ELECTRICITY TRANSMISSION NETWORK owners

Review of the Regulatory Test

Response to Proposed Regulatory Test Version 3 & Application Guidelines

6 September 2007

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1. Introduction

This submission is made by the Electricity Transmission Network Owners Forum (ETNOF), which comprises Powerlink Queensland, ElectraNet Pty Limited, SP AusNet, Transend Networks Pty Ltd and TransGrid. Collectively, this group owns and operates over 40,000 km of high voltage transmission lines and has assets in service with a current regulatory value in excess of $9.1 billion.

This submission is made in response to the Proposed Regulatory Test Version 3 & Application Guidelines released for consultation by the Australian Energy Regulator (AER) at the end of July 2007.

ETNOF was an active participant in the Australian Energy Market Commission (AEMC) review process that led to the 2006 amendments to the National Electricity Rules (NER). It considers that many of the changes proposed by the AER in relation to version 3 of the regulatory test achieve consistency between the regulatory test and the amended NER.

However, ETNOF has concerns in relation to the following areas:

1. Losses should be included in the list of direct *costs* that may be included in the regulatory test assessment so that investment decisions are not distorted;
2. Where an option that passes the regulatory test encompasses a stream of future investments, the TNSP should not necessarily be considered to be committing to the later components of that investment stream;
3. Further guidance should be provided in the regulatory test on the factors that Network Service Providers (NSPs) should consider in determining whether an alternative option is 'likely', in order to ensure that the regulatory test is capable of predictable, transparent and consistent application, in accordance with NER 5.6.5A(B)(7); and
4. The timeframe proposed for submissions to the Request for Information (RFI) is too long, and the provision of detailed cost, and benefit information as part of the RFI raises issues in relation to the timeframe required for the analysis and the commercial negotiations with non-network options.

The remainder of this submission sets out ETNOF's concerns in these areas. The final section provides some additional comments on other areas of the AER's proposed version 3 of the regulatory test and the accompanying guidelines.

ETNOF notes the review of the National Transmission Planning Arrangements which has recently been commenced by the AEMC. This review is being conducted at the same time as the AER's proposed revisions to the regulatory test. ETNOF expects that the outcomes of the AEMC review will involve material changes to the regulatory test arrangements, which are likely to supersede the changes the AER is proposing to make in relation to version 3 of the test.

2. Costs Included Under the Reliability Limb

The assessment of network investment under the regulatory test is a present value (PV) analysis, intended to ensure that the costs (and benefits) associated with a particular option are considered over a reasonable time period. In undertaking this assessment it is important to ensure that the costs included in the analysis are appropriate, so that investment decisions are not distorted.

ETNOF considers that the AER's proposed changes to the definition of *costs* to be included in an assessment under the regulatory test, has the potential to distort the investment decisions that result.

In particular, the AER's proposal to limit the costs that can be included in a regulatory test assessment under the reliability limb raises problems in two areas:

- the failure to include losses under the definition of *costs*; and
- the need to consider the impact of a particular augmentation on the requirements for future network augmentations.

Each of these issues is discussed below.

2.1. Losses Should Not be Precluded from Assessments under the Reliability Limb

The *costs* of a project are defined in version 3 to include:[1]

- costs incurred in constructing or providing that option;
- operating and maintenance costs over the operating life of that option; and
- the cost of complying with the laws, regulations and applicable administrative requirements in relation to the option.

ETNOF proposes that this list of *costs* should also include a reference to the incremental cost of electrical losses associated with an option compared to the alternatives, where this cost is considered to be material and has not been taken into account elsewhere in the analysis.

Under the reliability limb of the regulatory test, it is only an option's direct costs that are taken into account. As a result, by failing to include a reference to losses in the definition of *costs*, the AER is in effect precluding consideration of the cost of losses in assessments made under the reliability limb of the regulatory test.

In some cases a failure to consider the cost of losses associated with alternative options would result in sub-optimal investment decisions.

[1] Regulatory test version 3, paragraph (2).

