



AUSTRALIAN
ENERGY
REGULATOR

Regulatory Test Application Guidelines

November 2007



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AMENDMENT RECORD

| Version no. | Date | Pages |
|--------------------|---------------|--------------|
| 01 | November 2007 | 18 |
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1. Nature and authority

1.1 Introduction

Consistent with the requirements of clause 5.6.5A of the *National Electricity Rules (NER)*, these *Guidelines* provide guidance on the operation and application of the *regulatory test*.

1.2 Authority

Clause 5.6.5A(d) of the *NER* requires the *AER* to publish guidelines for the operation and application of the *regulatory test*. These *application guidelines* are to assist *Network Service Providers* and market participants in understanding and applying the *regulatory test*. The *AER* encourages all *Network Service Providers* to refer to these guidelines in conducting regulatory test analyses as a means of enhancing consistency in investment decision making across different organisations.

1.3 Role of these Guidelines

Under the *NER*:

- a) *Transmission Network Service Providers* are required to apply the *regulatory test* in respect of both *new small network assets* and *new large network assets*. The requirement to apply the *regulatory test* to:
 - a. *new small network assets* is contained in clause 5.6.2A (“Annual Planning Report”); and
 - b. *new large network assets* is contained in clause 5.6.6 (“Applications to establish new large transmission network assets”);
- b) *Distribution Network Service Providers* are required to apply the *regulatory test* under clause 5.6.2 (“Network Development”).

1.4 Definitions and interpretation

In these *Guidelines*:

- a) The words and phrases presented in italics *such as this* have the meaning given to them in:
 - a. the Glossary of these *Guidelines*; or
 - b. if not defined in the Glossary, the *NER*.
- b) The singular includes the plural and vice versa.
- c) “Including” and similar words do not imply any limitation.
- d) Where the expression “(or *alternative option*)” and similar words are used, subsequent references to “option” in that sub-paragraph also refer to *alternative option(s)*.

1.5 Processes for revision

The *AER* may amend or replace these *Guidelines* from time to time in accordance with clauses 5.6.5A(f)-(h) of the *NER*.

1.6 Version history and effective date

A version number and an effective date of issue will identify every version of these *Guidelines*.

2 Limbs of the regulatory test

2.1 Type of investment

Any application of the *regulatory test* to an option should explicitly state whether the option is intended to:

- a) minimise the *costs* of meeting a *reliability requirement* in accordance with paragraph (1)(a) of the *regulatory test* (ie be a *reliability option*); or
- b) maximise the expected *net economic benefit* to all those who produce, consume and transport electricity in the *National Electricity Market*, in accordance with paragraph (1)(b) of the *regulatory test* (ie be a *market benefit option*).

2.2 Reliability investments

Any application of the *regulatory test* to an option that is intended to be a *reliability option* should explicitly:

- a) refer to and state the precise:
 - a. service standard in schedule 5.1 of the NER; and/or
 - b. provision of any *applicable regulatory instruments*,
(together, *regulatory requirement*) that, in the view of the *Network Service Provider*, causes the option to be a *reliability option* and an explanation of why this is the case;
- b) state whether, and if so, when and where the option has been included in an *Annual Planning Report* of the *Network Service Provider*, or has been the subject of an *application notice* made available by the *Network Service Provider*;
- c) involve a comparison between the option and all *alternative options* in a number of *reasonable scenarios*.

2.3 Market benefit investments

Any application of the *regulatory test* to an option that is intended to be a *market benefit option* should explicitly state:

- a) whether it assists in the satisfaction of any *regulatory requirement*;
- b) whether, when and where the option has been included in an *Annual Planning Report* of the *Network Service Provider*, or has been the subject of an *application notice* made available by the *Network Service Provider*;
- c) involve a comparison between the option and all *alternative options*, in a number of *reasonable scenarios*.

2.4 Criteria for reliability investments

The revised definition of *reliability augmentation* in the *NER* provides that a *transmission network augmentation* will be regarded as a *reliability augmentation* so long as it is principally necessitated by a *reliability requirement*. This reflects a change from the previous provision where a *reliability augmentation* needed to be solely necessitated by a *reliability requirement*. The intent is that an option intended to meet a *reliability requirement* is not precluded from being assessed as a *reliability option* under paragraph (1)(a) of the *regulatory test* if the option also provides *market benefits*.

