NATIONAL GENERATORS FORUM

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Chairman
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Dear Mr Edwell

Pricing methodology guidelines issues paper (April 2007)

NGF would like to thank the AER for the opportunity to comment on the Pricing methodology guidelines issues paper (April 2007). Generators have a clear interest in the certainty and level of the connection charges they face, and in particular those for transmission entry services.

Introduction

On 9 May 2007, the NGF provided comment to the AER on the *First Proposed Electricity Transmission Network Services Providers Cost Allocation Guidelines*. In this submission we comment on the issues directly relating to the allocation of costs for pricing purposes. Particular focus is on charges for transmission entry services.

The NGF would like to raise its concerns in relation to:-

1. the interpretation of the Rules leading to a potential conflict between the process described in 6A.23.2 (d) and the AEMC's intention that generators not to be charged for deep connection costs;

2. the regulatory uncertainty caused by the risk of asset re-classification as a result of network re-configuration, other than at the generator's request; and

3. the potential 'price shocks' that could arise, either through (1) or (2) above, from the reclassification of assets, which were previously treated as shared network, as prescribed entry assets.

We encourage the AER to construct a set of pricing guidelines which conforms both with the new Rule for transmission pricing for prescribed transmission services and the stated AEMC objective of not imposing 'deep connection charges' on generators, and removes the above ambiguities and uncertainties. Should this not be possible within the confines of the guidelines, the NGF would appreciate the AER's views on

the need for any necessary minor changes to the Rules to provide this clarification, and its support for any such changes.

The Issue

For many generators, particularly those with new connections, the cost recovery of their connection assets is defined in the relevant connection agreement with the TNSP. Consequently the assets are treated as negotiated assets and are outside the AARR.

However, this is not the case for all generators. The problem arises due to the fact that many pre-existing generators do not have entry assets and charges explicitly defined in their connection agreements. They face prescribed entry charges for their connection services (deemed as such by Rule 11.6.11).

Whereas the Cost Guidelines provide protection from the risk of shared system costs being arbitrarily reclassified as negotiated assets, no provision is made for generators whose physical connections pre-existed the NEM and whose connection assets are currently included in the determination of the TNSPs AARR.

Following the allocation of directly attributable costs (and causal allocation of remaining costs) to service categories under clause 6A.19.2(3), clause 6A.23 lays out the pricing principles for prescribed transmission services. In particular, 6A.23.2 (d) describes a priority ordering process, which is to be applied whenever assets are directly attributable to more than one category of prescribed services.

Perceived Ambiguity in the Process

There is a level of concern within the NGF as to how the new pricing principles might be applied. This concern stems from the potential risk that significant costs, associated with parts of what is now considered shared network, could in the future be recovered from generators as prescribed entry assets. This interpretation of the new Rule is therefore that the cost of prescribed transmission assets which have been treated in the past as 'shared network', but which in fact function, at least partly, to serve a generator or group of generators, could under the new Rule be re-classified as 'entry services', based on their utilisation (ie 'directly attributable') and notwithstanding their past treatment as fully shared network assets.

Conversely, it could be argued that, despite this evident risk, this outcome would be directly contrary to the stated intention of the AEMC and therefore will not happen. However, under this assumption, the recovery by the TNSP of costs greater than the stand alone amount becomes problematic, (as discussed below).

We believe that part of the problem may arise from different interpretations of the term 'directly attributable'.

Possible Impact of 'Stand Alone Cost"

In generation rich regions, such as the West Coast of Tasmania, Northern SA generation corridor and the La Trobe Valley the technical capability of the prescribed shared network significantly exceeds the requirements of the connected load. In these circumstances, it could be interpreted that the 'stand alone amounts' in relation to

prescribed TUOS or prescribed common services are much less than the value represented by the actual physical network assets.

In the situation above, for the TNSP to remain whole, the residual amount must be recovered as either prescribed entry or prescribed exit assets[1]. In the locations above, the assets are utilised mainly by generation. Application of the priority ordering approach therefore potentially leads to reclassification as prescribed entry assets.

This result is incompatible with the AEMC's view that generators should not be charged for deep connection assets. It is however, on one reading, an inevitable outcome of the application of the directly attributable cost allocation and priority ordering process described in the new Chapter 6A Rule.

Keeping the TNSP Whole – Stranded Costs

Based on the argument that shared network assets cannot be part of prescribed entry services, there is no risk that assets will be re-classified as prescribed entry, unless their use changes. This raises the question of the precise identification of the limits of the "shared network". Does the partial use of a network element by load automatically render it "shared network" and therefore prevent it being treated as a prescribed entry asset?

If load only uses part of the network capacity, then the full network cost cannot be taken as being directly attributable to prescribed TUOS or common services. Given that every portion of the AARR must be allocated and that part of the network may provide both prescribed TUOS and prescribed common services, then what is to be done with that part of the network over and above the stand alone cost of these services? The possibility of stranded costs under this scenario again points to the possibility of shared costs being reallocated to entry services.

