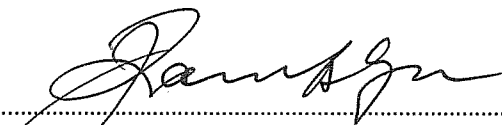


Australian Energy Market Commission

**Rule Determination**

**National Electricity Amendment (TransGrid  
Participant Derogation - Treatment of Contingent  
Projects (Interim Arrangements)) Rule 2006**

Rule Proponent: TransGrid  
Date: 27 July 2006

Signed:  .....

**John Tamblyn**  
**Chairman**  
For and on behalf of:  
**Australian Energy Market Commission**

**Commissioners**  
Tamblyn  
Carver  
Woodward

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## Summary

TransGrid proposed that a change be made to the National Electricity Rules (the Rules) to allow it to recover the costs of investment in approved contingent projects during the regulatory period they are incurred. Under its current revenue determination, TransGrid is not able to recover the cost of such investments until the next regulatory period because clause 6.2.4 of the Rules only permits reopening of the revenue cap within the current regulatory period on limited grounds.

TransGrid's proposal seeks to remove uncertainty surrounding its recovery of the costs of investment in approved contingent projects and thereby remove a potential disincentive to invest in contingent projects. The proposed Rule change - in the form of a participant derogation - would achieve this by allowing TransGrid to begin recovering its costs on an approved contingent project during the period in which it has been incurred.

The Commission released a draft determination on 19 January 2006. The draft determination took into consideration one submission from the AER, TransGrid's proposal submission and other issues identified by the Commission in the course of its assessment. Other factors considered by the Commission included:

- Relationship to the Review of Transmission Revenue and Pricing Rules;
- Revenue and investment predictability;
- Implementation of the Australian Competition and Consumer Commission's (ACCC) Revenue Determination for TransGrid;
- Proposed expiry date of the derogation;
- Efficient capital expenditure on contingent projects; and
- Treatment of contingent projects in the next regulatory period.

In making its Final Rule Determination, the Commission assessed further submissions from the AER, TransGrid, Powerlink and Wambo Power Ventures (WPV) and conducted further analysis. The Commission also issued a section 107 notice under the National Electricity Law (NEL) extending the release of this final Rule determination to coincide with the publication of the Transmission Revenue draft determination and draft Rule arising out of AEMC's review of Chapter 6 of the Rules. This enabled the Commission to incorporate the additional Chapter 6 analysis of contingent projects and align the two regimes as far as possible. As a result, the final Rule determination has adopted the same contingent project regime embodied in the Chapter 6 draft Rules for Transmission Revenue whilst not compromising the ACCC's determination for TransGrid.

The other major change from the draft determination is the inclusion of a higher powered incentive mechanism for projects which continue into the next regulatory period. This will not be addressed in the derogation itself but in the revenue component of the new Chapter 6 Rules that will apply to TransGrid's next revenue cap determination.

The final determination will contribute to the NEM objective by removing barriers to necessary investment in the transmission network by TransGrid while ensuring adequate incentives that better reflect the original ACCC Determination for TransGrid. If required, investment in contingent projects will ensure the safe and reliable operation of the transmission system thereby maintaining and improving operational outcomes for users.

# 1 TransGrid's Rule Proposal

On 16 September 2005, TransGrid submitted a proposal to the Commission for a participant derogation to provide allowances for approved contingent projects within the current regulatory period. In the Statement of Principles for the Regulation of Electricity Transmission Revenues (SRP) the ACCC introduced the concept of excluded (or contingent) investment projects. These projects are excluded from the *ex ante* capital expenditure allowance and require pre-defined triggers and AER approval before they can proceed. For TransGrid's 2004-09 Revenue Cap, the ACCC applied the concept of contingent projects but clause 6.2.4 of the Rules prohibits reopening the revenue cap to fund contingent projects triggered within the current regulatory period.

