Submission to the Australian Energy Regulator on its Draft Decision on Powerlink's 2017-2022 Revenue Proposal

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On 28 April 2016, Aurizon Network (**Aurizon**) responded to the call by the Australian Energy Regulator (**AER**) for submissions on the Negotiated Transmission Service Criteria (**NTSC**) for Powerlink in relation to the 2017-2022 regulatory control period (**Revenue Proposal**).

Aurizon's submission proposed amendments to the NTSC to provide supplementary principles which would be relevant to the negotiation of a replacement connection agreement for negotiated transmission services which cease to be prescribed exit connection services. The amendments are intended to provide non-binding guidance to an arbitrator in the event of a dispute on the terms and conditions of those services. This largely reflects the intention that the costs of providing essentially an identical service (notwithstanding the change in name of the service) using the same eligible assets are unchanged from the last day of being a prescribed exit connection service and the first day of being a negotiated transmission service.

The AER's draft decision on the Revenue Proposal (**Draft Decision**) concluded:

> *In our view the amendments proposed by Aurizon should not be included in our NTSC determination because they are not consistent with the cost reflectivity and non-discrimination principles in the NER.*
>
> *Although we have not accepted any of the proposed amendments, we are open to further submissions on the NTSC for the purpose of making our final decision.*

This submission has been prepared to:

- improve the clarity with respect to the intention of the proposed amendments;
- clarify that the principles are limited <u>only</u> to where a prescribed connection service transitions to a negotiated transmission service solely by virtue of expiry of the prescribed connection agreement;
- establish that the principles are supplementary to the NTSC, are not contradictory to the requirements of cost reflectivity and non-discrimination, and therefore are not in conflict with Chapter 6A of the National Electricity Rules (**NER**); and
- demonstrate that the proposed amendments are consistent with the National Electricity Objective.

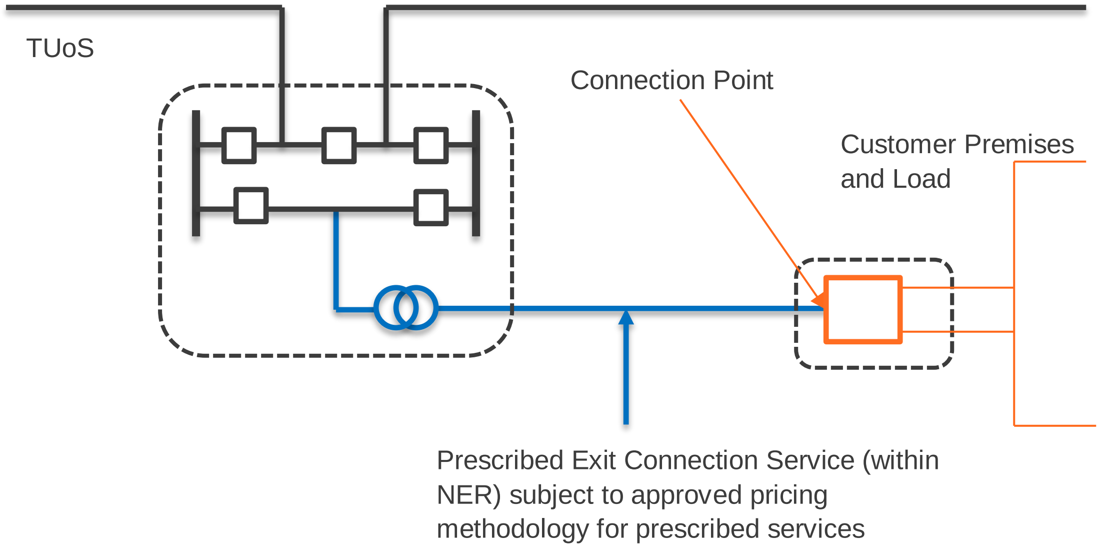
Grandfathering of Prescribed Exit Connection Services

Under clause 11.6.11 of the NER if a connection service ceases to be a prescribed connection service at the start of a regulatory control period for the relevant Transmission Network Service Provider (**TNSP**) the connection service is taken to be a negotiated transmission service. As the connection point is unchanged, then the previously prescribed connection service, inclusive of the extension assets, become incorporated within the negotiated transmission service.

