



Australian Energy Market Commission

**Draft Rule Determination**

**National Electricity Amendment (Cost  
Allocation Arrangements for Transmission  
Services) Rule 2008**

Rule Proponent  
National Generators Forum

28 August 2008

Signed: .....

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**Chairman**

For and on behalf of  
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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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## Abbreviations

AARR	Aggregate Annual Revenue Requirement
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
EUAA	Energy Users Association of Australia
MCE	Ministerial Council on Energy
MEU	Major Energy Users Group
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NGF	National Generators Forum
RAB	Regulatory Asset Base
Rules	National Electricity Rules
TNSP	Transmission Network Service Provider
TUOS	Transmission Use of System

## Summary

On 18 January 2008, the National Generators Forum (NGF) lodged a Rule change proposal (Rule proposal) with the Australia Energy Market Commission (Commission) regarding the cost allocation arrangements for transmission services.<sup>a</sup>

The NGF's Rule proposal aims to address an area in the National Electricity Rules (Rules) that it believes leads to the shifting of costs from historically shared transmission services to entry or exit services. This shift, it believes, is a result of a re-allocation of costs or a network reconfiguration undertaken for the benefit of network users generally.

The Rule proposal focuses on the following areas:

- clarifying the grandfathering provisions under clause 11.6.11 of the Rules;
- preserving the cost allocation methodology in respect of grandfathered services;
- preventing the removal of assets from a transmission network service provider's regulated asset base (RAB) due to asset reconfigurations; and
- clarifying interaction of transmission ring-fencing guidelines and cost allocation principles.

In accordance with section 99 of the National Electricity Law (NEL), the Commission has determined to make with amendments a draft Rule in relation to the proposed Rule (Draft Rule). As the Draft Rule includes amendments to the NGF's proposed rule, it is a more preferable Rule. The Draft Rule aims to improve the application of the grandfathering provisions with respect to the current Rule and the NGF's Rule proposal.

The Commission is satisfied that, having regard to the issues raised by the NGF, that the more preferable Rule will, or is likely to, contribute better to the achievement of the National Electricity Objective (NEO). The Commission considers that the Rule will satisfy the NEO as it:

- is consistent with the principles of good regulatory design;
- clarifies of the meaning, workability and implementation of the grandfathering provisions and cost allocation arrangements, thereby enhancing regulatory certainty;
- provides a mechanism for the end of grandfathering that is cognisant of the existing commercial relationships between transmission network users and transmission network service providers;

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<sup>a</sup> National Generators Forum, *Proposal for Rule on Transmission Entry and Exist Charges*, 18 January 2008 (Rule proposal).

- is fundamentally sustaining the Commission's policy intent with regard to the transitioning, over time, of prescribed transmission connection services to *negotiated transmission services* and their removal from the regulatory asset base; and
- clarifies the application of *Cost Allocation Principles* to grandfathered 'prescribed connection services' making them consistent with a shallow connection pricing approach adopted by the Commission.

In making this draft Rule determination, the Commission has had regard to a number of factors including the Rule proposal, stakeholder submissions and the requirements under the NEL.

The Commission invites submissions on this draft Rule determination by 10 October 2008.

In accordance with section 101 of the NEL, any interested person or body may request that the Commission hold a hearing in relation to the Draft Rule determination. Any request for a pre-determination hearing must be made in writing and must be received by the Commission no later than 5 September 2008.

Submissions and requests for a hearing may be sent electronically to [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au) or by mail to:

Australian Energy Market Commission  
PO Box A2449  
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# 1 The NGF Rule change proposal

## 1.1 Background

On 18 January 2008, the National Generators Forum (NGF) lodged a Rule change proposal with the Australia Energy Market Commission (Commission) regarding the cost allocation arrangements for transmission services (Rule proposal).<sup>1</sup>

In its Rule proposal the NGF has sought to address what it sees as ambiguities in the provisions in the National Electricity Rules (Rules). That is, clause 11.6.11 of the Rules, which grandfathers as *prescribed transmission services*, certain *connection services* which would otherwise be categorised as *negotiated transmission services*.<sup>2</sup> The NGF considers that these ambiguities can result in the costs of *shared transmission services* being allocated to *prescribed entry services* and *prescribed exit services* (in this Draft Rule determination, referred to collectively as 'prescribed connection services'). The NGF considers this to be inappropriate and, accordingly, requests changes to grandfathering provisions to preserve the costs of prescribed connection services as at the commencement of the *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18 (Revenue Rule)*.<sup>3</sup>

## 1.2 Context

Under section 35 of the National Electricity Law (NEL) the Commission was required to review the regulation of electricity transmission revenue and pricing.

Following a substantial review, in November 2006 the Commission published the Revenue Rule together with a final Rule determination<sup>4</sup> (Revenue Determination) which provides the Commission's reasoning. The Revenue Rule continued direct revenue regulation of shared transmission services provided by *Transmission Network Service Providers* (TNSPs) in recognition of the need to manage the associated market power. The Revenue Rule also established incentives for the competitive or negotiated supply of transmission services.

In the Revenue Rule, the Commission codified regulatory processes to provide better balance, certainty and transparency compared with previous practice. The Revenue Rule also provided guidance to the Australian Energy Regulator (AER) in relation to the criteria to be applied by the AER when exercising discretions conferred on it under the Rules.

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<sup>1</sup> National Generators Forum, *Proposal for Rule on Transmission Entry and Exit Charges*, 18 January 2008 (Rule proposal).

<sup>2</sup> Clause 11.6.11 of the Rules. Terms used in italics have the same meaning as they do in the Rules.

<sup>3</sup> The *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No18* commenced operation on 16 November 2006.

<sup>4</sup> AEMC 2006, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination*, 16 November 2006 (Revenue Determination).

In December 2006, the Commission published the *National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006 No. 22 (Pricing Rule)*. The Pricing Rule recast the regulatory framework for the pricing of *prescribed transmission services* by setting out principles to be used for developing pricing methodologies.

Chapter 11 of the Rules sets out arrangements for transitioning transmission revenue regulatory arrangements to the new the Chapter 6A environment. These arrangements include grandfathering assets used (or committed to be constructed) for the provision of certain *connection services* as at 9 February 2006 as assets for the provision of *prescribed transmission services* under Chapter 6A.

### 1.3 Problem to be addressed by the Rule proposal

The primary objective of the Rule proposal is to prevent the shifting of assets (and consequently costs) from *shared transmission services* to providing connection services as a result of reallocating costs or a network reconfiguration that may benefit network users generally. The NGF believes that the ability to shift assets creates uncertainty. In addition, there is potential for such a reallocation to cause price shocks to the detriment of generators. It considers this to be an unintended outcome of clause 11.6.11.

According to the NGF, the main issues to be addressed to ameliorate this problem are:

- Clarification of grandfathering provisions in clause 11.6.11: The grandfathering provisions in clause 11.6.11 are ambiguous and open to interpretation, particularly where the use of an asset changes over time.
- Cost allocation arrangements: *Connection services* may be subject to inefficient cost allocation from historically shared assets. There is a lack of consistency, in terms of cost allocation, between new and existing *connection services*. That is, new or reconfigured *connection services* cannot be liable for costs from historically shared assets whereas existing *connection services* can.<sup>5</sup> The NGF believes that this is inconsistent with the *Cost Allocation Principle* in Chapter 6A which prevents the reallocation of costs from *prescribed transmission services* to *negotiated transmission services* (that is, connection services).
- Removal of assets from regulatory asset base (RAB): Under clause S6A.2.3, the AER may remove the value of an asset from the RAB at a regulatory reset, undermining clause 6A.19.2(7). This is because, the NGF assumes, following a unilateral reconfiguration of the transmission system by the TNSP and once an asset value is removed from the RAB ‘...the service provided by that (previously grandfathered) asset would only be characterised as a negotiated service, leaving the network user liable to the full cost of the asset’.<sup>6</sup> Accordingly, this increases the level of investment risk.

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<sup>5</sup> Rule proposal, p.6.

<sup>6</sup> Rule proposal, p.11.

- Application of *Transmission Ring-fencing Guidelines*: One of the cost allocation principles indicates that the method of cost allocation for transmission services should be consistent with the *Transmission Ring-Fencing Guidelines*<sup>7</sup>. Similarly Rule 6A.21 does not clearly distinguish between the functions of those Guidelines and the *Cost Allocation Principles*.<sup>8</sup> Accordingly, these anomalies should be addressed.

#### 1.4 Rule proponent's proposed solution

In the Rule proposal the NGF has sought to make four substantive changes to the Rules.<sup>9</sup> They are summarised below:

- Clarify that the grandfathering provisions in clause 11.6.11 apply to 'prescribed connection services' provided at a point-in-time (as at 16 November 2006) that are being provided by particular assets (in the regulatory asset base as at 9 February 2006). Under this 'point-in-time services approach', any new connection services that result from the reconfiguration of shared assets would be classed as *negotiated transmission services* rather than *prescribed transmission services*. (Therefore under a reconfiguration, the assets relating to the new negotiated service cannot be reallocated to the 'prescribed connection services'). As such the TNSP could not reallocate costs associated with assets used to provide *prescribed transmission services* to *negotiated transmission services*. This would avoid price shocks for generators.
- The cost allocation position prior to the commencement of Chapter 6A would be preserved as an upper limit on costs to prescribed connection services. Only fully dedicated assets could be classified as connection assets for which costs were recoverable through prescribed connection service charges. Any shortfall resulting from the limit of the costs to be allocated to prescribed connection services would be reallocated into *prescribed transmission use of system services* (TUoS) and *prescribed common transmission services*. This would ensure no revenue shortfall for the TNSP.
- Prevent removal of assets from the RAB by the AER as a result of a reconfiguration of the transmission system if the relevant *transmission network user* (or group of users) has not consented and has not unreasonably refused consent.<sup>10</sup> This addresses the issue that a reconfiguration might result in an asset that has previously provided *prescribed transmission services* being reclassified as an asset providing *negotiated transmission services*, and such would be subject to a different charging regime possibly resulting in higher prices for generators.

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<sup>7</sup> Clause 6A.19.2(6) of the Rules.

<sup>8</sup> Rule proposal, pp. 5-12.

<sup>9</sup> Rule proposal, pp. 3- 4.

<sup>10</sup> In this situation refusal is deemed not to be unreasonable if network charges are likely to increase by five per cent.

- Amend provisions in the Rules to make it clear that the *Transmission Ring-Fencing Guidelines* do not affect the need for, and extent of, the allocation of costs between transmission services.