Due to clause 6.2.4 of the current Rules, TransGrid is not compensated for investments in approved contingent projects until the commencement of the next regulatory control period. As part of the cost recovery process, an incentive period associated with contingent project capital expenditure is determined by the AER. In recognition of the requirements of clause 6.2.4 of the Rules, the ACCC set out in its determination the following process to be applied at the commencement of the next revenue reset to recover the cost of incurred approved contingent projects in the current regulatory period:

- *“the ACCC will add to the closing RAB the target capex and Annual Revenue approved by the AER for each year of the incentive period leading up to the re-set; and*
- *the ACCC will add to the ex ante capex allowance the target capex and Annual Revenue approved for each year of the incentive period that comes after the re-set.*

*At the revenue reset following the completion of the incentive period, the ACCC will add to the closing RAB the depreciated value of the actual investment in the project that complies with the requirements of the Code. This will include the return on and return of the actual investment for the period between the end of the incentive period and the revenue cap re-set.”<sup>1</sup>*

In TransGrid's current revenue determination, the ACCC approved \$722 million of contingent projects out of a total capital expenditure allowance of \$2,010 million. <sup>2</sup>

TransGrid has submitted that the process for recovery of the revenue proposed by the ACCC involves risk and uncertainty that will impact on its capacity to commit to, and implement, contingent projects during the current regulatory period. The proposed Rule change would permit the following in the current regulatory period:

- The efficient capital costs for an approved contingent project incurred in each given financial year to be added to TransGrid's RAB at the end of that financial year;
- The maximum allowed revenue is to be increased at the end of the financial year to account for the return of and on capital associated with a contingent project's efficient capital costs; and

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<sup>1</sup> ACCC, "NSW and ACT Transmission Network Revenue Cap TransGrid 2004-05 to 2008-09", 27 April 2005, p. 211

<sup>2</sup> ACCC, 27 April 2005, p. 129

- Contingent projects commenced in the current regulatory period to be treated as non-contingent projects when setting the revenue cap for the next regulatory period.

TransGrid also requested that the derogation's expiry date be conditional on when the AER determines TransGrid's next revenue reset.

TransGrid indicated that the trigger for the Queensland-NSW Interconnect (QNI) upgrading was likely to be met by late 2005.<sup>3</sup> Furthermore, it is concerned that if the work is undertaken the AER may not have an obligation under the Rules to compensate TransGrid's expenditure on contingent projects at the next revenue reset.

## 2 The Final Rule Determination

The Commission has determined, in accordance with section 102 of the NEL, to make the final Rule set out in Appendix 1 of this final Rule determination. The wording of the final Rule amends aspects of the proposed Rule as put forward by TransGrid, for the reasons set out in Section 5 of this determination.

In coming to its decision, the Commission has considered:

- the Rule proposal and the proposed Rule put forward by TransGrid (see Section 1 of this Determination);
- submissions received (see Sections 4 and 5 of this Determination); and
- the requirements under the NEL (see Section 3 of this Determination).

The Commission has applied the statutory Rule making test and, for the reasons set out in section 6 of this final determination, is satisfied that the Final Rule is likely to contribute to the achievement of the NEM objective.

### 2.1 Summary of differences between the proposed Rule and the Final Rule

The Commission has made the following changes to the proposed Rule.

- The proposed conditional expiry date has been replaced with the specified date of 1 July 2009;
- The use of the undefined term "*efficient capital costs*" has been replaced with a reference to "*forecast capital expenditure for each remaining year of the current regulatory year of the current regulatory period*";
- The Commission has, where possible and where appropriate, aligned the contingent project regime embodied in the derogation with the approach to contingent projects contained in the draft Rules for Transmission Revenue and Pricing.

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<sup>3</sup> TransGrid submission to Draft Rule Determination, 19 April 2006, p 1, states late 2006 as the earliest that a contingent project may be triggered.

These changes, and the analysis that underpins them, is discussed in Section 5 of this determination.

### **3 Requirements under the NEL**

#### **3.1 The Rule Making Test**

The Rule making test requires the Commission to be satisfied that a proposed Rule will contribute to the NEM objective. The test requires the Commission to consider the implications of the proposed Rule, for the efficient investment in, and efficient use of these electricity services, in respect of specified elements which impact on the long term interests of end users of electricity.

The Rule making test states:

- “(1)The AEMC may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity market objective.*
- (2) For the purposes of subsection (1), the AEMC may give such weight to any aspect of the national electricity market objective as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.” (section 88 NEL)*

The NEM objective is at the centre of the Rule making test, and is set out in section 7 of the NEL:

*“The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.”*

The Commission has applied the Rule making test to the Rule to be made, as modified by the outcomes of analysis and discussion in section 5 of this determination.

#### **3.2 The head of power for the draft Rule**

The AEMC’s power to make Rules falls under section 34 and Schedule 1 of the NEL. Section 34 (1) (c) of the NEL states:

*the AEMC...may make Rules...for ...regulating – ...  
(c) the activities of persons (including Registered participants) participating in the national electricity market or involved in the operation of the national electricity system.*

Further, section 34 (3) (l) and (m) also confer power to make a participant derogation.

