Draft decision

TransGrid transmission determination

2015–16 to 2017–18

Attachment 12: Pricing methodology

November 2014

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on TransGrid's revenue proposal 2015–18. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – maximum allowed revenue

Attachment 2 – regulatory asset base

Attachment 3 – rate of return

Attachment 4 – value of imputation credits

Attachment 5 – regulatory depreciation

Attachment 6 – capital expenditure

Attachment 7 – operating expenditure

Attachment 8 – corporate income tax

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Attachment 10 – capital expenditure sharing scheme

Attachment 11 – service target performance incentive scheme

Attachment 12 – pricing methodology

Attachment 13 – pass through events

Attachment 14 – negotiated services

Contents

Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria

Shortened form	Extended form
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

12 Pricing methodology

This attachment sets out our draft determination on TransGrid's proposed pricing methodology for the 2015–18 regulatory control period.

We are required to specify a pricing methodology as part of our transmission determination.[1] A pricing methodology answers the question 'who should pay how much'[2] in order for a transmission business to recover its costs. To do this, it must provide a 'methodology, formula, process or approach'[3] that when applied:

- allocates the aggregate annual revenue requirement to the categories of prescribed transmission services that a transmission business provides and to the connection points of network users[4]
- determines the structure of prices that a transmission business may charge for each category of prescribed transmission services.[5]

A pricing methodology relates to prescribed transmission services only. For negotiated services, TransGrid must comply with other requirements, which are discussed in attachment 14 of this draft decision.

12.1 Draft decision

We do not approve TransGrid's proposed pricing methodology for the 2015–18 regulatory control period.[6] We have assessed that aspects of TransGrid's proposed pricing methodology do not give effect to the pricing principles in the National Electricity Rules (NER) or comply with the requirements set out in the pricing methodology guidelines.[7]

12.2 TransGrid's proposal

TransGrid's proposed pricing methodology seeks to introduce a number of changes. This is compared to the pricing methodology we approved for TransGrid's 2009–14 regulatory control period.

The changes TransGrid proposed include arrangements that would allow the transmission business to modify its pricing methodology within the 2015–18 regulatory control period.[8] It also proposed modifications to how costs for the locational component of prescribed transmission use of system (TUoS) services would be allocated.[9] The pricing structure for certain services was altered too, and provisions were added that would allow TransGrid to negotiate fixed price services with its customers.[10]

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1 NER, cl. 6A.2.2(4).
2 AEMC, *Rule determination: National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006 No. 22*, 21 December 2006, p. 1.
3 NER, cl. 6A.24.1(b).
4 NER, cl. 6A.24.1(b)(1).
5 NER, cl. 6A.24.1(b)(2).
6 NER, cl. 6A.14.1(8)
7 NER, cl. 6A.24.1(c).
8 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.
9 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.
10 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.

In addition to submitting its proposed pricing methodology, TransGrid provided us with a document called 'Transmission Pricing Methodology – Better Outcomes for Customers'.[11] It provides explanatory information about TransGrid's proposed changes.

12.3 AER's assessment approach

We must approve a proposed pricing methodology if we are satisfied that it:

- gives effect to, and complies with, the pricing principles for prescribed transmission services
- complies with the requirements of, and contains or is accompanied by information, as required by the pricing methodology guidelines.[12]

Our assessment approach was guided by these requirements. In particular, we assessed whether TransGrid's proposed changes from its 2009–14 pricing methodology give effect to the pricing principles and comply with the pricing methodology guidelines.

12.4 Reasons for draft decision

We have assessed that parts of the proposed pricing methodology give effect to and comply with the pricing principles in the NER and the pricing methodology guidelines. However, we have determined that other parts do not meet those requirements. We assessed each of the changes TransGrid proposed.

Table 122.1 Overview of our reviews for draft decision

Draft decision	Proposed change
Accept	Modifying the way the excess demand charge is calculated (section 12.4.1)
Further consultation required	For locational TUoS services, switching to a 20 day peak period cost allocation (section 12.4.2)
	The introduction of MVA pricing (section 12.4.3)
Not accept	The ability to amend aspects of TransGrid's approved pricing methodology during the regulatory control period (section 12.4.4)
	For non–locational TUoS and common transmission services, basing prices on maximum demand and applying a side constraint equal to CPI + 3 per cent (section 12.4.5)
	The availability to negotiate a fixed price with its transmission network customers (section 12.4.6)

[11] TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014.
[12] NER, cl. 6A.24.1(c).

