

NGF

Cost Allocation Arrangements for Transmission Services

Response to the AEMC Draft Rule and Determination

October 2008



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1. Executive Summary

The main points raised in this submission are:

- That the NGF understands that the AEMC's Proposed Rule Change seeks to transition *Existing Connection Services* provided by transmission companies to connected parties from *Prescribed Connection Services* to *Negotiated Transmission Services* over time. These are currently grandfathered under clause 11.6.11 of the National Electricity Rules (Rules). The Rule Change concerns how and under what conditions those *Existing Connection Services* should no longer be classified as *Prescribed Connection Services* and therefore removed from coverage under clause 11.6.11;
- That Clause 88A of the National Electricity Law (NEL) requires the AEMC to take into account the Form of Regulation Factors when making a Rule that specifies an electricity network service as a Direct Control Network Service or Negotiated Network Service. This means that the AEMC must have regard to the Form of Regulation Factors as they relate to an *Existing Connection Service* prior to establishing a trigger that causes these services to be automatically re-classified in the future. The NGF believes the AEMC has not fully considered the correct application of these Factors, and this submission outlines why it is both essential and necessary that this be done before the AEMC finalises its Proposed Rule Change;
- That the NGF does not consider that the expiration of a connection agreement is, *prima facie*, sufficient cause to reclassify an *Existing Connection Service* from a *Prescribed Connection Service* to a *Negotiated Transmission Service*. The NGF considers that the Form of Regulation Factors should form an integral part of the assessment as to whether a service should be re-classified. Unless the application of the Form of Regulation Factors would justify the *Existing Connection Service* being treated as a *Negotiated Transmission Service*, it should remain as a *Prescribed Connection Service*;
- That the NGF considers that the Form of Regulation Factors should be applied to each individual service comprising the *Existing Connection Service* when a decision needs to be made about a potential re-classification of the service. This is because the nature of the service, prices, market and market power environment are different for each service; and
- That the AEMC should amend its Rule Change to allow for an assessment to be undertaken by the Australian Energy Regulator (AER), once a connection agreement term has expired in relation to a particular service, for a service to be re-classified at the commencement of a subsequent regulatory control period. This could only take place at the request of a transmission network service provider (TNSP). The



assessment of the service would be conducted against the Form of Regulation Factors.

The NGF submits that under the Rule Change an *Existing Connection Service* should remain a *Prescribed Transmission Service*, notwithstanding any incremental or additional connection services requested by the connected party under its connection agreement. While such incremental or additional connections would under the Rules be treated as negotiated, it is only if a request is made to change the *Existing Connection Service* itself that grandfathering of the *Existing Connection Service* should cease. The NGF considers that the Draft Rule should be amended to give effect to this principle.

Further information is also provided in the following attachments:

- Attachment A - sets out an assessment of *New Connection Services* and *Existing Connection Services* respectively against the Form of Regulation Factors under the National Electricity Law; and
- Attachment B - provides suggested amendments to the Rule Change, reflecting the comments in this submission and other drafting issues.

2. Background

One of the key objectives of the NGF's original Rule Change Proposal was to resolve ambiguities in the grandfathering provisions in clause 11.6.11 of the Rules, which arise in the event of a network re-configuration. The NGF's Rule Change related only to those *Existing Connection Services* that were grandfathered as *Prescribed Connection Services* by virtue of clause 11.6.11 of the Rules. It did not relate to *New Connection Services* as the NGF considers that these are not covered under clause 11.6.11 and therefore are classified as *Negotiated Transmission Services*.

It was the NGF's intention in its original Rule Change Proposal, and in all contact made since with the AEMC on this issue, to give effect to what it understood to be the AEMC's intentions in establishing Chapter 6A of the Rules. The AEMC noted in its Rule Change Proposal Report in relation to Chapter 6A that "*assets cannot be reclassified and taken out of the RAB from Prescribed Services to allocate them to Negotiated Transmission Services*". The AEMC's report noted that it recognised that:

assets that were once used as part of the shared network may over time become dedicated to one user, as demand patterns change. However, given that the user's locational decision has already been made, there is nothing to be gained by providing a price signal to that user via a negotiated charge, and requiring that user to pay for the entire cost of the asset, when it had not previously been doing so, would increase investment risk for the user.¹

This principle appears to support a view that an *Existing Connection Service* should not be re-classified from a *Prescribed Connection Service* to a *Negotiated Transmission Service* and that costs should not be subsequently shifted between service categories for pricing purposes. The cost allocation provisions in clause 6A.19(a)(7) of the Rules assist to give effect to this principle.

The Draft Determination has apparently departed from this principle. In particular, it now appears that the intention of the Proposed Rule Change is to reclassify an *Existing Connection Service* to a *Negotiated Transmission Service* at the expiry of a connection agreement. This appears at odds with the original intention of clause 11.6.11 and with clause 6A.19(a)(7) of the Rules, which prohibits cost shifting from one classification to another.

Prima facie, the NGF accepts the classification of new connection services as *Negotiated Transmission Services* and does not seek grand-fathering of *Existing Connection Services* in perpetuity. It does, however, support treating existing connection services provided by existing assets (in place as at 16 November 2006) as prescribed entry or exit services where connected parties have little or no choice between suppliers and therefore little or no countervailing market/negotiating power.

¹ AEMC Rule Proposal Report, page 60

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The NGF has carefully considered the AEMC's analysis of its original Rule Change Proposal, the submission and Rule Change Proposal made by Grid Australia, the AEMC's subsequent rejection of the NGF Rule Change Proposal, and the AEMC's Proposed Rule Change.