Finally under Schedule 1 of the NEL, the Commission may make Rules regarding:

- *The regulation of revenues earned or that may be earned by owners, controllers or operators of transmission systems from the provision by them of services that are the subject of a transmission determination (section 15);*
- *Principles to be applied, and procedures to be followed, by the AER in exercising or performing an AER economic regulatory function or power (section 17);*

- *The mechanisms or methodologies for the derivation of the maximum allowable revenue or prices to be applied by the AER in making a transmission determination (section 20).*

The Commission is satisfied that the Final Rule falls within the subject matters for which the Commission may make Rules as set out in section 34 of the NEL and in Schedule 1 of the NEL.

### **3.3 Assessment against Rule making test**

The Commission expects this derogation will reduce regulatory uncertainty which could discourage efficient investment in contingent projects. It considers that this would improve the efficiency and reliability of the transmission system compared to the situation in the absence of the derogation. The reasons for this are:

- Under the contingent project provisions in TransGrid's current revenue cap, the timing of the expenditure and revenue recovery cash flows would be mismatched because cost recovery for approved investment does not occur until the regulatory period after the investment was undertaken. This derogation will allow a better alignment of TransGrid's contingent project investment cash flows thereby facilitating the more timely recovery of those costs reducing uncertainty regarding that outcome and thereby promoting efficient investment in those projects.
- The regulatory risk faced by TransGrid will be reduced because the derogation will give the TNSP a higher degree of certainty with respect to the recovery of the costs associated with efficient investment in approved contingent projects.
- The contingent project regime contains an incentive mechanism that rewards efficient and penalises inefficient investment under an *ex ante* capital expenditure framework.
- The derogation aligns with the contingent project regime contained within the draft Transmission Revenue Rules while still preserving the fundamental elements of the ACCC determination. The draft Transmission Revenue Rules provide an incentive for efficient investment in contingent projects by rewarding underspending on a project or penalising overspending, and in either situation rolling in actual expenditure into the TNSP's RAB at the end of the regulatory period.

Furthermore, the ACCC has recognised in its SRP, as has the AER in its submission to the AEMC, that a Rule change such as this would be beneficial. The requirements of the Rule change and the improved level of certainty of revenue recovery for TransGrid should also ensure that when triggers are met, TransGrid will present well specified and supported projects to the AER for approval under the process set out in Appendix F of TransGrid's revenue determination.

The Commission also considers that this Rule change has the potential to reduce the likelihood of sub-optimal investment choices occurring due to the truncation of the set of feasible projects available to resolve a network issue. For example, the disincentives inherent in the current determination to contingent project investment may have caused TransGrid to defer presenting the project to the AER for approval thereby allowing another party to resolve the network issue in another manner that may be less efficient. Ensuring that the full set of feasible investment options is

available to address network reliability or congestion requirements would increase the likelihood of selecting the best option for the efficient operation of the NEM.

Encouraging efficient and timely investment in the transmission system produces benefits for both upstream and downstream users and is therefore likely to contribute to the achievement of the NEM objective.

## **4. Consultation Process**

The Commission issued a section 95 notice under the NEL on 20 October 2005 and invited submissions from interested parties. Submissions closed on 18 November 2005.

The Commission published its draft determination and draft Rule on 19 January 2006. Submissions were due to close on 3 March 2006. However, as a result of an error occurring during publication of the draft Rule, the Commission considered it in the public interest to extend the time period for submissions. A section 107 notice was issued to extend the consultation process by a further six weeks to 19 April 2006. The Commission's final determination and final Rule was to be published on 17 May 2006.

The Commission considered the proximity of the final determination and the release of Transmission Revenue draft determination and concluded that, given the potential overlap with the outcomes of the transmission revenue and pricing review, it would be appropriate to incorporate the analysis undertaken as part of that review into its final decision on the TransGrid proposal. In the Commission's opinion, releasing a final determination prior to the finalisation of the draft Rule for transmission revenue requirements would not be in the public interest. Accordingly, the date for the publication of the final determination on the TransGrid derogation was extended to 27 July 2006.

### **4.1 Public Hearing**

No requests were made for a public hearing in relation to this proposal, and none were held.

