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Australian Energy Market Commission

## CONSULTATION PAPER

# PRUDENT DISCOUNTS IN AN ADOPTIVE JURISDICTION

### PROPONENT

The Honourable Lily D'Ambrosio MP, Minister for Energy, Environment and  
Climate Change, Minister for Solar Homes

8 OCTOBER 2020

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# RULE

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## ABOUT THE AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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# 1 INTRODUCTION

On 4 September 2020, the Hon Lily D'Ambrosio MP, Minister for Energy, Environment and Climate Change in Victoria (the proponent) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission) seeking to make clarificatory and procedural amendments to the way in which an application for a prudent discount to transmission network charges would be handled in an adoptive jurisdiction.

An adoptive jurisdiction is one where the declared network functions of the Australian Energy Market Operator (AEMO) apply. At this time, Victoria is the only such adoptive jurisdiction.

The Minister also requested that the Commission consider the proposal as a non-controversial rule under section 96 of the National Electricity Law (NEL), such that it could be assessed on an expedited basis.

This consultation paper has been prepared to facilitate public consultation on the rule change request and to seek stakeholder submissions.

This paper:

- provides background to the rule change request
- summarises the issues and solutions outlined in the rule change request and identifies a number of questions related to these
- explains the Commission's decision to consider the proposal as a non-controversial rule
- outlines the process for making submissions.

## 1.1 Background

Under the prudent discount arrangements in the National Electricity Rules (NER), a transmission network service provider (TNSP) may agree with a transmission customer to charge lower prices to that customer for certain services than the prices determined in accordance with the TNSP's pricing methodology.<sup>1</sup> The relevant services are prescribed transmission use of system (TUOS) services and prescribed common transmission services.

The rationale for providing such prudent discounts is to prevent an inefficient by-pass of the transmission network.<sup>2</sup> 'By-pass' in this context could refer to:

- a technical by-pass, such as the development of a duplicate transmission line from a power station to a large load
- an economic by-pass, such as a decision to not invest in or expand a load or to shut down an existing operation.

For a transmission customer, by-passing the existing transmission network might be economic in some instances. For example, this would be the case when by-passing the

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1 Clause 6A.26.1(b) of the NER.

2 AEMC, Rule Determination: National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006 No 22, 21 December 2006, pp. 52-54.

transmission network would have a lower cost for the transmission customer than paying the relevant transmission network charges.

However, if the by-pass option is only cheaper because transmission charges are greater than the incremental costs caused by the transmission customer, then the customer by-passing the transmission network will be an inefficient outcome overall.

Transmission charges levied on each customer by TNSPs will generally be greater than the incremental costs of serving that customer, because the natural monopoly characteristics of electricity transmission networks means that average costs are greater than marginal costs. Transmission charges overall will need to be sufficient to recover a TNSP's average costs. It will therefore be beneficial for customers as a whole for a customer to be provided with a discount if by-pass is avoided and that customer still makes some contribution to this difference between marginal and average costs.

Providing a discount that would prevent an inefficient by-pass of the transmission network by a transmission customer would also lead to transmission infrastructure being used more efficiently, which should decrease costs for other transmission customers over the long term.

### 1.1.1

#### **Operation of the prudent discount arrangements**

When a transmission customer requests that its TNSP reduce the transmission network charges it would be liable for, this triggers a requirement for that TNSP to negotiate with the requesting customer in good faith.<sup>3</sup>

If the TNSP agrees to provide such a discount on transmission charges to that customer, then that TNSP can automatically recover up to 70 per cent of the discounted amount from its other consumers, through increasing either or both of:<sup>4</sup>

- the adjusted non-locational component of TUOS charges
- prescribed common transmission services charges.

This cost recovery does not need to occur during the year when the TNSP provides a transmission customer with a discount; the TNSP could also recover the costs automatically from its other customers through the adjusted non-locational component of their TUOS charges during a subsequent financial year.<sup>5</sup>

The TNSP being able to automatically pass on up to 70 per cent of the discount to other customers and absorb the rest is consistent with incentive regulation practices implemented in the national electricity market (NEM) through various incentive schemes such as the Capital Expenditure Sharing Scheme, where a network service provider shares some of its overspending costs or its under-spending benefits with its consumers to encourage that

<sup>3</sup> Clause 6A.26.1(c) of the NER.

