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10 September 2007

Ms Michelle Groves
CEO
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Ms Groves

RE: Regulatory Test Version 3

I am writing in response to the AER's call for submissions regarding the proposed version 3 of the Regulatory Test and the associated application guidelines. I understand that the AER's review has been motivated by the AEMC Rule change from November 2006 and thus the review has been limited to ensuring the current test complies with the new rule requirements and clarifying some other minor areas.

The AEMC has now been asked to review the National Transmission Planner arrangements and has released its scoping paper for that review. It seems likely that this review will result in further changes to the Regulatory Test. Due to these potential changes, EnergyAustralia agrees with the AER's approach to minimise the changes at this time. However there is one area of concern where EnergyAustralia would appreciate the AER's reconsideration.

The concern is in relation to what costs can be considered under the Regulatory Test. The proposed version 3 of the test seeks to confine the concept of costs under the Test as those "direct costs" of an investment. Whilst explained as a clarification, it is clear that this is intended as a substantive change. This proposal would have the unanticipated affect of reducing the effectiveness of the least cost assessment under the reliability limb. The reasons why EnergyAustralia considers this unintentionally narrowing should be corrected are discussed in the attached submission. Several more general comments regarding the proposed test and guidelines are also included in the attachment.

It is worth noting that the AEMC's scoping paper on the National Transmission Planner review supports EnergyAustralia's view that the term costs in the Rules should encompass all costs, rather than being direct costs as expressed in the proposed test.

EnergyAustralia would be glad to assist with any further work in this area. If you have any enquiries in relation to this matter please do not hesitate to call me on (02) 4951 9411 or Mr Harry Colebourn on (02) 9269 4171.

Yours sincerely

Geoff Lilliss
Executive General Manager Network

EnergyAustralia Submission to the AER

Proposed version 3 of the Regulatory Test

Background

On 30 November 2006 the Australian Energy Market Commission (AEMC) released its final determination on the "Reform of the Regulatory Test Principles"[1]. The Rule change resulting from the determination required the Australian Energy Regulator (AER) to "*develop and publish the first Regulatory Test and Regulatory Test application guidelines under this clause 5.6.5A by 31 December 2007*"[2]

As a result of these events, the AER has released version 3 of the Regulatory Test, stating that the scope of its revisions to the test are limited to:

- those necessary to achieve consistency between the Regulatory Test and the NER (consistency amendments); and
- those which simplify or improve the clarity of the test based on recent experience (clarification amendments).

The AER has limited its revisions because it recognises that the Regulatory Test is part of a much broader upcoming review by the AEMC – the review of the "National Transmission Planner" arrangements. EnergyAustralia has provided comment on this review separately.

EnergyAustralia agrees with the stance the AER has adopted in undertaking this review and appreciates the opportunity to comment on the AER's review. The AER's review should aim to minimise the changes to the test now to consistency amendments. EnergyAustralia's concern with the clarification amendments is that they have the potential to be costly to implement and with the AEMC's review it is likely the AER's changes will be short lived.

The MCE and AEMC have focussed on market benefits of large transmission investments when reviewing the Regulatory Test. As the AER's review arose from the new transmission Rules, it seems that the AER's review is also focussed on transmission investments.

EnergyAustralia is concerned about the unanticipated impact of the transmission focussed Regulatory test on its distribution investments. The main issue raised in this submission is the issue of how "costs" are limited to direct costs and only to be considered for projects that are to be commissioned in the next 5-10 years.

This submission discusses how costs should be defined to comply with the Rule requirements and be pragmatic, in the light of the National Transmission Planner review. It would also better cater for distribution investments under the reliability limb.

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1 AEMC, *Final rule determination, National Electricity Amendment (Reform of the Regulatory Test Principles) Rule 2006*, 30 November 2006.

2 Clause 5.6.5A(f).

The remainder of the submission discusses:

- the new Rule requirements for the Regulatory Test;
- the current Regulatory Test (version 2);
- the proposed change to the Regulatory Test (version 3); and
- the benefit and detriment of that change.

As a result of the greater detriment of the proposed change, EnergyAustralia recommends that the AER should not limit costs to "direct costs" or impose a specific time period.

The Rule requirements

The Rules still require the AER to develop a Regulatory Test with two limbs. That is to develop a test, with a purpose of identifying new network investments (or non-network alternatives) that will:

> (1) maximise the net economic benefit to all those who produce, consume and transport electricity in the market; or
> (2) in the event the option is necessitated to meet the service standards linked to the technical requirements of schedule 5.1 or in applicable regulatory instruments, minimise the present value of the costs of meeting those requirements.[3]

In relation to the first limb, the Rules specify that the AER must provide, amongst other things, a list of costs and benefits that may be included in the assessment. This does not seem to allow the AER to specify:

- a list of costs or benefits that cannot be included in the first limb; or
- the costs that can or cannot be included under the second limb.

