



**Draft decision: SP AusNet transmission
determination 2008-14**

Pre-determination conference

11 September 2007

Steve Edwell

Process - submission to draft

28 February 2007	SP AusNet submits proposal
30 March 2007	Determination of non-compliance and request for further information
30 April 2007	SP AusNet submits additional information and public consultation commences
13 June 2007	Submissions on proposal close
14 June 2007	SP AusNet submits NERA papers
22 June 2007	AER publishes proposed NTSC
3 August 2007	Submissions on NERA papers and NTSC close
31 August 2007	Draft decision released
11 September 2007	Pre-determination conference and commencement of public consultation on draft decision

Decision making under chapter 6A

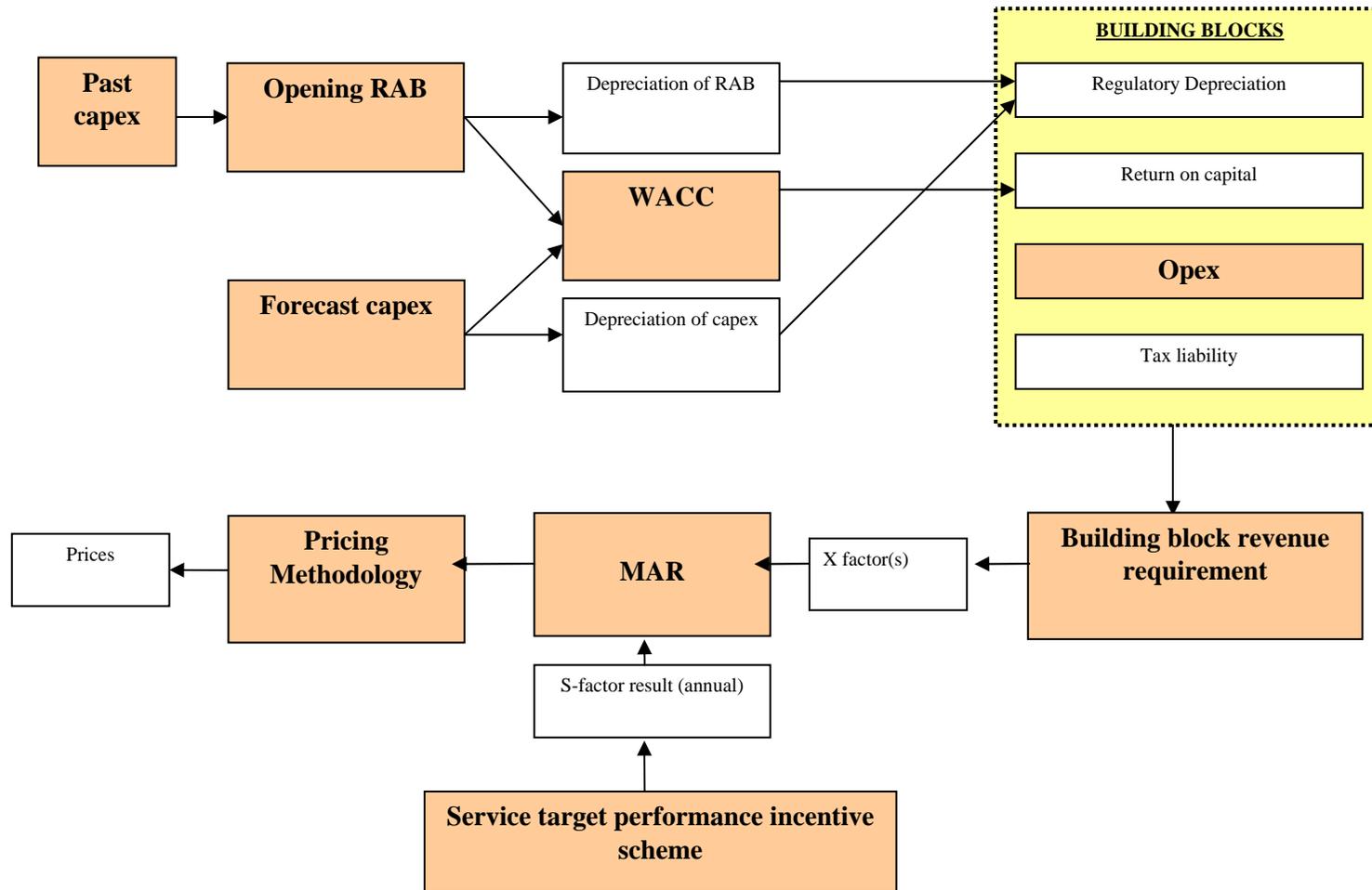
- Onus on TNSP to provide **fully supported** proposal that meets NER requirements
- If satisfied that proposal is compliant, the AER **must** approve the proposal
- If not satisfied that proposal is compliant, the AER **must not** approve the proposal, and **must** adjust or revise to achieve compliance
- Prescribed considerations and decision-making process to guide and assist the AER in assessing a TNSP's proposal, **and** a TNSP in developing its proposal

