



Draft

**Procedural guidelines on preparing a  
transmission network support pass through  
application**

January 2011

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## **Request for submissions**

The AER is seeking comments on its proposed process guideline for network support pass through applications. Interested parties are invited to make written submissions to the AER on this guideline by the close of business on 11 March 2011.

Submissions can be sent electronically to [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au). Alternatively, written submissions can be sent to:

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Any enquiries about the draft guideline, or about lodging submissions, should be directed to the Network Regulation North Branch at the above email address.

# 1 Introduction

The AER is responsible for the economic regulation of Transmission Network Service Providers (TNSPs) in the national electricity market (NEM). The form of economic regulation applied by the AER is a revenue cap which limits the earnings of each TNSP in a regulatory control period. The National Electricity Rules (NER) allow for a revenue cap to be adjusted during a regulatory control period, only in specific circumstances. One of the allowed adjustments to a revenue cap is a network support pass through amount. In such cases, the AER's role is to approve the amount (network support pass through amount) by which a TNSP can vary its revenue cap.

This guideline is designed to assist TNSPs prepare network support pass through applications consistent with the requirements of the NER. In particular, this guideline:

- sets out the process, timing and information requirements that TNSPs must consider when preparing the application
- provides information on the assessment procedures the AER will undertake when conducting an assessment of the application and the timeframe in which the AER must make its decision.

In publishing this guideline, the AER is increasing the transparency of the regulatory processes applying to network support pass through arrangements. The publication of this guideline provides stakeholders with details about the process undertaken by the AER when assessing network support pass through applications.

## 1.1 Background

Network support typically involves the sourcing of local generation by a TNSP in order to address forecast constraints in its transmission network. In certain circumstances, a TNSP may find it more cost effective to use generators for network support to maintain system reliability, rather than undertake network augmentation (such as building additional transmission lines). Network support payments are payments made by TNSPs to network support providers for management of forecast network constraints.

Network support provides a direct benefit to transmission customers and end users, as it can defer the need for transmission augmentation, and hence results in lower transmission charges, while maintaining the reliability of the network. However, the amount of network support required by a TNSP in any given year is dependent on some factors that are outside the control of the TNSP such as weather conditions, demand levels, and electricity usage patterns. Given the TNSPs' limited control over the factors that affect network support requirements, the incentives implicit in the revenue cap regulatory framework are unlikely to impact on the TNSPs' network support expenditure decisions. For that reason, TNSPs are allowed to recover actual network support payments. The network support pass through process (as set out in the NER) has been established to adjust any network support payments included in a revenue cap so that only actual payments are recovered from transmission customers.

## **1.2 Confidentiality**

The AER's obligations regarding confidentiality and the disclosure of information provided to it by a TNSP are governed by the *Competition and Consumer Act (2010)*, National Electricity Law and the NER. See the ACCC/AER Information Policy guidelines (October 2008) for more information, at the AER website [www.aer.gov.au](http://www.aer.gov.au).

## **1.3 Process for revision**

The AER may amend or replace these guidelines from time to time.

## **1.4 Version history and effective date**

A version number and an effective date of issue will identify every version of these guidelines.

## 2 AER issues and considerations

The following section sets out the AER's reasoning on the assessment procedures and the information requirements. This section also sets out how the network support pass through amount should be calculated.

### 2.1 General principles

#### Difference between actual and forecast network support payments

Network support costs are forecast at the time of making a revenue determination, but the accuracy of the forecast will depend on factors largely outside of the control of the TNSP.<sup>1</sup> A network support pass through event occurs when the actual amount of network support payment incurred in a regulatory year differs to the forecast amount allowed in the determination for that year. Clause 6A.7.2 of the NER states the AER must determine whether a network support pass through event has occurred. If such an event has occurred, the AER must allow for an adjustment to the TNSP's revenue cap.

As part of determining whether a network support event has occurred, clause 6A.7.2 of the NER requires the AER to make an assessment on the reasonableness of the pass through amount. Accordingly, an application for approval of a network support pass through amount should provide reasons why there was a difference between actual and forecast amounts (as provided for in the TNSP's revenue determination).

The AER notes it is difficult for TNSPs to accurately forecast network support costs, due to factors largely beyond the TNSPs' control.<sup>2</sup> Reporting on causes of network support pass through variations between forecast and actual payments will assist the AER:

- understand the forecasting difficulties associated with network support payments
- understand the cost drivers and environmental conditions impacting on the network operations and the need for network support
- assess the efficiency of the TNSPs actions in managing the magnitude of the network support event, including assessing the extent to which such actions may or may not be possible.

The TNSP needs to provide reasons for differences in forecast and actual network support payments for all network support pass through applications, and include reference to supporting information to verify the reasons. The TNSP needs to provide this information regardless of the materiality of the proposed amount.