For example, a decision might need to be made between (i) stringing a single circuit of a double circuit line initially, followed by a second circuit in a few years time: and (ii) stringing a double circuit initially. The total required investment under option (i) is greater than for option (ii) even though it has a lower PV. However, stringing a double circuit as part of the initial investment, results in a reduction in losses, and therefore, a reduction in NEM costs, which in some cases may outweigh the higher initial investment of this option. If the impact of the two options on losses were not taken into account, a sub-optimal investment would appear to satisfy the regulatory test, but would result in an inefficient investment, contrary to the NEM objective.

As a result, a number of TNSPs currently include the cost of losses when applying the reliability limb of the regulatory test. The inclusion of losses has fallen under the current clause (2)(d) as 'other costs relevant to the case concerned'.

ETNOF believes that the definition of *costs* in the regulatory test should not preclude the consideration of losses. Excluding losses from the assessment under the reliability limb of the regulatory test would introduce a distortion in relation to some transmission investment decisions. ETNOF is concerned that the AER's 'clarification' of the definition of the costs of an option will prevent the consideration of losses in cases where differences in losses will have a material impact on the outcome of the regulatory test assessment.

ETNOF therefore proposes that the regulatory test continue to allow TNSPs to include the impact of an option on the cost of losses under the reliability limb, in circumstances where this cost may be material to the outcome of the assessment. The reference to materiality reflects the reference in the amended NER 5.6.5A(c)(6) to the level of analysis under the regulatory test not being disproportionate to the size and scale of the investment.

2.2. Defining an Option to Cover a Future Stream of Investments

The regulatory test is a present value analysis conducted over a period of time. The aim of such an analysis is to ensure that the long term impacts of investment decisions are taken into account.

The AER comments in its Explanatory Statement that some NSPs may be interpreting the current definition of costs in the regulatory test to take account of the effect of an option on the (direct) costs of other transmission and distribution network projects that may be required in the future. The AER expresses concern that such an approach may lead to significant distortions in network planning decisions. They also say that these distortions would need to be compared against those that would arise if NSPs were forced to ignore network planning ramifications for their reliability investments. The AER has expressed interest in receiving views on the extent of this potential distortion.

Reliability augmentations are undertaken in order to meet certain network performance standards. Two alternative investments may both allow these standards to be met. However, the investments may differ in terms of the length of time they allow the standards to *continue* to be met, before further investments are needed.

Consider a situation in which reliability standards in a particular area may be met either by a 132kV augmentation or a 275kV augmentation. If the 132kV augmentation is undertaken, a subsequent augmentation will be needed in 5 years time in order to ensure that the reliability standard continues to be met. However, if the 275kV augmentation is undertaken, a further augmentation would not need to be made for 15 years. If only the first augmentations were considered, then the capital cost of the 132kV option would be lower than that of the 275kV option, and so the 132kV option may be deemed to satisfy the regulatory test. However, considered over a 15 year timeframe, the stream of investments that start with the 275kV augmentation may actually be lower cost in present value terms, since the larger initial augmentation allows the reliability standard to be met for longer.

In the above example, the benefits associated with the initial investments are not equal. The 275kV investment provides a greater benefit because it allows the reliability standard to continue to be met for a longer period of time.

ETNOF is of the firm view that to ignore the impact of a particular network option on future transmission constraints under the reliability limb of the regulatory test would not be consistent with minimising the long term capital and operating costs of the networks. This has the potential to result in sub-optimal investment decisions and is inconsistent with the NEM objective.

ETNOF views the issue as raised by the AER to be a consequence of restricting the analysis of reliability augmentations to direct costs only (as discussed above). In the absence of this restriction, the assessment of options for a reliability augmentation would include an assessment of the costs (or avoided costs) associated with the impact of those options on future streams of reliability augmentations that are incorporated in market development scenarios.

Whilst saying that the impact on future augmentations is not part of an option's 'direct costs',[2] the AER raises the possibility of defining an option as incorporating a stream of future network investments, which would allow the overall cost of all network investments in a stream to be assessed.[3]

In relation to the above example, the options being considered would become (i) the 132kV investment plus the subsequent augmentation in 5 years time; and (ii) the 275kV augmentation plus the subsequent augmentation in 15 years time.

Incorporating future network augmentations as part of the definition of 'the option' being assessed under the regulatory test raises a practical issue in relation to the degree of commitment implied to a later component of an option, if that option is determined to have satisfied the regulatory test.

