Rules Surrounding the ‘Ex-Ante’ Capex Regime to be Applied to TransGrid

Objectives

- Effective incentives to deliver efficient capital expenditure.
- Administrative certainty and simplicity for both the ACCC and the regulated business.
- Responsive decision making to enable the regulated business to meet service obligations in a timely fashion.

Assumed Framework

The rules proposed here assume the following overall framework characteristics:

1. There are Code provisions for reopening a revenue cap decision under some limited circumstances. These already exist and ACCC staff have proposed an extension of these provisions in recent Code change proposals.
2. There are some pre-defined ‘pass through’ events, albeit limited in nature, materiality and scope e.g. change of taxation events, generator support payments in the revenue cap decision, change in service obligations, and insurance events.
3. Certain pre-defined operating and capital expenditure targets are set for each year of the period covered by a revenue cap decision (reset period).
4. Operating cost targets can only be varied within the reset period following the occurrence of a pre-defined ‘pass through’ event or revenue cap decision reopening.
5. Capital cost targets (ex-ante cap) can only be varied within a reset period following the occurrence of a pre-defined ‘pass through’ event, approval of the inclusion of a previously excluded capital project, or revenue cap decision reopening.

The scope of the rules that follow is limited to the treatment of changes to the ex-ante capital expenditure caps within a given revenue cap decision period, including adjustments as a result of changing the status of an excluded project to facilitate the inclusion of the cost of such a project in the Regulatory Asset Base (RAB).

Rule 1 – Setting the Ex Ante Cap

To define an excluded (or contingent) project it is essential to clearly define the basis upon which the ex-ante cap is established. The *ex ante* cap is based on expenditure expected under a clearly defined range of reasonable assumptions – including a positive list of projects that are explicitly not included in the *ex ante* cap (explicitly “excluded projects”). These assumptions need not be point estimates (eg, average demand growth) but must be expressed in sufficient detail (narrow enough range) for the *ex ante* cap to be meaningfully derived from them.

An allowance of between 3% and 4% of the total project cost is also included in the ex-ante cap for each excluded project referred to in the excluded project list.

Examples of relevant assumptions in developing the ex-ante cap include:

- Load growth forecasts for each major supply point, including the adjustments made for temperature variation and general economic conditions where these impact on demand
- Committed generator and major end use customer connection applications
- Service obligations such as reliability standards, including relevant planning standards
- NEM reserve requirements
- The approach to be taken by NEMMCO to keep the main interconnected power system operating in a secure state, including the use of pre-emptive shedding of load or automatic under frequency load shedding
- Forecasts in capital project input costs over time
- Current legal obligations relating to taxation, safety, environmental, wholesale market etc
- No major force majeure events such as earthquakes, bushfires, floods, extreme weather conditions etc

Each of these assumptions (and the above may not be the complete relevant list) is set out within TransGrid's revenue cap application and, except as varied in the ACCC revenue cap decision, should be taken as the basis for setting the ex-ante capital expenditure revenue cap.

Rule 2 – Defining an Excluded Project

An excluded project is a project that is either on the list of excluded projects established at the time of the revenue cap decision or is substantive expenditure that can be shown to arise as a result of material change in the assumptions underpinning the establishment of the ex-ante cap.

Rule 3 - Treatment of Actual Capital Expenditure

If capital expenditure is not associated with an excluded project then it is deemed to be associated with the ex-ante cap (unless treated otherwise under revenue cap reopening or pass through provisions). At the end of the regulatory period the regulator will include in TransGrid's regulatory asset base the value of all such actual expenditure during the regulatory period associated with the ex-ante cap (adjusted for changes in the CPI since the expenditure was incurred) less the amount of regulatory depreciation provided in TransGrid's revenues (adjusted for changes in an agreed price index since the time of the relevant allowance). That is expenditure undertaken and treated as expenditure associated with the ex-ante cap is deemed to be efficient.

Rule 4 – Compensating for Material Variations from *Ex Ante* Assumptions

Where the assumptions specified in Rule 1 are materially violated with the consequence that TransGrid must undertake projects that were not reasonably envisioned under the *ex ante* cap (and can not reasonably be envisioned as close substitutes for such projects) the regulator will approve additional expenditure for revenue cap setting purposes, either in the form of including an excluded project within the revenue cap decision, or by way of a pre-defined 'pass through' adjustment.

