24 February 2006

Dr. John Tamblyn
Chairperson
Australian Energy Market Commission
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Dear Dr Tamblyn

Rule Change Applications: Reform of the Regulatory Test Principles;
Reform of dispute resolution process for the Regulatory Test; Last resort planning power

EnergyAustralia welcomes the opportunity to comment on the above captioned proposed National Electricity Rule changes.

EnergyAustralia supports the move to include the principles and purposes of the Regulatory Test in the National Electricity Rules. While EnergyAustralia generally supports the proposed principles, we question the role of the Australian Energy regulator (AER) in developing the test, and submit that its role should be confined to developing guidelines for the application of the test. Importantly, EnergyAustralia submits that the role of the Regulatory Test needs to be made more explicit.

EnergyAustralia is concerned that requiring the AER to settle disputes on the application of the Regulatory Test offends the separation of powers principles inherent in the design of the overall regulatory framework. In the proposed Rule, the AER would decide disputes on the application of the Regulatory Test and also decide on the overall application of the Test. While EnergyAustralia believes in this case that the streamlining of the process is a worthwhile objective, the AER should be required to seek advice from NEMMCO and the IRPC in any dispute, in order to ensure an appropriate balance of interests.

While EnergyAustralia recognises that a last resort planning power is consistent with the AEMC's role in market development, it is concerned that the AEMC may not be adequately equipped under the Rules to undertake this role.

Coordination with other processes

At its meeting of 10 February 2006, the Council of Australian Governments established the COAG Energy Reform Implementation Group (CERIG) to develop detailed implementation arrangements for the further reforms to the energy market. The Chair of the COAG Energy Reform Implementation Group is to report to COAG before the end of 2006 with the Group's proposals for, among other things:

> *(i) Achieving a fully national transmission grid including the most suitable governance and transitional arrangements having regard to COAG's objective of achieving a truly national approach to the future development of the electricity grid, the legitimate commercial interests of asset owners, and the need to promote investment that supports the efficient provision of transmission services;*

At the same time, the AEMC is also conducting its review of Chapter 6 of the National Electricity Rules. Regarding the role of the Regulatory Test in assessing the efficiency of investment, the AEMC has commented in its Transmission Rule Proposal report (page 59) that:

> *The Draft Rule also requires that the assessment of the prudency and efficiency of investment needs to take into account information that was available to the TNSP at the time the investment decision was made. This is to avoid opening up the TNSP to unnecessary risk that its actual investment costs will not be rolled into the RAB, where later information comes to hand or expected market developments do not materialise. <u>This principle means that the Regulatory Test is not to be re-applied in assessing the prudency of investment</u> [emphasis added].*

The MCE is also currently consulting on a national framework for energy distribution and retail regulation. The MCE's consultants have recommended releasing distribution businesses from the obligation to perform the Regulatory Test. In this context, EnergyAustralia supports reliance on internal corporate governance processes, commenting:

> *EnergyAustralia believes that it is possible, and desirable, to establish criteria in the Rules that would allow a distributor to meet the above requirements of the regulatory test through a more effective means, such as adherence to a rigorous internal investment processes. Similar processes are required to be undertaken by a distributor in order to demonstrate the regulatory compliance and efficiency of its investments to its Board, as required by any commercial organisation.*

EnergyAustralia is most concerned that these work streams, and the current Rule Change proposals relating to the Regulatory Test, should be coordinated to ensure the processes develop a consistent package for energy infrastructure regulation.

EnergyAustralia also notes that four proposed Rule changes were released simultaneously. Recognising the distinct process that each proposed Rule change must follow, on this occasion the process may have benefited from a covering note highlighting any interrelationships between the proposed Rule changes.

The Fundamental Role of the Regulatory Test should be clarified

It is a fundamental policy position that distribution and transmission augmentations (both large and small) which satisfy the Regulatory Test (i.e. either maximises the net present value of the market benefits or, in the case of reliability augmentations, finds the least cost solution) should be added to the proponent's regulated asset base. This is not clearly reflected either in the current or proposed change to the Rules, and should be.

Part of the proposed rule change (proposed 5.6.5A(e)) is to require the AER to ensure that the Regulatory Test or any guidelines address the extent to which the AER will use the result of an application of the Regulatory Test in determining whether an option will be included in the regulated asset base.

This is not a matter which should be left for the Regulatory Test or the AER guidelines to determine. The Rules should provide that once an option is justified by the Regulatory Test, that option must be recognised by the regulator (the AER in relation to transmission and the jurisdictional regulator for distribution) as part of the regulated asset base.

EnergyAustralia notes the proposed Rule change issued by the AEMC on the Review of the Electricity Transmission Revenue and Pricing Rules (p56) that "in relation to determining forecasts of future capital expenditure, the Rules provide for a presumptive approval of capital expenditure for reliability augmentations, projects that are required to meet regulatory obligations and projects that have satisfied the regulatory test."

This approach will more accurately reflect the role of the Regulatory Test as a tool for evaluation of proposed new network investment to ensure that the most efficient investment decision is taken, and that once taken and acted upon, will be recognised by the regulator.