Additionally, we assessed other aspects of TransGrid's proposed pricing methodology more generally against the requirements in the pricing principles (section 12.4.7) and the pricing methodology guidelines (section 12.4.8).

12.4.1 Excess demand charge

TransGrid proposed to modify how it calculates its excess demand charge. We approve the proposed modification because they are likely to lead to better outcomes for customers.

Customers who have chosen to have their non–locational TUoS and common transmission service charges set on the basis of contract agreed maximum, are liable to pay an excess demand charge if their demand goes above their nominated demand. In the 2009–14 regulatory control period, the excess demand charge was equal to more than TransGrid's costs in providing the incremental demand.[13] TransGrid proposes to modify this so that in the 2015–18 regulatory control period the excess demand charge will be more cost reflective. We consider this to be preferable and hence accept it.

12.4.2 Locational TUoS

We do not accept TransGrid's proposed 20 day peak period for allocating costs for the locational component of TUoS services, but may accept it at the final decision stage after consulting with stakeholders.

Our view is that this aspect of TransGrid's proposal is capable of meeting the pricing principles in the NER and the requirements for alternative pricing structures in the AER's guidelines.[14] However, we are not satisfied that TransGrid has provided the information necessary to support this aspect of its proposal. We note that this lack of information impacts upon the ability of stakeholders to comment.

Under the pricing principles in the NER, costs attributable to the locational component of TUoS services must be allocated under certain operating conditions. In particular, when applying either the standard or modified cost reflective network pricing methodologies, transmission businesses must have regard to:

> the conditions that result in the most stress on the transmission network and for which network investment may be contemplated.[15]

In practice, this requires transmission businesses to run their T-PRICE modelling software (which allocates costs according to electricity flows) during times of peak demand. The time period over which peak demand is assessed is not defined in the NER, however our pricing methodology guidelines specify two approaches transmission businesses may use.

These are either a 12 month or a 10 day peak method.[16] The 12 month method is sometimes referred to as the 'element peak approach' because it takes local system conditions into account. The 10 day method does not consider local conditions so it is often referred to as the 'system peak approach'. We can also approve alternative methods proposed by transmission businesses, subject to meeting certain requirements.[17]

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13 TransGrid, *Proposed pricing methodology 1 July 2009 to 30 June 2014*, January 2009, p.15
14 AER, Pricing methodology guidelines, July 2014, section 2.2(e).
15 NER, cl. S6A.3.2(3).
16 AER, *Pricing methodology guidelines*, July 2014, section 2.2(c).
17 AER, *Pricing methodology guidelines*, July 2014, section 2.2(e).

For the 2009–14 regulatory control period, TransGrid opted to use the 12 month period from the pricing methodology guidelines. TransGrid noted that this 'approach captures the maximum extent to which a connection point uses network assets over the course of a year, taking into account the full range of system conditions and generation patterns'.[18]

In the 2015–18 regulatory control period, TransGrid proposes a time period for running the T-PRICE software which is *not* specified in the pricing methodology guidelines. This is a 20 day *system* peak period. As an alternative pricing structure for the recovery of revenue attributable to locational component of prescribed TUoS services, TransGrid is required to show that applying the proposed method:

- gives effect to the pricing principles in the NER
- improves on the permitted pricing structures in the pricing methodology guidelines
- contributes to the national electricity objective.[19]

Our analysis of TransGrid's proposal concludes that applying the T-PRICE software over the 20 days with the highest system peak demand is likely to take into account network conditions for which investment across the transmission would be contemplated. It therefore gives effect to the pricing principles in the NER, to the extent they relate to locational TUoS services.[20]

As for offering improvements, in past decisions we have considered whether an alternative is at least on par with the permitted pricing structures.[21] Applying this approach, we consider it likely that the proposed 20 day peak period would be at least on par with the 10 day cost allocation method specified in the pricing methodology guidelines. It is basically the same as the 10 day cost allocation, but over a longer period.

