Energy Users Coalition of Victoria

Australian Energy Regulator

Victorian Electricity Transmission Revenue Reset

AER Draft Decision and SP AusNet Revised Application

A response

by

The Energy Users Coalition of Victoria

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Executive Summary

The Energy Users Coalition of Victoria (EUCV) welcomes the opportunity for presenting its views on the draft decision of the AER on the application from SP Ausnet (SPA) for a reset of its electricity transmission costs for Victoria, and on the revised application from SPA.

In the EUCV's view, the draft decision by the AER commences a trend to return SPA costs to levels that are more efficient and should result in returning costs consumers have to pay for the service, towards the level that applied before the rules gave NSPs free rein to massively increase costs.

Despite the very large increases in opex and capex allowed SPA for AA3 which drove the massive increases in SPA prices in the period, SPA has sought even higher allowances for its opex and capex in the AA4 period. These increases are despite SPA under-running both opex and capex allowances during the AA3 period. The AER draft decision proposed significant reductions in opex and capex but SPA refutes most of the reductions in its revised application.

The EUCV has provided details in this submission for elements of concern about the AER draft decision and support for other aspects, and has expanded its comments to incorporate the refutation by SPA in its revised application of many aspects of the AER draft decision.

The EUCV sees that the main aspects of concern with the draft decision and SPA revised application lie with:

- The debt risk premium calculated by the AER and SPA, as the calculated amount considerably exceeds the observed costs of debt actually incurred by SPA. Overstating the cost of debt provides SPA with a strong incentive to exceed its capex in addition to requiring consumers to pay an inefficient amount for the services provided.

- EUCV agrees with the AER approach to setting the efficient opex allowance, especially as SPA considerably under-ran the opex allowance granted by the AER in AA3. The EUCV also agrees with the AER that revealed opex costs supported by an incentive are the best indicator (in the absence of better benchmarking) of efficient levels. The approach used by SPA of using some revealed costs and then adding more costs calculated using a bottom up approach, is not in accord with the principles for using incentives to drive costs to the efficient frontier. The EUCV considers that the SPA approach is flawed and results in opex that is not demonstrably efficient.

- The EUCV considers that the AER assessment of the capex does not fully reflect the "top down" approach that the AER should utilise. When adjustment is made for the inclusion of the costs proposed by SPA for the revised WMTS project, the AER proposed capex allowance is considerably higher than the average annual capex used by SPA in AA3 - in fact SPA incurred less capex in AA3 than it was allowed and by doing so accrued a considerable benefit. The outcome of the under-run on capex in AA3 by SPA and the AER approach to capex for AA4 is that consumers are paying a premium because SPA deferred capex in AA3 and by doing so, made an additional profit at consumers' expense

- The approach by the AER to the network capability component of the service performance incentive scheme is confused and effectively provides SPA with a secondary source of opex and capex. The only difference between projects in the NCIPAP and projects in the capex is that if the projects in the capex allowance are completed as intended, SPA does not get a bonus whereas it those under the NCIPAP are completed, SPA is paid a bonus. This seems inappropriate as consumers are seeking for these projects to deliver them a quantifiable benefit.

Overall the SPA initial application sought an increase in opex and capex that sufficiently exceeded past performance, so much so that the benefits of the lower risk free rate were eliminated. The AER draft decision did result in a significant reduction in average costs to consumers but SPA has effectively overcome the AER reductions so that the revised application outcomes for consumers looks much like the initial application which consumers considered is inefficient.

1. Introduction

The EUCV welcomes the opportunity to provide comments on the AER draft decision on the SP Ausnet (SPA) application for an increased allowance to provide electricity transmission services in Victoria and the revised application by SPA issued subsequent to the AER draft decision.

1.1 A summary view of the AER Draft decision and SPA application

To demonstrate that its network costs are efficient, SPA provided a view of the cost of its services (relative to the growth in consumption) in its initial application for the AA4 revenue reset and opined that this would lead to a modest reduction in transmission costs.

In its draft decision, the AER provided a view that cost reductions for AA4 (relative to expected consumption) should show a significant fall[1] from the prices for the last year of AA3 and commence a trend back to where SPA costs had been in the past prior to the rapid increase in costs seen during the last regulatory period AA3 over where costs had risen massively.

The revised application by SPA reflects much the same costs/MWh as forecast by SPA in its initial application as the very modest cost reductions in opex and capex proposed in the revised application are offset by the rise in the cost of capital identified by the AER in its draft decision and accepted by SPA.

Overall, the cost comparisons for the maximum allowed revenues are shown in the following table, following a 10% fall in allowed revenue for 2013/14:

MAR smoothed outcomes ($nom)	2013/14	2014/15	2015/16	2016/17
Current	$546m			
SPA initial application		$502.5m	$535.1m	$560.1m
AER draft decision		$5!9.0m	$509.3m	$499.8m
SPA revised application		$519.0m	$531.3m	$543.9m

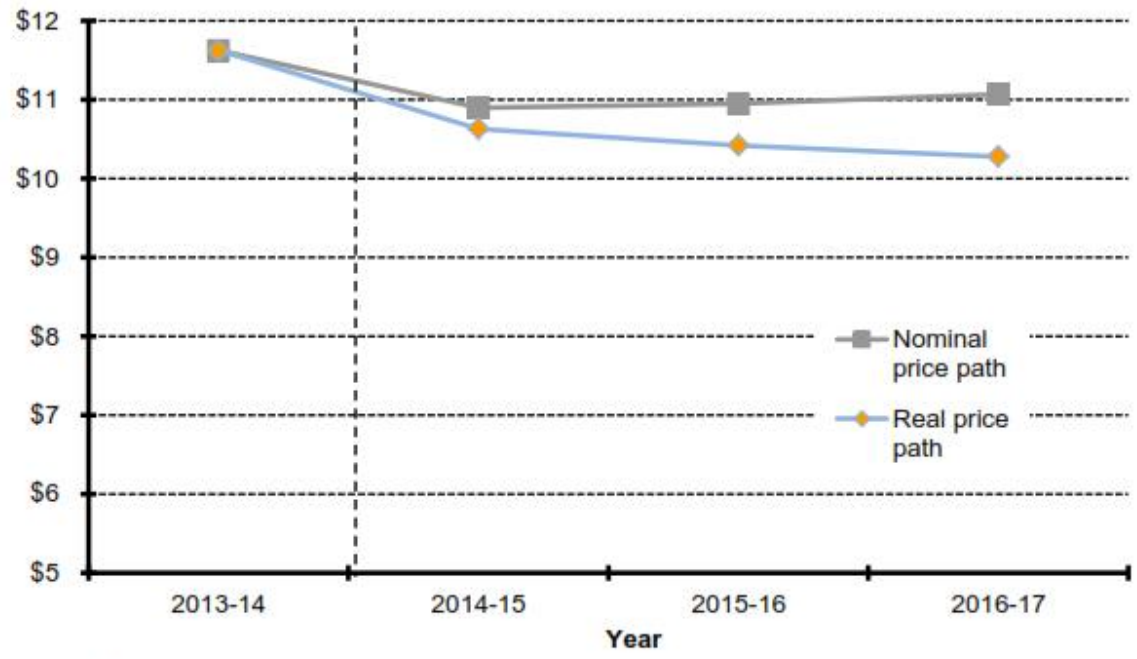
[1] This reflects the lower than expected consumption in the last years of AA3 and a modest increase in consumption for AA4

This clearly shows that SPA has retained its initially forecast revenue in its revised application; the SPA revised application has basically rejected the AER draft decision outcomes other than to concur with increasing the allowance for return on capital.

The EUCV has reviewed the AER explanations for why it considered the allowances for opex and capex should be reduced and agrees with much of what the AER has concluded. Despite the explanations, SPA has rejected the bulk of the AER reasons for change in these areas.

The only positive outcome from the revised application is that SPA forecasts that the average tariff for electricity transmission services will fall from the levels seen in AA3 to lower levels. This is shown in figure 11.1 in the SPA revised application[2].

Figure 11.1 – Future Real Price Path for SP AusNet ($/MWh)



Source: SP AusNet PTRM

[2] It is important to note that the consumption forecasts that underpin these future average prices incorporate an annual growth of 1.3% pa despite falls in recent years showing an increasing annual reduction in consumption.

The outcome of the revised application is that SPA is likely to continue to be the second least expensive TNSP in the NEM - this is despite SPA not having to include the cost of augmentations provided by AEMO under its role as the Victorian transmission operator and Victoria having a much denser consumption than TransGrid which has the lowest overall unit costs.

This comparison alone shows that the AER draft decision probably has continued to over-provide SPA with allowable revenue.

1.2 The helicopter view

The EUCV is unable to accept that the proposed maintenance of costs can be justified when assessed against a background of falling consumption and falling demand. Equally, we note that the applicant has provided arguments in support of each element of its claimed cost increases in its revised application, even though the AER had refuted many of them in its draft decision.

