TransGrid 2004/05-2008/09 Revenue Cap

Application by TransGrid for Revocation and Substitution

1. Background

1.1 On 27 April 2005 the Australian Competition and Consumer Commission ("ACCC") set a revenue cap under the *National Electricity Code* ("the Code") to apply to TransGrid for the regulatory control period 2004/05 to 2008/09. Pursuant to clause 13(1) of Schedule 2 to the *National Electricity (South Australia) Regulations* this revenue cap is deemed to have been set by the Australian Energy Regulator ("AER") and may be revoked and substituted by the AER in accordance with the *National Electricity Rules* ("the Rules").

1.2 The AER has received an application from TransGrid dated 22 November 2006 for the revocation and substitution of its revenue cap under clauses 6.2.4(d)(2) and 6.2.4(e) of the Rules. This letter is **Appendix A** to this decision.

2. Relevant laws

2.1 On 16 November 2006 new rules for the regulation of electricity transmission networks (Chapter 6A) commenced operation. These replaced the rules formerly set out in Part B of Chapter 6. However, clause 11.6.2 of the Rules provides that Chapter 6, as in force immediately before the commencement of Chapter 6A, continues to apply to an existing revenue cap determination. This means TransGrid's application is governed by the former Part B of Chapter 6 of the Rules.

2.2 Under clauses 6.2.4(d) and 6.2.4(e) (as they then were) the AER may revoke and substitute a revenue cap for the remainder of a regulatory control period. These provisions relevantly state:

> "(d) Notwithstanding clause 6.2.4(b), the *AER* may revoke a *revenue cap* determination during a *regulatory control period* only where it appears to the *AER* that:
> …
>
> (2) there was a material error in the setting of the *revenue cap* and the prior written consent of parties affected by any proposed subsequent re-opening of the *revenue cap* has been obtained by the *AER;*
>
> …
>
> (e) If the AER revokes a revenue cap determination under clause 6.2.4(d), then the AER may make a new revenue cap determination in substitution for the revoked revenue cap determination to apply for the remainder of the regulatory control period for which the revoked revenue cap determination was to apply."

2.3 Clause 13(4) of Schedule 2 to the *National Electricity (South Australia) Regulations* provides that the question of whether a pre-existing revenue cap should be revoked, amended or varied is to be decided by the AER taking into account only matters that would have been relevant for that purpose under, or for the purposes of, the Code as in force immediately before the commencement date of the new *National Electricity Law* (ie. the Code as in force at 30 June 2005).

3. TransGrid's application

3.1 TransGrid submits that material errors were made in setting its revenue cap, in particular, that the ACCC failed to consider a number of TransGrid's submissions in relation to the use of data from the CBASpectrum service in order to determine the debt margin applicable to TransGrid. TransGrid claims the effect of this error was to understate its Maximum Allowed Revenue ("MAR") in each year of the regulatory control period by the amounts set out on page 2 of its letter of 22 November 2006. The total shortfall over the regulatory control period is said to be $27.56 million (2005).

3.2 Given that TransGrid's prices for the first three years of the current regulatory control period have already been set, TransGrid submits that the shortfall in its MAR for each year of the regulatory control period should be recovered in the final two years in a manner that is NPV neutral to TransGrid. This would be achieved by changing the current X factor (used for the indexation TransGrid's MAR) from -2.93% to -4.99%. This adjustment would result in an increase in TransGrid's MAR for the final two years of the regulatory control period equal to the shortfall over the entire period.

4. Process

4.1 Under clause 6.2.4(d)(2), it is necessary to obtain the written consent of affected parties before a revenue cap can be revoked for material error. In its letter dated 22 November 2006, TransGrid identified the parties that it considered may be affected for the purposes of clause 6.2.4(d)(2), being parties with a direct commercial relationship with TransGrid whose prices may be affected by the re-opening of the revenue cap. These were EnergyAustralia, Integral Energy, Country Energy, ActewAGL, Norske Skog (in respect of Albury complex), Visy Pulp and Paper Mills Pty Ltd (in respect of its Tumut complex), Delta, Eraring Energy, Macquarie Generation and Snowy Hydro.

4.2 On 8 December 2006 the AER wrote to these parties, asking them to indicate whether they considered themselves to be affected and, if so, whether they consented to the re-opening of TransGrid's revenue cap. The AER asked for responses by 20 December 2006. The text of the letter sent to each of these parties is **Appendix B** to this decision. The AER also published a notice of this request via its electronic notification system on 13 December 2006, attaching TransGrid's letter and the text of the letter sent to the parties identified above.

4.3 Responses were received from ActewAGL, Integral Energy, Visy, Delta and EnergyAustralia. Each of these parties consented to the re-opening of the revenue cap. Visy strongly urged the AER to ensure that the circumstances that led to TransGrid's application not be repeated.

4.4 EnergyAustralia argued that its revenue cap was affected by the same error that affected TransGrid's revenue cap. EnergyAustralia requested that the AER also revoke and substitute its revenue cap. Given that the consent of affected parties to re-opening EnergyAustralia's revenue cap has not been sought, this request is not dealt with in this decision document.

