

Regulatory Investment Test for Transmission (RIT-T)

Response to AER Issues Paper

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1. Introduction

Grid Australia makes this submission in response to the Issues Paper on the Regulatory Test for Transmission (RIT-T) released for stakeholder consultation by the Australian Energy Regulator (AER).

Grid Australia comprises ElectraNet Pty Limited, Powerlink Queensland, 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 \$10 billion.

This submission discusses each of the questions raised by the AEMC in its Issues Paper. The key points raised can be summarised as follows:

- Grid Australia supports guidance being provided in relation to estimating competition benefits, option value and the approach to taking account the Carbon Pollution Reduction Scheme (CPRS) and the expanded Renewable Energy Trading Scheme (RET) in the RIT-T analysis. This guidance is likely to be most usefully provided via discussion and worked examples in the application guidelines, rather than the drafting of the RIT-T itself;
- Grid Australia supports the approach previously taken by the AER in developing the regulatory test (and associated guidelines) of providing guidance on the methodologies that may be adopted, without being overly prescriptive;
- The drafting of the RIT-T should not preclude the calculation of option value as an additional line item in the NPV analysis;
- The differential tax treatment of the costs of acquiring and surrendering Renewable Energy Certificates (RECs) compared with the cost of penalty payments will affect the price retailers are prepared to pay to purchase a REC in order to avoid a penalty. As a result, the maximum price which retailers are prepared to pay for a REC will not be the same as the shortfall penalty under the RET. The assessment under the RIT-T of the amount of renewable generation in the market development scenarios and the penalty payments made by retailers needs to take this tax impact into account; and
- The drafting of the RIT-T and the application guidelines should make clear that TNSPs are not required to separately quantify benefits arising outside of their region. This is consistent with the requirement of the National Electricity Rules (the Rules) that these benefits be quantified on an aggregate basis.¹

¹ NER 5.6.6(k)(6).

In drafting the RIT-T and the application guidelines the AER should also remain cognisant of the requirement in the Rules that the RIT-T should not require a level of analysis that is disproportionate to the scale and likely impact of each credible option being considered.²

2. Specification of the RIT-T

2.1 Additional classes of costs and benefits

Q1: Are there any additional classes of costs or market benefits (other than those set out in the Electricity Rules) which should be included in the RIT-T?

Grid Australia notes that the costs and benefits that can be included within the RIT-T assessment includes both those specified in the RIT-T and any other classes of costs or benefits identified by a TNSP and agreed to by the AER in writing.³ That is, it is not necessary for all costs and benefits to be explicitly identified in the RIT-T, provided that the AER agrees in writing to the inclusion of any additional category of cost and/or benefit in the analysis.⁴

Grid Australia agrees that any penalty payments made by retailers as a result of the expanded RET not being met should be allowed to be incorporated as a cost within the RIT-T analysis, and that this should be identified as an additional class of cost in the drafting of the RIT-T.

2.2 Clarification of classes of market benefits

Q2: Do some classes of market benefits or costs set out in the Electricity Rules (such as competition benefits and option value) require further clarification in the RIT-T?

Grid Australia agrees that there should be clarification of the approach to quantifying both competition benefits and option value.

Clarification could be achieved through the drafting of the RIT-T itself, including in relation to the method or methods permitted for estimating these classes of benefit.⁵

² NER 5.6.5B(c)(2).

³ NER5.6.5B(c)(4)(x) and (8)(iv).

⁴ The summary of the Rules on page 8 of the AER's Issues Paper is incorrect in that it states that additional classes of benefit must be specified in the RIT-T.

⁵ As required under NER 5.6.5B(c)(10)(i).

Alternatively (or in addition) clarification could be provided in the application guidelines (which could include worked examples). Grid Australia considers that, on balance, clarification in the application guidelines is likely to provide the greatest practical assistance in applying the RIT-T.

Grid Australia also considers that the appropriate treatment of the CPRS and the expanded RET under the RIT-T should be clarified. However, the more appropriate place for such clarification is likely to be in the application guidelines rather than within the RIT-T itself.

Below we discuss each of these three areas in turn, and consider the clarification that could be provided as part of the drafting of the RIT-T and in the application guidelines. The following discussion is therefore also relevant in relation to the AER's specific questions relating to the application guidelines (discussed in section 3 of this submission).

