



Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
Australia Square NSW 1215

Dear Dr Tamblyn,

re: Transmission Pricing for Prescribed Transmission Services: Rule Proposal
Report and Rule Change

Alcoa World Alumina appreciates the opportunity to comment on the issues outlined in AEMC's report and proposed rule changes.

Alcoa operates in a highly competitive global market in which the delivered cost of energy determines the ongoing nature of its operations. Given this, the focus of our submission relates to the proposed changes to prudent discounting.

Alcoa supports the AEMC's view that the rules should provide the scope for the negotiation of prudent discounts and welcomes the changes for upfront discount approvals and their application (if approved) for the duration of the relevant TNSP/Major customer agreement.

However, Alcoa has a number of remaining concerns regarding proposed rules for prudent discounting. At Alcoa's request Synergies Economic Consulting has developed a report (see attached) to consider these issues in greater detail and to propose changes. These are summarised as follows:

1. The Rule Proposal Report considers a broader interpretation of inefficient bypass than has previously been applied by the ACCC. However, the Rule Proposal as drafted remains unclear with respect to the bypass test and therefore open to interpretation. To ensure consistency with the Proposal Report the following amendment to section 6A 27.1 (e) (1) is required:

"(1) the discount amount is no larger than that necessary to prevent the Customer TUOS general charges and common transmission service charges altering the beneficiary's behavior to the point of adopting the most attractive alternative in place of the course of action the beneficiary would have adopted (including actions such as transmission duplication or a decision to not invest in or expand a load or to shut down an existing operation) if no such charges were levied"

Alcoa believes this amendment will increase the level of certainty to all parties and specifically avert concerns of a narrower interpretation that may result in the loss of major loads and the associated market benefit.

2. Given concerns about positive incentives for TNSPs to negotiate (as outlined in the report) there should be recourse to binding arbitration as an essential part of the discounting framework. Given the uncertainty, this would appear to provide a justifiable “safety net” for consumers.

With regard to broader economic considerations, Alcoa believes that the proposed discounting arrangements may still unduly restrict the ability of major loads to obtain a discount in circumstances where such a discount would be justified on the basis of standard economic principles and be consistent with the NEM objective.

To avoid this Alcoa suggest that the AEMC need to consider the relative merits of an “incremental cost” test for considering discounts rather than the current “inefficient bypass” test as the former would be more in line with standard economic principles. Alcoa notes that while this issue has been raised in submissions to the recent Issues paper it does not seem to have been addressed by the AEMC as part of its Rule Proposal Report.

Yours sincerely



25/09/06

Steve Abbott
Energy Manager
Alcoa World Alumina, Australia



Alcoa's Submission to the AEMC

Transmission Pricing for Prescribed Transmission Services: Rule
Proposal

25 September 2006
Synergies Economic Consulting Pty Ltd
www.synergies.com.au

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In conducting the analysis in the report Synergies has used information available at the date of publication, noting that the intention of this work is to provide material relevant to the development of policy rather than definitive guidance as to the appropriate level of pricing to be specified for particular circumstance.

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1 Introduction

Alcoa is a major Australian business with significant operations in Victoria, New South Wales and Western Australia. Alcoa's aluminium operations are energy intensive and, as such, it is a major industrial user of electricity. Alcoa operates two aluminium smelters in Victoria (Point Henry and Portland) which are connected to the Victorian transmission network and consume in excess of 15% of Victoria's electricity generation. As a major energy user, Alcoa has a considerable interest in the AEMC's Rule Proposal Report for Prescribed Transmission Services and, in particular, the proposed rules for prudent discounting. Alcoa welcomes the opportunity to make a submission to the AEMC on this issue.

Alcoa operates in a highly competitive global market in which the delivered cost of energy determines the competitiveness of its operations. Given this, Alcoa is particularly concerned about the prudent discounting rules in the Rule Proposal and their likely application by the AER. The Rule Proposal largely reflects the approach in the present AER Guidelines. Alcoa submits that this approach does not reflect a sound economic test and is too narrowly based. Specifically, the test of 'inefficient bypass' is not the appropriate economic test for discounting. Alcoa considers that this approach may result in large loads being lost to the network, to the detriment of all users.

