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Ref. 2/902/1

9 November, 2005

AUSTRALIAN ENERGY REGULATOR MELBOURNE 2 1 NOV 2005

Michelle Groves
Chief Executive Officer
Australian Energy Regulator
GPO Box 520
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FILE No:	
DOC: 005/41156	
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Dear Michelle,

REGULATORY ACCOUNTING METHODOLOGY

I am writing to you to highlight Powerlink's serious concerns regarding the accounting method proposed to be prescribed by the AER. This matter is currently under consultation by the Transition Group of the AER. We understand this will be formally considered at an AER Board meeting shortly with a view to a final position being issued in late November.

The AER issued a Position Paper on Regulatory Accounting Methodologies in September 2005. The preliminary position of the AER was to prescribe the 'as incurred' approach for capital expenditure, subject to any new issues identified or comments raised by stakeholders in response to the paper.

Powerlink was part of a joint response to the Position Paper with ElectraNet, SP AusNet and Transend. The position of these organisations is that the 'as incurred' framework could be accepted <u>provided</u> it does not include depreciation of Work in Progress (WIP). These organisations also considered that the 'as incurred' approach should not apply until the next revenue cap decision for each TNSP and changes also need to be made to the PTRM, information requirements and regulatory accounts as a result of the proposed change to 'as incurred'.

Contrary to the views expressed by the AER in its position paper, these organisations consider that there is no material difference in the incentive properties between the 'as incurred' or 'as commissioned' approach, if the modelling is done correctly.

Representatives from Powerlink, ElectraNet and SP AusNet subsequently met with Mr Blair Burkitt of the AER and Mr Bruce Mountain of Mountain Associates (consultant engaged by the AER). The discussions centred around the issues associated with depreciation of WIP.

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The represented transmission businesses reiterated difficulties associated with depreciating WIP and the inconsistency of such an approach with accounting standards, which would result in additional audit requirements for regulatory accounts.

By way of explanation, different depreciation rates apply to different asset classes. However, WIP is not allocated to assets until the completion of the project. In order to depreciate WIP, the amount would need to be <u>arbitrarily</u> allocated to classes of assets. For the regulatory accounts this would also need to be audited (in accordance with the NER and your guidelines). As accounting standards <u>specifically preclude</u> the depreciation of assets until they are placed in service, special audit arrangements would need to be implemented to deal with this novel treatment.

We understand the AER position to be that depreciation of WIP needs to be included as it is a requirement of the Statement of Regulatory Principles (SRP). This was stated by Mr Mountain during the discussions. The AER were requested to provide references to the clauses in the SRP which mandate depreciation of WIP. Mr Burkitt advised that the references are "of a general nature" and do not specifically discuss whether WIP should be depreciated or not.

We would note that, in other recent correspondence (letter to Powerlink dated 2 November 2005 "Proposed Chapter 6 grandfathering arrangements"), the AER appears less compelled to be bound by the SRP:

"The SRP is a statement of policy that sets out how the AER proposes to apply the NER. While the SRP must be consistent with the NER, as a statement of policy it does not bind the AER or limit the discretion conferred on the AER under the NER."

In any event, whether or not depreciation of WIP is a requirement of the SRP (and Powerlink does not consider there is an explicit requirement in the SRP), the more fundamental issue is the questionable desirability of imposing regulatory requirements which contradict accounting standards, and which impose additional administrative requirements for the TNSP and additional audit requirements for the regulatory accounts.

From the discussions with Mr Burkitt and Mr Mountain, it appears there is a (misguided) notion that depreciation of WIP would somehow increase the incentive on the TNSP under the ex ante capex regime. The incentive under the ex ante capex framework arises from differences between forecast and actual expenditure. The incentive associated with return of, and on, WIP is a subset of the total incentive. The incentive resulting from depreciation of WIP is very small (around 2½%) compared to the incentive from the return on WIP component (around 8 – 9%).

The difference in the incentive resulting from depreciation of WIP is therefore marginal at best, and hardly seems a sound basis on which to contradict accounting standards and impose additional administrative and audit costs.

We would also suggest that it would do little to enhance the AER's reputation in its pursuit of 'best practice' regulation.

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In summary, Powerlink is very concerned about the position being advanced by the AER on this matter. Powerlink felt it was important that these matters be escalated in the AER to ensure that the key decision makers are cognizant of the disproportionate risks and disbenefits.

Should you have any questions regarding this please contact Merryn York on (07) 3860 2143.

Yours sincerely,

Gordon H. Jardine CHIEF EXECUTIVE

cc. Warwick Anderson, Acting General Manager, Access Branch, Australian Energy Regulator