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Dear Sir

AER Regulatory Accounting Methodologies Position Paper – September 2005

Thank you for the opportunity to comment on the above mentioned position paper. In general TransGrid supports the AER's approach to this matter and would encourage a continuing commitment to the 'as incurred' treatment of capital expenditure for regulatory accounting purposes.

TransGrid has been through an exhaustive process with the ACCC to establish its current revenue cap arrangements. These arrangements reflect the intent of the Statement of Regulatory Principles finalised as recently as December 2004, including an ex-ante capital expenditure scheme designed for operation in conjunction with the 'as spent' form of regulatory modelling. TransGrid has not identified any material issues with the accounting approach used or the form of the Post Tax Revenue Model (PTRM), and is monitoring and controlling its business performance in conjunction with this approach.

The remainder of this letter addresses each of the issues canvassed in the Position Paper in turn.

Issue 1: Will different accounting approaches result in different efficiency incentives?

TransGrid has experience with the ex-ante capex regime used in conjunction with the 'as spent' based methodology but does not have experience with the ex-ante regime used in conjunction with the 'as commissioned' based methodology. Although it is early days, there appears to be no perverse incentives arising from the use of the 'as spent' framework per se. Whether the 'as commissioned' approach would alter this is not immediately clear.

However, the concept and definition of 'commissioning date' would need to be addressed very carefully under ex-ante regime using an 'as commissioned' approach to regulatory accounting. For large projects, timing in the recognition of expenditure for incentive purposes can be very sensitive to the determination of the commissioning date by the regulated business.

To the extent that there appear to be issues with the incentive framework these are not related to the choice of the 'as spent' accounting methodology. As the AER is aware, TransGrid has previously opposed, and still opposes, the use of depreciation as an active component of the ex-ante capex incentive regime.

Issue 2: Will the administration of an as-commissioned regulatory approach be onerous?

TransGrid has adjusted its roll forward and PTRM modelling to accommodate these arrangements. Input data to this revised modelling can be, and is, linked to audited financial accounts with a clear data trail. While this was not costless to establish, it was considered appropriate to meet the requirements of the ACCC/AER.

As already noted, TransGrid has not identified any material issues with the accounting approach used, and is monitoring and controlling its business performance using this arrangement.

However, it would be useful to review the annual reporting requirements for regulatory purposes to align these requirements more closely to the current regulatory modelling and accounting arrangements.

Issue 3: Will different accounting approaches impede consistent comparison of TNSP expenditure?

TransGrid acknowledges that there are advantages in having consistent application of regulatory accounting approaches across transmission businesses. In this regard, there may be some benefit in having all transmission businesses reporting on the same basis as the 'as spent' arrangements now applying to TransGrid and Energy Australia. We understand from Energy Australia that this would also enable that organisation to preserve consistency between its transmission and distribution businesses.

However, it should be noted that any differences arising from the 'as incurred' versus the 'as commissioned' approach pale into insignificance compared with the many other factors that impact on these comparisons.

For example, the ACCC/AER have often used the ratio of regulatory opex allowance to the value of the regulatory asset base to compare the relative opex performance of transmission businesses. However, this form of comparison is all but meaningless if there is no clear understanding of the process for establishing either the value of regulatory opex or the value of the regulatory asset base used in these comparisons. To date, such comparisons have not been accompanied with explanations of the factors that impact on the value of these important variables. Relevant factors include the method used to establish the regulatory asset value originally. If an optimised depreciated replacement cost method was used, the age of the assets, and the basis for establishing the depreciation already recognised at that time, are among a range of matters that can impact on the base valuation.

Issue 4: Will the choice of accounting approach deliver price shocks?

All things being equal the shift from an 'as commissioned' to an 'as-incurred' regulatory accounting approach for capex will bring forward cash flow, at the same time reducing growth in the value of the regulatory asset base. This can cause an upward price shock, particularly when revenue caps are set on the basis of major capital expenditure programs. Of course, future prices will tend to be lower on average because of the reduced value of the regulatory asset base.

However, it should be noted that the treatment of depreciation for regulatory purposes can have similar price impacts. Indeed, measuring economic depreciation is not a science and pragmatic approaches to this question have evolved. Furthermore, as long as all depreciation is properly tracked and recognised in the PTRM over time, there is clearly scope to use regulatory depreciation to manage material price shocks. This includes price shocks that may arise from a move from an 'as commissioned' to an 'as incurred' approach to regulatory accounting.

In this regard, as the AER is probably aware, the ACCC made an adjustment to the timing of recognition of regulatory depreciation between TransGrid's draft and final revenue cap decisions. While this change should be NPV neutral over time, the reduction in revenue cap for each year of the current regulatory control period resulting from this change largely offsets the impact of moving from an 'as commissioned' to 'as spent' capex accounting approach.

In summary, TransGrid has adapted its processes to accommodate the AER's Statement of Regulatory Principles as implemented in the recent TransGrid and Energy Australia revenue cap decisions. While this has not been costless, it has not presented any material difficulties either. In particular, TransGrid has done this without identifying any need for further changes to the PTRM as this model has been applied to TransGrid and Energy Australia.

Accordingly, there appears to be no good reason to move away from the 'as incurred' treatment of capital expenditure for future regulatory accounting purposes, or make further changes to the PTRM to accommodate the 'as incurred' methodology.

Yours sincerely

Philip Gall 17/10/2007

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