Components of transmission determination

A transmission determination under Chapter 6A has four elements:

- For prescribed services:
 - A **revenue determination** for the provider in respect of the provision by the provider of prescribed transmission services;
 - A determination that specifies the **pricing methodology** that applies to the provider
- For negotiated services:
 - A determination relating to the provider's **negotiating framework**
 - a determination that specifies the **negotiated transmission service criteria** that apply to the provider

Draft revenue determination



Draft revenue determination – past capex

- *SP AusNet proposed to include \$478.5m of past capex in its opening RAB for the forthcoming period.*
- *This figure represents an overspend of \$88.1m from the ACCC's 2002 decision.*
- *Despite identifying several concerns regarding the level of project documentation, the AER considered the vast majority of SP AusNet's past capex to be prudent and efficient.*

	Total
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<i>SP AusNet's Proposal</i>	
Net capex	455.4
Work-in-progress	23.2
Total proposed capex	478.5
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<i>AER's adjustments</i>	
Adjustment - RCTS	-0.43
Adjustment - non-network	-1.34
Total adjustments	-1.77
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<i>AER's conclusions</i>	
Net capex	453.63
Work-in-progress	23.21
AER's conclusion	476.84
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Draft revenue determination - RAB

RAB as at 1 April 2008 (\$m, nominal)

Year (1 April to 31 March)	1 Jan to 31 Mar 2003	2003-04	2004-05	2005-06	2006-07	2007-08
“Locked in” RAB	1,835.60					
Adjustment for capex estimated for 1 Apr to 31 Dec 2002	-47.34					
Opening RAB	1,788.26	1,812.96	1,830.98	1,867.20	1,935.03	2,014.75
Indexation	13.25	43.72	48.92	53.85	63.46	52.09
Actual prudent net capex	29.56	51.67	69.05	100.26	107.98	114.07
Inflation adjusted depreciation	-18.11	-77.37	-81.76	-86.28	-91.72	-97.62
Closing RAB	1,812.96	1,830.98	1,867.20	1,935.03	2,014.75	2,083.29
Roll in of non-contestable assets						115.85
Add compounded return on prudent overspend						8.17
Removal of benefit associated with estimated capex adjustment						-27.06
Work in progress						23.21
Opening RAB 1 April 2008						2,203.45

Draft revenue determination - RAB

SP AusNet proposal

- Uses locked in RAB of \$1, 835.6m
- Less difference between actual and forecast capex for 9 months to 31 December 2002
- Retain benefit of this difference (~\$27m)
- Net prudent capex of \$474.3m
- Non-contestable assets of \$118.0m
- **Closing RAB in March 2008 of \$2,222.9m**

AER draft decision

- Removes benefit of capex overestimate, consistent with NER and AER's undertakings to SP AusNet (\$27m reduction)
- Adds return on prudent overspend (\$8m increase)
- Review of non-contestable assets (\$2.1m reduction)
- **Closing RAB in March 2008 of \$2,203.5m**
- **0.9% less than SP AusNet's proposed value**

Draft revenue determination – forecast capex

AER draft decision:

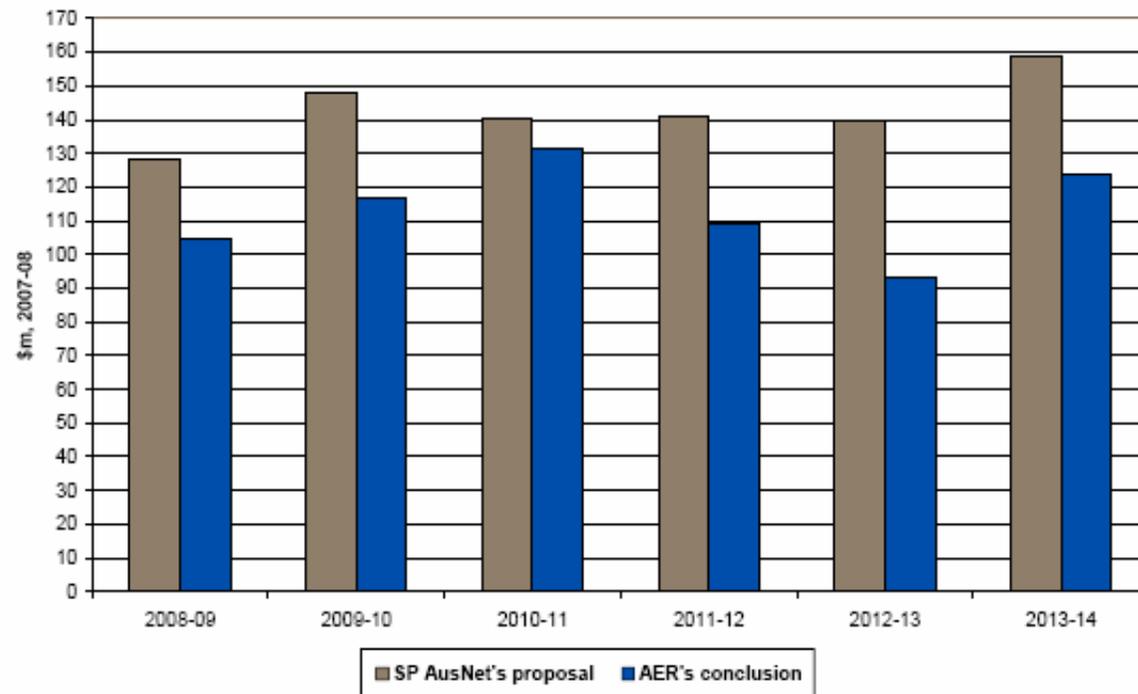
- approved forecast capex allowance of **\$679.0m** (as incurred, \$2007-08)
- *In nominal terms, approved forecast capex allowance of \$732.5m (as-com, \$nominal), a **59% increase** compared to the AER's approved prudent past capex).*

	Total (\$m)
SP AusNet's proposal	855.26
<i>AER's adjustments</i>	
Project-specific adjustments	-169.53
Labour & materials escalations	-6.70
AER's total adjustment	-176.23
AER's draft decision	679.04

Draft revenue determination – forecast capex

AER draft decision:

- *Reduction of \$176.2m, representing around 21% of SP AusNet's proposal of \$855.26m*



Draft revenue determination – forecast capex

- ***AER's reductions as a result of PB's detailed sample project review: \$104.3m***
 - *sample of six forecast capex projects selected, with a value representing around 28% of SP AusNet's total proposed forecast capex allowance*
 - *detailed discussions over a number of weeks between PB, SP AusNet and the AER*
- ***Key themes***
 - *quantitative asset failure risk models a key driver of replacement program*
 - *early replacement of assets*
 - *lack of a clear economic and risk-based justification*
 - *overscoping*

Draft revenue determination – forecast capex

- **Extension of findings** from PB's review to balance of forecast capex allowance: AER's reductions **\$42.9m**
 - Drew on the information provided in detailed discussions between AER, SP & PB
 - Areas of proposal subject to targeted review by the AER
 - Targeted replacement programs: strategic 'threshold' asset failure risk level a key driver
 - Station rebuild / refurbishment projects: trade-off between deferral of upfront capex on less risky elements on one hand, and capture of efficiencies in a single station project on the other
- **Key themes:**
 - At a strategic level, SP AusNet's replacement capex proposal is excessive in terms of addressing genuine asset failure risks on its network
 - SP AusNet has not demonstrated that elements of its proposed expenditure reasonably reflect prudent and efficient capex in accordance with the NER

Draft revenue determination – forecast capex

- *AER's other reductions resulting from a review of SP AusNet's **cost accumulation process: \$28.4m***
 - *removal of general contingency allowance: SP AusNet has not demonstrated that its proposed allowance reasonably reflects capex objectives in the NER (\$21.8m)*
 - *adjustment to real labour and materials cost escalations: based on the data in the SKM report, it cannot be said that the proposed escalations reflect a reasonable estimate of the cost inputs required to meet the capex objectives in the NER over the period (\$6.7m)*

