Energy Users Coalition of Victoria

Australian Energy Regulator

Victorian Electricity Transmission Revenue Reset

AER Draft Determination

A response

by

The Energy Users Coalition of Victoria

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CONFIDENTIAL Appendix A

Provided as a separate attachment of 5 pages

Executive Summary

The Energy Users Coalition of Victoria (EUCV) welcomes the opportunity to provide comments on the AER's Draft Decision on the Victorian electricity transmission system. The EUCV has also provided separate comments on the AER's consultants' reports, which partly form the basis for the AER's Draft Decision.

The AER has undertaken a reasonably rigorous review, although there are a number of significant deficiencies which the EUCV details in this submission and in a confidential appendix that is being sent separately to the AER.

In the EUCV's view:-

- the AER and its consultants have not adequately carried out a post project verification of assumptions underlying past capex and the roll-forward
- the AER has erred in not returning to consumers the amounts paid in the current period for the return of capital (ie depreciation) on capex not spent
- the AER must explain to SPA that any benefit from unspent opex from the large amount forecast for 2007/08 will be returned to consumers at the next reset
- the AER must require SPA to expand the post implementation review to include verification of savings projected for capital projects
- the AER (and PB) have the EUCV's support for the identification of capex that has been unnecessarily brought forward
- the AER must reassess SPA's capex claims in light of:
  - **There is a lack of demonstration that the forecast savings used to justify the capex have been delivered and appropriately adjusted in the opex forecasts**
  - **The inputs used to value a failure need to be clearly stated, and be consistent across the market, rather than based on one jurisdictional view**
  - **The overt "aggressiveness" of the SPA capex program is a direct outcome of the building block approach to regulatory process. This needs to be recognised by the AER and adjustments made accordingly in the review process**

- **Unit costs used by SPA for developing capex estimates need to be assessed to ensure that not all are high within the +/- 20 bandwidth, and that on average the average of the unit costs matches the average of the PB benchmark unit costs**
- **There is no justification for building in a premium above CPI for higher forecast costs. If the AER persists in doing this it needs to recognise that the $A has increased reducing costs to SPA, and that wages have always been a premium of at least 2.2% above CPI. Additionally the AER should recognise that there have been compensating benefits in other periods where SPA has had a benefit that has not been assessed in a like manner and been given back to consumers.**

- the AER should use the Bloomberg data as inflation indicators, as they6 are independently arrived at and are soundly based

- the AER must consider that SPA should address the issue of increased asset failures through its capex program and that increased opex will be offset by savings due to new assets

- the AER must follow the processes implicit in the incentive regulation model/approach by assessing the **current** performance of the business, assessing it in terms of a benchmark, making adjustments to reflect known step changes and then finally adjusting the benchmark, the application is then measured against this benchmark

    - EUCV comments in that regard are provided on step changes, wages growth, rolled in assets, asset works program, routine works opex, corporate costs, easement land tax, equity raising costs, debt raising costs, availability of incentive scheme,

- the AER is wrong in proposing to estimate the future amount of easement tax payable, as there is a massive scope for error in estimation given that it is currently about 20% of the MAR; consumers and SPA face major risks in this AER approach.

- the AER must apply its new pricing guidelines to SPA

- the AER has erred in proposing to allow SPA to collect an automatic bonus via a projected fall in service standards

1. Introduction

1.1 The EUCV

The Energy Users Coalition of Victoria (EUCV) is a group representing large energy consumers in Victoria. The EUCV is an affiliate of the Major Energy Users Inc (MEU), which together comprise some 20 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland.

The EUCV welcomes the opportunity to provide comments on the AER's review of the revenue reset for the Victorian electricity transmission system.

Analysis of the electricity usage by the members of EUCV shows that in aggregate they consume a significant proportion of the electricity generated in Victoria. As such, they are highly dependent on the transmission network to deliver efficiently the electricity so essential to their operations. Being heavily dependent on suppliers of hardware and services, members also have an obligation to represent the views of their local suppliers. With this in mind, the members require their views to not only represent the views of large energy users but also those of smaller power using facilities, and even of the residences used by their workforces.

The companies represented by the EUCV (and their suppliers) have identified that they have an interest in the **cost** of the energy networks services as this comprise a large cost element in their electricity and gas bills.

Although electricity is an essential source of energy required by each member company in order to maintain operations, a failure in the supply of electricity (or gas) effectively will cause every business affected to cease production, and members' experiences are no different. Thus the **reliable supply** of electricity (and gas) is an essential element of each member's business operations.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important with the focus on the performance of the distribution businesses because they control the quality of electricity and gas delivered. Variation of electricity voltage (especially voltage sags, momentary interruptions, and transients) and gas pressure by even small amounts now has the ability to shut down critical elements of many production processes. Thus member companies have become increasingly more dependent on the quality of electricity and gas services supplied.

Each of the businesses represented by EUCV has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of energy are not available into the future these investments will have little value.

Accordingly, EUCV (and its affiliate MEU) are keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies.

The members of EUCV have identified that transmission plays a pivotal role in the electricity market. This role encompasses the ability of consumers to identify the optimum location for investment of its facilities and providing the facility for generators to also locate where they can provide the lowest cost for electricity generation. Equally, consumers recognise that the cost of providing the transmission system is not an insignificant element of the total cost of delivered electricity, and due consideration must be given to ensure there is a balance between the two competing elements.

1.2 The scope of this review

EUCV recognises that with the recent release of the AEMC Chapter 6A of the Electricity Rules (which is stated as being overtly pro investment by the AEMC and assessed to be biased and unbalanced by consumers), the AER is quite heavily constrained in its ability to exercise a holistic view of the final revenue that is determined as the outcome of this review.

It is noted by EUCV that the determination of the regulatory asset base is quite closely proscribed, the inputs to the CAPM used to develop the WACC are predetermined, the degree to which AER can determine inclusion of capital expenditure is limited, and the AER must allow the regulated businesses extensive freedom in determining the amount of depreciation to be included in the revenue.

Notwithstanding these constraints, the AER has devoted significant attention and detail to those aspects where it has the ability to exercise judgment. The EUCV notes that the AER commissioned and received reports on a number of specific elements of the review. The EUCV has undertaken a separate review of these and provided a separate submission discussing the reports, the conclusions reached and the views of EUCV where it has misgivings about the veracity of the investigation and the conclusions drawn.

1.3 Points made at the AER Draft Decision Conference

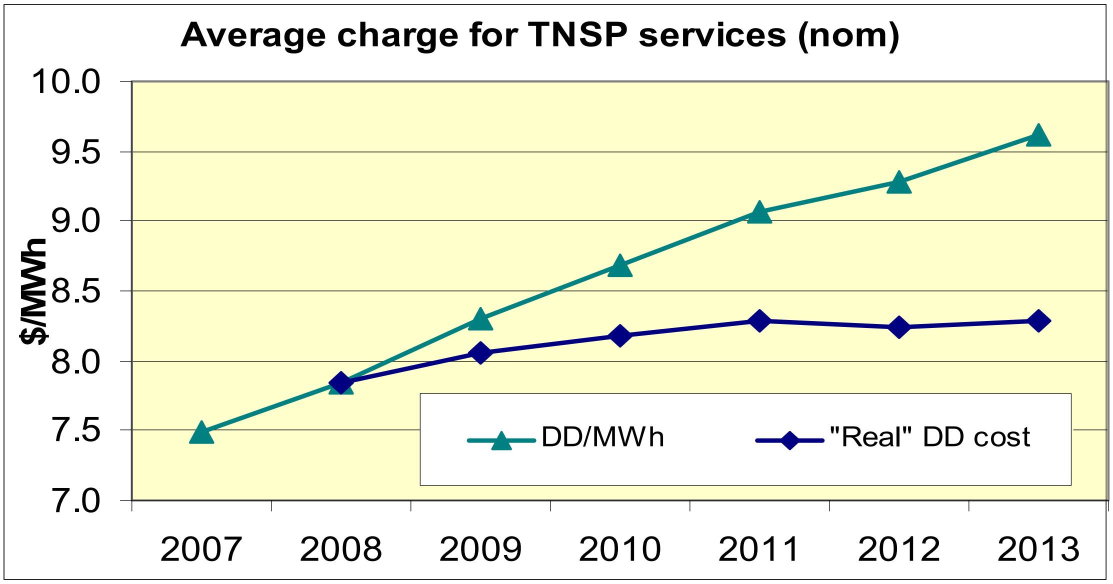
The AER made a presentation of its draft decision at a conference on 11 September 2007. As part of this process, EUCV made a brief presentation of its initial views and made the following observations:-

- The new tariff [charge]s take electricity transmission in Victoria into new highs, and are above the levels in other states, despite the Victorian system being recognised as the most compact in the NEM.
- The[se] tariff [charges] are based on VENCorp expected (medium) case consumption and ACCC final decision and VENCorp expected revenue.
- The increase in tariffs is [attributed] in part to increased demand, yet the pricing approach does little to provide signals for this.
- The AER does not assess the impact of its decision on consumers, especially between the current and next periods.
- SPA underspent its allowed opex by $44m in the current period. Therefore there is a $25.2m carryover.
- Corporate overhead is 27% of controllable opex
- The actual opex was intended to set the benchmark, but neither PBA nor AER looked at this as a benchmark and adding defined step changes.
- Land tax on easements is a replacement for the Smelter levy. Has the AER discussed the burgeoning amount with the Vic government or the premium included for SPA to accept the risk of future [tax] changes?