4.5 The AER also received a submission from the Energy Users Association of Australia ("EUAA") dated 21 December 2006. This letter is attached as **Appendix C** and is discussed in more detail below.

5. AER consideration

Was there a material error in setting TransGrid's revenue cap?

5.1 The AER does not consider that the ACCC's decision to use CBASpectrum data was, in and of itself, an error. The ACCC's decision to use CBASpectrum to establish TransGrid's debt margin was a judgment made by the ACCC within the boundaries of the discretion conferred on it under the Code. The AER does not believe there is an error simply because a party believes that a different decision should have been made or that a different conclusion was reached in another matter. The error in this case related only to the ACCC's process in dealing with TransGrid and its submissions relating to its revenue cap.

5.2 Following the ACCC's draft decision on TransGrid's revenue cap (April 2004) TransGrid made a series of submissions to the ACCC in June, September and November 2004 relating to the data that should be used to forecast bond yields for the purposes of determining its debt margin. TransGrid asked that these submissions not be publicly disclosed. Due to concerns about its ability to seek public comment on these submissions the ACCC refused to consider these submissions from TransGrid.

5.3 The EUAA argues that this was not a material error, as the ACCC was right to refuse to consider submissions provided on a confidential basis. The EUAA argues that disclosing a TNSP's submissions to public scrutiny is crucial, and failing to do so exacerbates the information asymmetry condition that exists in relation to the regulation of transmission network owners. A regulated business should not be able to seek a re-determination or re-opening based on information provided confidentially.

5.4 As a general rule, the AER does seek to disclose submissions relating to a regulatory decision to interested parties. However, the AER cannot adopt an inflexible rule of rejecting (or accepting) confidential submissions in every case. It must consider the merits and the consequences of each claim of confidentiality. It is not unknown for parties to submit information to a regulator on a confidential basis, or for the regulator to accept information on that basis where a claim of confidentiality is properly made. While procedural fairness will usually require that other interested parties are given a reasonable opportunity to comment on the substance of the confidential submission, this is usually managed through negotiation with the party making the confidential submission on an appropriate mechanism for consultation.

5.5 While there may be cases where confidential material can be accepted without any form of disclosure to interested parties, these are relatively rare. Equally, there may be rare instances where a regulator simply cannot accept material submitted in confidence. However, this was not such a case. There was a failure to properly pursue options for accepting TransGrid's submissions on a confidential basis and establishing an appropriate mechanism for consultation. Had this been done, it is likely that a regime could have been put in place to enable an appropriate degree of disclosure to affected parties. Instead the ACCC declined to accept TransGrid's submissions and did not consider them in making its decision. This was an error within the meaning of clause 6.2.4(d)(2).

Should TransGrid's revenue cap be re-opened?

5.6 The AER is of the view that rectification of this error involves the proper consideration of TransGrid's submissions. Such a step will not necessarily lead to revocation of a revenue cap. The issue is whether proper consideration of TransGrid's submissions would have led to a different conclusion than the one reached by the ACCC in setting the revenue cap.

5.7 The submissions provided by TransGrid included a report by Professor Bruce Grundy, plus further reports by NERA and Professor Kevin Davis in support of Professor Grundy's findings, which argued that actual yields on long term debt securities over 2003-04 were, on average, 17.7 basis points above the estimates from the CBA Spectrum database. Professor Grundy implied that this was primarily due to CBA's method of estimating yield curves of various credit ratings simultaneously and for ensuring that the curves do not to intersect (which is the outcome that would be supported by theory). In response, CBA explained that its methods avoid distortions to estimated yields that can arise due to general volatility, company specific factors and the effects of using limited data. CBA also noted that the average differences between observed and estimated spreads, on any bond with a term to maturity in excess of 5 years, was negligible.

5.8 There are obviously limits on the extent to which the AER can determine what would have happened had the ACCC considered these submissions at the time they were made. The appropriate methodology for determining a TNSP's debt margin can vary depending on the type of debt facility selected. Different sources or combinations of data may be appropriate for forecasting yields depending on the type of debt facility, including the credit rating and maturity period. The AER considers both CBASpectrum and Bloomberg to be respected providers of financial information and has stated that it will use whichever service (or whichever combination of services or other data) is most appropriate in the circumstances. However, the AER is of the view that a full consideration of this issue, having regard to TransGrid's submissions, would most likely have lead to the conclusion that the Bloomberg service would have produced estimated yields for A rated bonds with a maturity period of 10 years that are more consistent with observed yields on similarly rated bonds than those produced by CBASpectrum. Over the longer term, and for all types of debt facility, the differences between observed and estimated spreads produced by CBASpectrum may be negligible. However, there are appreciable differences between the observed and estimated yields on the particular type of facility used for the purpose of estimating TransGrid's debt margin. This AER considers that this would have lead to TransGrid's debt margin being established on the basis of data from the Bloomberg service.[1]

5.9 In making this decision, the AER must have regard only to matters that would have been relevant under the Code. This means that the AER is not required to make this decision in accordance with section 16 of the *National Electricity Law*. Part B of Chapter 6 of the Code gave considerable discretion to the regulator, to be exercised in accordance with the principles, objectives and other requirements in clauses 6.1.1 and 6.2.2 to 6.2.4. These include:

[1] It should be noted that this was the decision reached by the AER in setting a revenue cap for Directlink, less than 12 months after the final decision setting TransGrid's revenue cap.

