6 November 2013

Mr Warwick Anderson
General Manager
Network Regulation
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: SPAusNetTransmission.2014@aer.gov.au

Dear Warwick

The Energy Users Association of Australia appreciates the opportunity to represent the views of its members to the AER, on its Draft Decision and also on SP Ausnet's Revised Proposal for the Maximum Allowed Revenue for SP Ausnet in Victoria from 1 April 2014 to 31 March 2017.

To reiterate a point we have made many times in this consultation process: Victorian electricity users have had to bear very significant electricity price increases over the last 5 years. The AER's Draft Decision is unlikely to result in price increases and while we support many parts of the AER's Draft Decision decreases, we think that more should be done to reduce transmission charges.

In Attachment A to this letter we have identified an estimated $117m that we suggest should not be recovered in regulated charges in the coming regulatory period. This is accounted for through changes to the calculation of Debt Risk Premium ($48m), changes to the methodology for the capitalisation of the Equity Raising Costs ($26m), abolishing the NCIPAP incentive payment ($19m), a reduction in the allowance for the Richmond Terminal Station ($9m) and abolishing the recovery of AEMO's Availability Incentive Scheme Payment ($8.6m) in regulated charges. We do however agree with SP Ausnet's rejection of the AER's cost estimation bias.

Finally we would like to acknowledge the excellent working relationship that we and our advisors have established with SP Ausnet. SP Ausnet answered all our questions and were constructive in their dealings with us.

Yours sincerely,

Phil Barresi
CHIEF EXECUTIVE OFFICER

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Attachment A

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1. Introduction

This attachment provides the EUAA's detailed response to the AER's Draft Decision and SP Ausnet's Revised Proposal. It examines in turn opex, capex, the network capability incentive scheme, and the weighted average cost of capital (WACC). In each of the sections we firstly respond to the AER's Draft Decision and then we respond to SP Ausnet's Revised Proposal

2. Opex

2.1. Response to AER Draft Decision

In general we support the approach that the AER has taken to the determination of SP Ausnet's opex allowance, particularly the weight that the AER has placed on SP Ausnet's "revealed costs". We support the application of this approach to SP Ausnet. Our support for this in the case of SP Ausnet is largely as a result of the significance of incentive payments through the efficiency benefit saving scheme, in the management contract between SP Ausnet Group and Singapore Power.

During the regulatory period ending 31 December 2013, SP Ausnet (SPN) has been managed by a subsidiary of its largest securityholder Singapore Power. Under this management contract Singapore Power retains 40 percent of any network incentive payments received by SPN, with deficits capped at $2 million but carried forward. This provides very strong managerial incentives to reduce opex below the AER allowances in order to maximise fees under the Efficiency Benefit Sharing Scheme (EBSS) which count as part of the network incentive payments in the management control.

Evidently SPN has been very successful in reducing opex over the last regulatory period, delivering EBSS payments of $34m in the coming regulatory control period on total savings during the current regulatory control period of $22m. This is a very substantial reward for SP Ausnet's opex reduction efforts and energy users expect that in setting future opex allowances, that the AER has regard to this actual outcome.

For this reason we share the AER's rejection of much of SP Ausnet's selective use of revealed costs for part of its opex allowance, but zero base budgeting for other parts of their proposed allowance.

The AER's Draft Decision sets an opex allowances that is, after adjusting for the capitalisation of equity raising costs, approximately the same as SP Ausnet's actual average opex in the current regulatory control period. Considering on-going productivity improvement as a result of a younger network and on-going technology change, our assessment is that this still leaves significant room for SP Ausnet to achieve further efficiency savings in the coming regulatory period.

2.1.1. Step changes

We support the AER's decision to reject most of SP Ausnet's proposed step changes. However, we do not support the rationale that the AER has specified for eligible step changes. In particular, the Draft Decisions suggests that "*the main consideration for step changes is whether regulatory obligations have changed. A step change should relate to a new or changed obligation placed upon the TNSP, or to some change in its operating environment beyond its control*".