3 Costs

- a) For the avoidance of doubt, *costs* refers to the present value of the direct costs of providing or operating an option (or *alternative option*). This includes:
 - a. capital construction costs of the option; and
 - b. operating and maintenance costs of the option.
- b) The costs referred to in (a) should, in turn, include the capital, operating and maintenance costs of ensuring that the option complies with all applicable laws, regulations and applicable administrative requirements in relation to the option. For example, the costs of an option meeting mandatory environmental standards should be included within the *costs* of that option under the *regulatory test*. Further, an environmental subsidy should be treated as making a negative contribution to the *costs* of an option. However, the costs of meeting non-mandatory standards are not part of an option's *costs*, unless the proponent of the option has stated that it intends to incur those costs.
- c) For the avoidance of doubt, *cost* excludes any negative consequential impacts of an option (or *alternative option*) on the *National Electricity Market*. For example, if an option leads to the bringing forward of (other) plant build, or an increase in electricity losses, these are not part of the *costs* of that option. Rather, these negative impacts are taken into account in the calculation of *market benefit* under paragraphs (3)-(4) of the *regulatory test*. Therefore, such negative impacts are not to be taken into account in the assessment of a *reliability option*.
- d) For the avoidance of doubt, where an option consists of more than one individual project (as discussed in part 7 of these *Guidelines*), the *costs* of the option includes the *costs* of all of those projects.

4 Market benefit

4.1 Calculation

- a) The *market benefit* of an option (or *alternative option*) reflects the present value of the increase in the overall economic surplus arising as a consequence of an option but excludes the option's *costs*.
- b) The *market benefit* of an option (or *alternative option*) can only be calculated by a comparison between the state of the world with the option in place to a state of the world in which the option is not in place. Generally, the base case for a *regulatory test* assessment (against which all other states of the world can be compared) will be a state of the world without any of the potential options in place. However, where options that assist in meeting a *reliability requirement* are assessed as *market benefit options*, it may not be possible to identify a base case as a state of the world without any of those options in place. This is because at least one of the options will have to be commissioned – there will be no state of the world in which the *Network Service Provider* does not pursue or develop any option. To the extent possible, the same base case should be used to assess the *market benefits* of all options so that there is a common point of comparison between them.
- c) *Reasonable scenarios* are states of the world used to test the sensitivity of the existence and magnitude of the *market benefits* and *costs* of an option or *alternative option* to changes in key inputs such as demand growth, project commissioning dates, discount rates and so on.
- d) Overall economic surplus includes:
 - a. consumer surplus, being the difference between what consumers are prepared to pay for electricity and the price they are required to pay; and
 - b. producer surplus, being the difference between the price electricity producers and transporters receive for their services and the cost of providing those services.
- e) For the avoidance of doubt, the calculation of *market benefit* of an option or *alternative option*:
 - a. should not include wealth transfers between consumers, producers and transporters of electricity; and
 - b. should reflect a netting-off process, whereby both the positive and negative impacts of an option (or *alternative option*) on the *National Electricity Market* are taken into account. Each category of potential benefits under paragraph (4) of the *regulatory test* (or that are otherwise appropriately included) may each make a positive or negative contribution to the *market benefit* of the option. The sum of all such contributions equates to the *market benefit* of that option. This process may result in an option having either a positive or negative *market benefit*.