Draft revenue determination - WACC

$$WACC = (r_f \times 1 \times 0.06) \times 0.4 + (r_f + DRP) \times 0.6$$

Value or methodology prescribed in NER for each WACC parameter

- Equity beta = 1, MRP = 6%, etc*
- limited discretion for SP AusNet and AER*

WACC for purposes of draft decision

- 8.85%*

Draft revenue determination - WACC

Nominal risk-free rate

SP AusNet – proposes NERA adjustment

AER – methodology prescribed / NERA adjustment not allowed

Debt risk premium (DRP)

Data source

SP AusNet – Bloomberg / adjusted CBA Spectrum hybrid approach

Data source

AER – Bloomberg

Sampling period

SP AusNet – historical (Oct/Nov 2006)

Sampling period

AER – same dates as risk free rate (confidential)

Draft revenue determination - WACC

Inflation

SP AusNet – proposes difference b/w nominal and indexed government bonds (ie. Fisher equation) with NERA adjustment

Leads to inflation forecast of 3.08% at 31 August 2007

AER – accept that Fisher equation may not lead to best estimates at this time

AER – consider NERA adjustment not likely to lead to best estimates

AER – consider a general approach, having regard to a number of inflation indicators, then selecting between 2% , 2.5% or 3% is best approach

Leads to inflation forecast of 3.00% at 31 August 2007

Draft revenue determination - opex

AER draft decision:

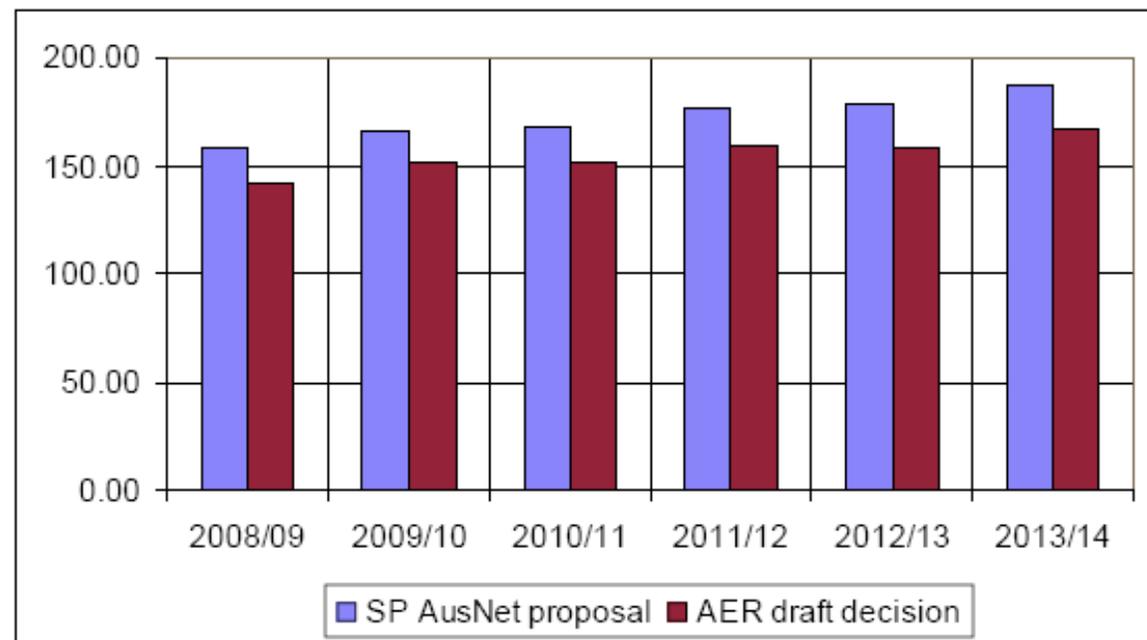
- Approved forecast opex allowance of \$929.5m (\$2007-08)

	SP AusNet's proposal	AER's adjustment	AER's conclusion
Asset works	90.26	-4.69	85.56
Routine maintenance	206.63	-11.67	194.96
Corporate	117.71	-15.19	102.52
Rolled in assets opex	11.40	-4.92	6.48
Inventory	-	+0.24	0.24
Controllable opex	426.00	-36.24	389.76
Self-insurance	15.24	-6.86	8.37
Equity raising costs	11.81	-11.81	0.0
Debt raising costs	10.30	-3.72	6.58
Rebates	40.13	-31.60	8.52
Easement land tax	530.85	-14.60	516.25
Other opex	608.34	-68.60	539.73
Total opex	1 034.34	-104.84	929.49