The EUCV presentation also provided its assessments of the changes of opex, capex and average tariffs resulting from the AER draft determination

1.4 The helicopter view

The AER implies from its figure 8.1 that there will be a small step rise in the average cost of transmission from year commencing 2007 to year commencing 2008. This is misleading when assessed against the forecast of consumption of electricity over the period. Essentially, there is little growth forecast in electricity consumption over the period, yet the “real” revenue is to increase. Using VENCorp forecasts for consumption, the average cost for transmission services still increases markedly as shown in the following graph. This allows for the starting point costs for year commencing 2007 to use the approved revenue from the ACCC decision on SPA in 2002, and includes the impact of the easement tax. It should be noted that the cash benefit SPA has from the ACCC decision are not included.



Source: AER DD, ACCC FD, EUCV adjustments, VENCorp

The AER has implicitly accepted that SPA is entitled to increase its charges for supplying the electricity transmission service. This is despite there being only a modest increase in demand and a nominal increase in consumption forecast over the next six years.

There is a significant step change from year 2007 to year 2008, and it should be noted that in addition to these average tariffs, the VENCorp charges of nearly $1/MWh have to be added, increasing the "real" tariff in 2013 to ~$9.50/MWh.

SPA states that it requires a massive injection of capital to maintain the quality of the service and a large increase in its opex budget, yet at the same time, the service standards are proposed to fall. SPA alleges that this is entirely due to the lack of investment made in previous years by the then government owner, yet the SPA assets have now been in private hands for a decade – which is about 25% of the average life of most of SPA assets. This consistent complaint is losing credibility.

What SPA fails to point out is that under the current regime it is not constrained in any way by an owner that is concerned about the outcome of the prices it charges, or that they will impact on the sales of its services. An owner of electricity transport assets is all too fully aware that electricity supply is essential for modern day life, and consumers have no alternatives to using its monopoly services. This is in stark contrast to the time when, under government ownership, the asset owner was exposed to community backlash if costs were seen to be too high. Consumers have seen a consistent rise in electricity transmission services ever since corporatisation and the subsequent sale of the assets to the private sector.

SPA is a viable business enterprise, being sufficiently well developed to recently complete the acquisition of much of the energy transport businesses of Alinta. SPA has consistently traded[1] above its listing price in December 2005, and a review of the publicly available documentation reveals that SPA has returned a tax adjusted dividend **twice** that of the market average as measured by the All Ordinaries index. The fact that the market is prepared to support SPA to more than double in size as a result of the Alinta asset acquisition is testament to the view of the market that SPA is a very attractive business.

This status as the dominant energy transport business in Victoria (and in other states) will be enhanced by the decision of the AER to significantly increase its revenue through a large increase in its capital base and its proposed opex.

1.5 SPA revised application

EUCV notes that SPA has responded to the AER draft determination and released an adjunct to its application. The bulk of this response relates to SPA essentially seeking to retain its initial proposal in terms of revenue. The net revenue for the 6 year period reduces by an average $10m pa over the entire period (a reduction of 3%). The bulk of the revenue reduction is related to opex adjustments, as SPA has only modified the timing of its proposed capex, resulting in a more consistent annual spend, but having the same amount expended overall.

SPA states that its changes will basically result in the average tariff remaining unchanged in real terms. In part this statement has some validity if the SPA forecasts for growth are accepted (which EUCV does not), but this also excludes the very significant step change increase of some 10% from current tariff levels. Effectively, SPA has paid lip service to the AER draft determination requirements.

As might be expected, SPA has addressed each of the observations made by AER and its consultants, effectively rejecting many of the comments made by the consultants. The EUCV would point out the ease with which a party is able to address specific comments made and develop a strategy for rejecting them – arguing a bottom up estimate can be most challenging and ultimately result in an agreement to disagree. What SPA has failed to do is address the commentary in terms of a top down review which the AER is effectively only able to carry out. The EUCV concurs with the AER approach and points out that this approach is what inevitably occurs in a competitive situation.

[1] Its recent price is lower than its listing price but this is attributed to its seeking of an additional $3bn to fund the Alinta acquisitions.

In a competitive environment, senior management of a business receive bottom up estimates from staff. These bottom-up estimates are assessed in terms of the overall business and its competitive situation. It is the competitive situation that is the final determinant of what is able to be spent in maintaining the competitive situation of the business – not the bottom up estimates. In a monopoly situation, there is no competitive pressure to provide the controls that competition imposes, and the regulator is required to provide this discipline on the regulated business. It is only by doing so will requests for expenditure remain in keeping with the overall ability of the community to manage burgeoning claims for increases in expenditure from regulated monopolies.

It is interesting to note that when the regulated businesses were vertically integrated government owned businesses, there were controls placed on claims for increased expenditure. Governments recognised two fundamental issues:-

⇒ The reality of the government seeking capital has been closely controlled by the debt market. The government was able to secure limited funding for its activities and then this scarce resource had to be allocated amongst several competing elements of government. Thus there was always a constraint on each government business seeking capital

⇒ Governments recognised the impact of increasing costs on the community. This forced governments to assess the ability of the community to pay for the services provided by the government owned business. This recognition provided a competitive pressure to ensure that the outcomes of the expenditure claims were assessed in terms of the community‘s willingness to accommodate the cost increases for the services provided

Unfortunately, the regulatory environment has lost both of these implicit controls and leaves the regulator apparently in the unenviable role of having to assess claims for increased expenditure from the “bottom up”. The EUCV would point out, however, that the regulator does have the ability to assess claims for expenditure in terms of top down assessments. This is provided by the use of incentive regulation and the performance of the regulated business itself.

The EUCV considers that the AER must use the historic performance of the business as the basis for all approved expenditure. A failure to do so removes from the AER its ability to address the claims from a business using a “top down” approach. The top down approach allows the regulator to set a low starting point and requires the regulated business to argue for increases based purely on changes from the conditions that applied, which resulted in the historic performance.

In its revised submission, SPA maintains the view that it is (comparatively) the most efficient and best performed TNSP in the NEM. The EUCV considers that this is to be expected bearing in mind the meshed nature of the Victorian system and the high density of power used relative to area. Notwithstanding its basic benefits in this regard, SPA appears determined to increase its revenue to reduce the cost differential between it and its comparators.

2. Past Capital Expenditure and RAB roll forward

2.1 Consultants views

EUCV has reviewed the reports of the AER consultants PB Strategic Consulting, and Nuttall Consulting. In summary, EUCV noted in its separate submission on these reports as follows:-

- EUCV was unable to comment on the Nuttall recommendation to reduce the roll forward amount by 3% due to a methodological error, as EUCV is not privy to the confidential information that has not been released for public scrutiny
- Nuttall had identified an issue raised earlier by EUCV that the NPV assessments used in justifying replacement of assets are developed by SPA and were unchallenged by PB
- EUCV agrees with Nuttall that the AER decision to reduce the capex amount would not lead to a lesser performance by SPA
- EUCV is concerned that the rigour used by PB in assessing future projects was absent when examining projects for roll in, despite PB's very overt criticisms of the SPA processes
- EUCV is concerned that the PB assessment of past capex has been extrapolated without any rigorous assessment, and that on the balance of probabilities, past capex has been included where it might otherwise not be considered prudent and efficient

2.2 AER proposals for inclusion of past capex and roll forward

The AER states that its decision making process is based on the premise that its

> "… task is to assess whether a prudent TNSP would have made the same decisions [having regard to the information available to the TNSP at the time it made the decisions to invest]. If the AER determines that a prudent TNSP would have made different decisions to those actually made, then the task is to quantify the difference in investment under each set of decisions."

The EUCV considers that this basis for assessment, while having some validity, must also address the execution of the work. If the execution is poorly performed, resulting in additional costs, then the AER has the responsibility to not allow the cost impact of this poor performance to be passed onto consumers. It is by providing this discipline that drives a TNSP to strive for competent execution of capital works.

