of the Rule requires the Commission to develop and publish guidelines with respect to the following matters:

- the process to be followed by the Commission in exercising the LRPP;
- a request to NEMMCO to appoint additional members to the expert advisory panel;
- the advice to be provided by the expert advisory panel;
- the matters that the expert advisory panel and the Commission may consider in recommending or nominating a person as an appropriate directed party; and
- provision of information to the Commission in relation to the exercise of the LRPP.

The Commission proposes to issue a draft of the LRPP Rule Guidelines (Draft LRPP Guidelines) and publish them for consultation after the commencement of the Rule. Clause 5.6.4(p) of the Rule requires the Guidelines to be published in accordance with the transmission consultation procedures set out in Rule 6A.20. In the present case, these procedures require the Commission to:

- publish the proposed guidelines with an accompanying explanatory statement and an invitation for written submissions;
- allow no less than 30 business days for the making of submissions;
- within 80 business days of the proposed guidelines being published, publish its final decision and publish notice of the making of the final decision.

The Commission intends that the Draft LRPP Guidelines will address a number of matters that are important to the operation of the Rule. These include:

- the advice that the Commission may request from the independent advisory panel;
- the procedure for public consultation on the panel's advice;
- requests from the Commission for information to inform its decision-making;
- public reporting on the exercise of the LRPP; and
- nomination of a directed party.

Once published, the LRPP Guidelines are mandatory. The Commission believes the effect of the Rule requiring it to comply with the LRPP Guidelines will provide greater certainty to market participants on issues concerning the exercise of the LRPP.

5. Commission's analysis of the Proposed Rule

The Commission has examined a number of issues in detail in developing the Rule. These include:

- the appropriate body to be empowered to exercise the LRPP;
- the guidance on its discretion to exercise the LRPP, including the development of guidelines;
- the role of the industry advisory panel;
- identifying the party to be directed to undertake the Regulatory Test;
- identifying the potential transmission project; and
- issues concerning timeframes and compliance.

In addition to these general issues, the Commission also examined a number of issues raised in submissions, including:

- whether the LRPP should be limited to investments relating to transmission flow paths; and
- whether the Rule should provide for the recovery of the costs of undertaking the Regulatory Test following a direction in accordance with the LRPP.

The Commission has enhanced the Draft Rule and made some minor modifications to ensure the legal framework surrounding the LRPP is robust and transparent. Where there are differences between the Draft Rule and the Rule to be made, the Commission has provided appropriate comment.

This chapter details the Commission's analysis and reasons underlying its LRPP Rule in relation to each of the issues identified above.

5.1. Who should exercise the LRPP?

The Proposed Rule provided for the LRPP to be exercised by the Commission. It envisaged that the Commission would independently identify and determine whether there might, at any particular time, be a need to exercise the proposed power.

The Commission has considered whether it is the most appropriate entity to exercise the LRPP, given that the body that exercises the power must be capable

of obtaining sufficient information to independently determine whether it is appropriate to exercise the LRPP.

5.1.1. Submissions

A number of submissions made during the first round of consultation commented on whether the LRPP should reside with the Commission or with other bodies, such as the Australian Energy Regulator (AER).

AGL said:⁹

“There are a number of related issues in the Rules that relate to network investment, disputes over the application of the regulatory test and payments for regulated assets. The overseeing body for these areas is the AER not the AEMC. Matters of system standards and reliability are also specifically assigned to the Reliability Panel rather than generally to the AEMC. It is not, therefore obvious why the AEMC is given this power rather than the AER or possibly the Reliability Panel.

AGL considers that the correct role of the AEMC is the assessment of Rules and assessment of the operation of the market and that the LRPP should lie with the AER.”

The Group said the Rule proposal:¹⁰

“expands the regulatory powers of the AEMC in a way not envisaged in the development of the new NEM governance arrangements, and thus increases regulatory risk, at two levels:

- specifically, it increases uncertainty associated with transmission investment, as affected parties will have to second guess not just the likely response of a TNSP to an identified investment project but also the likely response of the AEMC if the TNSPs response is inaction;*
- philosophically, it challenges and upsets the established governance principles of AEMC as ‘rule-maker’ and AER as ‘enforcer’ by creating a precedent for the AEMC awarding itself new ‘executive’ regulatory powers on the basis that these promote the NEM objective.”*

Furthermore, TransGrid’s submission in response to the Draft Determination supported AGL’s first round submission, stating that:¹¹

“a separation of powers [between the Commission and the AER] would increase the transparency of the LRPP arrangements ... One possibility of

⁹ AGL, 24 February 2006, p2. TransGrid agreed with this view in its submission to the Draft Determination (TransGrid, 29 January 2007, pp3-4).

¹⁰ The Group, February 2006, p4. See also National Generators Forum, 23 February 2006, p4.

¹¹ TransGrid, 29 January 2007, p4.

overcoming these concerns in the final determination could be to vest the LRPP in the AER. Among other matters, this would complement the AER's other roles, such as the AER being the arbitrator of Regulatory Test disputes."

5.1.2. Commission's analysis

The Rule making functions and powers conferred under s 29(1) of the NEL ensures power can be conferred upon the Commission to exercise the LRPP.

Section 34 of the NEL prescribes the subject matter over which the Commission may make Rules. Section 34(3)(c) of the NEL relevantly provides that Rules made by the Commission may:

- "(c) confer functions or powers on, or leave any matter or thing to be decided or determined by-*
 - (i) the AER, the AEMC, NEMMCO or a jurisdictional regulator...*
 - (d) confer rights or impose obligations on any person or a class of person (other than the AER, the AEMC or a jurisdictional regulator)..."*

These sections of the NEL allow the Commission to make a Rule that provides the Commission with a power to direct market participants, such as the LRPP.

The Commission is also empowered by s 29(2):

"to do all things necessary or convenient to be done for or in connection with the performance of its functions".

The Commission considers that while the NEM governance arrangements contemplated a separation between Rule making and regulatory and enforcement functions, the Commission does not consider that conferring the LRPP upon itself is contrary to those arrangements.

The Commission notes, but does not agree with, the views expressed by AGL and TransGrid that the LRPP should reside with the AER or the Reliability Panel. The LRPP is a power to issue a direction to institute a regulatory process – the application of the Regulatory Test – rather than a function concerning oversight of the Regulatory Test.¹² The Commission believes it would be inappropriate for the AER to have the power to develop the Regulatory Test, direct parties to undertake it and arbitrate disputes arising from its application. Proper principles of regulatory governance require these functions to be split. To provide the AER with a power of direction as well as regulatory and arbitration functions may provide the AER with an inappropriate level of influence over the behaviour of market participants in relation to transmission infrastructure development.

¹² The AER will continue to perform this oversight role as part of its regulatory functions.