The NGF believes that significant ground has been made, and considerable clarity has been provided in relation to the treatment of *Existing Connection Services*. As a consequence, the NGF is supportive of most aspects of the AEMC's proposed Rule Change as it presently stands.

Importantly, the NGF does not support the approach set out in the AEMC's Proposed Rule Change for reclassifying a service. In particular,

- The NGF does not agree that the expiry of a connection agreement should automatically result in the connection services that were being provided under it ceasing to be grandfathered. Instead, the trigger in the Rule Change should take the Form of Regulation Factors into account in determining whether such grandfathering should be lost, with the consequence that the services cease to be treated as *Prescribed Connection Services* and become *Negotiated Transmission Services*; and
- The NGF considers the best way forward is to augment the AEMC's Rule Change to provide that once a connection agreement ceases, an assessment of the services provided under that agreement is conducted by the Australian Energy Regulator, against the Form of Regulation Factors.

The specific areas where the NGF supports the AEMC's proposed Rule Change, and the areas of concern that the NGF has in relation to the AEMC's proposed Rule Change, are detailed in the remainder of this submission.

The NGF agrees with the majority of the AEMC's proposed Rule Change

The NGF acknowledges and accepts the AEMC's stated aims that:

- There should be a transition of *Existing Connection Services* from *Prescribed Transmission Services* to *Negotiated Transmission Services*, where this is justified;
- The final mechanism selected should acknowledge and deal with the existence of connection agreements; and
- Where appropriate, grandfathering should cease.



The NGF therefore agrees with the majority of the Grid Australia and the AEMC Proposed Rule Change provisions. In particular, the NGF welcomes the AEMC's proposed Option 3 that it has used as the basis for its new proposed Rule Change.

The NGF agrees with the creation of a class of "eligible assets" that captures all of the assets used to provide a connection service to a user at a connection point prior to the introduction of Chapter 6A. This is a useful term which appropriately connects the "asset" focussed clause 11.6.11 with the "services" focussed Chapter 6A.

The NGF also supports:

- The definition of "Prescribed Connection Services" being amended to include services provided by "eligible assets" for the purpose of clause 11.6.11 of the Rules under an existing connection agreement. This is a useful clarification; and
- The AEMC's proposal that an existing service would remain as a *Prescribed Connection Service* even if some or all of the eligible assets which are used to provide the *Prescribed Connection Service* are replaced on a like for like basis. This adds considerably to the interpretation of clause 11.6.11 as it separates the service from the asset that is providing that *Prescribed Connection Service*.

By agreeing with these components of the AEMC's Draft Rule Proposal, the NGF is agreeing with the AEMC on two important principles, being that:

- Clause 11.6.11 provides that while *Prescribed Connection Services* are being provided by existing or replacement assets, there should be no change in the way in which those *Prescribed Connection Services* are classified; and
- If there is a change in the *Prescribed Connection Service* that is being provided, such that it is no longer classified as a *Prescribed Connection Service*, then clause 11.6.11 should no longer apply.

For this reason, the NGF fully supports the following aspects of the Rule Change Proposal:

- Clause 6A.21.2(e) ;
- Clause 11.6.11(a) - definition of *eligible asset*;
- Clause 11.6.11(a) - definition of *existing asset* (subject to a minor amendment referred to in Attachment B);



- Clause 11.6.11(a) - definition of *prescribed connection service*, parts (1), (3) and (4) (subject to a minor amendment to part (3) referred to in Attachment B);
- Clause 11.6.11(a) - definition of *replacement asset*;
- Clause 11.6.11(b);
- Clause 11.6.11(c)(1)&(2) (subject to amendments to clause 11.6.11(c)(1) designed to "mirror" the cost allocation language in Chapter 6A and clause 11.6.11(c)(2) and to make more explicit the categories of costs that are allocated to prescribed TUOS services under clause 11.6.11(c)(2): see the more detailed explanation referred to in Attachment B)
- Clause 11.6.11(c)(3); and
- Clause 11.6.11(d).

The NGF does not support proposed clause 11.6.11(a) - definition of *prescribed connection service*, part (2)

Subject to the amendments referred to above, the NGF agrees with all aspects of the Rule Change Proposal other than clause 11.6.11(a) - definition of *prescribed connection service*, part (2), which requires that the services be supplied under a connection agreement first entered into before the commencement date. The NGF understands that this is being used as a proxy for a "change in the nature of the service", is intended specifically to remove grandfathering arrangements, and is therefore a tool for re-classifying services from *Prescribed Connection Services* to *Negotiated Transmission Services*.

On page 36 of its Final Rule Determination in introducing Chapter 6A of the Rules, the AEMC noted:²

Consistent with generally accepted policy and regulatory thinking, the Commission concluded early in the Review process that more intrusive forms of economic regulation (such as revenue or price cap regulation) should be confined to those services that are supplied under monopoly (or near monopoly) conditions, with less intrusive forms of regulation, or no regulation, being applied to services supplied under conditions where there is limited market power or the potential for competitive supply.

² See

<http://www.aemc.gov.au/pdfs/reviews/Economic%20Regulation%20of%20Transmission%20Services/aemcdocs/011Rule%20Determination.pdf>



Further, prior to classifying connection services as *Negotiated Transmission Services*, the AEMC noted that:

It has also concluded that the scope and form of regulation is more appropriately determined on the basis of the functional and economic characteristics of services provided by the TNSPs, rather than on the basis of the assets involved in the delivery of services.

