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6 February 2006

Dr John Tamblyn  
Chairman  
Level 16  
1 Margaret Street  
Sydney NSW 2001

Dear Dr Tamblyn

**Re: Draft National Electricity Rules Amendment (TransGrid Participant Derogation – Treatment of Contingent Projects (Interim Arrangements)) Rule 2005**

I refer to the Draft Rule Determination made by the AEMC on 19 January 2006. While the AER opposed the need for the derogation, it was on the basis that it was not necessary for the derogation to be considered at this time. TransGrid's proposal, which has relevance to all TNSPs operating under an ex ante capital expenditure regime, could be considered in the wider review of chapter 6. Further the AER did not support the detail of TransGrid's proposed derogation as it seemed to reflect a cost of service approach which was inconsistent with the ACCC's 2005 decision on TransGrid.

The AER supports the concept of allowing revenue determinations to be re-opened for contingent projects in a way consistent with incentive based regulation. I note that the AEMC draft rule determination recognises the importance of preserving the integrity of incentive mechanisms and proposes changes to the TransGrid application to address this issue. However, the AER is concerned that the current draft rule does not fully preserve the incentive mechanisms of TransGrid's revenue determination, and submits that amendments are necessary.

The AER has prepared the following submission to assist the AEMC in its consideration of this matter. Attached to this submission are suggested amendments to the derogation proposed in the AEMC Draft Determination to ensure that it provides certainty to TransGrid without altering the ACCC's Revenue Cap decision on TransGrid or compromising the incentive arrangements established in the TransGrid decision.

This submission:

- briefly sets out the incentive regime that applied to contingent projects in the TransGrid decision;
- explains how the AEMC's Draft Determination could disrupt the incentive elements of the TransGrid decision; and
- explains how the AER's proposed derogation addresses TransGrid's concerns regarding certainty but preserves the incentive regime for contingent projects that was part of the TransGrid decision.

### **Incentive regime in the TransGrid decision**

The ex ante incentive regime in the TransGrid decision applied to both forecastable capex and more uncertain projects which were described as "contingent projects". The operation of the contingent projects regime contained several elements:

- a trigger event occurring during a regulatory period. These events were defined in detail in the TransGrid decision (see Appendix G).
- the AER determining an ex ante allowance for the contingent project. This ex ante element was in part designed to provide TNSPs with certainty regarding the amount they would receive for capex projects prior to undertaking them. This contrasted with the previous ex post approach where the regulator would assess an efficient allowance for a project after expenditure on that project had occurred. The principles and process for determining this ex ante allowance are set out in Appendix F of the TransGrid decision.
- a five year incentive period would be established for the contingent project. At the end of this period the written down value of the actual expenditure on the project would be rolled into TransGrid's asset base. TransGrid would benefit from achieving efficiencies and underspending against the ex ante allowance by retaining the return on and return of capital on the difference between the ex ante allowance and the actual capex which would be rolled into the asset base at the end of the incentive period.

### **Effect of the proposed derogation on the TransGrid decision**

It appears that the derogation proposed by the AEMC in its Draft Decision replaces the ex ante approach to contingent projects in the TransGrid decision with an ex post approach. This would modify the TransGrid revenue cap set by the ACCC.

The proposed derogation does not provide for the AER to set an ex ante allowance for an incentive period once a trigger event has occurred. Instead, it provides for the efficient capital costs incurred on a contingent project in each year to be added to the asset base at the end of that year. This is an ex post approach to adjusting TransGrid's asset base for actual expenditure on a contingent project. At the end of each year, TransGrid's asset base would be increased by its actual expenditure in that year that is considered "efficient" by the AER.

Further, the proposed derogation does not preserve the five year incentive period applying to contingent projects, but rather treats contingent projects in one period as non-contingent projects in the next period.

A derogation expressed in such terms would, in effect, over-ride Appendix F of the TransGrid revenue cap determination. The process established in Appendix F to determine an ex ante allowance for an incentive period would be replaced by a process for an annual adjustment to the asset base on an ex post basis. The incentives created by the ACCC's decision would be negated.

### **AER proposed derogation**

The AER agrees that, in the absence of a derogation, TransGrid's revenue cap cannot be adjusted to include an allowance for a contingent project until the next re-set. The TransGrid determination (at p 212) provides for the asset base to be adjusted at that re-set in a manner that would be neutral in NPV terms. However, the AER supports a participant derogation that will permit the target revenue for a contingent project, determined in accordance with Appendix F, to be rolled into TransGrid's MAR during the regulatory control period.