During AA3, SPA increased its prices by a massive 70% despite falling consumption. In AA4, SPA's revised application reduces prices by about an average of 6% (in nominal terms) by the end of AA4. For SPA to consider that these prices should be maintained and funded by consumers for another 3 years is unreal and must not be approved.

Even the reduction of ~10.5% proposed by the AER in its draft decision still does not rectify the massive impost placed on Victorian electricity consumers.

As noted above, consumption is showing an increasing downward trend and therefore the falls implied by the SPA consumption forecasts could well become increases.

The EUCV sees that of the total revenue allowed SPA, nearly 20% is to pay for the easement tax - a charge levied in Victoria on all consumers to provide Alcoa with discounted electricity prices. This charge alone costs consumers about $2/MWh. The EUCV notes that the Victorian government liability to Alcoa for low cost electricity should now be approaching its completion date, so the EUCV expects the AER to verify that the cost being included in the SPA revenue needs to continue for the entire period of AA4.

1.3 The materiality of transmission costs

Both SPA and AER point to the SPA charges being quite a small proportion of the overall cost of electricity and that erring on the SPA costs has minimal impact. This is not quite true. Whilst the observation might apply to residential costs for

electricity, the closer a consumer is to the transmission supply point and the larger the demand of the consumer, the more significant transmission costs can become.

Transmission costs are significant, and it is essential that transmission costs are not treated as insignificant, and are addressed in a comprehensive manner.

2. Forecasts of demand, consumption and input cost changes

2.1 An overview of electricity (demand and consumption) forecast changes

The EUCV recognises that SPA is not responsible for augmenting the Victorian electricity transmission system to meet increases in demand – this is the responsibility of AEMO. However, SPA is required to replace assets due for replacement on an age basis with assets that meet any expected increase in demand.

SPA has advised that it is using the latest AEMO data as the basis for expected demand increases yet the consumption data for 2012/13 that was not available to SPA when it made its initial application. The recent data indicates that the AEMO forecast for 2012/13 in its 2012 ESoO is overstated as it continues to show a lower consumption than AEMO forecast, reinforcing the view that AEMO's forecast of consumption for later years is likely to be optimistic. Similarly the actual demand data for 2012/13 shows that demand has increased less than AEMO forecast as its 50% PoE in the 2012 ESoO.

The expected consumption by the end of the next (three year) period is forecast by AEMO to be much the same as at the start of the current period (AA3), so the opex and capex SPA is claiming for the coming period (AA4) are overstated relative to those costs they had early in AA3.

The impact of a lower consumption than forecast will result in higher forecast prices for provision of the services and will distort the advice the AER and SPA provide stakeholders by implying lower unit prices than are likely to occur.

Importantly, a lower than forecast consumption will place less load on the SPA assets and so extend their likely lives, reducing the need for replacement in AA4 (ie less capex) and less failure of exiting plant (ie less opex). The AER needs to keep this expectation of lower expected loads in mind as it assesses the SPA claims for opex and capex.

2.2 Escalation forecasts for labour and materials

2.2.1 Wages cost growth

SPA continues to have a preference for using BIS Shrapnel (BIS) labour escalation forecasts rather than the AER preferred DAE LPI data. The EUCV sees that the only reason for SPA having a preference is that

they consider use of the BIS data will provide a better outcome for SPA (and the data provided by SPA in table 2.6 of its revised application supports this view by a considerable margin). SPA provides an argument that the BIS approach is more accurate than the DAE approach.

What SPA does not do to support its contention is to demonstrate whether the long term forecasts of BIS provide a more historically accurate outcome than those of DAE. Previously the AER has compared the accuracy of the forecasters (see for example table C2 in section 3 of the AER Sep 2012 draft decision on Multinet). This data is quite fascinating and from it the AER concludes that the LPI forecasting by DAE is more stable, exhibits less volatility and provides greater accuracy than does BIS forecasting and so the AER considers the DAE forecasting is a more appropriate tool for setting future labour costs.

What the AER does not do is to assess the aggregate accuracy of the forecasts over time. For example (using the table C2 data referenced above) the DAE forecast for EGW labour costs made in 2007 for year 2010/11 shows a small under-run compared to the actual LPI. Yet these forecasts are compounded – the forecast for 2010/11 is the compounded increase of all the previous years of data. When compounding is implemented, the actual increase in LPI for 2010/11 based on movements from 2007 implies labour costs in 2010/11 were 24% higher than in 2007. The DAE forecast for the same period shows an increase of 26% (the BIS increase is nearly 29%).

Further, the errors between the actual values and the forecasts show a consistent overestimation of future LPI values. The number of times the forecasters underestimated the actual LPI is 25% whereas the overestimates comprise 60% of the forecasts – the balancing 15% of forecasts is where the forecasts were accurate. On this basis the forecasters are likely to overestimate the LPI 4 times more than they get it right and underestimate it 2 times more than they get it right.

SPA points out that the BIS forecast for 2011/12 was more accurate than that from DAE and therefore the BIS data should be used. To use a single point as the basis for assessing long term accuracy is flawed logic - more than one year of data has to be assessed to provide a better view on accuracy. At least the AER did look at a longer time line in their analysis for the gas decisions.

However, in its analysis, not only does the AER identify that both DAE and BIS tend to over-estimate the LPI but that they identify that DAE tends to less over-estimate than does BIS.

SPA suggests that an average of the two forecasts could be an approach to address its needs as was allowed in the AER decision for SPA's gas distribution business. The argument provided by SPA is based on the advice of Professor Borland who opined that an average is statistically more accurate than using a single source of information.

The EUCV considers that the AER would err in taking such an approach. If both DAE and BIS have a track record of overestimation then the most accurate outcome would be to use the party that is more accurate over time. In this case the AER would appear to be correct in the use of DAE forecasts.

In order to provide a more accurate allowance, the EUCV considers that the AER should look at a longer time line than the data it provided for the gas decision and then discount the preferred data to a level where there is an expectation that the a more accurate wage inflation forecast will result[3].

In its revised application SPA provides information that it has entered into an enterprise agreement for its direct employees and that the EBA should be used for the basis of forecasting labour escalation. The EUCV considers that the use of an EBA to set the future costs is inappropriate and should not be used as the basis for wage escalation.

An EBA is a unique arrangement made between an employer and its staff and reflects many different needs. The allowed costs for providing network services is based on the notional efficient provider and not on the future movements in wage costs agreed to by a specific firm. The risk to consumers if the AER allows an EBA to be used as the basis for future wage movements would allow a specific firm to agree on wage growths above what an efficient firm would allow, in the full knowledge that the regulator will include such increases without demur. This is unacceptable to consumers. Such automatic cost escalation goes against the grain of incentive regulation, more so when

[3] An even more accurate approach is to avoid using forecasts at all and implement an annual adjustment for labour and materials movements as proposed in section 2.2.3 below

the issue concerns wage growth and productivity growth where firms involved in an EBA mandate tradeoffs between these two factors.

The EUCV notes that the AER has decided to use LPI values unadjusted for productivity and that is has also decided not to adjust SPA forecasts for changes in productivity. The AER notes (page 62)

> "We acknowledge the EUCV's considerations that productivity adjustments should be applied. However while we expect labour productivity to improve in the long run, estimation difficulties mean we did not seek to address this effect in SP AusNet's forecast of labour costs."

The EUCV finds this observation totally unacceptable. The AER is charged with ensuring that only efficient allowances are provided to provide the service. If there is an expectation that there will be increased productivity which will reduce the cost of the service to a more efficient level, then the AER is required to implement the more efficient outcome. To recognise there is an adjustment to render the outcome efficient and not to implement the adjustment does not ensure that the cost allowed is efficient.

Earlier in the AER discussion on the approach for setting forecasts of efficient allowances for future opex and capex the AER comments (page 62):

> "We acknowledge the Energy Users Coalition of Victoria's (EUCV) recommendation that we should continue to monitor and review forecasters' approaches and the accuracy of these approaches over time. As part of the Better Regulation program of work, we are reviewing real cost escalation approaches for future resets."

It is quite apparent that the AER intends to implement better approaches to ensure that only efficient costs are included in the forecasts of future allowances. It is bizarre that the AER has decided that it will opt, knowing that future improvements in productivity will occur, to exclude such improvements in the case of SPA's allowance for the electricity transmission service.

In contrast, the AER did impose a productivity improvement in the forecast allowances for APA GasNet, and did so using a specific expectation of improved productivity. By not making a similar forecast for SPA allowances, the AER has not complied with its requirement that the AER must be mindful of the electricity objective - that cost allowances must be efficient.

2.2.2 Materials cost growth

The EUCV notes that the AER accepted the SPA/SKM forecasts for materials but with some minor changes, specifically relating to the inclusion of labour, the impact of changed carbon tax impositions and exchange rates.

The EUCV notes that SPA has not accepted the AER forecast changes and has sought more changes leading to an increase in the allowance. The EUCV has a concern that materials price forecast adjustments are being made that are inconsistent with other determinations and allow the NSPs to "game" the process to increase their profitability.