Moreover, there are grounds for finding that the adoption of the 20 day peak method improves on the 10 day peak period. This is by lengthening the operating conditions under which network stress is analysed for the purposes of allocating costs. Similar reasons could also be given for finding that the 20 day peak method contributes to the national electricity objective, which requires us to consider the long term interests of consumers.

We conclude that the proposed cost allocation approach is capable of being approved as an alternative pricing structure. However, we wish to consult with stakeholders about the approach before we accept it.

This decision has been made in light of stakeholder submissions. ElectraNet submitted that the 'merits of the proposed change do not appear to have been adequately demonstrated to support an informed decision on this proposal by the AER or consumers at this stage'.[22] By not accepting this aspect of the proposal, however, TransGrid will be required to provide additional information and stakeholders will have an opportunity to make further submissions to us.

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18 TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014, p. 15.
19 AER, *Pricing methodology guidelines*, July 2014, section 2.2(e).
20 NER, cl. S6A.3.2(3).
21 AER, *Final decision: TransGrid transmission determination 2009–10 to 2013–14*, 28 April 2009, p. 131.

12.4.3 MVA pricing

TransGrid proposed that transmission prices would be levied on the basis of MVA from 1 July 2017. It stated that this 'charging approach will improve cost reflectivity and enable distributors to pass through transmission prices more readily to their customers'.[23] TransGrid did not submit any information that indicated the views of its network users on the timing of this change, particularly in relation to whether affected parties will be able to arrange for the necessary metering to be installed in time. We consider that this approach has merit but we wish to consult with stakeholders further before deciding whether to approve this aspect of TransGrid's proposed pricing methodology.

12.4.4 Within period amendments

We do not accept TransGrid's proposal to be able to amend aspects of its approved pricing methodology within the 2015–18 regulatory control period. This does not comply with the requirements under the NER and the pricing methodology guidelines.[24]

TransGrid sought to be able to amend:

- the type of cost reflective network pricing methodology it applies
- aspects of its approved pricing methodology to address a rule change TransGrid is planning to lodge with the Australian Energy Market Commission (AEMC).[25]

Cost reflective network pricing

A pricing methodology must allocate a transmission business' revenue requirement to the connection points of network users.[26] For a proportion of shared network services, referred to as the non-locational component of TUoS services, the NER requires transmission businesses to conduct this allocation using either a *standard* or *modified* cost reflective network pricing methodology.[27]

At a high level, both the standard and modified cost reflective network pricing methodologies comprise of running a software program called T-PRICE. This program allocates revenue to a transmission business' connection points by modelling the flow of electricity along its network. The difference between the methodologies is that when allocating revenue, the standard version does not discount for the level of network utilisation at a connection point whereas the modified version does take that factor into account.[28]

TransGrid's proposed pricing methodology provides that it will apply the *standard* cost reflective network pricing methodology.[29] Notwithstanding this, it seeks the option to switch to the *modified* cost reflective network pricing methodology within the 2015–18 regulatory control period. TransGrid states that it would exercise this option if it determines that the switch would provide better price signals.[30]

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23 TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014, p. 7.
24 NER, cl. 6A.24.1(e) and (f)
25 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.
26 NER, cl. 6A.24.1(b).
27 NER, cl. S6A.3.2 and S6A.3.3.
28 NER, cl. S6A.3.2 and S6A.3.3.
29 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 11.
30 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 12.

In effect, TransGrid does not want to commit to either the standard or modified cost reflective network methodologies. We understand that this is so TransGrid has additional time to assess the benefits of each.[31] We, however, consider this to be non-compliant with the NER.

The rules stipulate that a pricing methodology as approved by us and as included in a transmission determination applies for the duration of the regulatory control period and may not be amended during the regulatory control period.[32] We consider that switching methodology at any time during the regulatory control period would be effectively an amendment to the approved pricing methodology.[33] Additionally, we would have concerns about TransGrid making unilateral decisions to alter its pricing methodology without us making a determination and, potentially, in the absence of effective consultation with stakeholders. The proposal also removes the certainty for customers that prices will be determined in a particular way.

We thus consider this aspect of TransGrid's proposed pricing methodology to be non-compliant with the regulatory requirements. To be approved at the final decision stage, we require certainty as to the methodology (standard or modified) TransGrid will use throughout the 2015–18 regulatory control period.