What the review of the consultant's report shows is that there is concern that the documentation practices have been inadequate. In this case, the AER has a responsibility to consumers is to ensure that there is no inclusion of costs that could have been avoided.

A criticism of the PB assessments was that there was no cross referencing between the projected savings for implementing the work with the actual situation. If such cross referencing is not carried out then there is no discipline on the TNSP to ensure that its stated benefits from implementation of the project will ever be confirmed. This leads to a view that if the forecast seems reasonable, then it will be accepted by the regulator. This allows the TNSP to use an inflated savings estimate to justify the implementation. Not to cross reference is a poor business and regulatory practice!

The AER makes the specific point that despite the lack of comprehensive and reliable documentation, it considers that the amounts claimed by SPA are **not imprudent** subject to minor adjustments for inclusion of contingency and incorrect cost allocations.

The EUCV does not have any evidence that this decision by the AER is incorrect, as it does not have access to all of the information. Therefore EUCV must assess the decision on a high level basis. EUCV retains a concern that too much past capex might have been accepted without demonstrating the rigour that is needed to assess the veracity of the detail. The very fact that the AER uses the term "not imprudent" provides some disquiet. That the AER and PB have not tested the basic business cases against outcomes only serves to increase this disquiet.

EUCV members operate in a competitive environment, and any cause to increase costs is investigated after the event by internal audit teams. One of the key aspects of internal audit is to verify that the assumptions made at the time of the recommendation are realised. In the case of many of the SPA projects, the driver of the project was the estimated cost of a "do nothing" scenario. Internal audit of a business would always assess these assumptions after the project was completed to provide veracity of the estimation/forecasting process.

Neither AER nor is consultant have carried out this post project verification of assumptions. Without such verification EUCV continues to be concerned that too much has been rolled into the RAB.

2.3 Roll forward of RAB and inclusion of capex

EUCV has no view on the adjustment made to the roll forward due to the inclusion of non-contestable capex, but notes that Nuttall recommended that the methodology be modified resulting in a 3% reduction of the amount rolled forward.

Prior to the last review SPA made an estimate of its capex for the last year of the previous period. SPA forecast that it would spend $55.5m in the 9 months between 1 April 2002 and 1 January 2003 (approximately $62m in $2007). This amount was included in the opening RAB for 2003 and was over four times the rate of capex for the previous two full years. **The AER identified that SPA did not spend $47.34m of the estimated capex, ie the bulk of the capex estimated was not spent.**

Although SPA accepts that the amount not spent should not be rolled forward it considered that the benefits (ie return of and return on) of the over-estimated amount should be retained. SPA's argument is that such retention is in keeping with subsequent advice from the AER that a TNSP should retain the benefit of any under-run of capex (ie the benefit on the amount between approved and actual capex) for the life of the regulatory period. As actual capex is to be rolled forward, the benefit expires at the completion of the regulatory period.

The outcome of this retention of the capex for the current period is that consumers have paid an amount of $27m as a return on the amount never spent and there would be some $5-7m in depreciation that would also have been paid. Thus consumers have been levied some $32-34m premium in the current period for a gross error in forecasting capex for the last nine months of the previous regulatory period.

The AER has determined that there should be a net return to consumers only of the return on the capital but has either overlooked or deliberately omitted to return to consumers the amount paid in the current period for the return of (ie depreciation) on this never spent capex. The EUCV considers the AER to be in error and requests that the unearned premium be returned to consumers.

The approach to setting the starting RAB for the new period prevents further payments being made for return of and return on this never spent amount.

The AER has allowed for the inclusion in the SPA RAB for non-contestable works directed by VENCorp. This capex was included in the forecast capex

included in the ACCC decision for VENCorp. EUCV expects that the AER, by including this capex in the SPA RAB, will ensure that this amount is excised from the RAB of VENCorp. If this does not occur than there will be a double counting of the same amounts – to the detriment of consumers.

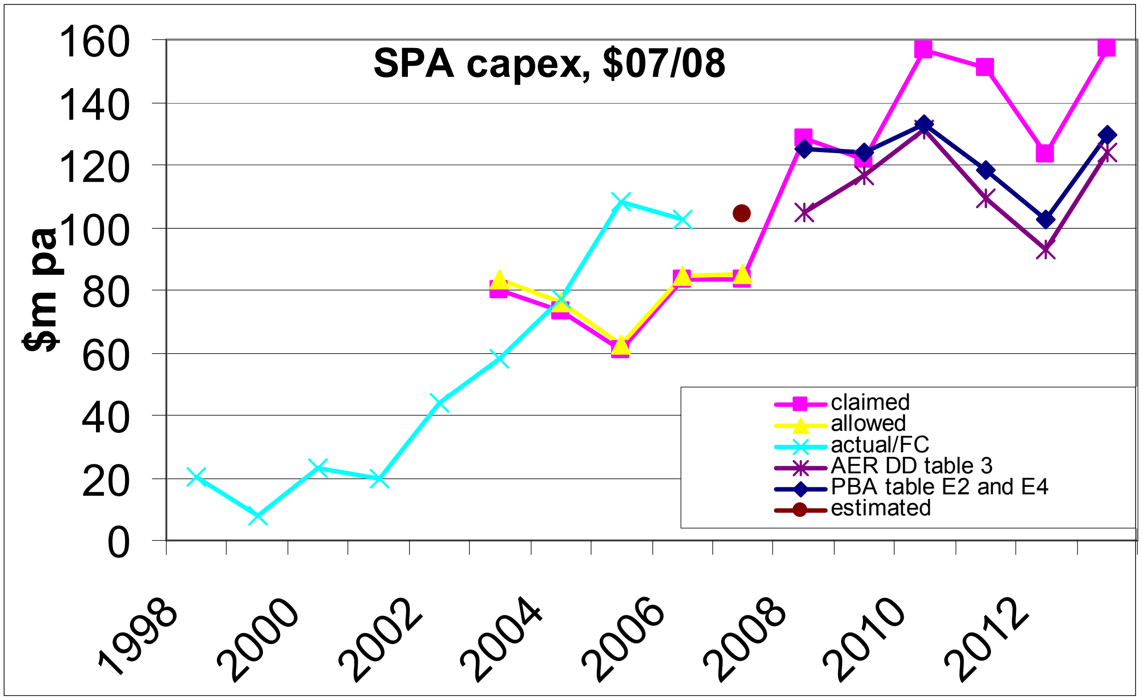
EUCV notes that SPA has forecast a large amount of capex for year 2007/08. The AER should explain to SPA that if this amount is not used, then it will exclude the benefit of the return on and return of the unspent amount when the next revenue reset is carried out. If the AER does not do this then it is encouraging all TNSPs to increase the forecast of capex for the final year of each regulatory period. If this is not made clear then this would encourage regulatory gaming of the most blatant kind.

The AER notes that SPA has provided actual capex data for the 2006/07 year and a revised forecast of capex for 2007/08. A review of the revised SPA application shows that it has reduced forecast capex by a total of $18m. It is expected that the AER will use these revised amounts in the Final decision.

3. Forecast Capital Expenditure

3.1 The history of SPA capex

The history of SPA capex is as shown in the following graph.



Sources: AER draft decision 2007, SPA application and revised application, ACCC final decision 2002

The graph shows that SPA's request for capex has been reduced by the PB recommendation, and then further reduced by the AER. The average approved capex for the next period would be about 10% higher than the recent SPA capital expenditure program.

On a benchmarking basis, the draft decision implies a continuation of the current rate of capex. In principle, this does not appear to be excessive, and well within the capabilities of SPA to manage.

SPA had advised that its capex estimate was driven by a range of factors –

- substation rebuilds in confined metro locations
- transformer replacements
- increased compliance
- higher commodity prices
- higher labour costs

The AER notes the SPA comment that its estimate is driven by the condition of the assets more than its age, developing a concept of "probability of failure" as the basis of replacement. The EUCV review of the AER consultants' reports on this seems to indicate that this new concept would lead to earlier replacement of assets than implied by the economic life assumptions that underpin the depreciation schedule used in the regulatory approach.

The EUCV also noted from its review of the AER consultants' reports that there is an implicit desire of SPA to standardize its fleet. Whilst EUCV members might see there is value in such an approach, their own experience is that the benefits of standardisation do not provide an economic basis for retiring non-standard plant early. Accordingly the EUCV strongly counsels the AER to reject any move by SPA to retire plant for any reason other than condition, and that the assessment of condition must be made using an unbiased evaluation process.

3.2 The SPA processes

The PB report implied (and this is picked up by the AER) that the SPA economic evaluation processes need to be better documented and rely less on individual opinion. EUCV supports this view and adds that the bases for the economic assessments should be clearly stated and accepted by the AER. For example, SPA estimates the likely economic impact on consumers of failure. There is an assumption used by SPA that the loss of supply will impact consumers at a cost of $30k/MWh, yet VoLL in the market is $10k/MWh. The EUCV accepts that there is a wide range of values for VoLL and that these are dependent on the time of the failure, the duration of the failure and the degree of forewarning of a failure. The EUCV considers that there needs to be some degree of consistency of what value for VoLL is used to justify capital works.

