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5 May 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
Via email: submissions@aemc.gov.au

Dear Mr Pierce

Ausgrid is pleased to provide these comments to the Australian Energy Market Commission (AEMC) regarding the Scale Efficient Network Extensions (SENE) Draft Rule Determination and Draft Rule.

For the most part, we support the approach taken by the AEMC in the draft determination and draft Rules. We believe that the AEMC's approach of making minimal changes to the current market and regulatory arrangements will better contribute to the achievement of the National Electricity Objective in comparison the to the changes proposed in the original MCE Rule change request.

While we consider the AEMC's analytical approach to be sound, our submission raises concerns about the workability of the approach to classification of SENE services. Our submission also outlines why we believe that the SENE provisions should not apply to dual function assets.

If you have any questions or require further clarification, please do not hesitate to contact me or Ms Catherine O'Neill, Executive Manager – Regulation & Pricing on 02 9269 4171.

Regards,

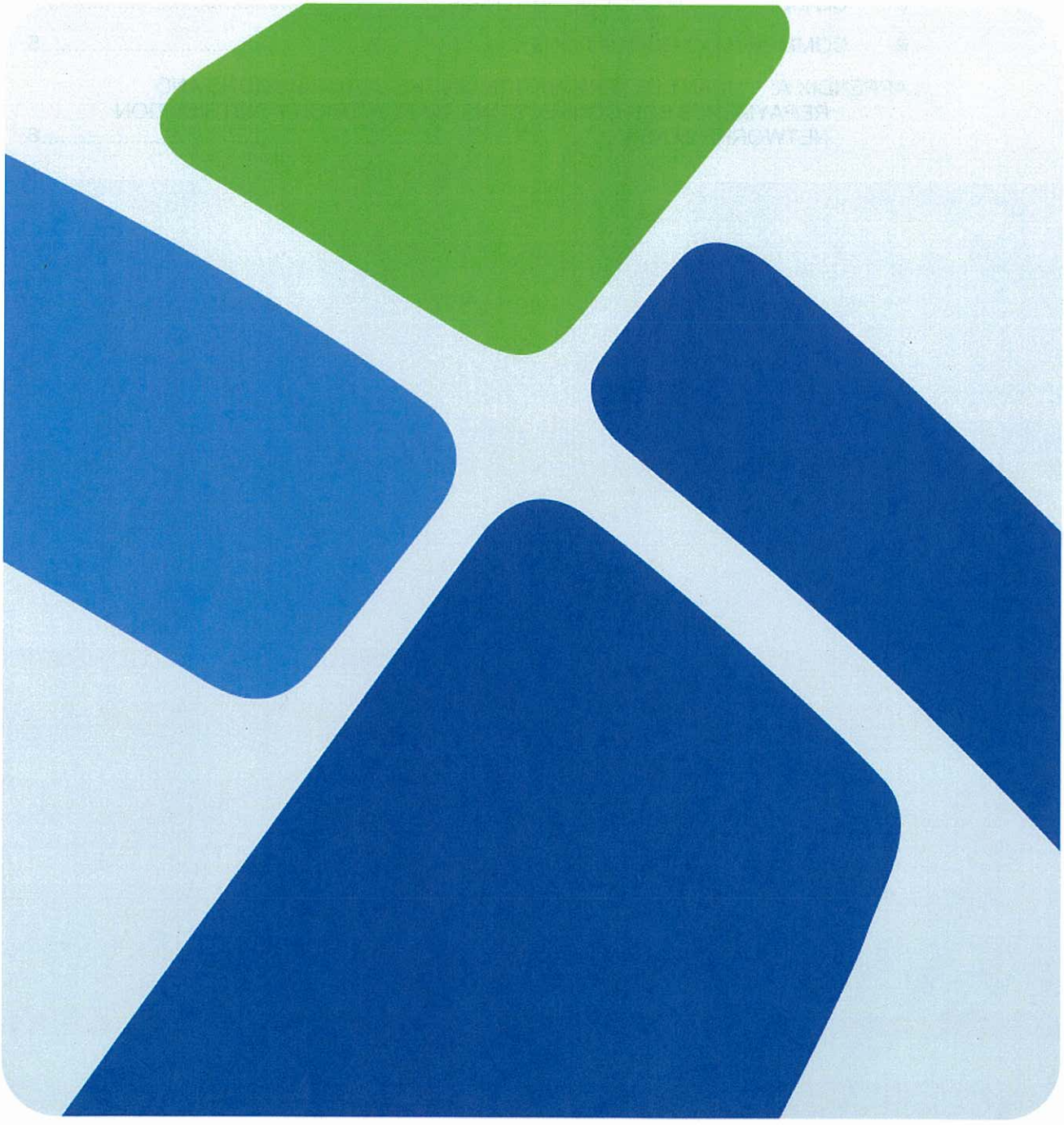
Peter Birk
Executive General Manager (Acting)
System Planning & Regulation