2.2.1 Competition benefits

Q3: Is the current definition of competition benefits in the regulatory test suitable for inclusion in the RIT-T? Are there any alternative definitions which the AER should consider?

The regulatory test currently expands on the definition of *competition benefits*, as being:

(4)(g) 'net changes in market benefit arising from the impact of the option on participant bidding behaviour.'

Grid Australia considers that this current definition is adequate and suitable for inclusion in the RIT-T.

Grid Australia also considers that the coverage of the existing application guidelines for the regulatory test in relation to the calculation of competition benefits is appropriate, and could be included in the AER's application guidelines for the RIT-T. The coverage of the application guidelines could be expanded to also include worked examples of the calculation of competition benefits.

Consistent with the current guidelines, there should be no requirement to separately identify competition benefits as a line-item in the RIT-T analysis. In practice, competition benefits are likely to be one element of the overall market benefit associated with differences in generation development and bidding scenarios with and without the option being considered. Therefore, separately identifying the

component relating solely to 'competition benefits' would be both complex and somewhat arbitrary.

2.2.2 Option value

Q4: What methods for incorporating option value as a class of market benefits under the RIT-T should the AER consider?

Grid Australia considers that additional clarification in relation to the nature of the benefit captured under 'option value', and the method or methods permitted for estimating option value⁶ should be included in the RIT-T.

In addition, given that this is a new class of benefit to be incorporated in the RIT-T analysis that is not currently included in the regulatory test, Grid Australia considers that there should be a more expansive discussion (including worked examples) in the application guidelines in relation to the calculation of option value, compared to other categories of market benefit with which market participants are more familiar.

Grid Australia notes that the AER (supported by Frontier Economics) considers that a real options approach is a different way of calculating market benefits, rather than a distinct type of market benefit not captured under a scenario based approach. The AER's preliminary view is therefore that the benefits associated with flexibility will often be captured through a reasonable scenario approach required under the Electricity Rules and through a suitably wide range of credible options.⁷

Option value is related to the additional value associated with investments that allow for a degree of flexibility in meeting uncertain future requirements. Once a TNSP commits to an investment, this 'option value' is lost.

Flexibility may come (for example) from:

- the ability to stage investment, ie, to undertake a smaller investment now (or only the initial stage of an investment) followed by a later investment that may be more appropriately scoped given the additional information that will available at that later time; or
- the ability to convert an initial investment to accommodate future alternative states of the world, eg, building larger transmission towers but only stringing one side, or augmenting the shared network to accommodate a range of different future patterns of generation investment.

⁶ In line with the requirements of NER 5.6.5B(c)(10)(i).

⁷ AER, *Regulatory Investment Test for Transmission - Issues Paper*, p. 10.

In each case, the investment may be more expensive overall than an alternative, if the benefits of flexibility are not included in the assessment. However, taking into account the 'option value' of the investment may result in it being shown to be the most appropriate alternative.

The calculation of 'option value' can be undertaken in a variety of ways. The view reached by the AER and Frontier Economics that option value is an alternative approach to the traditional NPV scenario analysis stems from the financial theory approach to calculating real option value (eg, Black-Scholes).

However, there are alternative approaches to calculating option value. In the context of infrastructure investments, a dynamic programming approach is often adopted.⁸ Under this approach, it is possible to calculate the 'additional' option value of any investment and add it to the overall NPV analysis, as required under the Rules.⁹ The modelling can be undertaken on the basis of allowing for the additional flexibility and then of not allowing for it, and the difference between the outcomes in the two cases would be the identified option value.

Grid Australia notes that such analysis would not be justified in all circumstances, due to its complex nature. For many investments the analysis is likely to be clearly disproportionate to the scale and likely impact of the investment options being considered, and so would not be required under the Rules.¹⁰ However, the drafting of the RIT-T should not preclude approaches such as dynamic programming being used to calculate 'option value' as an additional line item within the NPV scenario analysis (where this value has not already been included in the other classes of market benefit).

2.2.3 Treatment of climate change policies

Q8: Is the proposed approach an appropriate means of treating the CPRS under a RIT-T analysis?