EUCV also notes that SPA uses the savings in costs for operating and maintenance to justify capital works. If there is, verification of the opex saving is essential. But what has happened is that there is no verification undertaken, and the opex is simply just increases. The EUCV considers that it is being charged twice – once for the capital and then again by the savings not being recognised in the opex. In the SPA processes there is a post implementation review (see page 56 of the DD). Unfortunately this does not include for any review of the projected savings that are the initiators of the project, purely concentrating on the issues that impact SPA rather than what impacts consumers. The AER should require SPA to expand the PIR to include verification of the savings projected for the project.

EUCV observed in its submission on the SPA application, that there is a commercial driver for regulated businesses to increase capex. The review by PB indicated that SPA was driving for capex to occur earlier than was needed, as the draft decision (page 53) observes:-

> "The timing of some of SP AusNet's proposed replacement capex appears to be aggressive on the basis of the condition of the assets alone, providing some opportunities to prioritise tasks and prudently defer some expenditure beyond the end of the forthcoming regulatory control period."

The EUCV supports the work by PB (and AER) in identifying where capex has been unnecessarily brought forward and the AER must ensure that consumers are not being used to provide funding for early (unnecessary) replacement of assets.

3.3 The capex forecast

The EUCV observed in its review of the PB report that PB had carried out a rigorous review of capex for the projects that it identified (as opposed to the EUCV view of the PB review of past capex). The result of this review was that PB recommended significant reductions to the capex for these projects. Despite this major reduction in these identified projects, PB assumed that all other capex was not affected and basically accepted the SPA requests. There was no attempt to assess the impact of any extrapolation from the projects reviewed to all other capex. This is a significant shortcoming of the PB review.

Fortunately, the AER has not accepted the PB view of remaining capital works and observes (page 69) that it:

> "… considers that the issues identified by PB as part of the detailed project reviews may be indicative of the issues likely to be encountered across SP AusNet's entire proposed forecast capex allowance. The AER considers that the issues most likely to be prevalent are:
>
> - Aggressive timing and the lack of a clear replacement need identified by SP AusNet (eg. for its targeted CT and Transformer replacement programs).
> - Lack of a clear economic and risk-based justification (eg. for some elements of the RTS Redevelopment)."

The AER then undertook additional reviews of specific projects and decided to decrease the amount of capex included in a number of areas. It then sought a review by another consultant (Nuttall Consulting) to confirm its decisions from this further review were sound. That the AER has carried out such further analysis is supported by EUCV, and although EUCV cannot comment on the actuality of the outcomes, it accepts that the AER approach should at least result in an appropriate outcome.

The AER required PB to examine the unit costs used in developing capital requirement costs. PB suggested that an error factor of +/- 20% between SPA cost assessments and PB cost assessments was acceptable. In principle, this is not unreasonable but there is a residual concern about whether this range was always in favour of SPA. For example if all of the SPA estimates were 19% higher than the PB estimates, then they would not be captured by the error permitted, but would be indicative that SPA had factored in a near 20% premium to its estimates.

What is required is that the AER should assess the average of the errors between SPA and PB to ensure there is not a systemic bias in favour of SPA. If there is, then the AER should further discount the outstanding capex by this bias.

The AER has accepted that SPA capex forecasts based on current pricing need to be increased to allow for greater escalation then the CPI ie that the capex forecasts need to be increased for an expected “real” increase in costs. The impact of this increase is to add $20m into the allowed capex forecast of $680m, an average increase of 3% over inflation. The AER devotes extensive effort in developing this capex inflator, and in doing so reduces the SPA claim by some $8m. **What the AER has not done in its assessment is:-**

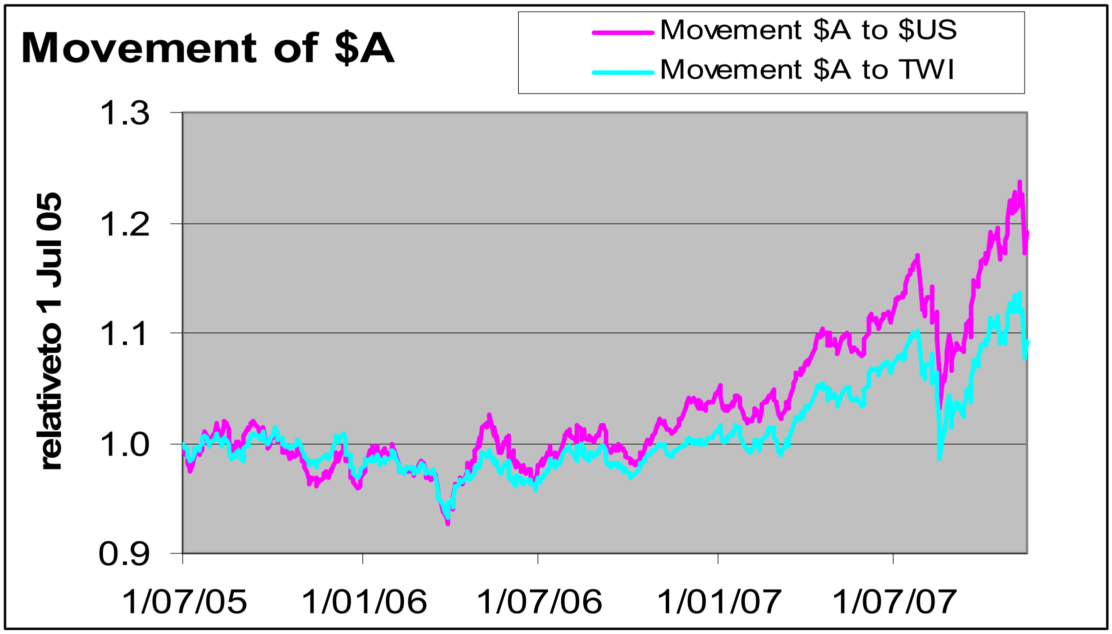
- **Calculate the impact of the rising value of the $A**
- **Recognise that the labour premium is consistently applied**
- **Recognise the inconsistency of permitting this asymmetry**

3.3.1 Rising dollar

The assumptions made by the AER relate to price movements within Australia, yet much of the hardware used by SPA is imported, such as transformers and switchgear.

In its submission to the AER on the SPA application, the EUCV pointed out that the rising $A would have an impact on the cost of equipment needed (and even made the suggestion that SPA could use Chinese equipment like many Australian businesses have). The fact that the $A has risen significantly must be an essential element of any assessment made of future costs for capital works. Unfortunately the AER has completely overlooked this element in assessing capital works costs.

The following graph plots the relative movements of the $A compared to the $US and the TWI (as a surrogate for sourcing electrical hardware from a variety of countries) and this shows that the TWI has increased by over 10% in the last year.



Source: RBA

The AER has used as its base costs applying as at 1 July 2005 and the following graph uses this starting point of $A movement. Even if SPA costs are based on 1 July 2006 prices (as might be assumed from the timing of the revised application) this has no impact, as the observation for 2006 is similar to that for 2005.

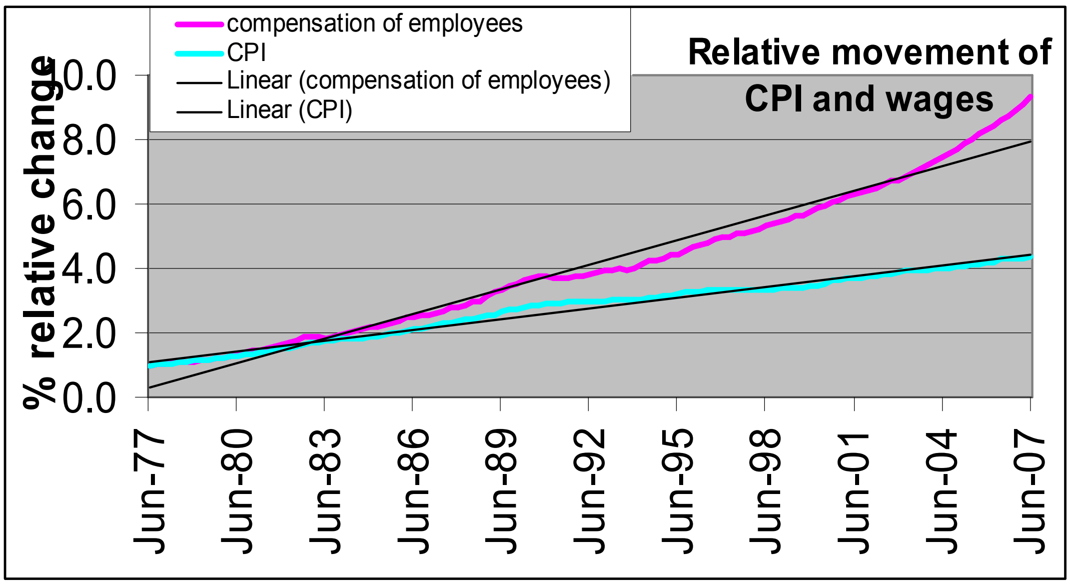
The AER made a detailed assessment to develop the view that the capex for the next period should be inflated for expected increases in costs for materials and labour, yet if has completely overlooked that the $A costs for capital equipment imported would have fallen. Therefore, as a basic calculation, the AER should have discounted the costs for imported equipment for year 2008 as a starting point.

