



Appendix S

Easement Value Adjustment Submission to the AER



ElectraNet Transmission Network Revenue Cap 2008-09 to 2012-13

Easement Value Adjustment Submission to the AER

May 2007

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1. Executive Summary

ElectraNet requests that the Australian Energy Regulator (AER) revalue ElectraNet's easements in the context of its revenue cap determination for the 2008-09 to 2012-13 regulatory control period.

ElectraNet and its owners have held numerous discussions on this topic with the Australian Competition and Consumer Commission (ACCC) commencing prior to the privatisation sale of the assets through to the present time.

On the basis of the material presented by ElectraNet over the course of these discussions, the ACCC (Commissioner Ed Willett) wrote to ElectraNet on 3 August 2004 (copy attached) giving an undertaking that it (as regulator) would consider revaluation of ElectraNet's asset base at the next revenue reset (for the regulatory control period commencing 1 July 2008):

“...if ElectraNet was able to establish that such a step accords with the reasonable expectations of ElectraNet's investors”.

A savings and transitional provision in clause 11.6.13 of the National Electricity Rules (Rules) confers on the AER the power to consider an easement value adjustment for ElectraNet as the ACCC agreed to do by its letter dated 3 August 2004.

In addition to establishing the reasonable expectations of ElectraNet's investors, this submission also outlines the proposed methodology for determining an appropriate easement value adjustment, which is based on using a proxy historical cost consistent with the approaches previously adopted by the AER (and the ACCC).

On this basis, ElectraNet is seeking an easement value adjustment of \$80.8 million as at 30 June 2008. ElectraNet notes that this is a conservative value which is significantly lower than:

- The independent easement valuations that were made available to investors by the South Australian Government at the time of their investment decision; and
- The investor prepayment for the network land lease (including easement) of \$156.1 million.

2. Background

ElectraNet and its owners have held numerous discussions with the ACCC on the subject of future asset revaluation and in particular the revaluation of easements commencing prior to the privatisation sale of the assets through to the present time.

The following table sets out a summary of key events relevant to the consideration of ElectraNet's easement value adjustment.

Date	Event and its Significance
11 June 1999	The SA Parliament passes the Restructuring and Disposal Act, which permits the privatisation (by long term lease) of its electricity assets, including ElectraNet.

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Date	Event and its Significance
11 August 1999	<p>The South Australian Government Electricity Reform and Sale Unit states in a submission to the ACCC on 11 August 1999 that:</p> <p><i>“Easements have been included in the initial asset base at book value, since asset valuations consistent with the approach set out in the Draft Regulatory Principles have not yet been undertaken”</i></p> <p>ACCC consultants NERA reiterated this point in their October 1999 report on a review of the South Australian Electricity Pricing Order.</p>
30 August 1999	<p>Professor Fels, then Chairman of the ACCC, gives a speech to the “SA Power Lease Briefing”, in which he states...</p> <p><i>“The Commission is currently undertaking a public consultation process on the Draft Regulatory Principles and a conference on depreciation is scheduled for September. The Statement of Principles will be finalised shortly afterwards”.</i></p> <p><u>Significance:</u> The investors who acquired ElectraNet had a reasonable expectation that the draft regulatory principles for transmission would soon become the established regulatory principles. Those principles included valuations of easements. The speech was significant because:</p> <ul style="list-style-type: none"> (a) it was at an event targeted at potential investors in the South Australian assets; and (b) there was only one set of electricity transmission assets being privatised – ElectraNet.
25 January 2000	<p>ACCC publishes its revenue determination for TransGrid, the initial application of its (draft) regulatory principles. The determination contains three salient points for ElectraNet investors:</p> <ul style="list-style-type: none"> (a) the ACCC argued that the National Electricity Code did not allow it, at its initial determination for a TNSP, to vary the jurisdictional valuation of assets (b) the ACCC listed (section 1.2.2 p6 and p7) the principles which it would apply to determining future transmission revenues – including <i>“use of optimised depreciated replacement cost (ODRC) as a cap on the initial asset valuation as part of an optimised deprival assessment”</i> (c) a decision on easement values (p61 and 62) <i>“...the Commission considers it appropriate to include TransGrid’s existing easements in the regulated asset base at their historic purchase cost rolled-forward to 1 July 1999. In the absence of properly documented historic cost records, the Commission has used the values identified in the oldest available valuation as a proxy for those costs, being the ODRC value determined during the 1996 SKM valuation”</i> <p><u>Significance:</u> In undertaking their pre-acquisition due diligence on ElectraNet, the investors believed that the ACCC argument about being bound by the jurisdictional valuation in its first determination was challengeable, and in any event, that the ACCC would not be so constrained at subsequent revenue determinations, at which time it would apply its regulatory principles including asset revaluation.</p>

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Date	Event and its Significance
25 January 2000 (continued)	Further, the investors reasonably believed that the TransGrid easement valuation determined by the ACCC provided a benchmark and an approach against which an easement valuation for ElectraNet could be imputed.
April 2000	A consortium of investors is formed to bid for ElectraNet. The role of technical/ regulatory due diligence was undertaken primarily by Powerlink.
April 2000 to July 2000	<p>Investors undertake pre-acquisition due diligence on ElectraNet. During the due diligence process, the investors:</p> <ul style="list-style-type: none"> (a) identified anomalously low values for easements (b) based on the ACCC (draft) regulatory principles and the TransGrid decision, identified the expectation for items, including the value of easements, to be increased at a subsequent ACCC revenue determination for ElectraNet. <p>Investors, using easement values from TransGrid as a benchmark, and allowing for differences in real estate values, estimate an expected value for ElectraNet easements if the ACCC regulatory principles were applied.</p>
August 2000	Investors finalise their bid price including a separate prepayment for network land lease (including easements) of \$156.1m.
October 2000	Investor's bid is successful and sale finalised – network lease and network land lease are part of the sale documentation.
2001	ElectraNet commences discussions with the ACCC on revaluation of its easements in the context of its 2003 to 2007-08 revenue cap determination.
10 August 2001	<p>The SA Department of Treasury and Finance writes to the ACCC acknowledging that \$3.1m was included in the jurisdictional asset valuation for easements and that a proper valuation was not undertaken...</p> <p><i>“as asset valuations consistent with the approach set out in the ACCC’s draft Statement of Principles for the Regulation of Transmission Revenues dated 27 May 1999 had not been undertaken”.</i></p>
16 April 2002	ElectraNet submits its revenue cap application to the ACCC, which seeks adjustment to the jurisdictional asset value for easements (and IDC).
5 September 2002	<p>The SA Minister for Energy states in a letter to the ACCC...</p> <p><i>“It is recognised that there is a need to include a fair and reasonable value of the easements in the asset base... the South Australian Government proposes that the ACCC adopt an approach that discounts the easement values in Victoria for the difference in real estate values, and values easements in South Australia accordingly”.</i></p> <p>ElectraNet proposes an approach similar to this in response to the ACCC’s draft revenue cap decision.</p>