This submission outlines relevant considerations in regard to the discounting framework. It begins by considering the relevance and scope of the NEM objective in the context of discounting. This is followed by a discussion of Alcoa's concerns regarding the approach to discounting in the current rules, on the basis of which Alcoa offers comments on the AEMC's Rule Proposal.

2 National Electricity Market objective

The National Electricity Market (NEM) includes as part of its overall objective the long term interests of consumers. The objective as stated in the NEL is:

The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

This objective suggests that the long term interests of consumers should be interpreted in a broad economic context. That is, it should take into account a much broader range of issues than simply price paid, including the long term sustainability of investments and service quality.

This broader context was explicitly acknowledged in the Second Reading Speech for the NEL, which noted that the objective reflects an economic concept and should be interpreted as such. For example, it noted that investment in and use of electricity services will be efficient when services are supplied in the long run at least cost, when resources, including infrastructure, are used to deliver the greatest possible benefit and when there is innovation and investment in response to changes in consumer needs and productive opportunities.

This wider economic context for the objective is reflected in the following statement:¹

The long term interest of consumers of electricity requires the economic welfare of consumers, over the long term, to be maximised. If the National Electricity Market is efficient in an economic sense the long term economic interests of consumers in respect of price, quality, reliability, safety and security of electricity services will be maximised.

In light of this broader economic context (that is economic welfare in a broad sense) for considering the objective of the long term interests of consumers, Alcoa believes that it would be consistent with the NEM objective (and therefore appropriate for the AEMC to consider) the wider economic implications of a large industrial user such as Alcoa ceasing to operate in the context of the Rules governing discounting of TUOS.

¹ National Electricity (South Australia) (New National Electricity Law) Amendment Bill 2005 - Second Reading Speech, p. 2

These wider economic considerations are significant in the context of the major electricity consumers in the NEM. Load information is not public domain data and is not supplied by NEMMCO. However, Alcoa believes that major power users in the NEM include operations that provide significant economic benefit to the national economy and include:

- smelters (principally aluminium but also zinc) are probably the largest energy users in the NEM;
- mining companies, particularly those involved in extractive activities as well as downstream transport operations; and
- major manufacturing, including paper and steel manufacturing.

A key point to emerge is that a relatively small number of customers represent a very significant proportion of the NEM's load. Indeed, Alcoa believes that the combined loads of aluminium and zinc smelters (involving a handful of customers alone) constitute around 20% of the total load of the NEM.

For each of these users, uncompetitive electricity supply has adverse consequences for the long term interests of consumers due to a loss of economic activity that will occur if these customers are not able to access internationally competitive delivered energy prices, both in terms of:

- a foregone opportunity to spread the common costs of transmission across a wider group of consumers which could arise where major loads are lost to the NEM whether due to:
 - a failure to attract (or retain) the load in the NEM due to cost competitiveness; or
 - the substitution of another energy source for electricity supplied from the NEM; and
- a loss of national output and employment that arises where there is a failure to attract (or retain) the load in the NEM due to cost competitiveness.

The loss of a large industrial user such as Alcoa to the NEM would have adverse consequences for consumers in terms of the smelter load's significant contribution to the payment of common costs (approximately \$25 million per annum). Given the sheer magnitude of Alcoa's load, such an outcome would clearly have adverse consequences for consumers in a wider economic sense. Alcoa directly employs more than 7,500 people, primarily in regional Victoria and Western Australia. More than 1,800 people are directly employed by Alcoa in Victoria, and Alcoa provides another 2,000 indirect jobs in Australia.

Accordingly, the failure to create an environment in which TUOS charges are able to be discounted for major users operating in internationally competitive markets, for which the delivered cost of energy is pivotal to project economics, must increase the likelihood of both the closure of local smelter operations and the failure to secure new investment over time. To the extent that the national economy forgoes such opportunities, it must have a significant adverse economic impact, particularly on employment, given the significance of the major energy users to the national economy.

The present test of inefficient by-pass (which on one interpretation could be proposed to continue under the Rule Proposal) that must be met for a discount to be approved reflects stand alone costs and is fundamentally the wrong economic test, to which we now turn.