Current Regulatory Test (version 2)

The current Regulatory Test (version 2) currently defines "costs" as the "total cost of an option (or an alternative option) to all those who produce, distribute or consume electricity in the National Electricity Market". It then further sets out in a non-exhaustive way what may be included in the analysis to determine costs. This seems to already achieve the Rules objective of providing a minimum list of what costs and benefits may be included, whilst not limiting what may be included as a cost under either limb. The current test states:

> In determining costs, the analysis may include, but need not be limited to the following:
>
> (a) In determining costs, the analysis may include, but need not be limited to the following:
> (b) costs incurred in constructing or providing the option;
> (c) operating and maintenance costs over the operating life of the option;
> (d) the cost of complying with existing and anticipated laws, regulations and administrative determinations such as those dealing with health and safety, land management and environment pollution and the abatement of pollution (including greenhouse abatement). An environmental tax should be treated as part of a project's costs. An environmental subsidy should be treated as part of a project's benefit or as a negative cost.
> (e) Other costs that are determined to be relevant to the case concerned.[4]

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3 NER, clause 5.6.5A(b)

4 AER, *Compendium of Electricity Transmission Regulatory Guidelines*, August 2005, pg 32.

EnergyAustralia considers this list to satisfy the Rule requirements in relation to cost under the first limb and, further it does not contradict the Rule requirements in relation to the second limb.

The AER's proposed change to the Regulatory Test (version 3)

The proposed Regulatory Test version 3 and the accompanying explanatory statement proposes to change the meaning of "costs", by limiting the consideration of costs to:

- costs that are "direct costs" of an investment; and
- costs of those projects with a commissioning time horizon of ten years – although this time period has not been stated anywhere in the Test itself.

The AER has termed this a clarification, however it is clearly more than that when a comparison is made between the Version 2 wording and that now proposed. It is worth noting that EnergyAustralia considers the term direct cost to mean the expenditure on an investment to meet the current need. This would potentially include the costs of establishing and running a generator, were such an option economic, or expenditure involved in implementing any demand side initiative. The expenditure (which in the case of joint planning would include the expenditure of other NSPs) of the immediate network investment and would not include the expenditure on the required subsequent network investments in the following years.

This would not include any assessment of benefits, such as the benefit of increased competition in the wholesale market or the benefits provided through lower greenhouse emissions, etc.

Benefits of the change

The proposed change has the benefit of simplifying the understanding of what the AER considers appropriate for consideration under the test. The AER is concerned that the catch-all nature of the current definition of costs could be construed to include market costs.

This catch-all nature should not be off concern considering the Regulatory Test is a test of relative economic efficiency. When making this decision the relevant definition of costs is more akin to the economic concept of cost, which is all encompassing. The concept of direct cost is more an accounting concept and does not seem appropriate here for reasons explained below.

Detriment of the change

The benefit of simplification is far outweighed by the detriments. The detriments of the change, which are discussed below, are:

- inconsistency with the NEM objective
- inconsistency with annual planning requirement;
- inconsistency with the Rule requirements for the Regulatory Test; and
- inconsistency with the AEMC review of a National Transmission Planner.

1. Inconsistency with the NEM objective

The NEM objective includes the promotion efficient investment for the long term interest of consumers. To review efficiency of an investment over the long term, the costs over the longer term must be considered. The explanatory statement contradicts the NEM objective in this regard by stating:

> ...all projects to be combined to form an option should have anticipated commissioning dates within a reasonable timeframe of the Regulatory Test assessment, such as within 5-10 years.[5]

Obviously, this depends on how "long term" is defined. The medium term is often defined in economics as five to ten years. So it would seem reasonable that a greater period of time would constitute the long term – ideally for a period commensurate with the economic life of the assets concerned. It may still be possible that the AER has a view that the long term efficiency objective can be achieved with this medium term focus. EnergyAustralia would appreciate the AER's view on how this objective is better achieved.

2. Inconsistency with the annual planning requirements

Further, in relation to the five to ten year time limitation, it is concerning that the AER has this view considering the *minimum* planning horizon for a DNSP is five years and for a TNSP ten years under clause 5.6.2(d) of the Rules.

Both the NEM objective and the annual planning requirements in the Rules anticipate a minimum of five and ten years consideration. Rather than the maximum proposed in the explanatory statement. In the case of TNSPs there is a competing objective here. First, as an annual planning requirement the TNSP must plan for at least ten years but under the proposed Regulatory Test (version 3) the TNSP must not consider more than ten years.