The Commission also believes that the inclusion of a purpose clause in clause 5.6.4(b) of the Rule to be made, the factors limiting the use of its discretion to exercise the power in the Rule (see clauses 5.6.4(d), (g) and (h)), together with the limitations that will be contained in the LRPP Guidelines minimise any concerns that market participants may have over the exercise of the LRPP by the Commission. The LRPP Guidelines and the criteria contained in clauses 5.6.4(d), (g) and (h) are discussed in further detail at sections 4 and 5.3 respectively of this determination.

Further, the Commission considers that its ability to request expert technical advice prior to exercising the LRPP (see clause 5.6.4(e) of the Rule) will assist the Commission to effectively exercise the LRPP.

5.1.3. Commission's decision

The Commission has decided that it is appropriate that the LRPP be conferred upon it. However, as discussed in section 5.3 below, the Commission considers it is prudent to provide transparency and certainty about the Commission's approach to exercising the power by imposing certain limitations on its discretion to exercise the LRPP.

5.2. The role of the industry panel

As noted above, the Proposed Rule required the Commission to identify potential transmission projects with the assistance and advice from a panel of industry experts. The Proposed Rule did not specify how these experts should be appointed, who should be appointed, or who should appoint the panel. It did provide that a representative from NEMMCO must be on the panel.

The Proposed Rule envisaged an ad-hoc panel of experts to provide technical advice to the Commission in relation to its exercise of the LRPP. However, the Commission is mindful of the need to maximise its own efficiency and has considered some panels that have already been established under the Rules and that have the requisite expertise to carry out the role of technical advisor to the Commission.

The Commission has the power to establish committees and panels pursuant to s 39 of the NEL for the purpose of providing advice on specified aspects of the Commission's functions or undertake any other activity in relation to the Commission's functions as specified by the Commission. The Commission does not consider it is necessary to establish a new committee or panel to advise it in relation to the LRPP. The Commission is of the view that the panels and committees already established under the NEL, such as the Reliability Panel and the Inter-Regional Planning Committee (IRPC), should be the starting point for identifying an appropriate advisory body.

In its Draft Determination the Commission was of the view that the Reliability Panel was the most appropriate body to advise the Commission in relation to the LRPP.

5.2.1. Submissions

A number of submissions received by the Commission commented on the role of the expert panel.

VENCorp, in its first round submission, expressed concern about the funding arrangements that would apply to the expert panel and the representatives who would be appointed to the panel. It said:¹³

“Arguably, the panel should not be limited to Registered Participants, as there may be a requirement for specialist skills (eg economic, engineering) that do not lie with a registered participant, or for which the AEMC wishes to have independent advice. Therefore VENCorp believe that the membership of this industry panel should be clarified within the Rules.”

VENCorp also noted that the Proposed Rule was “silent on how the panel should conduct itself or provide advice to the AEMC,”¹⁴ and suggested that Terms of Reference should be established for the panel in consultation with industry and which is embedded in the Rules.

Second round submissions from Powerlink and TransGrid supported the Commission’s decision for the Reliability Panel to be the advisory body to the Commission in relation to the LRPP.¹⁵ VENCorp, however, suggested that the Inter-Regional Planning Committee (IRPC), which is established by NEMMCO and responsible for reviewing inter-regional transmission network developments, is a more appropriate advisory body for the LRPP.¹⁶

The Commission also sought comment in the Draft Determination from interested parties as to whether the Rule should additionally require the Commission to consult with NEMMCO. Second round submissions from TransGrid and Powerlink stated that NEMMCO’s membership of the Reliability Panel was sufficient to meet the policy requirement of the MCE proposal that NEMMCO be included in an advisory capacity in regards to the LRPP.¹⁷

¹³ VENCorp, 24 February 2006, p2.

¹⁴ *Id.*

¹⁵ TransGrid, 29 January 2007, p5; Powerlink, 29 January 2007, p1.

¹⁶ VENCorp, 1 February 2007, p3.

¹⁷ TransGrid, 29 January 2007, p5; Powerlink, 29 January 2007, p1.

5.2.2. Commission's analysis

The Draft Rule provided for the Reliability Panel to be the technical advisory body in relation to the LRPP. Since publishing the Draft Rule, the Commission has re-examined the appropriateness of the Reliability Panel performing this role and also considered the ability of the IRPC to fulfil this function.

The NEL requires the Commission to establish a Reliability Panel constituted in accordance with Chapter 8 of the Rules. The Reliability Panel has statutory functions and powers under the NEL and the Rules, including providing advice in relation to the safety, security and reliability of the national electricity system. Sections 34 and 38 of the NEL allow the Commission to make Rules that confer functions on the Reliability Panel.

The Reliability Panel has been established to provide technical and expert advice in relation to issues concerning the safety, security and reliability of the network. This includes providing advice to the Commission on such matters. By conferring an additional advisory function upon the Reliability Panel in the context of the LRPP, the Commission is drawing on a well-established and tested advisory structure that is already in existence.

The Reliability Panel currently carries out advisory and other functions that require technical expertise of the kind necessary to advise the Commission in relation to potential transmission projects. The Panel is able to draw on the experience of its members and can engage technical sub-committees to source additional expertise as appropriate.

There are, however, some disadvantages associated with appointing the Reliability Panel as the Commission's advisory panel in relation to LRPP. Firstly, the focus of the Reliability Panel is on reliability issues rather than network investments with an anticipated market benefit. Given that in most instances the LRPP is likely to be exercised to apply the market benefits limb of the Regulatory Test, it may not be appropriate for the Reliability Panel to provide the necessary advice in relation to a Commission decision to exercise the LRPP. Further, the Commission recognises that there may appear to be a close relationship between the Commission and the Panel given that a sitting Commissioner of the AEMC is also the Chairman of the Reliability Panel. Any appearance that the advice given by the Panel to the Commission is not wholly independent is to be avoided.

As suggested by VENCorp¹⁸, the Commission also considered the ability of the IRPC to act as its advisory body in relation to the LRPP. The IRPC has already been established under s 39 of the NEL and clause 5.6.3 of the Rules. Its functions and powers, representation and funding have already been provided for in the NEL and the Rules. As the membership of the IRPC includes NEMMCO, it satisfies the policy requirement of the MCE Proposal. Further, the inclusion of the TNSPs on the IRPC ensures that the class of Registered

¹⁸ VENCorp, 1 February 2007, 3.

Participants that is most likely to be affected by an exercise of the LRPP has the opportunity to provide input into the advice being provided to the Commission. Finally, the IRPC already has sufficient powers to undertake any necessary consultation or information gathering that would be required to fulfil a proposed advisory role.