3 AEMC Rule Proposal

Alcoa supports the continuation of the option for the negotiation of prudent TUOS discounts in the Rules as this will provide for an economically efficient outcome in certain circumstances.

Given the long term nature of investments by large industrial users, regulatory certainty as to the treatment of the discount for a long period (often in excess of 20 years) is necessary. Accordingly, Alcoa supports the proposal for regulatory approval to last for the term of the discount negotiated in the customer contract.

However, Alcoa believes that the existing discounting arrangements unduly restrict the ability of major loads to obtain a discount in circumstances where such a discount would be consistent with the NEM objective. While some of the AEMC's proposals in the Rule Proposal are an improvement on the current situation, Alcoa remains concerned that the criteria still do not reflect an appropriate economic test. Moreover, Alcoa does not agree that TNSP's will have sufficient incentive to negotiate discounts with customers and, therefore, we believe that access to dispute resolution is essential. These issues are addressed below.

3.1 Problems with existing approach

The key issue for a large industrial user of energy such as Alcoa is whether the pricing arrangements are sufficiently flexible and whether they are cost reflective for large industrial loads. Alcoa considers that the structure of TUOS charges is overly prescriptive and not cost reflective in an economic sense.

Lack of cost reflectiveness

The Cost Reflective Network Pricing (CRNP) approach currently used for calculating TUOS charges is a fully distributed cost approach involving a relatively high degree of averaging and cost allocation. The "cost reflectiveness" of the current TUOS charges for large industrial loads is not clear. This is due to a number of factors:

- as the TUOS usage price is based on usage of assets by each customer during peak summer demand, this pricing arrangement may not recognize the benefit provided by the assets during other periods;²

² For example, in the context of Alcoa's current operations, the Victorian country transmission loop can feed off the 500kV line to Moorabool (which is an important element of the transmission network supplying the aluminium

- the common service price may recover the cost of services not used by large loads. This charge covers costs such as land tax, network control centre, administrative overheads and reactive plant and equipment. Large loads such as that required by Alcoa's smelters may not obtain any value from planning and administrative functions or the network control centre. Further, the reactive support to the network provided by large loads in remote regions is not recognised as a deduction to the common service charge; and
- as the general price is designed to recover the remaining unallocated costs making up the revenue cap, this may not provide value to large energy intensive loads.

While the discounting provisions in the Rules provides some flexibility, this framework also has its limitations. Firstly, the TNSP may, but is not required to, agree with a user to charge a lower price than those determined in accordance with the Part 6 Rules. The AEMC has not proposed to change this in its Rule Proposal.

Incentives under revenue cap

One negative consequence of a revenue cap form of regulation is that it may not provide sufficient incentives to ensure that efficient discounts will always be offered. Under a revenue cap form of regulation, the service provider has no incentive to increase volumes by attracting new loads (or retaining existing loads) because it will receive the same revenue regardless of volume. This is in contrast to a price cap form of regulation, where the price is fixed but the regulated business can capture the upside benefit of greater revenue from an increase in load. This gives the business an incentive to take on additional loads.

In fact, there can be a positive disincentive for TNSPs to connect new loads to the network, especially major new loads that could bring forward capital expenditure.

Alcoa believes that that a revenue cap form of regulation gives a very poor alignment of incentives, particularly in a growing system. In this context, even where assets are optimised, they are likely to come back into the asset base relatively quickly. As such, the threat of optimisation will not provide an adequate incentive for a TNSP to negotiate a discount. A price cap would provide a better alignment of incentives, with TNSP's having a greater incentive to take on new loads under this form of regulation.

smelters in Victoria). Electricity flows through this line when no imports occur through the Snowy to Victorian interconnect, which typically occurs during off-peak periods or when the interconnect is down during peak periods. Therefore, only low levels of flows may occur from Moorabool through this loop during peak periods, when the country loop is fed by imports from NSW. Presumably flows through the country loop from Moorabool is the lowest marginal cost options during off-peak periods (resulting in lower line losses), but this benefit may not be recognized by the pricing arrangements, which allocate costs according to flows across the system peak days.