## 1.5 Consultation

Under section 95 of the NEL, on 3 April 2008 the Commission notified its intention to commence the Rule change process and initial consultation on the Rule proposal. Submissions closed on 2 May 2008.

The Commission received five submissions on the Rule proposal in the initial consultation round. The submissions are available on the AEMC website. Initially, submissions were received from:

- Grid Australia (Grid Australia initial submission);
- Major Energy Users Group (MEU); and
- Energy Users Association of Australia (EUAA).

A further two submissions were received after the closing date from Grid Australia (9 July 2008) (Grid Australia supplementary submission) and the NGF (18 July 2008) (NGF submission).

The Commission published two notices under section 107 of the NEL to extend the time for publication of this draft Rule determination so as to have adequate time to consider these additional submissions from Grid Australia and the NGF.

The MEU and EUAA do not support the NGF's proposal to preserve the cost positions for prescribed connection services as at the commencement date of the Revenue Rule.<sup>11</sup> These respondents consider aspects of the NGF's proposed cost allocation arrangements to be inequitable. The MEU and EUAA focus on the need for costs between shared and connection services to be allocated on an equitable basis.

In its initial submission, Grid Australia agrees that the grandfathering provisions are ambiguous. However, it has expressed concern that the Rule proposal would not adequately address broader issues such as the consequences of the replacement of grandfathered assets providing prescribed connection services. Grid Australia regards the NGF's proposal as an overly complex approach to addressing the cost allocation arrangements for grandfathered services.<sup>12</sup>

The Grid Australia supplementary submission proposes an alternative approach to the NGF Rule proposal to allow for the transitioning of prescribed connection

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<sup>11</sup> Major Energy Users, *Cost Allocation Arrangements for Transmission Services*, 16 May 2008 (MEU submission). Energy Users Association of Australia, *Request for a Rule Change – Cost Allocation Arrangements for Transmission Services*, 2 May 2008 (EUAA submission).

<sup>12</sup> Grid Australia, *Cost Allocation Arrangements for Transmission Services – Response to NGF Rule Change Proposal*, 2 May 2008 (Grid Australia initial submission).

services to *negotiated transmission services*. Grid Australia has suggested that assets replaced on a like-for-like basis continue to be grandfathered. Grid Australia proposes that the expiry of *connection agreements* be used to trigger the end of grandfathering for the relevant prescribed connection service.<sup>13</sup>

The NGF has responded to Grid Australia's alternative proposal.<sup>14</sup> It does not support the use of *connection agreements* as a trigger for grandfathering of a service to end or the proposed reference to asset values to calculate charges for grandfathered prescribed connection services.

## 1.6 Consultation on draft Rule determination

The Commission invites submissions on this draft Rule determination by 10 October 2008.

In accordance with section 101 of the NEL, any interested person or body may request that the Commission hold a hearing in relation to the draft Rule determination. Any request for a pre-determination hearing must be made in writing and must be received by the Commission no later than 5 September 2008.

Submissions and requests for a hearing may be sent electronically to [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au) or by mail to:

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<sup>13</sup> Grid Australia, *Cost Allocation Arrangements for Transmission Services*, 9 July 2008 (Grid Australia supplementary submission).

<sup>14</sup> NGF, *Cost Allocation Arrangements for Transmission Services Rule change: NGF comments on Grid Australia's Alternative Rule Change Proposal*, 18 July 2008 (NGF submission).

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## 2 Draft Rule determination

### 2.1 Commission's Draft Rule determination

In accordance with sections 99 and 91A of the NEL, the Commission has determined to propose to make a draft Rule which is a more preferable Rule than the NGF's proposed Rule (Draft Rule).<sup>15</sup>

The Commission is satisfied that the more preferable Rule will or is likely to better contribute to the achievement of the National Electricity Objective (NEO) than the NGF's proposed Rule, having regard to the issues raised by the NGF's Rule proposal.

The Draft Rule to be made is attached to, and published with, this draft Rule determination.

### 2.2 Commission's considerations

This draft Rule determination sets out the Commission's reasons for making the Draft Rule. In making Draft Rule, the Commission has taken into account:

- the Commission's powers under the NEL to make to the Rule;
- the Rule proposal;
- submissions received;
- the Revenue Rule and Revenue Determination;
- the Pricing Rule and Pricing Determination;
- form of regulation factors and revenue and pricing principles under the NEL;<sup>16</sup> and
- the Commission's analysis on the ways in which the proposed Rule will, or is likely to contribute to the NEO so that the statutory Rule making test is satisfied.

For the reasons set out in the following chapters, the Commission has concluded that the Draft Rule satisfies the Rule making test. In brief, having regard to the issues raised, the Commission is satisfied that the Draft Rule will, or is likely to, contribute to the achievement of the NEO better than the NGF's Rule proposal because it

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<sup>15</sup> Refer to section 91A of the NEL.

<sup>16</sup> Under sections 88A and 88B of the NEL the Commission is required to take into account the form of regulation factors set out in section 2F and revenue and pricing principles set out in section 7A in certain cases. The form of regulation factors must be taken into account where a proposed Rule either specifies (or confers discretion on the AER to specify through a regulatory determination) a network services as a direct control or negotiated service. The revenue and pricing principles must be taken into account with respect to matters or things specified in items 15-24 and 25 - 26J of Schedule 1 to the NEL.

ensures a greater level of clarity and consistency across the Rules. This includes being more reflective of the underlying objectives and principles of the Revenue Rule.

The NGF has cited several ways in which it considers that its Rule proposal meets the NEO. The Commission acknowledges that the NGF has raised significant issues. However, the Commission has concluded that the NGF's proposed Rule does not address the relevant issues and concerns raised in submission in a comprehensive manner.

In short, the Draft Rule satisfies the Rule making test because it:

- is consistent with the principles of good regulatory design;
- promotes efficiency;
- provides for certainty; and
- provides for consistency.

For example, the Draft Rule:

- clarifies of the meaning, workability and implementation of the grandfathering provisions and cost allocation arrangements in the Rules, enhancing regulatory certainty;
- is consistent with the Commission's objectives regarding the transitioning of connection services from *prescribed transmission services* to *negotiated transmission services* and their removal from the RAB;<sup>17</sup>
- clarifies the application of *Cost Allocation Principles* to grandfathered prescribed connection services making them consistent with a shallow connection pricing approach; and
- provides for consistency between existing and new *Transmission Network Users*.

### **2.3 The Commission's power to make the Rule**

The Commission is satisfied that the Draft Rule falls within the subject matters that the Commission may make Rules for as set out in section 34 of the NEL and in Schedule 1 to the NEL. The proposed Rule is within:

- the matters set out in section 34, as it relates to the activities of persons participating in the national electricity market or involved in the operation of the national electricity system; and

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<sup>17</sup> This is also consistent with the form of regulation factors.

- the matters set out in items 15-24 of Schedule 1 to the NEL as it relates to the application of provisions in the Rules grandfather assets providing certain connection services as *prescribed transmission services*.

## 2.4 Differences between the Rule proposal and Draft Rule

The key differences between the proposed Rule and Draft Rule are summarised below.

First, the NGF's proposed Rule seeks to amend clauses 6A.19.2, 6A.19.4, 6A.21.2, S6A.2.3 and 11.6.11 of the Rules as follows:

- Clauses 6A.19 and 6A.21.2 - to clarify that the *Transmission Ring-Fencing Guidelines* do not affect cost allocation as between transmission services (as opposed to cost allocation as between transmission services and other services)
- Clause 6A.19.4 - to draw attention to the requirements of clause 11.6.11 in the context of each TNSP's cost allocation methodology
- Clause S6A.2.3 - to prevent the removal of the value of an asset from the RAB during a regulatory reset in circumstances where:
  - there has been a reconfiguration of the *transmission system*;
  - that reconfiguration causes relevant conditions for removal from the RAB to be met; and
  - the affected transmission network users have not requested or consented to the reconfiguration or have not unreasonably refused or failed to consent to the removal of the asset from the RAB.
- Clause 11.6.11 - to clarify what the NGF understands to have been the intent of this clause:
  - introduces separate definitions of 'eligible assets', 'existing assets' and 'eligible committed assets';
  - provides that services to be grandfathered are those which were being provided when the Revenue Rule came into effect;
  - explicitly grandfathers assets committed to be constructed when the Revenue Rule came into effect;
  - recognises that for so long as the value of a qualifying asset is included in the RAB, a connection service provided by that asset will continue to be treated as a grandfathered service;
  - recognises that, for so long as the price for the service is not negotiated, a connection service provided by a qualifying asset should continue to be treated as a grandfathered service;

- preserves the cost allocation methodology that existed before Chapter 6A came into effect by limiting the costs of assets that may be allocated to prescribed connection services to the costs of those assets which were fully dedicated to the provision of those services at the relevant connection point as at 16 November 2006; and
- deals with any residual portion of the *aggregate annual revenue requirement* (AARR) that may be left unallocated as a result of the point above. First the costs are to be allocated to TUoS and then to prescribed common transmission services.

Secondly, the Commission's Draft Rule seeks to amend clauses 6A.21.2 and 11.6.11 of the Rules as follows:

- Clause 6A.21.2 – to insert an additional provision to the effect that the *Transmission Ring Fencing Guidelines* cannot require allocation of costs as between *prescribed transmission services* and *negotiated transmission services*, or between categories of *prescribed transmission services* in a manner which is inconsistent with the *Cost Allocation Principles*.
- Clause 11.6.11 – to delete the current clause 11.6.11 and insert a new clause 11.6.11 which:
  - creates a suite of definitions for the purposes of clause 11.6.11, being 'existing asset', 'replacement asset', 'eligible asset' and 'prescribed connection services';
  - provides that 'prescribed connection services' are deemed to be *prescribed transmission services*;
  - provides that 'prescribed connection services' will not be treated as *prescribed transmission services* and will be taken to be *negotiated transmission services* when:
    - ... the current term of existing *connection agreements* under which those services are provided expire or otherwise terminate; or
    - ... the *connection agreement* has been amended at the request of the *transmission network user* for the purposes of altering the relevant service;
  - specifies how the general provisions in Chapter 6A apply to prescribed connection services to achieve the same outcome as that proposed by the NGF; (that is, limiting the assets which can be attributed to 'prescribed connection services' and substituting a requirement for allocating any shortfall in costs to another category of prescribed transmission services); and
  - includes certain consequential provisions. For the purposes of clause 11.6.11, when services transfer from *prescribed transmission services* to *negotiated transmission services* then clause 6A.19.2 does not apply and the existing assets or replacement assets will transfer out of the RAB at the next revenue determination.