#### Efficiency

Clause 6A.7.2(i)(3) of the NER states that the AER must make an assessment on the efficiency of the TNSPs' decisions and actions in relation to the risk of network

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<sup>1</sup> A determination generally spans a regulatory control period of five years.

<sup>2</sup> For example, due to uncontrollable events such as weather conditions impacting on the network.

support events. The AER can undertake an efficiency assessment of a TNSP's decision and actions by investigating the contracts a TNSP enters into with network support providers. For this reason, the AER will review the contractual arrangements associated with each network support pass through event. The TNSP's application should provide the following information:

- the name of the network support provider/s engaged to provide the service
- the activities which the network support provider/s have been engaged to undertake
- length of the contract arrangements and whether the network support provider/s have been engaged by the TNSP to perform network support services previously
- if existing network support arrangements have changed, the TNSP should identify any changes to the arrangements.

In assessing the efficiency of network support arrangements, the AER will review:

1. the process for awarding the contract to the network support provider
2. whether the TNSP conducted a regulatory investment test to determine whether a non-network solution such as network support is the most cost effective option to address a network constraint
3. the processes undertaken by the TNSP, and its negotiations with the network support providers.

In some cases, the AER may have reviewed the network support contractual arrangements as part of the TNSP's revenue determination. In such cases, the AER will not review contractual arrangements again unless any changes have been made to those arrangements.

### **Administration costs**

The AER must determine a network support pass through amount that reflects the NER requirements. The network support pass through amount is the network support payment that has been made by the TNSP for network support services. This definition does not allow for administration costs incurred by the TNSP to be recovered through the network support pass through mechanism. The AER therefore will not approve any other costs, such as administrative or indirect costs, as part of the network support pass through amount.

The AER considers administration and other general costs should have already been provided for as part of a TNSP's revenue determination.

### **Materiality**

Network support pass through events are different to other pass through events as the NER does not specify a materiality threshold to apply to the pass through amount. As such TNSPs are required to pass through all differences between the network support amount allowed in the revenue determination and its actual network support payments, irrespective of the size of the difference. Therefore, unless the forecast and actual network support payments are the same, TNSPs are expected to lodge a



network support pass through application for either a positive or a negative network support pass through amount in each regulatory year.

The AER will make a determination on the application, in accordance with the provisions of clause 6A.7.2 of the NER regardless of the materiality of the proposed network support pass through amount.

### **Under/over recovery of network support pass through amounts from previous years**

Due to the timing of network support pass through approvals and variations transmission revenues during a regulatory year, a network support pass through amount may not be fully recovered in a regulatory year. Some TNSPs have previously incorporated a 'true up' amount in their calculations of network support pass through amounts. That is the proposed pass through amount has included under or over recoveries of previous network support pass through amounts.

The AER considers the NER does not allow for under or over recovery of a network support pass through amount from a previous regulatory year to be included in a network support pass through amount. The network support pass through amount is defined as the difference between actual and forecast network support payments made by the TNSP for network support services in a regulatory year. This definition does not allow for under/over recovery amounts arising from previous years to be recovered through the network support pass through mechanism. Accordingly, the AER will not approve any under or over recovery amounts from previous regulatory years as part of the network support pass through amount.

The AER considers that once incorporated into the MAR for a regulatory year, any under/over recovery amounts that may be attributed to network support pass through should be incorporated into the treatment of the under/over recovery of the MAR.

## **2.2 Calculation of network support pass through amount**

The network support pass through amount is calculated as the difference between forecast and actual network support payments, adjusted to take into account the time cost of money.

### **Time cost of money**

Clause 6A.7.2(i)(4) of the NER requires the AER to take into account the time cost of money as part of deriving the network support pass through amount. The NER requires that the weighted average cost of capital (WACC) is used to account for the time cost of money.

The time cost of money is the principle that a dollar is worth more, the sooner it is to be received, all other things being equal.<sup>3</sup> This is because if received today, a dollar can be invested and earn interest, making it more valuable than a dollar received in the future. The time cost of money is effectively an interest payment from the TNSP

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<sup>3</sup> Peirson, Brown, Easton, Howard, Pinder, *Business Finance*, 9<sup>th</sup> edition (2006), p. 843.

to its customers on a negative network support amount (over recovery) or an interest payment to the TNSP from its customers on a positive network support amount (under recovery).

To account for the time cost of money, TNSPs are required to apply the WACC in determining the network support pass through amount. The time cost of money calculation needs to reflect the time period that the money is owed to or by customers. This includes accounting for the time cost of money in the year in which:

- the network support event occurs (year t)
- the application for approval of the network support pass through amount is being assessed by the AER (year t+1)
- the approved network support pass through amount is passed back to customers through an adjustment to the maximum allowed revenue (year t+2).