Q9: Are there any alternative approaches to treating the CPRS which the AER should consider?

The AER notes that its preliminary view is that the CPRS could be considered under a RIT-T analysis by treating the purchase of carbon permits in the same way as any

⁸ See for example the discussion in, *Real Options and Urban Water Resource Planning In Australia*, Adam Borison and Gregory Hamm, Stratelytics LLC, with input from Sally Farrier and Geoff Swier, Farrier Swier Consulting, Water Services Association of Australia Occasional Paper No. 20, April 2008.

⁹ NER, 5.6.5B(c)(4)(ix).

¹⁰ NER, 5.6.5B(c)(2).

other generation cost input. The AER references the earlier advice from the Allen Consulting Group to the AEMC in relation to the treatment of the CPRS within the RIT-T analysis.

Grid Australia considers that this is an appropriate means of treating the CPRS under the RIT-T. Grid Australia supports the AER providing guidance and worked examples in the application guidelines in relation to the treatment of the CPRS under the RIT-T analysis.

Q10: Is the proposed approach conceptually sound and an appropriate means of treating the expanded RET under a RIT-T analysis?

Q11: Are there any alternative approaches to treating the expanded RET which the AER should consider?

The AER's proposed approach to incorporating the expanded RET within the RIT-T analysis can be summarised as:

- where it is likely that the expanded RET will be met, the TNSP will account for the RET through its analysis of future generation scenarios. In this case the cost of RECs would not be separately included in the analysis; and
- where it is likely that retailers will pay the penalty rather than purchase RECs, the analysis should incorporate the impact of the RET on future generation scenarios, but also the payment of penalties by retailers under the RET.

Grid Australia considers that the AER's proposed approach is an appropriate way of accounting for the expanded RET as part of a RIT-T analysis. However, in the second case where retailers choose to pay the penalty rather than purchase RECs (with the consequence that the RET target is not met), Grid Australia notes that the differences in the tax treatment between the costs of acquiring and surrendering RECs (which are tax deductible) and the cost of penalty payments (which are not tax deductible¹¹) will influence the maximum price retailers are willing to pay for RECs. For example, if the shortfall charge is set at \$65 per MWh, then a company (bearing tax at 30%) would in theory be prepared to pay up to \$93 per MWh for RECs.¹² The after tax cost of \$93/MWh paid for RECs would be approximately \$65/MWh.¹³ This is

¹¹ Section 7A of the Renewable Energy (Electricity) Act 2000 (Cth) explicitly denies any deduction of the shortfall charge for income tax purposes, but does not deny a deduction for the costs (and losses) incurred via the process of acquiring and surrendering RECs.

¹² The tax treatment of RECs has also been noted by other stakeholders, e.g. AGL Energy Ltd, *Renewables .. Early Mover Advantage*, Jeff Dimeray, Group General Manager - Merchant Energy, Presentation to the UBS Australian Resources, Energy & Utilities Conference, June 2009, slide 10.

¹³ i.e. $\$93/\text{MWh} * 70\% = \$65/\text{MWh}$.

the same after tax cost as a non-deductible payment of \$65 made as a shortfall charge. As a result, it would not be correct to assume in the RIT-T analysis that the shortfall penalty for RECs is the appropriate cap on REC prices.

The assumption regarding the price that retailers will pay to purchase RECs rather than incur a penalty will impact the amount of renewable generation included in the market development scenarios as well as the assumed level of penalties paid by retailers. It will therefore be important to factor this tax impact into the RIT-T analysis.

Grid Australia supports the AER providing guidance and worked examples in the application guidelines in relation to the treatment of the expanded RET under the RIT-T analysis, including in circumstances where it is likely that the expanded RET will be met and the alternative where retailers decide to pay the penalty rather than to purchase RECs.

2.3 Estimating market benefits and costs

Q5: Should the current provision in the regulatory test regarding the methods that must be used in estimating costs and benefits be adopted in the RIT-T?

The Rules require the RIT-T to specify the method or methods permitted for estimating the magnitude of the different classes of costs and market benefits.¹⁴ This requirement relates to each class of costs and benefits.