ETNOF believes that it would be neither practical nor consistent with the NEM objective for a TNSP to be deemed to have necessarily committed to *all* components of an option that satisfies the regulatory test where that option is made up of a stream of investments over a significant period of time.

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2 p. 35

3 p. 36.

It is only the earlier components of an option that a TNSP would definitely set out to construct. Later components may be subject to further assessments closer to the times that those components are required, in order to determine that they are still the most efficient investments, given the circumstances at the time. For example, the timing of later components is likely to be dependent on demand growth. Differences between forecast and outturn demand may delay or bring forward the timing of those later components.

Revisiting the need for the later components closer to the lead-time within which they are required is consistent with the approach that would be taken by a prudent business. It also results in more economically efficient outcomes over time.

ETNOF considers that there should be clarification in the regulatory test (or in the Application Guidelines) that the option is only the initial investments and not the entire stream of investments. The later components need to be included in the economic comparison but be referred to as modelled projects and not form part of the recommended works of that option. The TNSP is then only committing to undertaking the earlier components where it has satisfied the regulatory test.

Alternatively, if economic theory demands that the option be considered to comprise the entire stream of future investments, the AER should clarify that the TNSP is entitled to state that it intends to only commit to the earlier components of the option.

3. Determining Whether an Alternative Option is Likely

The amended NER requires that network investment assessed under the market benefits limb of the regulatory test must be assessed against *likely* alternative options, rather than all 'genuine and practicable' alternative options, as is the case under the current version 2 of the regulatory test.[4]

The AER is proposing to add a provision in relation to an alternative option being 'likely' in the wording of the market benefits limb of the regulatory test, ie:

> 'the option maximises the expected net economic benefit [..] compared to the <u>likely</u> alternative option/s in a majority of reasonable scenarios.'

ETNOF previously made submissions to the AEMC during its review of the regulatory test principles which raised concern in relation to how the term 'likely' would be interpreted in practice.[5] The AEMC noted in its Determination that the process for establishing a counterfactual (ie, determining which alternative projects are 'likely') may be assisted through the regulatory test guidelines prepared by the AER.[6]

4 NER, 5.6.5A(c)(1)

5 ETNOF, *Reform of the Regulatory Test Principles – Submission*, 3 November 2006, p.5

6 AEMC, *Final Rule Determination National Electricity Amendment (Reform of the Regulatory Test Principles) Rule 2006*, 30 November 2006, p. 62.

3.1. Guidance proposed by the AER

The AER has proposed additional paragraphs in the regulatory test relating to the determination by an NSP as to whether an alternative option is 'likely'. Specifically the AER says that it has 'set out some parameters in line with the NER on what NSPs should consider in determining whether a project is likely'.[7]

The AER refers to the NSP making an assessment of which options are 'likely' alternatives 'having regard to the criteria in the test'[8]. These criteria are contained in paragraphs (17)-(19) of the Regulatory Test Version 3. In particular:

- Proposed paragraph 17(a) is a requirement to consider all alternatives as potentially likely;
- Proposed paragraph (17)(b) implies that an alternative can be proposed in response to an RFI but still be considered not to be 'likely'. While ETNOF would agree with this principle, the determination of whether a project proposed in response to an RFI is or is not likely is potentially contentious.
- Proposed paragraph 18 is similar to the existing regulatory test provision (3)(b) in that the absence of a proponent does not exclude a project from being an alternative option for the purposes of the market benefits limb of the regulatory test. However, (3)(b) also currently includes a requirement for an alternative option to be 'commercially feasible', which the AER proposes to remove in the revised version of the regulatory test. As a result, the overall guidance provided under the regulatory test version 3 in considering likely alternative projects is less clear than under version 2.

The proposed Regulatory Test Application Guidelines released for comment by the AER contains a section in relation to how an NSP should determine whether an alternative option is 'likely'.[9]

However, in ETNOF's view the criteria proposed in the regulatory test fall short of a full set of criteria that could be used to determine whether an option was 'likely'. In particular, there is no guidance given on how the NSP should determine whether an option 'is likely to be developed in the absence of the proposed option proceeding.'

ETNOF considers that further guidance should be provided in the regulatory test on the factors that Network Service Providers (NSPs) should consider in determining whether an alternative option is 'likely'.