Enclosed

Ausgrid submission to AEMC

Scale Efficient Network Extensions Draft Rule Determination

5 May 2011



Ausgrid submission to AEMC
Scale Efficient Network Extensions

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1 Introduction

Ausgrid is pleased to provide this submission to the Australian Energy Market Commission (AEMC) regarding the Scale Efficient Network Extensions (SENE) Draft Rule Determination and Draft Rules.

For the most part, we support the approach taken by the AEMC in the draft determination and draft Rules. Our previous submissions[1] to the AEMC did not support the MCE Rule proposal nor the AEMC derived options on the basis they did not appear to promote the National Electricity Objective (NEO). We submitted that the Rules should not be amended as there was no evidence of market failure occurring under the existing arrangements. Furthermore, we raised concerns about customers facing the risk of stranded and underutilised assets without an assessment of whether they will benefit from the SENE, nor with any ability to manage the potential risk.

We are pleased that the AEMC has addressed issues raised by Ausgrid in previous submissions. We consider that the AEMC draft Rule and draft determination is more beneficial than the Rule change request in the following ways:

1. The Rule now clarifies that SENEs do not apply to distribution networks. The impact of the preferred Rule on Distribution Network Services Providers (DNSPs) is limited to providing information to TNSPs in relation to a SENE design and costing study.

2. Customers no longer underwrite the costs of SENEs. Rather these costs will be borne by the party funding the SENE. This is an appropriate allocation of risk in a competitive wholesale market.

3. The AEMC's draft rule promotes a market driven approach, rather than a regulated one, as the first best option.

There are some matters where we seek further clarification. These matters include ensuring that dual function assets owned by Ausgrid are not captured by the SENE provisions and clarifying the definition of the SENE services. Further, it is not clear what responsibilities a party operating a SENE, but exempted from registering as a TNSP, would have under the Rules. These issues are not insurmountable but would benefit from further consultation with the industry. We note that these issues may be considered as part of the AEMC Transmission Framework Review.

On the matter of commercial negotiations between parties, we suggest a type of reimbursement scheme contained within the NSW capital contributions policy[2] may provide a template for regulatory guidance should negotiations on funding prove problematic.

Our comments are set out in more detail below.

2 AEMC assessment criteria

In making its draft determination, the AEMC's assessment criteria placed a high importance on efficient investment, efficient risk allocation, promoting market-driven solutions and solutions that are proportionate to the problem. We believe the AEMC's criteria are appropriate and have resulted in a balanced assessment of the Rule change request.

The primary amendment to the existing Rules relates to new provisions for the preparation of a SENE design and costing study. The funding arrangements for SENE are to be commercially negotiated thereby placing the financial risk of SENEs on market participants and investors. The AEMC approach allows the risk of underutilised and stranded assets to be allocated to those parties that are best able and willing to manage that risk through a process of commercial negotiation. We consider this to be appropriate.

[1] Ausgrid (formerly EnergyAustralia) submissions dated 13 May 2010, 16 June 2010 and 12 November 2010.
[2] NSW Independent Pricing and Regulatory Tribunal, Capital Contributions and Repayment for Connections to Electricity Distribution Networks in NSW, 2002.