- f) For example, a particular transmission option may, compared to the base case state of the world, lead to:
- a. the deferral of new gas-fired generation plant located close to load centres;
 - b. the bringing forward of new coal-fired generation plant located far from load centres;
 - c. a reduction in gas fuel costs;
 - d. an increase in coal fuel costs;
 - e. a reduction in load shedding (valued at VCR or a comparable estimate of the value consumers place on electricity);
 - f. a reduction in transmission losses due to the commissioning of transmission elements with greater capacity; and
 - g. an increase in transmission losses due to increased power flow from remote generation.
- g) The effect of the hypothetical changes in (f) on the individual potential benefit categories under paragraph (4) of the *regulatory test* may be:
- a. a net increase in generation capital costs – assuming that the \$/MW capital costs of the coal-fired plant are higher than those of the gas-fired plant. This would constitute a negative contribution to the *market benefit* of the option;
 - b. a net reduction in generation fuel costs – assuming that the \$/MWh fuel costs of the gas-fired plant are higher than those of the coal-fired plant. This would constitute a positive contribution to the *market benefit* of the option;
 - c. a net reduction in load shedding. This would constitute a positive contribution to the *market benefit* of the option; and
 - d. a net increase in transmission losses – assuming that the effect of the transmission option on reducing line losses was more than offset by the increased losses arising due to increased power flow from remote generation. This would constitute a negative contribution to the *market benefit* of the option.
- h) The net effect of all of the hypothetical changes under paragraph (f) of the example option may be a positive *market benefit*. The calculation of *net economic benefit* would then require the subtraction of the *costs* of the option from its *market benefit*.
- i) Wherever a *Network Service Provider* is required under the *NER* to prepare a report (including an *application notice*) in which it is required to provide details of how it has applied the *regulatory test*, or identified options that would satisfy the *regulatory test*, the *Network Service Provider* should include detailed calculations as to how it determined the *costs* and *market benefits* (as applicable) used in, or derived from, the analysis. For example, a *Network Service Provider* should provide such details in its *Annual Planning Review* under clause

5.6.2A(5) of the *NER* in respect of each relevant proposed *new small transmission network asset*.

4.2 Modelling process

The process for determining *market benefit* typically involves two key modelling steps.

- a) First, market development modelling should be undertaken to derive *modelled projects*. Market development modelling involves determining what kind of projects (in particular, generation projects) would be developed in the longer term in both the presence and absence of the proposed option (or an *alternative option*) proceeding.
 - a. In accordance with paragraphs (22) and (23) of the *regulatory test*, market development modelling:
 - i. must be undertaken on a least-cost/central planning-style basis (least-cost market development modelling); and
 - ii. may, where appropriate, be undertaken on a private benefit basis as a sensitivity (market-driven market development modelling).
 - b. The reason why least-cost market development modelling must be undertaken is that it relies on relatively uncontroversial assumptions (derived from operations research), whereas market-driven market development modelling may be strongly influenced by assumptions regarding bidding behaviour and plant ownership.
 - c. By enabling the derivation of *modelled projects* in the presence and absence of an option, market development modelling assists in determining the *market benefits* of the option. In particular, market development modelling may assist in determining whether a particular *network* option is likely to lead to the deferral/advancement of generation capital investment compared to the base case, which would constitute a positive/negative contribution to the *market benefit* of that option, respectively.
 - d. For example, consider a situation where there is a proposed *network* option under consideration by a *Network Service Provider*. Assume that there is one *alternative option*, which is a demand-side response option. There is also a base case of no regulated option going ahead. The *Network Service Provider* would need to undertake market development modelling to derive individual *market development scenarios* (particularly focussed on deriving *modelled projects*) under each case. Assume that the *network* option led to no *modelled projects* being developed whereas the demand-side option led to one *modelled project* being developed and that two *modelled projects* arose in the base case. The *market benefits* of the *network* option would then include the *costs* of two *modelled projects*, while the *market benefits* of the demand-side option would include the *costs* of one *modelled project*. Note that despite these benefits, neither option may produce positive *net economic benefits* if their own *costs* were substantial enough to offset these and other *market benefits*.

- b) Second, pool dispatch modelling may be undertaken to assist in deriving the impact of an option (or *alternative option*) on *market benefits*, given the plant build resulting from the market development modelling in (a).
- a. Pool dispatch modelling involves simulating real-time wholesale spot market outcomes in the presence of the proposed option (or an *alternative option*), as well as in the base case. In doing so, pool dispatch modelling may assist in determining whether, for example, a particular *network* option is likely to lead to the dispatch of plant with lower fuel costs compared to the base case, which would constitute a positive contribution to *market benefit* of that option.
 - b. As noted in paragraph (12) of the *regulatory test*, any model used for the purpose of pool dispatch modelling must incorporate realistic treatments of plant and network characteristics.

5 Competition benefits

5.1 Inclusion of competition benefits

The *regulatory test* allows for (but does not require) *competition benefits* to be included in the assessment of an option intended to be a *market benefit option*.