We don't agree that changes in regulatory obligations should automatically result in step change increases in opex allowances. The relevant consideration, we suggest, is whether any changes in regulatory obligations or in the operating environment result in higher costs. So, for example, SP Ausnet are seeking approval for additional expenditure as a result of the AER's benchmarking work. It is plausible that this results in additional expenditure, but it is also likely that the information that will arise from this will benefit SP Ausnet in delivering cost reductions from which it will benefit. The relevant issue therefore in considering step changes is not just the changed regulatory requirements, but also whether this is likely to result in additional total expenditure after consideration of the benefits that might arise as a result changes in the operating environment or regulatory obligations.

2.1.2. Availability Incentive Scheme

At the time of the Draft Decision, AEMO has said that it intends to continue to apply the AIS to SP Ausnet. Neither the AER, nor the EUAA nor SP Ausnet supported this. In further discussions with AEMO after the Draft Decision, we understand that AEMO is not yet fully decided on the continued application of the AIS. They do however continue to have some concerns that the AER's Service Target Performance Incentive Scheme may not adequately incentivise SP Ausnet to deliver appropriate service outcomes.

In its Revised Proposal SP Ausnet is seeking to recover $8.6m AIS payments (revised down from $9.9m in its initial proposal).

We are not convinced that the continued application of the AIS in addition to the STPIS is beneficial to energy users. We call on the AER to disallow any AIS payments in the opex determination in the Final Decision (as it has proposed in the Draft Decision). Should AEMO insist that there are some service outcomes that are not adequately protected, then we propose that AEMO and SP Ausnet should seek to resolve this in a way that does not impose additional costs on energy users.

2.1.3. Network scale factors

We do not support the scale factors that the AER has applied for routine maintenance and insurance in calculating the opex implications of the inclusion of Group 3 Assets. We suggest that the AER's approach is flawed because it values the additional opex as a function of asset values.

Such an approach may be acceptable (after consideration of scale economy effects) if assets were valued consistently. But this is not the case: the RAB is valued at the depreciated current costs, while the Group 3 assets added to the RAB are essentially undepreciated (because they are newly constructed). As such, a calculation of the increase in opex on the basis of pro-rata RAB increases will almost certainly over-state the additional opex that SP Ausnet will incur for its Group 3 assets.

We raised this issue in our submission on SP Ausnet's proposal and the AER does not appear to have responded (or indeed there does not seem to be evidence that the AER has even recognised it). We call on the AER to reconsider its opex calculation as the result of Group 3 asset roll-in.

2.1.4. Capitalisation of equity raising costs

The AER has capitalised equity raising costs that were previously funded as operating expenditure. The method that the AER has used for this, which we understand is consistent with the method that it has applied in the Electranet decision, is to go back to the ACCC's decision in its first regulatory determination for SP Ausnet in 2002 and then calculate the income stream as if the equity raising cost (ERC) had been capitalised in 2002 rather annuitised in perpetuity. The AER then nets off the equity raising payments that have been made since 2002 in order to arrive at a value for the capitalised equity raising cost for the closing regulated asset base in 2013/14.

Effectively the AER is re-writing a regulatory decision in 2002, and consumers are being asked to compensate SP Ausnet for the regulated return on the capitalised value of the ERC (net of ERC annuity) as if the expenditure had always been capitalised.

Our advisors have discussed this with the AER's staff. The Staff's view is that the ACCC's decision in 2002 was always to capitalise the Equity Raising Cost at that time, but it was then expressed as an annuity in perpetuity. And so, Staff argue, they are simply revisiting what the ACCC always intended to do.

We do not agree with that. The 2002 Decision quite explicitly calculates an annuity and makes no provision for an ex-post recalculation of a capital sum rather than an annuity. A necessary step in the calculation of an annuity is to calculate the equity raising costs as a lump sum and then to annuitise that amount. The 2002 Decision does that, but this can not be taken to mean, many years after the Decision, that SP Ausnet has an option to capitalise the Equity Raising Cost at the time of the initial decision, and then to reap the substantial regulated return on the capitalised value between 2002/3 and now. This amounts to re-writing a previous regulatory decision for no good reason, and to great benefit for SP Ausnet and expense for energy users.