The IRPC does, however, carry with it concerns about the possibility for conflicts of interest to arise. This is most likely to arise where an individual TNSP is directly affected by a specific network transmission problem in relation to which the IRPC has been asked to provide advice, for example, the IRPC is considering recommending that a direction notice be issued to that TNSP. In addition, the IRPC does not have representatives from energy users or generators, whose input may be relevant in an assessment of a potential network transmission congestion problem.

A third option, and the option preferred by the Commission, is to augment the IRPC's membership by empowering it to appoint, at the request of the Commission, up to four additional members who have experience in generation, transmission, retail and end user issues. The Commission considers that supplementing the composition of the IRPC for the limited purpose of providing LRPP advice in this way will ensure that the advice provided by the IRPC is representative of the interests of all industry participants while still benefiting from the expertise of the IRPC. The Commission also considers that perceived conflicts of interest are also reduced under this approach.

5.2.3. Commission's decision

The Commission has made modifications to the Draft Rule which provided for the advisory role to be performed by the Reliability Panel. The Rule to be made appoints the IRPC to serve as the expert industry panel for the purposes of providing advice on the LRPP, and gives the Commission the discretion to request that NEMMCO appoint up to four additional members to the IRPC for the limited purpose of advising the Commission in relation to the exercise of the LRPP. This discretion must be exercised in accordance with the LRPP Guidelines.

5.3. Exercising the LRPP

In line with the Commission's approach in developing the Transmission Revenue and Pricing Rules, the Commission considers it is appropriate to provide guidance about the exercise of its discretion arising from the LRPP Rule. This provides greater transparency and certainty as to the likely exercise of the LRPP amongst market participants.

The Commission's approach is to require the LRPP to be exercised in accordance with those matters specified in clauses 5.6.4(d), (g) and (h) of the Rule and the LRPP Guidelines, which are currently being developed by the Commission.

5.3.1. Submissions

A number of submissions expressed concern about the proposed Rule having no constraint on the power to exercise the LRPP and, therefore, that the LRPP may be used more widely than anticipated by the MCE.¹⁹

Submissions from TransGrid and Powerlink during the first round of consultation each stated that:²⁰

"There are no safeguards in the proposed Rule to avoid more widespread use of the last resort planning power than intended by the MCE. It is stated several times in the preamble that this power is to be applied to inter-regional issues and is expected to be exercised 'when normal market arrangements fail to promote efficient and timely investment to address material network congestion'."

Other submissions also suggested that limitations should be placed on the use of the LRPP.

AGL, in its first round submission, noted that despite the MCE's acknowledgement that a party other than a TNSP may be directed, the Rule does not limit the exercise of the LRPP. AGL suggested that a directed party should be able to reject the direction if they:²¹

- *"Lack the technical capability;*
- *Are unable to complete the work in a reasonable time; or*
- *Have a conflict of interest."*

The Group, in its first round submission, suggested that the:²²

"AEMC should explicitly be restricted to using the LRPP only in relation to investment projects which have been identified through the ANTS process and which have a high likelihood of being economic".

In regard to publishing guidelines, the Group said:²³

"the AEMC should be required to develop and publish guidelines describing when and how it proposes to use the LRPP – and of course adhere to these; ...

¹⁹ TransGrid, 24 February 2006, p8; Powerlink, 24 February 2006, p3.

²⁰ TransGrid, 24 February 2006, p8; Powerlink, 24 February 2006, pp3-4.

²¹ AGL, 24 February 2006, p2.

²² The Group, February 2006, p5.

²³ *Ibid.*

These guidelines should specifically allow and encourage a voluntary response to the identified investment need, from either regulated or non-regulated investors”.

In its second round submission on the Draft Determination, TransGrid noted that:²⁴

“the only constraint to the exercise of the LRPP in the proposed Rule is that it must be consistent with the proposed purpose clause)”.

5.3.2. Commission’s analysis

The Commission is mindful that an open-ended discretion to exercise the LRPP provides considerable flexibility to respond to MCE policy initiatives or changes in market requirements. However, the Commission believes that the benefits of flexibility must be balanced against the need to provide certainty and transparency to market participants about the matters the Commission will have regard to when deciding whether or not to exercise the power in a particular circumstance.

To achieve this balance, the Commission has introduced limitations on its discretion to exercise the LRPP in the Rule to be made. Providing criteria against which the power will be exercised is also consistent with the Commission’s broad policy view that unfettered discretion should be structured. Accordingly, the Rule to be made requires that the Commission must:

- exercise the LRPP:
 - consistently with the purpose of the LRPP (clause 5.6.4(d)(1)); and
 - in accordance with guidelines to be developed by the Commission (clause 5.6.4(d)(2)); and
- in deciding whether or not to exercise the last resort planning power in a particular circumstance:
 - take into account information from certain specified sources (clauses 5.6.4(e) and (g)); and
 - make certain enquiries that are specified in the Rule to be made (clause 5.6.4(h)).

The Commission considers that requiring the exercise of the LRPP to be consistent with a purpose clause helps to frame the exercise of the LRPP discretion. The purpose of the LRPP as provided in clause 5.6.4(b) is as follows:

²⁴ TransGrid, 29 January 2007, p3.

“the purpose of the last resort planning power is to ensure timely and efficient inter-regional transmission investment for the long term interests of consumers.”

The Commission considers this amendment enhances the Proposed Rule by improving the certainty and transparency concerning the application of the LRPP. These enhancements are not considered to detract from the intention of the Proposed Rule, which was to give the Commission the:²⁵

“flexibility to respond to a policy direction from the MCE or autonomously on the basis of market information such as through the ANTS.”

The Commission has also amended the Rule to be made to require the Commission to make certain enquiries as part of the process of deciding whether to make exercise the LRPP (see clause 5.6.4(h)). The Commission must:

- identify a constraint problem within the national transmission flow paths;
- undertake all reasonable inquiries to be satisfied that no current Regulatory Test is being undertaken in relation to the identified problem;
- consider other options that could address the identified problem, and be satisfied that these options are unlikely to address the problem;
- be satisfied that the problem may have a significant impact on the efficient operation of the market; and
- be satisfied that the problem is unlikely to be addressed but for the exercise of the power.

The Commission acknowledges that these specific matters were not the subject of prior public consultation. As indicated in its Draft Determination, the Commission had intended to specify the matters that it would have regard to in deciding whether or not to exercise the LRPP in its guidelines. However, in the course of drafting the Rule and considering the matters to be included in the guidelines, the Commission formed the view that these matters are more appropriately included in the Rule to be made. The Commission believes that the inclusion of these matters will provide further guidance and certainty to market participants.

The Commission also considers that these factors ensure that the LRPP is only exercised as a last resort, which is consistent with the intention underlying the MCE proposal. Whilst the Commission would have preferred to consult specifically on these matters, given the importance of providing direction for the discretion, as indicated in a number of submissions, the Commission has included these in the Rule to be made.