5.2 Description of competition benefits

- a) The identity and description of *competition benefits* was discussed extensively in the ACCC's 2004 Regulatory Test Decision including in Appendices C, D and E by Dr Darryl Biggar.
- b) As discussed in that document, and as set out below, the computation of the *market benefit* of an option (or an *alternative option*) in a given scenario includes *competition benefits* where the modelling process explicitly takes into account the likely impact of the option (or *alternative option*) on the bidding behaviour of *Generators* (or other *Market Participants*) which may have a degree of market power relative to the base case. A *Market Participant* has a degree of market power in a given *dispatch interval* if it can, by varying its bid or offer, alter the pricing, *dispatch* and flow outcomes in the *market* (including possibly inducing 'clamping') in that *dispatch interval* in a manner that is profitable for that firm.
- c) Where realistic bidding is used to consider the effect of an option or *alternative option*, the measured change in overall economic surplus will, by implication, include *competition benefits*.
- d) To be precise, the computation of the *market benefit* of an option includes *competition benefits* where the modelling process calculates the *market benefit* as the difference between the present value of:
 - a. the overall economic surplus arising in a network with the option, with bidding behaviour reflecting any market power in a network with that option, and
 - b. the overall economic surplus in the base case, with bidding behaviour reflecting any market power in that base case.
- e) Where the computation of the *market benefit* includes the calculation of *competition benefits* it is desirable (but not required) to separately identify the component of the *market benefit* that can be attributed to *competition benefits* (that is, that can be attributed to the impact of the option on bidding behaviour. Where the component of the *market benefit* that is attributable to *competition benefits* is separately identified, the methodology for separately identifying that component should be clearly stated. It will not be necessary to separately calculate *competition benefits*. It is only where the *Network Service Provider* seeks to separately identify *competition benefits* as a line item in the calculation of *market benefits* will it be necessary to consider and describe the methodology for doing so.

- f) The Appendices to the 2004 Regulatory Test Decision suggested two possible methodologies for identifying that component of the *market benefit* which is attributable to *competition benefits*:
- a. the methodology suggested by Dr Biggar, which involved finding the difference between:
 - i. the overall economic surplus arising in a network with the option, with the bidding behaviour of *Market Participants* reflecting any market power they have in a network with that option; and
 - ii. the overall economic surplus arising in a network with the option, with the bidding behaviour of *Market Participants* reflecting any market power they have in the base case network (this methodology requires a modelling process which allows the bidding behaviour to be “held constant” while the underlying network is changed); and
 - b. the methodology suggested by Frontier Economics, which involved finding the difference between:
 - i. the change in overall economic surplus resulting from the *augmentation* assuming bidding reflected any market power both before and after the *augmentation*; and
 - ii. the change in overall economic surplus resulting from the *augmentation* assuming competitive bidding both before and after the *augmentation*.
- g) To be clear, both of these approaches involve the same methodology for the calculation of the *market benefits*. The difference between the two approaches is in how the *market benefits* of an *augmentation* are divided between *competition benefits* and other benefits (also referred to as efficiency benefits).
- h) Both of these approaches have certain merits. Dr Biggar considered that his approach yielded a more natural economic interpretation to *competition benefits* than Frontier Economics’ approach. However, he noted that Frontier Economics’ approach meant that its measure of “efficiency benefits” were directly comparable to the definition of market benefits in previous applications of the *regulatory test* – or indeed, future applications of the *regulatory test* that did not seek to account for the impact of an *augmentation* on bidding behaviour.
- i) Participants are free to adopt either approach or another approach of their choosing in calculating *competition benefits* and the *regulatory test* reflects this intention. However, in any case, it is important that there is no double-counting of the *competition benefits* of an option or *alternative option*.

5.3 Calculating competition benefits

- a) As implied by paragraph (5) of the *regulatory test*, *competition benefits* do not need to be separated out as a line item in the calculation of the *market benefit* of a given option (or *alternative option*).
- b) As suggested in paragraph 5.2(d), a relatively straightforward way for *Network Service Providers* to include *competition benefits* in their assessments is simply

to calculate the *market benefits* of an option (or *alternative option*) as the difference between the present value of:

- a. the overall economic surplus arising in a network with the option, and
- b. the overall economic surplus in the base case,

using realistic bidding in each case. The consequent changes in fuel costs, transmission losses, plant entry dates, other network commissioning dates, ancillary services costs, and so on would, in net terms, constitute the *market benefits* of the option and by implication include *competition benefits*.