Rather than the AER's method we suggest that the capitalisation of the equity raising cost should be based on the capitalisation of the equity raising cost that was allowed (and expensed) in 2013/14 ($1.375m in 2007/8$). This should be capitalised using the allowed return in the coming regulatory control period. On the basis of the Draft Decision we have used 5.9% real, Vanilla. Capitalisation at this rate gives a capitalised value of the ERC of $23.3m in 2007/8$.

Updated to 2013/14 dollars this gives a capitalised value of the ERC of $27.5m. This is $25.9m less than the capitalised value that the AER has calculated pursuant to its approach.

We do not believe that the correct approach is for the AER to re-write a previous regulatory decision in 2002, as it has. Accordingly we call on the AER to adopt our suggested approach to the capitalisation of ERC, or simply to leave the ERC to be expensed as an annuity as it currently is. We understand that our suggested approach is inconsistent with the decision that the AER made for Electranet recently. But regulatory precedence should be valuable when the precedent decision is defendable. In this case, the AER's approach to the capitalisation of equity raising costs is not defendable and so appealing to the Electranet decision as a precedent is not sustainable.

2.2. Response to SP Ausnet's revised opex proposal

2.2.1. Asset works

SP Ausnet contends that the AER has significantly underestimated the efficient level of "asset works" opex, both in respect of the amount of opex included as part of the recurrent expenditure, and also because the AER disallowed all of SP Ausnet's "step change" opex claims related to assets works (this includes Overhead Line Inspections, Corrosion prevention work and communications infrastructure).

SP Ausnet is very critical of the approach that the AER has taken to determine asset works opex. Our understanding of SP Ausnet's main counter-arguments is as follows:

1. The AER should not have used the evidence of revealed costs in 2011/12 to set the asset works opex allowance.
2. The AER has erred under the Rules in giving primacy to the evidence of historic outcomes, rather than focussing on SP Ausnet's claims of the efficient level of opex that is required in future.
3. The AER has failed to assess the step change level of asset works-related opex on its own merits.

SP Ausnet's revised asset works opex proposal has dropped the claimed communications step change (already recovered through base opex) and has proposed that the allowance (excluding the steps changes) be based on the average actual asset works opex during the current regulatory period. In summary therefore SP Ausnet's proposal for asset works opex arrives at an allowance consistent with the AER's historic total asset works allowances.

We have considered SP Ausnet's counter-arguments and we disagree that they justify a change to the approach that the AER has taken in the Draft Decision. We deal with the three main counter-arguments below:

Argument 1: Wrong base year

In period from 2003/4 to 2013/14, the AER has allowed SP Ausnet to recover $180m from energy users to fund asset works expenditure. Over this period SP Ausnet has spent $104m, resulting in a difference of $76m or around 42% of the amount that has been allowed. Evidently, significantly more income to cover asset works related expenditure has been recovered from energy users than has actually been incurred by SP Ausnet.

The AER's approach uses this information of the revealed cost of asset works, to set the future allowance.

SP Ausnet points out that the asset works spend in the base year used to set the allowance (2011/12) was the lowest since 2003/4. While this may be the case, SP Ausnet's argument against the use of this year as the base year is internally inconsistent. Specifically, SP Ausnet accepts the use of 2011/12 for the base level of opex for base opex, but suggests that a different methodology be used for asset works opex. This is "cherry picking" – accepting a base level that is advantageous for one part of the opex budget, but then rejecting it for the other when it is not advantageous. The integrity of the use of revealed cost approach (and of the resulting EBSS incentive payments) demands a consistent application of the base year to all controllable opex elements. Accordingly we disagree with SP Ausnet's rejection of the 2011/12 base year for the determination of asset works opex.