### 3 Commission's assessment approach

This chapter set out the Commission's approach for assessing the Rule proposal and alternative options developed through the first round consultation process. Its detailed assessment and the reasons for its draft Rule determination are set out in chapters 4 and 5.

#### 3.1 Methodology

In assessing any proposed Rule change against the NEL criteria the first step is to consider the counterfactual arrangements against which the Rule change is being compared. In the present case the counterfactuals are the current arrangements as well as two other options for resolving the major issue that is the subject of the NGF's Rule proposal, being the grandfathering arrangements in clause 11.6.11. The resolution of this major issue will affect the resolution of the other issues raised by the NGF. To assess the NGF's Rule proposal the Commission's approach has been to:

- clarify the application and operation of clause 11.6.11 in its current form;
- confirm the objectives and principles underlying the Commission's review of the economic regulation of transmission services, as set out in the Revenue Determination;
- examine different approaches to resolving the issues arising from the grandfathering provisions against the objectives and principles; and
- decide on a preferred approach to resolve the grandfathering issues.

On establishing a preferred approach to address the issues arising on grandfathering the Commission has:

- examined the issues regarding cost allocation between the different categories of *prescribed transmission services*;
- examined the issues regarding the removal of assets from the regulatory asset base in the Rules; and
- ascertained the role of the *Transmission Ring-Fencing Guideline* and the relationship to the *Cost Allocation Principles*.

#### 3.2 Rule making test and the National Electricity Objective

In accordance with section 88(1) of the NEL, the Commission may only make a Rule if it is satisfied that the Rule will, or is likely to, contribute to the achievement of the NEO.

The NEO, as set out in section 7 of the NEL, is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system.

The NEO is founded on the concepts of economic efficiency (including productive, allocative and dynamic efficiencies), good regulatory practice (which refers to the means by which regulatory arrangements are designed and operated) as well as reliability, safety and security priorities.

According to the NGF the proposed Rule would contribute to the NEO by:

- reducing inefficiency;
- reducing regulatory uncertainty;
- reducing inconsistency in the treatment of generators;
- providing a proportionate response to an issue with the Rules;
- increasing stability and predictability of the regulatory framework; and
- ensuring the robustness of the change.<sup>18</sup>

Comments from stakeholders challenge the NGF's claims. Grid Australia has stated that the NGF's proposed Rule does not reduce regulatory uncertainty as it leaves a number of practical difficulties unresolved.<sup>19</sup> The MEU noted that the benefits enunciated by the NGF need to be balanced against equity between new and existing users of the transmission network.<sup>20</sup> Similar comments were made by the EUAA. It also stated that the NGF Rule proposal may promote inefficient generation investment and burden consumers with risks that should rightly sit with generators who have the ability to manage and diversify them.<sup>21</sup>

### **3.3 Form of regulation factors and revenue and pricing principles**

This Rule proposal requires the Commission to take into account the form of regulation factors and the revenue and pricing principles. The form of regulation factors refer to the presence of market imperfections in the provision of electricity network services, such as barriers to entry, externalities and market power. The Commission's interpretation of this obligation is that economic regulation of network

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<sup>18</sup> Rule proposal, p.17.

<sup>19</sup> Grid Australia, *Cost Allocation Arrangements for Transmission Services*, 2 May 2008, p.10.

<sup>20</sup> Major Energy Users, *Cost Allocation Arrangements for Transmission Services*, 16 May 2008, pp.1-2.

<sup>21</sup> Energy Users Association of Australia, *Cost Allocation Arrangements for Transmission Services*, 2 May 2008, p 4.

services under the Rules should only apply if, and to the extent that, market forces are unlikely to yield competitive provision of those services.

The revenue and pricing principles relate to providing a reasonable opportunity to service providers to recover efficient costs, effective incentives to promote efficiency and to ensuring that prices should allow for a return commensurate with the regulatory and commercial risks involved in providing the service.

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## 4 Assessment of grandfathering transmission services

This chapter addresses the issues arising from the NGF's proposed changes to the grandfathering provisions in clause 11.6.11 of the Rules. The discussion includes the consideration of matters raised in submissions and an assessment of alternative solutions to the NGF's concerns.

### 4.1 Issue raised by the NGF

The NGF is seeking to clarify what it considers to be ambiguities relating to grandfathering provisions for *prescribed transmission services* in Chapter 11 of the Rules. In its view, the current Rules can lead to the inefficient shifting of costs from *shared transmission services* to, *entry services*, or *exit services* as a result of a reallocation of costs or a network reconfiguration undertaken for the benefit of *network users* generally. This creates a possibility for generators to experience price shocks.

The NGF considers that it is essential that *connection services* be classified on a clear and unambiguous basis either as *prescribed transmission services* or *negotiated transmission services* as this will determine the principles that apply for the purposes of allocating costs to that service.

### 4.2 Description of NGF's Rule proposal

The NGF's objective is to prevent the reallocation of costs of assets from historically shared *prescribed transmission services* to existing 'prescribed connection services'. Under the NGF's preferred interpretation following a reconfiguration of assets undertaken for the benefit of the shared network, clause 11.6.11 grandfathers the services provided by the assets at a 'particular point in time'. Therefore, in a situation where the reconfigured asset provides a different service, that new service is therefore not grandfathered. Instead the new service is classified as a *negotiated transmission service*.

The NGF states that its Rule proposal will ensure that only those services which provided entry services before the Revenue Rule came into operation (16 November 2006) are grandfathered as *prescribed entry services*. It considers this to be consistent with the intent of this provision and the underlying purpose of grandfathering, which is to ensure that matters treated in a particular way before a regulatory change continue to be treated in the same way after that change<sup>22</sup>.

The NGF states that:

'...the proposed Rule clarifies that it is the services provided by relevant assets at a point-in-time that are grandfathered, and not the services provided by those assets at any time. A subsequent change in the use of an asset (e.g.

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<sup>22</sup> Rule proposal, p.3.

from network to dedicated connection as a consequence of a reconfiguration project undertaken to benefit network users) cannot result in new prescribed entry services being provided by that asset. Such services will instead be classified as *negotiated transmission services*.<sup>23</sup>

That is, the NGF maintains that a *TNSP* should not be able to reallocate the related *prescribed transmission service* costs to negotiated *entry services*, protecting the relevant generator from a price shock.

## 4.3 Submissions

### 4.3.1 Grid Australia

In its initial submission, Grid Australia expressed support for measures that increase regulatory certainty and reduce the scope for 'uneconomic' price shocks. However, it is concerned that the Rule proposal does not sufficiently address the shortcomings of the current grandfathering provisions. In particular, Grid Australia considered that further amendments to clause 11.6.11 are required to ensure that the grandfathering arrangements can operate in a practical and effective way.

Grid Australia identified a number of concerns relating to clause 11.6.11 that would not be addressed by the Rule proposal, including:

- confusion as to whether services or assets (or both) are grandfathered. The clause is drafted as if it is grandfathering services, although the AEMC's comments at the time of making the Rule could be read as suggesting an intention to grandfather assets.
- there is no clear trigger as to when a *prescribed entry service* or a *prescribed exit service* ceases to be grandfathered. Nor is clear what changes in the assets used to provide a grandfathered connection service trigger a change in status of the service or part of the service.
- the application of clause 11.6.11 to the replacement of assets that were previously used to provide grandfathered *connection services* is open to interpretation. Grid Australia advised that the AER has concluded that it is currently obliged to interpret clause 11.6.11 as requiring any replacement of a grandfathered asset to be treated as providing a *negotiated transmission service* and therefore to be remunerated outside the *TNSP's* revenue cap. According to Grid Australia, the practical implications of AER's interpretation include:
  - Network users will be required to engage in negotiation with *TNSPs* for *entry services* and *exit services* as assets technically transition from *prescribed transmission services* to *negotiated transmission services*. These negotiations will be required even if neither party wishes to change the existing service or the charges for the existing service.

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<sup>23</sup> Ibid.

- The existing Rules relating to a *TNSP's* negotiating framework are predicated on the presumption that the *Transmission Network User* is seeking a service from the *TNSP*.<sup>5</sup> However, if negotiation is required as a result of an asset replacement, it is the *TNSP* that will be approaching the network user in order to provide 'new' *negotiated transmission services*. The *TNSPs'* existing negotiating frameworks do not contemplate this situation.
- Network users and *TNSPs* may be required to engage in multiple renegotiations in respect of the same entry service or exit service as connection assets are replaced over time.

Grid Australia has stated that there is a clear and practical need for the AEMC to examine clause 11.6.11 more broadly in light of the NGF Rule change proposal and its own submission. In any event, Grid Australia considers that the proposal put by the NGF is not the only, or the preferred, means of dealing with the issues identified by the NGF.

The Grid Australia supplementary submission proposes an alternative to the Rule proposal. It aims to address broader issues not covered by the NGF proposal. Grid Australia has outlined a number of clear principles which it submits should underpin any redrafting of clause 11.6.11.<sup>24</sup> The most important of those principles are:

- *negotiated transmission services* can only arise through a process of negotiation; and cannot be deemed to exist between a *TNSP* and *Transmission Network User* under the Rules; and
- *connection services* can be provided at a connection point on a 'divisible' basis, and hence multiple or separate services could be provided.

Grid Australia's proposal is to replace clause 11.6.11 in its entirety with a clause of a simpler structure to that proposed by the NGF. In general terms, the new clause 11.6.11 would 'grandfather' as *prescribed transmission services, connection services* (called 'prescribed connection services') provided by a defined group of transmission system assets (called 'eligible assets'). The new clause would also deal with how the general provisions in Chapter 6A apply to prescribed connection services. The grandfathering of services as *prescribed transmission services* would cease on expiry or termination of an existing *connection agreement*.

#### 4.3.2 NGF response to Grid Australia

In response to the Grid Australia alternative, the NGF has commented that:

- it does not agree that a connection service which is provided by an existing or committed eligible asset should cease to be treated as a *prescribed transmission service* on the basis that the service is provided under a *connection agreement* that is entered into after the commencement date;

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<sup>24</sup> Grid Australia supplementary submission, 9 July 2008, pp.6-7.

- *connection agreements* are a contractual matter between parties, and hence are expected to differ widely as to their terms, coverage, history and duration;
- it is of the view that clause 11.6.11 of the Rules is intended to grandfather connection services provided by such assets for the life of those assets, irrespective of the term of any *connection agreement* pursuant to which the TNSP provides *connection services* to the relevant *transmission network user*; and
- the alternative Rule drafting put forward by Grid Australia would result in existing *connection services* prematurely ceasing to be grandfathered, and would leave affected connected parties (entry or exit services) exposed to unjustified prices increases. On this basis, the use of *connection agreements* as a grandfathering termination trigger is inappropriate and inconsistent with the NGF's original objectives of avoiding price shocks and promoting regulatory certainty.