## **5. Matters raised in Analysis and Consultation**

The Commission received two submissions from TransGrid and the AER in response to TransGrid's Rule proposal. The AER opposed the Rule change and noted that the incentive properties contained in TransGrid's revenue cap determination had been removed. TransGrid questioned the approach taken by the AEMC to impose a fixed expiry date upon the derogation.

Following the release of the draft Rule, the Commission received two submissions from TransGrid and one each from the AER, Powerlink and Wambo Power Ventures (WPV).



TransGrid supported a derogation that was largely independent of the review of Transmission Revenue and Pricing Rules and only supported incentives within the current regulatory period but not beyond.

While the AER does support revenue cap reopenings for contingent projects, it claimed that the AEMC draft Rule institutes a “cost of service” approach that introduces an *ex post* element into TransGrid’s revenue cap. The AER expressed concern that the draft Rule determination amounted to the Commission overturning or modifying an aspect of the final AER ruling on TransGrid’s transmission determination, and that market participants may attempt to use the AEMC Rule change process as a means of subverting the regulatory process. The AER’s submission in response to the draft Rule states:

*“The AER does not believe it is appropriate to use a participant derogation to overturn or modify an aspect of a regulatory decision that has already been made. The AER is concerned that regulated entities may seek to use the Rule change process as an appeal mechanism against a revenue cap determination by the regulator.”<sup>4</sup>*

Powerlink supported the draft Rule determination and noted that the QNI project that TransGrid expects to be triggered as a contingent project is a joint project with Powerlink.<sup>5</sup>

WPV is concerned that allowing contingent project revenue to be received in the period when the project is triggered will favour network solutions at the expense of non-network alternatives.<sup>6</sup> However it should be noted that where required, contingent projects will still be required to undertake the Regulatory Test, which includes an assessment of non-network solutions. In addition to this the Regulator must approve all projects.

The fact that non-network solutions only receive costs as opposed to the return of and on capital associated with a network solution is a significant issue, but one that relates to the overall framework for assessing and funding non-network solutions. Accordingly, these issues would need to be addressed in a more general review of how to remove any bias between network and non-network solutions. The TransGrid final Rule gives effect to provisions in its ACCC Revenue Determination that were compromised by uncertainty created by the Transmission Revenue Review.

## **5.1 Relationship to AEMC Chapter 6 Review**

### **TransGrid’s view**

TransGrid is concerned that the Rules to be made by the AEMC as a result of the Review of Transmission Revenue and Pricing may not provide for the transition of existing arrangements for contingent projects triggered in its current revenue reset period, and may lead to an unacceptable degree of uncertainty. In TransGrid’s view, the degree of uncertainty created prevents the planned operation of its revenue determination.

Specifically, TransGrid is concerned that these incurred costs may not be included in the regulatory arrangements that will apply to its next revenue reset. Under the current TransGrid revenue determination adjustments to fund approved contingent projects

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<sup>4</sup> AER submission, 6 February 2006, p. 3

<sup>5</sup> Powerlink submission, 30 January 2006, p. 1

<sup>6</sup> Wambo Power Ventures submission, 3 March 2006, p.2

incurred in the current regulatory period would occur at the beginning of the next reset period (1 July 2009), and can continue into the next regulatory period. Furthermore, TransGrid's Revenue Determination seeks to bind TransGrid and the AER to regulatory arrangements that may apply in the next (and subsequent) regulatory period, but potentially could conflict with the Transmission Revenue Rules due to be in force by 1 January 2007.

### **Submissions**

The AER's response to the Rule change proposal acknowledged that the regulatory treatment of contingent projects was an important issue, but stated that the AEMC's Review of Transmission Revenue and Pricing Regulation was the appropriate channel for addressing TransGrid's concerns<sup>7</sup>. It also expressed the view that TransGrid's expenditure associated with investment on the QNI upgrade would be minimal before the middle of 2006, by which time the AER expected the Rule changes arising from the review of Transmission Revenue and Pricing would be in place<sup>8</sup>.

TransGrid's submission to the draft Rule determination concurred with the Commission's view that a participant derogation was the most appropriate way to resolve the matters raised in the proposal, given the uncertainty at the time over how these issues would be addressed in the transmission revenue Rules.<sup>9</sup>

### **Commission's consideration and reasoning**

The Commission initially analysed TransGrid's proposed Rule change within the context of a revenue cap under which the ACCC granted the TNSP an allowance for contingent projects but withheld the additional revenue required to fund these projects until TransGrid's next regulatory period. The ACCC was prevented by the Rules from allowing TransGrid to reopen its revenue cap, resulting in the adoption of a retrospective approach. The Commission, in its Transmission Revenue Rule proposal, sought to remove the concept of a contingent project regime, preferring instead to adopt a reopener provision for unforeseen or uncertain projects.