The EUCV sees that the AER has been remiss in not identifying this element of price movements

3.3.2 Labour cost movements

In its submission, the EUCV pointed out that the labour market has consistently permitted a premium in wages over CPI, and because of this the AER should not permit an additional amount in capex and opex to reflect this.

The following graph shows the relative movement in wages (via compensation of employees) and CPI over the past decade.



Source RBA

This shows that growth in employee compensation has consistently outperformed CPI over the past 30 years. In fact, the trend lines imply that CPI has grown at an average of about 5% per annum over this time, and wages have grown by an average 7.2% (or higher) over the same time.

It also shows that wages have always outperformed CPI by at least 2.2% (and probably higher) and the view that this is an anomaly applying only to the near future is purely fallacious. This information was provided to the AER in the EUCV submission on the SPA application, yet the AER makes no reference to this underlying trend at all.

The AER comments in its section on opex, that it considers that the 20 year PB analysis of labour costs provides a forecast of the labour costs for the next six years (especially the latter years of the next period), and applauds the work of Econtech in that it identifies costs in the utilities sector. As noted by

EUCV, Econtech has taken the data for the utilities sector without consideration of its make up or derivation.

In its draft decision, the AER provides table 6.5 summarizing the work on wages growth by BIS and Econtech. This table indicates the expectations of both consultants and both have forecast inflation lower than the AER proposes for its WACC. If the inflation rate as calculated from inflation swaps is used (ie an independent expectation of inflation based on what businesses are prepared to spend money on) then the inflation expectation of Econtech is significantly in error, and so is the BIS forecast.

If the AER value for inflation of 3% is used than the SPA estimate of real wages growth is 2.7%. If the AER used the swaps as the indicator of inflation then the SPA forecast of real wages growth is 2.4%. This is readily comparable to the long term historic premium of wages over inflation of 2.2%.

The EUCV considers that as there is an underlying trend for wages to consistently demonstrate a premium over CPI, then it must, as a matter of equity to consumers, allow only an adjustment for the premium between the underlying trend and the expectation for the next period. For the AER to allow the full differential between wages and CPI as a basis for a step change, will create a regulatory precedent and enshrine this erroneous approach into the future.

The differential between long term growth in wages and the CPI is effectively the improvement in productivity of labour over time. The AER has not proposed to build into the allowance for opex and capex labour, a fixed reduction for productivity improvement over time. This is on the basis that to now, regulators have assumed this increase in productivity has been implicitly incorporated into the revenue through allowing only CPI adjustments on the revenue stream. To exclude the underlying premium and grant the full differential as is proposed, is illogical and a clear bias against consumers' interests..

The EUCV considers the AER should not accept that there is a wages change that warrants adjustment for this current period, as wages have consistently outperformed CPI over the long term, and the current premium is not significantly different from the past. At most, the AER should only allow for the premium in wages over the underlying wages premium over CPI, and use the inflation estimate it sets for the WACC as the forecast of inflation when developing the wages premium over CPI.

3.3.3 Asymmetry risks

Throughout all regulatory reviews, the regulated businesses have frequently referred to the asymmetry implicit in a number of the risks they face. This asymmetry has been accepted by regulators and accommodations made.

It is in the aspect of forecasting capex and opex that this asymmetry has been overlooked. Where costs have risen less that CPI, it has been ignored that the regulated business would have accrued an unearned benefit where costs increased at a rate less than CPI. In fact, where this has resulted in an apparent "efficiency gain" the regulators have permitted the business to retain the benefit and have additionally carried forward an efficiency bonus into the next period.

In principle, consumers have seen that this efficiency mechanism should lead to an overall benefit to consumers, and any unearned benefits (such as from costs being less) will not be deducted by the regulator. However, where the businesses see that this general approach might not be to their benefit, they request some additional recognition of the potential downside to them.

The fact is that the AER has accepted in principle that SPA is entitled to an increased allowance because the market seems to be going against the business. Yet the AER has not required the business to return any unearned benefits due to market conditions favourable to the businesses. This is inconsistent unbalanced and needs to be rectified.

The EUCV is of the view that either the AER should not permit an increased capex allowance due to expected unfavourable market conditions, or it should include adjustments for all market condition movements. The EUCV considers that allowing adjustment for market conditions (which are faced by all businesses) is a movement towards cost plus regulation, rather than incentive regulation.

There is already an Australian regulatory precedent for the AER not to make adjustments for expected unfavourable market conditions. This relates to the use of a market risk premium of 6%. In previous decisions regulators (including the ACCC) have observed that the current market risk premium is less than the 6% used. They have stated that the regulatory approach is based on consistency and long term assessments and that the longer term view should prevail.

The EUCV points out that the CPI will adjust, in the long term, for short term movements of individual costs. The AER should retain the view that over the long term, CPI will accommodate all of the individual short

term price movements expected in the market, and therefore should not allow for short term adjustments that are biased in one direction.

3.4 Conclusions on capex

The AER has been diligent in assessing the capex needs of SPA and has reduced the allowances considerably. On a benchmarking basis, using recent actual capex, the outcomes of the AER deliberations appear to be consistent with actual activity by SPA. At a high level, the EUCV considers, however, that the capex allowance is probably overstated and should be reduced. Certainly the EUCV does not consider that any increase above the AER allowance should be contemplated.

However, the EUCV considers that the AER has been overly considerate of the SPA and PB analyses. In particular, the AER should reduce the allowed capex further when considering:-

- **There is a lack of demonstration that the forecast savings used to justify the capex have been delivered and appropriately adjusted in the opex forecasts**
- **The inputs used to value a failure need to be clearly stated, and be consistent across the market, rather than based on one jurisdictional view**
- **The overt "aggressiveness" of the SPA capex program is a direct outcome of the building block approach to regulatory process. This needs to be recognised by the AER and adjustments made accordingly in the review process**
- **Unit costs used by SPA for developing capex estimates need to be assessed to ensure that not all are high within the +/- 20 bandwidth, and that on average the average of the unit costs matches the average of the PB benchmark unit costs**
- **There is no justification for building in a premium above CPI for higher forecast costs. If the AER persists in doing this it needs to recognise that the $A has increased reducing costs to SPA, and that wages have always been a premium of at least 2.2% above CPI. Additionally the AER should recognise that there have been compensating benefits in other periods where SPA has had a benefit that has not been assessed in a like manner and been given back to consumers.**

4. Cost of capital (WACC)

The degree of flexibility permitted the AER with respect to the WACC is proscribed by the Rules. Effectively the AER is permitted to assess the risk free rate the expected inflation rate and the premiums for debt and equity.

4.1 Risk free rate and inflation

The risk free rate is a key element of the WACC development as it sets the basis for all calculations within the CAPM formula. As the regulatory processes are based on the "real" risk free rate, if there is no confidence in the indexed bond yield, then an assessment has to be made of the confidence of the nominal bond yield and the expected inflation.

SPA (and its consultant NERA) is of the view that indexed bond yields have a discount applying to them and that there is probably a discount applying to nominal bonds as well. The outcome of their considerations is that the risk free rate is probably higher than implied by bond yields.

It would appear that all of the parties are convinced that the indexed bond yield is probably understated due to there being a scarcity discount applying to this instrument. The independent parties all commented that the nominal bond yield is not so affected, due to the Commonwealth Treasury ensuring there is sufficient issuance of bonds to maintain their integrity.

The issue then is that if the nominal bond rate is used, then there is a need to develop an independent assessment of future inflation. Using this assessment, a risk free rate can then be developed.

In developing their views the AER had contact with the Reserve Bank of Australia, the Commonwealth Treasury, and Professor Handley. The EUCV has provided a separate submission relating to the reports from each of these parties.