²⁵ See MCE Rule Proposal, p4.

The Commission is also of the view that additional certainty for market participants can be achieved by prescribing the scope and content of the LRPP Guidelines in the Rules. Again, prescribing the items that can be included in the Guidelines provides structure around the exercise of the Commission's discretion.

The development of mandatory LRPP Guidelines will also provide greater certainty to market participants. As discussed at 4 above, some of the matters that the Rule to be made requires the Guidelines to address are the processes the Commission will follow in exercising the LRPP and, if the power is exercised, matters the Commission may consider in nominating a person as an appropriate directed party. The LRPP Guidelines are also required to provide for provision of information to the Commission in relation to the exercise of the LRPP.

5.3.3. Commission's decision

The Commission has decided to include in the LRPP Rule a statement of the purpose for the LRPP (clause 5.6.4(b)) and a requirement for the Commission to develop guidelines to outline its proposed approach to exercising the LRPP (clause 5.6.4(o)). The Commission notes that clause 5.6.4(o) of the Rule to be made also prescribes the minimum items that must be included in the LRPP Guidelines.

The Commission has also decided to include criteria in the Rule to be made that constrains its exercise of the LRPP (clauses 5.6.4(d), (g) and (h)). Whilst the Commission has been unable to consult on these criteria, it considers their importance is such that they are appropriately included in the Rules.

5.4. Directing a party to undertake the Regulatory Test

The Commission is provided with discretion in the Proposed Rule to determine the Registered Participant (or Participants) who should be directed to undertake the Regulatory Test.

While the Rule proposal enabled the Commission to consider who is best suited to undertake the Regulatory Test, the MCE stated that it expected the direction would typically be given to TNSPs. While the Commission anticipates that this will be the case, the Rule proposal acknowledged there may be circumstances where the Commission may wish to direct other parties to undertake the Regulatory Test, for example, in situations where there may be a conflict of interest. A direction notice could also be given to a planning body (such as VENCORP), or to other market participants if the party initially directed fails to comply with the direction notice.

5.4.1. Submissions

Most submissions received by the Commission in both the first and second rounds of consultation addressed the issue of who should be directed to undertake the Regulatory Test. This was a particular area of concern given the Rule proposal (and the Draft Rule) did not explicitly provide for directed parties to recover the costs of undertaking the Test.

The majority of submissions favoured the directed party, in the first instance, being the TNSP or jurisdictional planning body from the jurisdiction most affected by the need for additional transmission investment infrastructure or most significantly contributes to the constraint in question.

5.4.1.1. First round submissions

CS Energy said:²⁶

“It is appropriate that the AEMC has suitable discretion and breadth of choice in selecting the appropriate party to undertake the Regulatory Test. The most appropriate parties would usually be TNSPs and planning bodies who are most affected by the potential project and have the expertise to effectively and efficiently undertake the regulatory test required. If the AEMC identifies good reasons that the most affected party should not be directed then the next most affected party should be directed and so on. There is no justification that, for example, the AEMC might reasonably direct a generator, retailer or MNSP. The proposed Rule should be amended to place appropriate limits on the AEMC’s range of choices.”

NEMMCO stated that the transmission planning body for any region connected by the national transmission flow path that would be augmented by the project to which the regulatory test is to be applied should be the directed party.²⁷ NEMMCO considered that:²⁸

“Only when all these avenues have been exhausted should the AEMC resort to directing other parties to run the Regulatory Test.”

Ergon Energy said:²⁹

“The ‘directed party’ should be a transmission network service provider (TNSP). TNSPs are appropriately equipped to efficiently act on a LRPP direction given their experience in undertaking the regulatory test and access to relevant data. By only engaging TNSPs it should ensure LRPP assessments are conducted efficiently and in a timely manner.”

²⁶ CS Energy, 24 February 2006, p1.

²⁷ NEMMCO, 24 February 2006, p2.

²⁸ *Ibid*, p2-3.

²⁹ Ergon Energy, 24 February 2006, p1.

Powerlink, in its first round submission, said:³⁰

“Powerlink also believes that the Rules should require that the directed party is the most likely proponent of any notional augmentation, ie the body (or bodies) whose network most significantly contributes to the constraint in question. Such Network Service Providers have the experience of carrying out regulatory tests and would have relevant expertise and local technical data to undertake the regulatory test assessments effectively and efficiently. It would appear inappropriate to engage a third party registered participant to undertake such assessments and in so doing incur the unrecoverable costs of complying with the direction.”

The NGF said:³¹

“it is the NGF’s view that generators should be excluded from being directed because the Rule is directed primarily at correcting for failures of the regulated investment process which, as the MCE proposal notes, could be due to:

- *the failure of the TNSPs regulatory or policy framework;*
- *TNSPs or jurisdictional planning bodies that do not behave rationally;*
- *the TNSPs or jurisdictional planning bodies not undertaking the regulatory test because they believe that the particular investment would not pass the test.*

None of these failures are due to any action or inaction on the part of generators, furthermore this is an area where generators are unlikely to have sufficient expertise or resources to carry out the assessment. The inclusion of generators as a class only for the purpose of addressing conflicts of interests is therefore unlikely to be helpful.”

The NGF also submitted that the costs and penalties to a generator of complying with a direction notice would not establish appropriate incentives for participants that are in fact responsible for applying the Regulatory Test, ie TNSPs, as was intended by the MCE’s Proposed Rule. NGF suggested that this imbalance could be addressed in the following ways:³²

- *“the power to direct should only apply to those participants undertaking regulated investment, this is consistent with the MCE view that ‘it is expected that the AEMC normally would direct the TNSPs’, or alternatively,*
- *if generators are directed to undertake the test they should be compensated with full cost recovery for so doing.”*

³⁰ Powerlink, 24 February 2006, p4.

³¹ National Generators Forum, 24 February 2006, p4.

³² *Id.*

The Group said:³³

“the Rules should make clear which party or parties may be directed using the LRPP. One would expect that this would be only the TNSP or TNSPs with transmission franchises in the location of the investment project.”

In relation to the possible direction of third parties, the Group reiterated that:³⁴

“...any suitably qualified third party should be entitled to:

- *request that a TNSP submit an identified project to the Test, so long as the TNSPs direct costs are covered;*
- *itself submit an identified project to the Test where the relevant TNSP has declined to do so; and*
- *develop an efficient project which a TNSP has declined to develop, and receive regulated revenue for that project on the same terms as those for a TNSP.”* (footnotes omitted)

The Group considered that the benefits of this approach were that:³⁵

“...such enhanced contestability will encourage a TNSP to develop economic projects and, where it declines to do so, will allow a third party to develop the project itself. Importantly, this is achieved without increasing the scope of regulatory intervention or the level of regulatory risk.”

