TransGrid

ABN 19 622 755 774

201 Elizabeth Street (cnr Park St)
PO Box A1000 Sydney South
New South Wales 1235 Australia
Facsimile (02) 9284 3456
Telephone (02) 9284 3000
Web http://www.transgrid.com.au
DX1122 Sydney

Mr John Tamblyn
Chairman
Australian Energy Market Commission
Market Street
Sydney NSW 2000

Dear Mr Tamblyn

Re: National Electricity Rules Transmission Revenue Cap Derogation

This letter confirms our recent discussions that TransGrid is seeking a participant derogation from the National Electricity Rules (as set out in Attachment 1) in respect of projects classified by the ACCC as 'contingent' projects:

- to give effect to certain aspects of the regulatory framework the ACCC sought to establish in its recent TransGrid revenue cap decision but did not for want of a Code change; and
- to clarify the treatment of revenue cap impacts of approved contingent projects under the recent ACCC determination of TransGrid's revenue cap for the period July 2004 to June 2009.

Most importantly, implementation of this derogation will support the achievement of the Market Objective as set out in the National Electricity Law. This is explained more fully in Attachment 2 to this letter.

Furthermore, as it is likely that the first contingent project to be affected by this derogation will be triggered before the end of 2005, TransGrid requests that this derogation be processed with some urgency. Without this contingent project derogation in place, TransGrid will not have access to a mechanism to adjust its revenue cap during TransGrid's current regulatory control period for expenditure on any contingent project, regardless of whether the project passes the regulatory test and is accepted as efficient by the Australian Energy Regulator (AER).

On 27 April 2005, the ACCC released its decision on TransGrid's revenue cap for the five-year period commencing 1 July 2004, titled "NSW and ACT Transmission Network Revenue Cap TransGrid 2004-05 to 2008-09" (the Final Decision) pursuant to clause 6.2.4 of the Code which has become section 6.2.4 of the Rules. The Final Decision adopted a new "ex ante" regulatory regime for setting capital expenditure and excluded projects which the ACCC considered uncertain at that time.

The projects identified in the Final Decision, and which the ACCC considers uncertain (contingent projects), included the upgrade of the Queensland to NSW Interconnector (QNI).

Under the Final Decision, investment in a transmission project, which the ACCC has identified as a contingent project, requires the occurrence of a predefined trigger before that project can become eligible for regulated revenue. The triggers for each contingent project are set out in Attachment G of the Final Decision. For example, the trigger for the Upgrade of QNI is "*justification against net benefit criterion as set out in the Regulatory Test*". Initial assessments indicate that this trigger, for at least some upgrading of QNI, is likely to be met before the end of 2005.

The Final Decision also proposed that contingent projects are to be subjected to a five (5) year incentive period. Under the Final Decision the incentive period for each contingent project would commence at the date investment in the project is first committed or at a date determined by the ACCC, and would extend beyond the expiry of TransGrid's current regulatory control period on 30 June 2009.

Since the Final Decision provides for several contingent projects, it is likely that each contingent project will have a different incentive period, and with each contingent incentive period operating concurrently.

Furthermore, the Final Decision identified a particular limitation of section 6.2.4 of the Rules, and more generally the Rules governing the setting of TNSP revenue caps, that prevents the full and proper achievement of the arrangements sought to be implemented by the determination:

> "The revenue cap cannot be adjusted during the regulatory control period as a result of the ACCC's approval of the contingent project. In the absence of a Code change to permit this to occur, the ACCC decision will be implemented at the re-set of the revenue cap in the manner discussed at Stage 5 below.
>
> ...
>
> This revenue cap is due to expire on 30 June 2009. At the re-set of the revenue cap:
>
> - the ACCC will add to the closing RAB the target capex and AR approved at Stage 3 above for each year of the incentive period leading up to the re-set."

As a result, the Final Decision envisages an adjustment to the closing Regulatory Asset Base (RAB) (and associated Maximum Allowable Revenue) at the end of the current regulatory control period for contingent projects implemented before 30 June 2009.