ElectraNet in its submission supported the breaking of the nexus between the revenue determination process and the approval and implementation of revised pricing methodologies. However, it was of the view that this required a broader review of transmission pricing arrangements, possibly through a rule change.[34] We concur with this view to the extent that a rule change would be required in order to allow the kind of flexibility that TransGrid seeks. The rule change process is the better mechanism for engaging with the sector on these types of changes.

Rule change

In its proposed pricing methodology, TransGrid stated that the transmission business is considering lodging a rule change request with the AEMC. The request, if made, would be based on analysis TransGrid has conducted questioning whether the current cost reflective network pricing methodologies, as administered by T-PRICE, are delivering appropriate price signals.[35]

We accept that if there is a change to the NER, then TransGrid would want to have the necessary scope to move to the new arrangements. We nonetheless determine that it is not open to the AER to approve a pricing methodology that will permit this scope for change within the 2015–18 regulatory control period. As set out above, this is because the rules stipulate that a pricing methodology applies for the duration of the regulatory control period and may not be amended during that period.[36]

To be approved, TransGrid must remove any reference to amending its pricing methodology in response to a rule change. If such a rule change takes place, we note that the AEMC would have the power to decide when transmission businesses would be able to institute any changes and would make such a decision in line with the national electricity objective and other considerations.

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31 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.

32 NER, cl. 6A.24.1(e) and (f); see chapter 10 for the definition of "pricing methodology": For a [TNSP], means the pricing methodology approved by the AER for that [TNSP] and including in a transmission determination as referred to in rule 6A.24. .

33 A TNSP may amend its pricing methodology but only in very limited circumstances under clause 6A.15.

34 ElectraNet, *Submission on TransGrid's proposed pricing methodology*, 7 August 2014, p. 3-4.

35 TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014, p. 15.

36 NER, cl. 6A.24.1(e) and (f).

12.4.5 Non–locational TUoS and common services

We do not accept TransGrid's proposed pricing structure for non–locational TUoS and common transmission services. We consider TransGrid's proposed approach has merit, but it does not comply with the pricing principles in the NER and therefore cannot be accepted.

The proposed structure sets prices according to maximum demand only. This is different to the 2009–14 regulatory control period where TransGrid set non–locational TUoS and common transmission services prices according to *either* contract agreed maximum demand or historical energy.

As well as setting prices on the basis of maximum demand only, TransGrid proposed to introduce a side constraint. It provides that 'the annual change in transmission costs for any TransGrid customer or large distribution customer will be capped at a maximum of CPI + 3 per cent'.[37] TransGrid stated that it intends to liaise with electricity distributors in NSW to extend the application of the side constraint to their customers on an annual basis.[38] An additional element of its methodology is a transitional arrangement that allows for an increase in the price for non–locational TUoS and common transmission services to compensate for any revenue lost through the application of the price constraint.

We assessed TransGrid's proposal for non–locational TUoS and common transmission services to be an 'alternative pricing structure'. This means it is not expressly set out in the pricing methodology guidelines as an acceptable approach but may still be acceptable as an alternative approach if it meets the relevant criteria. The pricing methodology guidelines do permit pricing structures for non–locational TUoS and common transmission services based on 'maximum demand'. TransGrid combines this with a side constraint which is not contemplated in the guidelines, and with a compensating increase in the price at certain connection points. As TransGrid recognises, 'the application of the side constraint is unprecedented and will raise a number of implementation issues'.[39] All these three aspects of TransGrid's proposal are considered below.

Pricing principles

We do not accept that TransGrid's proposed postage stamp structure complies with the pricing principles in the NER.

An alternative pricing structure must give effect to and be consistent with the pricing principles in the NER. This requires the prices for non–locational TUoS and common transmission services to be recovered on a 'postage stamp basis'.[40] The NER defines this as:

> A system of charging Network Users for transmission service or distribution service in which the price per unit is the same regardless of how much energy is used by the Network User or the location in the transmission network or distribution network of the Network User.[41]

TransGrid proposed to use maximum demand to devise prices for non–locational TUoS and common transmission services. We accept that this, by itself, meets the requirements of developing prices on a 'postage stamp basis'. We then considered if the addition of the 'CPI + 3 per cent' side constraint affected that conclusion.