VENCorp suggested that the Rule provide for the TNSP in whose region the potential transmission project may be constructed to be the directed party in the first instance. It also submitted that:³⁶

“In accordance with the proposed Rules, if the party first fails to undertake or complete the project the AEMC may then direct a second party to undertake the regulatory test. The process the AEMC would use to select and engage the second party under clause 5.6.5B(g) is not specified and requires clarification.”

The ERAA expressed concern that the Proposed Rule:³⁷

“...allows the AEMC to direct any registered participant to undertake the regulatory test. This could potentially lead to the situation where a business with no experience in and no desire or capability to invest in transmission is directed under the LRPP...”

5.4.1.2. Second round submissions

³³ The Group, February 2006, p5.

³⁴ *Ibid*, p6.

³⁵ The Group, February 2006, p6.

³⁶ VENCorp, 24 February 2006, p1.

³⁷ Energy Retailers Association of Australia, 24 February 2006, p1.

Submissions made in response to the Draft Determination focused on concerns about the procedural aspects of identifying a directed party. Powerlink stated:³⁸

“Powerlink believes that before exercising the power the Commission should be required to consult with the party or parties who the Commission is considering directing. The advantages in requiring this procedural step are that the Commission can be fully informed as to:

- *What steps, if any, are already being undertaken to conduct a Regulatory Test analysis;*
- *When the most recent analysis of the matters was conducted and the results of that analysis;*
- *Whether any of the key input assumptions to the analysis have changed;*
- *The likely costs of conducting the Regulatory Test analysis.”*

TransGrid also expressed concern about the lack of consultation:³⁹

“TransGrid’s [sic] further submits that the current LRPP provides insufficient due process to directed parties even though it is those parties that carry the burden of undertaking the consequential regulatory test process. Under the draft Rule the AEMC would not be required to consult with the directed party (or parties) before directing them to undertake the Regulatory Test. In TransGrid’s opinion this is a major shortcoming of the draft LRPP process and should be corrected.”

In developing the LRPP Guidelines, the Commission will have regard to the comments made in submissions.

5.4.2. Commission’s analysis

The Commission considers that, in most instances, either a TNSP or jurisdictional planning body would be directed to undertake the Regulatory Test in accordance with the LRPP Rule. However, in relation to interconnectors that operate between regions it may be difficult – and, in some cases, inappropriate – to identify a single party to undertake the Regulatory Test. There may be affected parties in each or all of the affected regions, or more than one affected party in a single region. In these circumstances it may be appropriate for more than one party to jointly undertake the Regulatory Test. In some circumstances, it may be the case that different parties individually undertake the Test in relation to the same potential transmission project.

³⁸ Powerlink, 29 January 2007, p1.

³⁹ TransGrid, 29 January 2007, p4.

The Commission has therefore amended the Draft Rule and the Rule to be made permits a direction notice to be issued to a single Registered Participant, or to two or more participants to jointly and co-operatively comply with the notice to undertake the Regulatory Test (see clause 5.6.4(a)). The Commission considers that whether the parties are directed to jointly or individually undertake the Regulatory Test should be decided on a case-by-case basis. How the directed parties would work together in a practical sense to ensure compliance with the notice would be a matter for the parties to determine.

The Commission does not consider it is necessary for the Rules to prescribe specific criteria that the Commission must have regard to in identifying the party (or parties) to whom a direction notice will be issued. The Commission believes that these details relate to the implementation of the LRPP and are more appropriately addressed in the LRPP Guidelines. As the Guidelines will be mandatory, the Commission must have regard to these criteria as part of its deliberations. The Commission considers that the public consultation process for the LRPP Guidelines will assist in the development of appropriate processes and procedures.

The Commission accepts Powerlink's and TransGrid's submissions that it should seek input from those parties that it is considering issuing a direction notice to prior to the issue of the notice. In this context, the Commission notes that clause 5.6.4(o)(4) requires the LRPP Guidelines to set out matters that the Commission and the IRPC may each have regard to in considering who might be an appropriate directed party.

5.4.3. Commission's decision

As infrastructure investment projects for interconnectors may affect parties in multiple regions, the Commission has amended the Rule to be made to permit it to direct two or more Registered Participants to jointly undertake the Regulatory Test.

With respect to the question of identifying who should be directed to undertake the Regulatory Test, the Commission has decided to not include specific criteria in the Rule to be made that govern how it will identify the party (or parties). These matters are considered by the Commission to be issues of implementation best addressed in the course of developing the LRPP Guidelines following a public consultation process.

The Commission does, however, recognise the benefits of seeking comment from the party (or parties) that it proposes to issue a direction notice to prior to such a notice being issued. Accordingly, the Commission proposes to canvass this issue during the public consultation process for the development the LRPP Guidelines.

5.5. Identifying the potential transmission project

The Proposed Rule provided the Commission with the power to specify alternative projects to be considered by the directed party undertaking the Regulatory Test. This power represented an extension to the Regulatory Test process where the proponent identifies viable alternatives. The directed party is therefore not only directed to undertake the Regulatory Test in regards to a specific proposed transmission project but may also be directed on which alternative options it must also consider.

5.5.1. Submissions

A number of submissions expressed concern about the MCE's Proposed Rule in relation to the requirement for the Commission to identify the potential transmission project.

NEMMCO, in its first round submission, suggested that the task of identifying the potential transmission project is likely to be involved and require detailed information. Although NEMMCO's submission on this issue was directed to the Reliability Panel, the Commission considers the observations to be applicable to the Commission's role in this regard:⁴⁰

"Considerably more study is required to refine conceptual augmentations published in the ANTS to projects able to be assessed under the regulatory test. This work is generally performed by the relevant TNSPs. The Panel would need to have access to information held by TNSPs to ensure any project put forward is sufficiently developed to allow assessment under the regulatory test. This information may also include information regarding the feasibility of the project (for example, information regarding existing easements, etc). Consideration should be given to providing means of ensuring the Panel has access to the required information."

The complexities inherent in identifying specific transmission projects led a number of TNSPs to submit that it would be impractical and inappropriate for the Commission to perform this function.⁴¹ For example, Powerlink stated in its first round submission:⁴²

"...it is impractical to require the AEMC to identify actual projects and determine whether they would alleviate the forecast constraints. This is a very resource intensive exercise in inter-regional planning which the AEMC should not be expected to undertake before exercising the last resort planning power."

⁴⁰ NEMMCO, 24 February 2006, p3.

⁴¹ Powerlink, 24 February 2006, p3; TransGrid, 24 February 2006, p9.

⁴² Powerlink, 24 February 2006, p3.