Potential Re-Configuration of Transmission

In many parts of the network, generators are faced with the potential risk of network re-configuration as the network evolves and develops over time, leading to the creation of radial elements which could be treated in the future as prescribed entry assets. Current examples of this situation include Stanwell's Kareeya Power Station and also with Flinders Power's Northern and Playford Power stations.

These generators have found themselves in a situation where they may be required to fund network projects driven entirely by the needs of network users which:

- were not triggered or sought by the generator;
- provide no material benefit to the generator;
- leave the actual entry services provided to the generator unchanged (or even a reduced level of service).

Although in theory, it is possible for the generator to negotiate with the TNSP to manage this risk, in practice it has proven impossible in most cases for generators to

[1] Unless, as is unlikely, the shared network assets are included in a connection agreement and can therefore be considered to be *negotiated* assets or are not classified as *prescribed* because they are deemed to be *contestable*, and are thereby fully recoverable automatically.

achieve certainty in future connection costs, particularly given the ambiguity in the relevant clauses above. The recovery of these sunk costs from generators, by treatment as 'entry services' even though originally constructed as shared network assets, would not deliver any positive influence on pricing or investment behaviour. Clearly, there is no economic merit in applying locational pricing signals to a sunk asset.

Suggested Solution

It is recommended that the AER resolve this ambiguity by clarifying the treatment of 'directly attributable' costs in its pricing guidelines to exclude the possibility of shared network costs being reallocated to generator entry charges. This would remove the present uncertainty, and achieve consistency in the allocation of costs across all entry charges.

Alternatively, should the AER believe it is limited in the extent to which it can clarify the situation through the mechanism of the pricing guidelines, the NGF seeks its views on the potential nature and scope of any minor Rule change that may be required to address this anomaly. To this end, the NGF seeks the AER's view on the helpfulness or otherwise of the sample clause below, in providing clear direction in the application of the pricing principles and the processes in Chapter 6A of the Rules:

> 6A.19.2 (9) Costs which have been allocated to other categories of *prescribed transmission services* must not be reattributed or reallocated to *prescribed entry services*.

The expectation of the NGF is that a provision of this nature should assist in ensuring equivalent treatment of both new and pre-existing generator connections from a network cost allocation perspective.

From a regulatory perspective, it is also expected that this provision would be straightforward to apply and administer. TNSPs have also expressed initial support for a provision of this nature.

Price Shock

If the above step is not taken, then generators could be subjected to a very material step increase in transmission charges as a consequence of the recent regulatory change, and this may result in a price shock at the start of the next regulatory period[2].

The risk of retrospective imposition of such significant price shocks, and the spectre of similar future shocks to investors, does not increase investor confidence in the market. The provision of a smooth price path would be better regulatory practice and consistent with general practice, for example, in relation to the draft decision of the AER on the Moomba to Sydney pipeline system—access arrangement, Section 2.7.4, where it is said that, "The Commission notes that a smooth price path has the beneficial property of avoiding unnecessary price shocks to users during the access

[2]That is, where currently due to the assets not being "fully dedicated" a generator does not at present pay transmission entry charges, (prescribed or negotiated) but in future may do so under the above interpretation of the 'stand alone cost' principle. If these assets were deemed to be "*directly attributable*" to generation, then they would be treated as *prescribed entry assets* from the start of the next TNSP regulatory period.

arrangement period”. We see the avoidance of price shocks as being consistent with the 2% cap on annual price increases in TUOS charges, (Clause 6.5.5 of the Rules).

In the event that the AER is not in a position to draft the pricing principles to remove the risk of reclassification of assets currently treated as prescribed common, TUOS or exit as entry assets, the NGF would like the AER to include some provisions for the restriction of year on year changes in entry costs as a result of assets migrating from prescribed TUOS, common or exit to the prescribed entry classification.

Conclusion

The NGF seeks to include provisions in the pricing guidelines to prevent the possibility of re-classification of assets from prescribed common, prescribed TUOS or prescribed exit to prescribed entry services.

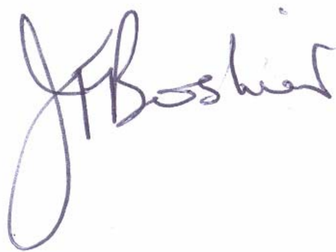
Failing that, we seek to include within the final Pricing Guidelines, some provisions for the mitigation of price shocks, limiting the year-on-year change.

Should it be necessary in the opinion of the AER, the NGF would also appreciate the support of the AER for a Rule change to clarify the operation of the transmission pricing framework to address these anomalies.

The NGF appreciates the opportunity to comment on the pricing methodology guidelines issues paper, and urges the AER to clarify the apparent ambiguity in intent and drafting of the transmission pricing framework.

Please contact me on 02 6243 5120 should you wish to discuss our position further.

Yours sincerely



John Boshier
Executive Director