The absence of contingent projects from the proposed new Rules on Transmission revenue regulation meant that, at the time, the derogation was the most effective means of addressing the issues raised by TransGrid and would enable the operation of a very different regime to that which currently applies under the Rules.

In the intervening period since the publication of the draft Rule, the Commission has moved to introduce a contingent project framework into the draft Rules for Transmission Revenue. In order to minimise potential incompatibilities between two contingent project regimes, the Commission extended the timeframe for this determination to incorporate the analysis underpinning the new Rules and has aligned the treatment of contingent projects under the processes as far as possible.

## **5.2 Revenue and Investment Certainty**

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<sup>7</sup> AER submission, 17 November 2005, p.1

<sup>8</sup> The AER has advocated that a contingent projects regime be introduced into the Rules as part of the Transmission Revenue and Pricing Rules.

<sup>9</sup> TransGrid submission, 19 April 2006, p.1

### **TransGrid's view**

*"...the ACCC decision cannot bind a future AER and the arrangement does not provide TransGrid with any reasonable level of certainty that efficient investment in a contingent project will be recognized in the RAB."*<sup>10</sup>

TransGrid is concerned that there remains uncertainty whether contingent project expenditure incurred (by TransGrid) in the current regulatory period will be fully funded in the next regulatory period because the ACCC's determination can not bind the future actions of the AER, and is, in any event, unclear on the mechanism to be applied.

### **Submissions**

The AER's response to the TransGrid proposal referred to a suggested amendment to the Rules that it had raised in its submission to the Review of Transmission Revenue and Pricing Rules. This amendment would provide for the accommodation of contingent projects under the Transmission Revenue Rules and, in the AER's view, would provide the certainty TransGrid is seeking. However, this was not a formal Rule change proposal, but rather what the AER considers would be an appropriate change to the Rules.

The AER's second submission, in response to the draft determination, agreed that in the absence of a derogation, it would not be possible to adjust TransGrid's revenue cap to include an allowance for a contingent project until the next re-set.<sup>11</sup> TransGrid welcomed this view in its second submission, and emphasised that it would be inappropriate to wait for a change in the Rules to address the issues raised in the Rule proposal, given that the Rules will apply to a subsequent regulatory period and it is uncertain what the outcome of the Review of Transmission Revenue and Pricing will be.

WPV supported measures to increase certain in relation to efficient investments, agreeing that delayed recovery of contingent project expenditure produces an inhibitive level of regulatory risk. However, WPV argued that the derogation should aid investment in non-network alternatives by removing barriers to investment. WPV was unconvinced that the draft Rule would permit recovery of payments for a non-network solution that was proven to be more economic than the approved contingent project.<sup>12</sup>

### **Commission's consideration and reasoning**

TransGrid's current regulatory period commenced on 1 July 2004.<sup>13</sup> In the absence of the current Review of Transmission Revenue and Pricing Rules, TransGrid would have been exposed to a level of regulatory risk because the Rules do not allow the regulator to bind the decisions of a future regulator. This creates the risk for TransGrid that the AER may not allow it to recover its incurred contingent project expenditure.

The Review of Transmission Revenue and Pricing Rules has created an additional level of uncertainty for TransGrid should new Transmission Revenue Rules not allow for contingent project cost recovery in the next revenue reset. The new Transmission Revenue Rules are expected to commence on 1 January 2007. While the Commission has sought to address this uncertainty by coordinating the release of this final Rule

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<sup>10</sup> TransGrid, Rule change proposal, 16 September 2005, p.2

<sup>11</sup> AER submission, 6 February 2006, p.3

<sup>12</sup> Wambo Power Ventures submission, 3 March 2006, p.1

<sup>13</sup> ACCC, NSW and ACT Transmission Network Revenue Cap TransGrid 2004-05 to 2008-09, 27 April 2005, p.8

determination with the Transmission Revenue draft determination, the review process is still on a step behind the derogation process.