However, in its Draft Rule Determination regarding clause 11.6.11, the AEMC has not sufficiently addressed the Form of Regulation Factors. These factors are contained in section 2F of the NEL and provide a means of classifying a service for the purposes of applying a “heavy” or “light-handed” form of regulation. The Form of Regulation Factors allow for the individual circumstances of the service, the company that provides the services, the user that receives the service, and the market in which the service is being provided to be taken into account in order to establish the extent of market power and therefore the true potential for “negotiation” to be used in the establishment of the price and service quality / levels for a service.

The NGF’s primary concern with clause 11.6.11(a) - definition of *prescribed connection service*, part (2)) is that it does not specifically incorporate a requirement to consider the Form of Regulation Factors, yet this provision clearly establishes a trigger event that causes a *Connection Service* to no longer be classified as a *Prescribed Connection Service* and to be reclassified instead as a *Negotiated Transmission Service*. This trigger is contained in the definition of a *Prescribed Connection Service* which requires that a *Connection Service* can only be a *Prescribed Connection Service* if it is being provided under a connection agreement first entered into before the commencement date. If a connection agreement expires without extension, then the *Connection Service* would be re-classified.

As currently drafted, part (2) of the definition of *prescribed connection service* under clause 11.6.11(a) is deficient because it establishes a trigger without any consideration of the service to which it is being applied, except in the most general of terms. It is true that connection services are defined as *Negotiated Transmission Services* in the Rules, however this clearly applies to *New Connection Services* where a connected party selects an efficient party, among several possible options, to provide a *New Connection Service*. A *New Connection Service* – entry or exit – generally involves design, equipment procurement, installation, testing and inspection and energisation of a new or altered connection point.

The NGF accepts that users to some extent have the ability to negotiate some or all of *New Connection Services* from multiple parties, and therefore there is seen to be a degree of countervailing market power in the negotiation which enables scope for efficient prices and service levels to be achieved. The NGF agrees that in this instance, direct control regulation is not required - the TNSP recovers its costs from design, procurement, installation, testing and energisation via a charge which it negotiates with users.

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The critical issue with a *New Connection Service* is that a user is seen to have countervailing market power in the period before it makes the investment decision. Until the user has invested in the connection, the user retains a choice to direct its investment towards the best offer that it can procure in the market. Once this competitive investment decision has been made, the user has established the basis on which it will be charged going forward and pays those charges on an ongoing basis until the capital has been repaid – either immediately or over time.

An *Existing Connection Service* is different. It is a different kind of connection service to a *New Connection Service* in that the design, procurement, installation, testing and energisation have already taken place. Instead, an *Existing Connection Service* involves payment in exchange for the ongoing right to be connected to the network at the connection point under specific technical circumstances, and the use of existing connection assets which have been supplied under monopolistic circumstances. The prices are established by the TNSP allocating the current value of the assets that were designed, procured, installed, tested and energised through its cost allocation methodology. It is critical to note that the original investment decision made by the user for an *Existing Connection Service* was not conducted in a competitive market because, prior to the establishment of the regulatory regime, generators and other parties had no choice but to be connected by the TNSP. The user did not have countervailing market power when the service was first established and did not establish via negotiation the basis on which it would be charged for that service into the future.

Moreover, the connection assets for *Existing Connection Services* already exist and are owned by the TNSP, so there is no countervailing market power on the part of the connected party. The decisions have been made, the investments are sunk and the user has no alternative choice available to it.

The NGF notes that the current clause 11.6.11(a)(2) of the Rules, which the AEMC now proposes to remove, allows for grandfathering of the classification of an *Existing Connection Service* unless a negotiated outcome had been previously reached in relation to that service. The NGF understands that the original purpose of this clause was to distinguish between:

- *Existing Connection Services* where the ongoing pricing arrangements to compensate the TNSP for the design, procurement, installation, testing and energisation of the assets for that service were negotiated with the TNSP – it is understood there are very few cases where these were negotiated in relation to “eligible assets”; and
- *Existing Connection Services* where the ongoing pricing arrangements to compensate the TNSP for the design, procurement, installation, testing and energisation of the assets for that service were not negotiated with the TNSP – it is understood these are overwhelmingly the services presently provided by “eligible assets”.

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The effect of the AEMC's Proposed Rule is therefore to remove the distinction between these two types of *Existing Connection Services* and to replace them with a trigger for re-classification of *Existing Connection Services* that assumes, *prima facie*, that they should be classified the same as *New Connection Services*. It is presumably for this reason that the AEMC has not proposed any analysis, assessment or consideration to occur once the connection agreement has expired. Under the Proposed Rule, once the connection agreement expires, the service is simply re-classified.

Reclassifying *Connection Services* from *Prescribed Connection Services* to *Negotiated Transmission Services* is a step which must be taken with a great deal of caution. This is because the distinction between services that require direct control classifications and those that do not drive the appropriate forms of regulation to be applied: this is one of the most important distinctions under the Rules.

Indeed, the NEL requires the AEMC to take into account the Form of Regulation Factors when making (or revoking) Rules that cause services to be classified as Direct Control Network Services (such as *Prescribed Connection Services*) or Negotiated Network Services (such as *Negotiated Transmission Services*). Section 88A of the NEL requires that:

In addition to complying with sections 88 and 88B, the AEMC must take into account the form of regulation factors and any other matter the AEMC considers relevant—

(a) *in making a Rule that—*

- (i) *specifies an electricity network service as a direct control network service or negotiated network service; or*
- (ii) *confers a function or power on the AER to specify under a network revenue or pricing determination an electricity network service (to which the relevant determination applies) as—*
 - (A) *a direct control network service; or*
 - (B) *a negotiated network service.*

Further, the NGF notes that section 102(2)(a)(iii) of the NEL requires that a Final Rule Determination must contain, "*if the AEMC is required to take into account the form of regulation factors or the revenue and pricing principles, the reasons of the AEMC taking those factors or principles (as the case requires) into account*".