Whilst Alcoa accepts the wider economic considerations that have underpinned the adoption of a revenue cap for TNSPs, this misalignment of incentives has implications for the negotiation framework for discounts, an issue which is addressed below.

3.2 Criteria for discounting

Alcoa supports the elevation of the AER's existing negotiation guidelines into the Rules as this will provide greater certainty for all stakeholders,

The AEMC's Rule Proposal retains the equivalent of Guidelines 1 and 2 in the Rules. This is expressed in the Rule Proposal as follows:³

- (e) A Transmission Network Service Provider may recover greater than 70 percent of the discount amount if:
 - (1) the discount amount is no larger than that necessary to prevent the Customer TUOS general charges and common transmission service charges altering the beneficiary's behavior to the point of adopting the most attractive alternative in place of the course of action the beneficiary would have adopted if no such charges were levied; and
 - (2) the giving of the discount would not place other customers of the Transmission Network Service Provider in a worse position than if the discount was not offered.

The proposed Rule highlights two issues of significance for the proposed discounting framework:

- the threshold that should be met to qualify for a discount to be passed through to other transmission customers; and
- once the threshold is met, the quantum of the discount that may be effectively "recovered" from other transmission customers.

3.2.1 Characterisation of the bypass test

Similar to the AER Guideline, the Rule Proposal refers to a discount beneficiary's 'behaviour' and 'course of action' in a very general sense rather than in a more technical or economic sense. Alcoa notes that, in the past, the ACCC has taken a very narrow interpretation in assessing this behaviour.

³ AEMC, Proposed National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006, p. 15.

However, the actual wording in the Rule Proposal does not reflect the AEMC's intention as set out in the discussion in the Rule Proposal Report, which expressly states that the rationale for allowing prudent discounts is to prevent inefficient by-pass of the transmission network and that by-pass, in this context, refers to:⁴

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

This commentary in the Report suggests that the AEMC is envisaging a broader interpretation of this test than has previously applied. However, the scope of what the AEMC considers constitutes inefficient by-pass is, in Alcoa's view, not as clearly reflected in the Rule Proposal itself as it could be (especially given the ACCC's interpretation of the discounting guidelines in the past).

Accordingly, Alcoa believes that the Rule should be clarified to reflect the AEMC's view as expressed in the report, namely that the consideration of behaviour and course of action of the beneficiary should expressly include economic by-pass. This could be reflected in the Rule by amending section e (1) above as follows:

- (1) the discount amount is no larger than that necessary to prevent the Customer TUOS general charges and common transmission service charges altering the beneficiary's behaviour to the point of adopting the most attractive alternative in place of the course of action the beneficiary would have **adopted (including actions such as transmission duplication or a decision to not invest in or expand a load or to shut down an existing operation)** if no such charges were levied;

Alcoa considers this change is necessary to avert the adoption of a narrow interpretation of inefficient by-pass criteria that could result in the loss of major loads to the NEM, to the detriment of other users and the community more generally from the loss of economic benefits associated with these loads.

The narrow interpretation (which the ACCC has applied in the past and which focuses strictly on the economics of physical by-pass opportunities) merely contemplates a discount to avoid the inefficient duplication of transmission capacity. This is inconsistent with the underlying economic principles of infrastructure pricing.

⁴ AEMC 2006, Proposed National Electricity amendment (Pricing of Prescribed Transmission Services) Rule 2006, Rule Proposal Report, 24 August 2006, Sydney, p. 72.

For example, the present by-pass test does not consider the failure of a load to connect to the network or ceasing to take supply from the network. The adverse consequences of such an outcome have already been outlined above.

Moreover, it will produce sub-optimal plant locational decisions, with major load having an incentive to locate closer to power stations than is necessarily desirable having regard to all other relevant locational factors. As such, the current rules create incentives whereby locational decisions for major users become artificially based around accessing the discount rather than from the perspective of the best location.

Moreover, the avoidance of by-pass does not reflect economically efficient price discrimination (being based on a stand alone rather than an incremental cost test), an issue which is elaborated upon in the following section.