TransGrid's initial submission to the Commission implied that a contingent project was "likely" to be triggered in late 2005.<sup>14</sup> The Commission is concerned with ensuring regulatory certainty to facilitate necessary investment in the transmission network. The ACCC TransGrid Determination set aside over \$700 million of capital expenditure for contingent project and the Commission believes that it is appropriate that the level of certainty created by this is retained in spite of the uncertainty created by the Review of Transmission Revenue and Pricing Rules.

The Commission is of the view that, in the absence of a derogation, the increased uncertainty created by the requirement for delayed recovery of contingent project expenditure (for TransGrid) and the ongoing Review of Transmission Revenue and Pricing Rules produces a level of regulatory risk that may inhibit or delay investment decisions. Consequently, the Commission has adopted the position that it is appropriate for the proposed Rule change to proceed, but that it should be aligned as closely as possible with the work undertaken as part of the Review of the Transmission Revenue and Pricing Rules, and should implement an approach to contingent projects for TransGrid that reflects that adopted in the Transmission Revenue draft determination.

### **5.3 Implementation of the ACCC's Determination**

#### **TransGrid's view**

With respect to contingent projects, TransGrid is seeking a derogation to give effect to certain aspects of the regulatory framework the ACCC sought to establish:

*"...the Final Decision identified a particular limitation of 6.2.4 of the Rules, and more generally the Rules governing the setting of the TNSP revenue caps, that prevents the full and proper achievement of the arrangements sought to be implemented by the determination."<sup>15</sup>*

#### **Submissions**

The AER's first round submission suggested that an amendment to the Rules is needed to ensure that contingent projects are provided for as intended by the SRP. The AER considers that this will address TransGrid's risk concerns. In its submission to the draft Rule determination, the AER expressed concern that the Commission was subverting the ACCC's original revenue determination for TransGrid through the decision to reduce the power of the incentive mechanism and implement what the AER considered to be a cost of service capital expenditure regime.

TransGrid does not support the incentive mechanism - as proposed by the AER and in the ACCC TransGrid determination - extending beyond the current regulatory period, as this would involve the AER making intra regulatory period decisions.<sup>16</sup>

#### **Commission's consideration and reasoning**

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<sup>14</sup> TransGrid's second submission (dated 19 April 2006) states that a project may be triggered in late 2006.

<sup>15</sup> TransGrid, Rule change proposal, 16 September 2005, p.2

<sup>16</sup> TransGrid submission, 19 April 2006, p.2

In TransGrid's final decision the ACCC stated that:

*"The revenue cap cannot be adjusted during the regulatory control period as a result of the ACCC's approval of the contingent project. In the absence of a Code change to permit this to occur, the ACCC's decision will be implemented at the re-set of the revenue cap..."<sup>17</sup>*

In the SRP the ACCC recommended that the Rules be changed to allow for the revenue cap to be reopened to fund contingent projects.

*"An amendment to the code which allowed a reopening of the revenue cap to deal with excluded investment would permit the necessary adjustments to be made during the regulatory period. The ACCC considers that there is a strong case to amend the code, as it would provide absolute certainty to TNSP's as to the treatment of excluded projects."<sup>18</sup>*

The Commission considers that these statements in the ACCC determination and the SRP provide a clear indication that the TransGrid Final Decision would have allowed for revenue cap reopening for approved contingent projects if it were not for clause 6.2.4 of the Rules. The ACCC took this approach in developing the relevant provisions of the SRP and the AER took a similar view in its submission to the AEMC's Review of Transmission Revenue and Pricing Rules.<sup>19</sup>

The draft determination attempted to curtail the carry over effects of the ACCC determination so that the Transmission Revenue Rules could be implemented without additional complex transitional provisions. In doing this the ACCC incentive mechanism was reduced, as noted by the AER in its submission, but only to the extent that contingent project capital expenditure extended into the next regulatory period.

As a result of further work undertaken on the review of Transmission Revenue and Pricing, the Commission now considers that a contingent project regime should be included in the draft Rules for Transmission Revenue. This regime includes a higher powered incentive mechanism for projects that traverse two regulatory periods than what was proposed by TransGrid and in the Commission's draft determination. Thus, the need to curtail the regime applying to TransGrid is not as relevant and the concerns raised by the AER have, to a large extent, been addressed. Where possible, and without compromising the ACCC's decision for TransGrid, the Commission has applied the contingent project regime contained in the draft Transmission Revenue Rules to TransGrid in this Rule change.

## **5.4 Expiry date of the derogation**

### **TransGrid's view**

Under TransGrid's proposal, the expiry date for the derogation is 1 July 2009 unless the AER has not set the next revenue cap by then, in which case the derogation expires when the AER sets the next revenue cap.