Argument 2: Wrong to give primacy to evidence of historic outcomes

The AER's approach is indeed based on the "revealed" level of asset works expenditure. However we disagree with SP Ausnet, that by relying on this information it has failed to have regard to likely future expenditure requirements. The history of asset works expenditure shows that SP Ausnet has consistently convinced the AER to allow it to recover far more asset works opex than has been required. The evidence of this is powerful and the AER is justified in weighing this evidence highly in assessing the likely future level of asset works opex, and weighing this information more highly than what SP Ausnet has told it, it requires in future.

Argument 3: Wrong not to assess step changes related to asset works on their own merits

The AER included SP Ausnet's proposed step change increases in Overhead Line Inspections, Corrosion prevention work and communications infrastructure as part of its allowance for asset works, which is determined based on the revealed level of expenditure in 2011/12. As such it rejected SP Ausnet's claim for separate remuneration of this expenditure as "step changes".

Like the AER, we are not convinced by SP Ausnet's claim to strip this expenditure from the rest of the asset works expenditure and claim it separately as a step change. Expenditure on overhead line inspections, corrosion prevention work and communications infrastructure has historically always been included within the "asset works" bucket. As such, using information on the revealed cost to set future asset works allowance, as the AER has, will compensate this expenditure.

SP Ausnet says that its over-head line inspection is a step change since it is the roll-out methods that have been developed recently but not yet widely deployed. Likewise SP Ausnet's full tower painting program on the 220 kV Rowville circuits are significantly different to its historic tower paining program. But this of itself is not sufficient to justify separate additional provisions. The asset works budget is sufficiently large for SP Ausnet to prioritise expenditure as it sees fit, and we suggest that it is reasonable for the AER to weigh heavily the historic outcomes compared to historic projections, in assessing SP Ausnet's current claims.

2.2.2. Network growth and scale factors

SP Ausnet has reiterated its proposal to apply a 100% scale factor to taxes and leases. We do not support this, in the absence of evidence that taxes and leases change as a result of the roll-in of Group 3 assets.

2.2.3. Insurance

SP Ausnet originally proposed $19.1m for insurance, but revised this (before the revised proposal) to $16m. The AER's Draft Decision is an allowance of $11m, and SP Ausnet's revised proposal is $14m.

The AER said that its insurance calculation is based on "revealed costs" but there is no information to support this since the insurance appendix is marked "commercial in confidence" (so we do not know what the revealed costs are).

Our advisors took this up with SP Ausnet and we understand from information supplied pursuant to their request that a like-for-like comparison requires the exclusion of the Fire Services Levy from historic insurance data (this accounts for $450k per year on average over the regulatory control period).

SP Ausnet (and the AER) has characterised the AER's insurance allowance for the coming regulatory period ($3.7m per year) as a reduction in the actual insurance in 2013/14 ($4m after deducting the Fire Services Levy).

This is seems to be correct. But SP Ausnet's average annual insurance over the current regulatory control period has been $2.95m per year (after deducting FSL). The AER's allowance is therefore a step change increase of ~$0.8m or 27% on the average annual insurance spend in the current regulatory control period. Therefore the AER's Draft Decision allowance – to be compared with actual historic insurance – is a step change increase, not a step change decrease.

In addition, we are not convinced by SP Ausnet's argument that the advice of Aon Risk Services negates the reliance that the AER has placed on revealed costs. Aon is a major insurance broker and underwriter and in weighing their advice in the context of a revenue control decision, it can not considered to be disinterested.

2.2.4. Risk margin on self insurance

We do not agree with SP Ausnet's argument that failing to recover a margin will distort insurance decisions. The point is that self-insurance will occur when the insurers are not able to offer a competitive product. A margin on self-insurance is unlikely to bridge the gap. More generally, it would obviously be inappropriate to allow a margin on operating expenditure and self-insurance is no different.

2.2.5. Step changes

We generally do not agree with SP Ausnet's revised (or initial) submission on step changes (the exception being the Fire Services Levy). In most cases SP Ausnet draws attention to changes that it suggests will result in additional expenditure. However there does not appear to be consideration of the possibility that that expenditure will actually reduce total expenditure.