2.2.3 A new approach to adjustments for escalation

In recent times affiliates of the Major Energy Users (of which EUCV is one) have suggested that the AER should cease to use CPI as the only annual escalation of allowed revenues and to develop a unique energy networks escalator which the AER would calculate each year and have applied to all energy network costs.

This concept has been previously rejected by the AER as it considers that consumers want to see stable price movements based on CPI. This observation is facile as, especially for networks regulated with a revenue cap, revenues are adjusted each year to reflect the unders/overs incurred in the previous year and in transmission where revenues are adjusted for distributing the inter-regional settlements residues.

In recent discussions, as part of the Better Regulation program, the AER has also instituted a number of new approaches that will make such predictive assessments significantly less related to the movements in the CPI. One such change is to adjust the cost of debt allowance each year. Other activities in the Rules which cause a lesser relationship are pass through costs (eg the Victorian Bushfire Royal Commission recommendations) and introduction of contingent projects. Other impacts are exogenous but have the same impact such as the changes to state imposed feed in tariffs into network charges.

Overall, all these changes move the initial concept of prices moving just in relation to CPI moves further from reality. It is therefore illogical that the AER persists in making allowances for forecast movements in costs that are, at best, informed guesses and which are consistently shown to be in

error as the future unfolds.

As the AER has already planned to make significant changes that will reduce the relation between CPI and future prices, it makes sense that the inflation of costs be accurate through annual adjustments of actual labour and materials changes rather than making consumers pay more than the efficient allowance and at the same time increase the risks faced by NSPs that costs might not be sufficient for the needs.

3. SPA WACC

The AER and SPA have agreed on the methodology for calculating the weighted average cost of capital to be used for this reset. The EUCV recognizes that most of the parameters to be used were developed and set at the WACC determination in 2009 and these have been applied.

SPS revised application accepts the AER draft decision on WACC and the methodology used by the AER to set the WACC

In recent years the AER has been concerned that it has been allowing greater costs for debt than is incurred by NSPs; in the past year it has devoted considerable attention to this issue during the development of the Better Regulation program. Despite this, the AER draft decision applies a methodology for establishing the debt risk premium (DRP) for SPA which has been demonstrated as being flawed.

The EUCV remains concerned at the way the allowance for the DRP has been calculated in the AER draft decision (and agreed by SPA in its revised application) as it does not reflect the actual costs that SPA has acquired its debt for. By providing an allowance greater than needed by the firm it provides an incentive to overspend on capex as well as imposing an unnecessary cost on consumers.

As debt is a cost to the firm, the AER should not be providing a premium as this is not efficient and therefore does not comply with the Objective.

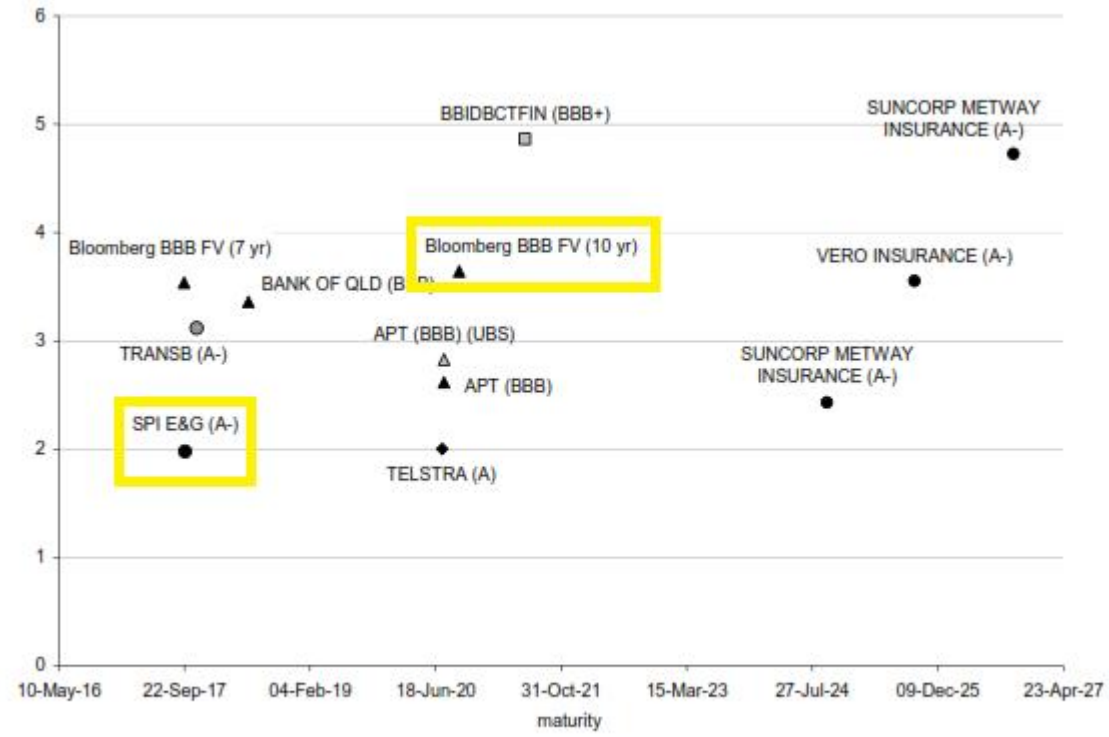
3.1 Evidence of a lower cost of debt for SPA

As part of its processes leading to the Final Decision on the Victorian electricity distribution network service providers determination 2011–2015 issued in October 2010, the AER carried out considerable investigation into the cost of debt incurred by regulated energy network service providers, in an attempt to identify why the coupon rate for the APT bond issue in 2010 (seen as a typical debt cost for regulated networks) was significantly lower than the Bloomberg Fair Value estimates for similarly rated bonds.

In that process, the AER also included details of the costs for an SPI bond[4] which also exhibited that the price for the long dated bonds it had issued were also well below the BFV estimates[5].

The following figure was included in the AER final decision (page 508).

Figure 11.5 Spreads on long dated bonds



Source: Bloomberg, UBS, AER analysis.

Highlighting by EUCV

What the figure shows is two fold:

1. The cost of debt for SP Ausnet as shown in the cost of bonds issued is 200 bp. This compares very unfavourably with the allowance that the AER has in its draft decision of 300 bp - a massive difference which imposes a considerable (and unnecessary) cost penalty on consumers.

[4] SPI is a subsidiary of SP AusNet which was one of the NSPs included in the review and which is the focus of this review

[5] The same figure also shows that another regulated network service provider (Telstra) also had issued bonds with a cost well below those for other bonds of similar credit rating

2. There is considerable variation between the yields on the bonds (even though they are of similar rating ranging between A to BBB) and that the Bloomberg Fair Values (BFV) are consistently higher than the yields of bonds issued by regulated energy and telecom networks. What is also apparent is that there is little (if any) consistency in price between bonds of the same credit rating. The AER did not attempt in its decision to address this very apparent inconsistency.

What is clear is that by allowing SPA a DRP of 300 bp calculated by extrapolation and interpolation from Bloomberg data for 10 year bonds the AER has provided SPA with a significant margin above its actual costs causing consumers to pay an unreasonable premium for the provision of the services

3.2 Why is there a difference between BFV and actual costs?

To assist in assessing the cost of debt faced by NSPs, the AER commissioned Oakvale Capital (reporting to the AER February 2011) and Chairmont Consulting (reporting to the AER in February 2012). Both consultants advise that credit rating is but one element considered by lenders when setting the cost of debt they will provide - they cite there are many other aspects than just credit rating that determine the cost of debt provided to a firm. Of these other aspects, both consultants state unequivocally that the industry the firm operates in is the critical determining factor in setting the cost of the bond, and not the credit rating.

Chairmont (report page 6) advises that there are three principles that determine the cost of debt and which reinforce the importance of the industry of the borrower:

> "Principle 1: The industry and entity specific characteristics of the issuer should be reflected in the industry and entity characteristics of the proxy;
>
> Principle 2: Debt structure and seniority and other key features of the debt being benchmarked should be reflected in the key features of the debt proxy; and
>
> Principle 3: The proxy bonds chosen should have risks perceived similarly in capital markets to the risks to the debt being benchmarked. The benchmarking process should seek to deliver results consistent with one undertaken by market practitioners in capital markets reflecting their perception of risk relating to the potential proxy bonds."

These principles do not refer at all to credit rating other than in passing - by reference to debt structure and seniority of the debt.

The market evidence supports the three principles and explains why debt provided to different firms but with the same credit rating exhibits such a large variation in the cost of the debt. The AER has made no attempt to address this clearly enunciated concern of Chairmont.

