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1 August 2002

Mr Michael Rawstron
General Manager
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Australian Competition and Consumer Commission
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Dear Mr Rawstron

ELECTRANET SA ASSET BASE REVIEW – MERITEC CONSULTANCY REPORT

NRG Flinders appreciates the opportunity to provide comment on Meritec's review of the ElectraNet SA asset base, released in July 2002.

It is understood this initial report will be followed by further consultancy reports into the capital expenditure and operation and maintenance expenditure levels proposed in ElectraNet SA's revenue cap application, under review by the ACCC.

Optimisation

Meritec has recommended that previously optimised assets, with a combined value of $12.9m, should all be reintroduced into the asset base as at July 2001. A detailed summary has been provided outlining the rationale for the re-inclusion of these assets.

Meritec has also proposed that all asset additions undertaken since the last valuation date should be included at cost. However, no specific analysis or evidence appears to have been provided to justify the inclusion of these assets into the asset base at face value.

As a key aspect of the transmission revenue reset process, it is understood that the ACCC only intends to allow appropriately sized, timed and efficient construction costs to be accepted into the regulated asset base, irrespective of the actual costs incurred, in order to place incentives on the TNSP to undertake efficient investments.

It would therefore appear to be important for the integrity of the process that the ACCC ensure that appropriately detailed assessment has been undertaken into the reasonableness and cost efficiency of all asset additions, accompanied by supporting evidence to justify the inclusion of these assets in the regulated asset base.

Similarly, while previously optimised assets have been reintroduced into the asset base, it is unclear that any downward optimisation of assets has been considered or applied. Notably, no specific assets have been identified for removal from the asset base.

This appears to conflict with the recent response to submissions provided by ElectraNet SA, which suggested that:

"There can be no question of the transmission network being overbuilt. A recent optimisation of the transmission network in South Australia identified all transmission assets surplus to customer requirements and excluded these assets from the regulated asset base."[1]

It is important to demonstrate that sufficient analysis has been undertaken to optimise the value of the transmission network, and to identify any underutilised or uneconomic assets that should be excluded from the asset base.

Depreciation

It is proposed that accelerated depreciation should be applied to a number of assets nearing the end of their technical and economic lives. However, it is noted that no accelerated depreciation for bypass risk has been sought. This is surprising, given that ElectraNet SA has separately argued for a higher risk-adjusted rate of return to account for such risks.

NRG Flinders understands that the use of accelerated depreciation has been made available to TNSPs as a tool to manage risks such as asset stranding through network bypass. Clearly, such a tool can only be applied in advance, and ex post adjustments should not be made to compensate the TNSP for any asset bypass that does occur during a regulatory period.

Easement compensation costs

Meritec has expressed the view that market based valuation is the most appropriate means of establishing the deprival value of transmission easement compensation costs. However, Meritec has acknowledged that the ACCC prefers historic cost valuation to avoid negative depreciation effects, and price shocks for network users.

[1] *Revenue Cap Application: Response to Submissions from Interested Parties*, ElectraNet SA, 19 July 2002, p6

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To reconcile this conflict of objectives, Meritec has chosen to adopt an historic valuation of easement compensation costs, escalated by a property based indexation figure. However, this approach appears prone to significant step changes and produces a considerable increase in the estimated valuation given the substantial increases in property values in recent years.

Consequently, it is not clear that the approach proposed meets the ACCC's objectives.

It is noted that the indexation principles applied to easement compensation values are inconsistent with those applied in the recent Powerlink application, as acknowledged by Meritec. It is also noted that the final valuation estimate proposed ($137m) considerably exceeds that sought by ElectraNet SA ($111m).

In view of the ACCC's stated aims, its preference for historical cost estimates, and the fact that any concept of market value in relation to easements held in perpetuity is purely hypothetical in any event (as noted by Meritec) NRG Flinders queries whether the use of a more general price escalation factor (eg all cities CPI) might be more appropriate.

Easement acquisition costs

In valuing easement acquisition costs (reflecting the transaction costs involved in establishing an easement) it is noted that considerable uncertainty surrounds both the treatment of these costs in the jurisdictional asset base, and the intentions of the jurisdiction in this regard. In particular, Meritec notes that the jurisdictional valuation "did not mention easement acquisition costs so there is no clear appreciation of whether this was realised if it was not fully allowed in the replacement costs."

In the absence of evidence to the contrary, it has been assumed that the exclusion of such costs from the jurisdictional asset base was an unintentional oversight and should therefore be corrected. However, it could equally be argued that a judgement was made by the jurisdiction not to explicitly include easement acquisition costs in the initial asset base, and that this must be assumed in the absence of any evidence to support the assertion that the exclusion of such costs was an inadvertent omission.

Despite these uncertainties, Meritec arrives at the conclusion that an allowance for items such as route selection, environmental impact assessment and approvals was incorporated in the pre-existing valuation. On this basis, remaining costs such as route survey costs, registration fees and other on costs are deemed to lie outside the existing asset base, and an argument is made for the inclusion of these costs.

On this assumption, estimates of various relevant land transaction costs are applied to the estimated number of easement holdings to derive an overall estimate of the market value of the additional acquisition costs deemed to be omitted from the asset base. A final figure of $36m is recommended for inclusion.

The case for including additional easement acquisition costs and the robustness of the costs estimated is far from clear, and would not appear to provide a satisfactory basis on which to increase regulated asset value.

In view of the considerable uncertainty attached to the valuation of easement acquisition costs, and the intent of the existing jurisdictional valuation, a conservative approach would be to include an allowance only for estimated compensation costs in the asset base at this stage, and to defer consideration of additional acquisition costs until a subsequent reset.

Support for this approach might also be found in comparisons with other TNSP easement valuations across the NEM.

ElectraNet SA, with a transmission network comprising 5576 circuit km, which is stated to be heavily decentralised and radial in nature, has claimed a total easement valuation of some $215m, which Meritec has adjusted to $173m (noting that the asset base is already assumed to include various easement acquisition cost elements).

At face value, this proposed valuation appears high relative to the easement values ascribed to the majority of the transmission networks interstate, namely SPI Powernet at $232m (6,400 km), TransGrid at $321m (12,176 km) and Powerlink at $114m (9,263km). Furthermore, when considering the denser rural/urban territory traversed by networks interstate and higher land values of the Eastern Seaboard, the easement costs proposed in South Australia appear particularly high.

It would therefore appear that network customers are being asked to fund a significant premium for easement valuation in South Australia through regulated network charges, the justification for which remains unclear. This appears to support the need for a more conservative approach, including the application of a general price escalation factor to compensation costs and the deferral of any increase in easement acquisition costs in the absence of definitive analysis.

Conclusions

In summary, NRG Flinders submits that:

- It is important to ensure that sufficient review has been undertaken of all new transmission asset additions, to justify their inclusion in the regulated asset base, at their efficient cost level.

- It is also important to demonstrate that the network has been efficiently optimised, with any underutilised and uneconomic assets identified and appropriately written down in the asset base.

- The proposed escalation factor to be applied to easement compensation costs should be reconsidered in favour of a general escalation factor in view of the ACCC's objective of preventing negative depreciation and price shocks.

- The estimation of deemed easement acquisition costs warrants closer scrutiny. In view of the considerable uncertainties associated with the estimate derived (noting that a range of acquisition costs are already found to be included within the existing asset base) it may be preferable to defer consideration of additional easement acquisition costs to a subsequent reset.

Should you have any queries in relation to this submission, please feel free to contact Simon Appleby on (08) 8372 8706 or myself on (08) 8372 8726.

Yours sincerely

Reza Evans
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