The NGF considers that the effect of the Proposed Rule is to enable the re-classification of *Connection Services* from *Prescribed Connection Services* to *Negotiated Transmission Services*, and therefore section 88A requires the AEMC to have regard for the Form of Regulation Factors.

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In the NGF's view:

- The Form of Regulation Factors have not adequately been taken into account in the Draft Determination, and therefore the AEMC must do so in its Final Rule Determination; and
- There is a role to be played by the Factors, because they provide a framework to reasonably assess the key question that accompanies a re-classification of services, being “do the users have appropriate countervailing power to negotiate the price or quality of the services that are being provided by the monopoly TNSP?”. If the answer is “no”, then the NGF considers that the services should not properly be classified as Negotiated Transmission Services, regardless of their definition in Chapter 10 of the Rules.

The Form of Regulation Factors are set out in section 2F of the NEL. These factors are:

- (a) the presence and extent of any barriers to entry in a market for electricity network services;*
- (b) the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other electricity network service provided by the network service provider;*
- (c) the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other service provided by the network service provider in any other market;*
- (d) the extent to which any market power possessed by a network service provider is, or is likely to be, mitigated by any countervailing market power possessed by a network service user or prospective network service user;*
- (e) the presence and extent of any substitute, and the elasticity of demand, in a market for an electricity network service in which a network service provider provides that service;*
- (f) the presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be);*
- (g) the extent to which there is information available to a prospective network service user or network service user, and whether that information is adequate, to enable the prospective network service user or network service user to negotiate on an informed basis with a network service*



provider for the provision of an electricity network service to them by the network service provider.

Attachment A sets out an assessment of *New Connection Services* and *Existing Connection Services*, respectively, against the Factors. Attachment A shows that:

- *New Connection Services* and *Existing Connection Services* have very different market characteristics. Users can have countervailing market power in the case of *New Connection Services* whereas they cannot in the case of *Existing Connection Services*;
- *New Connection Services* are competed for in the market, and the values of the assets installed are able to be “market tested”. *Existing Connection Services* involve the use of assets that were installed in monopoly situations, without “market testing” and therefore are subject to none of this competitive discipline; and
- It is reasonable to consider *New Connection Services* as “passing” the Form of Regulation Factors on this basis, and that an assessment needs to be taken of *Existing Connection Services* against the Form of Regulation Factors before either “passing” or “failing” them.

3. Amending the Existing Rule Change Proposal

The NGF’s principal concern with the current Rule Change Proposal is that it establishes the expiration of a connection agreement as the only trigger for the re-classification of *Existing Connection Services* that remain unaltered.

The NGF does not support any trigger mechanism that allows for a re-classification of services from *Prescribed Connection Services* to *Negotiated Transmission Services* without appropriate consideration of the Form of Regulation Factors.

The NGF has considered four possible alternative options for reclassifying an *Existing Connection Service* from a *Prescribed Connection Service* to a *Negotiated Transmission Service*. These five options recognise that:

- The AEMC wishes to put in place transparent arrangements whereby a re-classification would take place, in the event it is justified;
- Connection agreements are commercial documents, and therefore using them as a trigger mechanism can create perverse outcomes – this is discussed further below;

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- The most logical time to re-classify a transmission service is at the commencement of a new regulatory control period for the relevant TNSP. This means that if a service is to be re-classified, then it should be done as close as possible to a new regulatory control period, in order to allow the revenue cap for direct control services for a transmission company to incorporate the relevant adjustments and for cost allocation to be appropriately undertaken;
- It would be sensible only to allow TNSPs to initiate a re-classification of a service, given that TNSPs incur the majority of the compliance costs of a re-classification investigation, and acknowledging that all affected parties would be provided with an opportunity to participate through public submissions to a re-classification decision.

The four options that the NGF has considered are:

- **Option 1** – To adopt the current version of the AEMC’s Rule Change Proposal as is, that is to allow the expiration of a connection agreement to be the trigger by which *Existing Connection Services* are re-classified, but only to allow this to occur after a minimum period of 15 years from the commencement date of 16 November 2006;
- **Option 2** - To allow TNSPs to propose a re-classification of *Existing Connection Services* at the end of each regulatory control period, but sufficiently in advance of the commencement of the next regulatory control period to allow a full assessment to be undertaken. The TNSP’s proposal would be assessed by the AER against the Form of Regulation Factors;
- **Option 3** - That once a current connection agreement expires, all of the services provided under that connection agreement should be assessed by the AER against the Form of Regulation Factors;
- **Option 4** – this is a modified version of Option 2 and Option 3. It would provide that once a current connection agreement expires, and not earlier, then the TNSP could propose a re-classification of *Existing Connection Services* at the end of the next, and any subsequent, regulatory control period, with that proposal being assessed by the AER against the Form of Regulation Factors.