Chairmont goes on to state (page 8)

> "A better outcome would be achieved by the inclusion of other securities and entities in the process to further decrease the impact of BFVC and to broaden the number of proxies used. In other words, the constituent sample in the BFVC proxy group is inappropriate and inconsistent with best practice benchmarking principles. In my opinion, both fixed rate and floating rate bonds from infrastructure and/or regulated entities and industries should be included in the benchmarking process. For instance, fixed and floating rate debt issued by the Sydney, Brisbane and [the New Terminal Financing bond] Adelaide Airports are good proxies on term, structure and industry grounds. These characteristics of the proxies make them a high value proxy group. In the case of these examples, they are effective or near monopolies relying on patronage and usage that is predictable and stable, fixed infrastructure similar to pipelines, and subject to regulation. The process is about employing good principles and judgement on the available data."

Chairmont provides a summary of its key findings (page 17). Of these most important are:

- "The current [AER] benchmarking process is flawed as it works on a principle that predominantly uses ratings to find proxies. If rating is the only thing that qualifies a proxy, then the benchmarking process is inappropriate;
- The industry of the debt issuer proxy is of paramount importance in benchmarking and banking is not a similar enough industry to infrastructure to qualify bank debt as an appropriate proxy for this process;"

The AER also commissioned reports from Professors Mackenzie and Partington and Frontier Economics to assess the risks faced by NSPs. Both highlight that the risks faced by regulated energy networks are very low. This observation ties in with the views of Chairmont and Oakvale that the industry in which the borrower operates has a major impact on the cost of debt likely to be incurred.

The import of the views of these experts is that two firms with the same credit

rating will incur different costs of debt based on the industry that the firm operates in. A firm in an industry with a lower risk will incur a cost of debt lower than a firm with the same credit rating but operating a higher risk industry.

The empirical observations confirm this assessment where the BFV for 10 year BBB rated debt is higher than the actual cost of debt secured by BBB rated APT and of SPI/SPA itself (see figure 11.5 above)

3.3 What does the Chairmont observation mean?

The clear import of the recognizing that the lower the risk of the industry a borrower operates in, is that the firm will pay a lower cost for its debt. The figure 11.5 above shows that regulated firms (such as SPI, APT and Telstra) will incur debt costs below the average experienced by firms with the same credit rating.

Although the process for developing the BFVs is proprietary and is not explained, it would appear that the BFVs represent a form of weighted averages of all firms with the same credit rating.

Both the AER and SPA are proposing to use the BFVs rather than actual experience of the costs incurred and as a result, the allowance for the cost of debt is an average of similar rated debt for all industries rather than reflective of the real cost of debt for an industry which has a risk profile well below the average of all industries with the same credit rating.

By continuing to use the BFVs, the AER has decided to not only ignore the advice of its own consultants, but to actively reject its own previous attempts to address what the AER itself had identified as delivering demonstrably wrong outcomes in relation to the cost for debt.

By not recognizing this truth, the AER is imposing on consumers a weighted average cost of capital which exceeds the efficient costs for providing the service.

3.4 Pass through events

The use of “pass throughs” is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Regulators have been inclined to accept this approach as they (rightly) fear that an allowance in the costs to accommodate the risks nominated might be too high reflecting the likelihood of exogenous low probability high impact events.

In its application SPA proposed the addition of three pass through events - natural disaster, terrorism and liability above insurance payout.

The AER accepted these additional pass through events although with proposed new wording. SPA accepted the AER proposed changes except for a minor difference it seeks for the insurance cap event. SPA also added a new pass through event which applies to the West Melbourne Terminal Station (WMTS) project.

As a general comment, the EUCV is concerned that SPA is reducing its risks by being able to pass these risks to consumers via the pass through provisions. This is particularly important because SPA is able to retain its market risk premium that was set on the basis of its risk profile that applied in 2009. It is inconsistent for the AER to reduce the risks for SPA yet still allow it to be rewarded as if it still had this risk exposure.

The EUCV notes that SPA, in its revised application, is proposing that if it gains some compensation from the Linking Melbourne Authority (LMA) because of the changes required to the WMTS project, then SPA is prepared to pass onto consumers some of any compensation it gets from the LMA This is laudable and the EUCV considers that in order to incentivise SPA to maximise any compensation, that it should be granted a fixed percentage of the compensation, with the bulk of the compensation passed onto consumers as they are the parties that have incurred the risks. In this regard, the EUCV cites the rewards a real estate agent gets for maximising the sale price of a property as an indication of what is seen in the market as an appropriate incentive.

The EUCV also notes that SPA excludes from the pass through the value of any compensation it gets from the compulsory acquisition of the land associated with WMTS. The EUCV does not agree with this. Included in the RAB is the value of the land allocated for WMTS and consumers are paying a return on this value. The EUCV considers that any payment for compulsory acquisition should be deducted from the RAB. This is equitable.

4. SPA Depreciation

The EUCV notes that the AER and SPA approaches to regulatory depreciation are generally in accord with each other, although there are minor differences.

The EUCV has no comments on the approach proposed by the AER other than to reinforce the views it provided in its response to the SPA application. The EUCV assumes that the AER has noted the EUCV concerns and ensured that the issues raised have been appropriately addressed.

5. SPA Opex

In its response to the SPA application for an increased allowance for opex, the EUCV identified that many of the reasons used by SPA to justify its increases in the allowance did not reflect what had been addressed in earlier regulatory decisions. A failure to recognise that each revenue reset is part of a continuum of assessments could result in regulated firms being allowed to be paid many times over for carrying out the same task. This would not be efficient.

The EUCV is pleased that the AER and its consultant EMCa recognized that much of what SPA used as arguments for increasing the opex allowance had been addressed in previous reset reviews and were accommodated within the actual costs incurred in AA3.

The EUCV notes that EMCa carried out considerable investigation as to where and why SPA had been able to under-run its allowances for opex during AA3 by so much and by doing so ensured the AER was well aware of the impacts of this under-run. The increasing amount of investigation carried out on the historical performance of NSPs is a pleasing feature of the AER approach. That this will be further intensified as a result of the Better Regulation program is even more pleasing.

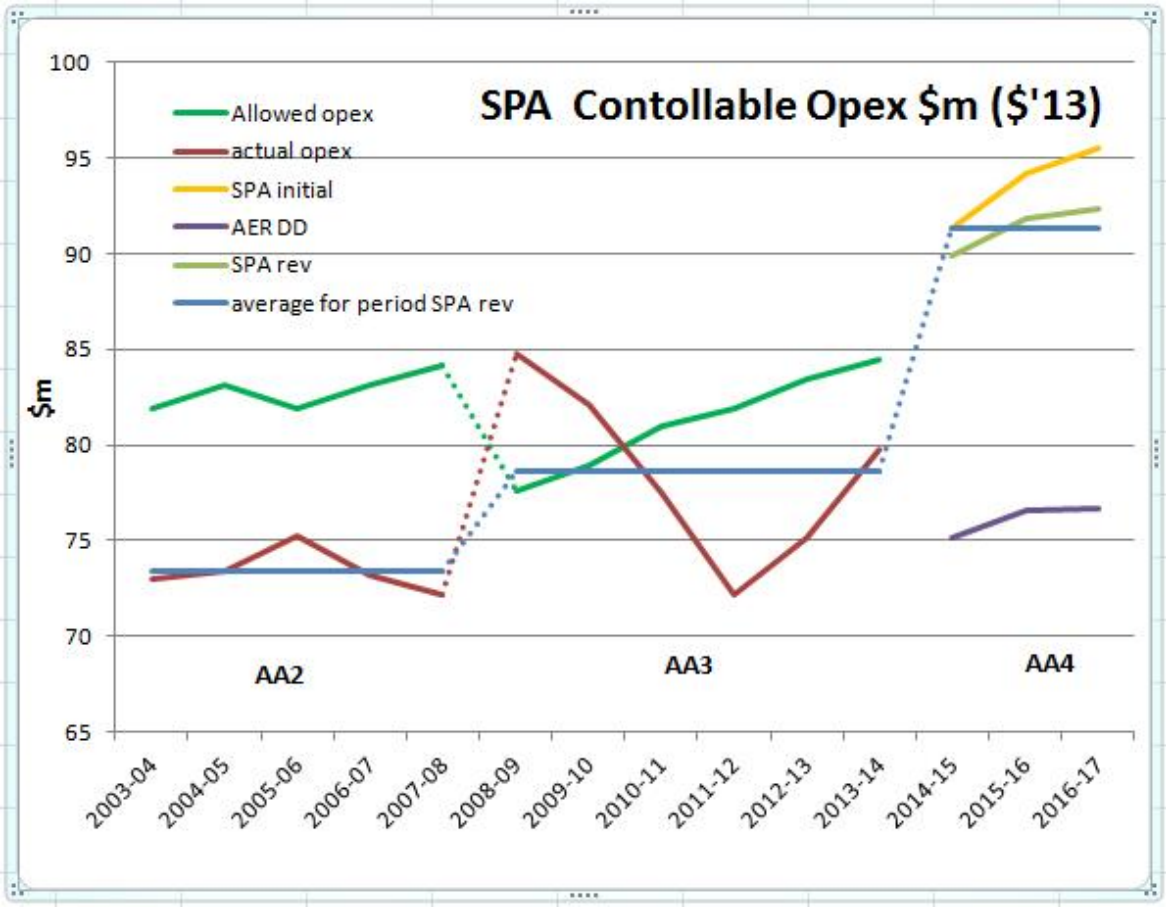
Overall, the EUCV considers the AER and its consultant have addressed in considerable detail the SPA claim for increased opex allowance and that the draft decision provides an appropriate allowance for SPA needs for AA4.

