Our Ref: M2006/503-3
Your Ref:
Contact Officer: Vani Rao
Contact Phone: 03 9290 1430

20 August 2007

Ms Merryn York
Chair – ETNOF
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PO Box 1143
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Mr Bob Lim
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By email: myork@powerlink.com.au, boblim@optusnet.com.au

Dear Ms York and Mr Lim

First Proposed Transmission Guidelines

We refer to the email correspondence from Mr Bob Lim (MEU) to Mr Mike Buckley (AER) and from Ms Merryn York (ETNOF) to Mr Paul Dunn (AER) respectively. AER staff have considered issues raised in submissions to the AER's consultation on the First Proposed Transmission Guidelines and at the AER's public round table discussion forum with interested stakeholders on 17 July 2007. The following summarises the AER's views on the matters as identified by you both in your emails. As discussed with Ms York, we would be happy to participate in a telephone discussion of these matters with members of ETNOF and the MEU, which can be arranged directly with Mr Dunn on 03 9290 1426.

1. Post Tax Revenue Model

No matters were identified for further discussion.

2. Post Tax Revenue Model

Tax values roll forward sheet (ETNOF)

The AER sent a revised Roll Forward Model to ETNOF and Energy Australia on 7 August 2007 for factual checking. No comments have been received to date. The AER would appreciate if any comments could be received by 24 August 2007.

3. Service Target Performance Incentive Scheme

Revenue at risk (ETNOF and MEU)

The AER is retaining the revenue at risk under the scheme at one per cent. However, the AER will consider increasing it from this level in the future after it has undertaken a full review of the scheme to assess whether it is achieving its intended outcomes. In this regard, the AER considers it may be appropriate to place additional revenue at risk for any market impact of transmission congestion (MITC) parameters that may be incorporated into the scheme in the future. The MITC issue is currently under separate consideration.

4. Efficiency Benefit Sharing Scheme

The AER has sought to develop an Efficiency Benefit Sharing Scheme ("EBSS") which is simple to understand and apply, predictable, requires minimal adjustments and does not threaten the financial viability of a regulated firm.

Clarification of Opex components to be included in the scheme (ETNOF and MEU)

Whilst the focus of the EBSS should be on controllable costs, the AER notes that it is a difficult exercise to develop a comprehensive list of those uncontrollable cost elements that can properly be excluded. There is not universal agreement on the most appropriate treatment of this issue and views range from making no adjustments at all to development of a comprehensive list of all permissible exclusions. The AER considers a middle course is appropriate.

The AER considers that adjustments to forecast and actual operational expenditure arising from pass-through events, changes in capitalisation policy and growth should be applied in calculating carry-over amounts. Transmission Network Service Providers ("TNSPs") will also be able to propose, for consideration by the AER, other adjustments in relation to uncontrollable events so that TNSPs are not unfairly penalised. The AER envisages that, over time, this approach will establish the appropriate range of matters for exclusion. In addition, the AER is not proposing to incorporate potential efficiency improvements in setting benchmarks.

Adjustments to carry forward calculation to ensure no 'double whammy' (ETNOF and MEU)

As noted above, the AER considers some adjustments may be made to forecast and actual operating expenditure in calculating carry-over amounts.

Carry forward of net negative amounts (ETNOF and MEU)

The proposed EBSS is intended to provide ongoing incentives to TNSPs to achieve efficiency gains, when the opportunity arises. The AER considers, after carefully considering all submissions and views, that the symmetrical treatment of gains and losses is an essential design element of the EBSS. A major concern that can arise with the operation of this scheme is an under-estimation of efficient revenue in the next regulatory period to meet the opex needs of a business. This risk will be greatly diminished by planned adjustments to account for variations in major uncontrollable factors: new responsibilities; demand growth variance and pass-through events. TNSPs will also be able to propose additional categories of uncontrollable costs for consideration by the AER as part of their revenue proposals.