<sup>4</sup> Clauses 6A.26.1(d) and 6A.26.1(e) of the NER.

<sup>5</sup> Clauses 6A.26.1(d) and 6A.26.1(g) of the NER.

network service provider to make decisions that are beneficial for its customers as well as for itself.<sup>6</sup>

However, a TNSP that agrees or proposes to agree to a discount can seek to recover more than 70 per cent of this discounted amount from consumers by applying to the Australian Energy Regulator (AER) for permission to do so.<sup>7</sup>

When making a decision whether to approve the recovery of the proposed amount, the AER must take into account a number of matters, including the requirements that:<sup>8</sup>

- the discount is no larger than needed to prevent the applicant transmission customer from adopting the most attractive alternative action (i.e. engaging in an inefficient 'by-pass' of the transmission network).
- providing the discount would not place its other transmission customers in a worse position than if the discount was not provided.

If the AER decides to reject the TNSP's proposed cost recovery from its other customers, then the AER must provide reasons for this decision.<sup>9</sup>

If a TNSP enters into an agreement to provide a discount to a transmission customer and seeks to recover more than 70 per cent of the value of the discount without receiving approval from the AER to do so, then the AER must review the discount amount when making a subsequent revenue determination for that TNSP.

If the AER determines that the recovery of any part of the discount does not comply with the two aforementioned requirements for allowing this cost recovery from other customers, then the AER can reduce that TNSP's total allowed revenue for the following regulatory control period by the amount that does not satisfy the requirements, i.e., up to the entire value of the discount.<sup>10</sup>

### 1.1.2

#### **Operation of the prudent discount arrangements in Victoria**

Victoria is an adoptive jurisdiction in terms of the sections of the NER that relate to transmission arrangements because it is the only jurisdiction which has declared that AEMO is authorised to exercise certain declared network functions associated with TNSPs.<sup>11</sup>

As the only adoptive jurisdiction, provisions apply in Victoria that cause the prudent discount framework to operate in a slightly differently manner in that jurisdiction. These provisions reflect the fact that the Australian Energy Market Operator (AEMO) operates as the TNSP in Victoria, meaning functions that are discharged by the TNSP in other NEM jurisdictions are shared between AEMO and declared transmission system operators (DTSOs) in Victoria. DTSOs are the owners of the transmission network assets in Victoria, meaning that, unlike in

6 For more information on this scheme and Efficiency Benefit Sharing Scheme that operates under a similar principle for operating expenditure, see: <https://www.aemc.gov.au/sites/default/files/content/01b14d8b-8d3b-46ce-bfe3-23cd5be6f629/Electricity-Network-Economic-Regulatory-Framework-Review-2016-final-report.pdf>, p. 23 and p. 27.

7 Clauses 6A.26.2(a)-6A.26.2(c) of the NER.

8 Clauses 6A.26.1(f) and clause 6A.26.2(d) of the NER.

9 Clauses 6A.26.2(e) of the NER.

10 Clause 6A.26.2(k) of the NER. The AER can impose additional reductions on the TNSP's allowed revenue for interest payments.

11 These functions are described in section 50C(1) of the NEL.

other jurisdictions, the TNSP in Victoria is not the owner of the transmission assets that it uses to provide transmission services.

When a transmission customer in Victoria requests a reduction in the transmission network charges it would be liable for, this triggers a requirement for AEMO (as the TNSP) to negotiate with the requesting customer in good faith.<sup>12</sup> AEMO and the relevant DTSO have a similar obligation to negotiate with each other in good faith.<sup>13</sup> While AEMO is the only party that can grant a prudent discount in Victoria, it cannot do so without obtaining written consent to provide the discount from the DTSO.<sup>14</sup>

In general, the same rules relating to cost recovery apply in Victoria as in other jurisdictions.<sup>15</sup> However, AEMO is a non-profit entity. This means that, unlike other TNSPs, AEMO would not be able to absorb a portion of any discounted amount itself.