Powerlink proposes that the AEMC should be able to exercise the power based on constraints identified in the ANTS, while leaving it to the directed party to identify the options to be assessed."

5.5.2. Commission's analysis

The submissions in relation to the requirement for the Commission to identify a specific potential transmission project for the exercise of the LRPP raised questions about the role of the LRPP in the overall framework for managing of transmission congestion.

The Proposed Rule envisaged that the Commission would identify a specific potential transmission project. One reason for this was to reduce the risk that a directed party may identify a project to address the particular transmission problem that is likely to fail the Regulatory Test so as to avoid infrastructure investment expenditure. In essence, the fact that the LRPP is being exercised suggests that there are insufficient incentives for a TNSP directed to undertake the Regulatory Test to identify the most efficient investment to resolve the identified inter-regional congestion problem. It would therefore be inappropriate for the LRPP to simply ask the directed party to identify the most efficient investment solution, in the absence of specific guidance from the Commission.

The difficulty with this approach, as NEMMCO correctly identified, is that the Commission may lack sufficient information and technical expertise to scope and specify a potential transmission project. To ensure the Commission is sufficiently informed and provided with technical expertise to identify and scope a potential transmission project, the Commission will rely on advice from technical experts provided via advice from the IRPC and such other technical assistance as it requires.

In considering these points the Commission is of the view that a flexible approach is the most suitable way forward. It appears that in some instances the best approach would be for the Commission to identify particular projects whereas in other instances it may be more appropriate for the directed party to undertake the identification process and then apply the Regulatory Test.

5.5.3. Commission's decision

The Commission has given itself the power in the LRPP Rule to either direct parties in relation to a project identified by the Commission, or direct parties to identify a project and then undertake the Regulatory Test.

The Commission has decided to maintain the requirement in the Rule to be made for the LRPP to direct a Registered Participant to undertake the Regulatory Test for a potential transmission project. It has also decided to enhance this direction

so that the Commission can direct a party to identify a potential transmission project and then undertake the Regulatory Test.

5.6. Timeframes and compliance

The Rule proposal empowered the Commission to set timeframes for the completion of the Regulatory Test. The Proposed Rule provided that where the timeframe is not met the Commission may direct another party to undertake the Regulatory Test. The Proposed Rule did not otherwise provide for the consequences of a directed party failing to comply with the direction notice.

5.6.1. Submissions

A number of submissions indicated that the Proposed Rule did not provide any guidance on the timeframe within which the Regulatory Test should (or must) be undertaken in order to comply with a notice issued in accordance with the LRPP.⁴³

NEMMCO, in its first round submission, stated that:⁴⁴

“Some projects may be more advanced than others in terms of their specification of scope, impact on network limitations and costs, as well as in assessments of feasibility. Consideration should be given to all of these aspects in the establishment of the timeframe. NEMMCO suggests that the Rules require the AEMC to take advice from relevant parties such as the directed party and the panel of industry experts when deciding the timeframe.”

VENCorp’s first round submission noted that the Rule should provide for “**a reasonable** timeframe in which the regulatory test must be carried out by the directed party.”⁴⁵

Second round submissions from Powerlink and TransGrid called for a consultation process prior to the exercise of the LRPP in each instance so that the Commission can be fully informed in making a LRPP decision.⁴⁶

VENCorp’s second round submission raised two additional issues:⁴⁷

- the Rule should permit the Commission to modify or rescind its LRPP direction to meet changed circumstances to take into account situations such as where the directed party cannot meet the timeframes specified in the direction due to circumstances beyond its control; and

⁴³ NEMMCO, 24 February 2006, p4; TransGrid, 24 February 2006, p8; Powerlink, 24 February 2006, p4.

⁴⁴ NEMMCO, 24 February, 2006, p4.

⁴⁵ VENCorp, 24 February 2006, p4

⁴⁶ Powerlink, 29 January 2007, p1; TransGrid, 29 January 2007, pp4-5.

⁴⁷ VENCorp, 1 February 2007, p2.

- the inclusion of a power in the Rule for the Commission and directed parties to gather information from third parties.

5.6.2. Commission’s analysis

The Commission believes that timeframes, and consequences for flagrantly failing to meet those timeframes, are essential in any process as they provide guidance and, in the case of the latter, incentives for the timely completion of the required task. Timeframes should, however, be appropriate to the specific circumstances arising in each instance that the LRPP is proposed to be exercised.

The Commission believes it is therefore appropriate for the direction notice to provide a timeframe within which the Regulatory Test should be completed. The Commission agrees with submissions that it is appropriate to develop the timetable in consultation with the Registered Participants in order for the Commission to be able to make a fully informed decision.

The Commission is concerned that the absence of any consequences for failing to comply with a direction means there are insufficient incentives on a directed party to comply. The Commission understands it is the MCE’s intention to introduce civil penalties in the future to prevent breaches of timeframes.

In light of the issues raised in second round submissions, the Commission considers that the Rule to be made should permit the Commission to inform the AER that a directed party has failed to comply with a direction notice, including failure to comply with any timeframes imposed in the notice. The Commission considers that a provision of this sort makes explicit that issues regarding compliance with a direction notice may be considered sufficiently serious to warrant investigation as to enforcement action by the AER and addresses any concerns about the absence of incentives for directed parties to comply.

5.6.3. Commission’s decision

The Rule to be made provides that the direction notice may specify the time by which the Regulatory Test must be completed (clause 5.6.4(j)(2)). The Commission proposes to develop this timeframe on a case-by-case basis in consultation with market participants.

The Commission has also decided that the Rule to be made provide that the Commission may inform the AER of any non-compliance of a LRPP notice by a directed party (clause 5.6.4(m)(2)). Accordingly, the Commission has amended the Draft Rule as reflected in the Rule to be made to better identify and clarify the process around the direction notice.

5.7. Limiting the LRPP to National Transmission Flow Paths

The Proposed Rule was limited to apply only to investments relating to constraints within the national transmission flow paths between regional reference nodes (as defined in the Rules). This recognised that the purpose of the proposed LRPP is to address concerns regarding the incentives for investment within the national transmission flow paths between regions, rather than investments within a region.

5.7.1. Submissions

AGL, in its first round submission, submitted that the LRPP should not be restricted to inter-regional links. Its view is that all major flow paths identified by the ANTS should be subject to this power since they impact on the efficient operation of the market and therefore the long term interests of customers in terms of price and reliability.

This issue was not addressed in submissions on the Draft Determination.

5.7.2. Commission's analysis

The Commission believes that the LRPP should be limited to investments to relieve constraints within the national transmission flow paths between regions as proposed by the MCE. While intra-regional congestion can contribute to inter-regional congestion, the Commission considers that the Congestion Management Review will examine this matter and recommend appropriate responses. In the meantime, the Commission considers that limiting the LRPP to national transmission flowpaths is appropriate as this recognises the underlying incentive problem that the Rule proposal is seeking to address.