It is noted, however, that this time horizon does not appear in the Regulatory Test itself. EnergyAustralia recommends not placing a time horizon on what can be assessed because it will be different depending on the investment. Nevertheless, EnergyAustralia considers the AER should at least explain how it considers it is possible to meet these competing objectives.

3. Inconsistency with the Rules

The Rule requirements do not include any express powers for the Regulatory Test to include any provisions to limit what an NSP may consider an appropriate cost. For the market benefits limb the Rules provide that the Test must include a list of costs and benefits that may be considered. Under the reliability limb no guidance is provided.

Thus limiting the concept of costs to direct costs is not appropriate. The list of costs in the Regulatory Test should be reviewed to provide a list of costs as guidance as to what may be included.

If a NSP has an appropriate cost that should be included in the analysis that is not provided for in the guidance there should still be scope to include the cost in the analysis. The AER's concern of a NSP misusing the provisions to include "benefits", under the second limb, would be best addressed in the context of monitoring compliance with the Rules.

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5 AER, *Proposed Regulatory Test Version 3 – Explanatory Statement*, 30 July 2007, pg 36.

Also in relation to the five to ten year limitation, the second limb of the test in the Rules, requires the present value to be assessed. This accounts for the future costs being less reliable further into the future. That is, a cost that will be incurred in 15 years will have very little impact on the preferred option if it did not occur until 17 years. This supports a longer time horizon consistent with the NEM objective and the annual planning requirements.

4. Inconsistency with National Transmission Planner

Without pre-empting the changes that will result from the National Transmission Planner review, EnergyAustralia has looked to the AEMC scoping paper for guidance as to how costs are likely to be treated in the future. The scoping paper compares the current limbs of the Regulatory Test. For both the market benefits and reliability limb the AEMC states the costs that should be included are:

> Total current and future costs of an option to all those who produce, distribute or consume electricity in the NEM.[6]

This confirms EnergyAustralia's interpretation of the AEMC's Rule. The term cost is intended be all encompassing.

Recommendation

EnergyAustralia suggests two changes. These changes address the limitation of costs to only direct costs. The issue in relation to the time five to ten year time horizon is not found anywhere in the test and EnergyAustralia does not propose including it.

The recommended changes are to:

1. remove the term "present value" because it duplicates what is already in the Rules; and
2. move the term "direct cost" into the bullet point to avoid limiting what costs may be included cost, but still provide guidance from the AER that direct costs are most appropriate.

Suggested drafting:

(2) *Costs* ~~means the present value of the direct costs of~~ an option (or an *alternative option*) <u>may</u> includ<u>e</u> ~~ing~~:

- (a) <u>direct</u> costs incurred in constructing or providing the option;
- (b) operating and maintenance costs over the operating life of the option; and
- (c) the cost of complying with laws, regulations and applicable administrative requirements in relation to the option.

Further Comments in relation to Version 3 Regulatory Test and Guidelines

Version 3 of the Regulatory Test

Clause 1(a), there appears to be some words missing in the first line; "in the event the option is necessitated principally by to meet the service standards..."

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[6] AEMC, *National Transmission Planning Arrangements: Scoping Paper*, August 2007, pg 14.

Clauses 10 and 11 refer to cost allocation for DNSPs being consistent with the relevant Distribution Ring-Fencing Guidelines. In NSW the relevant Distribution Ring-Fencing Guidelines do not address cost allocation, this is addressed through the current IPART guidelines: Regulatory Information Requirements for Electricity Distribution in New South Wales".

Clause 32- Transitional Arrangements. It is not clear why the AER has included transitional arrangements in Version 3 of the Test. The relevant transitional arrangements for the introduction of Version 3 of the Test are set out in Rule 11.7. Whilst those set out in clause 32 are generally consistent with those in Rule 11.7 the existence of two sets of provisions is likely to cause confusion and does not assist clarity. Rule 11.7 is more general than clause 32 of the Test and could potentially apply to situations not specified in clause 32. Version 3 of the Test should simply refer to Rule 11.7 for the transitional arrangements.

Regulatory Test Application Guidelines

A general comment is that the guidelines do not always make appropriate distinction between the reliability limb and market benefits limb of the test. This is likely to lead to confusion, particularly as regards the operation of the request for information provisions. An example here is section 9 of the Guidelines. This could be read as indicating that a NSP must issue a request for information in all cases, which is not the case. It is suggested that the guidelines be clearly separated into those provisions which apply to both limbs, those that apply to the reliability limb only and those that apply to the markets benefits limb only.