3.1. Option 1

The primary advantage of Option 1 is that, as identified by the AEMC, it would provide a clear end to the current grandfathering arrangement at the expiry of the existing connection agreement, subject to a minimum transition time which minimises price shock and regulatory uncertainty. The 15 year time period represents an appropriate transition time period. First, it is consistent with a standard period for negotiated services and secondly, aligns with typical corporate planning timeframes for the industry. Against this, the NGF notes that Option 1:

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- Does not seek to consider or assess the differences between the services that are being considered for re-classification;
- Does not seek to assess individual services against the Form of Regulation Factors, in order to identify whether any countervailing market power exists in the supply of those services;
- Does not take account of the timing of regulatory control periods and allow TNSPs sufficient time to amend their cost allocation arrangements;
- Fails to adequately acknowledge and deal with the existence of connection agreements, as intended by the AEMC;
- Opens the potential for the TNSP to exercise its market power against users and to cause price shocks. If a TNSP chooses to allow a connection agreement to expire, the user is very likely to suffer financially in any “negotiation” with a TNSP. This could also provide the TNSP with power over users in other negotiations; and
- Is not equitable for users, nor does it propose a way of dealing with similar services in the same way. By allowing services provided under long dated or non-expiring connection agreements to be grandfathered indefinitely, Option 1 potentially leaves some services grandfathered in perpetuity, while leaving other services to be reclassified after an arbitrary time period. While this might be appropriate for some services, it may not be appropriate for others.

For these reasons, the NGF opposes Option 1.

3.2. Option 2

Option 2 involves allowing TNSPs to propose a re-classification of *Existing Connection Services* at their discretion at the end of each regulatory control period, but sufficiently in advance of the commencement of the next regulatory control period. This could occur in a similar manner to the way in which services are classified in the electricity distribution sector, whereby a DNSP is required to propose a classification of services in its Regulatory Proposal to the AER, albeit that under this Option it would only occur at the discretion of the TNSP.

Once the TNSP has nominated the service under consideration, that service would then be assessed against the Form of Regulation Factors in order to decide upon its re-classification.



The advantages of Option 2 are that it:

- Seeks to assess the differences between the services that are being considered for re-classification;
- Seeks to assess these individual services against the Form of Regulation Factors under the NEL, in order to identify whether any countervailing market power exists in the supply of those services;
- Provides an assessment framework which takes account of the timing of regulatory control periods and allows TNSPs sufficient time to amend their cost allocation arrangements;
- Does not rely on connection agreements, and therefore does not affect the commercial relations between TNSPs and connected parties; and
- Is equitable for connected parties, as each TNSP will make a decision at the end of each regulatory period whether it believes that the characteristics of a particular service justify the administrative costs and benefits of re-classification.

The main disadvantages of Option 2 are that it creates a potentially significant regulatory and administrative burden for TNSPs, and does not take any account of the existence of connection agreements. In this regard the NGF notes that connection agreements provide the main platform by which new charges would be levied and services would be amended. However, under Option 2, there is a strong possibility that the timing of regulatory periods and the expiry of a connection agreement will not occur at the same time.

The NGF therefore does not support Option 2.

3.3. Option 3

Option 3 provides that once a current connection agreement expires, all of the services provided under that connection agreement would be assessed by the AER against the Form of Regulation Factors.

The advantages of Option 3 are that it:

- Seeks to assess the differences between the services that are being considered for re-classification;

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- Seeks to assess these individual services against the Form of Regulation Factors under the NEL, in order to identify whether any countervailing market power exists in the supply of those services; and
- Relies on connection agreements (as does Option 1) but, unlike Option 1, would not enable TNSPs to misuse their market power because the Form of Regulation Factors are the ultimate arbiter of any re-classification.

Against this, however, Option 3:

- Does not take account of the timing of regulatory periods and allow TNSPs sufficient time to amend their cost allocation arrangements; and
- Is not equitable between connected parties, nor does it propose a way of dealing with the same services in the same way. This option has the same disadvantages of Option 1, in that it allows services provided under long dated or non-expiring connection agreements to be grandfathered indefinitely, but allows grandfathering of other services to terminate arbitrarily.

On balance, the NGF does not support Option 3.

3.4. Option 4

Option 4 involves a balanced mix of Option 2 and Option 3. It would provide that once a current connection agreement expires, and not earlier, then a TNSP could propose a re-classification of *Existing Connection Services* at the end of the next and any subsequent regulatory period.

In practice, once a connection agreement expires, then the services provided under that connection agreement would become “open for re-classification”. Once this has occurred, the TNSP could nominate the service for assessment at the commencement of any subsequent regulatory period following the expiry of the connection agreement.

As for Option 2, once the TNSP has nominated the service under consideration, that service would then be assessed against the Form of Regulation Factors in order to decide upon its future classification. The assessment could be undertaken by the AER.

The advantages of Option 4 are that it:

- Seeks to assess the differences between the services that are being considered for re-classification;

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- Seeks to assess these individual services against the Form of Regulation Factors, in order to identify whether any countervailing market power exists in the supply of those services;
- Provides a framework for this to occur which takes account of the timing of regulatory periods and allows TNSPs sufficient time to amend their cost allocation arrangements;
- Leaves the choice of when the assessment should be conducted with the TNSPs, as they will bear the regulatory and administrative burden of any assessment exercise;
- Takes account of the existence of connection agreements;
- Is equitable between connected parties, as each TNSP will make a decision at the end of each regulatory period whether it believes that the characteristics of a particular service justify the administrative costs and benefits of re-classification, but not before the existing connection agreement has expired.

The NGF strongly supports Option 4 as a workable option and advocates that the AEMC should reflect this approach in the final Rule Change.