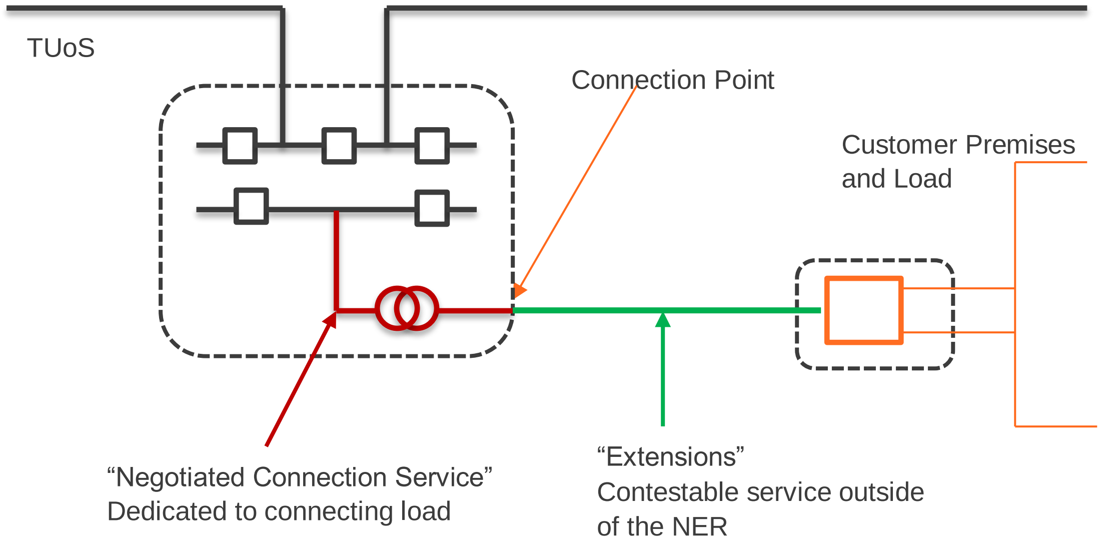
In order for a prescribed connection service to continue to be provided as a negotiated transmission service, it requires the negotiation of a new connection agreement which is subject to the NTSC and any dispute would be resolved through commercial arbitration.

The practical effect of the grandfathering provisions in clause 11.6.11 is that there are material differences in the scope of a prescribed connection service which is transitioning to a negotiated transmission service relative to the negotiation of a new negotiated connection service as show in the following schematics.

Schematic A. Prescribed Connection Exit Service



Schematic B. Negotiated Connection Service[1]



In relation to the non-discrimination principle, only a small proportion of the existing prescribed exit connection service is comparable to a new negotiated transmission service. This leaves a substantial proportion of the dedicated exit connection service being irrelevant to the non-discrimination principle as

[1] Adapted from AEMC (2015) National Electricity Amendment (Transmission Connection and Planning Arrangements) Rule 2015: Consultation Paper, p. 11

each connection will have its own cost and risk profile specific to the service (i.e. is not the same service). Similarly, where the exit connection service is unique to servicing only a particular customer load that is not in direct competition with new connection customers in the same market, then the competition objective relevant to efficient prices for negotiated transmission services between grandfathered and new generators will also be of limited relevance.

The grandfathering provisions also terminate a prescribed connection service on expiry of the connection agreement, irrespective of whether the continuation of the service requires no reconfiguration or replacement of assets. However, a connection service will remain a prescribed connection service where:

> *the whole of the relevant service is being provided under a connection agreement which was first entered into before the commencement date (as extended, amended or novated from time to time).*

It therefore remains within the discretion of the TNSP to continue to offer a prescribed connection service through appropriate contractual amendments and or extension to the existing connection agreement. This is an asymmetric exercise in discretion as, had the customer been aware of the potential for its prescribed connections services to be subject to an alternative form of regulation in the future, it may have negotiated a longer contractual term or a term in perpetuity (as Aurizon understands exists for some connections). However, only the TNSP has the right to change the form of regulation as opposed to the customer having the ability to retain the form of regulation associated with the establishment of the connection.

Limited Contestability for a Prescribed Connection Service

Aurizon acknowledges that where a Customer seeks to materially alter its connection service (such that it would require changes in the asset configuration or involve a different risk profile) then it is appropriate for the cessation of the prescribed connection service and for the negotiation of the alternative negotiated transmission service to be subject to the negotiate-arbitrate model. This is largely consistent with the Australian Energy Market Commissions view expressed in the *National Electricity Amendment (Transmission Connection and Planning Arrangements) Rule 2015* (**Rule Determination**) that:

> *the reconfiguration and replacement of assets was clearly intended to end the grandfathering of prescribed connection services*[2]*.*

The modification or replacement of the assets which would fall within the scope of a negotiated transmission service for a new connection would allow for consideration of alternative e technologies or changes to the customer service requirements, which would increase the extent of contestability of the service or provide some countervailing market power.