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37 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 14.
38 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 14.
39 TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014, p. 10.
40 NER, cll. 6A.23.4(d) and (j).
41 NER, Chapter 10.

The side constraint would be applied in order to minimise price shocks for any customer, including distribution customers. As an overall cap on annual transmission costs, it would be applied on the assumption that the customer's demand is unchanged from the previous year.[42]

The inclusion of the side constraint is to be applied in conjunction with an added transitional arrangement in order that TransGrid not be adversely affected by the price constraint. TransGrid stated that 'if the application of the price constraint would result in a revenue shortfall, this shortfall may be recovered by adjusting upward the charges that would otherwise apply in respect of non–locational TUoS services'.[43] The result would be that 'the postage stamp charge will therefore be reduced at the relevant connection point(s) on a transitional basis, and a compensating increase will apply at the remaining connection points'.[44] The duration of this transitional arrangement is not specified.

ElectraNet submitted that it is unclear that this upward adjustment at some connection points is permissible under the NER.[45] It also stated that the proposed side constraint, which caps prices in reference to CPI changes, 'would not necessarily be achievable in the event of a material change in the revenue path (for example due to annual adjustment for the weighted cost of capital)'.[46] ElectraNet proposed that maximum allowed revenue, as opposed to CPI, would be a more appropriate mechanism for the side constraint.

We do not accept that the proposed side constraint is permissible under the NER and therefore it is unnecessary to consider ElectraNet's suggestion that revenue would be a better mechanism. In particular, we consider that transitional aspect of the methodology, specifically the 'compensating increase', does not comply with the pricing principles. It would be contrary to the requirement that the postage stamp pricing system apply the same price per unit 'regardless of how much energy is used by the Network User'.[47] TransGrid advised that the compensating increase would apply to customers with poor load factors.[48] However, we consider derogations based on load factor are akin to charging customers differently on the basis of their 'energy use'. It is therefore contrary to developing prices on a 'postage stamp basis'.[49]

We further note that the NER only expressly permits an adjustment of this kind where it arises from the application of the two per cent side constraint on locational prices under clause 6A.23.4(f). There is no equivalent NER provision that permits an equivalent kind of adjustment to the pricing for non-locational TUoS and common transmission services.

Improves on permitted pricing structures

The pricing methodology guidelines provide that an alternative pricing structure must improve on the permissible postage stamp pricing structures for non–locational TUoS and common transmission services.[50] We assessed whether TransGrid's proposed alternative pricing structure, and in particular the 'CPI + 3 per cent' side constraint, meets this requirement.

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42 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.
43 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 18.
44 TransGrid, *Proposed pricing methodology*, 2 June 2014, p.19.
45 ElectraNet, *Submission on TransGrid's proposed pricing methodology*, 7 August 2014, p. 3.
46 ElectraNet, *Submission on TransGrid's proposed pricing methodology*, 7 August 2014, p. 3.
47 NER, Chapter 10.
48 AER staff file notice, Discussion on 2 September 2014 (D14/137282)
49 NER, Chapter 10.
50 AER, *Pricing methodology guidelines*, July 2014, section 2.3(e)(2).

First permissible pricing structure

The pricing methodology guidelines provide for two permissible structures. The first requires a transmission business to determine both *contract agreed maximum demand* and *historical energy* prices at each of its connection points.[51] Out of these, the pricing methodology guidelines provide that a network operator must apply the price which results in the lower charge.[52]

We consider the first permissible structure provides for equitable pricing outcomes. As TransGrid stated, charging according to the cheaper of *contract agreed maximum demand* and *historical energy* means that larger customers make a greater contribution to fixed costs.[53] It also means that transmission charges will tend to reflect a customer's ability to pay.[54] Notwithstanding, we consider TransGrid's proposed alternative pricing structure, which uses maximum demand, may offer improvements.

TransGrid stated that during its consultation processes, a number of stakeholders questioned whether it was appropriate to recover transmission costs on the basis of an energy throughput. According to TransGrid EMRF, Ellipson Energy Pty Ltd, Energy Users of Australia Association (EUAA), the NSW distribution businesses and Visy all made submissions to this effect.[55]

The AER accepts that using energy based prices may not lead to cost reflective prices. This is because investment in TransGrid's network is driven by demand, and not energy.

