

11 March 2011

Mr Warwick Anderson
General Manager
Network Regulation North Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: aer inquiry@aer.gov.au

Dear Warwick,

Guidelines for Preparing a Transmission Network Support Pass Through Application

The Australian Energy Regulator (AER) released its draft Procedural Guidelines and accompanying calculations spreadsheet on preparing a transmission network pass through application in January 2011. The AER's identified purpose for the Guidelines is to:

- set out the process, timing and information requirements that TNSPs must consider when preparing a network support application; and
- provide information on the assessment procedures the AER proposed to undertake when conducting an assessment of the application and timeframe to make its decision.

Grid Australia welcomes the opportunity to make comment on the draft Guidelines and provides its response on specific matters below.

Network Support Contracts

The AER proposes that a pass through application should provide various information in relation to contractual arrangements with network support providers where such arrangements have not already been reviewed as part of a revenue determination process.

In terms of network support arrangements with providers, transmission network service providers (TNSPs) are incentivised under the regulatory framework to establish arrangements which provide the most efficient cost outcomes having regard to regulatory and other obligations. Not only are these commercial negotiations, but the outcomes of such negotiations are required to be demonstrated as efficient under the AER's Regulatory Investment Test for Transmission (RIT-T). In light of these requirements under the Rules (including the RIT-T promulgated under the Rules), Grid Australia does not consider that it is necessary or reasonable for the AER to seek to review such negotiations with network support providers after the event.

Grid Australia also notes that confidentiality arrangements between contracting parties may also apply to such arrangements which the AER should acknowledge and have regard to in seeking certain information regarding these contracts.

Pass through Costs

In its draft Guidelines, the AER considers that only network support payments made by the TNSP for network support services should be passed through to customers. In other words, administrative and other indirect costs should not form part of a pass through application.

Grid Australia considers that it is reasonable to pass through all incremental costs that would not have been incurred but for the network support event. For example, in addition to the network support payments to a generator, other legitimate costs would include legal advice relevant to contract negotiations/ renegotiations during a regulatory year as well as any additional internal and external costs incurred in administering these arrangements.

The AER's proposal to exclude these costs appears to be based on an unduly narrow reading of clause 6A.7.2 of the Rules. Grid Australia submits that doing so would be incorrect both as a matter of legal interpretation and, more importantly, as a matter of good regulatory policy.

First, the AER appears to be equating the incremental costs identified in clause 6A.7.2(i) that make up the network support pass through amount with the change in network support payments (a specific, but not the only, piece of information that the TNSP is required to provide under Rule 6A.7.2.(c)(3)(i)). There is nothing in the Rules that provides that, simply because the TNSP must inform the AER as to the amount of the payment variation, the AER should not allow other incremental costs incurred solely as a consequence of the network support event.

Indeed, it is clear from the drafting of clause 6A.7.2(i) that the AER is required to look beyond the additional network support payment alone to take into account any other incremental costs. On the AER's interpretation, the definition of the network support pass through amount should simply read "the difference between the amount provided for in the annual building block revenue requirement for that regulatory year and the amount actually paid". This is contrary to what the Rules state. Grid Australia considers that it is reasonable and correct to say that any additional incremental costs must be solely as a consequence of the event. However, this is not the same thing as saying that only the difference in network support payments is incremental. A copy of legal advice in support of these points is attached.

In coming to a decision on how best to interpret the Rules, it is also important to recognise and take into account the different incentives that apply under the regulatory framework. In particular, it could be argued that TNSPs may be less incentivised to utilise network support arrangements if such costs are not recognised by the AER as being legitimately and efficiently employed for the purposes of establishing and administering network support arrangements throughout the year.

In effect, TNSPs would be required to incur higher operating expenditure to implement such arrangements and be potentially adversely affected under the Efficiency Benefit Sharing Scheme (EBSS), since the pass through amount excluded under the EBSS would only capture the network support payment amount. On the other hand, labour costs directly attributable to a network investment can be capitalised and continue to earn a return over the life of the asset. On balance, Grid Australia considers that it is both reasonable and legitimate to claim additional legal and administration costs as a pass through.