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12 Clauses 6A.26.1(c) and S6A.4.2(k)(3)(1) of the NER.

13 Clause S6A.4.2(k)(3)(2)(ii) of the NER.

14 Clause NER S6A.4.2(k)(3)(2)(i) of the NER.

15 The exception to this is that Clause 6A.26.2(k) allowing the AER to impose additional reductions on a discounting TNSP's allowed revenue does not apply to AEMO due to Clause S6A.4.2(k)(4) of the NER.

## 2 ISSUES FOR CONSULTATION

This chapter provides an overview of the issues and solutions identified in the rule change request in relation to the application of the prudent discount regime in an adoptive jurisdiction. It aims to facilitate stakeholder feedback so that the Commission can assess the rule change request against its assessment criteria. This chapter sets out:

- a summary of the key issues, and the solutions proposed to address these, as set out in the rule change request
- our proposed framework for assessing the rule change request.

The chapter includes a number of questions which stakeholders may wish to consider when preparing their submissions to this consultation paper.

### 2.1 Issues raised in the rule change request

In the rule change request, the proponent raises three key issues related to the application of the prudent discount regime in an adoptive jurisdiction, as discussed below.

#### 2.1.1 **A lack of negotiation and associated information obligations on the DTSO**

The proponent notes that, in NEM jurisdictions other than Victoria, there is a single TNSP which both assesses the request for a discount by a transmission customer and which is also the asset owner. The proponent suggests that information that is needed by that transmission customer in order to be able to pursue its request can often be held by the asset owner. This information might, for example, include information necessary to ascertain the avoidable costs associated with the customer's facility and, therefore, whether or not there would be a risk of inefficient bypass.<sup>16</sup>

In Victoria, the obligation to negotiate in good faith with a transmission customer applies to AEMO in its capacity as TNSP. There is no obligation on the relevant DTSO to negotiate in good faith directly with a transmission customer who requests a discount.

In addition, the proponent suggests that, while AEMO and the DTSO are required to negotiate in good faith with each other, the obligation on the DTSO to negotiate in good faith with AEMO is not triggered in the absence of a proposal by AEMO to exercise its power to grant a discount.

Given that AEMO can only grant a discount if it has obtained the DTSO's consent, the proponent suggests that there is a gap in the overall procedural rights of transmission customers in Victoria requesting a discount as compared to transmission customers in other jurisdictions, where transmission asset owners (i.e., TNSPs) have obligations to negotiate with those customers in good faith, including, in the view of the proponent, to exchange such information as may be needed by the customer.

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<sup>16</sup> Rule change request, p. 5.

### 2.1.2 **A lack of obligations relating to a refusal to agree to a discount**

The proponent suggests that another issue with the current prudent discount regime in Victoria is that, if a prudent discount application is rejected, there is a lack of obligations on AEMO and the relevant DTSO to explain to the transmission customer why the discount was not agreed to.

Specifically, the proponent notes that there is no express obligation on AEMO or the DTSO to provide reasons to the transmission customer where:<sup>17</sup>

- AEMO as the TNSP refuses to grant a discount to a transmission customer
- the relevant DTSO refuses to consent to AEMO providing a discount to a transmission customer.

The proponent considers that the lack of obligations on AEMO or the DTSO to explain to a transmission customer why its discount proposal was rejected:

- denies the requesting transmission customer the opportunity to respond to any adverse information or interpretation of the NER which is held or made by AEMO or the relevant DTSO (as applicable)
- makes it difficult for a transmission customer whose request is not granted to properly address the reasons for refusal in any future discount requests and/or to properly utilise any dispute resolution processes available under the NER
- contributes to a lack of transparency and accountability in the prudent discount process.

### 2.1.3 **A lack of clarity around AEMO's ability to apply to the AER for full cost recovery on a conditional basis**

The proponent further suggests that there is a lack of clarity in the NER as to whether AEMO can propose to agree to a discount on a conditional basis, pending the outcome of an application to the AER for approval to recover the entire discounted amount from other customers.<sup>18</sup>

The proponent understands from the experience of Alcoa Portland Aluminium Pty Ltd (APA) in seeking a discount for its Portland Smelter that:

- AEMO considers that it cannot agree to a discount or propose to agree to one without being certain that the AER will approve the recovery of the full discounted amount from other transmission customers
- the AER, in turn, is unlikely to be willing to provide a definitive view as to whether or not it would grant approval for passing on more than 70 per cent of the discounted amount to other transmission customers without receiving a formal application from AEMO.