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Date	Event and its Significance
11 December 2002	<p>The ACCC releases its final revenue cap decision for ElectraNet. The final decision reiterates that the ACCC may have discretion to value easements according to the DRP as suggested by South Australian authorities and that it would only consider doing this on the basis of indexed historical costs.</p> <p>However, because ElectraNet was unable to provide actual (historical) costs the ACCC made no adjustment to the jurisdictional asset valuation for easements (p44-45).</p>
11 December 2002	<p>The ACCC releases its final revenue cap decision for SPI PowerNet, which allows additional value in the RAB for assets that were not valued in the jurisdictional asset valuation, including easements. Easement compensation costs are included to the value of \$88.9m on the basis of indexed historical costs.</p>
August 2003	<p>The ACCC releases a Discussion Paper to commence its 2003 Review of the Draft Statement of Regulatory Principles and proposes a “lock-in” of asset values and an end to future asset revaluations.</p> <p>The paper proposes that, if necessary, a benchmark approach to easement valuation be used where historical cost records are incomplete or unavailable (p30-33).</p>
20 May 2004	<p>ElectraNet writes to the ACCC seeking confirmation that its claim for corrections to the asset base will be acted upon as part of the revenue cap decision for the 2008-09 to 2012-13 regulatory period.</p>
3 August 2004	<p>The ACCC writes to ElectraNet noting that ElectraNet will be making a submission to the ACCC seeking an adjustment to the RAB. The letter states...</p> <p><i>“The ACCC’s preference to roll forward a TNSP’s asset base reflects its views as to the best approach, under the Code, to asset valuation in the future. However, the decision on ElectraNet’s asset base will be made at the reset of its revenue cap in accordance with the requirements of the Code.</i></p> <p><i>As previously noted by ACCC staff, the ACCC would consider revaluation of ElectraNet’s asset base if ElectraNet was able to establish that such a step accords with the reasonable expectations of ElectraNet’s investors”.</i></p>

3. National Electricity Rules

ElectraNet's current regulatory control period expires on 30 June 2008. ElectraNet's revenue cap for this period was set by the ACCC, but the ACCC no longer performs this regulatory role. In accordance with the Rules the AER must make a transmission determination for the next regulatory control period (i.e. 2008-2013).¹ One component of that transmission determination involves determining the opening value of ElectraNet's regulatory asset base (RAB).

¹ Section 6A.2.1 of the Rules.

3.1 Savings and transitional provisions relating to easements

The Rules provide that ElectraNet's RAB at 1 July 2008 must be determined by rolling forward the value of the RAB as at 1 January 2003.

However, clause 11.6.13 of the Rules provides that in establishing ElectraNet's RAB at the 2008 revenue reset, the AER may consider adjusting the easement valuation:

“Without limiting the operation of the new Chapter 6A, in establishing the opening regulatory asset base for ElectraNet for the regulatory control period subsequent to ElectraNet's current regulatory control period, the AER may also consider adjustments to the regulatory asset base for ElectraNet that relate to easements, as agreed by letter dated 3 August 2004, between the ACCC and ElectraNet.”

This clause confers on the AER the power to consider an adjustment to ElectraNet's easement value as the ACCC agreed to do by its letter dated 3 August 2004.

The ACCC letter clearly states that if ElectraNet establishes that its investors had a reasonable expectation that its easements would be revalued, the ACCC would consider a revaluation of those easements:

“The ACCC's preference to roll forward a TNSP's asset base reflects its views as to the best approach, under the Code, to asset valuation into the future. However, the decision on ElectraNet's asset base will be made at the re-set of its revenue cap in accordance with the requirements of the Code.

As previously noted by ACCC staff, the ACCC would consider revaluation of ElectraNet's asset base if ElectraNet was able to establish that such a step accords with the reasonable expectations of ElectraNet's investors.”

This submission establishes that ElectraNet's investors did in fact have a reasonable expectation that its easements would be revalued.

4. Why the AER should revalue ElectraNet's easements

The National Electricity Law (Section 16) requires the AER to have regard to the National Electricity Market Objective (NEM Objective) in making a transmission determination:

“The AER must, in performing or exercising its economic regulatory function or power perform or exercise that function or power in a manner that will or is likely to contribute to the achievement of the national electricity market objective.”

Specifically, a component of the NEM Objective is to *“promote efficient investment... in electricity services”*.

The AER should revalue ElectraNet's easements because:

- (a) Investors purchased ElectraNet with a reasonable expectation that the easements would be revalued;
- (b) It would be inconsistent with the NEM Objective to promote efficient investment in electricity services to decide not to revalue the easements as it would deny

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ElectraNet a fair return on its investment and therefore raise doubt as to the treatment of future investments with resultant implications for incentives for efficient investment;

- (c) It is important to preserve regulatory certainty and the reliance investors can place on a regulator's undertaking; and
- (d) As clearly shown below, the easements are currently undervalued (under any sensible valuation methodology). In consequence, ElectraNet's RAB is set at an inappropriately low level and this can be corrected by revaluing ElectraNet's easements.