For example, SP Ausnet points to additional resources needed to produce the benchmarking data that the AER requires. While we agree that this additional obligation is likely to impose additional costs on SP Ausnet, we would envisage that a benefit of the resulting additional information is better understanding which will spur innovation and cost reductions which will in-turn reduce total expenditure. Such expenditure reductions are not countenanced in SP Ausnet's initial or revised proposals. For this reason we can not accept that the step changes that SP Ausnet has proposed (except FSL) will result in additional total expenditure. As such we do not agree that this expenditure be allowed. In the case of the FSL, we suggest that this be treated as non-controllable opex and subject to ex-post true-up for actuals, rather than use SP Ausnet's projections which are twice the average annual level for the last six years.

3. Capex

3.1. Response to AER Draft Decision

3.1.1. Prudency adjustments

The AER had regard to SP Ausnet's historic expenditure outcomes in comparisons to its claims, in assessing an adjustment to SP Ausnet's proposed expenditure. We support this approach, although we agree with part of SP Ausnet's response to it, discussed in the next sub-section.

3.1.2. Cost estimation bias

The AER proposed to reduce SP Ausnet's forecast of total project expenditure for site-specific network projects and non-site-specific programs of capital work by 1.4% to reflect the AER's assessment of "cost estimation bias". We do not support this adjustment. It is not clear to us why cost estimation bias is different to the AER's prudency adjustment (which we support) and so we are not convinced by the AER's justification for this additional adjustment.

3.2. Response to SP Ausnet's revised capex proposal

3.2.1. Prudency adjustment

SP Ausnet rejected the AER's prudency adjustment on three grounds:

1. That it is wrong to use historic outcomes in deciding future prudency adjustments because this discounts SP Ausnet's improved ability to forecast expenditure and because it is a three year rather than six year regulatory control period.
2. That the AER has ignored SP Ausnet's own prudency adjustment.
3. That the AER has incorrectly calculated the adjustment even with its own methodology.

On the first of these arguments, we accept that SP Ausnet is better able to forecast expenditure and that forecasts three years ahead are likely to be more accurate than six years ahead. On the other hand there is evidence that significant errors ate still possible. For example, in its regulatory proposal SP Ausnet forecast that the spending at the Richmond substation would be $12.5m in 2012/13, whereas in the Revised Proposal that has been corrected to $19m, a circa 40% error for expenditure in the same year that the forecast was produced.

The issue therefore is whether SP Ausnet's ability to forecast is so much better that its justifies discounting the historic evidence. On balance we are not convinced, not least because of the recent Richmond experience.

On the second argument we are not convinced that SP Ausnet's "portfolio" reduction in expenditure of 1.4% is meaningful. Network service providers are hardly going to argue that they have overstated their claims, and being able to point to an adjustment that has been made is an unconvincing response to the hard evidence that claims have been overstated in the past.

On the third, we accept SP Ausnet's argument that the AER's consultant erred in only comparing the costing of projects that were proposed and then developed, instead of comparing the allowed and actual spend across the program. We therefore agree to the adjustments that SP Ausnet has proposed, although we add that we have not assessed the veracity of SP Ausnet's revised calculation.

Richmond

SP Ausnet's revised proposal is that an additional amount of $9m will be required for the relocation of distributors' equipment. As we noted earlier such a significant revision after the Draft Decision for what is meant to be a very well known project is regrettable. In addition, as noted earlier the actual spend in 2012/13 is significantly above the expected level. We understand that the 2012/13 difference may reflected a variance in the timing of the incidence of expenditure but not a variance in the total expenditure on the project and accordingly we call on the AER to reduce the allowance for expenditure on the Richmond submission in the coming regulatory period by the sum of the variances between SP Ausnet's original and revised proposals for 2012/13 and 2013/14 for Richmond terminal station expenditure.

West Melbourne

We understand that last-minute land acquisition claims related the East-West road link have substantially altered SP Ausnet's proposals for the redevelopment of the West Melbourne submission. Their revised proposal is for a project that is $26m – about 20% more than their initial proposal, although the incidence of the expenditure in the forthcoming regulatory period will be reduced from $107m to $69m. We are concerned about the late changes, albeit that the circumstances are beyond SP Ausnet's control.

