

17 October 2005



Mr Sebastian Roberts
General Manager – Transition Group
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

145 Newcastle Road
Wallsend NSW 2287
Telephone 13 1525
+61 2 4951 9555

Address all mail to
PO Box 487
Newcastle NSW 2300
Australia

AERInquiry@aer.gov.au

Dear Mr Roberts

Regulatory Accounting Methodologies: Position Paper

EnergyAustralia appreciates the opportunity to make a submission in response to the Australian Energy Regulator's position paper on regulatory accounting methodologies released in September 2005. It is clear in the AER's first position paper that concerted effort has been directed towards considering the practical and philosophical implications of decisions both embodied in the ACCC's latest Transmission Network Revenue Cap Decision for EnergyAustralia and TransGrid, and the ACCC's latest Statement of Regulatory Principles.

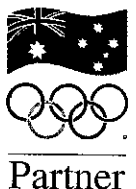
EnergyAustralia concurs with the AER's preliminary position of prescribing the "as incurred" approach to recognising capital expenditure for regulatory purposes. EnergyAustralia believes that this approach, inter alia, is compatible with its recent Revenue Determination; simplifies regulatory treatment of inter-period capital spend; and promotes transparency in reporting between TNSPs. I note that EnergyAustralia was a proponent of the "as incurred" approach that was adopted by the ACCC in EnergyAustralia's 2004-09 Revenue Cap Decision.

Before commenting on the issues raised by the AER in its position paper, EnergyAustralia would like to point out the importance of carefully defining relevant terms. Specifically, it appears that the AER has interchanged the terms "accounting approach" and "regulatory approach" to describe the "as commissioned" and "as incurred" approaches. I note that "as commissioned" and "as incurred" differ in terms of the timing of recognition of capital expenditure and would be better described as "recognition approaches". The distinction is important in order to avoid confusion about the impact of adopting either approach for accounting or regulatory purposes.

The AER raised four issues in its position paper, each of which is addressed below:

Issue No. 1: Will different accounting approaches result in different efficiency incentives?

Not necessarily. Provided that the "as incurred" and "as commissioned" approaches are recognised and modeled appropriately, the same efficiency incentives would result. However, it is ultimately a question of complexity and transparency linking the PTRM modeling and the targeted incentives.



In the example provided in the position paper, Project X, the AER compares the “as incurred” method with the **unadjusted** “as commissioned” basis. EnergyAustralia believes that the AER’s subtle inclusion of this qualification reflects their awareness of the scope to potentially modify the “as commissioned” approach to replicate the intended incentives of the ex ante incentive framework (discussed below).

Working on the assumption with Project X that the “as commissioned” approach was adopted upfront, so that the regulatory target was set to \$180M in Year 5 alone, then it is clear that the TNSP would not be subject to any incentive associated with depreciation and return on capital. That is because Project X will be commissioned in Year Five and as a result depreciation and return on capital would **not** have been included in the calculation of the TNSP’s revenue requirement for Years One to Five.

As the AER notes, the incentive of the ex ante regime is to allow the TNSP to “retain the depreciation and return on asset payments commensurate with the forecast higher level of expenditure for the first five years.” Because there is no depreciation or return on capital included in the revenue cap with the “as commissioned” approach in this example, the incentive therefore does not exist. That is, the TNSP ‘beats’ the target, but does not get rewarded.

However, it is feasible that adjustments could be made to the “as commissioned” approach such that it incorporates the same incentives as the “as incurred” approach. In the example of Project X, for instance, Interest During Construction (IDC) could be calculated and either added directly to the revenue requirement or capitalised and added to the Regulatory Asset Base. At the end of Year Five the TNSP would stand to gain from difference (in present value terms) between the IDC allowance based on \$180M and the return on the actual project spend of \$136M. Similarly, for depreciation a WIP balance could be determined as part of the project’s forecast costs and, for the sake of equating incentives between the two approaches, would be depreciated and included in the revenue requirement for Years One to Five. At the end of Year Five the TNSP would stand to gain from the difference between the depreciation calculated on the forecast project cost of \$180M and the actual cost of \$136M in present value terms.

It is obvious from the suggested adjustments above that the calculations associated with accommodating the “as commissioned” approach into the ex-ante incentive regime would be administratively complex. Indeed, the calculations rely on that same information used for the “as incurred” approach.

The “as commissioned” approach is inferior to the “as incurred” approach in terms of the incentives for efficiency created with the ex ante framework. The ex ante regime establishes an overall allowance for capex based on a forecast “bottom-up” approach to individual projects and programs of work. Once set, the TNSP is able to invest in any way it sees fit in order to meet the needs of its network. Before the development of the ACCC’s latest ex ante incentive framework, EnergyAustralia espoused similar benefits embodied in the “as incurred” approach in its submission to the ACCC on its Transmission Revenue Determination in September 2003:

“[The “as incurred”] approach offers superior management incentives. It ensures that the regulator does not implicitly accept the particular projects that make up a TNSP’s forecasts, but rather accepts that the level of expenditure is most likely to be prudent

based on forecast data. Secondly, it provides management of the TNSP with the flexibility and incentive to manage the capital expenditure allowance as efficiently as possible ... This is critical to ensure that management has the appropriate incentives to respond to the changing circumstances that arise during the regulatory period, without being bound to the specific projects that may have been forecast at the time of the original Determination." (p. 52)

The "as commissioned" approach requires an ex post review of individual projects in order to manage inter-period issues. This ex post review is incongruous with the intention of the operation of the ex ante incentive mechanism.