However, where the service is not changing and the eligible assets have significant remaining service life, or there are limited or no technical substitutes for the current connection, there is limited scope to introduce contestability in the negotiation.

Importantly, it may not be economically desirable or technically feasible to introduce contestability for the connection service being provided by the extension to the customer premises. This is likely to particularly be the case where an alternative easement would be required to bypass the existing connection.

[2] Ibid, p. 19

Role of the Negotiated Service Transmission Criteria

The Draft Decision affirms that:

> *the NTSC sets out the criteria to be applied in negotiating terms and conditions of access for negotiated transmission services and access charges. The NTSC also sets out the criteria to be applied by a commercial arbitrator in resolving any dispute in relation to those matters.*

As noted in our initial submission, Aurizon does not consider that the NTSC, as currently proposed, provides sufficient guidance to a commercial arbitrator in relation to the cessation of prescribed exit connection services.

Aurizon strongly supports the view that the access charges for the negotiated transmission service associated with the cessation of a prescribed exit connection service should be consistent with the principle of cost reflectivity. The primary purpose of the amendments proposed by Aurizon is to ensure that the access charge is cost reflective and commensurate with the costs of providing the service immediately prior to the expiry of the connection agreement.

The proposed amendments are also intended to avoid a price shock associated with the wide price band facilitated by paragraph 6 of the NTSC which states that the price must be at least equal to the avoided costs of providing the service but no more than the stand alone costs. This is consistent with the view of Grid Australia, whose submission to the AEMC expressed support for measures that increase regulatory certainty and reduce the scope for uneconomic price shocks[3].

The amendments proposed by Aurizon are not inconsistent with the NTSC. They included additional matters that the arbitrator should have regard. In the event of an inconsistency between these amendments and the requirements of clause 6A.9.1 of the NER, the requirements of clause 6A.9.1 would prevail.

The matters expressed in clause 11.6.11 in relation to what occurs when a connection service ceases to be a prescribed connection service should be relevant to the arbitration of the negotiated transmission service. To do otherwise would be to:

- protect the interests of the TNSP by providing regulatory certainty for ensuring the regulatory approved revenue is not affected by the cost allocations or the removal of eligible assets from the regulated asset base (**RAB**); but

- not adequately consider the interests of the Customer in relation to price variations for the same service. Therefore, the following matters in clause 11.6.11(d) are relevant to the NTSC:

> *If a connection service ceases to be a prescribed connection service at the start of a regulatory control period for the relevant Transmission Network Service Provider:*
>
>> *(1) the connection service is taken to be a negotiated transmission service;*
>>
>> *(2) despite clause 6A.19.2(7), the costs which were allocated to the prescribed connection service may be reallocated to negotiated transmission services;*

3 Ibid, p. 24

(3) the eligible assets that previously provided the prescribed connection service cease to be eligible assets; and

(4) despite clause S6A.2.3, the value of the eligible assets which previously provided the prescribed connection service may be removed from the regulatory asset base of the Transmission Network Service Provider.

In the absence of a global price cap for negotiated transmission services, the reference to stand-alone costs infers a potential price which is not reflective of the actual costs being incurred as imputed from the value of the assets to be removed from the RAB, but a broader economic construct of a hypothetical bypass price (even though bypass is not economically viable).

In summary, the proposed amendments are:

- supplementary to the NTSC and not inconsistent with the NER;
- restricted in their application to a limited set of circumstances that involve materially different costs and risks relative to the negotiated transmission services for new connections; and
- symmetric in the treatment of cost and risk between the Transmission Network Service Provider and the customer associated with cessation of the prescribed connection service and the commencement the negotiated transmission service.

Evaluation of the Proposed Amendments

Aurizon's submission to the AER proposed to supplement the NTSC with additional guidelines which applied only to:

> *the negotiation of an access charge for a negotiated transmission service that ceases to be a prescribed transmission service due to the expiry of the term of the connection agreement.*

This section describes the matters which should be relevant to the negotiation of an access charge which promotes a price that is cost reflective.

Value of the assets in the regulatory asset base

The objective of the amendments to the grandfathering provisions under the Rule Determination regarding the cost allocation arrangements for transmission services was to change the focus from the assets to services. However, in circumstances where the service being provided under the expiring connection agreement is unchanged, (only the name of that service is changing), then the value of the regulatory assets to be removed from the RAB is the most reliable estimate of the costs of providing the service. These assets have been subject to a competitive economic depreciation framework within the operation of chapter 6A of the NER and the residual RAB value should represent an efficient cost. If this were not the case, then this would cast doubt on the efficiency of the current building blocks model.