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<sup>17</sup> ACCC, NSW and ACT Transmission Network Revenue Cap TransGrid 2004-05 to 2008-09, 27 April 2005, p.212

<sup>18</sup> ACCC, Statement of Principles for the Regulation of Electricity Transmission Revenues - Background Paper, 8 December 2004, p.143

<sup>19</sup> AER, Submission to AEMC Revenue Issues Paper, p.9

## **Submissions**

In its submission responding to the Commission's draft determination, TransGrid proposed an alternative expiry date for the derogation of 30 June 2011 or when the new Transmission Revenue Rules come into effect, depending on which event occurs first. The AER included an expiry date of 30 June 2014 in the proposed drafting included as part of its submission responding to the draft determination in order to comply with its proposed incentive period.

TransGrid's response to the AER's submission argued that an expiry date of 30 June 2009 was necessary in order to ensure that the derogation is linked directly to the expiry of the current revenue cap framework, enabling the transition to the new Rules for Transmission Revenue.

## **Commission's consideration and reasoning**

The conditional expiry date initially proposed by TransGrid and its subsequent request is inconsistent with the requirements of the NEL. Section 103 (4) NEL requires a derogation to specify an expiry date. The Commission's advice indicates that TransGrid's derogation must specify an expiry date. In the draft determination the Commission amended TransGrid's proposed Rule by replacing the conditional expiry date with 30 June 2009, which coincides with the current TransGrid regulatory control period. This date has been maintained in the final Rule.

## **5.5 Efficient Capital Expenditure on Contingent Projects and Incentives**

### **TransGrid's view**

The efficient capital costs of a contingent project incurred in each financial year are to be added to TransGrid's RAB at the end of that financial year.

### **Submissions**

The AER expressed the view that the derogation proposed by TransGrid adopts a "cost of service" approach to regulation and is not consistent with the incentive regulation elements of the AER's approach. The AER's submission to the draft determination stated that the Rule should be amended to ensure a five year incentive period.<sup>20</sup>

TransGrid does not support the extension of incentive mechanism beyond the current regulatory period, as proposed by the AER and embodied in the ACCC TransGrid Determination<sup>21</sup> In TransGrid's view, regulatory efficiency is served by the avoidance of additional "incentive periods" outside of the main regulatory period.<sup>22</sup>

### **Commission's consideration and reasoning**

The AER's SRP states that the aim of the incentive based regime is to provide TNSP's with incentives to operate efficiently and undertake required investment. It allows TNSP's to retain any revenue returns associated with the difference between forecast and actual capital expenditure during a regulatory period. It also provides for the recovery of the cost of undertaking approved contingent projects and the application of an incentive

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<sup>20</sup> AER submission, 6 February 2006, p.1

<sup>21</sup> TransGrid submission, 19 April 2006, p.2

<sup>22</sup> TransGrid, submission 19 April, 2006, p.1

regime to such projects. Contingent projects were introduced to account for uncertain projects that become necessary if certain pre-defined triggers were met.

The Rule to be made allows TransGrid to recover the revenue associated with the forecast capital expenditure of approved contingent projects in the year following the investment, consistent with the intention of the SRP. An "approved contingent project" refers to a project approved by the ACCC and identified in Appendix F of TransGrid's current revenue cap determination.

The AER's initial concerns related to TransGrid's use of the phrase "efficient" capital expenditure in its proposed derogation without providing a definition for the term. To overcome any potential ambiguity, the Commission defined "efficient capital costs" in the draft determination as "the amount of capital expenditure for a contingent project that the AER will include in the RAB in accordance with Section F of TransGrid's Final Decision." The AER interpreted this to mean that the RAB would only be adjusted for efficient capital costs determined on an ex-post basis.

To avoid further confusion, and in the interests of minimising the introduction of new terminologies, the Commission has now decided to remove any reference to "efficient capital cost" or "target capital expenditure". The final Rule now refers to the "*forecast capital expenditure for that contingent project for each remaining regulatory year of the current regulatory period.*" This forecast capital expenditure, which is recovered in each year of the contingent project, is used to derive the target revenue for the contingent project in the current regulatory period. This forecast capital expenditure is determined by the AER once a trigger event has been identified and represents what the AER considers to be efficient capital costs in accordance with Appendix F of the Determination.