#### 4.4 Commission's analysis of the issues

The Commission has given careful consideration to the matters raised by the NGF and Grid Australia. The Commission recognises that there needs to be greater clarity about the meaning of the grandfathering provisions to improve their application and workability in a manner consistent with the regulatory objectives in the Revenue Rule.

This section comments on the key issues relevant to the Rule proposal and assesses the possible solutions to the grandfathering provisions of clause 11.6.11.

##### 4.4.1 Meaning and operation of the grandfathering provisions

Clause 11.6.11 provides:

*11.6.11 Transition to new Chapter 6A: existing prescribed transmission services*

*(a) References to prescribed transmission services in the new Chapter 6A include a service provided by an asset used in connection with, or committed to be constructed for use in connection with, a transmission system as at 9 February 2006:*

*(1) to the extent that the value of the asset is included in the regulatory asset base for that transmission system under an existing revenue determination in force at that time; or*

*(2) if the price for that service has not been negotiated under a negotiating framework established pursuant to old clause 6.5.9, and, but for this clause, that service would not otherwise be a prescribed transmission service.*

*(b) Where a service is a prescribed transmission service by virtue of the operation of this clause, that service is taken not to be a negotiated transmission service.*

*(c) For the purposes of this clause 11.6.11, an asset is, and is only, to be taken to be committed to be constructed if it satisfies the*

*criteria which a project needs to satisfy to be a “committed project” for the purposes of the regulatory test.*

The Commission considers that, in its current form, clause 11.6.11 provides for the assets to be grandfathered rather than the particular services provided by the assets at 9 February 2006. On this basis grandfathering ends on replacement, but not on reconfiguration, of assets.

In the case of asset reconfigurations, the assets are the same and remain in the RAB. Therefore the status of transmission services does not change from *prescribed transmission service* to *negotiated transmission service*. The Commission acknowledges that this is contrary to the NGF’s interpretation. Further, the AER can only remove the value of the assets out of the RAB at a reset if a number of criteria are met. These criteria include:

- the asset is no longer contributing to the provision of prescribed services. This is not met if the services from those assets are deemed to be providing prescribed services (as in the case of reconfigurations); and
- the value of the assets or group of assets exceeds \$10 million (indexed).<sup>25</sup>

The Commission notes that while it is possible to define triggers and timing to end grandfathering, there are three significant impediments to the *TNSP* recovering costs from the relevant user as charges for *negotiated transmission services* once grandfathering ends. They are:

- *operation of existing connection agreements*: While each contract is different, the Commission understands that there is a substantial risk that *TNSPs* do not have a contractual right to adjust charges to reflect a change in the nature or cost of the services being provided by an asset under their existing *connection agreements* with users. From discussions with *TNSPs*, it is understood that *connection agreements* are generally long term arrangements under which *transmission network users* agree to pay *TNSPs* a specific sum for dedicated connection assets. There may be little scope for new assets being unilaterally allocated to this category by the *TNSP*.
- *Cost Allocation Principles*: These principles provide that costs allocated to *prescribed transmission services* cannot be reallocated to *negotiated transmission services*.<sup>26</sup> Therefore in the event of a reconfiguration, costs could not be allocated

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<sup>25</sup> Schedule 6A.2.3 of the Rules sets out provisions for the removal of assets from the regulatory asset base. Under S6A.2.3, the Commission intended to provide *TNSPs* with an incentive to enter into commercial negotiations with large network users to manage any risk of by-pass or disconnection by large network users. In the event that a *TNSP* does not meet the conditions under S6A.2.3 then the AER can determine to remove the value of the assets from the RAB.

<sup>26</sup> Clause 6A.19.2(7) prevents costs which have been allocated to *prescribed transmission services* being reallocated to *negotiated transmission services*. The Commission’s policy intent in adopting this approach was to avoid potential for *TNSPs* ‘double-dipping’ by recovering certain costs from both *prescribed* and *negotiated transmission services*.

in this way. The Commission acknowledges that this would prevent the outcome intended by the Commission as stated in the Revenue Determination.<sup>27</sup>

- access framework: The ability and practicality of a *TNSP* initiated negotiation for new services or charges with existing users is limited because the access framework in the Rules is user focussed. The access provisions in Chapter 5 of the Rules do not envisage the *TNSP* driving the negotiation process. The Commission accepts that it is difficult to see that a *Transmission Network User* can be compelled, at least as a matter of law, to accept a change proposed by the *TNSP*.

The Commission has concluded that the approach to grandfathering assets adopted in clause 11.6.11 does not work in the manner that was intended. As a result the Commission considers that other approaches to grandfathering should be explored with a view to adopting a workable and practical approach that will meet the regulatory objectives set out in the Revenue Determination.

#### **4.4.2 Rationale for the grandfathering provisions**

To address the concerns raised about the meaning and application of the existing grandfathering provisions it is necessary to revisit the objectives and principles adopted by the Commission in its review of the economic regulation of transmission services as set out in the Revenue Determination. These are discussed in turn below.

##### **4.4.2.1 Objectives and principles**

A central principle was to design a regulatory framework that would facilitate the efficient investment in and operation of transmission services and promote competition and efficiency in the electricity market. The Commission sought to create a regulatory framework that would provide strong incentives for *TNSPs* to provide transmission services in line with the needs of network users and for the long term benefit of consumers. The intention was to develop an approach that regulates transmission services rather than the assets providing those services. The Commission also intended to adopt an approach that was consistent with the work of the Expert Panel on Energy Access Pricing.

A fundamental tenet of regulatory economic policy is that effective competition is the most efficient approach to the provision of services. Economic regulation is an imperfect substitute for effective competition and should be considered only as a last resort where effective or workable competition is not occurring. This thinking formed a key plank of the Commission's approach in developing Chapter 6A of the Rules. Accordingly, the Commission's approach was to base the form and scope of regulation on the economic characteristics of transmission services affecting the potential extent of market power:

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<sup>27</sup> This issue does not arise on replacement as the assets are new and their costs have not strictly been allocated to *prescribed transmission services* in the past.

- transmission services supplied under monopoly (or near monopoly) conditions should be subject to forms of economic regulation such as revenue or price cap regulation. Under these conditions economic regulation can be an appropriate means of providing network operators with incentives for efficient investment; and operation of the infrastructure while also providing incentives to limit the costs and inefficiencies that may arise from the exercise of market power.
- transmission services supplied under conditions where the service provider operates where there is limited market power or the potential for competitive supply should be subject to forms of regulation such as a negotiate-arbitrate approach, if at all.

The Commission identified the need to provide greater clarity regarding the type of transmission services that should be subject to a more intrusive form of regulation and those that should be subject to a less intrusive form of regulation. Of particular concern to the Commission was that there was a lack of clarity on this matter under the old Rules which led to an over-inclusion of services in the revenue cap. As a result, the TUOS charges paid by consumers may have included the cost of services that did not contribute to the services provided by the shared network. In addition, market outcomes could be distorted by crowding out the opportunities for the competitive supply of services.

#### **4.4.2.2 Scope of regulation**

In identifying services based on their economic characteristics, the Commission adopted a tiered approach to the regulation of transmission services which sought to ensure that the form of regulation applied to different classes of service was commensurate with the degree of market power involved in their supply.

The Commission stated that transmission services supplied by the shared transmission network are generally provided under natural monopoly conditions. That is, due to the large capital investment costs, low incremental operating costs and network externalities that are involved, transmission services tend to be supplied more efficiently by a single service provider rather than two or more. However, the absence of competitive pressure from rivals introduces the potential for market failure due to the capacity of a *TNSP* to exercise its market power. Service provided by these monopoly assets are *prescribed transmission services*.

Some transmission services such as services dedicated to or requested by specific parties which are characterised by either a lack of homogeneity, limited market power, or material countervailing buyer power. These services create fewer market failure concerns. In addition, the end users for these services are likely to be large and well resourced. These are *negotiated transmission services*.

Providing a framework where generators and other large end users to negotiate with *TNSPs* about the recovery of costs directly related to their connection will ensure that the costs are subject to scrutiny by a well informed and commercially interested counterparty. This should encourage the *TNSP* to incur only efficient costs in providing connection services. Therefore the scope for the *TNSP* to exercise market power is considerably reduced relative to the supply of *prescribed transmission*

*services*. As a result, such services do not require extensive regulation. Connection services fall into this category.

The regime also provides for regulatory oversight of cost allocation between different categories of services. Over time, assets will only be rolled into the RAB when the costs of those services are appropriately allocated to *prescribed transmission services* in accordance with the *Cost Allocation Principles*.

#### **4.4.2.3 Form of regulation**

As discussed above, the form of regulation that is appropriate for a particular service, should correspond to the degree of market power exhibited in the provision of that service.

For *prescribed transmission services*, the Commission determined that the regulator must use a CPI-X revenue cap form of price control with the maximum allowable revenue determined under the building block methodology. This is an intrusive or heavy-handed form of regulation.

For *negotiated transmission services*, where there are fewer market failure concerns, the Commission considered that a commercial negotiation and arbitration regime was a more appropriate. Should negotiations between access providers and access seekers fail, an arbitrator would review the basis of the dispute and make a decision on the price and related terms and conditions to be applied.

#### **4.4.2.4 Transitional arrangements**

Under the Revenue Rule, the Commission intended for *connection services* to be classed as *negotiated transmission services*. However, in order to minimise disruption to arrangements at that time, the Commission recognised the need to provide transitional arrangements that grandfathered existing *connection services* as *prescribed transmission services*. The provisions in clause 11.6.11 allowed for the grandfathering of TNSP assets used to provide connection services under long term contracts by TNSPs where those assets had traditionally been incorporated into the RAB.

Without the grandfathering clause, connection services provided by assets that existed at the commencement of the Revenue Rule would have been treated as *negotiated transmission services* rather than *prescribed transmission services*.

To avoid this the Revenue Determination stated that it would be appropriate for any replacement or reconfiguration of a connection asset, grandfathered as providing prescribed services in accordance with clause 11.6.11 of the Revenue Rule, be treated as a *negotiated transmission service* asset.

It is important to note that in establishing this provision, the Commission did not intend that grandfathering be permanent. It was formed as a transitional measure only. The reconfiguration and replacement of assets was clearly intended to end the grandfathering of prescribed connection assets.

A key aspect of the Revenue and Pricing Rules was for *negotiated transmission services* (*connection services*) to be subject to a commercial negotiation and arbitration regime (rather than form part of the maximum allowable revenue). The Commission's objective in relation to the grandfathering provision was for *connection services*, over time, to be transitioned from a revenue determination to a negotiate-arbitrate framework.