Grid Australia notes that the different nature of the costs and benefits included in the RIT-T analysis means that there is not a single method that is appropriate for calculating all classes of costs and benefits. In addition, the stipulation in the Rules that the RIT-T is not to require a level of analysis that is disproportionate to the scale and likely impact of each of the credible options being considered¹⁵ may mean that different methods may be appropriate depending on the particular options being considered.

The provision in the current regulatory test is:

- (12) In estimating the magnitude of costs and benefits, a pool dispatch modelling methodology, or any other applicable methodology, should be used. If pool dispatch modelling methodology is used, it must incorporate:
 - (a) a realistic treatment of plant characteristics, including for example minimum generation levels and variable operation costs; and

¹⁴ NER 5.6.5B(c)(10)(i) and (ii).

¹⁵ NER 5.6.5B(c)(2).

- (b) a realistic treatment of the network constraints and losses.

Grid Australia notes that pool dispatch modelling is appropriate for estimating some classes of costs and benefits, but not all costs and benefits, and so this provision does not have general applicability.

The current regulatory test also contains the following requirement in relation to the methodology to be adopted for market development modelling (in order to derive generation development scenarios):

- (22) [...] Market development modelling must be undertaken on a 'least-cost' basis and, where appropriate, may be undertaken on a 'market-driven' basis. [...]

A 'least-cost' approach is defined in the regulatory test as 'akin to conventional central planning':

- (22)(a) [...] The *modelled projects* derived from such an approach would be those where the net present value of benefits, such as fuel substitution and reliability increases, exceed the costs.

In the current regulatory test applications guidelines the AER comments that:

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.¹⁶

Whilst a focus on a 'least cost' approach may in many circumstances be appropriate, Grid Australia suggests that that the RIT-T should not be prescriptive in this regard. It is arguable that under a 'least-cost planning' approach it is necessary to take into account changes in minimum reserve levels over the period of analysis, which in turn relies on assumptions regarding future network development and can result in the modelling requiring hundreds of simulations to be run.

An alternative approach which is likely to represent a more proportionate level of analysis would be a form of market-driven modelling based on when new entry is expected to become economically viable. Grid Australia notes that this type of 'market-based new entry' approach has been employed by NEMMCO¹⁷ in deriving the Annual National Transmission Statement (ANTS).¹⁸ Such an approach has the advantage of also relying on relatively uncontroversial assumptions (e.g. the assumed

¹⁶ AER, Regulatory Test Applications Guidelines, November 2007, p.8.

¹⁷ Now the Australian Energy Market Operator (AEMO).

¹⁸ See for example NEMMCO, *2008 ANTS Consultation: Final Report*, February 2008, section 7.5.1 'Generation expansion algorithm'.

fuel and operating costs of new generation plant), compared to market-driven modelling based on 'realistic' behavioural assumptions (e.g. Cournot-Nash).

As a result, Grid Australia considers that the RIT-T should not require TNSPs to undertake market development modelling on a 'least cost basis' where that is not the most appropriate or proportionate modelling approach.

In general Grid Australia supports the approach that the AER has adopted in relation to many areas of the current regulatory test of providing guidance in relation to methodologies that may be used, without being overly prescriptive. Grid Australia recommends that a similar flexible approach is adopted in developing the RIT-T.

2.3.1 Benefits outside of a TNSP's region

Q6: What methods for estimating market benefits which may occur outside a TNSP's region are appropriate for inclusion in the RIT-T?

Clause 5.6.6(k)(6) of the Rules makes clear that a TNSP is required to identify any class of market benefit that arises outside of its own region, but only to quantify any such benefit on an aggregate basis across all regions. This reflects the AEMC's recognition in its Final Report in relation to the review of National Transmission Planning Arrangements that:

requiring the TNSPs to quantify separately the value of any market benefits which occur outside its' region will add complexity to the analysis and will require subjective, uncertain allocation of impacts across regions.¹⁹

The RIT-T should make clear that TNSPs are only required to qualitatively identify where benefits arise outside of their region.

Any guidance in the RIT-T on quantifying benefits that cross more than one region would already be provided as part of the guidance required more generally in relation to estimating benefits (discussed in the previous section), given that quantification of benefits is only required on an aggregate basis.²⁰

2.4 Discount rate

Q7: Should the RIT-T and application guidelines adopt the same approach to specifying the appropriate discount rates to be applied as the regulatory test (version three) and application guidelines?