Materiality

The AER notes its requirement to make a determination on a network support pass through application regardless of the materiality of the proposed pass through amount.

Consistent with its 2007 revenue cap decision, a materiality threshold of 1% of the maximum allowable revenue (MAR) currently applies to Powerlink for its 2008-12 regulatory period. Therefore, for Powerlink, the requirement to seek a determination by the AER under the Rules is only invoked where the pass through amount exceeds this threshold. In other cases, Powerlink is required to notify the AER of its actual network support expenditure for the relevant year then proceed to automatically pass through any difference between forecast and actual network support to customers.

While Grid Australia acknowledges the AER's position under the Rules above, consistent with Powerlink's revenue cap arrangements, Grid Australia recommends that the AER consider adopting a similar approach for all other TNSPs where the proposed pass through amounts are less than 1% of the MAR. This could take the form of a notification arrangement or a fast-track process which requires less time, information and consultation in such circumstances. Grid Australia considers that such an approach would be consistent with the AER's previous position in relation to Powerlink that these events would be less onerous to administer.

Negative Pass throughs

The AER proposes to assess negative pass through events in the same way as positive pass through events, including the timeframe for making a determination under the Rules. Grid Australia agrees that a consistent timeframe and high-level process should apply on a symmetrical basis. However, the Rules do not require certification by an independent and appropriately qualified expert for negative pass-through events and this should be reflected in the AER Guideline.

Further, Grid Australia agrees with the AER that audited financial statements or regulatory accounts are sufficient evidence to satisfy the requirement for independent expert certification of network support payments under clause 6A.7.2(c)(3)(i) of the Rules, and suggests this be noted in the final guidelines.

Timing Change Impacts

In general, network support allowances are provided on the basis that they will be incurred in or over specific years within a regulatory period. However, there may be situations where actual network support costs may be incurred outside the year in which an allowance was provided in a revenue cap decision and, potentially in a regulatory year for which no AER allowance is provided. For example, where invoices arrive or other incremental costs are accounted for beyond a particular regulatory year. In these cases, TNSPs would still lodge a pass through application to the AER which would include reasons why costs varied from the allowance – even where the allowance was zero – and this should be perfectly acceptable.

CPI Escalation

The method of CPI escalation applied to the network support allowance should be consistent with the CPI escalation applied to the total MAR under the TNSP's revenue determination. This ensures that the escalated allowance is the same as that actually recovered by the TNSP, and therefore avoids any distortionary revenue impacts. While the draft guideline implies that this should occur (Appendix B, footnote 4) it should be made even more explicit, as this principle was not applied uniformly in the determination of 2009-10 network support pass through amounts,

Calculations Spreadsheet

The AER has developed a reporting template to accompany its guidelines. In the interests of efficiency and consistency, it would be useful to confirm explicitly that the model published with the final guidelines will be taken as a fully compliant method of submission, without the need for each TNSP to individually seek an audit assurance to verify the accuracy of this model.

If you have any queries or require further clarification on any of the matters raised above, please contact Jennifer Harris on (07) 3860-2667 or me on (08) 8404-7983.

Yours sincerely,



Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

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8 March 2011

John Hodgkinson
TransGrid
201 Elizabeth Street (cnr Park Street)
Sydney NSW 2000

By email:
john.hodgkinson@transgrid.com.au

Dear John,

National Electricity Rules - Network Support Pass Through

Introduction

On 28 September 2010, TransGrid wrote to the Australian Energy Regulator (*AER*) requesting a (negative) pass through of its unspent network support costs for 2009-2010.

In calculating the relevant pass through amount, TransGrid deducted certain external consultant and other administrative costs associated with the relevant network support projects (we have referred to these in the remainder of this memorandum as *Administrative Costs*).