In our view, the arrangements under the MCE Rule change request created a potential moral hazard whereby there was no incentive for SENE proponents to manage or mitigate the risk of underutilisation of the built SENE asset. Instead the risk was transferred to all customers of the shared network untilthe capacity of the SENE was taken up by connecting generators. There was a risk that the SENE was never fully utilised. We support the outcome whereby customers of the shared network are not required to bear the risk of commercial entities – especially where there has been no economic assessment undertaken of the proposal.

The approach taken by the AEMC ensures that the locational costs of connecting to the network are taken into account by generators before making an investment decision. This provides a discipline that ensures only financially viable investments will go ahead. The inclusion of locational costs into investment decisions improves the scope for allocative efficiency compared to the MCE Rule change request.

We support the emphasis given by the AEMC to the principle of proportionality when considering Rule change requests. We consider that the MCE Rule change request created a regulatory and administrative burden on the AEMO and AER that was greater than the scale of the identified issue it sought to resolve. The costs on these entities would have been significant with very little evidence of any actual problem or market failure. Further, the potential for network inefficiency (paid for by consumers) as a consequence of the Rule change request may have been greater than any potential benefit.

Given the lack of evidence of market failure, we support the AEMC adopting a market driven approach as the preferred option. The AEMC acknowledges that the gas sector faces network extensions of the type anticipated in the SENE proposal. Contrary to market failure, the gas sector has managed to develop similar network extensions without regulatory intervention. In the electricity sector, there is nothing to prevent rational investors from developing remote sites if it is economic to do so. We support the AEMC's approach of letting the market work as the first option – rather than regulatory intervention.

Ausgrid considers the AEMC to have adopted a sound analytical approach in considering the Rule change request.

3 Dual function assets

The draft Rule specifies that the application for a SENE study is made to a Transmission Network Service Provider (TNSP). We are pleased that the AEMC has clarified that the SENE does not apply to distribution network service providers. We agree with the AEMC's findings that the scope for efficiency gains at the distribution level is less than those likely to be available in transmission due to the nature of the assets and the likely location of clusters of generation. The AEMC considered that the integrated nature of the distribution network implies that providing assets that are dedicated to generator connections is likely to be impractical and potentially inefficient given the greater potential for load to connect to the SENE in the future.[3]

As currently drafted the Rule will apply to Ausgrid in its capacity as a TNSP in relation to its dual function assets. We note that the fact that an asset falls within the definition of "dual function asset" does not change the status of those assets as transmission assets for the purpose of Chapter 5. We consequently request that the Rule be amended so that a request for a SENE study cannot be made in relation to a TNSP in respect of dual function assets. We consider that it is consistent with the AEMC's policy position that dual function assets not be subject to the SENE provisions and our reasons are set out below.

Dual function assets, by their nature, are assets owned by distribution networks that operate in parallel to and provide support the transmission network. In a recent Rule determination regarding the economic regulation of dual function assets, the AEMC acknowledged that DNSPs have developed dual function assets "primarily to provide distribution services rather than to provide transmission services or to support the main transmission

[3] AEMC 2011, Scale Efficient Network Extensions, Draft Rule Determination, 10 March 2011, pages 15-16.

system."[4] As such, for the purposes of economic regulation, dual function assets are defined as an asset which forms part of a network that is predominantly a distribution network.[5]

As acknowledged by the AEMC, the opportunity for large scale renewable generation within a distribution network is likely to be limited.[6] It is unlikely that Ausgrid's dual function assets would be suitably located for SENE connections. In any event, the current provisions in chapter 5 of the Rules would be adequate for SENE type connection inquiries and applications received by distribution networks.

The extent to which dual function assets support the transmission network can change depending on a number of factors regarding the operations of the incumbent TNSP's network. Due to the potential scope for dual function assets to change back to distribution assets over time, we consider that it would increase administrative complexity and uncertainty for potential proponents if the SENE provisions applied to dual function assets. As such we consider that it is not appropriate or necessary for SENE provisions to apply to dual function assets.

We consider that due to the nature of dual function assets it would be appropriate to exclude the application of the SENE provisions to dual function assets owned by distribution network service providers. Instead of the SENE provisions, a proponent that sought a SENE type arrangement within the distribution network would be processed as any other connection applicant under chapter 5 of the Rules.