On that basis, we conclude TransGrid's proposed pricing structure for non–locational TUoS and common transmission services may improve on the first permissible pricing structure in the pricing methodology guidelines. It bases prices on maximum demand only, which by removing the availability of energy based prices, should lead to greater cost reflectivity. The Major Energy Users took this view also, when it stated that it considers the 'new [TransGrid] pricing methodology is a major step forward in ensuring transmission costs are shared equitably between all users of the services provided'. Other stakeholders took a similar view too.[56]

Notwithstanding this, we note that the side constraint TransGrid proposed would dampen any immediate benefits, relating to cost reflectivity, in the 2015–18 regulatory control period.

Second permissible pricing structure

The second permissible structure for non–locational TUoS and common transmission services requires prices to be based on 'maximum demand'.[57] We observed TransGrid's alternative pricing structure to be the same as this permissible option with the exception that it adds the 'CPI + 3 per cent' side constraint.

We accept that switching to demand based prices without a transition period would not be prudent. For customers whose prices are calculated on an energy basis, in the absence of a period of adjustment the switch to maximum demand is likely to lead to price shocks. Such an outcome would

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51 AER, *Pricing methodology guidelines*, July 2014, section 2.3(c)(2).
52 AER, *Pricing methodology guidelines*, July 2014, section 2.3(c)(6).
53 TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014, p. 9.
54 TransGrid, *Transmission pricing methodology - Better outcomes for customers*, 2 June 2014, p. 9.
55 TransGrid, *Summary of stakeholder submissions: Transmission pricing consultation*, January 2014, p. 1.
56 Norske Skog, *Submission to the AER*, 8 August 2014; EUAA, *Submission to the AER*, 8 August 2014.
57 AER, *Pricing methodology guidelines*, July 2014, section 2.3(b)(2).

be contrary to the national electricity objective, which requires us to consider the long term interests of customers in terms of 'price', among other things.[58]

For that reason, we accept that TransGrid's proposed alternative pricing structure improves on the second permissible option. It applies the same measure of network usage (maximum demand) but adds a 'CPI + 3 per cent' side constraint. This should lead to better outcomes for many of TransGrid's customers compared to if the transmission business switched to demand based prices without any transition period.

Least distortionary

To be approved, an alternative pricing structure must be 'least distortionary' to transmission users' behaviour.[59] To be least discretionary requires prices to have a limited impact on the behaviour of users. This is in terms of their 'production, operation, location, or expansion decisions'.[60]

We accept that the alternative pricing structure TransGrid proposed may lead to the 'least distortionary' outcome for transmission users. In past AER decisions, stakeholders have submitted that recovering a business's revenue requirement for non–locational TUoS services on 'energy based prices rather than demand based prices provides a "free ride" to occasional users'.[61] To a certain extent, we accept that this may occur.

Moreover, as a result of energy based pricing for some customers we accept that larger network users, on demand based prices, may alter their behaviour. We took this view when we first developed the pricing methodology guidelines in 2007. This prompted us to note that 'if a demand based postage stamped pricing structure reduces the likelihood of a user with a large sunk investment from shutting down and disconnecting from the transmission network it should be used to derive postage stamp prices'.[62]

We reiterate that view. The switch to maximum demand prices for non–locational TUoS and common transmission services may stop larger network users from leaving the network. We consider this to be particularly the case in New South Wales where demand is declining. On that basis, we accept that TransGrid's proposal—by removing all energy based prices in favour of using maximum demand only—would lead to a least distortionary outcome.

National electricity objective

We note that the alternative pricing structure TransGrid proposed is likely to contribute the national electricity objective.[63] There are grounds for concluding that it improves on the permissible pricing structures in the NER and potentially satisfies the requirement that the alternative pricing structure is 'least distortionary' for network customers. However, as set out above, this aspect of TransGrid's proposal does not comply with the pricing principles in the NER and therefore cannot be accepted.