Although it approved the pass through of TransGrid's unspent network support costs for 2009-2010, the AER refused to allow consideration of TransGrid's Administrative Costs. The AER's position on this point was described in its letter to TransGrid of 3 March 2011:

"The ACCC and AER have previously included administrative costs when approving allowances and pass through amounts relating to network support payments. However, the NER now provides for a more limited recovery of costs than was previously available.

This is because the definition of "network support payment" in the NER is limited to payments made to a generator or any other person providing a network control service. As labour or external consultant costs are not payments to generators or other network support providers, they cannot be considered as "network support payments" and accordingly cannot be included in the network support pass through amount."

The AER has indicated to TransGrid that its position is based on legal advice obtained by the AER. The AER is not willing to provide its legal advice to TransGrid.

Network support pass through events are specifically addressed in Rule 6A.7.2 of the National Electricity Rules (*NER*). You have asked us to advise whether, in our opinion, Administrative Costs are recoverable by TransGrid under Rule 6A.7.2 of the NER.

Rule 6A.7.2 and relevant definitions are set out in the Annexure. Italicised words in this memorandum have the meaning given to them in the NER.

Analysis

Rule 6A.7.2 only applies where a *network support event* occurs (Rule 6A.7.3 contains a more general pass through mechanism for costs arising as a result of events such as regulatory changes). A *negative network support event* occurs when the *network support payments* made by a Transmission Network Service Provider (*TNSP*) are lower than the amount of *network support payments* provided for in its *annual building block revenue requirement*. There is no dispute between TransGrid and the AER that a *network support event* occurred in this instance.

If a *network support event* occurs, the next step is that the AER must determine the relevant *network support pass through amount*. The AER must do this by taking into account the matters referred to in Rule 6A.7.2(i).

There is nothing in Rule 6A.7.2(i) that limits the AER's determination of a *network support pass through amount* solely to consideration of the relevant *network support payments*. Rule 6A.7.2(i) does not use the term *network support payments*. It refers to the recovery of the TNSP's incremental "costs", a considerably broader concept. Rule 6A.7.2(i) also allows the AER to consider "*any other factors the AER considers relevant*" (Rule 6A.7.2(i)(6)).

Accordingly, we disagree with the AER's statement (in its letter dated 3 March 2011) that Administrative Costs cannot be included in the calculation of a *network support pass through amount* solely on the basis that they are not payments made to generators or other network support providers.

In our opinion, Rule 6A.7.2 does not prohibit the recovery of Administrative Costs, provided those Administrative Costs are incremental, cost-effective and occur solely as a consequence of the relevant *network support event*.

Background Materials

We reviewed materials produced by the Australian Energy Markets Commission (*AEMC*) and other industry participants on the proposed changes to the NER that resulted in the introduction of Rule 6A.7.2 (as part of the *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 no. 18*). We have not been able to identify any statements in these materials evidencing an intention that Rule 6A.7.2 should prohibit the recovery of reasonable Administrative Costs.

However, there are statements in these material that appear to support (in principle) the recovery of reasonable Administrative Costs – e.g. the following passage from page 104 of the AEMC's Rule Determination for the *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 no. 18*:

"The Commission recognises that TNSPs operate in a dynamic and uncertain environment where the quantity, nature and timing of the services they are required to deliver can vary due to a range of often unexpected and uncontrollable reasons. The Revenue Rule therefore makes provision to manage many of these uncertainties, particularly in relation to capital expenditure via a regime of pass through provisions and 'contingent project' arrangements.

In addition to the risk management provision described in the 'contingent projects' section (section 4.2), the Revenue Rule also provides an allowance for the pass-through of significant increases (or decreases) in a TNSP's costs resulting from certain categories of unexpected events that may occur during the regulatory period.

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 of its control. The Commission considers that such a mechanism provides a reasonable reflection of the operation of a competitive market where efficient costs are eventually passed through to customers, whether they are expected or not. Such a mechanism lowers the risks faced by the TNSP, which would otherwise have to be compensated for in the calculation of regulated revenues."

In our opinion, Rule 6A.7.2 was not intended to prohibit recovery of a TNSP's reasonable Administrative Costs and it should not be interpreted in that manner.