Any discretion in relation to the recognition of the project must be confined to the value of the option which is eventually reflected in the asset base. Differences will inevitably arise between the actual cost of the project and the planning value reflected in the Regulatory Test; the actual cost of the project should be included in the Regulatory Asset Base. The role of the Regulatory Test is not to determine the efficiency of the out-turn costs of the project; rather, it is to assess which option is to be pursued.

EnergyAustralia notes that this concept has been recognised by the AEMC in its Review of the Electricity Transmission Revenue and Pricing Rules (p59):

> *Importantly, the Draft Rule does not require that the value of the project as included in the Regulatory Test be included as the value of the project that is to be taken by the AER as being efficient. There are a number of reasons why the actual cost incurred by the TNSP may differ from the estimated project cost used by the TNSP at the time at which it applied the Regulatory Test, and which do not imply that the actual cost incurred is then imprudent. The Regulatory Test needs to be applied before the TNSP puts the contracts to construct that project out to tender, and usually before the TNSP undertakes the Environmental Impact Statement (EIS) associated with the project. Both the tendering of contracts, and changes to the project arising out of the EIS process, may impact on the project cost.*

Connected with the role of the Regulatory Test is its reasonable application. EnergyAustralia considers that the benefits of conducting the Test must be commensurate with the associated costs. The current thresholds above which the Rules require the Regulatory Test to be conducted - $10 million for a new large transmission (or distribution) network asset, and $1 million for a new small transmission (or distribution) network asset – are too low to maintain that cost/benefit relationship. The conduct of the Regulatory Test does impose burdens on the investment process, and it is important to ensure that the burden is reasonable relative to the benefits that can be obtained for smaller projects. EnergyAustralia believes that the benefits of conducting the Regulatory Test on relatively small projects are overwhelmed by the costs associated with conducting the Test. EnergyAustralia suggests that more reasonable thresholds for the definitions of large and small transmission (and distribution) network assets would be $20 million and $5 million respectively.

Should the Regulatory Test being promulgated by the rule maker or regulator?

While historically the Code conferred the role of promulgating the Regulatory Test upon the ACCC, that role is now inconsistent with the allocation of functions under the National Electricity Law and Rules. The Regulatory Test functions in the same way as any other rule; specifically, it prescribes the manner in which proposed network augmentations should be assessed, in the same way as the Rules prescribe other matters in relation to the augmentation and expansion of transmission and distribution systems.

The MCE proposal indicates that consideration was given to including a "highly prescriptive regulatory test" in the Rules, but that this was discarded as it would go beyond setting policy requirements and would leave network services providers and the AER with little discretion in applying the test. The reasoning behind this decision is not clear. It appears to indicate that including the Regulatory Test in the Rules offended some concept that the Rules should only set policy requirements. This is clearly not the case. While the role of the MCE is to set policy requirements, it does not follow that it would be inappropriate to request the AEMC to promulgate a Rule which resulted in the Regulatory Test being contained in the Rules. The MCE would not need to require "a highly prescriptive Regulatory Test", merely that the test be made in

accordance with the proposed principles. This would ensure that the Regulatory Test was made in accordance with the same process and rigour as the Rules.

Care must be taken to ensure the guidelines do not increase the scope for discretion of the AER in relation to the application of the Regulatory Test. The principles should operate to provide a useful scope for the guidelines; the guidelines should not be used to embellish or change the operation of the test itself.

EnergyAustralia is concerned that the current proposals place incompatible responsibilities on the AER, inconsistent with the allocation of functions in the National Electricity Market. Under the current proposals (including the proposed Rule change on Regulatory Test dispute resolution), the AER would become rule maker, enforcement body and dispute resolution body. It is clearly not appropriate for the AER to promulgate the Regulatory Test, apply it as regulator when assessing the efficiency of network investment, issue guidelines about the application of the test and then resolve disputes in relation to the application of the Test.

The AER would be first and final arbiter of all issues relating to the Test and its application, which is clearly not appropriate or consistent with the allocation of functions in the National Electricity Market. While it is appropriate for guidelines to be developed to assist in the application of the Regulatory Test, the Rules must contain safeguards to ensure that the guidelines are treated as guidelines, and not as some quasi form of Rules or to fill in perceived gaps or ambiguities in the Test or Rules. There must be scope, for example, for the guidelines not to be strictly adhered to if a proponent forms the view that the guidelines do not result in the proper application of the Regulatory Test and its underlying principles.

A further risk for network businesses in relation to the Regulatory Test is that it can be changed from time to time without due consideration of the impacts such changes may have on network businesses. If the Regulatory Test formed part of the Rules, then such impacts could be identified and addressed as part of the Rule change process.

Terminology relating to "satisfying" the Regulatory Test should be reconsidered

To date, the Code (and now the Rules) has referred to a process to determine whether an option "satisfies the Regulatory Test". This gives the impression that the Regulatory Test could be satisfied by any one of a number of options or that an option could be developed to "satisfy" the Test, neither of which reflects its intended purpose or function.

This anomaly has arisen because neither the Code nor the Rules have actually specified the purpose of the Regulatory Test.