¹⁹ AEMC, *National Transmission Planning Arrangements, Final Report to MCE*, 30 June 2008, p. 46.

²⁰ i.e. the guidance required as a result of NER 5.6.5B(c)(10)(i).

Grid Australia agrees that the provisions in the current regulatory test in relation to the discount rate and the further guidance in the current regulatory test application guidelines would be appropriate to include within the RIT-T and the RIT-T application guidelines.

Grid Australia notes that the issue of the appropriate discount rate was considered in detail as part of the ACCC's earlier development of the regulatory test.²¹ This issue does not need to be re-examined in the context of developing the RIT-T and the RIT-T application guidelines.

3. Application Guidelines

3.1 Operation and application of the RIT-T

Q12: Are there any additional areas (other than those set out in the Electricity Rules) that should be addressed in the application guidelines?

Q13: Are there any areas where interested parties have views on the form or substance of the matters that the applications guidelines should address?

Q14: Do aspects of the current regulatory test application guidelines provide useful information which should be adopted in the RIT-T application guidelines?

As noted earlier, Grid Australia considers that the application guidelines are likely to provide the greatest practical assistance in applying the RIT-T. As a result, in some areas it may be appropriate for the guidelines to be more expansive than they are currently. The requirement under clause 5.6.5B(f) of the Rules for the application guidelines to include worked examples is likely to assist in further clarifying the guidance provided.

Clause 5.6.5B(f) sets out the matters that the RIT-T application guidelines must cover. The remainder of this section presents Grid Australia's suggestions as to the appropriate coverage of the application guidelines in relation to some of these areas. Grid Australia has no specific suggestions at this stage of the AER's review process for the coverage of the remaining areas of the application guidelines.

²¹ See for example, ACCC, Draft Decision, *Review of the Regulatory Test for network augmentations*, March 2004, p. 36-37.

(3) What may constitute an externality

Grid Australia notes that disputes cannot be raised in relation to matters that are treated as externalities under the RIT-T.²²

Providing guidance in the application guidelines as to what may constitute an externality under the RIT-T will assist all stakeholders in clarifying the scope for potential disputes in relation to the RIT-T. Grid Australia considers that externalities under the RIT-T include impacts on visual amenity and any impacts on the wider economy, outside of the costs and benefits to those that produce, consume and transport electricity in the national electricity market.²³

Guidance provided on what may constitute an externality should also make clear that the list is not intended to be exhaustive (see section 3.3).

(5) Suitable modelling period and approach to scenario development

The majority of regulatory test applications have adopted a fifteen year modelling period. This length of period has typically been found to be sufficient to allow all options to be assessed on a comparable basis. However in some instances a longer time period has been considered to be appropriate. This may be in the case, for example, where one of the options is of a substantially larger size, enabling a deferral of future network augmentation beyond a 15 year period. In such circumstances, adopting a longer analysis period allows the benefit of this increased deferral to be adequately taken into account in the analysis.

Grid Australia suggests that the application guidelines should not be prescriptive in relation to the modelling period that should be adopted for the analysis, consistent with the approach currently taken in the regulatory test. A modelling period of 15 years could be highlighted in the guidelines as a generally suitable period, but there should be flexibility to alter this period on a case by case basis, as appropriate, given the particular nature of the options being considered.

In relation to the approach to scenario development, as discussed in section 2.3, Grid Australia considers that TNSPs should not be required to adopt a 'least cost' approach to market development modelling, in circumstances where that is not the most appropriate methodology to use. Flexibility to tailor the approach used to the particular circumstances will better ensure that the analysis required under the RIT-T is not disproportionate to the scale and likely impact of the options being considered.

²² NER 5.6.6A (b)(1).

²³ These classes of externality reflect the provision in NER 5.6.5B(c)(9).

(6) Acceptable methodologies for valuing market benefits

Consistent with Grid Australia's views in section 2.2, the application guidelines should provide additional guidance and worked examples in relation to competition benefits, option value and the appropriate treatment of climate change policies.