On this basis, Aurizon considers that the value of the assets to be removed from the RAB provides an appropriate benchmark for the assessment of a fair and reasonable price.

Costs allocated to the prescribed connection service

Clause 11.6.11(d)(2) of the NER stipulates that the costs which were allocated to the prescribed connection service may be reallocated to negotiated transmission services. Consistent with the points made in relation to the value of the RAB, the current level of allocated costs to the prescribed connection service represents the most relevant benchmark for the costs associated with providing the negotiated transmission service.

Aurizon acknowledges that these costs may differ from those that might otherwise be allocated in accordance with the approved cost allocation methodology. Nevertheless, it would be expected that in order to avoid a material variation in the price of the connection service, the revised allocated costs would need to be reasonably commensurate to the current level of allocated cost.

Renewals capex is an avoidable cost

While the eligible assets currently providing the prescribed exit connection service have a remaining service potential, it may be necessary for those assets to be replaced during the term of the replacement connection agreement for the negotiated transmission service. It will therefore be necessary for the price of the negotiated transmission service to reflect the forward looking costs of replacement capex.

As the current price is reflective of an allocation from the revenue pool attributed to all prescribed exit connection services, it may not be representative of the costs of renewing the dedicated assets associated with an individual connection.

The proposal that the negotiated transmission service price should have regard to:

> *the direct costs attributable to the continuous provision of the negotiated transmission service,*

is intended to ensure that the price reflects the avoidable costs if the connection service was to terminate on the same date as the expiry of the connection agreement.

Aurizon recognises that this could be made clear by adding the words "*continuation of the connection services provided as a prescribed transmission service*."

Current price is an efficient price

The primary role of chapter 6A of the NER is to ensure that the prices for prescribed connection services are cost reflective and efficient. It is therefore reasonable to assume that the current price for the prescribed connection service represents an efficient price for the same negotiated transmission service. This does not require the arbitrated price for the negotiated transmission service to match to the current price of the connection service. However, it would generally be expected the variation in the price can be attributed to a change in the costs or risks of providing the service.

Consistency with the National Electricity Objectives

Aurizon considers that the supplementary principles proposed in its submission are consistent with the National Electricity Objective[4] for the reasons outlined in the following part of this Submission.

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[4] 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 – price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system

Discrimination between a new and existing negotiation transmission service

The Draft Decision considers that the proposed amendments to the NTSC would not be consistent with the non-discriminatory principle in clause 6A.9.1(5) which requires:

> *the price for a negotiated transmission service must be the same for all Transmission Network Users unless there is a material difference in the costs of providing the negotiated transmission service to different Transmission Network Users.*

This clause has limited practical application with respect to a dedicated connection service. Similarly, as connection requirements are likely to be location, asset and customer specific, a common price for negotiated transmission service would be expected to primarily arise for shared connections.

Aurizon is of the view that the continuation of a prescribed connection exit service as a negotiated transmission service which involves no new or additional investment represents a substantially different risk profile to establishing a new negotiated transmission service for a new connection. As such the proposed amendments would not be contrary to the non-discrimination principle where there application is restricted to a dedicated connection.

Aurizon also acknowledges that the amendments to the grandfathering provisions in the *National Electricity Amendment (Cost allocation arrangements for transmission services) Rule 2009* were strongly influenced by the provision of prescribed *entry* connection services and the objective of providing consistency between existing and new transmission network users. This is likely to be particularly the case where the connection charges for existing generators could be substantially more favourable than those for a new generator. Therefore any concerns regarding the distortions in competition between generators could be overcome by limiting the application of the supplementary guidance to *exit* connection services.

Price shocks are not in the long-term interests of consumers

The prescribed exit connection services provided to Aurizon are for the purpose of the supply and sale of electricity via a distribution network service to rail operators for the purpose of operating electric powered locomotives. This distribution service is regulated under the access regime in Part 5 of the *Queensland Competition Authority Act, 1997* (Qld) (**QCA Act**).

The uncertainty regarding the potential price outcomes associated with cessation of a prescribed exit connection service is of considerable concern to Aurizon's customers and is a commercial risk relevant to a decision to procure locomotives which will utilise electricity supplied by Aurizon's distribution network.