5.1 Opex: historic, allowed and claimed

The EUCV notes that a considerable amount of the SPA opex is for the payment of the easement land tax - a method for the Victorian government to recover from electricity consumers the benefit Alcoa gets for its guaranteed low electricity price for its aluminium smelters which costs consumers over $100m pa. The assessment by EUCV for SPA opex is therefore focused on the controllable costs SPA has for its opex.

However, in addition to the controllable opex and the easement tax, the EUCV notes that SPA has other opex costs which it asserts are uncontrollable, including self insurance costs, the Availability Incentive Scheme costs, and debt and equity raising costs.

The following chart showing controllable opex has been developed from data in SPA applications 2002, 2007 and 2013 (initial and revised) and the AER draft decision.



Source: SPA applications 2002, 2007, 2013, 2013 rev, AER DD

Basically this chart shows that SPA has marginally reduced its claim for controllable opex for AA4 by about $2m pa to an average of about $92m pa following its review of the AER draft decision.

In contrast, the AER draft decision indicated that controllable opex should be quite similar (in real terms) to the opex SPA had incurred during the later years of AA3. The difference between the AER opex allowance and the SPA revised opex in terms of costs to consumers, adds some $0.30/MWh or nearly 3.5% to the total cost of the service to consumers. This marked difference is concerning.

Throughout the last four years of AA3, SPA under-spent, by a considerable margin, the allowance it had for opex and thereby earned a considerable bonus through the opex incentive scheme (the efficiency benefit sharing scheme - EBSS). The purpose of the EBSS is to drive SPA to the efficient level of opex so that the revealed cost for opex can be assumed to be efficient.

In the absence of very large step changes, the chart clearly shows that there is little justification for the large step increase from $75m pa seen in 2012/13 to the claimed $92m pa for AA4, especially considering augmentation of the network has been minimal (meaning there has been little “growth” opex needed), real input cost increases are modest, and the long term actual opex for SPA has been in the range of $75m-80m pa for a decade.

The very large step increase sought by SPA in its revised opex seems to reflect a view that SPA considers that it can "game" the regulatory process to garner further bonuses, repeating what it has done in AA2 and AA3.

On this high level analysis, the EUCV sees that an increase in opex is not justified and that the AER draft decision assessment reflects an efficient level of opex.

SPA comments in its revised application (page 55):

> "Looking forward, SP AusNet identified a number of factors that will put upward pressure on opex requirements in the 2014-17 period including:
>
> - asset failure risks, and the consequential increase in maintenance activity – associated with the ageing asset base;
> - increased resource requirements necessary to comply with legislation, rules and regulations;
> - the effect of rolling non-contestable prescribed service assets constructed in the current regulatory control period into the RAB; and
> - real cost increases in labour, materials and equipment.
>
> The overall effect of these factors will be to drive overall increases in opex."

What SPA fails to explain is why all of these factors warrant a 20% premium over what the AER considers is an efficient cost, which was based on SPA's on actual performance for the last three years of AA3. There is a considerable difference in view as to whether there is legitimacy in these comments and what is really happening!

5.2 The SPA approach

SPA asserts that the 20% gap is driven primarily by step changes (with smaller contributions from real labour increases, increases in insurance and a larger asset base) yet when the steps changes are analysed in more detail, they do not justify the massive rise.

The single largest impact proposed by SPA is in regard to recurrent asset works - specifically overhead line condition monitoring, corrosion risk mitigation and communications infrastructure. Like the AER and its consultant EMCa, the EUCV also has great difficulty in seeing these as step changes.

In its revised application SPA devotes considerable effort to explain why it considers that there needs to be an upwards adjustment for its asset works. SPA makes no reference to the massive increase in routine maintenance (which increased by some 30% (ie by $7.5m pa) but then stating separately the cost of the asset works is not included in the recurrent maintenance cost allocation. This implies that SPA has not carried out any asset works within its allowances yet it considerably under-ran its regulatory allowance which did include for an appropriate level of asset protection.

SPA can't have it both ways! Either the work is included in the actual revealed opex or SPA is attempting to "game the regulator" by claiming a benefit by not doing work allowed for and is then seeking it again as a future cost.

Throughout the revised application SPA concentrates just on the aspects where the AER has reduced the amounts claimed by SPA. Effectively SPA has used the revealed cost approach for the bulk of its opex and then used a bottom up approach for other elements to "prove" the legitimacy of costs which have risen considerably; this applies particularly its asset works.

The AER approach looks at the SPA opex on a holistic basis, driven by an EBSS which provides support that the opex in the base year is efficient. SPA has the ability to shift costs from one cost element to another and would appear to have done so in the case of asset works.

SPA points out that the AER approach is at odds with the EMCa assessment of the asset works proposed. What EMCa did was to assess the cost of the asset works on the same basis as did SPA (ie from a bottom up basis) assuming that the costs had not be included elsewhere. The AER assessment considers that SPA has carried out all of the necessary "asset works" tasks within its total actual opex. If this was not the case, then SPA had elected to regard this work as unnecessary and able to claim the saving as a benefit.

Specifically, the AER approach recognises that consumers have already paid for works within the allowance and which SPA has elected not to do by deferring the works, recognising they are not needed or carrying them out for less.

The EBSS allows SPA to retain the cost reductions within AA3 and to be paid a bonus in AA4 for achieving a lower cost. The AER points this out succinctly when commenting that the SPA approach effectively double counts the costs.

For example, for the last three years of AA3, SPA received a benefit for not carrying out works that it now considers are necessary. It would be inappropriate for the AER to give SPA funds for doing work in AA4 that SPA was already paid to do in AA3 but did not do and, by not doing so, was entitled to a bonus. For SPA to claim a step change to include in AA4 for work they were paid to do in AA3 is bizarre in the extreme.

The EUCV considers that the AER has carried out a comprehensive assessment of the opex needed by SPA, properly utilising SPA's own incentivised performance to set the efficient level of opex for AA4.

In contrast, SPA has accepted that its historic performance sets the efficient opex level for some of the costs, and considers that it is entitled to assess other costs on a bottom up basis without accepting that:

- Much of the costs for "new" tasks claimed were already included in the base year efficient level, and
- Some of the costs that SPA might have been able to justify as "new" tasks were actually legitimately being added to the base year costs were included in the allowance but as SPA elected not to perform the tasks, it claims the absence of the work as a step increase
- There was considerable capex during AA3 yet, despite this, there has been an increase in opex where there is an expectation that replacement capex (the bulk of the capex program during AA3) should have led to a considerable reduction in opex.

5.3 Insurance

The EUCV agrees that the AER has been correct in using an adjusted insurance allowance which recognizes that the base year opex includes for some allowance for insurance already and that, while the insurance premium might have increased (as asserted by SPA) the allowance needs to reflect the actual costs less what is already included in the base year costs.

The EUCV sees that the advice from SPA consultant and the AER appendix B are classified as commercial in confidence and therefore the EUCV is not able to comment further. This inability of seeing the actual advice constrains consumer involvement.

The EUCV is concerned about the issues of self insurance and allowances made for it in the allowed revenue. Most firms recognise that externally sourced insurance is limited on the basis of value for money, especially in the area of low probability high impact risks. In a competitive environment these risks are not insured and if they occur, they are taken to account by the firm as a loss. The EUCV notes the observations made by the AER in relation to self insurance, and considers the AER approach reflects what occurs in a competitive environment, which is what the AER is required to emulate under the Rules.

If the AER allows SPA to include increases in insurance for non-insurable risks, the AER should assess whether the return on equity should be adjusted to reflect the lower risk profile of SPA.

5.4 Equity raising costs

The EUCV agrees with the AER that equity raising costs should only be reimbursed if the NSP actually raises new equity from the market. Most firms increase the shareholder's equity through retaining some of the profits generated by the firm and this does not require the costs incurred in raising new equity.

5.5 Step changes

In its response to the SPA application, the EUCV provided its views on the step changes proposed by SPA and we accept that the AER has addressed the EUCV concerns in its analysis of the step changes that should be included in the SPA opex allowance.

In its revised application, SPA accepts some of the step changes excluded by the AER but considers that the AER erred in rejecting others. One of the arguments provided by SPA is that the AER rejected the advice of EMCa which appeared to support that some of the proposed step changes were warranted. The EUCV differs with SPA on what EMCa's advice to the AER is.