4 Interaction with DNSPs

The AEMC indicates that in some cases distribution network service providers may need to provide information to the TNSP for the SENE study.

In particular the AEMC noted that the most efficient stand alone connection for a connecting generator may be a direct connection to the distribution network rather than to the transmission network. In this instance, the study would require input from the relevant DNSP as well as the TNSP to assist in determining the stand alone cost of connection. The draft Rule therefore:

1. requires DNSPs to cooperate with TNSPs that request information for the purposes of the SENE study; and

2. allows the DNSP to recover from the relevant TNSP its reasonable costs incurred in contributing to the study.

As a DNSP, we are supportive of providing information to the transmission network service provider. These provisions are consistent with the existing connection process under Rule 5.3. A fee for this service can be determined on a case by case basis as currently occurs with connection applications under Chapter 5. Under clause 5.3.3(c)(5) it is expressed as a fee to meet the reasonable costs incurred in processing an application.

[4] AEMC 2008, Economic Regulation of Transmission Services Undertaken by Distributors, Rule Determination, 26 June 2008, page 13.
[5] In Chapter 10 of the National Electricity Rules Dual Function Assets means any part of a network owned, operated or controlled by a Distribution Network Service Provider which operates between 66 kV and 220 kV and which operates in parallel, and provides support, to the higher voltage transmission network which is deemed by clause 6.24.2(a) to be a dual function asset. For the avoidance of doubt:
(a) a dual function asset can only be an asset which forms part of a network that is predominantly a distribution network; and
(b) an asset which forms part of a network which is predominantly a transmission network cannot be characterised as a dual function asset, through the operation of clause 6.24.2(a).
[6] AEMC 2011, Scale Efficient Network Extensions, Draft Rule Determination, 10 March 2011, page 15.

5 Classification of SENE services

The AEMC has expressed the view that customers should not bear the costs of SENEs and so the services they provide would be classified as negotiated and/or un-regulated – but not prescribed transmission services.

We have concerns about the implications of the AEMC's view that these type of services are correctly classified as an unregulated service. This is explained below.

Section B of the draft Rule determination includes the comment that "The framework under which negotiations between the generator and the TNSP take place (i.e. under the Rules or outside of the Rules) will depend on the classification of the services provided by means of the SENE".

The AEMC presents two diagrams, one showing the SENE as an un-regulated asset (Diagram B.1) and diagram B.2 showing the SENE as a negotiated asset.

- In the un-regulated case, the AEMC explains that - where a generator (G1) seeks connection to the transmission network prior to the SENE being built, the services to be provided by the SENE assets may be treated as un-regulated transmission services. This is because construction of the SENE and the subsequent services provided by means of the SENE are contestable.

- The AEMC's second scenario of the SENE as a negotiated asset considers a case whereby a second generator (G2) seeks connection to the transmission network once the network has been augmented by a SENE. The service provided by means of the SENE may be treated as providing a negotiated transmission service. This is because there are no longer any opportunities for contestable activities to be undertaken in the building of the SENE.

In the unregulated case, the AEMC seems to be saying that because the building of the SENE assets was contestable, then the SENE services should be treated as unregulated for the first generator (G1) but will be treated as negotiated for the next generator (G2). We question the workability of this proposed arrangement and whether it reflects the current approach under the Rules. In particular, we question whether the services provided by the same SENE asset be defined/ classified as both negotiated and un-regulated.

In our view, the key issue is not so much who builds the assets but whether the assets form part of the conveyance of electricity to users and if so, the nature of the service provided by that network. Contestability of itself does not determine the classification of a service, classification is determined by a careful application of the relevant definitions in the Rules. For example:

1. If the asset is built by a third party (investor/generator) and then owned and operated by that third party the services provided by the SENE will, most likely, not be subject to economic regulation under the Rules. However, regardless of the funding arrangements there will need to be a connection agreement between the SENE funder and the TNSP. It is not clear how AEMC's proposed approach to open access would operate where a third party owned the SENE.