Importantly, due to a range of regulatory and commercial constraints, Aurizon is required to maintain most of its connections associated with a reduction in electricity demand. In the event of a reduction in demand, Aurizon could:

- absorb any increase in costs from the repricing of its connection services in order to maintain demand of the service and thereby fail to earn a return on its investment in regulated assets commensurate with the commercial and regulatory risks; or
- pass on the increase in costs from the repricing of its connection services to its customers and risk further reduction in demand.

Under clause 6A.9.1(9) of the NER, the price for a negotiated transmission service is to be treated as being fair and reasonable if it complies with principles (1) to (7) of clause 6A.9.1 (the NTSC). That is, provided the price falls between the avoidable and stand alone cost then it is deemed to be a fair and reasonable price. However, this does not take into consideration the consequential impacts of electricity demand on consumers of electric traction services. A reduction in demand would also reduce the load demanded at Aurizon's connections which could lead to an increase in costs for all consumers of transmission network services.

It is Aurizon's view that the likely impacts of the price on demand for electricity consumers in the affected downstream market is a matter relevant to the long term interest of consumers, and that the repricing risk for prescribed exit connection services is inconsistent with the National Electricity Objective. Aurizon's inclusion of the reference to only downstream markets is intended to ensure it is relevant to only exit services.

Options to limit the application of the supplementary principles

Aurizon considers the impacts of the proposed amendments could be further narrowed to ensure alignment with the AEMC's objectives for neutrality between generator connections. This could involve restricting the supplementary guidelines to:

- exit services for exempted Network Service Providers; and
- negotiated transmission services that would not otherwise be a negotiated transmission service if not for the operation of clause 11.6.11 of the NER.

Exit services for an exempted Network Service Provider

Under the definitions in the NER, a negotiated transmission service does not include connection services from one network service provider to another network service provider (i.e. a TNSP to a DNSP). A primary reason for this exclusion is that the network service providers are subject to regulatory pricing arrangements in either Part 6 (distribution pricing) or Part 6A (transmission pricing) of the NER.

Aurizon Network is currently not a registered network service provider under the NER as its distribution network of over 2600 kilometres is subject to regulated access pricing under the QCA Act.

Aurizon submits that by restricting the application of the NTSC in the manner contemplated by Aurizon's proposed amendments, the supplemented NTSC would align with the broader policy objectives of the NER.

Restrict the scope of the guidelines to comparable negotiated transmission services

The AER's concerns regarding discrimination, to the extent those concerns are relevant to a dedicated connection, could be addressed by restricting the scope of the supplementary guidelines to that part of the negotiated transmission service that would otherwise not be a negotiated transmission service if not for the operation of clause 11.6.11 of the NER. This ensures the guidelines are limited in their application to those parts of the prescribed exit connection service that are not associated with establishing a new connection.

Conclusion

This Submission has outlined the circumstances relevant to supplementing the NTSC to address issues associated with the cessation of a prescribed exit connection service where the customer has not requested a change in the nature of the services being provided.

In Aurizon's opinion, the proposed supplementary guidelines are consistent with the objective of cost reflective pricing and are not inconsistent with the NTSC. The proposed supplementary guidelines are also consistent with the National Electricity Objective and are in the long term interests of not just users of Aurizon's distribution network but other electricity consumers in regional Queensland.

Aurizon has also identified additional amendments which would limit the scope of application of the guidelines and address any potential concerns of the AER regarding discrimination. The revised proposed amendments are as follows:

Cessation of Prescribed Connection Services under clause 11.6.11 of the NER

13. *Subject to clause 14, the price for a negotiation transmission service that is the continuation of a connection service which ceases to be a prescribed exit connection service to the owner or operator of a distribution system that is exempted under clause 2.5.1(d) of the NER due to the expiry of the term of the connection agreement should have regard to:*

    a. *the value of the eligible assets that are to be removed from the regulatory asset base;*

    b. *the costs that were previously allocated to the prescribed connection service which will be reallocated to the negotiated transmission service;*

    c. *the avoidable costs associated with the continuous provision of the connection service as a negotiated transmission service;*

    d. *the relativity of the price of the negotiated transmission service to the price of the prescribed connection service immediately prior to the cessation of the connection agreement; and*

    e. *the likely impacts of the price on demand for electricity by consumers in the relevant downstream market.*

14. *The principle of non-discrimination which is limited to those parts of the negotiated transmission service which would not otherwise be a negotiated transmission service if not for the transitional provisions in clause 11.6.11 of the NER.*