AUSTRALIAN ENERGY REGULATOR

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15 November 2007

Mr Kevin Murray
Managing Director
TransGrid
PO Box A1000
Sydney South NSW 1235

Dear Mr Murray

**EnergyAustralia revenue cap — request for revocation and substitution**

The Australian Energy Regulator (AER) has received a request from EnergyAustralia dated 11 May 2007 for the revocation and substitution of its revenue cap under the *National Electricity Rules*. EnergyAustralia's revenue cap for the regulatory control period 2004/05 to 2008/09 was set under the former *National Electricity Code* by the Australian Competition and Consumer Commission (ACCC) on 27 April 2005.

Pursuant to the *National Electricity (South Australia) Regulations* (Sch 2, clause 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.

EnergyAustralia seeks the revocation and substitution on a series of grounds, each of which relate to the determination of its cost of debt. The application cites the AER's decision to revoke and substitute TransGrid's 2004/05 to 2008/09 revenue cap. The grounds are discussed below.

The laws that apply to EnergyAustralia's request are clauses 6.2.4(d) and 6.2.4(e) of the Rules, as in force prior to 16 November 2006. On this date a new Chapter 6A was inserted into the Rules to govern transmission network regulation. Consequential changes were made to Chapter 6 (including clause 6.2.4) which now applies only to distribution network regulation. However, clause 11.6.2(a) provides that the old Chapter 6 continues to apply to an existing transmission revenue cap determination and Chapter 6A has no effect. This means that EnergyAustralia's request must be considered under clause 6.2.4 of the Rules as they applied prior to 16 November 2006.

Clause 6.2.4 of the Rules empowered the AER, in limited circumstances, to revoke a revenue cap and substitute a new revenue cap for the remainder of a regulatory control period. Clause 6.2.4(d) relevantly stated:

> "(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:
>
> (1) the revenue cap was set on the basis of false or materially misleading information provided to the ACCC;
>
> (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;*"

***Background***

EnergyAustralia's request to re-open its revenue cap follows a similar request that was made by TransGrid in November 2006 and approved by the AER in February 2007. TransGrid argued that there was a material error in setting its revenue cap due to the ACCC's failure to take into account submissions that were made by TransGrid relating to the use of data from the CBASpectrum service to determine its cost of debt. On 7 February 2007, the AER decided that this was a material error within the meaning of clause 6.2.4(d)(2). The AER found that the decision to use data from CBASpectrum was not an error in and of itself. However, the AER found that there was an error of law resulting from the process by which TransGrid's revenue cap was determined, and that this error justified the revocation and substitution of TransGrid's revenue cap. The AER's decision relating to TransGrid can be found on the AER's web site.[1]

***Grounds identified by EnergyAustralia***

EnergyAustralia's request of 11 May 2007 identifies several grounds which, in its submission, justify the revocation and substitution of its revenue cap. In particular, that there was a material error, within the meaning of cl 6.2.4(d)(2), resulting from:

(a) the ACCC's decision to use of CBASpectrum;

(b) the ACCC's process in determining EnergyAustralia's debt margin.

In relation to the first ground, EnergyAustralia submits that the use of data from CBASpectrum was a material error as its use did not conform to the requirements of the *National Electricity Code.*

In relation to the second ground, EnergyAustralia submits that there was a material error because the ACCC failed to have regard to relevant material in determining its cost of debt, namely, TransGrid's submissions on the use of CBASpectrum. TransGrid's submissions outlined concerns in relation to the use of data from the CBASpectrum service in order to

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[1] http://www.aer.gov.au/content/index.phtml/itemId/709219/fromItemId/660355

determine the appropriate debt margin. EnergyAustralia argues that these submissions were relevant to setting its revenue cap as well and should have been considered in this context.

EnergyAustralia submits that, due to the use of CBASpectrum data to establish its debt margin, its revenue cap is affected by a shortfall in its MAR in each year of the current regulatory control period, resulting in a total shortfall over the regulatory control period of $6.93 million ($nominal).

***Method of correction***

Given that EnergyAustralia's prices for the first three years of the current regulatory control period had already been set (when the initial letter seeking revocation and substitution was written), EnergyAustralia submitted 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 EnergyAustralia.

As the fourth year of EnergyAustralia's regulatory control period has commenced, any adjustment can only be made to the final year covered by the revenue cap determination. This would be achieved by changing the current X-factor (used for the indexation or EnergyAustralia's MAR) from -5.40% to -11.29%. This adjustment will result in an increase in EnergyAustralia's MAR for the final year 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 as a result of the ACCC's failure to take TransGrid's submissions into account in setting EnergyAustralia's revenue cap. 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. While submissions made in relation to one party are not necessarily relevant to a revenue cap set for another, the AER considers that, in the particular circumstances of this case, the debt margins for TransGrid and EnergyAustralia were effectively set through a single process. Accordingly, the AER considers that TransGrid's submissions were relevant to the determination of EnergyAustralia's debt margin. The AER's current view is that the failure to have regard to TransGrid's submissions in setting EnergyAustralia's revenue cap was a material error for the purposes of clause 6.2.4(d)(2) of the Code.

As was the case in relation to TransGrid's revenue cap the AER believes that TransGrid's submissions would have justified the conclusion that a better estimate of EnergyAustralia's debt margin would be achieved using data from the Bloomberg service rather than the CBASpectrum service. The AER therefore considers it appropriate that EnergyAustralia'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 EnergyAustralia'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 EnergyAustralia's MAR for each year of the regulatory control period. The AER is also of the view that it would be appropriate for EnergyAustralia to recover this shortfall over the final year 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 -5.40% to -11.29%.

The AER does not consider that the use of CBASpectrum data in setting EnergyAustralia's revenue cap was, in and of itself, an error within the meaning of clause 6.2.4(d)(2). EnergyAustralia has also identified, on a confidential basis, a third ground for the revocation and substitution of its revenue cap. However, the AER does not consider that there is any basis to re-open EnergyAustralia's revenue cap under this confidential ground.

***Process***

Under clause 6.2.4(d)(2) of the Rules, it is necessary to obtain the written consent of affected parties before a revenue cap may be revoked for a material error. EnergyAustralia has identified the parties that it considers may be affected parties for the purposes of clause 6.2.4(d)(2). These parties are Country Energy and TransGrid.

The AER is writing to each of these parties to ask:

1. whether you consider that you are a party affected by the re-opening of EnergyAustralia's revenue cap for the purposes of clause 6.2.4(d)(2); and

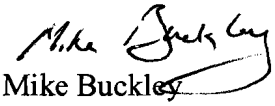
2. if so, whether you consent to the re-opening of EnergyAustralia's revenue cap in the manner proposed above?

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 EnergyAustralia'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 29 November 2007.

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

Yours sincerely



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