In giving approval the regulator will commit to ensuring that TransGrid receives the compensation for the capital financing costs associated with the approved expenditure (either during the current regulatory period or at the beginning of the next regulatory period). The RAB will also be adjusted to include the actual cost of the project.

Rule 5 – Approval Process for Excluded (Contingent) Projects that are Subject to the Regulatory Test

Step 1 – TransGrid will alert the regulator of the perceived need for an excluded project at the same time as it commences its public consultation on the regulatory test.[1]

Step 2 - TransGrid will progressively provide the regulator with the information required to enable the regulator to assess:

(A) whether the project is required to meet [statutory/jurisdictional] standards or is desirable from a net market benefit perspective ;
(B) whether the need for the project is caused by events/actualities materially outside the range of assumptions identified in Rule 1 as underlying the *ex ante* cap; and
(C) the magnitude and timing of any displacement by the proposed project of expenditure already allowed for under the *ex ante* cap.

TransGrid will make all reasonably requested information available to the regulator or its consultants in this process.

Step 3 – After the completion of public consultations on the regulatory test TransGrid will lodge an application to the regulator addressing A, B and C above.

Step 4 – [10] working days after TransGrid lodges its application (or TransGrid finalises its regulatory test whichever is later) the regulator will release a draft decision on A, B and C above.

Step 5 – Submissions on the draft decision will be due after [10] working days. After a further [15] working days the regulator will release its final decision on A, B and C above.

Step 6 - In general an incentive scheme will be applied in relation to an excluded project that is approved for 'inclusion' by the regulator. However, in the event that the regulator and TransGrid agree not to apply any incentive regime to the excluded

1 In this way the ACCC's assessment of the project and project costs could be conducted in parallel with the conduct of the regulatory test without adding any delays to the overall process.

(contingent) project then, at the beginning of the next regulatory period, the RAB will be adjusted to reflect actual expenditure as per Rule 3 above. In addition, the net capital financing costs of the project will be added to the RAB (i.e. net of the capital financing costs determined after adjustment for relevant displacement of expenditure from the ex ante cap by the implementation of the project (as determined by the regulator in its final decision)). This will include a return on costs incurred in progressing the regulatory test and application to the regulator.

Note: TransGrid may re-submit any rejected project for re-assessment by the regulator only if material changes are included for consideration of the regulator.

Rule 6 – Incentive Regime to be Applied to Excluded Projects

If an incentive regime is to be applied to the excluded project the regulator must make an additional decision in which it identifies target levels and timing of expenditure on the project during the current regulatory period (and hence the associated capital financing costs associated with that expenditure). This decision should be based on the cost estimates developed as part of the most recently completed regulatory test for the project. Where TransGrid is required to repeat the regulatory test due to changes in circumstances (such as higher than assumed tender prices or unforeseen environmental requirements) then the regulator shall adjust the project expenditure targets used for incentive purposes to reflect the revised regulatory test outcomes.

The incentive mechanism would allow TransGrid to keep the total of any saved capital financing costs as a result of lower than the project expenditure targets and would require TransGrid to absorb the total of the capital financing costs (foregone return) on expenditure in excess of the benchmark. The actual costs on the project during the current regulatory period would be rolled into the RAB at the end of the regulatory period. The balance of costs associated with the project would be included in the ex-ante cap for the next regulatory period.

[To be clear this arrangement differs from the ACCC's proposal in that expenditure targets are only set until the end of the regulatory period – with any expenditure in future periods benchmarked at the time of the next review.]

Rule 7 – Adjusting the Revenue Cap Within the Regulatory Period

The above incentive regime can be given effect with or without a within period adjustment to regulated revenues.

In either case, at the beginning of the next regulatory review, the RAB must be adjusted as per Rule 3 above. If there has been no within period adjustment to revenues then the RAB at the beginning of the next period must also be increased by the regulator's benchmark estimate of capital financing costs (foregone returns) of the excluded project within the regulatory period. If benchmark capital financing costs of the excluded project have already been reflected in regulated revenues then no such adjustment is required.

Whether or not a within period adjustment to the revenue cap is performed will be a matter of agreement between the regulator and TransGrid. [The approach adopted in relation to this matter appears to be linked to the outcome of the ACCC Code change proposal intended to clarify the regulator's powers in this regard.]