Overall the AER considers there is a two year lag involved with passing through the approved network support pass through amount to transmission network customers, and the WACC must be applied to reflect this time lag. Examples of how the time cost of money (WACC) should be applied to calculate a network support pass through amount are provided in appendix C to this guideline.

### **Negative network support events**

The AER will assess negative network support pass through events in the same manner as when assessing positive network support pass through events. When making a determination on a negative network support pass through application, the AER will consider the factors listed in clause 6A.7.2 of the NER which relate to positive network support events. The AER considers these factors are relevant for determining the network support pass through amount where there is a negative network support event.

For example, where a negative network support event occurs, the AER will consider the concept expressed in clause 6A.7.2 (i) (5) of ensuring costs occur solely as a consequence of the event. The AER would have to be satisfied the network support costs used to calculate the network support pass through amount reflect only those which can be considered network support payments.

## **2.3 Conclusion**

The AER considers its approach to making a determination on a TNSP's proposed network support pass through amount is consistent with clause 6A.7.2 of the NER. The AER will comply with the assessment procedures and information requirements listed in section 3 to ensure sound administrative decision making on TNSP network support pass through applications.

### 3 Network support pass through application guideline

This section sets out the processes which a TNSP should follow when preparing a network support pass through application.

#### 3.1 Timing

Table 1 summarises the key dates which TNSPs and the AER must meet under clause 6A.7.2 of the NER.

**Table 1: Timing of network support pass through processes**

Event	Timing
TNSP submits positive network support pass through application	60 business days after the end of the relevant year
TNSP submits negative network support pass through application	60 business days after the end of the relevant year
AER determination (positive network support pass through)	The AER must make a determination within 60 business days after receiving the application. If the AER does not make a determination, then the AER is taken to have determined the amount as proposed by the TNSP.
AER determination (negative network support pass through)	The NER allows for the timeframe to be decided at the AER's discretion. However, the AER intends to assess negative network support pass through applications within the same timeframe as when dealing with a positive amount (that is, 60 business days after receiving the application). If circumstances require the AER to take more than 60 days to assess the application, the AER will advise the TNSP in writing of the additional time required.

The AER intends to make a determination within 60 business days for both positive and negative network support pass through applications. This is to ensure the pass through amount can be incorporated into the following year's transmission prices in a timely manner. The timeframe allows for any consultation processes which the AER may carry out as part of the determination process, including seeking further information from the relevant TNSP, or other parties.

#### 3.2 NER information requirements

In accordance with clause 6A.7.2 of the NER, TNSPs are required to provide the following information when preparing a network support pass through application:

1. Details of the network support event, including whether it was a positive or negative network support event
2. A proposed network support pass through amount, including a spreadsheet showing how the proposed network support pass through amount was calculated (refer to appendix C for examples of spreadsheet calculations)

3. Evidence of the contractual arrangement, including details on the provider/s of the network support services; specifically:
  - a. the name of the network support provider/s engaged to provide the service
  - b. the activities which the network support provider/s have been engaged to undertake
  - c. the length of the contract arrangements and whether the network support provider/s have been engaged by the TNSP to perform network support services previously
  - d. if existing network support arrangements have changed, the TNSP should highlight any changes to the arrangements.
4. If the AER reviewed the contractual arrangements as part of the transmission revenue determination, any changes to the existing contractual arrangements.

Appendix B lists the information which TNSPs should use as basis for preparing a network support pass through application, and appendix C provides examples of the spreadsheet calculations.

### **3.3 AER network support pass through information requirements**

The AER considers that the NER requires TNSPs to provide the following information:

- calculations on how the proposed network support pass through amount was derived, including application of the CPI adjustment and application of the time cost of money
- reasons for the difference between the actual network support payment and the amount included in the revenue determination
- evidence that the proposed network support pass through amount relates only to network support payments. The payments can be verified by checking the TNSP's certification of costs, audited financial statements or regulatory accounts or through an independently certified cost valuation report
- details on the TNSPs actions to manage the magnitude of the pass through amount, given that network support pass through events cannot be forecast with certainty. The AER will assess whether the processes undertaken by the TNSP in reaching the contractual arrangements are efficient.

### **3.4 AER assessment procedures**

In accordance with clause 6A.7.2 of the NER, the AER will:

1. Determine whether a network support event has occurred.

2. Check the date when the application was received meets the timeframe as prescribed in the NER (60 business days).
3. Check the details of the network support event and whether a positive or negative network support pass through amount has been proposed.
4. Check the calculations, including whether:
  - a. the proposed network support pass through amount is arithmetically correct
  - b. costs included in the proposed amount reflect the NER definition of network support pass through amount
  - c. the time cost of money (as prescribed in the TNSP's revenue determination) has been applied correctly.
5. Check that the actual network support payments have been certified by an independent and appropriately qualified expert.