#### **4.4.3 Criteria for evaluating the options for grandfathering**

On the basis of these principles, and the fact that clause 11.6.11, in its current form, poses consequential issues, the next step is to consider possible options for improving the operation of the grandfathering provisions.

In order to assess the alternative options for grandfathering provisions the Commission has developed a set of criteria. These criteria are based upon achieving the Commission's intentions in regulating transmission services, as summarised above, while recognising commercial arrangements between *TNSPs* and *transmission network users* and the need for certainty and clarity. The assessment criteria are:

- provide a clear and practical trigger to end the grandfathering provisions to facilitate transitioning of 'prescribed connection services' to *negotiated transmission services*; and
- allow for fair and reasonable transitioning with respect to the existing commercial and legal arrangements between *TNSPs* and *Transmission Network Users*.

These criteria will be used to assess the Rule proposal and other identified options to clarify the interpretation and operation of the grandfathering provisions in clause 11.6.11.

#### **4.4.4 Assessment of grandfathering options**

The Commission has identified three options based on grandfathering connection services (rather than assets used to provide those services, as is currently the case) as *prescribed transmission services* to address the issues raised.

The description of each option highlights what is being grandfathered and what, if anything, triggers the end of grandfathering. Each discussion also includes a consideration of the impact of asset reconfigurations and replacement.

Each option has been assessed against the criteria identified above.

## Option 1: NGF services approach

The key features of the NGF services option are:

- Grandfather as *prescribed transmission services* the services provided at 16 November 2006 by existing and committed assets as at 9 February 2006 (2006 Assets).
- Provide that reconfiguration may lead to assets providing *negotiated transmission services* and therefore an end to grandfathering.
- The costs of the new services cannot be allocated to *negotiated transmission services* because of the *Cost Allocation Principle*. In this case the services would continue, in effect, to be treated as *prescribed transmission services* as the price to be paid is not negotiated.

### Comment

The NGF services option is not consistent with the policy intent of the Commission because:

- It does not provide for a transition of services to *negotiated transmission services* and therefore, a removal assets from the RAB. The NGF's approach is aimed at maintaining the grandfathering of prescribed connection services indefinitely. This option provides that any new services arising from a reconfiguration would be *negotiated transmission services* – although the costs of these services would be reallocated to the *shared transmission services (prescribed transmission services)*. This outcome is inconsistent with the regulatory framework adopted in Chapter 6A.
- It does not acknowledge the existence of *connection agreements* and therefore does not provide an approach for dealing with them.
- It does not provide a clear trigger for the end of grandfathering. Under this approach it appears that a replacement of assets does end grandfathering. However, this issue is not considered by the NG and so uncertainty remains and the , the consequences are not explained.

## Option 2: Grid Australia services approach

The key features of the Grid Australia option are:

- Grandfathers connection services, called 'prescribed connection services', provided by a defined group of transmission system assets called 'eligible assets'.
- A 'prescribed connection service' must be provided under a *connection agreement* which was first entered into before the commencement date (prior to the new Chapter 6A).
- *Connection services* provided by a *TNSP* at a connection point are to be regarded as 'divisible' services. Where an improvement or increase in service occurs as the request of the *Transmission Network User* the required higher capability is outside

the concept of replacement. The service required to provide the additional or higher capability is to be regarded as a request for a *negotiated transmission service*. The higher capability would be treated as a 'divisible connection service'.

- The effect of using the divisible services concept is that it is possible to have a grandfathered *connection service* (a 'prescribed connection service') and another non-grandfathered (a 'negotiated connection service' or a 'non-regulated transmission service') being provided at the same connection point.
- An existing service would remain a 'prescribed connection service' even if some of all of the eligible assets which are used to provide the 'prescribed connection services' are replaced on a like for like basis.
- Reconfiguration of assets would not end grandfathering but the proposal limits the assets which can be attributed to 'prescribed connection services' by allocating any shortfall in costs to another sub-category of prescribed transmission services.
- The expiry of a *connection agreement* would trigger the end of grandfathering of a *connection service*.

#### Comment

This option meets the criteria to a greater extent than the NGF option (option 1) because:

- It provides for a transition of services to *negotiated transmission services* and therefore, a removal of assets out of the RAB. It is consistent with the intention that grandfathering was to be a transitional measure. The divisibility of services approach will result in transitioning over a longer period of time than option 3 below.
- It acknowledges the existence of *connection agreements* and provides for the creation of *negotiated transmission services* in a context where there is a true negotiation between the parties.
- It provides a clear trigger for the end of grandfathering, being the expiry or termination of an existing *connection agreement* providing 'prescribed connection services'. Following expiry or termination, any further connection services would be negotiated and occur either as *negotiated transmission services* or as *non-regulated transmission services*.

This option differs from the position under the existing clause 11.6.11 (as it has reportedly been interpreted by the AER) because it will allow an existing *connection service* to remain as a 'prescribed connection service' even if some or all of the existing assets (or committed assets) are later replaced on a like-for-like basis.

However, where the customer has requested a service additional to the existing service then the divisibility provision would apply. The existing service would remain as a *prescribed transmission service* but the additional service would be a *negotiated transmission service*.

The use of the divisibility of services concept may cloud the distinction between *prescribed transmission services* and *negotiated transmission services* which are effectively the same service. While possible in theory, it is questionable whether this approach would be consistent with the definition of *negotiated transmission services* which includes *shared transmission services* which exceed regulatory requirements. The definition suggests that *negotiated transmission services* constitute one service while the concept of divisibility contemplates that part of the service meeting the standard is a *prescribed transmission service* while the excess is a *negotiated transmission service*. This conceptual complexity of option 2 may lead to variations in its interpretation that may cause unintended consequences in its implementation.

The Commission notes that the NGF does not support the use of *connection agreements* to end grandfathering provisions. It has argued that the use of *connection agreements* is an arbitrary approach. In the Commission's view the NGF's objections are based on its assumption, and preferred view, that grandfathering of prescribed connection services should continue indefinitely.

### **Option 3: Alternative services option**

Option 3 is based on the Grid Australia option. It amends option 2 with the aim of reducing its complexity. The key features of option 3 are:

- The creates of a category of 'prescribed connection services' being, the services provided:
  - under a *connection agreement*; and
  - by defined *transmission system assets* ('eligible assets').
- Grandfathers as *prescribed transmission services* the new category of 'prescribed connection services'.
- A 'prescribed connection service' must be provided under a *connection agreement* which was first entered into before the commencement date (prior to the new Chapter 6A).
- An existing service would remain as a 'prescribed connection service' even if some of all of the eligible assets which are used to provide the 'prescribed connection services' are replaced on a like for like basis. Reconfiguration of assets would not end the grandfathering of the service while an existing *connection agreement* is in force and the reconfiguration is not as a result of a request by the customer.
- The expiry of the *connection agreement* will trigger the end of grandfathering of the *connection service*. Extensions of such an agreement on the same terms and conditions beyond the existing term would not be considered an expiry of an agreement. In such cases the grandfathering would continue.
- A customer initiated change to a *connection service* requiring negotiation of new or additional services under an existing *connection agreement* would also constitute

an end to grandfathering of the total service (this is a variant from option 2). The amended service would be treated as request for a *negotiated transmission service*.

#### Comment

Of the three options presented, option 3 is the most consistent with the criteria established previously (see section 4.4.3 of this chapter). This is because:

- It provides for a transition of services to *negotiated transmission services* and therefore, a removal of assets out of the RAB, acknowledging the intention that grandfathering was to be a transitional measure. The transition would occur over a shorter period of time than option 2 as grandfathering of the total service would end when the *Transmission Network User* seeks an amended service.
- It acknowledges existence of *connection agreements*. It provides for the creation of *negotiated transmission services* in a context where there is a true negotiation between the parties.
- It provides a clear trigger for the end of grandfathering, being the on expiry or termination of an existing *connection agreement* providing ‘prescribed connection services’.

The Commission considers that this approach is simpler than the Grid Australia option (option 2) because the concept of divisibility of connection is not required.

Incidental changes to the Rules would be required to implement this approach. This includes permitting the removal of assets from the RAB and some relaxation of the *Cost Allocation Principles* to enable reallocation of costs from *prescribed transmission services* to *negotiated transmission services*. The Commission does not consider these incidental changes as problematic.

#### 4.4.5 Commission’s preferred approach

The current grandfathering provisions in the Rules are open to interpretation and have been found to be impractical in their application. The Commission agrees that there is a substantial case for amending clause 11.6.11 to improve its workability as, in its current form, it does not accommodate the legal impediments created by the existence of *connection agreements*. Further, the operation of the clause is inconsistent with the user focused access arrangements in the Rules. There is also an inconsistency with the *Cost Allocation Principles* which preclude costs from *prescribed transmission services* assets being be reallocated to *negotiated transmission services*.

The Commission acknowledges that NGF’s concerns and understands its approach to address its concerns surrounding clause 11.6.11. However, the Commission’s assessment, as noted above, is that the NGF’s approach is not consistent with the policy intent of the grandfathering provisions. Therefore the Commission does not regard option 1 as its preferred solution to this matter.

Grid Australia's proposal (option 2) to use the expiry of *connection agreement* presents a workable and logical approach to trigger the end of grandfathering. The expiry of a *connection agreement* would, in any event, trigger fresh negotiations between the TNSP and connected user. This seems to be a suitable time for new services to transitioned from *prescribed* to *negotiated transmission services*.

This option does address the practical limitations relating to existing *connection agreements*, frequent negotiations, and defining a precise point when grandfathering would cease, which exist under clause 11.6.11 as it is currently drafted as well as Option 1.

These features make option 2 preferable to option 1. However, the divisibility aspect of Grid Australia's option appears to be complex and could be problematic to implement. For this reason, the Commission does not consider option 2 as its preferred option.

In the Commission's opinion, option 3 has all the advantages of option 2. However, it also provides for a *Transmission Network User* initiated change to the service to be a trigger for the end of grandfathering in addition to the expiry or termination of *connection agreements*. In this regard, option 3 presents a clearer and more workable solution than option 2. Option 3 is also consistent with the principles adopted by the Commission in the Revenue Determination (subject to incidental changes being made).

The Commission understands that some *connection agreements* do not have defined terms and may continue to exist in perpetuity. In this regard the services to be provided under these agreements will continue to be grandfathered as *prescribed transmission services* on an ongoing basis. However, it is feasible that in the future the *transmission network users* who are parties to these agreements will request an amended service. When this occurs the grandfathering of the *connection service* will end. Nevertheless, the existence of these *connection agreements* do not, in the Commission's view, mean that expiry or termination of a *connection agreement* should not be a trigger for the end of grandfathering.