Draft revenue determination - opex

AER draft decision

- Reduction of \$104.84m, representing about 10% of SP AusNet's proposal of \$1,034.34m



Draft revenue determination - opex

Controllable opex

- **Routine maintenance**
 - SP AusNet – based on base year expenditure + labour escalator
 - AER – adjustment to take account of new NW contract (-\$6.8m total adj.)
 - AER – adjustment to take account of forward capex program (-\$2.4m total adj.)
- **Corporate**
 - SP AusNet – management fees based on base year expenditure + labour escalator
 - AER – consider contract with related party unlikely to be on arms length terms
 - AER – management fees allowance based on AER modelling (-\$15.2m total adj.)

Draft revenue determination - opex

Other opex

- **Availability Incentive Scheme (AIS) rebates**
 - SP AusNet – based on half annual cap (\$6.7m pa allowance)
 - AER – based on historical average (\$1.4m pa allowance)
- **Easement land tax**
 - SP AusNet – based on base year expenditure + 4% real land value escalator
 - AER – several adjustments made (total adj. -\$14.6m), including to make forecast compatible with easement tax pass-through mechanism

Draft revenue determination – service target performance incentive scheme (STPIS)

SP AusNet proposal

SP AusNet proposed reductions to its 7 existing targets

Asymmetric caps and collars

Total revenue at risk 1% of MAR, spread across all parameters

+ve weighting attached to loss of supply events for the first time

8 exclusions in addition to those set out in the scheme

AER draft decision

Increases to all of SP AusNet's proposed targets

Symmetrical caps and collars

Accepts all SP AusNet's proposed weightings

Of the 8 additional exclusions proposed, accepts 2, amends 1 and rejects 5

Draft revenue determination – (STPIS)

Measures	Collar	Target	Cap	Weighting
<i>Availability measures</i>	%	%	%	%MAR
Total circuit	98.41	98.73	99.05	0.20
Peak critical	98.76	99.53	99.92	0.20
Peak non-critical	98.95	99.53	99.81	0.05
Intermediate critical	97.71	99.09	99.78	0.025
Intermediate non-critical	97.94	99.10	99.68	0.025
<i>Loss of supply events</i>		No.		%MAR
>0.05 min per annum	9	6	3	0.125
>0.3 min per annum	4	1	0	0.125
<i>Average outage duration</i>		Minutes		%MAR
Lines	667	382	98	0.125
Transformers	556	412	268	0.125

Draft revenue determination - MAR

Building block calculation (\$m, nominal)

Year ending 31 March	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Return on capital	195.01	200.90	207.48	215.44	221.11	224.97
Economic depreciation	44.26	51.35	57.36	62.45	68.02	63.27
Opex (includes easement land tax)	146.37	160.62	165.06	179.19	183.25	200.20
Glide-path	8.65	7.12	5.50	3.78	1.95	0.00
Tax liability	13.61	14.22	14.72	14.93	15.26	14.21
AER Building block requirement	407.89	434.22	450.13	475.79	489.59	502.65
SP AusNet's proposal	428.70	455.10	480.70	505.30	529.50	541.90
Difference	-20.81	-20.88	-30.57	-29.51	-39.91	-39.25