Since AEMO agreeing to or proposing to agree to a discount is a necessary prerequisite for a formal application to the AER for discount approval, the proponent suggests that these procedural requirements unnecessarily hamper the ability and incentives for AEMO to seek approval for a discount in Victoria, even if it would be prudent to do so.

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<sup>17</sup> Rule change request, p. 6.

<sup>18</sup> Rule change request, p. 7.

The proponent contends that this issue is exacerbated in Victoria as compared to other jurisdictions because AEMO is required to assess the discount request without being the asset owner, and therefore does not have the same economic incentives to grant a discount as might be expected for a TNSP who is also the asset owner. The proponent suggests that this disincentive for AEMO to grant a prudent discount compared to other TNSPs could be exacerbated by the fact that AEMO (unlike other TNSPs) cannot absorb any of the costs of providing a prudent discount because, as a non-profit entity, it does not have the capacity to take on the risk of not being able to fully recover the revenues forgone by granting a discount.

#### **QUESTION 1: ISSUES RAISED IN THE RULE CHANGE REQUEST**

1.1. What are stakeholders' views on the issues raised by the proponent? To what extent are outcomes under the arrangements that apply in Victoria likely to differ from those in other jurisdictions?

1.2 What do stakeholders consider would be the appropriate role for the DTSO in the prudent discount process in Victoria, particularly in regards to negotiating with transmission customers and providing them with relevant information?

1.3 Are there any other issues relevant to this rule change request that the Commission should consider?

## **2.2 Proposed solution**

The proponent has proposed solutions in the rule change request that seek to address the issues it has raised with the prudent discount regime. The rule change request includes a proposed rule.<sup>19</sup> The proposed changes all relate to NER Schedule 6A.4 which covers the application of Chapter 6A (Economic Regulation of Transmission Services) to AEMO and DTSOs.

Each of the solutions proposed to address the three issues raised by the proponent is discussed in turn below.

### **2.2.1 Placing negotiation and associated information obligations on the DTSO**

To address the issue raised around the lack of an obligation on the relevant DTSO to negotiate directly with a transmission customer who requests a discount, the rule change request includes a proposal to insert a provision into the NER to require the relevant DTSO to negotiate in good faith with a transmission customer who requests, or proposes to requests, a discount.<sup>20</sup>

To address the proponent's specific concerns regarding the lack of an obligation on the DTSO to provide the transmission customer with relevant information, the rule change request also

<sup>19</sup> Copies of the rule change request may be found on the AEMC website, [www.aemc.gov.au](http://www.aemc.gov.au).

<sup>20</sup> Rule change request, p. 6.

proposes to include an additional, explicit obligation on the DTSO to provide the transmission customer with such information that is reasonably required by that customer for making a discount request to AEMO.

The proponent suggests that this solution would remove any ambiguity around the information provision obligation that would otherwise be present under an obligation to negotiate in good faith alone.

The Commission is interested in stakeholders' views as to the appropriateness of placing an obligation on DTSOs to negotiate with customers in good faith and whether explicit obligations to provide information would be required in addition to this.

### 2.2.2 **Obligations to explain any refusal to agree to a discount**

To address the issue raised around the lack of obligations on AEMO and the relevant DTSO to provide the transmission customer with reasons for the rejection of a discount proposal, the rule change request includes a proposal to insert a provision into the NER to provide that, for any prudent discount application in an adoptive jurisdiction:<sup>21</sup>

- AEMO must provide reasons for any refusal to grant a discount
- the relevant DTSO must provide reasons for any refusal to provide its consent to AEMO granting the discount.

The Commission notes that, in other NEM jurisdictions, there is no explicit obligation for a TNSP to provide reasons to a transmission customer for rejecting a discount proposal.