The application of both positive and negative carry-over amounts under the incremental rolling scheme design, which has previously been adopted by the ACCC as described in its Statement of Regulatory Principles, and the adjustments to forecast operating expenditure should mean that the magnitude of any negative carry-over amounts are likely to be small compared to the total allowed revenue.

The AER also proposes that the EBSS calculations be conducted in real, not nominal, terms to minimise errors arising across regulatory periods.

Sharing basis to achieve fair sharing (ETNOF and MEU)

The sharing ratio depends on the carry-over period and discount rate. The AER proposes a 5 year carry-over period in the EBSS which is consistent with the 5-year regulatory period. Therefore, assuming a real discount rate of approximately 6% and a 5 year carry-over period, the sharing ratio between TNSPs and customers is 30:70.

5. Submission Guidelines

Relationship between Rules and Guidelines (ETNOF)

The AER notes that the Submission Guidelines are consistent with the provisions of the National Electricity Rules and, as such, no distinction can be drawn between the two. Therefore, paraphrasing is not required.

Audit requirements (ETNOF)

The AER will provide more detail and certainty regarding audit requirements to allow TNSPs sufficient time to arrange for suitable verification of their information. There will be no audit requirements for forecast capex and opex information and TNSPs will be able to choose from a number of options regarding the level of assurance provided. The AER also agrees that it is inappropriate for an auditor to explicitly provide a duty of care to the AER and this requirement will be removed.

Director's sign-off (ETNOF)

The AER is proposing to amend the Directors' Statement from that provided in the January 2007 consultation documents. The AER considers the amendments to be reasonable regarding the assurances requested from Directors. This will entail redrafting to clarify that Directors are not expected to verify forecasts but merely that any estimates provided are the best available at the time.

Recognise change to ex-ante (ETNOF)

The AER acknowledges that, under an *ex-ante* regime, historical capital expenditure will not be subject to the reviews undertaken for an *ex-poste* regime. However, the AER has an obligation to assess historical costs against the relevant original forecast costs when reviewing and assessing the forecasts provided in a TNSP's Revenue Proposal. The AER considers that information on both historical and forecast capital expenditure are necessary components of a TNSP's Revenue Proposal to facilitate understanding of the firm's ability to implement the proposed capital works program.

Dealing with confidential information (ETNOF)

The Guidelines have been amended to better reflect the intention of the National Electricity Rules ("NER").

Provision for safe harbours (ETNOF)

The AER believes that TNSPs should have flexibility in preparing their Revenue Proposals. As such, 'safe harbour' provisions are not included in the Submission Guidelines. While TNSPs may find it useful to refer to Revenue Proposals previously accepted by the AER, they are also able to discuss specific matters with the AER in the course of the pre-lodgement discussions. Whilst not labelled as such, in particular respects, 'default' approaches are evident in the guidelines and the AER would regard submissions made consistent with the guidelines to *prima facie*, be compliant.

6. Cost Allocation Guidelines

Only higher level information relating to a methodology is required (ETNOF and MEU)

The AER will provide further detail to clarify what level of detail should be provided to allow the AER to replicate the TNSP's reported outcomes as required by the NER.

Audit requirements (ETNOF and MEU)

The AER's proposals for audit requirements will be clarified. An important element of the AER's regulatory functions is to monitor and enforce compliance with the TNSP's Cost Allocation Methodology.

Clarify avoided cost is not prohibited (ETNOF and MEU)

The AER proposes to allow application of the avoided cost methodology, subject to assessment of the circumstances.

7. Information Guidelines

The Information Guidelines share a number of important elements with the Submission Guidelines and, consequently, a consistent approach will be taken in relation to cost reporting and audit requirements, amongst other matters.

As you are aware, the AER must publish the First Proposed Transmission Guidelines by 30 September 2007. Decision documents and final guidelines will be prepared for AER Board review and approval in time for publication of the guidelines by 30 September 2007.

Yours sincerely

Chris Pattas
A/g General Manager
Network Regulation South