There are at least two major problems with this arrangement as follows:

1. As explained further in Attachment 2, the ACCC decision cannot bind a future AER and the arrangement does not provide TransGrid with any reasonable level of certainty that efficient investment in a contingent project will be recognised in the RAB. It also requires TransGrid to fund each triggered contingent project until at least the end of the current regulatory control period without any offsetting income in relation to that contingent project. As such, the commercial implications of undertaking a contingent project remain highly uncertain, putting the timely delivery of efficient transmission infrastructure at risk, thereby undermining the achievement of the National Electricity Market Objective. This is further discussed in Attachment 2

2. It is inappropriate to bind TransGrid, and a future AER, beyond the current regulatory control period, to an arrangement that may be inconsistent with the new Rules for transmission revenue regulation currently being developed by the AEMC. The continuation of contingent project revenue cap arrangements, involving separate 5 year regulatory control periods for each 'triggered' contingent project extending beyond 30 June 2009, will have this effect.

This derogation will address these issues by:

(a) providing assurance that the AER has sufficient legal authority to make an appropriate adjustment to the closing value of TransGrid's Regulatory Asset Base at the end of each financial year in the current regulatory period for contingent projects (once triggered);

(b) providing assurance that the AER has sufficient legal authority to make an appropriate adjustment to TransGrid's Maximum Allowed Revenue, in the current regulatory control period that reflect the impact of contingent projects (once triggered) on the RAB; and

(c) ensuring that the treatment of contingent projects, triggered during TransGrid's current regulatory control period, will be subjected to any new National Electricity Rules established by the AEMC in relation to transmission revenue setting arrangements from the completion of TransGrid's current regulatory control period.

The derogation itself does not approve any particular project as being efficient or result in any particular project being undertaken. Rather, the AER would remain responsible for approving each contingent project and providing the relevant assurance as to its efficiency.

It is proposed that this derogation would expire on 1 July 2009, unless the AER has not set, by that date, the revenue cap to apply to TransGrid for a future regulatory control period, in which case the derogation will expire on the date the AER sets that revenue cap.

Your assistance in processing this derogation request as a matter of priority would be appreciated. Should AEMC staff need further information please do not hesitate to contact Mr Philip Gall, TransGrid's Manager/Regulatory Affairs, on 02 9284 3434 in the first instance.

Yours faithfully

Kym Tothill 16/9/2005

Kym Tothill
General Manager/Corporate Development

Attach.

Attachment 1

PARTICIPANT DEROGATION REQUEST FROM TRANSGRID – 16 SEPTEMBER 2005

Derogation for the treatment of Contingent Projects on an interim basis.

X.X.1. This derogation expires on 30 June 2009 unless the AER has not by that date set the revenue cap for TransGrid for a Future Regulatory Period, in which case the derogation will expire on the date the AER sets that revenue cap.

X.X.2. 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.

Financial Parameters means the cost of capital parameter values stated in Table 8.6.1 of the Determination.

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

Maximum Allowed Revenue means the maximum allowable revenue in the Determination.

Post Tax Revenue Model means the revenue model including the Financial Parameters, applied by the ACCC in determining the Determination.

Regulatory Asset Base means the regulatory asset base in the Determination.

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

X.X.3 Where the Trigger identified in respect of the Contingent Project has occurred prior to 1 July 2009:

(a) the efficient capital costs of the Contingent Project incurred in each given *financial year* are to be added to the value of TransGrid's Regulatory Asset Base at the end of that *financial year* in the Current Regulatory Period applying the Post Tax Revenue Model; and

(b) at the end of each *financial year* the Maximum Allowed Revenue of TransGrid for the next year which is set out in the Determination is increased to include an additional amount consistent with the application in the Determination of the Financial Parameters to the Regulated Asset Base equal to:

(i) the return on capital; plus

(ii) the return of capital,

for the sum of all efficient capital costs that are included in TransGrid's Regulatory Asset Base pursuant to sub-section X.X.3(a) in that or any previous *financial year*; and

(c) notwithstanding anything to the contrary in the Determination, in setting the *revenue cap* for the Future Regulatory Period, the AER must treat the Contingent Project as a non-Contingent Project commenced in the Current Regulatory Period.

