Appendix I:

SPI PowerNet Pty Ltd

Transmission Revenue Reset (TRR) 2014/15 – 2016/17

Commentary on Draft Decision Capex Adjustments - Deloitte Access Economics

11 October 2013

Deloitte Access Economics

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Mr Tom Hallam
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10 October 2013

Dear Tom

Re: Commentary of the Capex Adjustments in the AER's Draft Decision

SP AusNet has engaged Deloitte to provide advice in response to issues raised by the Australian Energy Regulator (AER) and its advisors EMCa on the Draft Decision on SP AusNet's 2013 Transmission Revenue Reset. These issues specifically related to certain aspects of the AER's adjustments to SP AusNet's forecast capital expenditure (capex) for the 2014-15 to 2016-17 regulatory control period.

Background

EMCa reviewed SP AusNet's forecast capex in the context of SP AusNet's actual capex in the current (2007-08 to 2013-14) regulatory control period. 57 projects were reviewed, of which 14 were classified as site-specific projects and the remaining 43 as programs of work. On average, EMCa found that in the current regulatory period SP AusNet spent 11.7 per cent less than it proposed on site-specific projects and 12.6 per cent less on programs of work. EMCa subsequently recommended a prudency adjustment (reduction) be applied to SP AusNet's capex forecast, citing the following contributory factors:

- Prudent changes to the scope of some projects
- An optimisation of the engineering design and specification of works, and
- The prudent deferral of some projects.

The AER considered that if SP AusNet had achieved these capex reductions at a portfolio level relative to the bottom-up forecast in the current regulatory period, then reductions of the same magnitude (i.e. 11.7 per cent for site-specific projects and 12.6 per cent for programs of work) should be achievable in the forthcoming period. Accordingly, the AER reduced SP AusNet's capex forecasts by the percentages recommended by EMCa.

Commentary

In preparing this advice Deloitte has not reviewed the detailed build-up of the capex forecasts underpinning SP AusNet's capex program. Nevertheless, it is possible to make a number of observations regarding the approach adopted by the AER to reduce the forecasts based on the current period's underspend.

In order to justify forecast capex reductions of the same magnitude as the underspend against forecast in the current regulatory period, we would expect to see tangible evidence that the underlying circumstances influencing the forecast capital works program were similar. That is, we would expect that:

- The underlying macroeconomic circumstances which affected the quantum of works delivered in the current regulatory control period remain unchanged
- SP AusNet's forecasting methodology remained the same
- The proportion of the total capital program commenced or with business case approval would be the same at the start forthcoming regulatory control period as it was at the commencement of the current period

Whilst this list of factors is not exhaustive, we have not seen any tangible evidence in the data and material available that might support the factors listed above. On the contrary:

- The underlying macroeconomic forecasts are quite different, and a number of factors which influenced capex in the current regulatory period (e.g. the GFC) are unlikely to be repeated
- Although we have not reviewed the approach in any detail, SP AusNet's current forecasting methodology appears to have improved compared to that adopted 6 years ago (specifically with the development of the PAS 55 Asset Management System). We note the AER's views that "SP AusNet has good management policies and procedures"
- The proportion of the capital works program that is 'committed' or has firm cost estimates is much higher than in the current regulatory period, reflecting in part the shorter regulatory period, but more importantly the substantially more advanced status of most projects. While it remains an option for a business to prudently defer capex at any stage, it is reasonable to expect that if projects are already underway (or to a lesser extent, have received business case approval) then they are more likely to proceed according to forecast

Even if there was a greater level of consistency between SP AusNet's forecasts across the two regulatory periods the ongoing changes to regulatory, technological, micro- and macro-economic factors between (and within) regulatory control periods suggests that any adjustments to future capex expenditure should not solely be based on actual capex relative to forecast in the current regulatory period.

Also, given that SP AusNet's capex forecasts are forward looking and developed on a bottom-up basis, the magnitude of historical capex is not a strong indicator of the level of future capex required to meet the *capital expenditure objectives* set out in the NER.

Further, the approach adopted by the AER has the effect of penalising SP AusNet for making prudent and efficient reductions to capex in the current regulatory period. While we note that a continuous capex efficiency mechanism will not apply to SP AusNet in the forthcoming regulatory period the AER's approach appears to directly contradict the intention of the current and future mechanism, which is to reward efficient reductions in capex.

Consequently, Deloitte considers that the AER's decision to apply reductions to forecast capex in line with efficiencies achieved by SP AusNet in the current regulatory period is unlikely to be consistent with allowing SP AusNet to meet the *capital expenditure objectives* set out in the NER.

Yours sincerely

Paul Liggins
Director
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