4. Other Proposed Amendments

The NGF notes that there is an inherent difficulty with all options involving connection agreements where a connection agreement is renegotiated or entered into during a regulatory period. In such a case the value of the assets providing the connection service may only be removed from the regulatory asset base at the next regulatory reset (cl.11.6.11(d)(3)), with a consequent reallocation of costs (cl.11.6.11(d)(2)). However, it is unclear how these services should be charged for during the period between the new or amended connection agreement coming into effect and the commencement of the next regulatory period. In this regard there seems to be a risk of double counting as a result of the asset continuing to be included in the regulatory asset base while the service is also being charged as a negotiated transmission service.

The NGF requests that the Commission clarify its intentions in this regard.

The NGF submits that under the Rule Change, an *Existing Connection Service* should remain a *Prescribed Transmission Service*, notwithstanding any incremental or additional connection services requested by the connected party under its connection agreement. While such incremental or additional connections would under the Rules be treated as negotiated, it is only if a request is made to change the *Existing Connection Service* itself that grandfathering of the *Existing Connection Service* should cease. The NGF therefore considers that the Draft Rule should be amended to give effect to this principle.

Attachment B provides the NGF's suggested amendments to the Rule Change to support Option 4, and includes a number of other suggested drafting amendments in relation to the Draft Rule. The suggested amendments to the definition of "prescribed connection service", together with new clauses 11.6.11(e), (f) and (g), are intended to give effect to Option 4. The reasons for the other suggested amendments contained in Attachment B are set out in that Attachment.

Attachment A – Assessment of Connection Services Against Form of Regulation Factors

This Attachment A assesses *Existing Connection Services* and *New Connection Services* against the Form of Regulation Factors in section 2F of the National Electricity Law.

The presence and extent of any barriers to entry in a market for electricity network services – section 2F(a).

The NGF interprets this clause to mean that a *Connection Service* should be a *Prescribed Transmission Service*, if a TNSP:

- Has a natural monopoly in the supply of that service;
- Has substantial market power in the supply of that service;
- Has a monopoly based in legislation so that no other party can be authorised to provide the service; or
- There are other significant (legislative or regulatory) barriers that prevent other parties from providing the service.

The NGF accepts that other parties may design, procure, install and test new assets, and therefore *New Connection Services* are appropriately treated as *Negotiated Transmission Services*. This is in accordance with the definition of a *Negotiated Transmission Service* under the Rules.

The NGF considers, however, that *Existing Connection Services* differ significantly from these. This is because the TNSP has a natural monopoly and substantial market power in the ongoing supply of the entry and exit service, and the component of the price that relates to the initial construction of the assets was not established in a competitive environment. Users cannot choose to receive the *Existing Connection Services* from another party, as the assets already exist and are owned by the TNSP.

The presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other electricity network service provided by the network service provider – section 2F(b).

The presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other service provided by the network service provider in any other market – section 2F(c).

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The NGF interprets these clauses to mean that a *Connection Service* should be classified as a *Prescribed Transmission Service*, if:

- The network services that a TNSP offers through its shared network give it the ability to exploit operational and economic efficiencies in the provision of other network services and thereby limit competition in the market for these other network services;
- The network services that a TNSP offers give it the ability to exploit operational and economic efficiencies in the provision of other services and thereby limit competition in the market for these other services; or
- It is difficult to quantify the incremental and stand alone costs and benefits for users of providing the services.

For the reasons set out above, the NGF accepts that *New Connection Services* should be treated as *Negotiated Transmission Services*.

Existing Connection Services fail this test because the TUOS network services that TNSPs provide through the shared network make it extremely difficult for users to select another supplier of an *Existing Connection Service*.

The extent to which any market power possessed by a network service provider is, or is likely to be, mitigated by any countervailing market power possessed by a network service user or prospective network service user – section 2F(d).

The NGF interprets this clause to mean that a *Connection Service* should be classified as a prescribed service, if:

- There are no large or concentrated groups of customers that have substantial power in negotiating the terms and conditions of supply, including prices, with TNSPs in relation to a service;
- Customers generally do not have a credible ability to by-pass or avoid the provision of the service being provided by a TNSP. This means that customers cannot fulfil their needs in any other way than acquiring the service from a TNSP; and
- The characteristics of the assets that are used to supply the service, and the customer base, are such that there is a low potential for full or partial asset stranding from reduced demand for that service.

The NGF notes that for *Existing Connection Services*, where generators have incurred sunk costs in the location of generation facilities, connected parties do not have a credible ability to by-pass or avoid the provision of the existing *Prescribed Connection Service*, as this would involve uneconomic duplication of the assets. Further, the NGF notes that the use of connection agreements as a proxy for a change in service allows TNSPs considerable bargaining power in the supply of other services or indeed of the particular *Connection Service*. Both TNSPs and generators will be aware that if a TNSP

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elects to allow a connection agreement to expire, it can cause significant cost imposts on a generator.



The presence and extent of any substitute, and the elasticity of demand, in a market for an electricity network service in which a network service provider provides that service – section 2F(e).

The presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be) – section 2F(f).

The NGF interprets these clauses to mean that a *Connection Service* should be a prescribed service if:

- Customers' demand for the service is relatively price inelastic (i.e. demand does not fall significantly as the price increases);
- The service being acquired is not a product of choice (i.e. discretionary purchase) for the customer; and
- Customers do not have options for sourcing the service from a supplier other than the TNSP.

The NGF notes that for *Existing Connection Services*, where connected parties such as generators have incurred sunk costs in the location of generation facilities, customers do not have options for sourcing the service from a supplier other than the TNSP. As a captive customer, an existing connected party would also be expected to have highly inelastic demand for the *Connection Service*.