5.7.3. Commission's decision

The Commission has accepted the MCE Proposal to limit the application of the LRPP to investments relating to constraints within the national transmission flow paths between inter-regional reference nodes.

5.8. Cost recovery

The Proposed Rule did not provide for the recovery of costs associated with a direction notice as it envisaged these costs would be borne by the directed party.⁴⁸

⁴⁸ MCE Rule Proposal, pp6-7.

5.8.1. Submissions

A number of submissions were received in relation to who should bear the costs of undertaking the directed Regulatory Test. In general, submissions supported the directed party being able to recover the costs of complying with the direction.⁴⁹

NEMMCO, in its first round submission, stated that:⁵⁰

“...it supports the MCE’s proposal that costs of undertaking the Regulatory Test should be borne by the directed party to the extent that the directed party is the relevant TNSP. However, NEMMCO believes that requiring a directed party who is not the relevant TNSP to bear the costs of the application of the Regulatory Test would not be appropriate.”

In its first round submission, TransGrid noted that:⁵¹

“...it needs to be made clear within the Rule that all reasonable costs imposed on TNSPs by this process are to be passed through as adjustments to regulated revenue caps. To do otherwise would be inconsistent with NEL provisions entitling TNSPs to a reasonable opportunity to recover costs associated with meeting a service obligation.”

In its Draft Determination, the Commission decided to not specify in the Draft Rule the approach to recovery of the costs of a direction in accordance with the LRPP.

The Commission also sought comments from interested parties on the following issues related to cost recovery:

- whether provisions for cost recovery are appropriate for parties directed to sit the Regulatory Test;
- if so, whether these provisions should be made part of the Rule or included in the LRPP Guidelines;
- the appropriate approach to the recovery of costs for both directed TNSPs and non-TNSPs, in the event that provisions for cost recovery are considered appropriate.

Second round submissions from Powerlink, TransGrid and VENCORP were in favour of the Commission providing for the directed party to be able to recover the costs of undertaking the Regulatory Test. For example, Powerlink stated that

⁴⁹ NEMMCO, 24 February 2006, p3; Powerlink, 24 February 2006, p4; TransGrid, 24 February 2006, pp8-9; AGL, 24 February 2006, p2; National Generators Forum, 23 February 2006, p6; VENCORP, 24 February 2006, pp2-3.

⁵⁰ NEMMCO, 24 February 2006, p3.

⁵¹ TransGrid, 24 February 2006, p9.

the Rule to be made should provide an explicit right to recover the costs of undertaking the Regulatory Test for both non-TNSPs and also for TSNPs where the solution would be remote from their existing service area.⁵² Powerlink also advocated for a right to cost recovery where there is “recent previous analysis, possibly within the previous two to three years, that indicates there are no options which pass the Regulatory Test”.⁵³

TransGrid made extensive submissions on this issue. It noted that s 35(3)(a) of the NEL requires that Rules made by the Commission under s 35 must provide a reasonable opportunity for a regulated transmission system operator to recover the efficient costs of complying with a regulatory obligation. TransGrid submitted that requiring TNSPs to undertake the Regulatory Test but not providing an opportunity for the directed party to recover the efficient costs of complying with this obligation rendered the Rule unlawful.⁵⁴ In TransGrid’s submission, recovery of efficient costs was only possible if the potential transmission project passes the Regulatory Test:⁵⁵

“If the project passes the Regulatory Test then, assuming adequacy of regulated rates of return on investment, the project will be delivered and the total project cost, including the cost of the regulatory test, will be rolled into the regulatory asset base at the end of the regulatory control period. If there is substantial expenditure within the TNSPs current regulatory control period then, under the ex-ante capex regulatory incentive scheme, the TNSP would forgo returns on that expenditure. The only way the TNSP could avoid most of this cost would be to defer expenditure on the project in question until the next regulatory control period, which would be inefficient under a range of plausible circumstances.

If the project fails the Regulatory Test then the costs of carrying out the Regulatory Test are normally treated as operating costs incurred during the current regulatory control period. In this case, under the ex-ante operating expenditure regulatory incentive regime the TNSP would forgo those costs, even though they were incurred as a result of meeting a regulatory obligation.”

To address this imbalance, TransGrid suggested that a potential transmission project that is identified as efficient should be deemed to be a contingent project for the purposes of revenue cap regulation. TransGrid submitted that provided the allowed rates of return were adequate, any incentive for the TNSP to defer the proposed transmission project would be removed.⁵⁶ If the project was shown to be inefficient, the efficient expenditure required to undertake the Regulatory Test should be treated as prudent capital expenditure and rolled into the value of the regulatory asset base at the end of that regulatory control period. In

⁵² Powerlink, 29 January 2007, p2.

⁵³ *Id.*

⁵⁴ TransGrid, 29 January 2007, p5.

⁵⁵ *Id.*

⁵⁶ *Ibid*, p6.

TransGrid's submission, this would "ensure that the TNSP can reasonably expect to recover LRPP imposed compliance costs."⁵⁷

Finally, VENCorp submitted that any unaffected party, TNSP and non-TNSP, must be able to recover the costs of either identifying a project and/or applying the Regulatory Test. Failing to do so would:⁵⁸

- *"place a financial burden on consumers who would not reap any direct benefit from the work being undertaken by the directed party; and*
- *provide a perverse incentive on the party to undertake the Regulatory Test as quickly and at the lowest cost, without regard for the outcome."*

5.8.2. Commission's analysis

The Commission notes the various submissions made during the public consultation processes and has considered the various points raised.

In response to TransGrid's submission that the Rule is, as a matter of law, problematic, the Commission is of the view that the LRPP is not strictly a "regulatory obligation" as that term is defined in s 10 of the NEL. Accordingly, s 35(3) does not strictly apply in relation to a LRPP direction.

Irrespective of this strict position, the Commission has considered the issues surrounding cost recovery and whether to provide direct cost pass through for the efficient cost of complying with a direction to undertake the Regulatory Test. In the absence of a specific cost recovery clause in the Rule, where the Regulatory Test is successful, the costs are likely to be capitalised into the cost of the subsequent investment and therefore recovered by the directed TNSP. In circumstances where the Regulatory Test is unsuccessful, the costs would necessarily be borne by the TNSP within existing budgetary requirements for operational expenditure. The Commission considers there are three options to address cost recovery where the Test is not satisfied:

- determine whether costs can be recovered on a case by case basis;
- expressly provide for directed parties to be able to recover efficient costs in the Rule; or
- expressly provide in the Rule that directed parties are not permitted to recover costs.