Draft revenue determination - MAR

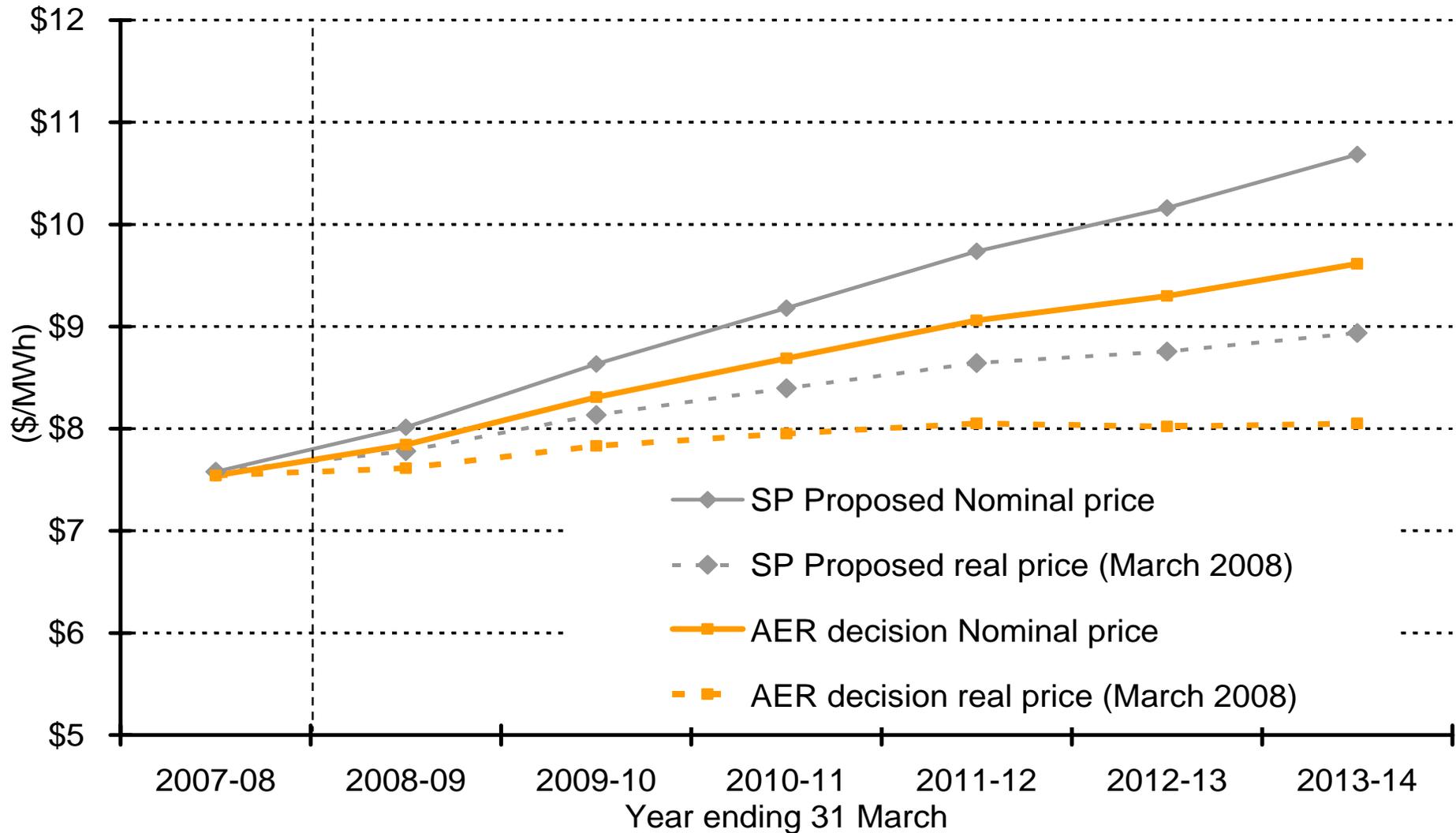
Key AER considerations:

- Minor adjustments to depreciation schedules (economic life of vehicles, non-contestable works)
- Reductions arising from changes to capex, opex and RAB calculations
- Average annual price increase of 4.2% nominal (1.1% real)

Building block calculation (\$m, nominal)

Year ending 31 March	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Building block requirement	407.89	434.22	450.13	475.79	489.59	502.65
Expected MAR	410.56	429.30	448.91	469.40	490.84	513.25
Difference	0.65%	-1.13%	-0.27%	-1.34%	0.26%	2.11%