Table 1 shows easement values allowed in ACCC TNSP revenue cap decisions in comparison with easement lengths. The easement value allowed for ElectraNet at the last revenue reset was \$607 per km compared to \$13,714 per km for the next lowest easement valuation – in other words all other TNSPs received recognition of easement value that is in excess of 20 times higher than that allowed for ElectraNet. This comparison is illustrated in Figure 1.

Table 1: TNSP Transmission Line Circuit Lengths and Easement Values

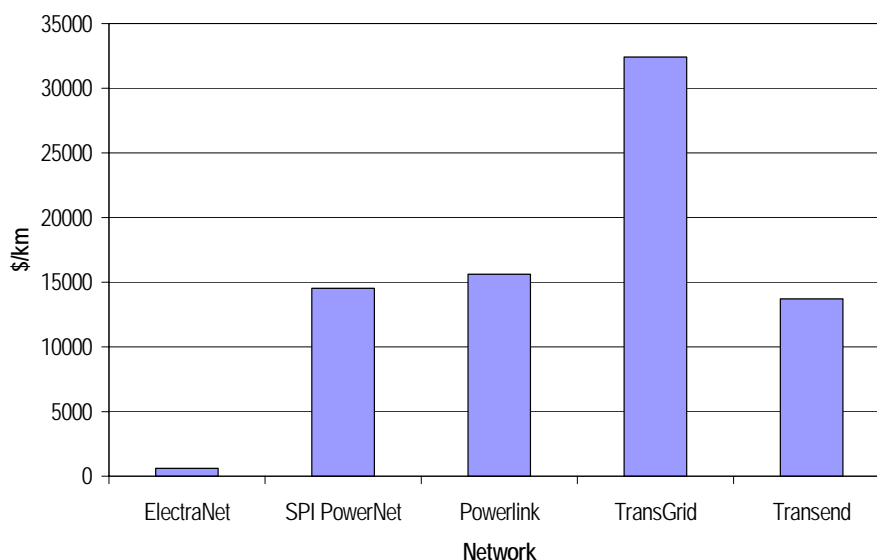
Network	Length (circuit km)	Easement value (\$million) ⁽¹⁾	Ratio ⁽²⁾
ElectraNet	5,600	3.4	607
SPI PowerNet	6,500	94.5	14538
Powerlink	11,200	174.9	15616
TransGrid	12,400	402	32419
Transend	3,500	48	13714

Notes

(1) ACCC decisions

(2) Ratio equals Easement value /Length

Figure 1: Comparison of TNSP Easement Values (\$/km)



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In a review conducted for ElectraNet commenting on this comparison, Sinclair Knight Merz conclude that:

“In making a broad assessment of the value of easements for ElectraNet SA it is reasonable to compare it with the other TNSPs, probably excluding TransGrid. The general characteristics of the networks are similar in terms of the types of line and land occupation where the lines are located.

It is apparent then, that the easements for ElectraNet SA are grossly undervalued and that there is a strong case for this aspect of the ElectraNet SA asset base to be revalued.”

5. Establishing Investor Expectations

5.1 Summary

Section 2 of this submission summarises key events in the lead up to investors finalising their bid for ElectraNet. Investors held a reasonable expectation that ElectraNet’s RAB including easements would be revalued at a future revenue cap determination. This expectation was based on a number of matters including:

- (a) Statements made by the ACCC and SA Government during the sale process;
- (b) The ACCC’s Draft Statement of Regulatory Principles (DRP); and
- (c) The ACCC’s revenue cap determination for TransGrid dated 27 January 2000, which was made in accordance with the DRP.

Section 5.2 of this submission sets out in more detail the bases upon which investors held the above reasonable expectation.

Investors reasonably expected that a future revaluation would recognise easements at a significantly higher value than the \$3.1m that was included in the South Australian Government’s jurisdictional asset valuation.

The South Australian Government (Department of Treasury and Finance) wrote to the ACCC on 10 August 2001 on the subject of ElectraNet’s regulatory asset base and made the following statements:

“Easements were incorporated into the RAB at book value (i.e. \$3.1m) as asset valuations consistent with the approach set out in the ACCC’s draft Statement of Principles for the Regulation of Transmission Revenues dated 27 May 1999 had not been undertaken. Independent valuations of the transmission easements suggest a substantially higher value than \$3.1m”

“Treasury and Finance agrees that the ACCC has some discretion to amend the RAB”.

The letter notes the substantially higher than \$3.1m independent easement valuations that were available at the time. These valuations were included in the data room established for the purpose of potential investor due diligence.

Investors factored their reasonable expectation of a future upside revaluation of easements into their investment decision.

5.2 Specific facts relevant to investor expectation

Purchase process

On 15 September 2000, a consortium of investors (**Consortium**) lodged a bid (**Bid**) with the South Australian Government for the purchase of ElectraNet. This bid was successful and ElectraNet was acquired by the Consortium on 31 October 2000.

In the lead up to the bid, the Consortium established a bid team to conduct due diligence and provide advice to the Consortium in relation to its bid for ElectraNet (**Due Diligence Team**).

The Due Diligence Team made a number of presentations to representatives of the Consortium including early in August 2000, 12 August 2000, 18 August 2000 and 22 August 2000. In addition, the Due Diligence Team produced a report which was provided to the Consortium.

In making its bid, the members of the Consortium (ie ElectraNet's investors) held a reasonable expectation that the ACCC would consider revaluing ElectraNet's asset base. This reasonable expectation was based upon the information provided by the Due Diligence Team.

The remainder of this section sets out the information that was available to the Due Diligence Team and the Consortium at the time of its bid and therefore forms the basis for the members of the Consortium holding the reasonable expectation that the ACCC would consider revaluing ElectraNet's asset base.