SP Ausnet is also proposing a negative cost pass-through which will pass through to consumers 90% of any amount that SP Ausnet will be paid for land compulsorily acquired at the West Melbourne Terminal Station.

Metropolitan substation redevelopments are complex and have the potential for significant expenditure blow-outs. This project spans two regulatory control periods and we are concerned that as a result of this there is potential for risks to be shifted to users in ways that would not be possible (or at least more difficult) if all the expenditure was contained within one regulatory control period.

We have not attempted to assess the merits of SP Ausnet's revised proposal for West Melbourne. However, on balance, we support SP Ausnet's revised proposals and their proposed negative cost pass-through. This can not be taken to be support, necessarily, for the timing and level of their proposed expenditure and we expect the AER to scrutinise this closely. We also call on the

AER to develop appropriate expenditure reporting so that effective incentives (and consumer protection) will occur for such a significant project that spans two regulatory control periods.

3.2.2. Strategic IT

SP Ausnet suggests that the AER (on EMCa's advice) has mis-characterised IT as strategic, has incorrectly benchmarked SP Ausnet and has incorrectly expected opex reductions from IT expenditure that SP Ausnet suggests is substantially needed to renew redundant IT systems. We have read SP Ausnet's trenchant defence of its IT budget in Appendix O of the revised application. The core parts of this that would allow us to offer an informed view on SP Ausnet's proposal are marked "Commercial-in-Confidence". Hence we are not able to offer a fully informed view on SP Ausnet's revised proposal.

Finally we have examined the significant difference between SP Ausnet's estimate of its IT benchmarking and the benchmarking undertaken by EMCa. It seems that a main reason for the difference is different classification of IT expenditure. We do not have access to the detail of the data needed to assess SP Ausnet's claim and call on the AER to do this. However, we note that even on SP Ausnet's adjusted benchmarks, SP Ausnet ranks lower than all other TNSPs except Electranet on the measure of Annual IT Capex divided by Annual Revenue.

4. Network capability incentive payments

We strongly reject the AER's draft decision that SP Ausnet be allowed to recover 1.5% of its maximum allowable revenue for the three years of the control as part of the Network Capability Incentive Parameter Action Plan (NCIPAP). We suggest that this would be a bad waste of Victorian energy users' money. It provides a risk-free windfall for SP Ausnet for no good reason. We strongly oppose this and call on the AER to consider our alternative proposal.

4.1. Analysis of AER's proposals

SP Ausnet proposed a handful of NCIPAP projects worth around $5m. AEMO subsequently expanded the list of projects (to 23) and costed the expanded list at around $13m. SP Ausnet accepted the expanded list and included it in its revised proposal. SP Ausnet is committed to undertaking these projects.

The projects are mostly minor changes to protection settings, the development of a few inter-tripping schemes, changing the display of performance measurements, development of more accurate constraint equations and so on. There is one large project ($5m) – which seems to be about testing and then reporting on the fault levels of 22kV switchyards. All of the projects seem to have fairly clear deliverables (e.g. protection setting changed, display consols changed, studies done etc.)

We have not sought to test AEMO's costing of these projects, or indeed whether the expected benefits exceed the costs. In general we have no reason believe that the projects are not worthwhile. We are however sceptical that $5.3m should be allocated to studies of 22kV fault levels over the next three years, not least in view of the very considerable capex program that SP Ausnet has to manage over the coming period.

Notwithstanding this, the main point we make is that these projects have already been identified and costed.

In return for undertaking these projects, SP Ausnet will receive fees as follows:

- 1.5% of its Maximum Allowed Revenue for each of the next three years. Based on the AER's Draft Decision, this is worth $23m.
- In addition SP Ausnet will be allowed to include in its regulated asset base, the capitalised expenditure associated with this spend. This is worth, according to SP Ausnet, $7.5m

SP Ausnet's total "NCIPAP" compensation will therefore be worth, as a present value, around $31m. This amount will be even higher if the maximum allowed revenue in the Final Decision is more than in the Draft Decision.