3.2.2 Extent of the allowable discount

Alcoa notes that the Commission has expressly raised the issue of the extent of the discount that is appropriate for the Rules, which in turn leads to a consideration of the optimal level of discount that the Rules should allow.

Beyond meeting incremental costs, the discounting framework should provide for efficient price discrimination whereby users are charged in accordance with their capacity to pay – noting that for the vast majority of users, the capacity to pay transmission charges will rarely be contentious.

This would ensure that the costs to the network of the load are met, with the potential for contribution to the recovery of common costs. Provided incremental costs are met, all users of the network will be better off for retaining the major load in the network (noting that it is not necessarily reasonable that greater than necessary discounts should be provided to even major users of the transmission network).

Alcoa therefore believes that it would be more consistent with economic principles for the discounting framework to allow for efficient price discrimination on the basis of capacity to pay, provided that:

- the discount is no more than necessary to ensure that the customer remains connected to the network; and
- a user's incremental costs are at least met - so that attracting or retaining the customer results in a positive contribution to common costs.

Provided this test is met, the remaining customers will be better off than they would otherwise be if the new loads remains connected or connects to the NEM.

AEMC has proposed to retain the present guidelines 1 and 2 due to concerns that relaxing these guidelines to reflect a more simple incremental cost test may lead to undesirable distributional outcomes if smaller end-use customers effectively pay for discounts granted to large directly-connected consumers. Alcoa submits that this concern is misplaced as it does not recognise that a discount based on efficient price discrimination, provided incremental costs are met, will mean that all users will be better off for the inclusion of the large load if that load would be lost to the NEM absent the discount.

Nevertheless, Alcoa recognises that incremental costs are not readily ascertainable for all but the largest users of transmission services in the NEM. Accordingly, Alcoa accepts that if the current CRNP methodology remains in place, the current floor provided in the AER's guidelines provides a reasonable basis for discounting in the absence of evidence provided by the customer to the contrary as to the quantum of incremental costs to the network caused by that customer (which in turn would be determined by reference to transmission network modelling based on a with a without test).

Under such an approach, the economically efficient floor is properly recognised within the constraints of the current cost allocation framework. It would address the problems with the CRNP as a basis for determining long-run marginal costs. It would also address the locational distortions that could be created by a test that involves an inefficient floor whilst preserving the existing cost allocation framework.

Alcoa recognises that there is potentially a risk of gaming if discounts are granted too freely and, as such, there is a need to avoid excessive discounting applications. The discounting framework will need to be structured to facilitate genuine discounting applications.

This may be addressed through placing the onus of proof on the applicant to demonstrate its compliance with the relevant test, including substantiating that the proposed discount is no more than is necessary for the NEM objective to be achieved. It would also place the onus on the applicant to demonstrate that the discount would be consistent with at least the long-run incremental costs being met (with the current floor applying in the absence of such a test being met).

In addition, Alcoa accepts that it may be appropriate to include a materiality threshold such that it is necessary for the applicant to reasonably demonstrate that it is necessary for it to receive a discount to continue to take electricity from the grid. In practice, this is likely to be a high threshold (for example, a load in excess of 40GWh/annum).

In summary, taking into account the broader economic context of the NEL objective and well accepted economic principles in regard to infrastructure pricing, Alcoa submits that the appropriate test to include in the discounting rules is whether the discount is necessary to attract a load and the charge at least covers long run incremental cost. In terms of how the test is crafted, the ability to recover long-run incremental cost should effectively be the theoretical floor, with scope for the existing cost allocation framework to apply. This will provide a more economically rigorous approach to discounting applications. As noted above, the ability to apply for discounts should be subject to certain procedural qualifications.

Should the AEMC reject this approach in favour of retaining the existing by-pass test, Alcoa strongly believes that the Rules should be expanded to clarify that the meaning of inefficient by-pass encompasses economic by-pass and decisions in relation to the operation of plants and their loads.

3.3 Negotiation framework for discounts

Alcoa is concerned that the Rule Proposal does not require the TNSP to apply for up-front approval, instead allowing it to choose whether to seek regulatory certainty or take the risk that the AER may choose, at a subsequent regulatory reset, to adjust the TNSP's revenue requirement if it decides the discount does not comply with the Rules.