Regulatory Rules and Principles for Valuing Transmission Easements

Clause 6.2.3(d)(4) of the 1999 version of the National Electricity Code (**Code**) required the ACCC to accept the Jurisdictional valuation of existing assets as a cap for the first ACCC valuation. The ACCC had not finalised their Regulatory Principles for valuing transmission line easements by the year 2000. The ACCC's Draft Statement of Principles for the Regulation of Transmission Revenue dated 27 May 1999 (**DRP**) set out valuation principles for other transmission assets based on Optimised Deprival principles. On 31 October 2000, being the date of the acquisition of ElectraNet, the ACCC still had not finalised its approach to the regulation of transmission revenue, including the valuation of easements.

Potential Downside Risks

By late July - early August 2000, the Consortium formed the view that there was a very real and substantial downside risk that the ACCC would significantly reduce the valuation of ElectraNet's regulated transmission assets at the first ACCC asset valuation. This view had been formed from the conclusions reached by ACCC's consultants NERA in their confidential draft final report to the ACCC entitled "The South Australian Electricity Pricing Order – A Review" dated October 1999 (**NERA Review**).

Section 3.8 "Asset Valuation" of the NERA Review included the following statements and conclusions on the jurisdictional valuation of ElectraNet's pre-1999 transmission assets:

- "casts doubt on the robustness of the asset valuation"
- "noted that the asset lives are at the higher end of the range used by industry"

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- “the asset valuation for ElectraNet is more likely than not to be overstated, relative to the notional benchmark with which such a valuation should be seeking to identify”
- That there is some risk of a downwards adjustment in a subsequent regulatory period”.

The potential downside financial risk of such a reduction in asset valuation was discussed in a confidential report entitled “Due Diligence of ElectraNet SA Regulatory Matters – Initial Report on Key matters” (**Initial Report**). The Initial Report was prepared on 31st July 2000 and sent to representatives of the Consortium and included the following statements:

- "The SKM report and NERA report to ACCC claims the assumed Asset Lives are “towards the high end of the range used by industry”. (eg lines 55 years, transformers 45 years, substation 40-50)." (paragraph 3.1);
- "a reduction in asset lives could occur in the ACCC review and would reduce the ongoing asset valuation and regulated revenue." (paragraph 3.1); and
- "A reduction of say 5 years could reduce the DORV by about \$70M and annual revenue \$6Mpa after allowing for the offsetting increase in depreciation." (paragraph 3.1).

The implications of the Initial Report and NERA report were discussed by the Consortium in early August 2000 and the Due Diligence Team was asked to report back to the Consortium at the next meeting (which was held on 12th August 2000).

As a result of the downside risk that had been identified, the Due Diligence Team sought to identify any potential upside, including in relation to the revaluation of easements. Section 16.1.4 Asset Valuation in the in the final due diligence report states:

- "While there is little scope for ACCC to increase the asset value above that set by the jurisdiction, on balance the above opportunities will more than offset any valuation risks and allow the jurisdictional value to be preserved." (page 5)

Information Memorandum, 27th June 2000, SA Government

The Due Diligence Team determined that a potential upside that could offset any potential downside risk was a revaluation of easements.

Section 4.3.4 “Regulated asset Base’ of the Information Memorandum advised that:

- "The value of easements included in Table 4.16 above [ie the Regulated Asset Base of ElectraNet SA as at 30 June 1999] was incorporated into the Regulated Asset Base at book value, since asset valuations consistent with the approach set out in the ACCC’s Draft Statement of Principles for the Regulation of Transmission Revenues dated 27 May 1999 had not yet been undertaken. As discussed in Section 4.8.2, the ACCC is still formulating its approach to the regulation of transmission revenue. This includes determining the valuation of easements." (page 47)

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- "An independent valuer assessed the value of ElectraNet SA's easements in connection with all of its 275kV and 132kV transmission lines at \$227.2million as at 28 February 1997." (page 47)

Data Disclosed by SA Government in Sale Process

The Due Diligence Team determined that the independent valuation of ElectraNet's easements referred to on page 47 of the Information Memorandum is the valuation in the confidential report by Maloney Field Services dated 28 February 1997 and which was included in the data room (**Maloney Field Services Report**).

The Maloney Field Services Report, which was provided in the data room by the SA Government, as vendor concluded, on page 14, that the total "deprival value" of ElectraNet's 132kV and 275kV easements had been assessed by Maloney Field Services at \$227,188,400 as of the 28 February 1997.

Presentations to Consortium on 12 August 2006 in relation to strategy to Model Easement Valuation Upside Opportunity as an Offset to the Downside Valuation Risk

The Due Diligence Team presented at a meeting of representatives of the Consortium held on 12 August 2000 in Sydney, and provided advice on the status of the due diligence, its major findings including the regulatory due diligence and the recommended regulatory strategy. This included the potential upsides and downsides for future asset valuations of ElectraNet's regulated assets under the ACCC's regulatory regime. This presentation included the following advice on the emerging strategy for using the upside easement valuation opportunity to offset the downside asset valuation risks:

- "NEC Clause 6.2.3 (d) (4) is extremely important"
- "ACCC will not value above state valuation"
- "NERA advised ACCC that EPO valuations were high due to long asset lives"
- "Because asset lives are consistent with other TNSP's and easement valuation was omitted, it is expected that EPO values can be supported."

At this meeting, representatives of the Consortium:

- considered the potential downsides to asset valuation and agreed in principle to the strategy of including the potential upsides from increased easement valuation by assuming in the bid financial model that the overall jurisdiction valuation could be preserved, subject to finalising the due diligence;
- requested the Due Diligence Team to highlight to the ACCC that ElectraNet's easements are clearly grossly undervalued and to request the ACCC to explain their position on the revaluation of these easements at the first ACCC revenue reset (as part of the cap imposed by the state valuation) and at subsequent ACCC asset valuations; and
- agreed to engage expert regulatory consultants Price Waterhouse Coopers to undertake a review of the regulatory due diligence report including an assessment of downside risk of the ACCC's devaluing the regulatory asset base and the potential for offsetting this downside risk with the upside opportunity from increased easement valuation in the future.