On balance, the Commission has concluded that option 3 is consistent with, and meets, the policy objectives of grandfathering. Option 3 is the Commission's preferred approach to address the NGF's concerns in its Rule proposal.

#### **4.4.6 National Electricity Objective**

The Draft Rule implements Option 3. The Commission is of the view that the Draft Rule meets the NEO with respect to efficiency and good regulatory design.

Regarding efficiency, the Commission considers that the Draft Rule:

- allows for a transitioning of connection services from *prescribed transmission services* to *negotiated transmission services* and thereby narrowing over time the scope of intrusive regulation applying to transmission services;

- allows more commercial negotiation and risks to be transferred to the parties best able to manage those risks;
- offers a clear trigger to allow services provided in circumstances where the *TNSP* has less market power move out of revenue determinations and to be subject to the less intrusive negotiate/arbitrate form of regulation; and
- allows for better allocation of costs, in that, assets for dedicated *negotiated transmission services* would not be paid for by the shared network.

In terms of good regulatory design, the Draft Rule:

- creates consistency and better interaction within the Rules in relation to grandfathering;
- clarifies the current ambiguity in the grandfathering provisions;
- improves the workability and implementation of the grandfathering provisions;
- enhances regulatory certainty and transparency for all parties involved; and
- recognises the existing *connection agreements* established under Rule 5.3.

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## 5 Cost allocation arrangements, removal of assets from the RAB and ring-fencing

This chapter addresses issues raised by the NGF relating to cost allocation arrangements for *prescribed transmission services*, removal of assets from the RAB and the *Transmission Ring-Fencing Guidelines*.

The Commission's consideration of the NGF's issues on cost allocation arrangements and the removal of assets from the RAB are predicated on the clarification of the meaning and operation of the grandfathering provisions in clause 11.6.11 of the Rules, as set out in chapter 4.

### 5.1 Cost allocation arrangements

#### 5.1.1 Issues raised by the NGF

The NGF is concerned about the impact of the *Cost Allocation Principles* in clause 6A.19.2 and the *Pricing Principles for Prescribed Transmission Services (Pricing Principles)* in rule 6A.23. In particular, the NGF is concerned about how these provisions apply to the *connection services* grandfathered under clause 11.6.11 of the Rules in the event of a reconfiguration of assets.

The NGF's preferred interpretation of clause 11.6.11 is that only *entry services* and *exit services* provided by a 'grandfathered' asset as at 16 November 2006 are to be treated as *prescribed entry services* and *prescribed exit services* for the life of the asset. On this basis, the NGF has raised two issues in relation to the cost allocation:

1. existing *connection services* may be subject to inefficient cost reallocation from historically shared assets; and
2. there is a lack of consistency in terms of cost allocation between new and existing *connection services*.<sup>28</sup>

These issues are discussed in turn below.

##### 5.1.1.1 Cost reallocation from historically shared assets

The NGF supports the *Cost Allocation Principles* as, in its view, they are aimed at preventing 'inefficient' cost shifting from historically shared assets to dedicated new generator connection assets. The NGF is concerned that costs from historically shared assets can be shifted to generator (connection) assets that existed prior to 9 February 2006 as they form part of the RAB and are therefore grandfathered as *prescribed transmission services*. That is because a *TNSP's* costs are now allocated to each category of *prescribed transmission service* in accordance with the attributable cost

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<sup>28</sup> Rule proposal p.6.

share over time. Within the categories of *prescribed transmission services*, costs from historically shared assets can be reallocated to *connection services* grandfathered under clause 11.6.11.

According to the NGF, some generators (and network users) face the threat of increases in connection charges due to changes in the shared network beyond their control. In the case of generation, the NGF asserts that other (new) generators are protected from this risk. The two main outcomes from this are:

- Certain generators will face price shocks even though there is no efficiency gain. That is, the generator's placement decision has been made and hence there is no efficiency gain from imposing increased costs and pricing signals to these "sunk" investments.<sup>29</sup>
- The market setting will be one of regulatory uncertainty, as there could be a material increase in generator connection charges. This uncertainty could result in investors requiring higher returns. The additional costs resulting from this can increase the barriers to entry and will also have a detrimental impact on productive efficiency. Furthermore, due to the additional uncertainty for generators relating to network reconfiguration – a risk not faced by other market participants - the productive efficiency of the generation sector of the market is more affected.<sup>30</sup>

#### **5.1.1.2 Lack of consistency between new and existing connection services**

According to the NGF, the reallocation of costs described above means that existing generators can face locational pricing signals which they do not have the ability to respond to, and which are the result of a decision made in different regulatory circumstances. The NGF believes that this situation is inequitable and engenders a degree of regulatory uncertainty. The NGF depicts three different situations that in its view can lead to inefficient outcomes according to the current Rules.<sup>31</sup>

#### **5.1.2 Description of NGF's Rule proposal**

To address these issues the NGF proposes a Rule which specifically preserves the cost allocation methodology in respect of grandfathered entry services that applied

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<sup>29</sup> Rule proposal, p.7.

<sup>30</sup> Ibid.

<sup>31</sup> Rule proposal pp.8-10. The NGF considers that assets that provided TUOS services under the old Chapter 6 could under the new Chapter 6A now be attributed to providing TUoS services and some entry services. In the event of a network reconfiguration (undertaken for the benefit of the shared network), it would be possible for a large set of assets that once provided services to shared network and connection services to be reallocated to providing connection services only. For instance, where load has been shifted from a substation to another substation, a large set of assets could be characterised as providing connection services. And also, where two large network users are charged for connection (exit) services and one of these network users shuts down or leaves, the remaining user would be charged for an extended exit service as a result of this event (which was beyond its control).

immediately prior to the commencement of Chapter 6A of the Rules.<sup>32</sup> The proposed Rule limits the costs of assets that may be allocated to *prescribed entry services* or *prescribed exit services* to the costs of the assets which were fully dedicated to the provision of those services at the connection point on 16 November 2006.

According to the NGF, this limitation will maintain:

... the initial cost allocation position under the old Part C and schedule 6.2 of old Chapter 6 in that only fully dedicated assets could be classified as entry assets for which the costs were recoverable through entry service charges. In this way, the proposed Rule will ensure that a generator's attributable cost share can not in future contain costs relating to assets that previously were considered to be providing prescribed TUOS services and hence were shared between Transmission Customers, as a consequence of developments on the network not triggered by the generator.<sup>33</sup>

A consequential change is also proposed by the NGF to ensure that the TNSP is still able to recover its full *aggregate annual revenue requirement (AARR)* from *Transmission Network Users*. Any portion of the AARR that would have been allocated to *entry services* but for the limit described above will remain allocated first to *prescribed TUOS services* (up to the stand-alone amount) and second to *prescribed common transmission services*. Consequently, the TNSP will not suffer any revenue shortfall.<sup>34</sup>

The NGF Rule proposal is seeking to maintain the market position for 'prescribed connection services' prior to the introduction of the Revenue Rule in 2006 while preserving the operation of the new priority ordering approach. This, it says, will improve certainty.

The NGF states that, if implemented, the Rule proposal will ensure that costs:

- allocated to *prescribed entry services* remain consistent and stable over time, thereby avoiding any unforeseen price shocks; and
- remaining after the cost allocation process (as a consequence of the limit on costs which may be allocated to *prescribed entry services*) are allocated to *prescribed TUOS services* and *prescribed common transmission services* to ensure that no revenue shortfall occurs for the TNSP.<sup>35</sup>

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<sup>32</sup> Rule proposal, p.3.

<sup>33</sup> Rule proposal, pp.3-4.

<sup>34</sup> Rule proposal, p.4.

<sup>35</sup> The NGF's proposal is made in conjunction with its proposals for clarifying clause 11.6.11 of the Rules. See NGF Rule proposal p.12.

### 5.1.3 Submissions

#### Energy Users Association of Australia

The EUAA believes that the NGF's Rule proposal shifts the risk of network reconfiguration affecting existing generators away from those generators and onto electricity users. It does not consider this to be appropriate because the assets may not be contributing to shared network services.<sup>36</sup>

The EUAA is also concerned that new generators will be at a disadvantage relative to existing generators. The EUAA does not regard this as a regulatory uncertainty issue. It acknowledges that network connection charges change over time and connection versus shared network definitions adapt over time.

#### Major Energy Users Group

The MEU considers that there has to be equity between the costs incurred by current asset users and the costs a new entrant user will have to pay for the same service.<sup>37</sup> It asserts that there has to be equity between users of the same assets. Where entry and/or exit services utilise assets that are used by a number of different users, the cost of providing the service should be shared in proportion to the use each user derives from the service, and between users of the same assets.

The MEU does not believe that aiming to avoid price shocks as suggested by the NGF justifies an inequitable allocation of costs. It does not agree with allowing an existing user of the network to incur a lower cost than it would otherwise simply because certain cost elements of the network service are embedded in another element of the network cost structure should not be permitted.

#### Grid Australia

In its first submission, Grid Australia explains that another way to resolve the NGF's cost allocation issue is to amend the *Pricing Principles* to provide that costs which have been allocated to 'shared' categories of prescribed transmission services must not be reallocated to prescribed entry services and prescribed exit services. Grid Australia suggests that clause 6A.19.2(7) was originally intended to address the type of issue raised by the NGF but does not do so because the clause does not apply to the allocation of costs between shared transmission services and prescribed entry services and prescribed exit services under Part J of the Rules.<sup>38</sup>

In its supplementary submission Grid Australia stated that it does not support the NGF's Rule proposal to the extent that it 'grandfathers' a cost position in relation to the costs which may be allocated to deemed prescribed transmission services for the

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<sup>36</sup> EUAA submission, 30 April 2008.

<sup>37</sup> MEU submission, 16 May 2008, p.1.

<sup>38</sup> Grid Australia submission, 2 May 2008, pp.6-7.

purposes of Chapter 6A so as to preserve the position which previously applied under old Chapter 6 of the Rules.<sup>39</sup>

It considers that the consequence of 'locking in', under clause 11.6.11, a specific cost allocation for the purpose of Chapter 6A of the Rules would result in a relevant *Transmission Network User* being protected from the ordinary changes in the level of charges for the service which result from changes in the *AARR* of the *TNSP* under its *revenue determination* from time to time.

Rather, in Grid Australia's view, what is required in clause 11.6.11 is a provision which specifies the extent of the *transmission system* assets which are to be regarded as attributable to, or used in, the provision of 'prescribed connection services'.