Price impact

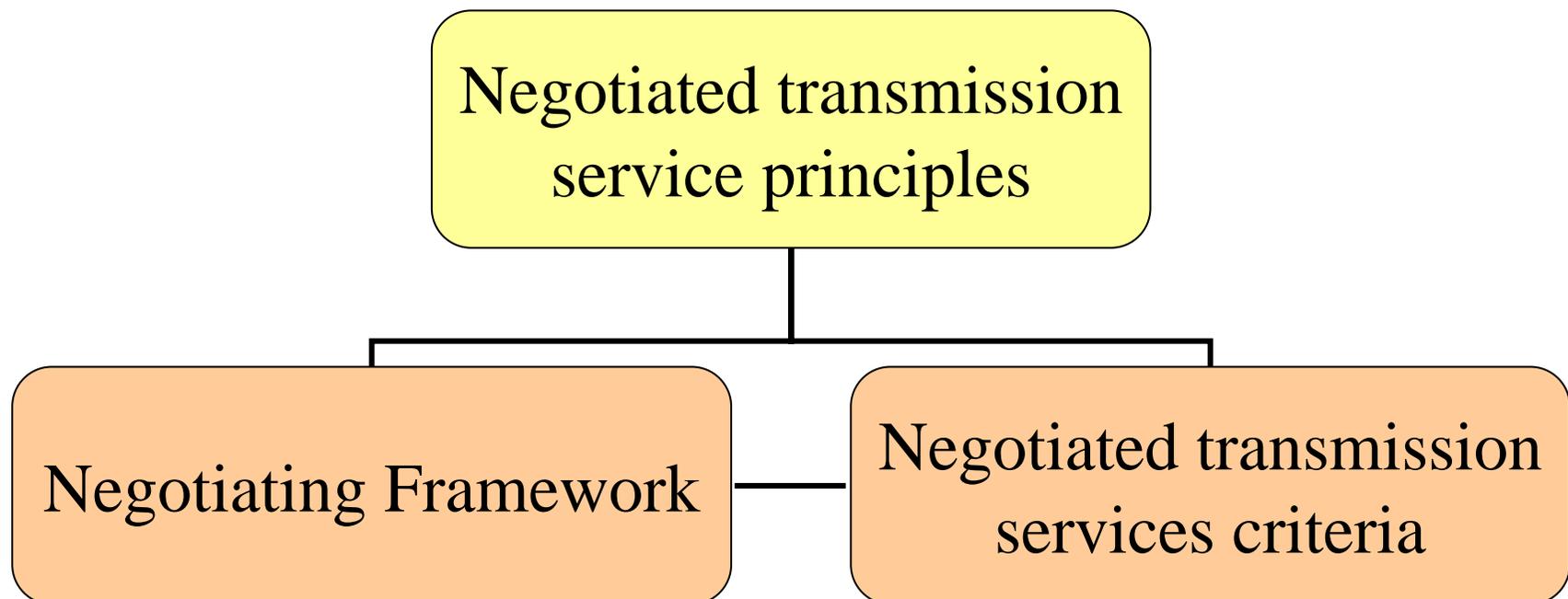


Draft determination – pricing methodology

- ***Applies to prescribed transmission services only***
 - *Allocates revenue requirement for prescribed transmission services to service categories and connection points*
 - *Determines structure of prices for each category of service*
- ***The AER's agreed interim requirements:***
 - *Methodology must be consistent with new part J of Chapter 6A, and*
 - *subject to above, must be consistent with part C (old NER)*
- ***AER's draft decision: SP AusNet's proposed pricing methodology is non-compliant in a number of respects:***
 - *allocation of assets to categories of prescribed services*
 - *lack of allocation methodology for new exit customers*
- ***Changes required to SP AusNet's proposal are limited to those necessary to achieve compliance***

Negotiated services

- *Designed to be light-handed - minimum prescription, reliance on commercial negotiation between able counter-parties*
- *Commercial arbitration available if necessary*



Draft determination – negotiating framework

- *Sets out the procedure to be followed by SP AusNet and a service applicant during negotiations for a negotiated transmission service.*
- *Framework must meet minimum requirements of cl. 6A.9.5*
- ***AER's draft decision:*** *SP AusNet's proposed negotiating framework is non-compliant in a number of respects:*
 - *purport to limit or alter the application of requirements in the NER.*
- ***Changes required to SP AusNet's proposal are limited to those necessary to achieve compliance***

Draft determination - NTSC

- *NTSC must be applied by SP AusNet in negotiating terms and conditions of access for service applicants, and by a commercial arbitrator in the event of a dispute*
- *The NTSC are determined by the AER:*
 - *They are the only component of the transmission determination that SP AusNet is not required to propose.*
 - *Must give effect to, and be consistent with, the negotiated transmission service principles*
- *NTSC for SP AusNet are designed to give effect to the principles, but not extend or alter their effect.*

Process – next steps

- | | |
|-------------------------|--|
| 12 October 2007 | SP AusNet may submit revised proposal |
| 14 November 2007 | Submissions on draft decision and revised proposal close |
| 31 January 2008 | AER final decision and transmission determination |
| 1 April 2008 | Transmission determination commences |

Questions?