Confirmation by ACCC of Future Easement Revaluation Opportunity

Having concluded that the jurisdictional valuation for the ElectraNet easements was grossly undervalued, the Due Diligence Team sought confirmation from the ACCC that the easements could be re-valued in subsequent revenue cap determinations under the ACCC.

The questions that were to be put to the ACCC at this meeting were reviewed and agreed by representatives of the Consortium beforehand and included:

Easements:

- The EPO has only included \$3.3 million for easements whereas there is clear evidence that a higher value is justified (i.e. ODRC \$227 million).
- Can the ACCC please explain their position on the valuation and inclusion of easements in the ODRC, at the initial ACCC reset and on an ongoing basis?
- To the extent that the allowance for easements is in excess of the \$3.3 million included in the State Valuator at July 1999, would the ACCC allow any additional easement costs when considering the Cap on total ODRC, as required by NEC Clause 6.2.3.

ODRC at First ACCC Reset:

- NEC Clause 6.2.3 requires ACCC to cap any asset valuation for assets in service by 1/7/99 to the State Valuator at that time. It is expected that the ACCC's consultant will independently assess the ODRC at the first ACCC reset. How will the ACCC apply the cap to adjust this valuation?

The Due Diligence Team attended a meeting with officers of ACCC in Canberra on 15 August 2000.

At that meeting, the Due Diligence Team drew the ACCC's attention to the jurisdictional valuation for easements for ElectraNet being only \$3.1 million (1997 prices) whereas there is clear evidence that a higher value is justified (e.g. an independent easement valuation in the data room of \$227 million).

Further, the Due Diligence Team discussed opportunities under the ACCC's regulatory arrangements for ElectraNet to seek a fair and reasonable adjustment to the jurisdictional asset valuation for land and easements at the first or subsequent ACCC revenue determinations. In particular, the following issues were discussed:

- the ACCC's progress in developing their principles for determining a fair and reasonable valuation of easements;
- the application of Code Clause 6.2.3 which requires the ACCC, at their first valuation, to cap the total asset valuation for assets in service by 1/7/99 to the Jurisdictional valuation; and
- the revaluation of these easements at subsequent ACCC revenue resets and associated asset revaluations.

The ACCC noted that it was still developing its approach to the valuation of easements and had not yet arrived at a definitive view, and noted that expert opinions varied on

the issue. The Due Diligence Team formed the impression that the ACCC was receptive to the concept of revaluing easements using the DAC approach (e.g. using an ODRC methodology for the cost of environmental impact studies, engineering investigations, survey costs etc but with the resumption cost portion being "actual costs plus CPI).

The Due Diligence Team was confident following this meeting that regardless of the detail of the ACCC's final principles for easement valuation, the resultant easement valuation for ElectraNet would be substantially greater than the existing \$3.1m Jurisdictional valuation.

The ACCC advised the Due Diligence Team that, depending on the final ACCC principles for easement valuation, it may be permissible to seek an increased valuation for ElectraNet's existing easements at the first ACCC reset, subject to any increase being within the overall cap. The ACCC confirmed that the Jurisdictional valuation at July 1999 is a firm Cap on the first ACCC valuation. After some discussion, the ACCC confirmed that this cap would apply to the total valuation of all pre 1999 assets - and not to individual asset classes, such as easements.

This confirmed for the Due Diligence Team that some of the potential upside in easement valuation could be accessed at the first ACCC valuation (in 2003) to offset the downside risks in the valuation of other pre 1999 assets. It was clear from the discussions that the cap would apply to all of the pre 1999 assets and that the pre-1999 easement valuation would not be capped to \$3.1 million at the first reset.

The ACCC also confirmed that the Jurisdictional Cap would not apply to their revaluations at their second and subsequent revenue resets when the Code would require them to revalue all assets.

Based on this meeting with the ACCC, the Due Diligence Team concluded that the Jurisdiction's gross undervaluation of easements presented an upside opportunity that additional easement value would be allowed at future ACCC valuations. However, because of the effect of the Jurisdictional Cap at the first ACCC valuation, this upside opportunity would be limited at the first revenue reset to offsetting the substantial downside risk that the ACCC would determine a lower valuation for other pre-1999 assets. Whilst easement valuation upside would not be limited by the jurisdictional cap at subsequent revenue resets, the Consortium decided to continue with the modelling of this upside opportunity as a counter-balance to other downside risks that were not explicitly modelled in the financial model.

Meetings between the Due Diligence Team and the Consortium

The Due Diligence Team made a number of presentations to representatives of the Consortium and related parties of the Consortium. These presentations occurred on 16 August 2000, 18 August 2000 and 22 August 2000. In these presentations, the Due Diligence Team made the following points, among others:

- although there was some risk of certain assets being revalued down by the ACCC:

"we have no reason to believe that ACCC will reduce the ODRC below the level assumed by the state regulators. The existing EPO is based on asset lives consistent with other TNSPs and no value was assigned to easements"

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- although there was some risk of certain assets being revalued down by the ACCC "Because asset lives are consistent with other TNSPs and easement valuation was omitted, it is expected that EPO values can be supported".
- "While there are some downsides of ODRC, our due diligence has identified much more "upside" to offset this risk, Hence wee [sic] are confident that ODRC will be preserved at ACCC reset"
- "There are 3 future upsides
 - "claw-back" at second ACCC reset
 - re-admitting \$61m of assets optimised out
 - upside from asset life extension"

Price Waterhouse Cooper's Advice

The Consortium engaged Price Waterhouse Coopers (**PwC**) as an expert regulatory consultant to review the Due Diligence Team's assessment of the regulatory arrangements, risks, opportunities and expected outcomes under the ACCC regulatory framework for transmission in Australia and to provide their own expert opinion on these matters.