Policy Considerations

We have also considered relevant NER public policy principles (e.g. the AER's 2005 *Compendium of Electricity Transmission Regulatory Guidelines*) and the *national electricity objective*. We have not been able to identify any policy considerations that would justify Rule 6A.7.2 prohibiting the recovery of reasonable Administrative Costs.

We note the following considerations:

- *Reasonable and necessary expenditure:* The key purpose of the AER's review of network pass through events under Rule 6A.7.2 is to confirm the cost-effectiveness of a TNSP's decision to incur the relevant costs. In undertaking its own initial assessment of whether or not to incur network support costs, a TNSP therefore needs to consider the same criteria and make a reasonable and informed assessment. Consistent with general practice in the industry, it will often be reasonable and prudent for a TNSP to obtain independent and/or expert advice to support its own analysis.
- *Administrative Costs subject to AER oversight:* All pass through amounts under Rule 6A.7.2 must be assessed by the AER as incremental, cost effective and solely occurring as a consequence of the relevant pass through event. Unnecessary or unrelated costs can be disallowed by the AER. Administrative Costs would only be approved where they met these criteria.
- *Consistency with past practice:* As acknowledged in the AER's letter of 3 March 2011, the Australian Competition and Consumer Commission and the AER have previously allowed the recovery of Administrative Costs (under mechanisms contained in prior TransGrid revenue determinations).
- *No other mechanism for recovery:* The NER does not contain any other mechanism for TNSPs to recover their reasonable Administrative Costs.

Conclusions

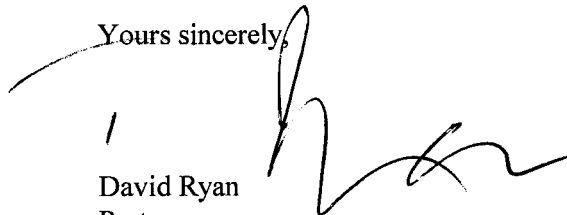
A *network support event* is defined solely by reference to a TNSP making, in any *regulatory year*, higher or lower *network support payments* than provided for in its *annual building block revenue requirement*. In this respect Rule 6A.7.2 is linked directly to *network support payments*.

However, once a *network support event* has occurred, there is nothing in Rule 6A.7.2 that prevents the AER from taking into account Administrative Costs in assessing the relevant *network support pass through amount*. Specifically, there is no requirement in Rule 6A.7.2(i) that a *network support pass through amount* be based solely on *network support payments*.

We disagree with the AER's view that Administrative Costs cannot be included in the calculation of the *network support pass through amount* solely on the basis that they are not payments made to generators or other network support providers. This interpretation is not supported by any background materials to the introduction of Rule 6A.7.2 into the NER and is not consistent with relevant policy considerations, including the *national electricity objective*.

In our opinion, Rule 6A.7.2 does not prohibit the recovery of Administrative Costs, provided those Administrative Costs are incremental, cost-effective and occur solely as a consequence of the relevant *network support event*.

