

Contact Officer: Justin Oliver
Contact Phone: (07) 3835 4645

8 December 2006

Mr Russell Skelton
Manager, Marketing & Trading
Macquarie Generation
PO Box 3416
Hamilton Delivery Centre NSW 2303

Dear Mr Skelton

TransGrid revenue cap – request for revocation and substitution

The Australian Energy Regulator (“AER”) has received a request 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 *National Electricity Rules*. A copy of this letter is attached.

On 27 April 2005 the Australian Competition and Consumer Commission (“ACCC”) set TransGrid’s revenue cap for the regulatory control period 2004/05 to 2008/09. Pursuant to the *National Electricity (South Australia) Regulations* (Sch 2, cl 13) this revenue cap is deemed to have been set by the AER and may be revoked and substituted by the AER in accordance with the Rules.

TransGrid seeks the correction of material errors which it submits were made in setting its revenue cap, specifically, in estimating its cost of debt. These are discussed below.

Under clauses 6.2.4(d) and 6.2.4(e) of the Rules, the AER may revoke a revenue cap and substitute a new revenue cap for the remainder of a regulatory control period. Clause 6.2.4(d) relevantly states:

- “(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,”

While the AEMC has recently promulgated new rules for the regulation of electricity transmission networks (Chapter 6A), clause 11.6.2 provides that Chapter 6 of the Rules, as in force immediately before the commencement of the new rules, continues to apply to an existing revenue cap determination.

Material errors identified by TransGrid

TransGrid believes that material errors were made in setting its revenue cap. In particular, TransGrid submits that the ACCC failed to consider a number of submissions outlining concerns in relation to the use of data from the CBASpectrum service in order to determine the appropriate debt margin applicable to TransGrid. TransGrid submits that the effect of this error was to understate TransGrid’s MAR in each year of the current regulatory control period by the amounts set out in TransGrid’s letter of 22 November 2006. The total shortfall over the regulatory control period is \$27.56 million (\$2005).

Method of correction

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 will be achieved by changing the current X-factor (used for the indexation TransGrid’s MAR) from -2.93% to -4.99%. This adjustment will 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.

AER position

The AER’s current view (subject to any submissions that may be made to the contrary) is that there was a material error for the purpose of clause 6.2.4(d)(2) of the Rules. TransGrid made a series of confidential submissions to the ACCC on the use of CBASpectrum data to determine its debt margin. Due to concerns about its ability to seek public comment on these submissions the ACCC did not accept, and therefore did not address, these submissions. The AER’s current view is that the failure to address these submissions was a material error for the purposes of cl 6.2.4(d)(2) of the Rules.

The AER is of the view that rectification of this error involves the proper consideration of TransGrid’s submissions on this issue. Such a step will not necessarily justify revocation of a revenue cap.¹ It would only do so if it is clear that TransGrid’s submissions would have led to a different conclusion than the one reached by the ACCC in setting the revenue cap. While both CBASpectrum and Bloomberg are respected providers of financial information, the AER has stated that it will use whichever service (or whichever combination of services or other data) is most appropriate in the relevant circumstances. The AER has now completed

¹ *NSW and ACT Transmission Network Revenue Cap, TransGrid 2004–05 to 2008–09, Final Decision, ACCC, 27 April 2005, p 143.*

this assessment and believes that TransGrid's submissions would have justified the conclusion that, in this particular case, a better estimate of TransGrid's debt margin would be achieved using data from the Bloomberg service rather than the CBASpectrum service. The AER therefore considers it appropriate that TransGrid's revenue cap be revoked and that a revised revenue cap be substituted, in which the debt margin is determined on the basis of data from the Bloomberg service.

The effect of this would be to determine TransGrid's cost of debt using a debt margin of 117.22 basis points, instead of the 90 basis points used in setting the revenue cap. This results in a cost of debt of 7.152%. The effect of this revocation and substitution would be an increase in TransGrid's MAR for each of year of the regulatory control period by the amounts set out in TransGrid's letter of 22 November 2006. The AER is also of the view that it would be appropriate for TransGrid 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%.

Process

Under clause 6.2.4(d)(2) of the Rules, it is necessary to obtain the written consent of affected parties affected before a revenue cap may be revoked for a material error. In its letter dated 22 November 2006, TransGrid identifies the parties that it considers may be affected parties for the purposes of clause 6.2.4(d)(2).

These parties are listed below:

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
 Snowy Hydro

As a potentially affected party could you comment on:

1. whether you consider that you are a party affected by the re-opening of TransGrid's revenue cap for the purposes of cl 6.2.4(d)(2); and
2. if so, whether you consent to the re-opening of TransGrid's revenue cap in the manner proposed above?

You do not need to respond to this letter if you do not consider yourself to be a party affected by the re-opening of TransGrid's revenue cap. In the absence of any response, the AER will proceed on the basis that you do not consider yourself to be such a party.

If you wish to respond to this letter, we would be grateful if you could provide that response by 20 December 2006.

If you have any queries please contact Justin Oliver on (07) 3835 4645.