It should also be noted that the Allen Consulting Group was approached in August by the ESCV to identify a method of developing the "real" risk free rate. In the ESCV draft decision on its review of gas distribution in Victoria (page 380) the ESCV commented:-

> ACG accepted that there is evidence that the yields on real government bonds provide a downward-biased estimate of the real risk-free rate of return. The reasons offered for this view by ACG are as follows.
>
> - The forecasts of inflation implied by returns on government bonds are generally above the target inflation range of the RBA of two per cent to three per cent. As at 28 June 2007, the average annual level of inflation implied by the 2010, 2015 and 2020 inflation indexed bonds were 2.77 per cent, 3.26 per cent and 3.47 per cent respectively. The level of inflation implied by the 10 year nominal and real risk-free rates calculated using the Fisher equation was 3.33 per cent.

This is consistent with the views of others that the nominal bond yield is a true representation of the risk free rate, and that the implied inflation rate from the difference between the nominal bond yield and the "real" bond yield was (in August 2007) implied to be 3.3%.

The ESCV developed a table (10.4) giving various independent estimates of inflation.

Table 10.4 **Inflation forecasts**
Per cent per annum

	2008	*2009*
ANZ Economic and Financial Market forecasts	2.70	2.90
BIS Shrapnel	3.00	3.00
KPMG	3.08	3.08
The Melbourne Institute Survey of Consumer Inflationary Expectations	3.80	n/a
RBA underlying inflation	2.50	2.50 – 3.00
Commonwealth Government	2.50	2.50
Victorian Government	2.50	n/a

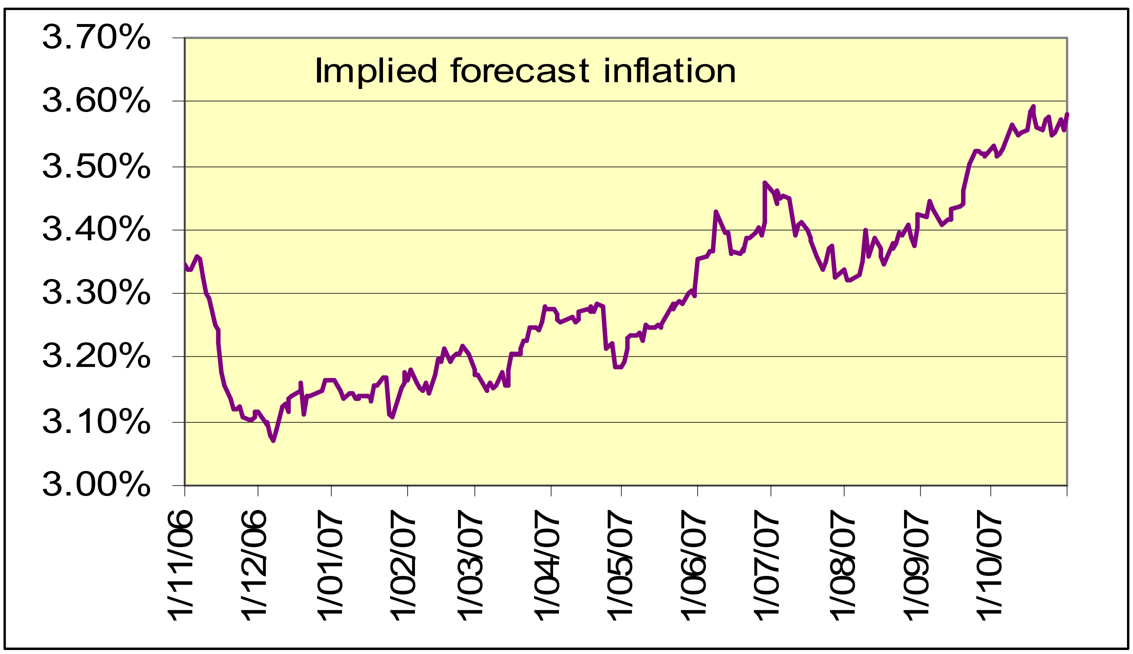
Source: ANZ 2007, *ANZ Economic and Financial Market Forecasts*, 1 June. BIS Shrapnel 2007, *Outlook for wages to 2012/13: Electricity, gas and water sector Australia and Victoria*, report prepared for Envestra, Multinet and SP AusNet, March. KPMG 2007, *Weighted average cost of capital*. A report prepared for Multinet and SP AusNet, March. The Melbourne Institute of Applied Economic and Social Research 2007, *The Melbourne Institute Survey of Consumer Inflationary Expectations: Monthly Report*, June. Reserve Bank of Australia (RBA) 2007, *Statement on Monetary Policy*, May. Costello, P. 2007, *Budget Speech 2007-08*, May. Brumby, J. 2007, *Budget Paper No. 2 – Strategy and Outlook*, May.

The ESCV then concluded that an appropriate value for inflation is 3%:-

> On the basis of these forecasts, the Commission considers that it would be appropriate to apply an inflation forecast of 3 per cent, which sits at the upper bound of the RBA target inflation range.

This forecast of 3% is less than the most recent estimates of inflation, as the Reserve Bank is currently increasing official interest rates to contain inflation within its upper bound of 3%.

The AER decision of 3% being the inflation rate is consistent with the ESCV assessment of future inflation, yet probably also underestimates this important element of CAPM. The following graph indicates that since the ESCV made its decision based on the June 2007 report from ACG, forecast inflation as measured by the bond yields has risen by another 20-30 basis points.



Source RBA

Therefore, using 3% as the forecast of inflation now may not be appropriate as the implied inflation estimates using bond yields show a larger inflation estimate than that based on the data available in June 2007, when the ESCV received its consultant's report. In fact, the setting of 3% is now inconsistent with more recent moves of actual inflation and forecasts.

The EUCV does not accept that using the differential between indexed and nominal bond yields will deliver a reasonable "real" risk free rate. But the EUCV does consider that it can be useful in making adjustments between one point in the regulatory review to another time in the same review, ie that it allows for adjustments over a short period of time. In this case, 3% inflation was considered appropriate in June 2007, yet when the risk free rate is set in early 2008, the inflation forecasts will have changed. Using the change in the difference between the two rates provides a method of making appropriate adjustments but holding the principles behind the decision constant.

It should be noted that underestimating the inflation forecast will lead to a higher "real" risk free rate than is appropriate. Equally, overestimating inflation can lead to SPA perhaps being constrained in raising the capital it needs for its capex program.

The AER refers to the Bloomberg approach to assessing future inflation, based on inflation swaps. Using this approach, Bloomberg forecasts the 10 year inflation as 3.37% (AER DD page 123). The AER comments that:-

> "The AER notes that whilst inflation swap rates give an estimate of the price at which firms can hedge inflation risk, they may not necessarily indicate the market's expectation of inflation. The swap rate is likely to include a positive or negative inflation risk premium, though of an unknown magnitude."

EUCV finds this observation contradictory. On one hand the AER accepts that businesses are prepared to pay for hedging this risk, ie that businesses see that there is a strong likelihood that this level inflation will occur. The AER then states that this approach is not an accurate forecast as it might include a risk of negative or positive risk premium of unknown magnitude.

However, the AER argument losses its force when it is accepted that until recently inflation forecasts were derived form the prices people were prepared to pay for government bonds. Just because bonds are issued by government does not rank them as better forecasters of inflation. In fact, the prices for bonds (and hence the yields are set by those prepared to buy the bonds and the purchasers are the same people who buy inflation swaps. There is no difference between purchasing indexed and nominal bonds where the purchaser sets a price on the bonds, which between them implicitly define an expectation of inflation to buying inflation swaps. If the market is deep enough, then the outcome of the purchase decisions is the average expectation of future inflation at that point in time.

Certainly independent estimates of future inflation based on people putting their money at risk (just as they do with government bonds), is a better indicator of future inflation than views of those who do not face any financial risk of being wrong. It is concerning that the AER is prepared to use an inflation forecast that is derived from consultant expectations rather than expectations of those prepared to put their money at risk!

The AER then opines that inflation will be 2%, 2.5% or 3%, as this is the target range for the RBA inflation control. The AER then decides that as inflation swaps (and indeed the implied inflation derived from bonds) indicate that the inflation expectation now is 3.37% (or 3.55% using bonds) then the answer must be 3% inflation. This is quite a bizarre leap of faith.

If historically the purchasing of bonds provided the calculation of expected inflation, then so should the purchasing of inflation swaps provide the same degree of confidence in the inflation implied from the decisions of those purchasing the products.

Rather than just observing that there may be a positive or negative premium of unknown magnitude in the inflation swaps and therefore discarding the tool, the AER should compare the outcome of inflation swaps over time with the assumed inflation forecasts embedded in the bond yields over a period of time. As the bond yields have been accepted as a forecaster of inflation for more than just the past decade of regulatory decisions, comparing the two sources should determine whether the AER observation has validity.