Yours sincerely,



David Ryan
Partner
+61 2 8922 5291
david.ryan@bakermckenzie.com

Relevant NER References

Rule 6A.7.2 Network support pass through

- (a) This clause applies where a *network support event* occurs with respect to a *regulatory year* ('the **previous regulatory year**').
- (b) If a *network support event* occurs, a *Transmission Network Service Provider* must seek a determination by the *AER* to pass through to *Transmission Network Users* a *network support pass through amount*.
- (c) Where a *Transmission Network Service Provider* seeks a determination as referred to in paragraph (b), the provider must, within 60 *business days* of the end of the previous *regulatory year*, submit to the *AER* a written statement which specifies:
 - (1) the details of the *network support event* including whether the event was a *negative network support event* or a *positive network support event*;
 - (2) the amount that the provider proposes should be passed through to *Transmission Network Users* in the *regulatory year* following the previous *regulatory year* as a result of the *network support event*;
 - (3) evidence:
 - (i) of the actual increase in the amount of *network support payments*, including certification by an independent and appropriately qualified expert; and
 - (ii) that such amounts occur solely as a consequence of the *positive network support event*; and
 - (4) such other information as may be required pursuant to the *information guidelines* in force under clause 6A.17.2.
- (d) If the *AER* determines that a *positive network support event* has occurred in respect of a statement under paragraph (c), the *AER* must determine the *network support pass through amount*, taking into account the matters referred to in paragraph (i).
- (e) If the *AER* does not make the determination referred to in paragraph (d) within 60 *business days* from the date it receives the *Transmission Network Service Provider's* statement and accompanying evidence under paragraph (c), then, on the expiry of that period, the *AER* is taken to have determined that the amount as proposed in the provider's statement under paragraph (c) is the *network support pass through amount*.
- (f) If a *negative network support event* occurs (whether or not the occurrence of that event is notified by the provider to the *AER* under

paragraph (c)) and the *AER* determines to impose a requirement on the *Transmission Network Service Provider* in relation to that *negative network support event*, the *AER* must determine the *network support pass through amount* taking into account the matters referred to in paragraph (i).

- (g) A *Transmission Network Service Provider* must provide the *AER* with such information as the *AER* requires for the purpose of making a determination under paragraph (f) within the time specified by the *AER* in a notice provided to the provider by the *AER* for that purpose.

Consultation

- (h) Before making a determination under paragraph (d) or (f), the *AER* may consult with the relevant *Transmission Network Service Provider* and such other persons as the *AER* considers appropriate, on any matters arising out of the relevant *network support event* as the *AER* considers appropriate.

Relevant factors

- (i) In making a determination under paragraph (d) or (f), the *AER* must take into account:
 - (1) the matters and proposals set out in any statement given to the *AER* by the *Transmission Network Service Provider* under paragraph (c);
 - (2) in the case of a *positive network support event*, the increase in costs in the provision of *prescribed transmission services* that the provider has incurred in the preceding *regulatory year* as a result of the *positive network support event*;
 - (3) in the case of a *positive network support event*, the efficiency of the provider's decisions and actions in relation to the risk of the event, including whether the provider has failed to take any action that could reasonably be taken to reduce the magnitude of the *positive network support event* and whether the provider has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of that event;
 - (4) the time cost of money based on the *weighted average cost of capital* for the provider for the relevant *regulatory control period*;
 - (5) the need to ensure that the provider only recovers any actual increment in costs under this paragraph (i) to the extent that such increment is solely as a consequence of a *network support event*; and
 - (6) any other factors the *AER* considers relevant.

Relevant NER Definitions

negative network support event

A *network support event* which entails a *Transmission Network Service Provider* making lower *network support payments* in the preceding *regulatory year* than the amount of *network support payments* (if any) that is provided for in the *annual building block revenue requirement* for the provider for that *regulatory year*.

network support event

- (a) If, at the end of a *regulatory year* of a *regulatory control period*, the amount of *network support payments* made by a *Transmission Network Service Provider* for that previous *regulatory year* is higher or lower than the amount of *network support payments* (if any) that is provided for in the *annual building block revenue requirement* for the *Transmission Network Service Provider* for that *regulatory year*, this constitutes a *network support event*.
- (b) In calculating the amount for the purposes of a *network support event* referred to in paragraph (a), the amount of *network support payments* made by a *transmission Network Service Provider* must not include an amount of *network support payments* that are a substitute for a *network augmentation* where an allowance for capital expenditure in relation to that *network augmentation* has been provided for in the *revenue determination*.

network support pass through amount

The amount that should be passed through to *Transmission Network Users* in the *regulatory year* following the preceding *regulatory year*, in respect of a *network support event* for a *Transmission Network Service Provider*.

network support payment

A payment by a *Transmission Network Service Provider* to:

- (a) any *Generator* providing *network support services* in accordance with clause 5.6.2; or
- (b) any other person providing a *network support service* that is an alternative to *network augmentation*.