As a basic premise, a step change is to accommodate changes that have occurred subsequent to the costs that were allowed for in the base year opex and that the step change was imposed on the NSP by an external agency. A step change is not to address good industry practice, a change which might generate future savings, or a better way of doing things unless there is a cost/benefit analysis showing there will be a long term benefit to offset the cost.

For example, SPA considers that its new approach for corrosion risk management warrants an increase in the opex allowance. EMCa is quoted by SPA as

supporting the work but that it is non-recurrent. SPA points out in the revised application that the work is needed due to the age of the towers

The AER rejected the additional cost not on the basis that this work was scheduled by SPA to be carried out during AA3 and allowances were provided in AA3 for the work to be done.

In its revised application for 2008/09 - 2013/14 (page 17 of 202) SPA commented:

> "The asset works program between 2008 / 09 and 2013 / 14 will continue to focus on managing operational risk to within an acceptable band through:
>
> - repair and prevention of tower corrosion through painting and component replacement;
> - significant repair or refurbishment projects for switchgear, gas insulated switchgear refurbishment and repairs to power cables and instrumentation;
> - reduction in occupational health and safety and environmental risk, through asbestos removal programs, switchyard resurfacing, removal of lead contamination and repair of transformer oil leaks; and
> - infrastructure maintenance, advanced condition monitoring and miscellaneous works."

This clearly shows that SPA intended to carry out a number of the programs that it now considers are step changes (eg corrosion protection and SF_6 replacement).

In particular, the corrosion prevention activities on its towers were part of the opex planned and allowed for in AA3. This means that SPA has either included in its base year opex for this work or SPA elected not to carry out the work so SPA could enjoy the benefits of a considerable under-run in its opex. If SPA had acted in the way it stated it was planning to do in AA3, the base year opex would have been higher.

The fact that SPA did not use the opex as allowed (and took the profits by not doing so) should not provide a requirement for consumers to pay twice for the same work - ie in AA3 when the work was paid for and not done (and generate a further bonus in AA4 under the EBSS) and again in AA4 when SPA again says it will do the work. The AER is quite correct not to allow for work to be paid for twice.

The fact the EMCa considers that the work is appropriate is not the issue that SPA makes. EMCa is correct that the work is probably required to be carried out, and SPA agrees that this is the case as it sought and was allowed funds to do the work in AA3. EMCa appears to be unaware that an allowance had been provided in AA3 and SPA elected not to do the work at that time.

5.6 Escalation of opex

The EUCV comments on escalation of opex are included in section 2 above.

5.7 Benchmarking

The AER revealed cost approach effectively uses past performance as the guide as to whether the allowance is efficient. In the absence of the data set being developed by the AER as part of its Better Regulation program, self benchmarking (using the revealed cost incentivised by an EBSS) does provide a better basis for identifying the efficient cost for providing the service than by the NSP recosting the work on a "bottom up" basis.

In its revised application, SPA provides two approaches in its revised application (figure 4.7 asset works opex/RAB and opex/GWh) as additional benchmarking above that provided in its initial application.

This additional benchmarking is quite limited and does not provide the comprehensive approach to benchmarking that is needed to give confidence that the forecast opex is efficient.

5.8 Easement land tax

Because the easement land tax is such a large proportion of the SPA opex, the EUCV considers the AER has a responsibility to ensure that its continuation is limited.

The easement land tax is a mechanism for the Victorian government to recoup the costs it incurs for providing Alcoa with discounted electricity costs. No other NSP is required to pay land taxes on their easements and the mechanism was a construct to avoid the government being challenged on the validity of its "Smelter levy" that it has previously imposed on electricity consumers to provide a benefit to Alcoa.

This agreement between the government and Alcoa has a limited life, and the government had advised the AER when the tax was introduced that the easement land tax would be revoked once the liability to Alcoa ceased. The AER should seek formal advice from the Victorian government as to when the easement land tax will cease to be a requirement so that SPA is not able to include this charge once the government ceases to require it.

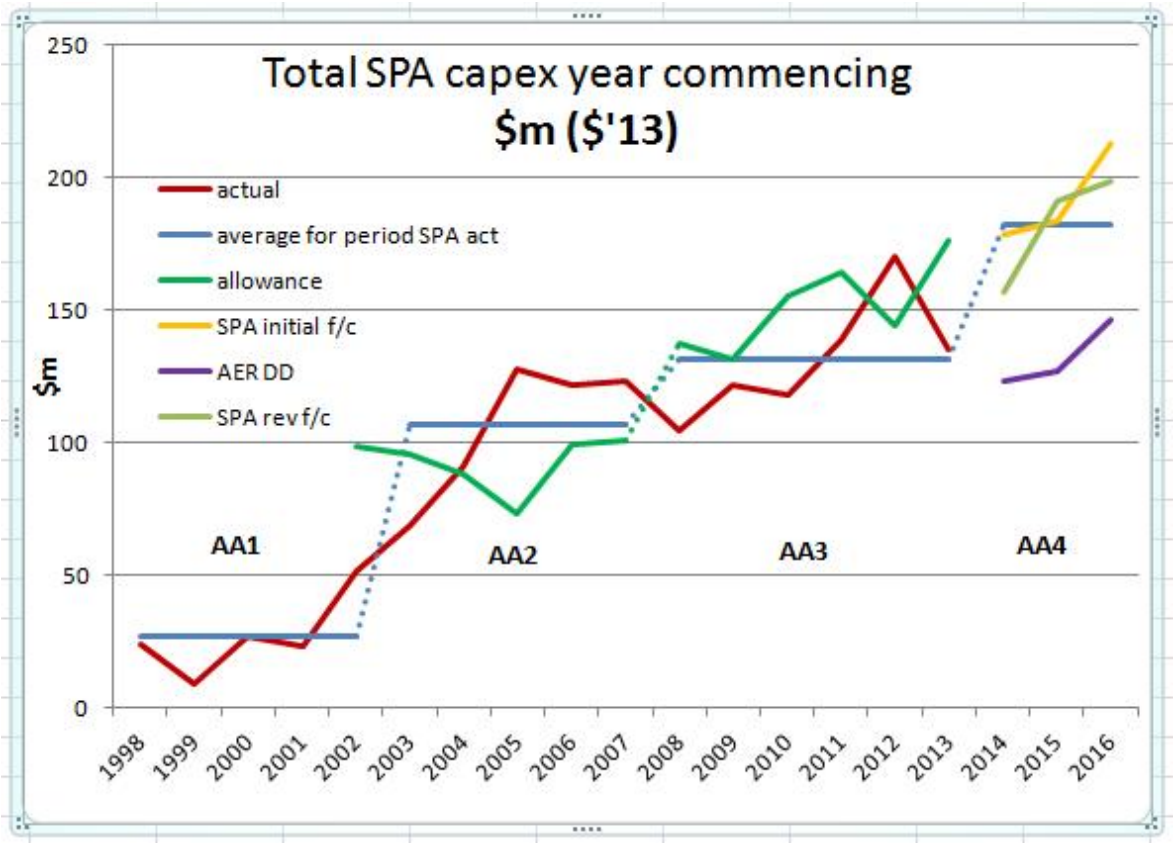
5.9 Overall assessment

The EUCV considers that the AER has addressed the efficient level of opex with rigour and supports the AER conclusions.

The EUCV has reviewed the SPA revised application and arguments provided for maintaining the opex marginally lower than the level initially sought. The EUCV does not consider that SPA arguments support changing from the AER draft allowance for opex.

6. SPA Capex

SPA capex for the Victorian transmission system is graphically presented in the following chart which spans regulatory periods AA1, AA2, AA3 and the forecast AA4. The chart shows the actual capex, the SPA initial forecast for AA4 and the SPA revised forecast for AA4. The average actual capex for each period is also shown (including the revised forecast average) as is the ACCC/AER allowances for capex and the AER draft decision on capex for AA4.



Source: Derived by EUCV from SPA applics for AA2, AA3 and AA4 (initial & rev), AER DD

This highlights that the initially proposed capex for period AA4 is quite excessive when seen in context with the capex incurred in periods AA2 and AA3. The revised forecast capex is only marginally lower than that initially proposed by SPA in its initial application, despite the AER draft decision implying that capex levels similar to that experienced in AA3 would be appropriate.