The ESCV decided to set the inflation rate at 3% based on the conditions applying in June 2007. Since then there have been a number of indicators (Bond rates, Bloomberg, the RBA) implying that inflation is higher than that 3% that was seen as reasonable then. The movement of the bond rates since June implies that over this short period from June to now, inflation expectation has risen by some 30 basis points. This seems to equate well with the expectation of inflation from the Bloomberg rates.

The AER has determined that inflation will be 3% as this is within the target range set by RBA. The AER is required to use an inflation target that is set based on contemporary data and not because it is a RBA target. If actual inflation is higher than the target range the AER has no alternative than to use the one based on contemporary information – neither is it permitted to use data which has no factual basis.

As the Bloomberg rates are independent and actually assess the likely inflation rate, the EUCV considers that the AER should use this as the indicator of inflation rather than relying on inflation being within the target range, albeit at the top of the range.

4.2 Debt risk premium

The EUCV concurs that setting the debt risk premium and the risk free rate need to be contemporaneous, and that debt premium be set using data from the same period as the risk free rate is calculated.

EUCV notes that AER intends to use Bloomberg data for BBB rated debt. This concerns the EUCV as the Rules specify that BBB+ rating is to be used.

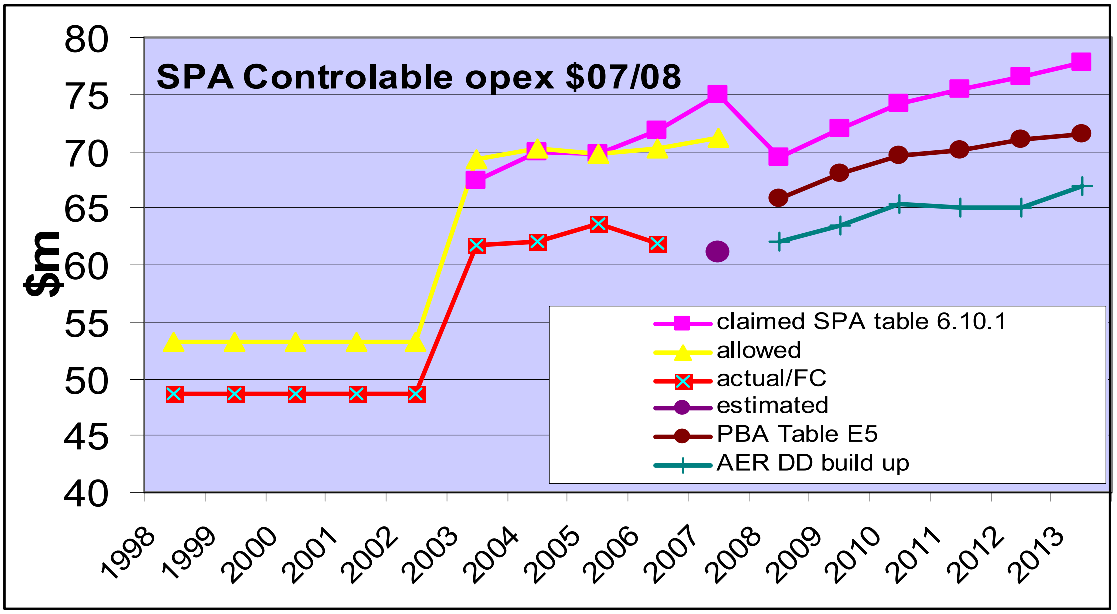
The EUCV notes that every TNSP except ElectraNet has a higher debt rating than BBB+ and that ElectraNet has such a (relatively) low rating due to its very high gearing, which is well above the notional 60% debt. Even TNSPs with a higher gearing than 60% (including SPA) have still been allocated debt ratings of A and higher.

On this basis if there is a difference between using BBB+ by Spectrum CBA and Bloomberg, the AER should bias towards the lower debt risk premium.

5. SPA Opex

5.1 The history of SPA opex

The history of SPA opex is as shown in the following graph.



Sources: AER draft decision 2007, SPA application and revised application, ACCC final decision 2002

The graph shows that SPA's request for opex has been reduced by the PB recommendation, and then further reduced by the AER. The average approved opex for the next period would be over 11% higher than the recent SPA operating expenditure program.

SPA claimed that its need to increase opex was the result of:-

- asset failure risks – and the associated increase in maintenance activity – associated with the ageing asset base;
- increased resource requirements associated with compliance with legislation, rules and regulations;
- increasing labour costs created by skilled labour shortages and the current resources boom;
- the increase in prescribed service opex in the forthcoming regulatory period associated with the rolling-in of non-contestable excluded service assets constructed in the current regulatory period; and
- the inclusion of the Company's self insurance claim

The EUCV considers that SPA should address the issue of increased asset failures through its capex program, and therefore increased opex will be offset by saving due to new assets.

Of the other aspects EUCV:-

- **does not accept that increased labour costs should be included (see section 3.3.2).**
- **accepts that including non-contestable assets might justify an increase in opex, but that this should be matched by an equivalent reduction in VENCorp opex**
- **accepts only legitimate *increases* that are not already within the current opex.**

On a benchmarking basis, the draft decision implies an 11% step change from the current rate of opex. In principle this seems excessive bearing in mind that there are savings in opex from the current capex program and that there is no augmentation of the network included in SPA program.

There is little doubt that the opex claimed by SPA (effectively an extension of its currently allowed opex) is seen as excessive by both PB and AER.

The EUCV observations of the PB assessment of opex is included in a separate submission but notes that PB has not been rigorous in assessing opex, in that it has not addressed

- Work that was allowed to be carried out in the current period but has been reallocated to the new period (asset work costs)
- Corporate costs which are demonstrably excessive
- Various activities which are duplicated (especially in management costs)

Notwithstanding EUCV criticisms of the PB analysis, it has recommended an average of $5m pa reduction from the SPA claim.

EUCV includes a confidential appendix A to this submission relating to opex costs incurred by SPA.

5.2 The base point and step changes

The focus of incentive regulation is to allow the regulated business to work to the most efficient point of operation by financial encouragement that allows the benefits of efficient operation to be held by the business during the current regulatory period and to be allowed to continue for a period the benefits of this into the next period. The purpose of this approach is that it allows (and encourages) the regulated business to effectively benchmark its own performance.

The ESCV has used this approach effectively in regulating the electricity and gas businesses in Victoria and the net result has been to the benefit of both the regulated businesses and consumers. Unfortunately, the AER has failed to use this approach and has instead used the approach of allowing the business to set its opex and then the AER has discussed its reasons for reducing this claimed opex.

The Rules do require the regulated business to declare what it considers its opex (and capex) needs are, and for the AER to either accept of reject this. How the AER decides what is best practice is for the AER to determine in whatever way it considers appropriate. On the basis of its assessment, the AER can then either accept or reject the application.

The EUCV considers that as incentive regulation is the model preferred in Australia, the AER has an obligation to follow the processes implicit in the approach. This requires the AER to start with the **current** performance of the business and assess if this is near the benchmark. The AER should then allow adjustments which reflect known step changes and then adjust the benchmark. This benchmark can then be measured against the proposal and the acceptance/ rejection decided.

SPA has determined by its actions that the current benchmark opex performance for its operations is between \$60m and \$62m pa. The AER should assess the cost elements comprising the opex actually achieved and then make decisions about whether this amount is overstated ie that the most efficient operational costs have been reached. The most efficient point is after making these adjustments.

Unfortunately, the AER has not followed this good regulatory practice, electing to review and reduce the amount in the application.

5.2.1 Step changes

From the SPA application, the step changes claimed by SPA are:-

- Increased labour costs
- Transfer from VENCorp of non-contestable works
- Changes in compliance requirements

Wages growth
As noted in section 3.3.2 EUCV does not see that the there has been a step change in labour costs, as there has been a consistent premium payable for wages over CPI of 2.2% for 30 years or more. The AER has totally ignored the fact of this underlying trend, and proposes to give SPA the full effect of this premium, rather than the difference. This is totally illogical as it denies that there has been a consistent differential between growth in wages and CPI. At most, the AER should only include the difference between the underlying and forecast differential

Further, EUCV considers that allowing this as a step change would create a regulatory precedent that is not appropriate.

EUCV also commented on the work by Econtech in its submission on AER consultants' reports, and particularly drew attention to the inappropriate differentiation between the utilities and construction sectors.

Rolled in assets
The transfer from VENCorp to SPA of non-contestable assets would most likely result in an increase in opex and is a step change. PB concludes that the cost of this roll in of additional assets not previously included would result in an increase of opex of $1.2m pa (see PB report pages 196, 197)

Compliance
SPA has not defined what laws and other statutory requirements have changed to cause this increase and until these are fully detailed, they cannot constitute a step change.