The reference to the National Electricity Market (NEM) objective also fails to provide sufficient guidance. Arguably a network development option would be contrary to the NEM objective (which refers to the promotion of 'efficient investment') if it were not the option that maximises the net economic benefit to all those who produce, consume and transport electricity in the national electricity market. However this implies that a regulatory test assessment of that option has been conducted, which in turn means that the option must be considered to be a 'likely alternative option.'

7 AER, *Proposed Regulatory Test Version 3 - Explanatory Statement*, p. 16
8 AER, Explanatory Statement, p. 16.
9 AER, Proposed Regulatory Test Application Guidelines, Section 7.4, p. 13.

The absence of sufficiently clear guidance on when an option should be considered 'likely' has the potential to lead to dispute and potential gaming of the regulatory test. One of the objectives of the AEMC in amending the NER provisions was to reduce the potential for proponents to game the regulatory test by proposing unrealistic alternatives.[10] The AEMC's view was that proponents of an alternative project would need to provide evidence as part of the RFI process that their project is likely to proceed but for the proposed network augmentation.[11] However, to the extent to which there is ambiguity in relation to the extent of evidence required, ETNOF considers that there remains a real possibility of gaming via the RFI process.

In summary, ETNOF considers that more specific guidance on the factors to be considered in determining whether an option is 'likely' should be incorporated in the regulatory test and/or the accompanying guidelines. This is important in relation to ensuring that the regulatory test meets the objective set out in NER 5.6.5A(b)(7) of being capable of predictable, transparent and consistent application.

3.2. Additional Guidance Proposed by ETNOF

ETNOF proposes that the criteria to be used to determine likelihood should be:

1. For a new large transmission network asset, whether the project has been proposed as a result of the RFI process. However, there should be no presumption that a project that has been proposed is therefore likely;
2. Whether the project has a proponent. However, the absence of a proponent does not by itself indicate that a project is not likely;
3. Whether the project is commercially feasible; and
4. Whether a project is considered to be anticipated as defined under paragraph 22 of the regulatory test.

The first two criteria proposed above are consistent with the AER's current proposed paragraph 17(b) and 18, respectively.

The proposed additional criteria relating to commercial feasibility and whether a project is anticipated are discussed below.

3.2.1. Commercial Feasibility

Currently alternative options considered under the market benefits limb of the regulatory test are required to be 'commercially feasible'. Commercial feasibility is defined as:

> 'to be demonstrated by determining whether an objective operator, acting rationally according to the economic criteria prescribed in [the] test, would be prepared to construct or provide this alternative option.'

[10] AEMC, p. 58.
[11] AEMC, p. 63.

The AER comments in its Explanatory Statement that it has removed the requirement for alternative options to be 'commercially feasible' from the regulatory test as leaving it in the test 'would place too high a hurdle on proposed options to qualify as alternative options, and would effectively eliminate them from the decision making process before the judgement as to their likelihood may take place'.[12]

ETNOF understands the AER's concern that alternative options are not defined too narrowly, given the 2-stage process now set out for the assessment of options, ie, first determining what the list of alternative options is and secondly which of these alternatives are then *likely*. However, commercial feasibility remains a relevant consideration in determining whether an option is likely. If commercially feasible, then an option may still be considered likely even in the absence of a proponent. Conversely, alternatives arising from the RFI process may still be considered not likely if not commercially feasible. In each of these instances, a consideration of whether a project appears commercially feasible is likely to be a key element in determining likelihood.

Rather than eliminating consideration of commercial feasibility from the regulatory test altogether, as is currently proposed by the AER, ETNOF proposes including commercial feasibility as one of the criteria that an NSP should have regard to in determining whether an alternative option is likely. The AER should require proponents of alternative projects in responding to the RFI to provide evidence that their projects are commercially feasible.

3.2.2. Whether a project could be classed as anticipated

In the absence of clear guidelines on how the likelihood of a project that emerges through the RFI process actually going ahead is to be determined, there is a potential for respondents to the RFI to potentially disrupt and delay the regulatory test process.