- c) The key requirement in calculating *competition benefits* is a robust approach to the methodology for determining realistic bidding behaviour. The *AER* does not wish to prescribe the methodology for determining realistic bidding behaviour other than to suggest that it should:
 - a. Be based on a credible theory as to how participants are likely to behave in the wholesale spot market over the modelling period; and
 - b. Take into account the impacts of other participants' behaviour on the bidding behaviour of any given participant.

6 Discount rate

- a) The *regulatory test* specifies that present value calculations must use a commercial discount rate appropriate for the analysis of a private enterprise investment in the electricity sector and that the type of discount rate used should be consistent with the cash flows being discounted. However, the discount rate may be the subject of sensitivity analysis.
- b) The weighted-average costs of capital for regulated electricity infrastructure ought to provide the lower bounds of the discount rate used in any sensitivity analysis.
- c) The choice of parameters for regulated and unregulated electricity infrastructure used to derive the discount rate will vary and depend on the prevailing market conditions at the time of the *regulatory test* assessment.
- d) The same discount rate should be used for assessing an option and all of its *alternative options*. Uncertainty in relation to the *market benefits* and *costs* of various options should be addressed through the use of appropriate *reasonable scenarios*, including *reasonable scenarios* reflecting the application of appropriate sensitivities.

7 Alternative options

7.1 Introduction

- a) The selection and use of projects as likely *alternative options* under the *market benefits* limb of the *regulatory test* involves three stages:
 - a. First, the narrowing of projects to options;
 - b. Second, the narrowing of options to *alternative options*; and
 - c. Third, the narrowing of *alternative options* to likely alternative options.
- b) The selection and use of projects as *alternative options* under the *reliability* limb of the *regulatory test* only involves the first two of these stages.

Details of how these stages ought to be undertaken are provided below.

7.2 Projects to options

- a) Each *Network Service Provider* should identify promising network and non-network projects that it considers may individually or combined in a reasonable manner produce a positive *market benefit* or satisfy a *reliability requirement* if it/they were commissioned in the absence of the proposed option under consideration. This should be informed by any relevant consultation and request for information processes. For example, a *Network Service Provider* may consider that an embedded generation project may produce a positive *market benefit* if the *network* option it is considering developing does not go ahead.
- b) As part of the process in (a), *Network Service Providers* should consider both:
 - a. how different *network* projects could be combined; as well as
 - b. how non-*network* projects could reasonably be combined with *network* projects,to yield an option (and by extension, an *alternative option*) for assessment under the *regulatory test*. However, all the projects to be combined to form an option should have anticipated commissioning dates within a reasonable timeframe of the *regulatory test* assessment.
- c) For the avoidance of doubt, a project may be considered as an option even if any or all of the *costs* of the project have been or will be incurred regardless of whether it does or will provide or substitute for *network* services. This means that any deviation in behaviour by an actual or potential non-*network* project from what is assumed in an established *reasonable scenario* should be capable of being assessed as an option. For example, in a world of realistic bidding, a *Network Service Provider* may consider that there is a risk to reliability during periods of high demand. The *Network Service Provider* may consider a *network* option to address this risk. However, it should be open to, say, existing *Generators* to offer to the *Network Service Provider* to change their bidding behaviour from what would otherwise be assumed in a *reasonable scenario* to overcome the risk to reliability. For example, an existing *Generator* could offer

to bid all of its capacity into the *market* at high demand times rather than just half its capacity, as assumed under the approach to realistic bidding applied by the *Network Service Provider*. The incremental capacity offered in this manner could constitute an option for the purposes of comparison under the *regulatory test*. Note, however, that such an option can only be considered in the assessment if realistic generator bidding behaviour is applied in sensitivity testing.

- d) Importantly, the process outlined in this paragraph 7.2 is not intended to consider whether the relevant project is “likely” to go ahead in the absence of the proposed option under consideration by the *Network Service Provider*.

7.3 Options to alternative options

The *Network Service Provider* should apply the criteria in the *regulatory test* to determine which of those promising options identified in paragraph 7.2 are *alternative options*. For example, an option that is being considered as an *alternative option* to the proposed *reliability project* being assessed may not meet the same *reliability requirement* as the proposed option under consideration – such an option should not be considered as an *alternative option* to the proposed *reliability option*.