Under the final Rule, TransGrid will be allowed to recover the return of and on capital attributed to the forecast capital expenditure for that contingent project in the current regulatory period. Any amendment to TransGrid's revenue cap determination will only apply to the remainder of the current regulatory period. Contingent projects that extend beyond the current regulatory period (and consequently beyond the expiry of the derogation) will be treated in accordance with the new Transmission Revenue Rules, which are due to come into effect from 1 January 2007.

## **5.6 Treatment of Contingent Projects in Next Regulatory Period**

### **TransGrid's view**

TransGrid has proposed that in setting the revenue cap for the future regulatory period, the AER must treat any contingent project that has commenced in the current regulatory period as a "non-contingent" project at the next revenue reset.

### **Submissions**

The AER's response to the draft Rule recommended the adoption of a five year "incentive period" for a contingent project that carries into and (possibly) beyond the next regulatory period. At the end this incentive period, the written down value of the actual expenditure on the project would be rolled into TransGrid's asset base.<sup>23</sup> TransGrid's response to the AER submission indicated a preference for the approach adopted in the

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<sup>23</sup> AER submission, 6 February 2006, p.2

draft Rule, which limits the duration of any incentive period to the end of the current regulatory period and treats expenditure on the contingent project incurred in the current period in the same way as capital expenditure incurred under the *ex ante* expenditure cap at the commencement of the next regulatory period.<sup>24</sup>

### **Commission's consideration and reasoning**

Under TransGrid's proposed derogation, efficient capital expenditure on a contingent project incurred in each year of the current regulatory period is added to the RAB at the end of that financial year. The applicable return of and on capital are calculated based on these additions to the RAB and this is added to the Maximum Allowed Revenue (MAR) for that financial year.

Clause 8A.1.3(c) of TransGrid's proposed Rule limits the duration of any incentive period to the end of the current regulatory period. Under this proposed Rule, at the commencement of the next revenue reset, contingent project expenditure (incurred in the current period) is to be treated in the same way as capital expenditure incurred under the *ex ante* expenditure cap. Discussions with TransGrid (and a later submission) indicated that it does not want the incentive period to continue into the next regulatory period and is prepared to have the future treatment of contingent project expenditure incurred in the current period determined by the Rules that result from the Review of Transmission Revenue and Pricing Rules.

At the time of the draft Rule determination, the Commission considered the limitation of the incentive mechanism to within each regulatory control period to be appropriate. This limitation removed uncertainty surrounding investment in contingent projects and avoided the potential complexity of having multiple contingent project incentive periods running concurrently within the next revenue period.

The Commission also saw benefit in not binding the AER or the TNSP to existing regulatory arrangements beyond the current regulatory period in a context where changed Rules were likely to be in force following the Review of Transmission Revenue and Pricing Rules.

Since the Draft Determination the Commission's view on contingent projects has changed and a contingent project regime is now included in the draft Rules for Transmission Revenue. The Commission has decided to apply the relevant parts of the draft Transmission Revenue Rules to TransGrid as the Commission believes it better reflects the intent of the ACCC determination, that it has an adequate incentive mechanism and aligns TransGrid more closely with the new revised Transmission Revenue Rules.

Under the draft Rules for Transmission Revenue, the depreciated actual expenditure in the current regulatory control period will be rolled into its opening RAB for the following regulatory control period. However, for contingent project that extend beyond the current regulatory period, any excess of forecast capital expenditure for the whole contingent project over actual capital expenditure in the current regulatory period will be applied to the *ex ante* capital expenditure allowance in the next regulatory period.

The treatment of forecast capital expenditure for contingent projects in the next regulatory control period is not subject to this derogation. Instead, the new Rules for

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<sup>24</sup> TransGrid submission, 19 April 2006, p.2



Transmission Revenue will apply to all aspects of TransGrid's next revenue cap determination, including contingent projects. The Commission will ensure that appropriate savings and transitional provisions will apply in respect of TransGrid so that the proposed incentive mechanism will apply to any contingent project triggered in this regulatory control period and extending into the next.

The Commission considers that the approach adopted provides TransGrid with the revenue certainty was appropriate for the current regulatory period and addresses the concerns raised by the AER in respect of the incentive properties of the contingent project regime between regulatory periods.

## **Attachment 1: Rule to be Made**

Refer to the AEMC website [www.aemc.gov.au](http://www.aemc.gov.au). See "Final Rule as Made" document under **Current Rule Changes - Treatment of contingent projects under current TransGrid revenue determination**