The extent to which there is information available to a prospective network service user or network service user, and whether that information is adequate, to enable the prospective network service user or network service user to negotiate on an informed basis with a network service provider for the provision of an electricity network service to them by the network service provider – section 2F(g).

The NGF interprets this clause to mean that a *Connection Service* should be a prescribed service if a TNSP's knowledge of its costs, services, infrastructure and market creates a substantial negotiating power imbalance in dealing with customers.

The NGF notes that for *Existing Connection Services*, any knowledge that a generator has about the TNSP's cost base is irrelevant. Customers do not have options for sourcing the service from a supplier other than the TNSP.

Lastly, and most importantly, a *Negotiated Transmission Service* involves the negotiation of the service and the price. A re-classification of *Existing Connection Services* to *Negotiated Transmission Services*, as envisaged by the AEMC's Proposed Rule, would not enable any form of negotiation to occur. The TNSP would simply re-classify the existing services and announce the new price to the user. It is the NGF's firm view that negotiation cannot occur on price alone – it must also involve the service in some form. Unless this occurs, it is impossible to see how the service could be regarded as a truly



Negotiated Transmission Service, which requires parties to come to a mutual agreement on both service and price.

Overall, the NGF considers that re-classifying *Existing Connection Services* needs to have regard for the following key characteristics of an *Existing Connection Service*, being that:

- An *Existing Connection Service* can only be provided by one party, the TNSP, as the investment has already taken place for both the TNSP and the generator, and the TNSP owns the relevant connection assets;
- The TNSP has significant market power in deciding or varying the terms and conditions for the supply of that *Existing Connection Service*. This is because the generator cannot choose to purchase the service from anyone else, nor are there any substitutes which could provide a realistic option for the generator;
- The generator does not have sufficient information, scale or market position to negotiate on an equal basis with the TNSP in relation to that *Existing Connection Service*;
- There is no “negotiation” left to take place.

Attachment B – Drafting Amendments

1. Revised definition of existing assets

- (2) was committed to be constructed for use in connection with a *transmission system* where the forecast value, or a portion of the forecast value, of that asset was included in the forecast capital expenditure,

Explanation: these changes reflect the corresponding wording contained in paragraph (1) of the definition of "existing asset".

2. Revised definition of prescribed connection service

prescribed connection service means, for a *regulatory control period* occurring after the commencement date, a *connection service* provided by a *Transmission Network Service Provider* on or after the commencement date in respect of which the following criteria are satisfied immediately before the start of that *regulatory control period*:

- (1) the relevant service is provided using eligible assets;
- (2) the relevant service is being provided under a *connection agreement* which:
- (i) was entered into before the commencement date; or
 - (ii) was entered into after the commencement date but the AER has not determined, in a *revenue determination* for the relevant *Transmission Network Service Provider* that applies in respect of a *regulatory control period* that commences after that *connection agreement* was entered into, that the *connection service* should cease to be a prescribed connection service;
- (3) the *connection agreement* under which the relevant service is being provided has not been amended at the request of the *Transmission Network User* for the purposes of altering the relevant service; and
- (4) the relevant service would not otherwise be a *prescribed transmission service* for the purposes of new Chapter 6A but for this clause 11.6.11.

For the purposes of this clause 11.6.11, a new *connection agreement* is not to be taken to be entered into by reason only of the extension or novation of an existing *connection agreement*.

Explanation: see the explanation contained in the body of this submission.

3. Revised clause 11.6.11(c)

Interaction with new Chapter 6A

(c) For the purposes of new Chapter 6A:

(1) the costs of 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) incurred in providing a prescribed connection service,
are limited to the costs of the eligible assets which, from time to time, provide the prescribed connection service;

(2) the following costs must be treated as costs that are attributable to the provision of, or are incurred in providing, prescribed TUOS services:

(i) costs that, under new Chapter 6A, would be allocated to a prescribed connection service but that are not so allocated as a result of the operation of paragraph (1); and

(ii) costs that, under Chapter 6A, are reallocated from a prescribed transmission service to a connection service that is provided using:

(A) an existing asset (or any portion of an existing asset) where that asset was immediately before the commencement date, or was or is when first commissioned after the commencement date, used to provide a connection service; or

(B) a replacement asset (or any portion of a replacement asset) where that asset is used after the commencement date to continue providing a connection service,

and the value of that asset (or a portion of it) is included in the regulatory asset base, or the forecast capital expenditure, for the

relevant transmission system under a revenue determination in force at that time.

To avoid doubt, the connection services ^ referred to in subparagraph (ii) which would otherwise be *negotiated transmission services* are taken to be *prescribed TUOS services*; and

- (3) the *stand-alone amount* for *prescribed TUOS services* is taken to include any portion of the costs referred to in clause 11.6.11(c)(2) that has not been allocated under clause 6A.23.2(d)(1).