ETNOF considers that the factors that should be considered in assessing likelihood in these cases would include those that are currently set out in the regulatory test in relation to the determination of whether a project is anticipated, namely:

- whether the project has met or is in the process of meeting any required planning consents, construction approvals and licences;
- whether construction of the project has commenced or a firm construction date has been set;
- whether the proponent has purchased/settled/acquired land or is in the process of so doing;
- whether contracts for the major components of the project are in the process of being finalised; or
- whether the financial arrangements for the project are in the process of being finalised.

12 p. 18.

ETNOF believes that the criteria above are consistent with the AEMC's intent in proposing that the alternative options under the market benefit limb of the test are 'likely' options rather than all genuine and practicable options, in that it:

- reduces the potential for disrupting and delaying the regulatory process by proponents proposing unrealistic alternatives; and
- reduces the likelihood that if the network alternative does not go ahead nothing will be built.[13]

It also appears consistent with the AEMC's view that the proponent of an alternative project as part of the RFI process will have to provide evidence that their project is likely to proceed but for the proposed network augmentation.[14] In effect, the proposed criteria also provide guidance for proponents of alternative projects as to what information they would need to provide in their responses to the RFI in order to be considered as likely alternatives.

4. The Proposed RFI Process

Clause 5.6.5(c)(4) of the NER requires a NSP to issue an RFI where it undertakes a regulatory test assessment under the market benefits limb for a new large transmission network asset.

The AER has reflected this requirement in its proposed changes to the regulatory test, which also includes details of the information regarding a preferred network alternative to be provided within an RFI.

4.1. Timeframe for RFI

The AER has proposed that Transmission Network Service Providers (TNSPs) issue an RFI at least four months prior to issuing their Application Notice in relation to a regulatory test application.[15] The regulatory test also requires that the TNSP is required to give interested parties at least 8-12 weeks to respond to an RFI notice.[16]

The AER proposal also allows for interested parties to apply to the TNSP to have the due date for submissions extended. There is no limit placed on the length of any such extension, or reference to the number of applications for extension there may be.

By specifying that a TNSP must issue an RFI 4 months (16 weeks) ahead of an Application Notice, but then allowing the submission period following the RFI to be 8-12 weeks, the AER appears to be implicitly allowing for a 4-8 week period for the TNSP to analyse the responses to the RFI and present them in its Application Notice. ETNOF considers that the proposed timeframes are overly prescriptive, and that only the submission period should be set out in the regulatory test. The timeframe within which the TNSP subsequently issues its Application Notice is more appropriately a matter for each TNSP, and can be expected to depend on the extent of responses received to the RFI and the clarity of those responses.

13 AEMC, p. 58.
14 AEMC, p. 63.
15 Regulatory test version 3, paragraph (28)
16 Regulatory test version 3, paragraph (29)

With regard to the required period for submissions, ETNOF considers an 8-12 week timeframe to be excessive. The current consultation period under the market benefits limb of the regulatory test is 30 business days (6 weeks) following the Application Notice. A 12 week timeframe for the RFI would double this consultation period.

ETNOF recommends that the RFI stage be a maximum of 30 business days. This proposal aligns with the current market consultation process, Application Notice submissions period and consideration of submissions period, and Final Report dispute period of 30 business days each. It should also be recognised that TNSPs are already required to publicise network constraints forecast to emerge within the next 5 years through their Annual Planning Reports.

ETNOF also considers that there should be no provision for extension to the submission period, in order to reduce the possibility of respondents delaying the process. This would be consistent with regulatory practice in other areas. If the regulatory test does permit extensions to the submission period then it needs to provide more guidance and assessment criteria around the extension process.

4.2. Information to be provided in the RFI

For a new large transmission network asset proposal to proceed under the market benefits limb the amended NER requires the TNSP to publish:

> 'a request for information as to the identity and detail of alternative options to the potential new large transmission network asset ;and
>
> details of the proposed new large transmission network asset.'[17]

The RFI process proposed by the AER sets out the specific information a TNSP is required to include in the RFI. In addition to information on the relevant technical details of the new large transmission network asset and the reasons for it the AER's proposal includes "all known expected direct costs and the likely sources of costs and market benefits associated with the proposed asset". [18]

This requirement appears to go significantly further than contemplated by the amended NER. The AEMC's determination refers to the following information being provided in the RFI:[19]

- The nature of the network limitation(s) that the regulated network investment and any alternative investment is intended to address;
- The timeframe over which the investment is likely to be required; and
- Any other supporting information that potential investors may require to prepare their responses.