Attachment 2

The Proposed Derogation Contributes to the National Electricity Market Objective

The National Electricity Market Objective as set out in the NEL 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."

Of particular relevance to this derogation are the following aspects of the objective:

- Promote efficient investment;
- Reliability and security of the national electricity system;
- Price; and
- Long term interests of consumers of electricity.

As noted below, a key purpose of the derogation is to provide greater regulatory certainty regarding the treatment of efficient transmission investments. How the derogation will promote efficient investment is explained below.

Furthermore, the derogation contributes to the implementation of aspects of the ACCC's intended regulatory framework for contingent projects as set out in the ACCC's recent TransGrid revenue cap determination. It does this by clarifying the intended operation of the relevant Code/Rules The ACCC's intended regulatory framework, and the derogation itself, contains a number of features to ensure that the investments in question are efficient investments. In particular:

- the derogation will not itself deem any project or expenditures to be efficient. Rather it will enable the AER to undertake an assessment of the contingent project triggers each of which was identified by the ACCC in the determination as appropriate to that contingent project. In undertaking such assessments the AER will be required by the NEL to apply the Market Objective;
- from an allocative and dynamic efficiency viewpoint, the TransGrid revenue cap determination sets out certain triggers for the contingent projects each of which is designed to ensure that inefficient investment projects are not commenced;
- from a technical efficiency viewpoint, the only expenditures that are permitted to be included in the Regulated Asset Base are efficient expenditures.

Implicit in the identification of the contingent projects within the TransGrid revenue cap determination is that they will contribute to the security and reliability of the supply of electricity and of the national electricity system, particularly that part of the system within New South Wales and supplies within and through New South Wales.

Similarly, implicit in the identification of the contingent projects in the determination is that they will contribute to appropriate and efficient use of infrastructure and pricing to end consumers of electricity.

For instance, the QNI upgrade would enhance the ability for electricity to be supplied between Queensland and New South Wales. That would better enable spare Queensland generation capacity to contribute to meeting NSW peak demands (or demand in regions further South) and vice versa, both with the result that the investments should tend to lower prices for electricity consumers in all regions.

Further, the derogation would also improve certainty for consumers concerning the prices they are likely to pay for transmission services.

Attachment 2

The Proposed Derogation Contributes to Implementing the Improved Investment Certainty Sought by the Recent ACCC Revenue Cap Determination for TransGrid

Minimising investment risks associated with pursuing capital intensive infrastructure projects is a key commercial challenge. A significant such risk is the regulatory treatment of a TNSP's investments in contingent projects at the next regulatory reset.

The ACCC revenue cap determination, and the AER's Statement of Regulatory Principles, implicitly recognise that risk:

> "The revenue cap cannot be adjusted during the regulatory control period as a result of the ACCC's approval of the contingent project. "

As an interim measure pending a Rule change, the Determination seeks to minimise the risk to TransGrid in the following terms:

> "In the absence of a Code change to permit this to occur, the ACCC decision will be implemented at the re-set of the revenue cap in the manner discussed at Stage 5 below.
>
> ...
>
> This revenue cap is due to expire on 30 June 2009. At the re-set of the revenue cap:
>
> - the ACCC will add to the closing RAB the target capex and AR approved at Stage 3 above for each year of the incentive period leading up to the re-set."

The transitional provisions contained in the National Electricity (South Australia) Variation Regulations 2005 provide that a determination made by the ACCC in accordance with Chapter 6 of the Code and in effect immediately before 1 July 2005 continues in effect and is to be taken as a determination made by the AER under Chapter 6 of the new NEL[1].

However, there is no provision in the Code, the new NEL, or the Rules, which provides the necessary certainty that a decision made by the AER under Chapter 6 of the Code/Rules binds the decisions of a future AER.

Hence, notwithstanding the intended effect of the Determination, absent a derogation, the above regulatory risk remains a live issue which, depending upon the specific circumstances of the contingent project concerned, stands to impede TransGrid from pursuing efficient investments as vigorously as should be the case.

[1] Regulation 7, Schedule 2, Part 2, clause 13(1)(a)