Grid Australia's approach proposes to ensure that all costs attributable to *prescribed transmission services* are allocated amongst the various sub-categories of *prescribed transmission services*. As a result no amount is unallocated due to the fact that clause 11.6.11 defines 'prescribed connection services' only in terms of 'eligible assets' and limits the assets which may be attributable to the provision of 'prescribed connection services' for the purposes of Chapter 6A to those eligible assets. Any shortfall in costs which would have been attributed under the provisions of Chapter 6A to 'prescribed connection services' (that is, *prescribed entry services* and *prescribed exit services*) will instead be allocated to *prescribed TUOS services*.<sup>40</sup>

#### **NGF response the Grid Australia supplementary submission**

The NGF suggested some changes to Grid Australia's approach to cost allocation arrangements. In the NGF's view clause 11.6.11(c)(1) of Grid Australia alternative drafting of the Rule should deal with the costs attributable to eligible assets just as clause 11.6.11(c)(2) deals with the costs attributable to assets that are not eligible assets. In this regard the NGF notes that the National Electricity Rules generally deal with the concept of 'costs' rather than 'assets' being directly attributable to the provision of services.<sup>41</sup>

#### **5.1.4 Commission's analysis of the issues**

The concerns raised by the NGF can be recast into two key issues:

- cost reallocation within *categories of prescribed transmission services*; and
- effects of *revenue determinations* on grandfathered prescribed connection services.

These are discussed in turn below.

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<sup>39</sup> Ibid, p.18.

<sup>40</sup> Grid Australia supplementary submission, 9 July 2008, p.17.

<sup>41</sup> NGF submission, 18 July 2008, p.3.

#### 5.1.4.1 Cost allocation between categories of prescribed connection services

There are three different aspects to the NGF' cost allocation concerns which are the shallow connections approach, reconfigurations and equity considerations.

##### Shallow connections approach

In the Pricing Determination, the Commission stated that it had substantially maintained the current approach to pricing in the (old) Rules.<sup>42</sup> A guiding principle adopted by the Commission was that the causer pays principle should be used as a guide to whether, in general, consumers or producers of electricity should contribute towards the recovery of particular costs. The Commission enunciated the view that the majority of transmission investment in the shared meshed network is undertaken to meet the reliability obligations imposed for the requirements of consumers rather than the requirements of generators to evacuate power. That is, most transmission investment is 'caused by' load rather than generation.<sup>43</sup> As a result, the principle adopted was that generators are to only pay for shallow connection as it is consumers that cause the need for network assets.<sup>44</sup>

On the basis of this principle, the Commission determined that generators should pay the costs directly resulting from their connection decisions. Accordingly, a 'shallow connection' approach was maintained in the Rules. This approach is consistent with the approach in the old Chapter 6 of the Rules. The Commission explained that the shallow connection approach to pricing for *connection services* was consistent with efficient pricing principles.<sup>45</sup>

Consistent with this approach, the Commission developed a two step approach in the *Cost Allocation Principles*. Firstly, costs are allocated on a directly attributable basis to a particular category of *prescribed transmission service*. Secondly, costs which are not directly attributable are allocated using an appropriate allocator which should, in most cases, be causation based.<sup>46</sup>

##### Reconfigurations

The Commission considers that the NGF has raised some legitimate concerns about the impact of the new cost allocation arrangements on the services grandfathered under clause 11.6.11. In particular, the NGF has identified that there may be situations where a reconfiguration caused by the needs of the shared network could lead to assets characterised as providing *connection services*. The NGF believes that, in this situation, 'prescribed connection services' may be subject to inefficient cost reallocation from historically shared assets.

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<sup>42</sup> Pricing Determination, p.3.

<sup>43</sup> Pricing Determination, p.21.

<sup>44</sup> Pricing Determination, p.23.

<sup>45</sup> Pricing Determination, p.20.

<sup>46</sup> Refer to clause 6A.19.2(3).

In situations where a generator, or large directly connected customer, (that is, a *Transmission Network User*) has not requested or caused a reconfiguration (that is, an “innocent bystander”), the Commission considers that the value of the reconfigured assets should not be allocated to ‘prescribed connection services’. This is because there is no efficiency gain from reallocating costs from the shared network to the prescribed connection services. The costs of the shared network are sunk.<sup>47</sup>

As implied in the Pricing Determination, the most efficient approach to allocating sunk costs should be to avoid potential distortion in the production and consumption of services.<sup>48</sup> That is, sunk costs should be allocated to the users whose consumption of the service will not be affected by a change in the price of the same service.

In the event of a reconfiguration of sunk assets, the shared network use (or consumption) of the network will likely be less affected than the use by *Transmission Network Users*. As a result, allocation of reconfiguration costs to the shared network will have the least distortionary impact on the utilisation of the network. Consequently, in the event of an unrequested reconfiguration, there are no economic reasons for the costs of reconfigured assets to be allocated to ‘prescribed connection services’. Instead the costs should remain allocated to *prescribed TUOS services*. The Commission considers this is the most appropriate cost allocation approach to adopt in these circumstances.

## Equity

Submissions have suggested that there should be equity between the users of the same assets and that under the NGF proposal existing generators would gain at the expense of electricity consumers.<sup>49</sup>

While sympathetic to these concerns, the Commission considers that it would also be inequitable for those parties receiving ‘prescribed connection services’ to be reallocated costs of the shared network in the event of an unrequested reconfiguration. This is especially true if there was no change in the service being provided by the TNSP. This approach is consistent with the high level causer pays principle. That is, generators and, by implication, directly connected large customers should only pay for shallow connection and not shared network costs.

As noted by the NGF, the *Cost Allocation Principles* applying to *prescribed transmission services* do not preclude the reallocation of costs from *prescribed TUOS services* and *prescribed common transmission services* to *prescribed entry services* and *prescribed exit services*. The NGF claims this is inconsistent with the Commission adopted the

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<sup>47</sup> Pricing Determination, p.2. Sunk costs are referred to as those costs that would not be recovered if the decision that caused those costs to be incurred were reversed.

<sup>48</sup> The Pricing Determination p. 24 states that “A relevant issue in designing the transmission pricing regulatory framework is therefore how best to recover these historical expenditures while minimising disincentives to the use of existing infrastructure”.

<sup>49</sup> MEU submission, 16 May 2008; EUAA submission, 7 August 2008.

principle that costs must not be reallocated from *prescribed transmission* to *negotiated transmission services* (that is, *connection services*).

Under Chapter 6A, the intention was for negotiated connection services to be charged with the costs dedicated to providing their *connection service*. Specifically, the *Cost Allocation Principles* preclude the costs of *prescribed transmission services* being reallocated to *negotiated transmission services*.<sup>50</sup> This is consistent with a marginal cost approach to pricing for services and is the basis for the shallow cost approach to pricing for connection services. Therefore, the Commission considers that, by precluding the reallocation of shared network costs to ‘prescribed connection services’, connected parties will be treated on the same basis in relation to sunk costs of the shared network.

Accordingly, on balance, the Commission considers, that, in the event of an asset reconfiguration, the costs attributed to ‘prescribed connection services’ should not be affected. Thereby, *Transmission Network Users* will be treated on the same basis in relation to sunk costs.

### **Commission’s preferred approach**

Under the Commission’s preferred approach to grandfathering, reconfigurations have no adverse impact on cost allocation because the assets attributable to the prescribed *connection services* are limited to the pre-configured connection assets. That is:

- The assets which can be attributed to providing ‘prescribed connection services’ are limited to ‘eligible assets’. That is, ‘existing assets’ or ‘replacement assets’ which were wholly and exclusively used, or committed to be used, to provide the *connection service* at 9 February 2006 or when commissioned or replaced.
- The ‘eligible asset’ category cannot increase as a result of a reconfiguration, caused by the shared network, although it can reduce.
- To the extent that ‘existing assets’, or ‘replacement assets’ are not ‘eligible assets’, their costs are allocated to *prescribed TUOS services* rather than to *prescribed entry services* or *prescribed exit services* or *negotiated transmission services*.

The Commission has concluded that this approach is the most appropriate. It will provide greater certainty to the existing *Transmission Network Users* because it adheres to a shallow connection pricing approach. This approach is also consistent with the arrangements under the old Chapter 6 of the Rules.

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<sup>50</sup> Clause 6A.19.2(7).

#### **5.1.4.2 Impact of revenue determinations on costs for grandfathered connection services**

The Commission understands that the NGF's Rule proposal would preclude the application of the pricing arrangements in Chapter 6A to the grandfathered prescribed connection services. One of the consequences of this proposal is to preclude the ordinary changes in the level of charges for the service which result from changes in the AARR of the TNSP under its revenue determination from applying to the grandfathered prescribed connection services.

As a result, the NGF proposal is not consistent with the Commission's intention in relation pricing arrangements for grandfathered 'prescribed connection services'. The cost allocation arrangements and pricing principles for prescribed transmission services, as set out above, are based on allocating costs of the AARR. This demonstrates that the Commission intended that charges for *prescribed transmission services*, including *connection services*, to be subject to the outcome of revenue determinations for TNSPs.

In considering the issues raised by the NGF, the Commission concurs with the views expressed in submissions that the NGF's proposal would not be equitable. Users of 'prescribed connection services' should be subject to regulatory changes in charges and prices like other users of the *prescribed transmission services*.

Overall, the Commission considers that the Draft Rule provides greater clarity on the workings of the *Cost Allocation Principles* in the event of a reconfiguration of the assets providing prescribed shared network services. The Commission's consideration has balanced the principles of economic pricing, equity and regulatory certainty. The Commission acknowledges the NGF's concerns about cost allocation in the case of asset reconfigurations but has not, on balance, decided to adopt its proposed approach to address these issues.

#### **5.1.5 National Electricity Objective**

The Draft Rule provides:

- for a definition of eligible assets which is limited and, accordingly, addresses the NGF's concerns about the impact of an asset reconfiguration on cost allocation; and
- that, for the purposes of new Chapter 6A the *transmission system* assets that from time to time may be treated as:
  - (i) directly attributable to the provision of a prescribed connection service; or
  - (ii) used in providing a prescribed connection service,

are limited to the eligible assets which under this clause 11.6.11 are attributed, from time to time, to the provision of the prescribed connection service.