The Commission considers that each option has advantages and disadvantages. Determining issues around cost recovery on a case-by-case basis may not provide adequate regulatory certainty and may lead to undue complexity in the

⁵⁷ *Ibid*, pp5-6.

⁵⁸ VENCorp, 1 February 2007, p2.

exercise of the LRPP. It does, however, provide the Commission with some flexibility to decide on an equitable outcome on an individual basis. Further, consistent with the intention expressed by the MCE in its Rule proposal, the Commission expects that it would exercise the LRPP infrequently. Whilst mindful of the potential financial impact on TNSPs, the Commission is concerned about the lack of incentives to undertake the Regulatory Test efficiently. Given that, if successful, the efficient costs of the Test would be capitalised into subsequent investment, the Commission believes the negative financial implications are likely to be sufficiently infrequent so as not to warrant specific pass through to be provided in the Rules.

If the Rule to be made did provide for cost recovery, the Commission is concerned that it will create an incentive for directed parties to over-capitalise on the Regulatory Test, leading to cost inefficiencies that are entirely recoverable or delay proper consideration of projects so that the costs are passed on to end users. Furthermore, it may discourage parties from proactively undertaking the market benefits limb of the Regulatory Test if they are able to recover the costs of undertaking the Regulatory Test as the result of a LRPP direction.

If the LRPP Rule prohibited cost recovery, the Commission is of the view that it creates an incentive for the directed party to undertake the Regulatory Test as quickly as possible at the lowest possible cost and with little regard for the outcome.

The Commission is of the view that the framework surrounding the Regulatory Test and the circumstances in which a party may be directed to undertake it are generally well understood. Therefore, the Commission considers that the Rule, together with the incentive package in relation to operating expenditures provided for in the Transmission Revenue and Pricing Rules, provide regulated businesses with a reasonable opportunity to manage operating costs, including in the event of a LRPP direction. For these reasons, the Commission does not consider it is necessary for the Rule to explicitly allow directed parties to recover the efficient costs of undertaking the Regulatory Test as a consequence of a LRPP direction.

Where a directed party is not a TNSP, consideration would need to be given to the costs of undertaking the Regulatory Test by that party. Given that the circumstances of individual non-TNSPs are likely to differ in each case, the Commission considers that issues concerning cost recovery are best resolved on a case-by-case basis.

The Draft Determination indicated that the Commission would develop some guidance on this issue in the context of developing the LRPP Guidelines. However, given the Commission's view that it is most appropriate to resolve issues of cost-recovery for non-TNSPs on a case-by-case basis, it considers it is prudent to consider each case on its merits.

In contrast to the Draft Rule, the Rule to be made does not expressly require the Commission to have regard to the likely costs of the directed party or parties of applying the Regulatory Test before it exercises the LRPP. The Commission is of the view that this issue is one of a number of issues that it may be appropriate for the Commission to seek advice from the IRPC on, or seek input from Registered Participants during the public consultation process. Accordingly, the Commission considers that its obligation to have regard to other matters that are relevant in all the circumstances in deciding whether it is appropriate to exercise the LRPP addresses this issue (see clause 5.6.4(g)(4)).

5.8.3. Commission's decision

The Commission has decided that there should be no provision relating to cost recovery for directed parties in the Rule to be made. It has also decided not to expressly require the Commission to consider the cost to a direct party (or parties) of undertaking the Regulatory Test prior to deciding whether to exercise the LRPP.

6. Differences between the Proposed Rule and the Rule

The Commission has largely adopted the substance of the MCE's proposed Rule subject to some modifications, enhancements and minor editorial drafting amendments. The Commission has included the provisions dealing with the LRPP in clause 5.6.4 of the Rules.

The key differences between the Proposed Rule and the Rule to be made are that the Rule to be made:

- permits the Commission to issue a direction notice to two or more Registered Participants who are to jointly and co-operatively comply with the direction (clause 5.6.4(a)(2));
- permits the Commission to identify the proposed transmission project and direct the directed party to undertake the Regulatory Test in relation to that project (clause 5.6.4(c));
- includes a clause expressing the purpose of the LRPP (clause 5.6.4(b)) and requires the Commission to exercise the LRPP consistently with it (clause 5.6.4(d)(1));
- does not expressly require NEMMCO to be part of the expert advisory group but does appoint the Inter-Regional Planning Committee to perform this role, of which NEMMCO is a member (clause 5.6.4(e));
- permits the Commission to request NEMMCO to appoint up to four additional members to the IRPC for the limited purpose only of providing advice to the Commission in relation to the exercise of the LRPP (clause 5.6.4(f));
- expands on the list of matters that the Commission must have regard to when deciding whether or not to exercise the LRPP (clauses 5.6.4(g) and (h));
- does not expressly require a directed party to publish a report setting out the results of the application of the Regulatory Test but does permit the direction notice issued by the Commission to specify additional consultation and publication requirements in addition to those required by the Regulatory Test (clause 5.6.4(j)(3));
- requires the Commission to publish notice of the giving of a direction notice (clause 5.6.4(k));

- permits the Commission to inform the AER of a directed party's failure to comply with the direction notice (clause 5.6.4(m)(2));
- requires the Commission undertake annual reporting in relation to the LRPP (clause 5.6.4(n));
- requires the Commission to develop and publish guidelines relating to the exercise of the LRPP and prescribes a non-exhaustive list of matters to be addressed in the guidelines (clause 5.6.4(o)). The Commission must exercise the LRPP in accordance with the guidelines (clause 5.6.4(d)(2)), which are also binding on a directed party (clause 5.6.4(l)(2));
- does not explicitly provide for the recovery of efficient costs incurred in complying with the direction notice;
- does not require a directed party to seek a determination from the AER as to whether the potential transmission project satisfies the Regulatory Test.

Consequential amendments have also been made to give effect to these changes.

The Commission has also made certain modifications to the Draft Rule. The key differences between the Draft Rule and the Rule to be made are that the Rule to be made:

- permits the Commission to appoint the Inter-Regional Planning Committee to perform this role, of which NEMMCO is a member (clause 5.6.4(e));
- expands on the list of matters that the Commission must have regard to when deciding whether or not to exercise the LRPP (clauses 5.6.4(g)(3) and (4) and 5.6.4(h));
- does not require the Commission to have regard to the likely costs of the directed party or directed parties in applying the Regulatory Test before it exercises the LRPP;
- requires the Commission to publish notice of the giving of a direction notice (clause 5.6.4(k));
- permits the Commission to inform the AER of a directed party's failure to comply with the direction notice (clause 5.6.4(m)(2));
- prescribes a non-exhaustive list of matters to be addressed in the LRPP guidelines (clause 5.6.4(o)).

Attachment A: Rule to be made