### 2.2.3 **Clarifying the conditions around AEMO's right to apply to the AER for prudent discount cost recovery approval**

The rule change further includes a proposed solution to address the procedural challenges and associated disincentives that the proponent considers currently prevent AEMO from applying to the AER for cost recovery as a necessary prerequisite for a discount being approved in Victoria.<sup>22</sup>

This proposed solution involves making changes to an existing provision in the NER with the intention of expressly clarifying that AEMO's right to apply to the AER for approval to recover more than 70 per cent of a discount from other transmission customers is triggered where AEMO 'proposes to agree' to a discount on a conditional basis. It would do so by amending clause S6A.4.2(k)(4) to provide that, in an adoptive jurisdiction:

Clause 6A.26.2(a) applies as if the words "agreed, or proposes to agree (subject to obtaining AER approval under this clause 6A.26.2)" were substituted for the words "agreed or proposes to agree".

This is intended to allow AEMO to approve a discount subject to the AER approving recovery of the proposed discounted amount from other transmission customers, thereby breaking the impasse that the proponent considers exists under the existing arrangements.

<sup>21</sup> Rule change request, p. 7.

<sup>22</sup> Rule change request, p. 8.

The Commission is interested in stakeholders' views as to whether the current rule that allows a TNSP to apply to the AER to recover more than 70 per cent of a discount from other transmission customers where it "proposes to agree" to grant a discount to a customer already allows sufficient conditionality to address the situation identified by the proponent, and whether the proposed change is necessary or would be useful in confirming or clarifying this.

#### **QUESTION 2: THE PROPOSED SOLUTIONS**

- 2.1. Do the proposed solutions effectively and efficiently address the issues raised in the rule change request? Do the proposed rule changes add an appropriate level of clarity?
- 2.2. Would it be appropriate to place an obligation on DTSOs to negotiate with customers in good faith, and would explicit obligations to provide information be required in addition to this?
- 2.3. Do stakeholders consider it appropriate for the prudent discount framework in adoptive jurisdictions to include obligations which do not have equivalents in the arrangements applied in other jurisdictions?
- 2.4. Do stakeholders support any alternative solutions that could better address the identified issues?

## **2.3 Assessment framework**

### **2.3.1 Achieving the NEO**

Under 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.<sup>23</sup> This is the decision-making framework that the Commission must apply.

The NEO is:<sup>24</sup>

- 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.

### **2.3.2 The proposed assessment framework**

In determining whether the rule change request promotes the NEO, the Commission will assess the rule change request having regard to the following two principles:

<sup>23</sup> Section 88 of the NEL.

<sup>24</sup> Section 7 of the NEL.

- **Improving consistency, clarity and transparency:** The provision of consistent, clear and transparent rules and processes is important, as it enables participants to understand their own and others' obligations with respect to the transactions that they undertake. This will promote confidence, and therefore efficiency, in the market.
- **Improving administrative efficiency:** Improving the effectiveness and efficiency of administrative processes can reduce costs for participants and contribute to cost savings being passed on to customers.

### QUESTION 3: ASSESSMENT FRAMEWORK

- 3.1. Is the assessment framework appropriate for considering the rule change request?
- 3.2. Are there other relevant considerations that should be included in the assessment framework?

#### 2.3.3 Making a more preferable rule

Under section 91A of the NEL, the Commission may make a rule that is different (including materially different) to a proposed rule (a more preferable rule) if it is satisfied that, having regard to the issue or issues raised in the rule change request, the more preferable rule will or is likely to better contribute to the achievement of the NEO.

#### 2.3.4 Making a differential rule

Under the Northern Territory legislation adopting the NEL, the Commission may make a differential rule if, having regard to any relevant MCE statement of policy principles, a different rule will, or is likely to, better contribute to the achievement of the NEO than a uniform rule. A differential rule is a rule that:

- varies in its term as between:
  - the national electricity system, and
  - one or more, or all, of the local electricity systems, or
- does not have effect with respect to one or more of those systems

but is not a jurisdictional derogation, participant derogation or rule that has effect with respect to an adoptive jurisdiction for the purpose of s. 91(8) of the NEL.

