

4 April 2008

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**BY EMAIL:** [AERinquiry@aer.gov.au](mailto:AERinquiry@aer.gov.au)

Dear Mr Buckley,

**TRANSGRID'S NOTICE OF PROPOSED PASS-THROUGH FOR NETWORK SUPPORT DURING 2008-09**

The Energy Users Association of Australia (EUAA) is aware that the Australian Energy Regulator (AER) has received a notice of proposed pass through for network support from non-network sources during the 2008-09 financial year from TransGrid.

The EUAA is a national body representing the interests of major electricity and gas users. We have 100 members, a significant number whom have operations and interests in NSW. Our members are affected by regulatory revenue determinations as regulated charges comprise a large proportion of large end users' electricity bills, and are reliant on effective assessment by regulators of expenditure by regulated network businesses, and their reasonableness.

End users have legitimate expectations for businesses subject to a regulatory framework to be customer focused. In particular, these expectations are for regulated revenue and charges to:

- Reflect efficient costs with commercial risk free returns on capital
- Be predictable over time without rate shocks,
- Only increase where service levels (including real time supply & restoration performance as well as asset management & planning) exceed reasonable expectations.

The EUAA understands that the pass through amount of around \$22 million relates to 350 MW of network support as part of the Western 500 kV conversion project. Importantly, we are supportive of demand side participating in the market, and recognize that it can play an important role in improving the efficiency and cost effectiveness of network augmentations. It is commendable that TransGrid is proposing to utilize demand management for network support as DSR can play an important role in offsetting the need for costly capital expenditure, offering the potential for substantial savings which would ultimately be passed on to energy users. At a cost of \$60,000/MW, compared with \$600,000/MW for peaking plant to meet the most extreme and very infrequent 'needle' peaks in demand present for only a small fraction of the time, DSR is a far more economical substitute.

The greater use of DSR and its treatment as a more natural part of the NEM can provide customers with an offset against exposure to peak prices, offer them opportunities to get more involved in

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innovative contracting opportunities, and provide an offset to market risks, which are embedded in retail contract prices.

We see the benefits of DSR as a separate issue to the pass through proposal by TransGrid.

As it has been identified as an operationally important to the Western 500kV conversion project, we consider the procurement of non-network services should not be made dependant on the pass through amount, and the proposed procurement should be made in view of the existing revenue provided in the previous regulatory determination.

If the AER approves TransGrid's application, the effect of this will be to raise prices in 2009-10 by 4.7% above the level allowed in the existing revenue cap. This corresponds to a 16.7% increase in the allowed operating expenditure that the ACCC determined to be the efficient level of operating expenditure by TransGrid for this year.

Overall, the EUAA strongly disagrees that this expenditure is a legitimate pass-through expense, and we consider that the approval of this pass-through is inconsistent with the regulatory arrangements established by the AER pursuant to the National Electricity Code for TransGrid for the 2004-09 regulatory period. Approval of this pass-through application would also be inconsistent with the National Electricity Rules established by the Australian Energy Markets Commission (AEMC) in 2006, applicable to revenue determination decisions by the AER from this time.

The EUAA is highly concerned that the AER's acceptance of this application will set a precedent that will adversely affect the integrity of the incentive-based regulatory regime that the AEMC has established and that the AER is responsible for enforcing.

The remainder of this submission addresses the following issues associated with TransGrid's notice:

1. The nature and the cost of network support services for the pass-through event, and whether the costs of the proposed network support services are reasonable in view of the proposed pass through amount;
2. The consistency of the proposed pass through costs with the ACCC's decisions on pass through rules for TransGrid's Revenue determination for 2004-05 to 2008-09;
3. The accounting treatment of the pass-through and implications for revenue

#### **1. Whether the Costs are Reasonable in view of the Proposed Pass-through Amount**

TransGrid has claimed as a "Pass Through Event", a contract that it has decided to enter into for network support. The contract consists of an availability payment and a usage payment. The availability payment is claimed to be around \$10.7 million and the usage payment is stated to be \$10.2 million. The usage payment will not arise unless the network support service is used. TransGrid claim that these network support contracts are elements of its Western 500 kV conversion project that allow for expenditure on network augmentation to be deferred.