This can lead, and has led, to confusion about the role of the Regulatory Test. The Regulatory Test essentially sets out a methodology for assessing and ranking identified options to identify the most economically justified option and one which should be recognised by regulators as efficient investment. Only one project or option can be justified under the Test. The ACCC has

recognised this anomaly in both the current and previous version of the Test by prefacing it with the words "an option satisfies the regulatory test if …".

However this is unsatisfactory, as it leaves the regulator to make assumptions about the purpose of the Regulatory Test and fill this gap in the rules through the Regulatory Test itself. It is submitted that it is essential that the Rules be amended so that clause 5.6.5A clearly articulates the purpose of applying the Regulatory Test to proposed new network investment and that references in the Rules to "satisfy the Regulatory Test" be replaced with the more accurate concept of a project being "justified" by the application of the Regulatory Test.

Dispute Resolution Process for the Regulatory Test

This proposal essentially removes disputes about transmission planning and investment for new large network assets from the Dispute Resolution Panel (DRP) and provides for the AER to determine all such disputes.

The effect of the rule change proposal is that any dispute about the final report to support a new large transmission asset will be determined by the AER in the first instance, and the issues which could be the subject of dispute have been limited slightly. Under the proposed Rule change, Registered Participants, the AEMC, Connection Applicants, Intending Participants, NEMMCO and interested parties may dispute the contents, assumptions, findings or recommendations of the final report with respect to possible alternatives considered and their ranking, whether the new large transmission network asset will have a material inter-network impact, the basis upon which the applicant has assessed that the asset satisfies the Regulatory Test (provided the assets is not a reliability augmentation) and whether the asset is a reliability augmentation.

The issue therefore arises as to whether it is appropriate and or efficient for the AER to determine such disputes. With the possible exception of whether the asset will have a material inter-network impact, each of the other matters are ones on which the AER must form a view when assessing the efficiency of network investment. This might indicate that it would be efficient for the AER to determine such disputes rather than the DRP, however there is the countervailing argument that the AER would not provide an independent review of the issues.

The main justification for the Rule change is that it will streamline the dispute resolution process. However, this streamlining comes at the expense of the principle of the separation of powers that is inherent in the rest of the regulatory framework; the AER would be responsible for resolving a dispute on a test, which it will subsequently use to assess the justification of the project.

EnergyAustralia believes that the matters likely to be disputed under these arrangements are matters on which the AER would be required to address in its overall assessment of the performance of the Regulatory Test. Where intermediate disputes can be settled at an early stage of the process, this will provide greater certainty to the TNSP on the ultimate acceptance of the Regulatory Test results.

On balance, EnergyAustralia believes that this streamlining of process and increase in regulatory certainty is, in this particular instance, an appropriate circumstance on which do diverge from the main principle of the separation of powers. EnergyAustralia suggests, however, that the Rule Change should require the AER to seek advice from NEMMCO and the IRPC, as appropriate, in deciding such disputes.

Appointment of the AEMC with Last Resort Planning Power

The proposed Rule change will provide for the AEMC to direct any person to apply the Regulatory Test to a "potential transmission project". A potential transmission project is defined as "[n]ew transmission network investment identified by the AEMC which would, if constructed, relieve forecast constraints in respect of national transmission flow paths between regional reference nodes." The power is limited to directing the application of the Regulatory Test; it does not extend to directing investment.

While the stated intention is that the power should not be exercised in relation to intra-regional or reliability projects, the power is not confined to "inter-connector investment" as it can be exercised in relation to any project that would, if constructed, relieve forecast constraints in respect of national transmission flow paths between regional reference nodes. The MCE proposal acknowledges that care will need to be taken to ensure that the AEMC does not exercise the power inappropriately.

Given the scope for ambiguity between the definition in the proposed last resort planning power Rule, and the definition of "inter-connector" in the Rules[1], EnergyAustralia believes that clarity would be improved by including a definition of what constitutes an inter-connector investment. This should be promulgated as part of the Regulatory Test for the purpose of exercising the last resort planning power.

EnergyAustralia generally supports the concept of Last Resort Planning responsibility resting with the AEMC as it is consistent with the AEMC's market development role and its monitoring to ensure that the market is providing the appropriate outcomes, including investment. However, the Rule as currently proposed does not equip the AEMC to carry out the role effectively. The role would obviously require the AEMC to either carry out ongoing monitoring or receive ongoing advice relevant to transmission planning and development.

The proposed Rule requires the AEMC to establish and seek advice from a panel of industry representatives including NEMMCO, "when identifying a potential transmission project". This indicates that the AEMC would seek advice from the panel from time to time when identifying a potential project, but it is not clear how the AEMC would know when to identify a potential transmission project in the absence of ongoing advice. It is suggested that the AEMC consider amending the proposal to include a requirement that the IRPC keep the AEMC informed of when the exercise of this power might be necessary.

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[1] A *transmission line* or group of *transmission lines* that *connects* the *transmission networks* in adjacent *regions*.

EnergyAustralia would be pleased to discuss these comments with you at your convenience.

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Yours sincerely

(GEORGE MALTABAROW)
Managing Director