Modeling capital expenditure on an "as incurred" approach also better facilitates the TNSPs' management of cash-flows, especially when considering the large, lumpy nature of transmission investment. In contrast, the "as commissioned" approach can result in a significant lag between capital spend and revenue recognition, placing increased pressure on the business to fund major investments as they occur.

Overall, EnergyAustralia submits that the "as incurred" method better achieves the objectives of efficiency, transparency and simplicity than the "as commissioned" approach.

Issue No. 2: Will the administration of an "as-commissioned" regulatory approach be onerous?

The effort required to accommodate the "as commissioned" approach in the ex ante incentive regime (as detailed in EnergyAustralia's response to Issue No. 1) suggests that it would be particularly onerous relative to the "as incurred" approach. EnergyAustralia recognised this in its submission to the ACCC in September 2003:

The ["as commissioned"] approach produces complications with both ODRC and roll-forward asset valuations. Under an ODRC valuation methodology, the accumulated IDC is held separate from the rest of the valuation and included as the last action, ensuring that unit rates do not distort any accumulated financing costs recognised by the ACCC and included in the IDC calculation. This situation could significantly damage the investment incentives where projects have long construction times.

Likewise, a roll-forward approach also faces complications from IDC as the timing of projects and inter-determination carry-overs need to be maintained and reported. This complicates the reporting process and results in total capital expenditure recognised in a period exceeding the actual expenditure made, as is likely to occur in the 2004 regulatory period. (p. 52)

EnergyAustralia believes that transitioning from an "as commissioned" to "as incurred" approach would not be particularly difficult for a TNSP. Historically, some TNSP's have provided a probabilistic approach to setting forecast capital expenditure requirements. In doing so, both the regulator and TNSP have understood the series of cash flows associated with a capital project. Assessing cash flow spends would also be necessary as part of the calculation of IDC. Clearly, the probabilistic approach to forecasting for "as commissioned" projects also supports the information and modeling requirements for an "as incurred" forecast.

Issue No. 3: Will different accounting approaches impede consistent comparison of TNSP expenditure?

Yes. The timing difference between the "as incurred" approach and "as commissioned" approach will necessarily render the two incomparable in the short to medium term. If appropriately modeled the two approaches should be value neutral over the life of the project in question.

EnergyAustralia recognises that there already exists a variety of differences between TNSPs that render comparisons ineffectual. The different age and composition of each TNSP's network, for example, complicates any comparison. It is for this reason that EnergyAustralia has not favoured the use of benchmarking for the purposes of establishing, or even determining the reasonableness of expenditure allowances.

Like the AER, EnergyAustralia is not aware of any other regulatory utility in Australia that has adopted the "as commissioned" approach (with perhaps the exception of the Queensland Competition Authority). This is an important consideration as we transition to a national framework for the regulation of energy utilities. Adopting the "as incurred" approach for future regulatory decisions will better align to the approach of most other jurisdictional regulators and in turn help deliver a more consistent national approach to energy regulation. This is particularly relevant for EnergyAustralia as the vast majority of its network is comprised of distribution assets and as such an "as commissioned" framework would be clearly impractical.

Interestingly, in this section of the paper the AER raises the concern of reconciling regulatory and financial accounts. Ideally, according to the AER, there would be a "high degree of alignment" between the two for the sake of "transparency and credibility" in the reporting framework. EnergyAustralia agrees but recognises that there are inherent differences between the two reporting frameworks that prevents perfect alignment. For example, the treatment of capital contributions and the inclusion of non-prescribed parts of the business.

Ultimately, regulatory reporting is special purpose financial reporting as defined by accounting principals. The transparency and credibility of differential reporting can be maintained where consistent audit procedures are applied.

Issue No. 4: Will the choice of accounting approach deliver price shocks?

A priori, the use of an "as commissioned" approach would result in price shocks relative to the "as incurred" approach. This is due to the one-time addition to the regulatory asset base of all capital-related costs under the "as commissioned" approach, rather than the phased recognition of expenditure into the asset base (and therefore in the revenue cap) under the "as incurred" approach.

When considering the transition from one recognition approach to the other, there is potential scope for price shocks but EnergyAustralia would argue that these would be relatively minor from an end-user perspective given that transmission charges reflect around 10% of a typical

customer's final bill. Additionally, the potential for price shocks is ameliorated to some extent by the 'smoothing' of a TNSP's notional revenue requirement in setting its price path in the PTRM model.

Other Issues

Forming a view on how capital expenditure will be recognised is critical to the development of a defined approach to the calculation of the return on and return of capital and establishing the regulatory asset base at the end of each regulatory control period under the new ex-ante framework. This subject is touched upon in Section 2.1 of the AER's position paper and we hope that the AER will expand on its approach to this matter in the near future.

EnergyAustralia appreciates that the AER is making a considered attempt at addressing a number of issues arising from the Statement of Regulatory Principles particularly in respect to the regulatory asset base. Providing early direction is key to securing greater regulatory certainty, especially where policies and decisions have the potential to significantly affect the financial outcomes and incentives of future regulatory decisions.

If you have any queries regarding this submission please do not hesitate to contact me on 02 49519411 or Mike Martinson on 02 9269 2234.

Yours sincerely

A handwritten signature in cursive script, appearing to read 'G Lillis', written in black ink.

GEOFF LILLIS
General Manager - Network