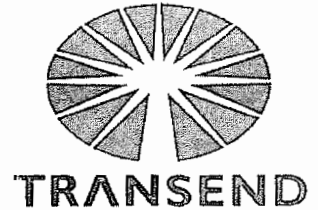


Our Ref: D05/44917



15 November 2005

Ms Michelle Groves
Chief Executive Officer
Australian Energy Regulator
GPO Box 520
MELBOURNE Vic 3001

Dear Michelle

REGULATORY ACCOUNTING METHODOLOGIES

As you may be aware Transend was a party to a joint submission by transmission network owners (TNOs) together with ElectraNet, Powerlink Queensland, and SP AusNet in response to the AER's Regulatory Accounting Methodologies Position Paper.

We appreciated the opportunity subsequently provided by staff from your office to meet with TNO representatives from ElectraNet, Powerlink and SP AusNet on 21 October 2005, to discuss in detail issues raised in the submission.

TNO position

In summary, the TNO position as outlined in the submission was that the TNOs could support the as-incurred framework provided that:

- the AER's Post Tax Revenue Model (PTRM), information requirements and regulatory accounts are implemented or amended to appropriately accommodate this approach;
- work in progress (WIP) is not depreciated; and
- the approach does not apply until the next revenue cap decision.

In regard to WIP, the submission noted the following:

The key change required for the approach to be practical is to allow the introduction of a Work in Progress (WIP) asset category, which would not be depreciated. In the absence of allowing such a modification, all TNOs using the as-commissioned approach are currently incapable of generating the information that would be required for regulatory reporting by the as-incurred approach.

We understand that the issue of a depreciating WIP category was raised by a number of parties in their submissions.

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AER preliminary position

Based on the outcomes of the meeting with your staff we understand that the AER maintains the view that under the as-incurred approach the WIP asset class included in the regulatory asset base should be depreciated (ie depreciation would commence prior to the asset actually being put into service).

This proposed approach is of serious concern to Transend.

As noted in the submission, under the as-incurred approach, actual expenditure by asset category is not necessarily known at the time the expenditure is incurred, as the final assets and the appropriate basis for allocation of general expenditure are not explicitly identifiable at that time (ie not until the time of commissioning).

The submission went on to note that, if a depreciable WIP asset category was implemented, then some form of estimating or forecasting per project would be necessary, which would impose the associated administrative burden of periodically correcting previous estimation and forecasting errors.

Based on feedback from the meeting with your staff, Transend understands that the AER appears to have discounted this argument on the basis that:

1. the Regulator is not interested in precision in relation to allocating WIP to asset classes and accepts that the actual allocation may be different to that estimated, but not expected to be material; and
2. the AER considers depreciating WIP is required by the Statement of Regulatory Principles (SRP).

Transend's response to each of these points is addressed below.

Issues with allocation of WIP to asset classes and depreciating WIP

While the AER may not be concerned that actual and estimated allocations to WIP classes may differ, *the requirement to make the allocation at all* imposes new administrative and compliance obligations on the TNOs, which should be carefully considered by the AER.

In relation to depreciation, Australian Accounting Standards (*AASB 116, Property, Plant and Equipment*), clause 55 states (in part):

Depreciation of an asset begins when it is available for use, that is, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

It is clear that the implementation of a depreciable WIP asset class (whereby depreciation commences before the asset is in use), is inconsistent with Australian Accounting Standards. This approach also contradicts the logical notion that an asset does not suffer the effects of wear and tear (ie depreciate) until it is actually used.

An arbitrary allocation of WIP to asset classes, for the purpose of calculating regulatory depreciation prior to commissioning, would necessitate modified information systems, asset creation processes and reconciliations. It would also necessitate the imposition of unique regulatory audit requirements (and associated cost increases) due to the methodology being totally at odds with accepted accounting practices. TNOs would seek for these additional compliance costs to be recovered from transmission customers.

Alignment with the SRP

The AER has not provided any information to demonstrate that the SRP requires a depreciating WIP class (or requires a WIP class at all). Mr Sebastian Roberts of the AER has previously assured TNOs that the SRP can be applied to both the as-commissioned or as-incurred approach to capitalisation. The as-commissioned approach does not incorporate an explicit WIP asset class in the revenue calculations, let alone a depreciating WIP class.

In any case, the AER must consider whether SRP incentives associated with depreciating WIP under the as-incurred approach are sufficiently powerful to necessitate the additional administrative and compliance burden.

Conclusion

As the TNO submission noted, there are a number of TNO concerns associated with the adoption of an as-incurred approach. However, Transend is of the view that the inclusion of a depreciating WIP asset class is entirely inappropriate under the proposed methodology because:

- it is totally inconsistent with Australian Accounting Standards and would impose an additional administrative and compliance burden on the TNOs and ultimately customers; and
- any benefits under the regulatory regime are considered unlikely to outweigh the additional costs.

Transend requests that the AER carefully consider this submission before finalising its position on this matter. Should you wish to discuss this issue further please contact Bess Clark, Manager Business Planning, Regulation and Compliance on 03 6274 3909.

Yours sincerely



Richard Bevan
Chief Executive Officer

cc Steve Edwell
Sebastian Roberts