In relation to competition benefits, Grid Australia considers that the content of the current regulatory test guidelines forms an appropriate basis for the RIT-T application guidelines. In particular the approach to estimating competition benefit should not be prescribed and there should be no requirement to identify competition benefits as a separate line item in the analysis. The current guidelines could be expanded via the inclusion of some worked examples.

Similarly, the guidelines should discuss alternative approaches to calculating option value, but should not prescribe or exclude any particular approach.

Finally, the application guidelines should provide guidance and worked examples in relation to the appropriate approach to incorporating the CPRS and the expanded RET in the RIT-T analysis.

(9) When a person is sufficiently committed to a credible option to be characterised as a proponent

The RIT-T requires a TNSP to assess all credible options to address an identified need that are technically and economically efficient. However, in the project assessment draft report the TNSP can only elect to proceed with an option in relation to reliability corrective action, if that option has a proponent whose identity can be included in the project assessment draft report.

The AER is required to provide guidance on when a person is sufficiently committed to a credible option to be characterised as a proponent. Grid Australia considers that the provision of guidance in this regard will assist in limiting disputes in relation to RIT-T assessments. In addition, such guidance can assist proponents of non-network options by clearly setting out the criteria they are required to satisfy in order to demonstrate sufficient commitment to be eligible as the preferred option in relation to reliability corrective action.

Given the importance of any option (either network or non-network) actually being available in the required timeframe to allow network reliability standards to be met, Grid Australia considers that the guidance in relation to the commitment of a non-network proponents should require either that the option should already have agreed a conditional contract with the TNSP, or (in the absence of an agreed contract) that the option should meet similar conditions to those currently incorporated in the regulatory test in relation to 'committed projects' for generation development

scenarios.²⁴ That is, the project should satisfy all of the following criteria (as they apply to that type of project) at the time of the project assessment draft report:

- (a) the proponent has obtained all required planning consents, construction approvals and licenses, including completion and acceptance of any necessary environmental impact statement;
- (b) construction of the project must either have commenced or a firm construction date must be set;
- (c) the proponent has purchased/settled/acquired land (or commenced legal proceedings to acquire land);
- (d) contracts for the major components of the project should be finalised and executed, including any provisions for cancellation payments; and
- (e) the financial arrangements for the project, including any debt plans, must have been finalised and contracts executed.

In relation to generation options, all of the above criteria would be relevant. In relation to demand-side options, Grid Australia notes that criteria (d) and (e) would be relevant, in relation to the contracting and financial arrangements for the projects having been finalised.

However Grid Australia notes that ultimately a TNSP would not be able to proceed to recommend an option in relation to reliability corrective action in its project assessment final report for which there was not an agreed contract in place between the TNSP and the project proponent.

Grid Australia notes that for network options that are under the control of the TNSPs the TNSP can be automatically considered as a proponent.

3.2 RIT-T assessment process

Q15: Are there any particular areas where further guidance on the RIT-T assessment process would be useful?

Grid Australia considers that the Rules in relation to the RIT-T assessment process are sufficiently detailed such that substantial additional guidance is not required.

²⁴ Regulatory Test, paragraph 20.

3.3 Dispute resolution

Q16: What guidance on the dispute resolution process would be helpful to interested parties? Are there any particular areas where more detailed guidance on the process would be useful?

Q17: Do the current regulatory test dispute resolution guidelines provide useful information on the current process for raising and resolving regulatory test disputes?

Under the Rules, disputes cannot be raised in relation to matters that are treated as externalities under the RIT-T.²⁵ As discussed in section 3.1, clarification in the application guidelines in relation to what matters may be treated as an externality under the RIT-T will assist all stakeholders in understanding the scope for disputes with regard to the RIT-T analysis. However, the dispute resolution guidelines should also clearly state that a matter can be determined as being treated as an externality under the RIT-T (and therefore be excluded from dispute) even where it has not been identified in the application guidelines as a potential externality.

Grid Australia considers that the current regulatory test dispute resolution guidelines provide useful information in relation to flow of information, procedural fairness and confidentiality (i.e. section 7 of the current guidelines) that should also be included within the dispute resolution guidelines for the RIT-T.

²⁵ 5.6.6A (b)(1).