The Draft Rule meets the requirements of the NEO as it will:

- Promote efficiency for the pricing of grandfathered *prescribed transmission services*. The Commission’s decision in relation to the cost allocation arrangements is consistent with the shallow connection pricing principle and a non-distortionary approach to the allocation of sunk costs.
- Remove uncertainty. The Commission has clarified that in situations where a reconfiguration occurs that was not caused by a directly connected network user, the costs of the assets for those services should not be reallocated to prescribed connection services.
- Promote the efficient use of transmission services and enhance economic efficiency as the use of transmission services by *transmission network users* will not be affected by potential change in charges as a result of a reallocation of prescribed shared network assets to prescribed connection services.
- Provides for consistency in the treatment of existing and new *transmission network users* on the reallocation of sunk costs. The reallocation of sunk costs to ‘prescribed connection services’ is prevented. This is consistent with the treatment of new generators under the *cost allocation principles*.
- Provide for greater certainty to *transmission network users* in relation to the charges for their *connection services*. These users will not be subject to changes as a result of reconfiguration, undertaken for the benefit of the shared network.

The Commission has had regard to the revenue and pricing principles set out in the NEL. The Draft Rule is consistent with the revenue and pricing principles in that it provides *TNSPs* a reasonable opportunity to recover the efficient costs of providing *prescribed transmission services* (‘direct control network services’). The Draft Rule allows for *TNSPs* to recover their efficient costs in the event of a reconfiguration of assets. This will provide appropriate incentives for efficient investment.

## 5.2 Removal of assets from the regulatory asset base

### 5.2.1 Issues raised by NGF

The NGF supports the principle in the Rules that prevents the reallocation of costs from *prescribed transmission services* to *negotiated transmission services*. However, the NGF asserts that it is still possible for such a reallocation to occur under the Rules if assets are removed from the RAB by the AER at the time of a regulatory reset, on the basis of a unilateral reconfiguration of the *transmission system* by the *TNSP*. It considers that this result would be inconsistent with the principles adopted by the Commission in the Revenue Determination. The NGF claims that the issue of reconfiguration of assets is a relatively recent one and is likely to arise more frequently due to the aging nature of much of the network.<sup>51</sup>

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<sup>51</sup> Rule proposal, p.11.

According to the NGF, if an asset that previously provided shared transmission services becomes a dedicated connection asset, the AER would have the discretion (under clause S6A.2.3) to remove the value of that asset from the RAB (provided all other conditions for removal are also met). Once removed from the RAB, the service provided by that asset could only be characterised as a *negotiated transmission service*. The NGF claims this would leave the network user liable for the full cost of the asset. This creates investment uncertainty for generators.

In addition, the NGF has stated that shifting of costs due to the reconfiguration of assets does not align with the shift of the benefit.<sup>52</sup> That is, The service provided to the user may not change. Therefore the NGF considers that a network user could be (adversely) affected by a reconfiguration of the *transmission system* without having requested or otherwise given consent to the change.

### 5.2.2 Description of NGF's Rule proposal

The NGF's Rule proposal aims to ensure that an asset cannot be removed from the RAB as a result of a reconfiguration of the *transmission system* if the relevant *Transmission Network User* or group of users:

- has not requested or consented in writing to the reconfiguration; and
- has not unreasonably refused or failed to consent to the removal of the asset from the RAB within a reasonable time after receiving a written request for such consent from the relevant TNSP. In this situation, such a refusal or failure is deemed not to be unreasonable if that removal, and the consequent application of the TNSP's Negotiated Transmission Service Criteria, is likely to result in an increase in the charges paid by a user of more than five per cent.

Consequently, if an asset which was characterised as providing prescribed TUOS services is reconfigured so that it subsequently provides only entry services, it cannot (as a result of that reconfiguration) be removed from the RAB (and be re-characterised as providing negotiated entry services) unless the above conditions have been satisfied.

### 5.2.3 Submissions

Grid Australia considered that the NGF's proposed amendment was unnecessary when considered alongside Grid Australia's alternative proposal for the grandfathering provisions. Under Grid Australia's alternative proposal a *transmission system* reconfiguration will not give rise to a situation where assets could be removed from the RAB on the basis that a *prescribed transmission service* under clause 11.6.11 is no longer being provided.

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<sup>52</sup> Ibid, p.11.

Accordingly, Grid Australia considers that the existing provisions in clause S6A.2.3 (on the circumstances in which assets may be removed from the RAB of a TNSP) are adequate if its approach is adopted in clause 11.6.11.<sup>53</sup>

#### **5.2.4 Commissions' analysis of the issues**

As discussed in Chapter 4, the Commission is proposing to amend the grandfathering provisions to a services rather than as assets approach. Under the services approach which has been adopted in the Draft Rule, a reconfiguration of the assets does not change the status of the service from *prescribed transmission service* to *negotiated transmission service*. Therefore the problem raised by NGF could not occur. Accordingly, the Commission does not accept the NGF's Rule proposal on clause S6A.2.3.

In any event, the Commission regards the intention of clause S6A.2.3 is to provide TNSPs with an incentive to enter into negotiations with large customers. That is, it would be incumbent on the TNSP to enter into commercial negotiations regarding the management of the risk of by-pass or disconnection by large network users. In the event that a TNSP does not meet the conditions under S6A.2.3 then the AER is able to remove the value of the assets from the RAB. In this case, the TNSP bears the cost of the removal from the RAB. The Commission is satisfied that this arrangement provides the appropriate incentives to TNSPs to manage their assets.

### **5.3 Application of Transmission Ring-Fencing Guidelines to cost allocation**

#### **5.3.1 Issues raised by NGF**

The NGF has noted that one of the *Cost Allocation Principles* (in clause 6A.19.2(6)) indicates that the method of cost allocation for transmission services should be consistent with *Transmission Ring-Fencing Guidelines* issued by the AER.<sup>54</sup> The NGF also stated that the drafting of clause 6A.21.2 does not clearly distinguish the functions of those *Guidelines* from the functions of the *Cost Allocation Principles*.<sup>55</sup> The NGF believes that cost allocation between transmission services should be the exclusive province of the Rules through the *Cost Allocation Principles* rather than being dealt with in the *Transmission Ring-Fencing Guidelines*.

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<sup>53</sup> Grid Australia supplementary submission, 9 July 2008, p.8.

<sup>54</sup> Clause 6A.19.2(6) states that the principles, policies and approach used to allocate costs must be consistent with the *transmission Ring Fencing Guidelines*.

<sup>55</sup> Clause 6A.21.2(b)(1)(iii) provides that the *Transmission Ring-Fencing Guidelines* may include, but are not limited to, provisions defining the need for and extent of "allocation of costs between *prescribed transmission services* and other services provided by the *Transmission Network Service Provider*".

### 5.3.2 Description of NGF Rule proposal

The NGF's Rule proposal deletes clause 6A.19.2(6) and amends provisions in clause 6A.21.2, in order to remove the ability for the *Transmission Ring-Fencing Guidelines* to deal with the allocation of costs as between transmission services (as opposed to the allocation of costs as between transmission and other services). The NGF seeks to ensure that the allocation of costs as between the different categories of transmission services (including *prescribed transmission services* and *negotiated transmission services*) can only be in accordance with the requirements of the *Cost Allocation Principles*.

### 5.3.3 Submissions

In its initial submission, Grid Australia agreed with the NGF's observations on this issue and supports the NGF's proposed Rule change.<sup>56</sup>

However, in its supplementary submission, Grid Australia considered that it would be preferable to retain the principle and deal with the issue identified by the NGF through other changes to clause 6A.21.2. It regards the *Cost Allocation Principles* in clause 6A.19.2(6) as a fundamental component of Chapter 6A. Therefore, it would be preferable to amend clause 6A.21.2 to make it clear that the *Transmission Ring-Fencing Guidelines* cannot require allocation of costs between *prescribed transmission services* and *negotiated transmission services*, or between categories of *prescribed transmission services*, in a manner which is inconsistent with the *Cost Allocation Principles*. That is, the AER, in the making the *Transmission Ring-Fencing Guidelines*, should not be able to alter the cost allocation approach which Chapter 6A has established.<sup>57</sup>

### 5.3.4 Commission's analysis of issues

As stated in the Revenue Determination, the Commission sought to achieve a balance between codifying regulatory decision making processes, methodologies and decision making criteria and providing guided discretion for the AER where appropriate. Certain aspects of the regulatory framework would be inappropriate for inclusion in the Rules. In these areas, the Commission allowed for the Revenue Rule to provide the AER with discretion in the exercise of its regulatory functions.

At the time, the Commission was satisfied that guidelines required by the Revenue Rule relate to the detailed application or implementation of matters that have been provided for at a more general level in the relevant Rule. The Commission's view was that as guidelines constitute a matter of detailed application, it is appropriate that the AER is provided with sufficient direction in the Rules on their formulation, in order to focus the powers conferred on it (that is, the scope of the guidelines).<sup>58</sup>

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<sup>56</sup> Grid Australia submission, 2 May 2008, p.9.

<sup>57</sup> Grid Australia supplementary submission, 9 July 2008, pp.7-8.

<sup>58</sup> Revenue Determination, pp.63- 64.

The Commission concurs with Grid Australia's comment that principles stand at a higher level than guidelines.<sup>59</sup> The intention was for the *Transmission Ring-Fencing Guidelines* to be consistent with the *Cost Allocation Principles*. The Commission agrees with the submissions made that there is scope to improve the clarity in the Rules with regards to the interaction between the *Transmission Ring-Fencing Guidelines* and the *Cost Allocation Principles* and *Cost Allocation Guidelines*.<sup>60</sup>

Under the Rules, the *Transmission Ring-Fencing Guidelines* require, among other things, the accounting and functional separation of *prescribed transmission services* by TNSPs from the provision of other services by TNSPs. These requirements have a broader scope than the allocation of costs between categories of transmission services which is the subject of the *Cost Allocation Principles*. Therefore, the Commission considers that greater clarification can be achieved by amending clause 6A.21.2 to specify that the *Transmission Ring-Fencing Guidelines* produced by the AER cannot require allocation of costs between transmission services in a manner which is inconsistent with the *Cost Allocation Principles* and *Cost Allocation Guidelines*.

### 5.3.5 National Electricity Objective

The Draft Rule amends clause 6A.21.2 to provide that the *Transmission Ring-Fencing Guidelines* cannot require allocation of costs as between *prescribed transmission services* and *negotiated transmission services*, or between categories of prescribed transmission services, in a manner which is inconsistent with the *Cost Allocation Principles*.

The Draft Rule meets the requirements of the NEO as it will:

- improve clarity in the Rules about the interaction between the *Cost Allocation Principles* and the *Transmission Ring Fencing Guidelines*; and
- enhance the regulatory design aspects of the Rules by making them more workable and consistent with the Commission's intentions.

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<sup>59</sup> Grid Australia supplementary submission, p.7.

<sup>60</sup> See Clause 6A.19.3.