12.4.6 Negotiated prices

TransGrid proposed arrangements where it is able to negotiate a fixed price with its customers for a period of up to five years.[64] It stated that a negotiated fixed price would not be able to extend between

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58 NEL, s. 7.
59 AER, *Pricing methodology guidelines*, July 2014, section 2.3(e).
60 AER, *Final decision: Pricing methodology guidelines*, October 2007, p. 19.
61 AER, *Final decision: Pricing methodology guidelines*, October 2007, p. 18.
62 AER, *Final decision: Pricing methodology guidelines*, October 2007, p. 19.
63 AER, *Pricing methodology guidelines*, July 2014, section 2.3(e)(3).
64 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 15.

regulatory control periods. TransGrid stated that it would consult with customers and other stakeholders to develop a framework for negotiating fixed price contracts, but in general the principles that it would apply would be:

- the negotiated price must reflect a reasonable forecast of the prices that would result from the annual application of TransGrid's pricing methodology
- consideration should be given to the value obtained by the customer in securing price certainty
- the negotiated price should not disadvantage other customers
- the methodology for determining the fixed price should be transparent to all customers
- TransGrid should not obtain any benefit or incur any cost as a result of providing price certainty.[65]

We agree that there may be benefits from providing increased certainty in the manner proposed by TransGrid. We note that the principles that TransGrid has outlined provide some guidance to developing a suitable framework although there is a large degree of uncertainty as to the impact upon other customers if the assumptions adopted prove to be materially wrong.

However, the NER at present does not contemplate arrangements whereby transmission businesses are able to negotiate the price of prescribed transmission services with customers. Such arrangements are also inconsistent with the prescribed cost allocation and pricing structure requirements in the NER.[66] We therefore do not approve this aspect of TransGrid's proposed pricing methodology.

As ElectraNet submitted, it supports a degree of price certainty to customers but a sustainable solution may be found in a broader review of the relevant rules.[67] Specifically it suggested broadening the current prudent discounts arrangement to include provisions for longer term contracting of transmission prices to customers.[68] We agree insofar as TransGrid's proposal in this respect is not currently permitted under the NER.

12.4.7 Assessment against the pricing principles

With the exception of those elements which we do not accept (as outlined above), we consider that the other aspects of TransGrid's proposed pricing methodology otherwise meet the requirements of the pricing principles in the NER. The pricing principles are intended to provide scope for transmission businesses to develop pricing arrangements that address the circumstances in which they operate their network.[69] This limits our review to a high level assessment.

Calculation and allocation of the aggregate annual revenue requirement

We assessed TransGrid's method for calculating and allocating its aggregate annual revenue requirement, and consider that this aspect of TransGrid's proposed pricing methodology meets the NER requirements.

The aggregate annual revenue requirement is the 'maximum allowed revenue' adjusted:

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65 TransGrid, *Proposed pricing methodology*, 2 June 2014, p. 16.
66 NER, Part J.
67 ElectraNet, *Submission on TransGrid's proposed pricing methodology*, 7 August 2014, p. 3-4.
68 ElectraNet, *Submission on TransGrid's proposed pricing methodology*, 7 August 2014, p. 3.
69 AEMC, *Rule Determination: National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006 No 22*, 21 December 2006, pp. 27–8.

- in accordance with clause 6A.3.2 of the NER, for a number of factors such as cost pass throughs, service target performance incentive scheme outcomes, and contingent projects
- by subtracting the operating and maintenance costs expected to be incurred in the provision of prescribed common transmission services

Table 122.2 summarises our review of how TransGrid proposed pricing methodology calculates and allocates the business's aggregate annual revenue requirement.

Table 122.2 TransGrid' proposed calculation and allocation of the AARR, and the NER requirements

NER requirements	Assessment
Requirement for the AARR to be calculated as defined in the NER—clause 6A.22.1	Section 6 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for the AARR to be allocated to each category of prescribed transmission services in accordance with attributable cost share for each such category of service—clause 6A.23.2(a)	Appendix C of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for every portion of the AARR to be allocated and for the same portion of AARR not to be allocated more than once—clause 6A.23.2(c)	Section 6 of TransGrid's proposed pricing methodology complies with this requirement.
Subject to clause 11.6.11 of the NER, requirement for adjusting attributable cost share and priority ordering approach to asset costs that would otherwise be attributed to the provision of more than one category of prescribed transmission services—clause 6A.23.2(d)	Appendix C of TransGrid's proposed pricing methodology complies with this requirement.