2. If the asset is built by a third party and then gifted back to the TNSP and operated by the TNSP, then it may be more appropriate to treat the SENE service as a negotiated service. The TNSP will incur costs for operating and maintaining the network which should be apportioned to the parties connected to the SENE. In this case the services provided by the SENE should be considered as negotiated services.

3. If the asset is built by a third party and then gifted back to the TNSP (as in case 2) and over time is used for conveyance to customers (thus becoming part of the shared network) then as the change in customer base occurred it would be more appropriate to define the SENE assets as prescribed services. Costs would need to be allocated between the customers and parties connected to SENE.

4. Lastly, an incumbent TNSP may propose to build the SENE asset and subject it to the regulatory investment test for transmission (RIT-T). A SENE proposal that passes a RIT-T conducted by a TNSP would not be a SENE as such but rather would be defined as prescribed transmission services.

The definition of the SENE services as either negotiated or unregulated, in our view, will depend on who owns and operates the assets and the nature of the service provided by those assets.

Ausgrid is not convinced of the workability of some aspects of the AEMC draft determination including the responsibilities a party that operates a SENE but exempted from registering as a TNSP, would have under the Rules. For instance what would be their responsibilities in terms of meeting reliability standards and access arrangements. These issues are not insurmountable and would benefit from further consultation with industry. We note that the AEMC has indicated that issues around access rights and connection will be considered as part of the Transmission Frameworks Review (TFR).

6 Commercial negotiations

The AEMC states that the draft Rule maintains a market based approach to connections and preserves the features of the existing connections framework while facilitating a more transparent and informed market. The intended result is for generators to have an opportunity to connect to the network in the most cost effective way and should provide for more efficient investment in transmission solutions.

Under the AEMC's approach, the party who funds the SENE will be compensated from connecting generators through commercial negotiation. The AEMC is placing its faith in commercial negotiations between parties to resolve the funding of the SENE. The AEMC envisages that the SENE funder would be entitled, through contractual arrangements with the TNSP that operates the SENE, to a stream of future revenues derived from charges for use of the SENE, should connections occur.

The AEMC cites that this type of coordination has and does occur in order to develop infrastructure in the gas sector.

We support the AEMC approach which adopts a market driven approach through commercial negotiation. This approach is appropriate given that there is no evidence of any market or regulatory failure, and because the gas sector is an example of a market driven approach working in practice.

If there are concerns that a market driven approach to compensation between parties may not work, then the reimbursement scheme under the NSW capital contributions policy may provide a helpful precedent for the AEMC's funding approach. In particular, the NSW capital contributions policy requires the establishment of a reimbursement scheme in situations where a large or rural customer has funded assets and contributed these assets to the network service provider. In situations where the assets are later accessed by a third party, the reimbursement scheme provides guidance about the allocation of costs to the third party. A NSW type reimbursement scheme may be appropriate in some cases where there is a limited number of parties involved in negotiations and the asset is gifted back to the incumbent TNSP.

An extract from the IPART determination is shown in Appendix A.

Appendix A: IPART determination on the Contributions and Repayments for Connections to Electricity Distribution Networks in NSW

Appendix A1 Reimbursement scheme[7]

The Tribunal requires DNSPs to establish and administer reimbursement schemes for customers that make capital contributions for connections in rural areas or taking large loads. Reimbursement schemes are provided for under section 25(2) of the Electricity Supply Act 1995.

These reimbursement schemes will:

- be applicable to all rural customers or customers with large loads that request new connections or augmentations and customers connecting at a later date who will use some, or all, of those assets
- reimburse the original customer according to the extent to which new customers will utilise those assets
- limit the total reimbursements to the amount of the original capital contribution adjusted for inflation
- limit the period over which reimbursements may be offered to 7 years
- only apply to connection assets provided after the commencement of this determination.

The DNSP is:

1. to establish and administer the scheme
2. responsible for ensuring that later connecting customers reimburse the current owner of the premises for which the original works were undertaken
3. to recover its administration costs through network charges
4. not be permitted to levy connecting customers a fee for participation in the scheme.

[7] NSW Independent Pricing and Regulatory Tribunal, Capital Contributions and Repayment for Connections to Electricity Distribution Networks in NSW, 2002, page 9