What the chart also shows is that in AA3, SPA was allowed considerably more capex than was actually used, and this provided SPA with a significant benefit which it can retain. In this regard, if the guidelines developed for the Better

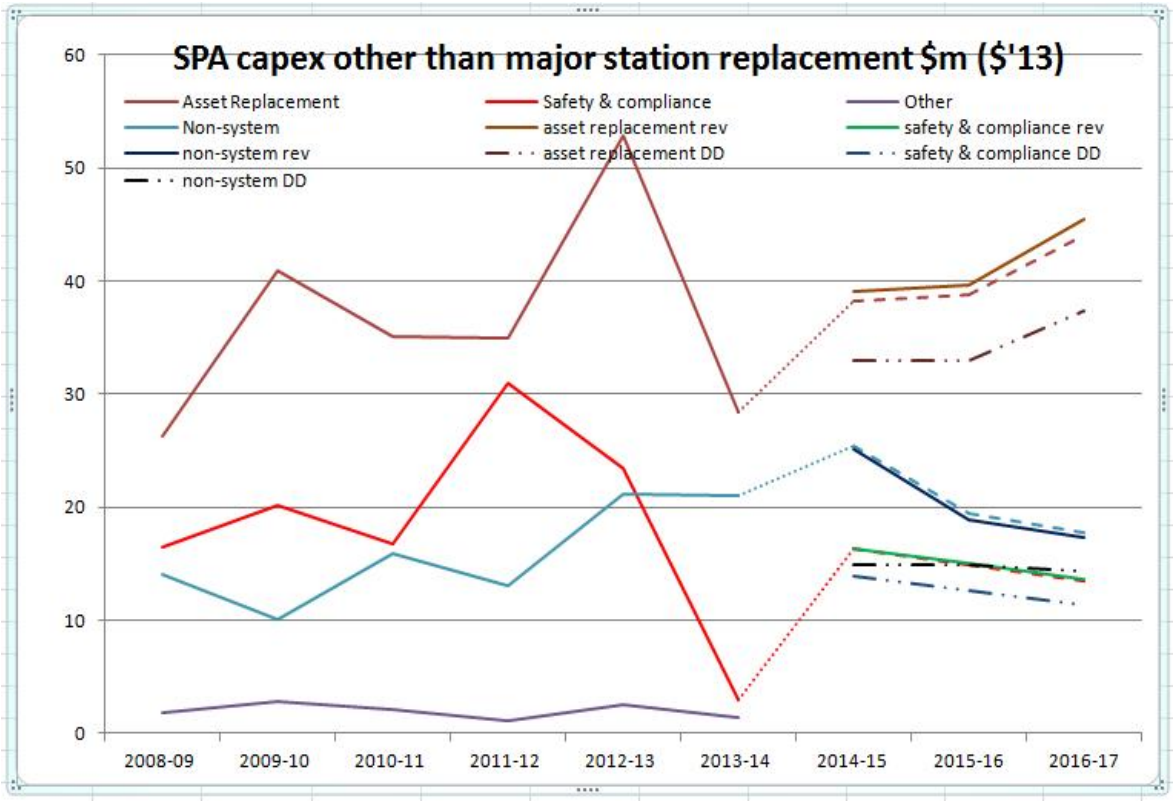
Regulation program were to be applied, SPA would have been granted an additional benefit under the Capital Expenditure Sharing Scheme (CESS).

Equally, under the Better Regulation guidelines for capex, there would be a much more detailed approach to assessing forecast capex, including greater use of the historic trends for capex which would indicate that the additional capex sought for AA4 is excessive.

SPA is seeking an average step increase in capex between AA3 and AA4 of over $50m pa, which is a step increase of some 40%. The bulk of this increase is for CBD works and major replacement at substations.

6.1 Breakdown of the forecast capex

Analysis of the SPA capex in AA3 and its forecasts (initial and revised) for AA4 is revealing.



Source: SPA applic for AA4 (init and rev), AER DD

Examining the proposed capex for AA4 compared to that of AA3 shows that the total capex forecast for all capex other than CBD rebuilds and major station replacements is essentially constant with the average for all capex other than CBD

rebuilds and major station replace for AA3 being some $73m pa whereas forecast for AA4 this same work is forecast to average $76m pa. Whilst this amount has some consistency with what was actually used in AA3, the AER concluded after considerable assessment that a lesser amount was needed. Despite this SPA rejected the AER draft conclusions and actually **increased** its claim for capex other than major works.

In its response to the SPA application the EUCV identified that the claimed capex for IT showed a considerable step increase which seemed out of proportion. Because the EUCV was unable to assess the reasons for the increase due to a lack of information being made available, it suggested the AER should examine the claim in detail. The AER did this and is of the view that the amount claimed was excessive. Despite this, SPA in its revised application maintains that its planned IT capex is needed for it to provide the appropriate outcomes for managing the network.

In contrast, the AER and its consultant EMCa consider that the SPA claim is unnecessary and that the service could still be provided with less IT capex. SPA state that the additional capex is to provide "resilience" of the infrastructure by ensuring increased security, reliability and quality are delivered.

SPA asserts that the AER has erred in its assessment that an increase in IT has to be offset by quantifiable benefits. This is an absurd assertion. The Rules require the AER to only allow for costs that are efficient. Efficiency demands that there w=be a quantifiable benefit to offset the costs claimed.

In its assessment, the AER emulates the approach that applies in competitive industry - capex is only invested if there are quantifiable benefits. What SPA overlooks is that its existing systems have proven to deliver appropriate outcomes in terms of the network - in fact as can be seen the service delivery provided by SPA generally exceeded the expected performance established at the commencement of AA3. Therefore if service delivery is already exceeding expectations, investment in IT to enhance the "resilience" of the network in terms of reliability, security and quality needs to deliver clear quantifiable outcomes, otherwise the investment is not efficient.

After reviewing the AER draft decision and the SPA revised application, the EUCV considers that the AER assessments on capex for safety and compliance and non-system are efficient and the arguments provided by SPA in its revised application do not provide substantiation from the AER assessments.

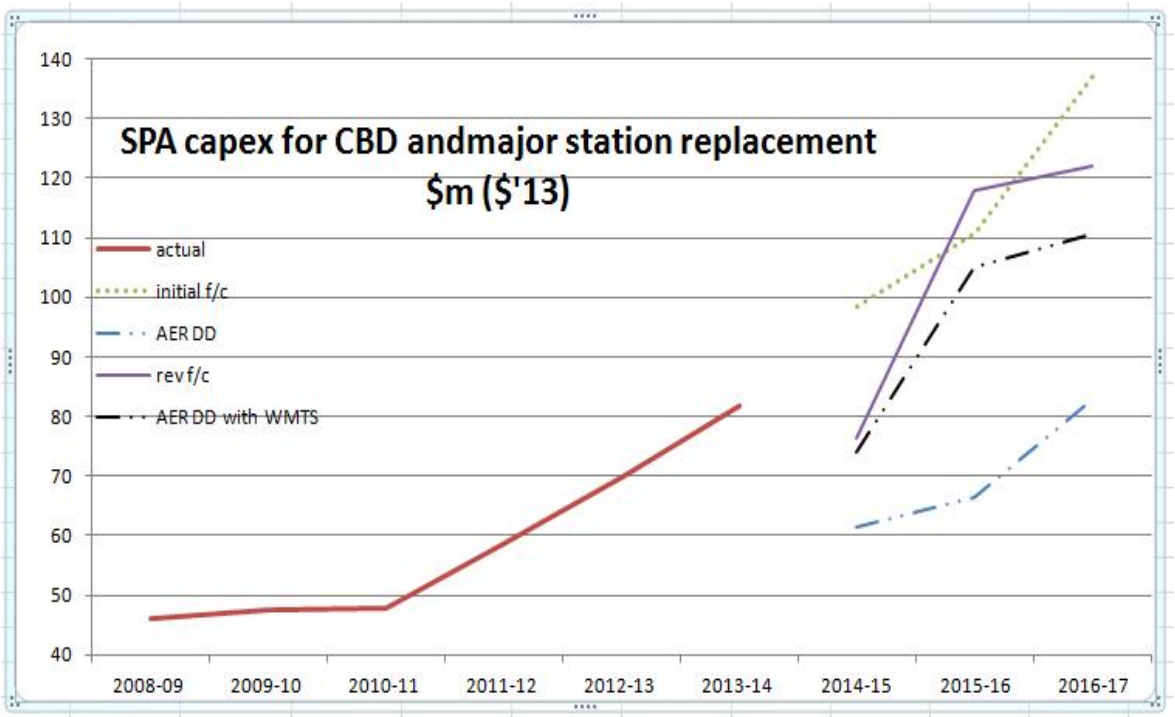
6.2 Replacement capex

The EUCV notes that the AER has generally agreed with the asset replacement program proposed by SPA (except for real cost escalators, prudency and cost estimation adjustments).

The EUCV has some concern that the AER has agreed to the allowances on the basis that the asset replacement program will maintain the "resilience" and reliability of the network. As the current performance of the network has exceeded expectations during AA3 when actual capex was less than is being sought for AA4, the EUCV queries whether an increased amount for this work is justified, and that a lesser amount would maintain service performance at the levels expected.

6.3 CBD and major station replacements

The costs proposed for the CBD and major station replacement program constitutes the bulk of the proposed increase in capex. The following chart shows that the SPA revised application still maintains similar amounts of capex that were sought in the initial application, whereas the AER draft decision considered that an amount similar to what was actually invested in AA3 is sufficient for the needs in AA4.