Yours sincerely


Mike Buckley
General Manager
Network Regulation North

PG/ar

ABN 19 622 756 774

Ms Michelle Groves
Chief Executive Officer
Australian Energy Regulator
PO Box 1199
Dickson ACT 2602

201 Elizabeth Street (cnr Park St)
PO Box A1000 Sydney South
New South Wales 1235 Australia
Facsimile (02) 9284 3456
Telephone (02) 9284 3000
Web <http://www.transgrid.com.au>
DX1122 Sydney

Dear Ms Groves

Request for Correction of Final Decision That Was Made in Error

I am writing on behalf of TransGrid to request the Australian Energy Regulator to revoke TransGrid's revenue cap made by the Australian Competition and Consumer Commission's (ACCC) in its *Final Decision: NSW and ACT Transmission Network Revenue Cap TransGrid 2004-05 to 2008-09* (the **Decision**) and substitute a new revenue cap that is free of material error.

This request is made pursuant to clause 6.2.4(d)(2) and 6.2.4(e) of the National Electricity Rules. Clauses 6.2.4(d)(2) and 6.2.4(e) 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.

TransGrid notes that transitional provisions in the National Electricity (South Australia) Regulations allow for the AER to be treated for all practical purposes as the decision maker in respect of ACCC decisions made under the predecessor to the National Electricity Rules, the National Electricity Code.

The Decision

TransGrid has identified material error in the Decision and decision-making process with respect to its revenue cap.

The National Electricity Code required the ACCC in the Decision to adopt a cost of debt which is "established with reference to current prices in domestic and overseas corporate debt markets".

TransGrid made initial submissions concerning an appropriate source for the cost of debt and, in the course of the revenue cap setting process, made a number of submissions to ACCC staff specifically outlining concerns TransGrid had with the use of the CBASpectrum data. In particular, TransGrid's concern was that the CBASpectrum service systematically understated the rate for 10 year bonds. In this case the Decision understated the cost of debt by approximately 27 basis points.

Notwithstanding those submissions, the Decision relied on unadjusted CBASpectrum data as the cost of debt without referring to the concerns expressed by TransGrid. TransGrid understands that its submissions were not considered by the ACCC. Subsequent decisions by a range of regulators performing analogous functions have recognised this problem or used alternative sources of data.

The decision was made in error in that it failed to take account of the above submissions resulting in a Decision that significantly understated the revenue that TransGrid would be permitted to earn. Rectification requires the AER to take TransGrid's submissions into account, with the effect of modifying the cost of debt used to establish TransGrid's revenue cap.

A comparison between TransGrid's allowed revenues during the control period as set out in the Decision and the allowed revenues as corrected for the revised cost of debt are as follows:

Unsmoothed (\$m)	MAR	04/05	05/06	06/07	07/08	08/09	Total
ACCC Decision		435.14	454.78	477.32	502.28	545.98	2,415.50
Corrected figures		440.06	459.92	482.73	508.02	552.33	2,443.06

Note, however, that the actual MAR is derived from the CPI-X formula in the decision and the above are figures are projections made at the time of the Decision. They are, therefore, illustrative only. The actual MAR figures depend upon movements in the CPI.

Method of correction

TransGrid has already charged for transmission services for each of the financial years 2004-2005 and 2005-2006 and disseminated its prices for the financial year 2006-2007. Those prices were all based on the ACCC Decision. TransGrid will therefore have earned less revenue in those years than it should have been permitted to do.

The correction to the permitted revenue in the final two years needs to enable the recovery of the lost revenues from the first three years. That correction can be achieved in a manner that is NPV neutral to TransGrid and in a manner that smoothes the adjustment over the final years of the revenue period by replacing the Decision's "X" value of -2.93% with -4.99% for those two final years.

Affected parties

TransGrid has identified as potentially affected parties under clause 6.2.4(d)(2) those that it invoices for transmission services. These parties are set out in Attachment A.

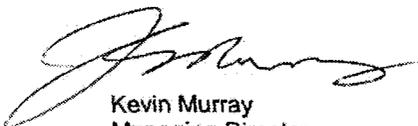
Timetable for correction

As per our discussions with respect to the appropriate process for this application, TransGrid will need to finalise and disseminate the prices for transmission services for the years 2007-2008 by 1 July 2007. TransGrid is the regional coordinator amongst NSW TNSPs which means it is responsible for collecting, combining and disseminating the overall TUOS charges for all NSW TNSPs. With this in mind the following timetable is necessary:

Time	Action
Early December 2006	The AER writes to potential affected customers advising them of TransGrid's request to revoke the existing revenue cap.
Early January 2007	Deadline for any responses by customers to the AER letter.
Late February 2007	The AER makes a new revenue cap determination for TransGrid.
Late March 2007	Based on the new revenue cap determination all cost inputs for the calculations of TUOS charges for 2007-2008 must be finalised by TransGrid.
April 2007	ABS releases 1 st Quarter CPI figures which is the last input to the calculation of prices.
April 2007	TransGrid's TUOS prices for 2007/2008 to be disseminated to DNSPs.
Early June 2007	DNSPs disseminate combined TUOS and DUOS charged to retailers and other customers.

Your assistance in progressing this matter to meet the proposed timetable would be most appreciated.

Yours sincerely

 22/11/06
Kevin Murray
Managing Director

Attachment A: Potentially affected parties

EnergyAustralia

Integral Energy

Country Energy

ActewAGL

Norske Skog (in respect of its Albury complex)

Visy Pulp and Paper Mills Pty Ltd (in respect of its Tumut complex)

Delta

Eraring Energy

Macquarie Generation

Snowy Hydro