## A. NER requirements

This section lists the NER definitions of network support event, network support payment and network support pass through amount. This section also sets out clause 6A.7.2 of the NER.

### 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 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.

### 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.

### Clause 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.



## B. Information requirements

Table 1 shows a pro forma which a TNSP should use when preparing a network support pass through application. This pro forma captures the information needed by the AER for the purposes of making a determination on the application.

**Table 1: TNSP network support pass through application information requirements (in real dollars)**

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**For the year ended 30 June XX:**

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- (1) Network support allowance (\$m)\*
  - (2) Actual network support expenditure (\$m)
  
  - (3) Network support pass through amount (\$m), including WACC calculations
  
  - (4) Reasons for variation
  - (5) Evidence showing actual network support expenditure
  
  - (6) Date network support pass through written statement submitted to AER
- 

\* As provided for in the TNSP's revenue determination.

### Calculations

As highlighted in table 1, the network support pass through amount (3) is the difference between the actual network expenditure (2) and the network support allowance provided for in the TNSP's revenue determination (1). The spreadsheets in appendix C show how the network support pass through amount can be calculated. Relevant definitions are listed below.

#### 1. Network support allowance

The network support allowance is the amount provided for in the TNSP's revenue determination. As the network support allowance is set in dollar terms at the time the determination was made, the network support allowance needs to be converted to a dollar amount relevant to the financial year in which the network support event occurred. This is to ensure dollar amounts are on comparable terms with the actual network support expenditure. The inflation adjustment would involve whole year adjustment of the network support allowance to the end of the applicable year based on the March to March CPI.<sup>4</sup>

#### 2. Actual network support expenditure

Actual network support expenditure is the total payments to the network support provider (or providers) during the relevant regulatory year.

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<sup>4</sup> Consistent with the TNSP's revenue determination and the PTRM.

### **3. Network support pass through amount**

The network support pass through amount is the difference between the network support allowance (that has been CPI adjusted), and the actual network support expenditure. The WACC is applied to the network support pass through amount. The WACC adjustment addresses lags between the time of the event and the time the network support pass through amount is passed through to customers. The WACC can be applied on a yearly or monthly basis. The worked examples demonstrate how the actual network expenditure can be adjusted to incorporate the WACC on a yearly or monthly basis. (The network support pass through amount should be approximately the same whether estimated on a yearly or monthly basis.)

#### *WACC calculations*

The AER will apply the WACC to take account of the time cost of money in the year in which the network support event occurs, in the following manner:

- **Monthly basis:** Where the TNSP maintains a monthly unders/overs account of network support receipts against network support payments, a monthly WACC is applied to the opening balance each month. Further the monthly network support receipts are to be calculated using an annuity formula. This ensures the time cost of money during the regulatory year is reflected in the monthly network support receipts.
- **Annual basis:** a half year WACC is to be applied on the total network support expenditure at the end of the year in which the network support event occurs. This is a proxy to account for the time cost of money as network support payments are generally paid in instalments throughout the regulatory year, and charged to customers on a monthly basis.

The AER will also apply the WACC to ensure network customers and TNSPs are compensated for the lag between the year in which the network support event occurs and the year in which the approved network support pass through amount is recovered. There are two time lags requiring the application of the WACC. These are:

- a one year time lag in which the network support pass through amount is approved by the AER. A full year calculation of the WACC will be applied.
- a further half year lag representing the period where network support pass through amount is passed through to customers in the form of transmission prices. The WACC will be applied for half a year to account for the time cost of money during the regulatory year. The AER considers this half year WACC as a reasonable proxy as it aligns with the PTRM calculations.

#### **4-6 Other information**

The TNSPs are expected to provide qualitative information in support of their application as discussed in section 3.

## C. Worked example

The attached spreadsheet shows worked examples on how to calculate the network support pass through amount. The spreadsheet shows formulas and examples on how to account for costs associated with the following hypothetical event:

*Negative network support pass through event (over recovery)*

Assume a TNSP has over recovered network support payments from customers during a financial year. Accordingly, it seeks a determination from the AER on a proposed negative network support pass through amount. The TNSP's revenue determination has approved a network support payment of \$60 million (\$2007–08) in the 2009–10 regulatory year. The TNSP has made actual network support payments of \$50 million to the network support service provider in 2009–10. Assume that the revenue determination for the TNSP allowed a nominal vanilla WACC of 10 per cent.