As the proposed rule relates to parts of the NER that currently do not apply in the Northern Territory,<sup>25</sup> the Commission has not assessed the proposed rule against additional elements required by the Northern Territory legislation.<sup>26</sup>

<sup>25</sup> The Northern Territory is not an adoptive jurisdiction, nor does Chapter 6A apply in the Northern Territory.

<sup>26</sup> From 1 July 2016, the NER, as amended from time to time, apply in the Northern Territory, subject to derogations set out in regulations made under the Northern Territory legislation adopting the NEL. Under those regulations, only certain parts of the NER have been adopted in the Northern Territory. (See the AEMC website for the NER that applies in the Northern Territory.) National Electricity (Northern Territory) (National Uniform Legislation) Act 2015.

## 3 PROCESS FOR THIS RULE CHANGE

### 3.1 Treatment as a non-controversial rule

The proponent has requested that the rule change request be treated as a non-controversial rule in accordance with section 96 of the NEL. The proponent considers that the proposed amendments are of the nature of procedural clarifications, which are intended to resolve potential drafting ambiguities and/or to address unintended consequences as to the way in which the procedural aspects of the prudent discount process apply in Victoria.<sup>27</sup>

The Commission considers that the proposed rule meets the definition of a non-controversial rule under section 87 of the NEL, in that it is unlikely to have a significant effect on the national electricity market. The rule change request is narrow in scope and the proposed changes are largely of an administrative nature, intended to better facilitate the achievement of the original policy intent of the prudent discount regime.

Rule changes that are considered to be non-controversial may be processed under an expedited (faster) process under which there is only one round of consultation and the AEMC is required to publish its final rule determination within eight weeks of commencing the rule change process.<sup>28</sup>

The Commission has decided to use an expedited process to consider this rule change request provided that it does not receive any valid requests not to use the expedited process by 22 October 2020. To be valid, an objection should set out the reasons why the rule change request is likely to have a significant effect on the national electricity market.

### 3.2 Key dates

Given the tightly defined nature of the issue, and the background information provided in the rule change request, this consultation paper is brief. Nevertheless, submissions are invited in relation to the matters identified above, and any other relevant issue.

The key dates for stakeholders in this process are as follows:

- Commencement of this rule change process: 8 October 2020
- Objections to an expedited process to be received by: 22 October 2020
- Submissions to the proposal to be received by: 5 November 2020
- Final decision to be published under an expedited process by: 3 December 2020.

<sup>27</sup> Rule change request, p. 3.

<sup>28</sup> The AEMC has published a notice under sections 95 and 96 of the NEL to commence and assess this rule change request as a non-controversial rule.

## 4 LODGING A SUBMISSION

The Commission invites both:

- requests not to make a rule under the expedited process
- written submissions on this rule change request.

All enquiries on this project should be addressed to Orrie Johan at orrie.johan@aemc.gov.au.

### 4.1 Lodging a request not to make a rule under an expedited process

Written requests not to make a rule under the expedited process in section 96 of the NEL must include reasons for the request, and must be lodged with the Commission by **22 October 2020**. Requests must be submitted online in accordance with the process specified below.

### 4.2 Lodging a submission to this rule change request

Written submissions on the rule change request must be lodged with Commission by **5 November 2020**. Submissions must be lodged online in accordance with the process specified below.

Where practicable, submissions should be prepared in accordance with the Commission's guidelines for making written submissions on rule change requests.<sup>29</sup> The Commission publishes all submissions on its website, subject to a claim of confidentiality.

### 4.3 Lodging online

Submissions, or requests not to make a rule under the expedited process, must be lodged online via the Commission's website, [www.aemc.gov.au](http://www.aemc.gov.au), using the "lodge a submission" function and selecting the project reference code ERC0317.

The request or submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

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<sup>29</sup> This guideline is available on the Commission's website [www.aemc.gov.au](http://www.aemc.gov.au).

## ABBREVIATIONS

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
APA	Alcoa Portland Aluminium Pty Ltd
Commission	See AEMC
DTSO	Declared transmission system operator
NEL	National Electricity Law
NEO	National electricity objective
NER	National Electricity Rules
TNSP	Transmission network service provider
TUOS charges	Transmission use of system charges