The confidential PwC draft report, dated 22 August 2000 (**PwC report**), provided the following advice on Asset valuation by the ACCC at future resets:

- "ACCC could be expected to look at reducing the asset value when the Code permits the opportunity, in 2008." (page 6);
- "One possibility ... is the ex-post normalisation calculation." (page 6);
- "It will also examine optimisation opportunities (involving optimal configuration and sizing of transmission assets)." (page 6);
- "Where there is potential for a full or partial stranding of assets the regulator will consider whether the value of the asset base or the useful life of the assets should be lowered." (page 6);
- "Write downs of the asset base can be by way of immediate write-downs....without compensation by way of depreciation" (page 7);
- "It may be in the best interests of the entity to anticipate these possibilities. The entity can request a write-down at any time but it would be understandably reluctant to do so." (page 7).

The PwC Report gave the following advice on the opportunities for increased easement valuation and the strategy for offsetting this increased valuation opportunity against the downside valuation risk:

- "as you say, there are some opportunities for arguing for increased value (e.g. more realistic value of land and easements) - but with little chance of success" (page 7); and

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- "On the other hand there are substantial risks of the ACCC writing the asset valuation down, or the entity itself having to request the write down." (page 7).

Further specialist advice

The Consortium also engaged a specialist consultant (**Specialist Consultant**) with extensive experience in the South Australian transmission business environment to provide local regulatory expertise and to assist with the regulatory due diligence activities.

The Specialist Consultant produced a confidential report which set out a number of matters including the following:

- In order to maximize the asset valuation for the next reset it will be important to provide a strong case for asset lives and to develop a proposal for the valuation of easements to be included in the asset valuation.
- It is likely that the ACCC will seek to reduce the opening regulated asset base as at 1 July 2003.
- However, recognizing that the inclusion of easements would increase the RAB, it is assumed that these two effects cancel each other out and we should assume an opening RAB as at 1 July 2003, of \$772.8 million (consistent with the IM and ElectraNet Business Plan).

Technical Due Diligence Report

The Due Diligence Team produced a confidential Due Diligence Report dated 4 September 2000 (**Final Due Diligence Report**) relevant to regulated revenue.

The Final Due Diligence Report sets out the expected regulated revenue under the ACCC period (ie post 2003) at Chapter 16. The following conclusions are set out in chapter 16 of the Final Due Diligence Report:

- "Based upon recent determinations, it is quite clear that the ACCC's interpretation of NEC Clause 6.2.3 (d)(4) is that at its first determination, it is prevented from valuing assets at a value greater than that set by the State jurisdiction ...
- Whether the ACCC is prepared to correct upwards valuation errors of their second determination is unknown, however, it would seem unrealistic to this." (page 60)
- "There are a range of opportunities for arguing for increased value of the asset base including:
 - More realistic value of land and easements; ...
 - While there is little scope for ACCC to increase the asset value above that set by the jurisdiction. On balance the above opportunities will more than offset any valuation risks and allow the jurisdictional value to be preserved." (page 61)

Final approach of Consortium

At a meeting on 22 August 2000, the Consortium confirmed its strategy to include the potential easement valuation upside opportunity as an offset to the known downsides in

asset valuation and other downside risks. Specifically, the Consortium agreed to include the full jurisdictional asset valuation in the bid financial model, notwithstanding the known downside risk of asset devaluation and the other potential downside risks, as the future upside easement revaluation opportunity was considered, by the Consortium, to offset these downside risks.

The agreed strategy was then included in the regulatory section of the due diligence report, and in the assumptions on regulated asset values in the Bid financial model.

Financial Modelling

The final \$926 million price which the Consortium agreed to pay the SA Government was based on a financial model and then agreed by the Consortium.

The financial model included the full jurisdictional valuation for all pre-1999 assets and assumed that the easement upside opportunity would offset the risks of asset optimisation and devaluation at the first and subsequent resets and other downside risks not explicitly modelled.

Bidder Reliance on Potential Upside of Easement Valuations

Based on all of the above, there were reasonable grounds for the Consortium (ie ElectraNet's investors) to base their bid for ElectraNet on the expectation that, and to reasonably expect that the ACCC would, consider adjusting the regulatory asset base for ElectraNet upwards to include the upside valuation of ElectraNet's easements at future ACCC asset valuations.

6. Methodology for Determining Easement Value Adjustment

6.1 Background

The ACCC wrote to ElectraNet SA on 6 March 2002 and advised that:

“While the South Australian Government has made provision for easements using book value, this does not appear to represent a judgement that book value is the appropriate methodology for the valuation of easements. Rather it appears to simply be the result of time pressure. The statements by the South Australian Government made in 1999 (and confirmed in 2002) indicate that it had not rejected the principles in the DRP; rather, it simply did not have time to apply these principles before finalising the RAB.

In these circumstances, it appears to be more accurate to say that no judgement has been made on the methodology for valuing easements. In the light of this, the Commission is of the view that it can depart from the South Australian Government's valuation of easements at book value for the purposes of determining the value of ElectraNet's sunk assets under s 6.4.2 of the Code”.

The ACCC thus confirmed that it could depart from the South Australian Government's valuation of easements and determine an appropriate easement value using a methodology other than book value.

In its 2002 draft revenue cap decision for ElectraNet SA the ACCC notes:

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“The South Australian authorities stated that they were unable to apply the DRP owing to inadequate time. Hence it is reasonable to suggest that they would have valued easements on the basis suggested by the DRP, if they had the time.

In the DRP the Commission stated that a consistent approach to easement valuation would be to provide compensation for actual amounts paid”.

However, this is not ElectraNet’s understanding of the DRP nor was it the understanding of ElectraNet’s investors at the time of their investment decision. In its 2002 SPI PowerNet draft revenue cap decision the ACCC states that:

“According to the DRP a replacement cost methodology should be used when valuing easements... However, in recent decisions... the Commission has adopted a historical purchase cost rolled forward using CPI as the index” (p44).