- promoting competition wherever practicable and regulating in a manner that replicates competitive outcomes

- providing an incentive based regulatory regime that includes a fair and reasonable return on efficient investment, given efficient operating and maintenance practices

- regulatory accountability, reasonable regulatory discretion that balances the interests of service providers and users and reasonable certainty and consistency over time.

5.10 It is clear that a revenue cap is not to be re-opened lightly. The need for certainty is recognised in clauses 6.2.2(j), 6.2.3(d)(5)(iii) and 6.2.4(d). Once a revenue cap is established, it should not be subject to continued revision or re-agitation of issues. A revenue cap is established through an extensive investigation of relevant issues and a high degree of interaction with the TNSP. Numerous opportunities are provided to make submissions to the regulator in a process that generally draws out the relevant material. Once this process is completed, a revenue cap should not be re-opened on the basis of further submissions or a re-stating of earlier arguments.

5.11 However, where it is clear that there has been an error that has a material impact on a TNSP's revenue cap, the principles and objectives in Part B of Chapter 6 will generally support rectification of that error. The AER considers that re-opening TransGrid's revenue cap to put it in the position it would have been in had there been no error is consistent with the principles and objectives in Part B of Chapter 6.

5.12 The effect of this decision is to determine TransGrid's cost of debt using a debt margin of 117.22 basis points, instead of the 90 basis points used in the original decision.[2] This results in a cost of debt of 7.152%, leading to an increase in TransGrid's MAR for each of year of the regulatory control period by the amounts set out on page 2 of TransGrid's letter of 22 November 2006. The AER considers it is permissible and appropriate for TransGrid to be allowed to recover this shortfall over the final two years of the regulatory control period in a manner that is NPV neutral. The AER therefore proposes to substitute a revenue cap in which the X factor is increased from -2.93% to -4.99%.

5.13 The changes to TransGrid's MAR that will result from this decision are as follows:

Smoothed MAR ($m)	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**Total**
Original revenue cap	432.75	456.50	481.56	507.99	535.87	2414.68
Amended revenue cap	432.75	456.50	481.56	518.13	557.48	2446.42

6. Consent of affected parties

6.1 The AER considers that it has obtained the written consent of parties affected by the re-opening of TransGrid's revenue cap. On 8 December 2006, the AER wrote to the parties identified in paragraph 4.1. No response was received from Country Energy, Norske Skog, Eraring Energy, Macquarie Generation or Snowy Hydro. The AER has proceeded on the basis that these parties do not consider themselves to be affected by

[2] *NSW and ACT Transmission Network Revenue Cap, TransGrid 2004–05 to 2008–09*, Final Decision, 27 April 2005, p 143.

the re-opening of TransGrid's revenue cap, and their consent is not therefore required. Each of the remaining parties who responded to the AER consented to the re-opening.

6.2 As noted above, the EUAA has objected to the re-opening of TransGrid's revenue cap. The EUAA represents major electricity and gas users. However, while the AER believes the views of the EUAA deserve careful consideration, it does not believe the EUAA's consent is required under clause 6.2.4(d)(2). The AER considers that clause 6.2.4(d)(2) requires the consent of parties directly affected - in this case, parties with a direct commercial relationship with TransGrid for the use of its transmission network whose prices may be affected by the re-opening. It would be impossible to obtain the written consent of every electricity user in NSW to the re-opening of a revenue cap. Similarly, the AER does not believe it would be feasible to delineate between 'major' users and other users. The AER does not consider that cl 6.2.4(d)(2) can be read as requiring the consent of such parties. Further, the AER does not consider that the EUAA can have a higher interest than the people it represents. Accordingly, the AER does not believe the EUAA or its members are affected persons within the meaning of clause 6.2.4(d)(2).

7. AER decision

7.1 The AER determines that, with effect from the date of this decision:

(a) pursuant to clause 6.2.4(d)(2) of the *National Electricity Rules*, the revenue cap set for TransGrid by the ACCC on 27 April 2005 for the regulatory control period 2004/05 to 2008/09 is revoked;

(b) pursuant to clause 6.2.4(e) of the *National Electricity Rules*, a new revenue cap is set for TransGrid for the regulatory control period ending 30 June 2009, being the revenue cap set by the ACCC on 27 April 2005, varied so that, in determining the maximum allowed revenue for the years 2007/08 and 2008/09, the X factor is increased from -2.93% to -4.99%.

Dated: 13 February 2007