NEMMCO

National Electricity Market
Management Company Limited
ABN 94 072 010 327

Sydney

3 November 2006

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
Australia Square NSW 1215

Dear John

**Submission on National Electricity Amendment (Reform of the Regulatory Test Principles) Rule 2006**

Thank you for the opportunity to make this submission regarding the above Draft Rule Determination.

NEMMCO did not make a submission to the original consultation, but takes this opportunity to provide input on a number of matters contained in the Draft Rule Determination, including some matters in respect of which the Australian Energy Market Commission (Commission) has indicated that it is seeking submissions.

This submission draws on the experience NEMMCO has gained in developing the Annual National Transmission Statement, which is now in its third edition, and focuses on the following two points:

- **Structure of the Regulatory Test**: The new Rule adopts the current structure of the Regulatory Test, which has two independent assessment limbs. This structure gives rise to a risk of inefficient transmission investment outcomes where it allows reliability driven network augmentations to be adopted in a form that does not capture the full extent of potentially efficient market benefits. Accordingly, there would be merit in making the new Rule less prescriptive in its requirement for the Regulatory Test to have two independent limbs;

- **Public requests for information on alternative options**: There may be merit in clarifying whether the request for information is to be done prior to, or as part of the Annual Planning Report (APR) process.

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Further details regarding the above are in the attached submission.

NEMMCO would be pleased if you could have these matters considered by the Commission. For further details, please to not hesitate to contact David Bones on 07 3347 3014.

Yours sincerely

Brian Spalding

**Brian Spalding**
Chief Operating Officer

Attachment

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**SUBMISSION**

## 1. Structure of the Regulatory Test

The principle at clause 5.6.5A (b) of the Draft Rule, effectively provides for potential network projects to be assessed on the basis of either of two independent tests:

a) The first relates to maximising the net economic benefit of a proposed project (the market benefits limb); and

b) The second relates to minimising the present value of the costs of meeting predetermined service standards (the reliability limb).

In respect of the form of the Test, the Commission notes that:

> *"The construction of the current principle effectively inserts a requirement in the Rules that the Test should take the form of having two limbs, with a different standard of assessment and justification required under each limb."*[1]

The Commission further notes that:

> *"It is worth noting that the distinction between "reliability" and "market" investment is in many respects an artificial one. An investment that is intended to meet a reliability criterion frequently delivers market benefits; conversely market investment may also deliver reliability benefits."*

NEMMCO agrees with these points made by the Commission, and that the current Regulatory Test has these attributes. However, the two limb structure gives rise to the risk that a least cost project identified under the Reliability Limb may not be the most economically efficient network development in terms of either timing, scope or project identification.

The following scenario aims to demonstrate how this issue could arise.

Once the least cost option to address a projected reliability requirement has been identified, a further assessment could be carried out to test the timing, scope and project identification as follows:

- Project timing: The least cost network project to meet reliability standards will generally be deferred to the extent possible to avoid the increased cost of earlier construction. As already noted however, reliability augmentations can often deliver market benefits as well as reliability benefits. If the incremental market benefit of implementing the project earlier than would be necessary to meet the reliability standard, exceeded the incremental cost of doing so, then there may be economic merit in adopting the earlier

[1] See page 34 of the Draft Rule Determination.

construction. The current Regulatory Test requires the least cost option to be pursued. Any net market benefits that could be captured from economically advancing the implementation of reliability driven projects are therefore likely to be missed under the current mechanism, and the new Rule would provide for this to continue.

- Project scope: Similar to the timing assessment, the least cost project required to meet a predetermined reliability standard will generally be the project with the smallest scope that can meet reliability obligations over a projected planning timeframe. If the incremental market benefit of a larger project (eg a larger transformer, or larger transmission line) exceeded the incremental cost of the larger project, then there may be economic merit in progressing the larger project instead of the least cost project. Again, the least cost approach to reliability driven augmentations may result in ongoing inability to capture potentially economic net benefits from variations to the base project.

- Project identification: In a similar vein to the above, there may be alternative projects that can satisfy the reliability obligations of the network service provider. Once the least cost project has been identified, there may be merit in comparing the incremental cost and incremental market benefit of progressing an alternative project. Again, progression of the least cost option without checking the relative benefits and costs of alternatives may result in the loss of some market benefits that could have been efficiently captured.

Each of the above planning issues effectively derives from having two independent limbs for the economic assessment of network options, rather than an integrated approach.

**Materiality and evidence of a problem** – Market benefits are currently not required to be determined by proponents of reliability driven projects. Therefore, the nature of this structural issue is such that current processes do not illuminate its materiality or even the practical reality of any efficiency loss that may derive from it.

Determination of market benefits for a number of variations from existing and past reliability driven augmentations would be necessary for materiality to be estimated, and such assessments could give rise to considerable debate over methodology.

**Implications for the Draft Rule** – NEMMCO notes that the Commission is seeking submissions on whether the two limbs of the Regulatory Test should be specified in the Rules, or alternatively if the Rules should specify an 'efficiency' principle and a 'reliability' principle that would not explicitly require the Test to have two independent limbs.

In order to address the issues described above, it would be necessary to provide a linkage between the two limbs of the Test, such that the assessment of reliability driven augmentations would include analysis of sensitivities to timing, scope and project identification. Any change to the existing assessment process along these lines would need to ensure that essential reliability driven augmentations could not be delayed by potentially more contentious market benefit assessments.

## 2. Public Request for Information on Alternative Options

The proposed new Clause 5.6.5A (d) of the Draft Rule introduces an obligation for NSPs to "publicly request information as to the identity and detail of alternative options to the proposed new network investment".

NEMMCO supports this process in principle, but notes that the Draft Rule appears to apply equally to new small and large network assets.

NEMMCO understands that consultation on potential new small network assets, as required by clause 5.6.6A of the current NEM Rules, can be carried out by NSPs using their APRs as the main instrument of the consultation. If no submissions are received on the proposal under the current mechanism, then further reporting would most likely be unnecessary.

It is not clear from the Draft Rule whether the proposed RFI for new small network assets would need to be carried out prior to issue of the APR or can be carried out as part of the APR. If the former was intended, then an additional hurdle may apply to the progression of new small network assets. The Commission may wish to consider clarification of whether the proposed RFI process is intended to apply to both new large and small network assets.