TransGrid claim that "*where the cost of a network support option is not included in the revenue cap it can be passed-through under the pass through rules set out at Appendix A to its revenue cap decision*". This is consistent with TransGrid's claim that it is subject to "*rate of return regulation*" that allows it to "*invest in the network where economically justifiable based on a Regulatory Test*"

TransGrid claim that, while an allowance was made for capital expenditure on the Western 500 kV conversion project, no allowance was made by the AER in its 2004 to 2009 regulatory decision for operating expenditure for the expected network support payments, or TransGrid's expenses associated with procurement or on-going operation of the network support.

TransGrid's application is dated 13 March 2008, the matter was only brought to our attention on 14 March 2008 and the deadline for this submission to you is 1 April 2008. This leaves insufficient time for us to make a technical assessment of the deferral of capital works through this procurement of network support. The fact that we have not commented on this in this submission should not be construed as acceptance of the economic merit of TransGrid's network support expenditure. We reserve our right to comment on this at a later stage.

## 2. Regulatory Framework Governing TransGrid's 2004-05 to 2008-09 Regulated Revenue

The regulatory framework under which TransGrid's 2004 to 2009 decision was made, is an incentive based regulatory control based on an *ex-ante* determination of capital and operating expenditure. Contrary to TransGrid's claim, this is not a rate of return framework. In addition, contrary to TransGrid's claim, the Regulatory Test does not provide approval or economic justification for TNSP investment.

The provisions regarding cost pass-through affecting TransGrid are clearly set out by the ACCC in its Decision document<sup>1</sup>. This document provided in the body (see section 4.6) provides a description of the criteria, and in Appendix A specific rules and definitions to implement those criteria.

For the avoidance of doubt, the Decision document in Section 4.6 specifically stated that the pass-through rules in Appendix A are pursuant to the principles set out in the Draft Statement of Regulatory Principles for the Regulation of Electricity Transmission Revenue. These are summarised in section 4.6 as follows:

*"In relation to pass-through applications, the ACCC considered that, in light of the Code requirements, a pass through event should, in general, have the following characteristics:*

- *it should be identified in advance with its scope precisely defined*
- *it should be beyond the control of the TNSP*
- *its financial impact should be better borne by parties other than the TNSP*
- *it should affect the TNSP, but not the market generally*
- *it should not already be compensated for in the forecast opex or other revenue cap costs*
- *it should not be more efficient for the TNSP to insure against the risk*
- *its financial impact should be material."*

As the ACCC's Decision document and its Draft Statement of Principles makes clear, the pass-through allowance is meant to deal with costs that arise as a result of exogenous factors, that are beyond a TNSP's control. This principle was accepted by the AEMC and is reflected in the AEMC's subsequent Rule Determination in 2006 which states that:

*"The Objective of the cost pass-through is to provide a degree of protection for the TNSP from the impact of unexpected changes in costs outside its control."*<sup>2</sup>

This background establishes the criteria that the AER should use to assess the merits of TransGrid's pass-through application.

The EUAA considers that TransGrid's application fails to satisfy these criteria. In particular:

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<sup>1</sup> Australian Competition and Consumer Commission, *Final Decision*, NSW and ACT Transmission Network Revenue Cap, TransGrid 2004-05 and 2008-09, 27 April 2005.

<sup>2</sup> Australian Energy Markets Commission, *Rule Determination*, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18, 16 November 2006.

- the expenditure on network support was completely within TransGrid's control and did not arise as a result of an exogenous event; and
- allowance has already been made in the revenue control for this expenditure.

**The expenditure on network support was completely within TransGrid's control and did not arise as a result of an exogenous event**

TransGrid's decision to enter into network support agreements was at all times entirely within their control, and was foreseen when the revenue control was determined in 2004. It was known at the time of its revenue application in 2004 that expenditure on network support to underpin reliability was likely to be a part of the cost of the Western 500 kV conversion. Indeed, TransGrid had foreshadowed in its application to the AER in 2004, that transmission constraints were likely by 2008-09, and that the essential elements of the augmentation may not be complete by this time, and so some other means of reliably meeting demand would be required.

The information TransGrid provided in their pass-through application is not new information, which would support the emergence of an exogenous factor. TransGrid has made no claim that there have been unexpected developments in the form of, for example, unexpected changes in demand growth or generation availability, that have required it to act in a manner that was not foreseen at the time that TransGrid's revenue application was made and approved by the AER in 2004. Accordingly, there is no reason to believe that TransGrid did not, or could not, adequately budget for this expenditure.