The AER does not believe it is appropriate to use a participant derogation to overturn or modify an aspect of a regulatory decision that has already been made. The AER is concerned that regulated entities may seek to use the rule change process as an appeal mechanism against a revenue cap determination by the regulator.

The AER has proposed amendments to the participant derogation which allow for the adjustment of TransGrid's revenue cap, during the regulatory control period, as a result of an allowance for a contingent project determined in accordance with TransGrid's revenue cap decision. This will ensure that TransGrid is funded to carry out its approved contingent projects, while also preserving the ex ante incentive aspects of the contingent projects regime.

The key elements of the AER's amendments are:

- instead of adding to the asset base the actual cost incurred in constructing a contingent project at the end of each year, the derogation would provide for the "Target Allowed Revenue" to be added to TransGrid's asset base once a trigger has occurred. This Target Allowed Revenue will consist of the return on and return of capital on the target capex determined by the AER in accordance with Appendix F of the TransGrid decision. The Target Allowed Revenue will be added to TransGrid's MAR on an ex ante basis (ie. once the trigger event occurs, there would be a single adjustment, which would result in the Target Allowed Revenue being added to the MAR for each year of the incentive period). Importantly, the incentive period can overlap the next re-set of the revenue cap. This is what is provided for in TransGrid's revenue cap;
- at the end of the incentive period, the depreciated value of the actual investment in the contingent project will be rolled into TransGrid's asset base. An amount equal to the return on and return of this additional capital will be added to TransGrid's MAR for each remaining year in that regulatory control period.

## **Conclusion**

The AER believes that the attached amendment preserves the AEMC's intention of providing a legislative base for TransGrid's contingent projects and also preserves the ex ante regime that applied to TransGrid contingent projects in the ACCC's decision. I hope that this public submission will assist the AEMC in its consideration of this issue.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Steve Edwell', with a large, stylized flourish extending to the right.

Steve Edwell  
Chairman

### 8A.1.1 Expiry date

This derogation expires on 30 June 2014.

### 8A.1.2 Definitions

In this derogation:

**Contingent Project** means a project identified in the Determination as a contingent project.

**Current Regulatory Period** means the period 1 July 2004 to 30 June 2009.

**Determination** means the “Final Decision, NSW and ACT Transmission Network Revenue Cap TransGrid 2004-05 to 2008-09” dated 27 April 2005 determined by the ACCC pursuant to clause 6.2.4(b) of the National Electricity Code.

**Future Regulatory Period** means the *regulatory control period* immediately following the Current Regulatory Period.

**Incentive Period** means the period for which Target Allowed Revenue is determined by the *AER* for a Contingent Project in accordance with Appendix F of the Determination.

**Maximum Allowed Revenue** means the maximum revenue for a *financial year* allowed under the Determination and the revenue cap applicable to TransGrid in the Future Regulatory Period.

**Regulatory Asset Base** means the regulatory asset base in the Determination or established for the purpose of the revenue cap applicable to TransGrid in the Future Regulatory Period.

**Target Allowed Revenue** means an amount for each *financial year* in an Incentive Period, comprised of a return of capital and a return on capital, determined by the *AER* in accordance with Appendix F of the Determination.

**Trigger** means an event identified as a trigger in Appendix G of the Determination and which must occur prior to implementation of a Contingent Project.

### 8A.1.3 Treatment of contingent projects

Where the Trigger identified in respect of a Contingent Project has occurred prior to 1 July 2009:

- (a) the Target Allowed Revenue for the Contingent Project is to be added to TransGrid’s Maximum Allowed Revenue for each *financial year* in the Incentive

Period, regardless of whether that *financial year* is in the Current Regulatory Period or the Future Regulatory Period; and

(b) at the end of the final *financial year* of the Incentive Period (whether that *financial year* is in the Current Regulatory Period or the Future Regulatory Period):

(1) the depreciated value of the actual investment in the Contingent Project that complies with the requirements of the Rules is to be added to TransGrid's Regulatory Asset Base; and

(2) an amount is to be added to TransGrid's Maximum Allowed Revenue for each subsequent *financial year* in that *regulatory control period* that is equal to:

(i) the return on capital; plus

(ii) the return of capital;

for the amount that is added to TransGrid's Regulatory Asset Base pursuant to clause 8A.1.3(b)(1).