Explanation: *clause 11.6.11(c)(1) effectively stipulates the costs that may be allocated to a prescribed connection service and confines these to the costs of the "eligible assets" that provide that service (ie. the assets that are used wholly and exclusively to provide that service). Because this is potentially more restrictive than the cost allocation that would result from applying the cost allocation provisions of Chapter 6A, clause 11.6.11(c)(2) is intended to ensure that any costs that would be allocated to connection services under Chapter 6A but are not so allocated because of the operation of clause 11.6.11(c)(1) are nevertheless recoverable by the relevant Transmission Network Service Provider (through prescribed TUOS service charges). For example, under the cost allocation methodology in Chapter 6A, the costs of other assets (including assets that provide both connection services and other services) may be allocated to connection services (see NER, cl.6A.9.1(1), 6A.19.2(3)(ii)). However, clause 11.6.11(c)(1) does not allow these costs to be allocated to prescribed connection services and these costs must instead be allocated to prescribed TUOS service charges.*

The suggested changes to clause 11.6.11(c)(2) are intended to make quite explicit the costs that are to be allocated to prescribed TUOS services. The first category of such costs (see cl.11.6.11(c)(2)(i)) is costs that would be allocated to prescribed connection services under Chapter 6A but are not so allocated due to the cost allocation rule set out in clause 11.6.11(c)(1). The second category of such costs (see cl.11.6.11(c)(2)(ii)) is costs that may be reallocated to connection services where the relevant asset is used to provide both connection services

and network services, that asset provided connection services as at the grandfathering date (or replaces an asset that provided such services as at that date), and the asset is included in the relevant TNSP's regulatory asset base. Assets of this kind are not "eligible assets" because they are not used wholly and exclusively to provide connection services.

In so far as this second category of costs is concerned, it is appropriate that costs should not be able to be reallocated from network services to connection services (or, put another way, it is appropriate that any such reallocation should increase prescribed TUOS service charges). This is because, if the relevant asset had been wholly and exclusively used to provide a connection service, that connection service would be a prescribed connection service. There is no reason for according different treatment in terms of the allocation of costs to connection services where the asset would be an eligible asset but for the fact that it is a dual purpose asset - the consequences of cost shifting are the same in each case. The NGF's concern is that existing clause 11.6.11(c)(2)(ii), in using the language "but for this clause 11.6.11", might be taken as suggesting that clause 11.6.11(c)(2) only applies to the first category of costs referred to above because clause 11.6.11(c)(1) is the only provision that expressly changes the cost allocation rules in Chapter 6A and that clause is limited in its application to eligible assets. Such a result would be inconsistent with the Commission's statement of its preferred approach (Draft Rule Determination, p.38) that:

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.

Because of their complementary nature, clauses 11.6.11(c)(1) and (2) should mirror each other in terms of their use of cost allocation language (ie. costs that are directly attributable to, or incurred in providing, the relevant service)

4. New clauses 11.6.11(e)-(g)

- (e) The AER must only determine that a *connection service* should cease to be a prescribed connection service for the purposes of subparagraph (2)(ii) of the

- definition "prescribed connection service" in this clause 11.6.11 if the *AER* is satisfied that application of the form of regulation factors in respect of that service means that the service should be specified by the *AER* as a negotiated network service rather than as a service the price for which, or the revenue to be earned from which, should be regulated under a *transmission determination*.
- (f) For the purposes of paragraph (e), "form of regulation factors" and "negotiated network service" have the same meanings as in the *National Electricity Law*.
 - (g) The *AER* may only make a determination referred to in paragraph (e) if the relevant *Transmission Network Service Provider* requests the *AER* to make that determination and such request is included in the *Revenue Proposal* submitted by that *Transmission Network Service Provider* to the *AER* in relation to the making of the *transmission determination* referred to in that paragraph. The *submission guidelines* made by the *AER* under rule 6A.10 must specify the information that a *Revenue Proposal* must contain or be accompanied by for the purpose of making such a request.
 - (h) For the purposes of this clause 11.6.11, an asset is to be regarded as providing a *connection service* irrespective of whether, at the relevant time, any charge for that *connection service* is being made.

Explanation: *the reasons for paragraphs (e) to (g) are contained in the body of this submission. The purpose of paragraph (h) is to make it clear that the cost allocation restrictions in clause 11.6.11 apply in respect of connection services even if those services are not, at the relevant time, charged for.*

5. Amendment to clause S6A.2.3

- (c) For the avoidance of doubt, where the value of an asset (or group of assets) is removed from the regulatory asset base under paragraph (a), the relevant *Transmission Network Service Provider* is not entitled to charge a *Transmission Network User* for the services that such asset (or group of assets) provides.

Explanation: *under the Rules, the only circumstance in which an asset can be removed from the regulatory asset base (other than under proposed new clause 11.6.11(d)) is where the requirements in clause S6A.2.3(a) are satisfied*

(see cl.6A.6.1(f), S6A.2.1(b), (f)). This is reinforced by clause S6A.2.3(a) itself, which provides that the AER may "only" determine to remove an asset from the regulatory asset base if the requirements specified in clause S6A.2.3(a)(1)-(3) are satisfied. In the Draft Rule Determination (p. 42) the AEMC states:

... 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.

However, the suggested amendment to clause S6A.2.3 is designed to put this beyond doubt.

6. Consequential amendments to clauses 6A.19.2(7), 6A.23.2(d) and S6A.2.3(a)

Amend clause 6A.19.2(7) to read as follows:

subject to clause 11.6.11(d)(2), costs which have been allocated to *prescribed transmission services* must not be reallocated to *negotiated transmission services*; and

Amend clause 6A.23.2(d) to read as follows:

... adjusted and applied such that any costs of a *transmission system* asset that would otherwise be attributed to the provision of more than one category of *prescribed transmission services*, is (subject to clause 11.6.11(c)) allocated as follows ...

Amend clause S6A.2.3(a) to read as follows:

For the purposes of rolling forward the regulatory asset base for a *transmission system* as described in clause 6A.6.1 of the *Rules* and this schedule, and subject only to clause 11.6.3(d)(3), the AER may only determine to remove

Explanation: the purpose of these suggested amendments is to alert readers of the *Rules* to the fact that clause 11.6.11 affects the operation of these clauses.

NGF