Source: SPA applic for AA4 (init and rev), AER DD

In its response to the SPA application, the EUCV commented that, in the allowance for AA3, a considerable amount of the rebuilds for RTA and WMTS was included. SPA actually under ran the capex allowance in AA3 by a considerable margin, and much of this under-run was because of the deferral of the planned works in AA3. Neither the AER nor SPA has addressed the EUCV concern that SPA has benefited considerably by moving works allowed for in AA3 to be transferred into AA4.

The EUCV notes that the bulk of the reduction of the SPA capex allowance included in the AER draft decision is due to the excision of the WMTS project works due to uncertainty. The AER made some other minor adjustments to costs for other projects.

The SPA revised application provides a different approach to the WMTS rebuild that will result in lower costs in AA4 that were forecast in the initial application but with the project still proceeding during AA4. If the AER agrees with SPA that the project should proceed, then the AER will increase its capex allowance considerably, which would provide SPA with a step increase in the capex budget for AA4 compared to that incurred (or allowed for) in AA3.

In its response to the SPA application, the EUCV pointed out that the SPA proposed capex for substation rebuilds would result in a considerable reduction in average asset age and, on this basis, drew the conclusion that some of the proposed capex was probably not warranted. The AER has effectively rejected this view by allowing all the rebuilds to proceed as proposed with the exception that the FBTS rebuild should be deferred with a 25% reduction in the allowance being made.

After making an adjustment for WMTS, the AER draft decision on capex shows that basically, the AER supports a large increase in the allowance for major rebuilds, even though SPA did not spend all the allowance provided for AA3.

6.4 Contingent projects

SPA proposed that there be three contingent projects included in the capex proposal. The AER rejected all three being included and in its revised application accepted the rejection of the project that was listed as non-confidential.

The EUCV is unable to comment on the two confidential contingent projects rejected by the AER but restated as required by SPA.

The EUCV considers that the AER and EMCa have reasonably assessed the risks associated with unplanned failure of the South Morang transformers over the next

three years. In this regard the EUCV observes that AA4 has only a three year regulatory period and the arguments made by the AER and EMCa are quite persuasive.

6.5 Overall assessment of the capex program

Whilst there appears to be a rational approach made by the AER on a "bottom up" assessment of the capex needs, the EUCV is concerned that the AER has not provided a "top down" assessment of the capex allowance. The EUCV considers that a "top down" approach would clearly show that the capex program shows large increases compared to the previous actual investment which was considerably less than was allowed, and that the age profile of the SPA assets and the service performance achieved by SPA do not warrant such a large capex program of AA4.

7. Service standards and incentives

The EUCV recognises that SPA has agreed to be subject to the revised STPIS including the new Network Capability Incentive (NCIPAP) program. As a general observation, the EUCV supports the new approach as it provides a better methodology for measuring performance and the impacts on consumers.

7.1 Service component

The EUCV is interested to see if the new STPIS service component using down time as the measure (rather than availability) delivers improved benefits to consumers. On this basis the EUCV is prepared to accept the targets proposed by the AER until the outcomes for consumers can be better identified.

The one significant concern the EUCV has with the new service component approach as interpreted by SPA and the AER is in the setting of the collars and caps. The STPIS guideline allows the caps and collars to be set asymmetrically and SPA has done this in its proposal. However, there is no justification as to why SPA has set the caps and collars (other than that for the loss of supply event frequency) so that all bonuses will be achieved faster than all penalties.

As a general rule throughout the better Regulation program the AER has been consistently of the view that incentives should be symmetric. The EUCV recognised that under the earlier versions of the STPIS, where availability of service was the primary measure of performance, it was unreasonable to implement caps symmetrical to collars as the target was so close to the 100% performance level. However, under the new approach, this is no longer the case with the new measures.

Pragmatically, the EUCV considers that there should be an ability to have asymmetric service incentives but there has to be a sound reason for these to be implemented - it should not be readily available that the NSP has the power to determine without sound reason to make the incentives asymmetric. To allow the unilateral ability for NSPs to determine the extent of asymmetry is not in the interests of consumers and provides NSPs a greater ability to generate benefits without having to earn the benefit.

In the case of SPA, it determined that it would set caps and collars at 2 x SD but where this resulted in a negative valued cap, the cap would be at 1 x SD. Whilst this provides some logic for providing a bonus faster than the penalty, this issue could have been resolved by applying 1 x SD to both cap and collar.

Whilst the SPA initial application has a degree of logic the AER draft decision almost invariably provides an asymmetric outcome for all the service parameters especially those where a bonus/penalty applies. The outcome of the AER approach delivers a consistent asymmetric bias in favour of SPA. Effectively an asymmetric approach provides a 1% improvement in service performance being worth more to SPA than a 1% fall in service is worth. As a matter of principle this is inequitable to consumers

This is not what consumers expect, especially as the AER had made its views strongly known that symmetry is much preferred in other aspects of network regulation and incentives.

Asymmetric service components of the STPIS as provided to SPA is not consistent with the incentive for opex (EBSS) and will not be in relation to the capex incentive scheme currently preferred by the AER.

7.2 Network capability component (NCIPAP)

SPA initially proposed a series of 15 projects for the network capability component of the STPIS of which only 11 had a cost (valued at $4.8m).

Prior to the release of the draft decision, AEMO provided the AER with an expanded list of 22 NCIPAP projects of which 18 had a cost (valued at $18.95m for opex and capex) which the AER inserted into its draft decision. SPA revised proposal accepts these projects to be part of its NCIPAP.

There are a number of faults that are inherent in the AER approach.

> **Firstly**, the AER has apparently unilaterally expanded the project listing and costs on the advice of AEMO, yet AEMO is not responsible for the projects or for their selection. AEMO's role is to assess those projects proposed by the NSP to assess whether they are likely to promote the NEO.
>
> The EUCV is bemused by the process undertaken by the AER and AEMO and was not able to interrogate the expanded listing. When the EUCV examined the list as part of the SPA initial application, the number and cost for the projects was a very modest amount. The AER has expanded this to comprise a four fold increase in cost.
>
> **Secondly**, there is no quantification as to the benefit any of these projects (whether of the SPA initial application or the AEMO listing accepted by the AER). Therefore the project listing cannot be seen to meet the requirement of the NEO.

In the early discussions on this NCIPAP concept, the point was made by consumers that there was an expectation that NSPs would actually invest their own funds to earn the STPIS rewards as this reflected what a firm in competition would do, where the rewards the NSP gets are related to the benefits consumers gain.

During the development phase of the NCIPAP, the allowance was a cap on a number of small projects that could be undertaken and which would deliver a clear definable benefit for consumers. This is clearly the intent behind the SPA initial application.

It was not anticipated that the entire allowance would always be used and be just like all capex allowances where the NSP had to demonstrate that the expenditure was prudent and efficient, and would deliver a benefit to consumers. Further, unless the projects were actually implemented, then there should be no acceptance of the funding that is provided because there would be no benefit provided.

The benefit to the NSP was to reflect their ability to do the projects for less cost than that allowed and to gain a reward. Sensibly, this reward has to bear some relationship to the benefits consumers gain rather than be related to the cost of the project. If the targeted benefits to consumers do not actually occur then the NSP must not benefit. Without applying these basic and sensible rules, then the concerns raised are very real.

What is concerning, is that NCIPAP projects generate a bonus to the NSP if all of the projects are completed. The EUCV is bemused as to why completion of an agreed listing of projects should be the basis for a reward.

Thirdly, other than the qualitative assessment by AEMO that the projects are worthwhile, there is no quantification that any of the projects are prudent or efficient. Even the most basic assessment of a minimum payback period is totally absent from the assessments of the projects to demonstrate they are efficient. The AER has the responsibility to only allow capex which is efficient, so unless SPA can prove there is a benefit to consumers and the expenditure is efficient, then the AER should not provide an allowance for the projects listed.

Fourthly, as proposed there is no reason for the NCIPAP to be utilized. The EUCV can see no difference between the 22 projects listed and "normal" capex if the amount of money for the projects is included in the revenue allowance.

> The concept of the NCIPAP is that it will comprise projects where the benefit to consumers within a given timeframe exceeds the costs of implementation. The structure and approach that underpins the way the AER, SPA and AEMO have approached this incentive is totally confused and which does not deliver on the expectation of consumers.

Effectively, the only penalty that SPA incurs is if it does not carry out the projects identified and if it does, it receives a bonus. The EUCV queries where the benefit is to consumers from this incentive because there is no defined and quantified benefit that any of the projects listed will provide consumers with a benefit. It is possible that none of the projects will actually deliver a benefit to consumers yet they will be required to pay a bonus if the works are completed. This means the only difference between projects in the NCIPAP and those in the capex, is that if projects in the main capex are completed, there is no bonus payable.

In conclusion, the AER needs to totally readdress how this process has developed and what it is intended to achieve. Certainly the EUCV does not consider that what is proposed by the AER in its draft decision (and accepted by SPA) meets the intent of the network capability incentive. The AER needs to totally revise its approach to the NCIPAP.