17 NER 5.6.5A(4)
18 Regulatory Test Clause 27(a)(iv)
19 AEMC, p. 59.

In ETNOF's view, a requirement to publish specific information on the expected cost and market benefits associated with a new large transmission network asset gives rise to the following issues:

- A full cost benefit analysis is unlikely to have been completed in the early RFI investigation stage. Any requirement to publish detailed information in relation to costs and benefits in the RFI would therefore imply an extension of the timeframe required to complete the regulatory test analysis; and
- Release of cost information in relation to any proposed network asset and alternatives will place a TNSP at a commercial disadvantage when negotiating with potential providers on non-network options. This could compromise a TNSP's ability to deliver the truly lowest cost solution and would appear to be contrary to NEM objective, as adopting a solution that was not the lowest cost solution would not be in the long term interests of electricity consumers.

ETNOF recommends the requirement to publish the expected direct costs be to a similar level of accuracy and detail as is provided in a TNSPs Annual Planning Report.

4.3. Treatment of Confidential Information

ETNOF notes that information obtained from the RFI process may be confidential; especially cost related information provided by third parties.

ETNOF recommends that any confidential information used in the regulatory test analysis be treated in accordance with the Clause 8.6 of the NER. The proposed regulatory test should be amended to reflect this requirement.

5. Additional Comments in Relation to Version 3 of the Regulatory Test

The remainder of this submission provides some additional comments in relation to other aspects of the proposed version 3 of the regulatory test and the accompanying guidelines.

5.1. Transitional Provisions

NER 11.7.1 and 11.7.2, provide transitional and savings provisions to manage the changes from Version 2 of the Regulatory Test to Version 3. In particular, where any action or process has been commenced in relation to the regulatory test by 31 December 2007, the existing regulatory test will continue to apply.

The AER is proposing to include more detailed provisions in the test which relate to the specific processes which might already have been commenced before 31 December 2007. The AER considers that these provisions are consistent with and supplement those in the NER.

ETNOF is concerned that the transitional provisions proposed by the AER are more restrictive than those in the NER. In particular, the AER is proposing that the existing regulatory test apply to new large network assets for which a transmission network service provider has published an Application Notice.

ETNOF notes that considerable work is required prior to the issue of an application notice. Such work represents an 'action or process', as set out in NER 11.7.1. Indeed some TNSPs issue RFIs for reliability augmentations which should be considered to have commenced Regulatory Test processes under the NER.

ETNOF recommends that the AER not include transitional provisions in this version of the proposed Regulatory Test to avoid any inadvertent conflict with the provisions already contained in the Rules.

Alternatively clause 32(d) should be amended to refer to 'actions or processes', consistent with the NER[20].

5.2. Revised Introduction to the Regulatory Test

The AER is proposing to include an Introduction to the regulatory test, to replace the current Preamble.

ETNOF considers that the proposed inclusion of an introduction to the regulatory test is uncontroversial, drawing as it does on other sections of the NER. There are advantages in summarising the NER provisions in relation to the regulatory test in one place.

Notwithstanding the above, ETNOF would also offer caution on the drafting of this introduction such that it does not require frequent revisions as other provisions in the NER change. In particular, the reference to the current $10 million threshold for a new large transmission network asset appears superfluous, and would require a revision to the regulatory test in the event that this threshold was revised.

5.3. Alternative Options can be Combinations

The AER proposes to clarify in the regulatory test that an option can be made up of a number of separate components (eg, DSM and generation).

ETNOF supports this clarification. It also notes that a single option could potentially involve a combination of non-network and network components.

5.4. Definition of Costs

ETNOF proposes that clause (2) which sets out the definition of *costs* should include a reference that where there is a proponent for a non-network option, the *costs* for that non-network options should be based on the price in the proponent's offer for network support, rather than an independent estimate based on resource input costs.

This approach is consistent with current practice under the regulatory test and has previously been confirmed as the AER's preferred approach to estimating the cost of non-network options.