Allocation of the ASRR to transmission network connection points

We assessed TransGrid' proposed pricing methodology for allocating the ASRR, and consider this aspect of TransGrid's proposal meets the NER requirements. Table 122.3 summarises our assessment.

Table 122.3 TransGrid' proposed allocation of the ASRR, and the NER requirements

NER requirements	AER assessment
Requirement for whole ASRR for prescribed entry services to be allocated to transmission network connection points in accordance with the attributable connection point cost share for prescribed entry services that are provided by the TNSP at that connection point—clause 6A.23.3(a)	Section 7 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for the whole ASRR prescribed exit services to be allocated to transmission network connection points in accordance with the attributable connection point cost share for prescribed exit services that are provided by the TNSP at that connection point—clause 6A.23.3(b)	Section 7 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for the allocation of the ASRR for: prescribed TUOS services locational components	Section 7 of TransGrid's proposed pricing methodology complies with this requirement.

NER requirements	AER assessment
pre-adjusted non-locational components —clause 6A.23.3(c)	
Requirement for adjusting attributable cost share and priority ordering approach to asset costs that would otherwise be attributed to the provision of more than one category of prescribed transmission services—clause 6A.23.2(d)	Section 7 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for the recovery of the ASRR for prescribed common transmission services and the operating and maintenance costs incurred in the provision of those services to be recovered through prices charged to transmission customers and network service and network service provider transmission connection points set in accordance with price structure principles set out in clause 6A.23.4—clause 6A.23.3(f)	Section 8 of TransGrid's proposed pricing methodology complies with this requirement.

Development of price structure

We assessed TransGrid's proposed pricing methodology and process for developing different prices for recovering the ASRR, and considers that some of these aspects of TransGrid's proposal do not meet the NER requirements. Table 122.4 sets out our assessment.

Table 122.4 TransGrid's proposed pricing structure and the NER requirements

NER requirements	AER assessment
Requirement for separate prices for each category of prescribed transmission services—clause 6A.23.4(b)	Section 8 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for fixed annual amount prices for prescribed entry services and prescribed exit services—clause 6A.23.4(c)	Section 8.1 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for postage stamped prices for prescribed common transmission services—clause 6A.23.4(d)	We do not accept that TransGrid's proposed pricing methodology complies with this requirement for the reasons given in section 12.4.5.
Requirement for prices for locational component of prescribed TUOS services to be based on demand at times of greatest use of the transmission network and for which network investment is most likely to be contemplated—clause 6A.23.4(e)	We do not accept that TransGrid's proposed pricing methodology complies with aspects of this requirement for the reasons given in section 12.4.2.
Requirement for prices for the locational component of ASRR for prescribed TUOS services not to change by more than 2 per cent per year compared with the load weighted average prices for this component for the relevant region—clause 6A.23.4 to clause 6A.23.4(f)	Section 8.2 of TransGrid's proposed pricing methodology complies with this requirement.
Requirement for prices for the adjusted non-locational component of prescribed TUOS services to be on a postage stamp basis—clause 6A.23.4(j)	We do not accept that TransGrid's proposed pricing methodology complies with this requirement for the reasons given in section 12.4.5.

12.4.8 Assessment against the pricing methodology guidelines

We are satisfied that the proposed pricing methodology complies with the information requirements of the pricing methodology guidelines. Key features of the proposal include:

- acknowledging that TransGrid is the only transmission business in its region (Tasmania)
- calculating the locational component of prescribed TUOS services costs using a cost reflective network pricing methodology
- basing the locational prescribed TUOS services price on an agreed nominated demand and the average half hourly demand
- basing the postage stamp pricing structure for the non-locational component of prescribed TUOS services and prescribed common transmission
- using the priority ordering approach under clause 6A.23.3(d) of the NER to implement priority ordering
- describing how asset costs that may be attributable to both prescribed entry services and prescribed exit services will be allocated at a connection point
- describing billing arrangements as in clause 6A.27 of the NER
- describing prudential requirements as in clause 6A.28 of the NER
- including hypothetical examples
- describing how TransGrid intends to monitor and develop records of its compliance with its approved pricing methodology.