7.4 Alternative options to ‘likely’ alternative options

When considering which *alternative options* are likely *alternative options* to the particular proposed option being assessed, a *Network Service Provider* should, in addition to the criteria specified in paragraph 17 of the *regulatory test* itself, note that likely means “a real chance or possibility rather than a mere possibility”.

8 Scenarios and sensitivities

- a) A *reasonable scenario* should reflect an internally consistent state of the world, in that all aspects of the *reasonable scenario* could reasonably coexist. For example, an obvious inconsistency would be a scenario based on a major drop in water inflows due to climate change but no adjustment made to the *costs* of hydro-electric generation projects that may arise in a *market development scenario*. Similarly, the *AER* would expect that changes to the *costs* of various options would be reflected in the *market development scenarios* developed as part of a *reasonable scenario*. For example, an increase in the *costs* of hydro-electric generation projects due to reduced water inflows ought to be reflected in a reduction in the expansion or development of hydro-electric plant in a *reasonable scenario* compared to a *reasonable scenario* that did not incorporate the same impact of climate change on water inflows.
- b) A sensitivity is a change to an input or variable within a scenario that may produce a new scenario, which may be a new *reasonable scenario* if the sensitivity that has been applied is an appropriate one. For example:
 - a. a reduction in water inflows due to climate change is a sensitivity that, if appropriate, may lead to the creation of a new *reasonable scenario* through the impact of the sensitivity on, for example, *market development scenarios* and extent of involuntary load shedding;
 - b. an increased demand forecast is a sensitivity that, if appropriate, may lead to the creation of a new *reasonable scenario* through the impact of the sensitivity on, for example, *market development scenarios* and extent of involuntary load shedding; and
 - c. a reduced discount rate is a sensitivity that, if appropriate, may lead to the creation of a new *reasonable scenario* through the impact of the sensitivity on, for example, the calculation of *market benefits*.

9 Request for information

- a) A *Transmission Network Service Provider* must provide a range of information in its request for information notice. This is intended to ensure that a potential proponent of an *alternative option* has all the information it requires to put forward an option that could be appropriately considered as an *alternative option* to the proposed option under consideration.
- b) The *AER* highlights that paragraph 26(e) of the *regulatory test* requires that the request for information notice includes any specific project requirements that an *alternative option* must fulfil, including, for example, the required speed of response or size, type and location of generation plant. The *regulatory test* also defines *alternative option* to mean genuine and practicable alternative to the option being considered. This means that it is incumbent on the *transmission network service provider* to provide information about anything that is relevant to an option potentially being considered as an *alternative option*. It should not be open to a *Transmission Network Service Provider* to rule out an option as an *alternative option* for reasons that it did not (but reasonably could have) set out in a request for information notice.
- c) A party responding to a request for information should indicate in its response whether it wishes to have its proposed project or option considered in combination with other projects or options.
- d) A party responding to a request for information who proposes a non-*network* option should, to the extent possible, provide information about *costs* that reflect what could reasonably be expected to arise from a network support tender process.
- e) Where confidential information is obtained from the RFI process, it should be treated in accordance with clause 8.6 of the *NER*.

Glossary

Note – italicised terms not included in this glossary are defined in the *National Electricity Rules (NER)*.

Alternative option has the same meaning as in the *regulatory test*

Application notice has the same meaning as in clause 5.6.6 of the *NER*.

Costs has the same meaning as in the *regulatory test*

Guidelines refers to the *AER's* guidelines for the operation and application of the *regulatory test*, as amended from time to time.

Market benefit option has the meaning set out in paragraph 2.1(b) of these *Guidelines*.

Market benefits has the same meaning as in the *regulatory test*

Modelled projects has the same meaning as in the *regulatory test*

Net economic benefit has the same meaning as in the *regulatory test*

Reasonable scenarios has the same meaning as in the *regulatory test*

Regulatory requirement has the meaning set out in paragraph 2.2(a) of these *Guidelines*.

Reliability option has the meaning set out in paragraph 2.1(a) of these *Guidelines*.

Reliability requirement has the meaning set out in paragraph 2.2(a) of these *Guidelines*.