20 NER 11.7.1

ETNOF notes that the AER's proposed simplifying of the wording of clause (2)(c) which refers to the cost of complying with laws, regulations and applicable administrative requirements has removed the previous reference to environmental subsidies being treated as part of a project's benefits or as a negative cost. ETNOF considers that this reference should be maintained in order to preclude any dispute as to whether an environmental subsidy should be included in the assessment of a project's cost under the reliability limb of the test. In the absence of this reference the concept of including a subsidy as a 'negative cost' may be questioned.

Finally, as a general point ETNOF considers that version 3 of the regulatory test has introduced a confusing distinction between the use of *cost* as a defined term under clause 2 (where it is used to refer to what the AER term 'direct costs') and the use of 'cost' as a non-defined term. ETNOF suggests that as a minimum the AER should review each usage of the word *cost* and cost in the regulatory test for appropriateness. For example, it appears that in clause 10 the three usages of 'cost' should in fact be '*cost*'. Alternatively, the AER could consider adopting alternative terminology which makes the distinction being drawn clearer.

5.5. Counterfactual Analysis

The AER notes in its Explanatory Statement that it considers that the analysis required by the amended NER (ie, the 'counterfactual approach' as described by the AEMC) is already accommodated by the current wording of the regulatory test. As a result the AER does not consider that any changes to the wording of the regulatory test are needed in order to reflect the changes to the NER.

ETNOF supports the AER's view that the current wording of the regulatory test already allows for the net economic benefit of an option to be compared with the net economic benefit of not undertaking that option. Where an option is not undertaken, the assessment encompasses both consideration of any alternative option that may be likely to emerge (ie, likely alternative options, which may include a 'do nothing' option) as well as anticipated developments of the market in the absence of the investment (ie, market development scenarios).

ETNOF therefore agrees with the AER that no drafting changes are needed to give effect to the counterfactual approach in the amended NER.

5.6. Treatment of Externalities

The AER is proposing to amend the following section of the test as shown:

> 'In determining costs or market benefits, any cost or benefit which cannot be measured as a cost or benefit to producers, distributors and consumers of electricity ~~in terms of financial transactions in the market~~ should be disregarded.'

The AER's view is that the term 'financial transactions in the market' is unnecessary and confusing as it could be interpreted as meaning that the analysis is limited to transactions in the wholesale electricity market.[21]

[21] p. 39

It is ETNOF's understanding that this paragraph in the regulatory test is intended to clarify that externalities are not to be included in the analysis. Previously there was significant debate around this issue including, for example, whether carbon emissions should be factored into the regulatory test analysis. Currently only costs that result in a financial transaction should be included.

It would seem preferable to retain the reference to financial transactions in the wording of the regulatory test in order to address this point.

An alternative which might address the AER's concern regarding misinterpretation of the phrase 'in the market' would be to only strike out those words, ie:

> 'In determining costs or market benefits, any cost or benefit which cannot be measured as a cost or benefit to producers, distributors and consumers of electricity in terms of financial transactions ~~in the market~~ should be disregarded.'

5.7. Proposed Clause (4)(d)

Clause 4 lists the benefits that may be considered in determining the *market benefit*. The majority of the sub-clauses refer to 'changes in …' or 'differences in …' factors.

The exception is clause (4)(d) which refers to the 'deferral of transmission investment'. For consistency and in order to accommodate comparison of options with different transmission developments (as opposed to those having the same transmission development but with different timings), ETNOF proposes that this clause be changed to 'differences in transmission investment.'

5.8. Regulatory Test Application Guidelines

The AER is required to issue Guidelines in relation to the operation and application of the regulatory test under clause 5.6.5A(d) of the NER.

ETNOF has the following minor comments in relation to the AER's proposed Application Guidelines:

- Section 2.4: The final sentence begins 'The intent appears to be …'To avoid confusion the guidelines should simply confirm that: 'An option intended to meet a reliability requirement is not precluded from being assessed as a reliability project under paragraph (1)(a) of the regulatory test if the option also provides market benefits.'
- Section 3(c): The reference to any negative impacts of an option on the NEM being taken into account in the calculation of market benefit is only true under the market benefit limb of the regulatory test.
- Section 3(c): The reference to electrical losses should be removed, for consistency with ETNOF's proposal that losses should be included in the costs of an option (discussed in section 4.1 of this submission).
- Section 7: The discussion here does not distinguish sufficiently between the identification of alternative options under the reliability limb of the test and under the market benefit limb.