In this way, TransGrid's application fails to meet the criterion that the expenditure on the network support was the result of an exogenous event over which TransGrid had little or no control.

**Allowance has already been made in the revenue control for this expenditure**

In its 2004 regulatory decision, the ACCC provided \$194 million for expenditure by TransGrid on the Western 500 kV conversion project, consistent with the amount that TransGrid had requested for this project.

TransGrid's claim is that this allowance only related to capex, and that the ACCC's determination of the opex allowance did not make provision for the cost of network support pass-through. The EUAA considers this claim to raise serious concern about TransGrid's accounting practices. We discuss the implications of this further at the end of this submission.

It is generally accepted accounting practice that all expenditure used to develop or procure assets that have a useful life beyond one year – such as the western 500 kV conversion assets – should be amortised over the useful life of those assets. Such expenditure may be on capital items such as transformers, or it may be an allocation of recurrent expenditure – such as staff costs, general overheads or other contractual payments – such as for network support contracts – associated with that capital asset.

The inclusion of all cash costs – whether capital items or recurrent expenditure - in project economic evaluation is also required under the Regulatory Test. This has been done, for example, in the application of the Regulatory Test to the Western 500 kV conversion project.

TransGrid's application to pass-through the network support element of the cost of the Western 500 kV conversion project, carves out one element of the expenditure on this project, defines it to be operating expenditure and then seeks to have it treated as a cost to be passed through to consumers.

But an allowance, \$194 million, exactly the amount that TransGrid requested, has already been made for this project and included in the regulatory asset base and maximum allowable revenue calculation. This allowance covers expected expenditure on capital items, as well as expected expenditure on recurrent items that have been capitalized into the project.

A possible counter-argument to this is that the \$194 million allowance may not have specifically identified \$22 million for expenditure on network support. While this may be true, this is in the nature of the incentive regulation regime, where it is not possible to forecast in advance precisely how money will be spent on each and every project. By establishing an overall allowance, TransGrid has an economic incentive to reduce expenditure below this allowance, and is not micro-managed by the economic regulator.

In other words, the inability to identify that precisely \$22m had been set aside as part of the \$194m allowance for expenditure in network support contracts, does not in any way undermine the point that TransGrid has already been compensated for their investment in the western 500 kV project, including expenditure on whatever contracts it has chosen to enter into pursuant to that project.

In this way, TransGrid's pass-through application fails to meet the criterion that allowance had not already been made for this expenditure.

### **3. The Accounting Treatment of the Proposed Pass-Through**

TransGrid claim that the \$194 million allowance related only to capital expenditure. Furthermore, they claim that since the ACCC made no provision in their operating expenditure allowance for network support payments, they have not been compensated for such expenditure. This necessarily implies that network support expenditure is classified as operating expenditure.

While it may be the case that, in some circumstances, network support contracts would be classified as operating expenditure, there is no reason for this generally, or necessarily, to be so.

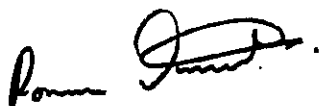
To classify the network support contracts associated with the deferral of the western 500 kV project as operating expenditure is incongruous with expenditure being made pursuant to the development of specific, long lived capital assets. Expenditure on network support contracts would not have been classified as operating expenditure at the time of the revenue reset application in 2004, and similarly should not be classified as operating expenditure now. The treatment of network support contracts as opex would result in an increase in revenue (of about 5%) in one year alone, on a service that provides benefits for the life of the augmentation.

The EUAA is concerned at what appear to be inappropriate accounting practices. This is not consistent with economic efficiency incentives, and shifts risks and costs onto consumers.

TransGrid's attempt to define such network support expenditure as operating expenditure raises concerns about the quality and robustness of the financial information it provided in its revenue application, its regulatory accounts and its financial accounts.

In addition, the EUAA strongly suggests that the AER should seek the advice of the Auditor General in the Government of New South Wales, and the Institute of Chartered Accountants in Australia, and the Australian National Institute of Accountants, on this matter.

Yours sincerely



Roman Domanski  
**Executive Director**