In return for this $31m compensation, SP Ausnet will incur costs that they estimate at $13.2m, leaving a net profit to SP Ausnet of $19m. This is not sensible: SP Ausnet is not incurring any risk to undertake these projects because they have already been identified and costed. Linking SP Ausnet's remuneration for undertaking these projects to the maximum allowable revenue, rather than their actual expenditure on these projects is indefensible.

We understand (from Version 4 of the STPIS) that if SP Ausnet (or other transmission network service providers) do not satisfactorily implement all the performance projects, a penalty up to a maximum of 2% of MAR in the last year of the regulatory control will be payable.

Therefore, as a worst case (i.e. SP Ausnet do not develop any of the projects and so are exposed to the maximum penalty) the payments to SP Ausnet under the NCIPAP arrangements would be as follows:

1. 1.5% of the MAR for the first two years of the regulatory control period ($15m)
2. Less 2% of MAR for the third year ($10m).

In other words, if SP Ausnet completely fail to develop the NCIPAP projects they still gain $5m. While it is very doubtful that SP Ausnet would not undertake all the NCIPAP projects (they have committed to develop them) it is obviously nonsensical that they would nonetheless receive $5m for not undertaking the investment.

4.2. Our proposal

The problem here seems to be that the AER sees the need for an incentive payment for NCIPAP projects that is completely independent of the actual cost of the projects. As explained above thus has no merit since the projects have already been identified and costed by AEMO. SP Ausnet does not need to be incentivised to discover these projects, or indeed to develop them.

Our proposal is that the NCIPAP aspect of the STPIS be suspended immediately for SP Ausnet (and also for the other TNSPs that intend to opt into the scheme during their current regulatory period).

We understand that in discussions between our advisor and the AER's staff that our concerns over the NCIPAP have been recognised and that the AER's staff has suggested that the scheme be reviewed in 2014/15. We suggest that it is quite inappropriate to implement a flawed scheme only to have to then set about rectifying those known flaws – which are at users' expense - later.

Adopting our suggested approach, in the case of Victoria alone, is likely to save energy users $19m in charges over the next three years.

5. WACC

5.1. Debt risk premium

The AER accepted SP AusNet's proposed method for determining the Debt Risk Premium (DRP), which was based on the extrapolated Bloomberg BBB fair value curve. This resulted in a DRP of 3%, reflecting the averaging period (24 June 2013 to 19 July 2013) used in the Draft Decision.

We reject the AER's Draft Decision on the DRP. In the Draft Decision the AER says its recognises our concerns about the calculation of the DRP, but suggests its hands are tied (because the old National Electicity Rules apply in this decision), and that the issue is being examined in the Better Regulation program. We do not agree with the AER's claim that its hands are tied as it suggests. While the existing Rules do require a 10 year calculation for the DRP and a benchmark BBB+ credit rating it does not specify the method to be used in the calculation.

The AER's adoption of SP Ausnet's method for the calculation of the DRP has resulted in a DRP of 300 basis points. This seems to be a significant premium to their actual DRP as revealed in SP Ausnet's two most recent Australian dollar bonds for 10 years and 7 years issued on 7 February and 25 February 2013 respectively. These bonds were priced at swap + 175 bp and swap + 160 bp respectively. Adding 60 basis points to convert from swap to 10 year bond gives a debt risk premium (on a comparable basis to the AER's definition of DRP) of 235 basis points and 200 basis points respectively. The resulting difference between the AER's determination and the actual cost of recent issues is therefore 65 to 100 basis points. With an average RAB for the coming three years of $3bn, and assuming 60% gearing, this difference is therefore worth $12m to $18m per year. This translates into allowed revenues of 2.3% to 3.6% per year (based on the AER's Draft Decision) higher than they would be if the DRP reflected actual outcomes. We call on the AER to reconsider its approach to the calculation of the Debt Risk Premium in order to ensure that the allowed DRP is much closer to the evidence of SP Ausnet's actual DRP as evidenced in recent bond issues.