In terms of the negotiation framework, the AEMC has retained the present approach of not requiring the TNSP to offer transmission customers a discount. This is on the basis that the threat of assets being treated as redundant and subsequently removed from the asset base for revenue purposes provides sufficient incentive.

Alcoa does not agree with this assumption.

Failure to attract a major load to the transmission network is likely to allow the TNSP to defer capex. Deferring capex provides a TNSP with a certain and potentially very significant financial benefit over the remaining life of a regulatory period.

The threat of optimisation will most likely be minimal given the growth in the system as the growth in demand will mean that existing assets are more fully utilised. Moreover, in this growth environment, there will be an issue as to whether there will be any optimisation of the asset at the next regulatory reset. Even if assets are optimised, they are very likely to be returned to the asset base within a relatively short period of time (especially given the impacts of lags between regulatory reviews).

The cost of this penalty applying to the TNSP is therefore small compared to the economic harm that can be caused by not providing a more robust and economically-

based framework for discounting. Given this potential cost, there is justification for greater regulatory intervention, particularly through imposing an obligation to negotiate prudent discounts, with recourse to binding arbitration.

In addition, under a revenue cap form of regulation, there will be insufficient incentives to ensure that prudent discounts will always be offered. Under this form of regulation, the TNSP has no incentive to increase volumes by attracting new loads (or retaining existing loads) as it will receive the same revenue regardless of volume. The TNSP will lose little from not discounting. In fact, there can be a disincentive for TNSP's to connect new loads to the network, particularly where major new loads bring forward capital expenditure. This contrasts with a price cap form of regulation where the regulated business may capture the upside benefit of greater revenue from an increase in load.

Moreover, the TNSP will have no real incentive to negotiate a discount with a particular user as it would effectively be giving one customer a discount, which is then recovered off other customers.

Given this lack of incentive to negotiate a discount, Alcoa believes that there should be an obligation on the TNSP to negotiate in good faith with a customer for a discount if requested, with recourse to binding arbitration in the negotiation process for a discount undertaken by the AER or another dispute resolution body. This will be an essential mechanism to overcome the lack of incentive for a TNSP to negotiate a discount and to ensure that discounts are granted where economically efficient.

3.4 Up-front approvals by AER of prudent discounts

Alcoa supports the AEMC's proposal to allow a TNSP to apply for upfront approval of a discount from the AER. This is a significant improvement on the present approach whereby the TNSP would bear the risk of the regulator not approving the discount at the next regulatory reset.

Alcoa also strongly supports the proposal that, if the regulator approves the discount, this approval will be effective for the term of the TNSP's agreement with the customer. This proposal will remove the significant regulatory risk presently faced by both the TNSP and the customer due to the fact that the regulator must re-determine the discount at the end of each regulatory period. In terms of the AEMC's proposals regarding the process for applying for regulatory approval of a discount (including requiring the AER to develop information requirements for a discount application as part of its Information Guidelines and a 3 month time limit for the AER to decide), Alcoa supports these developments as they should serve to provide greater clarity and

certainty regarding the process. As noted above, Alcoa believes that the framework should provide for recourse to binding dispute resolution.

4 Conclusion

Alcoa submits that proposed test for determining what is a prudent discount is not consistent with economic principles and is too narrowly based. Specifically, the test of 'inefficient bypass' is not the appropriate economic test for discounting. This approach may result in large loads being lost to the network, to the detriment of all users and the economy generally.

A more economically sound test that is consistent with the long term interests of consumers would need to explicitly take into account the possibility of economic bypass.

Even in the absence of any other change to the Rules, clarification of the scope of bypass considered for the purposes of the Proposed Rule is fundamental to its practical efficacy.

In this regard, recovery of incremental cost would provide a theoretical floor for assessing the discount. However, Alcoa recognises the current arrangements provide a workable basis for assessing discount levels for the vast majority of cases and should apply in the absence of evidence being provided as to the estimated incremental of meeting a load.

To overcome the lack of a positive incentive for TNSPs to negotiate with customers for a discount, Alcoa believes that recourse to binding arbitration is an essential part of the discounting framework.