This statement demonstrates that it was reasonable for investors to expect that a replacement cost methodology would be used in a future easement revaluation and that there was considerable upside potential from such a revaluation.

The South Australian Minister for Energy in a letter to the ACCC dated 5 September 2002 states:

“It is recognised that there is a need to include a fair and reasonable value of the easements in the asset base.”

The Minister continues that in the absence of historic cost data:

“the South Australian Government proposes that the ACCC adopt an approach that discounts the easement values in Victoria for the difference in real estate values, and values the easements in South Australia accordingly.”

ElectraNet proposed such a benchmark methodology for determining an easement compensation value adjustment to the ACCC in October 2002.

6.2 Description of easement costs

There are two categories of easement costs that need to be taken into account:

- Easement compensation paid to land owners; and
- Easement acquisition or transaction costs incurred in acquiring an easement.

Easement compensation is the compensation paid directly to the land owner which would generally have been recorded on the original easement title at the time of the transaction.

In order to acquire the rights to the easement additional costs are incurred, known as easement acquisition or transaction costs, which include costs for surveying, drafting, valuation fees, negotiations, conveyancing, Lands Titles Office and other government charges, mortgage production fees and reimbursement of professional fees incurred by the land owners. These costs are distinct from the compensation costs and would not be recorded on the easement title at the time of the transaction.

6.3 Proposed methodology for easement compensation costs

This section proposes a benchmark methodology to estimate a proxy historical cost of easement compensation from Victorian historical cost records consistent with the approach proposed by the South Australian Government. The ACCC's Statement of Regulatory Principles (SRP) also suggested that *"A variant on the historical cost approach is to use a benchmark approach"*.

The proposed methodology is based on the use of independent and reliable data including:

- Data from the Victorian TNSP, SP AusNet (formerly SPI PowerNet). This data formed the basis of the historical cost estimates used by ACCC in SPI PowerNet's 2002 revenue cap determination.
- The Australian Bureau of Agricultural and Resource Economics (ABARE), identifies a range of statistical information including the value of land and improvements by geographic location. The period covered is 1990 to 2005.
- The Australian Bureau of Statistics provides information on the (nominal) value of residential, rural commercial and other land by state/territory. The period covered is 1984 to 2006.

Figure 2 illustrates the proposed methodology for estimating the proxy historical cost paid by ElectraNet for landowner compensation for easements acquired.

The methodology includes the following steps:

(a) ElectraNet easement information

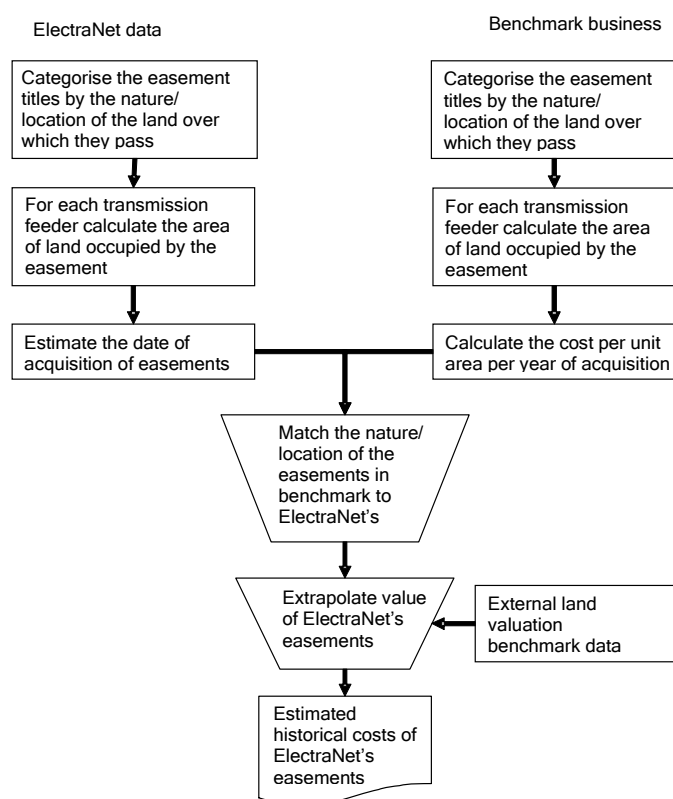
- Remove the extent of the route that was over crown land for which easements would have been acquired at no cost.
- Calculate the area of easement under each title.
- Estimate the date of acquisition of the easement based upon the date the transmission line was energised.

(b) SPI PowerNet easement information

- Remove the extent of the route that was over crown land for which easements would have been acquired at no cost.
- Eliminate potential cost anomalies by grouping costs across a number of years.
- From the identified year of acquisition calculate the cost per unit area of easement by ABARE's geographic regions and ABS categories.

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Figure 2: Methodology for Determining Proxy Historical Cost of Easement Compensation



- (c) ABARE data – Ascertain the relative values of land between Victoria and South Australia for each ABARE geographic region for each available year.
- (d) Australian Bureau of Statistics – Ascertain the relative values of land between Victoria and South Australia for each ABS land category for each available year.
- (e) Process – Apply the established relationships between the land values in Victoria and South Australia obtained via the independent data sources and apply it to the SPI PowerNet information to calculate a range of proxy costs for ElectraNet.

ElectraNet engaged Capital Value to develop and apply the proposed methodology to determine an appropriate easement value adjustment².

Capital Value has estimated landowner compensation costs in the range of \$25.9 million to \$30.7 million. Adopting the midpoint of this range and subtracting the \$3.5 million easement value recognised in ElectraNet's regulated asset base at 1 July 2002³ results in a proxy historical cost of \$24.8 million.

For the purposes of ElectraNet's Revenue Proposal, indexation of the proxy historical cost by CPI results in an easement value adjustment of \$29.1 million to be added to the regulated asset base as at 30 June 2008.

² Capital Value, "Establishing a proxy historical cost valuation of easement compensation", 17 May 2007.

³ ElectraNet SA revenue cap proforma provided to the ACCC on 15 November 2002.

6.4 Proposed methodology for easement acquisition or transaction costs

The South Australian Government 1998 jurisdictional asset valuation included no recognition of easement acquisition or transaction costs. This fact is established in statements provided by Sinclair Knight Merz (SKM) who carried out the jurisdictional asset valuation:

“SKM’s project manager for the 1998 Electranet valuation review was Mr Kerrod Beaton, who is still engaged by the company, and is actively involved in transmission line valuations for transmission companies across Australia. Mr Beaton is also involved in the continuous updating of the SKM asset valuation database, and has recently confirmed that no elements of easement acquisition or route selection costs are included, or were ever included in SKM valuations.

SKM can categorically and unequivocally confirm that its transmission line asset valuation database does not include any elements of route selection or easement acquisition costs. The database is constructed on the clear assumption that the transmission line is to be constructed on an existing easement.

If the SKM valuation of 1998 is considered to be the jurisdictional asset valuation, then we can confirm that all aspects of route selection and easement acquisition costs are excluded.”⁴

SKM has stated unequivocally that its transmission line asset valuation database does not include any elements of route selection or easement acquisition costs and that all aspects of these costs were excluded from the 1998 valuation.

Easement acquisition or transaction costs are not related to real estate values and replacement costs are expected to be a good proxy for indexed historic costs. The ACCC’s consultants Meritec recommended in 2002 that \$36m be introduced to the RAB to recognise easement acquisition costs based on a valuation by Maloney Field Services in 2000⁵. A more comprehensive valuation by SKM in 2002 suggested a higher value of \$54m (also included in Meritec report to the ACCC). Adopting the midpoint of the range established by these two valuations, results in a proxy historical cost of \$45 million.

For the purposes of ElectraNet’s Revenue Proposal, indexation of the proxy historical cost by CPI results in an easement value adjustment of \$52.8 million to be added to the regulated asset base as at 30 June 2008.

7. Easement Value Adjustment

In summary, ElectraNet is seeking an easement value adjustment of \$80.8 million to be added to its regulated asset base as at 30 June 2008. This figure has been determined as follows:

⁴ “ElectraNet SA Asset Valuation Review”, SKM File Note, 8 June 2002.

⁵ “ElectraNet SA Asset Base Review”, Meritec report to ACCC, July 2002, p32.

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Component	Proxy Historical Cost (\$m 2001-02)	Valuation Adjustment (\$2007-08)
Easement compensation costs	24.8	29.1
Easement acquisition or transaction costs	45.0	52.8
Total	69.8	81.9

8. Conclusions

ElectraNet requests that the Australian Energy Regulator (AER) revalue ElectraNet's easements in the context of its revenue cap determination for the 2008-09 to 2012-13 regulatory control period.

This submission establishes that:

- ElectraNet's investors at the time of their investment decision in 2000 held an expectation that the ACCC would at a future revenue cap determination revalue ElectraNet's easements and that this revaluation would recognise easements at a significantly higher value than the \$3.1m that was included in the South Australian Government's jurisdictional asset valuation;
- This expectation held by investors was reasonable; and
- Investors factored this expectation into their investment decision.

A savings and transitional provision in clause 11.6.13 of the National Electricity Rules (Rules) confers on the AER the power to consider an easement value adjustment for ElectraNet as the ACCC agreed to do by its letter dated 3 August 2004 (from Commissioner Ed Willett).

"...if ElectraNet was able to establish that such a step accords with the reasonable expectations of ElectraNet's investors".

The AER should revalue ElectraNet's easements because:

- (a) As has been established by this submission, investors purchased ElectraNet with a reasonable expectation that the easements would be revalued;
- (b) It would be inconsistent with the NEM Objective to promote efficient investment in electricity services to decide not to revalue the easements as it would deny ElectraNet a fair return on its investment and therefore raise doubt as to the treatment of future investments with resultant implications for incentives for efficient investment;
- (c) It is important to preserve regulatory certainty and the reliance investors can place on a regulator's undertaking; and

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- (d) As clearly shown in this submission, the easements are currently undervalued (under any sensible valuation methodology).

In addition to establishing the reasonable expectation of investors, this submission outlines the proposed methodology for determining an appropriate easement value adjustment, which is based on using a proxy historical cost consistent with the approaches previously adopted by the AER (and the ACCC).

On this basis, ElectraNet is seeking an easement value adjustment of \$81.9 million as at 30 June 2008.

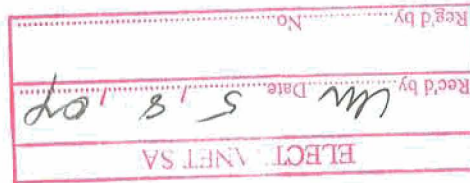
ElectraNet notes that this is a conservative value which is significantly lower than:

- The independent easement valuations that were made available to investors by the South Australian Government at the time of their investment decision; and
- The investor prepayment for the network land lease (including easement) of \$156.1 million.



Australian
Competition &
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Commission

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03 August 2004

Mr Ian Stirling
ElectraNet
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ADELAIDE SA 5000

Dear Mr Stirling 

Thank you for your letter of 12 July regarding the case for adjusting ElectraNet's regulatory asset base.

I note that ElectraNet will be making a submission to the ACCC seeking an adjustment to its regulatory asset base before the ACCC rolls forward ElectraNet's asset base at the next revenue reset 1 July 2008.

The ACCC's preference to roll forward a TNSP's asset base reflects its views as to the best approach, under the Code, to asset valuation into the future. However, the decision on ElectraNet's asset base will be made at the re-set of its revenue cap in accordance with the requirements of the Code.

As previously noted by ACCC staff, the ACCC would consider revaluation of ElectraNet's asset base if ElectraNet was able to establish that such a step accords with the reasonable expectations of ElectraNet's investors.

Yours sincerely

Ed Willett
Commissioner