5.3 Asset works program

The EUCV supports the concept of contracting out defined elements of works as a matter of principle. If these works are contracted out in a truly competitive manner, then this provides prima facie evidence that the works have been determined to be economically efficient – economic efficiency is the basis of regulatory decision making.

In assessing the asset works programs, the EUCV raises two basic concerns

1. The AER has included for the full increase of wages over CPI as an natural inflator of costs. As discussed above this is not correct, and at most the inflator should be the difference between the long term

underlying premium of wages over CPI, and the forecast premium. On this basis the inflator, if there has to be one, is only 0.6% pa.

2. **EUCV notes that many of the asset works program items are carried forward from the current period. The current period showed a significant saving in opex from that allowed.**

   As assets works is a significant element of the opex cost, then there is a real concern that assets works prgram that was to be completed in the current period (and allowed for in the current opex amounts) has been completed and is being carried forward into the next program. If this occurred, then consumers would be paying a "triple" dip – once for the allowance in the current period, a second amount for the carry forward of the opex efficiency amount, and a third time for the work in the next period.

   PB failed to address this issue in its report and neirther has the AER addressed this concern. The AER must verify that there is no carry forward of work that should have been completed in the current period into the next period.

The total amount of contracted out asset works pogram is assessed by SPA at $67m. To manage this SPA has forecast an amount of $13.5m for engineering and supervision – an attendance rate of 20%. This attendance rate is too high as attendance on most construction works (including conceptual and detailed enginerring design works) would average in between 10-15% of the costs. The lower range would apply where there was a significant degree of repetition of the construction works, such as in this case.

It is concerning that neither PB nor the AER has assessed the high level of SPA attendance on this external works program. In addition to the AER reductions in the asset works program, the EUCV considers that the degree of attendance on these works by SPA is too high and should be reduced by some $1m pa or a total of $6m.

5.4 Routine works opex

SPA has forecast that its recurrent opex is essentially maintained based on the current expenditure, and inflated by the full premium of wages over CPI. As noted earlier, this inflator should at most be the difference between the underlying long term premium of wages over CPI and the forecast premium, and not the full amount.

The AER has noted that there is an opex/capex trade off and an assessment has been made of this on a bottom up basis by PB. The EUCV has some concern with this approach as it effectively builds in a disconnect between the basis used by SPA to justify the capex and the actuality. EUCV considers that a more appropriate approach would be for the AER to use the documented justification for capex to identify the savings in opex expected from the capex. This is the amount that should be used in the opex/capex trade off, and reflects the controls used by businesses subject to competition.

The discipline inherent in such an approach cannot be faulted and will drive the regulated business to operate in a more financially sound manner. Following this approach does not encourage overly optimistic estimates being used for capex programs.

With the exception of these two issues, the EUCV considers that the AER approach is in keeping with the concept of incentive regulation.

5.5 Corporate costs

SPA current corporate costs at ~$18m pa are a massive 30% of the current controllable opex of ~$61m pa. Of this corporate cost, some 40% is attributed to management fees.

EUCV commented in its submission on the PB report that corporate costs might be related in way that for every 2 people active in the field there would be another person sitting in a corporate role.

PB stated that it considered the transfer of management costs internally has not resulted in a net change to SPA costs. At the same time, PB identifies in its table 7.3, that corporate costs are overrunning benchmark allowances set in 2002 by $4.5m pa.

Despite this, overall, SPA has achieved a net $8m pa under-run on opex. Put another way the savings in recurrent and asset maintenance activities were actually ~$12m pa, but the increase in corporate costs has eroded a major element.

No business in a competitive market will survive if its corporate cost is 30% of its opex, and 10% is seen as a more acceptable benchmark for competitive enterprises.

In its submission on the PB report EUCV observed that there appears to be many aspects of corporate costs normally included but SPA has included

these elsewhere – specifically in non-network capex and the RAB, such as IT, vehicles, premises, etc. Some of the activities detailed in the management fees are not appropriate to be included in the prescribed services – such as evaluation of business opportunities, public and investor relations, legal and company secretarial services.

The AER has assessed the amount of corporate costs and concluded that the costs are too high by some 13%. The basic approach used by the AER was to assess these costs in relation to the numbers of staff involved. This approach has validity if the numbers of staff is that needed for an efficient operation but the AER made no assessment of this aspect.

In its 2002 application SPA provided data that its break down of controllable opex averaged $43.2m for routine opex, $11,5m pa for non-recurrent opex and $11.7m for corporate expenses (excluding non-insured risks)[2]. This meant that corporate expense was 21% of the total of all other opex. This sets a benchmark for SPA for 2007. Using SPA as a benchmark for itself, indicates that its corporate costs have grown over the past five years.

In the same application, SPA provided its view of its assets base for the period. The average asset value was $2,222m[3], implying a corporate cost relationship to assets of 0.5% in 2002. In the current application this ratio has climbed to 0.8% based on the SPA assessment of its average asset value of $2471m for the period[4].

Compared to the changes over time in the costs for recurrent opex (effectively static between the periods) and only a modest change in costs for asset works there is no apparent reason for this growth in corporate costs, other than there has been rolled in a modest amount of non-contestable assets.

This benchmarking work using SPA figures themselves supports the view that corporate costs have increased unnecessarily and should have stayed at the previous level of ~$13.5m pa ($2007) The AER reduction to an average of $17m pa is still too high and needs further review.

The EUCV commented in the submission on the consultants' reports that:-

> **"Analysis shows that nearly half of the corporate costs are related to a management fee paid supposedly for a number of functions…Many of**

[2] SPI PowerNet application 2002 table 4.1
[3] Ibid table 7.11
[4] SPA 2007 application table 11.2.1

> **these functions[5] do not relate to the business of providing a transmission service. Particularly the activities of evaluation of business opportunities, public and investor relations, and legal and company secretarial services cannot be justified. Further, there are already costs provided for IT, finance management, HR and other corporate activities, indicating a double dip for these corporate services.**
>
> **As noted earlier, the ESCV has taken the initial view that these management fees are not part of the cost to provide regulated services. EUCV members are aware that many businesses owned overseas do have to pay a management fee to their offshore owner, but these fees are usually applied instead of profit repatriation for tax reasons. EUCV is very concerned that PB has not investigated more deeply such a large element of the opex claimed.”**

The ESCV has also undertaken a concurrent review of SPA activities (its gas distribution business) and concluded in its draft determination that many of the costs SPA includes in its management fee should not be included in the cost for providing the regulated service. The EUCV concurs with the ESCV having seen other regulators (eg ESCoSA) determine that such management fees need to be carefully examined to ensure all non-network service related costs are excised.

The EUCV does not consider that the AER has been as rigorous as other regulators in assessing the impact of management fees within the controllable opex allowed for SPA.

5.6 Easement land tax

The cost of the easement land tax comprises over 20% of the total revenue that is to be granted to SPA.

The draft decision of the AER notes that this is a tax and that the amount of the tax that will be collection is uncertain. Despite this the AER has decided that rather than seeking to find a way whereby the actual tax that is levied is “passed through” it considers that there is a need to try and “second guess” what the actual amounts might be.

[5] employee management , business management, valuation of business opportunities, management of regulatory compliance and relations with regulators, financial and management accounting, including treasury and tax services, asset management strategy, management of information technology, management and coordination of maintenance and engineering services, public and investor relations, legal and company secretarial services, general administration and company reporting

For small elements of the revenue stream this approach has some validity, but it is accepted that as the tax collection is such a large proportion of the total revenue, this approach has to be seen as totally inappropriate, as there is potentially a significant source of error in any estimate of land values and movements, therefore the AER would as a matter of policy institute a bias in any estimate towards SPA.

The AER states (page 186):-

> "The impact of the land tax on average end user costs was intended to be broadly neutral over time as the tax replaced the former Smelter Reduction Amount (SRA) levy on electricity spot market purchases."

Having clearly accepted that this cost is not really a cost related to the provision of prescribed electricity transmission services (although it uses this as the vehicle for its recovery) the AER is attempting to forecast the amount that the tax will raise over the next 6 years and then make SPA responsible to any under or over run.

This is absurd in the extreme. SPA should not be responsible for the risks associated with this tax at all. It should be a pass through only of the actual costs incurred.

The AER states (page 187) that when the easement tax was introduced, it could be treated as a pass through cost. The AER goes on to state that as the tax is in place now, it has to be treated as a cost to be included in the revenue cap. For such a large amount of the revenue, the implications of this approach are horrendous for both SPA and for consumers – for SPA as it places a risk on them that has very large implications if the assessment is too low, and on consumers if the assessment is too high, as the over run becomes a profit to SPA.

Both SPA and AER use 20 year average in the movement of land values as the basis for forecasting land value movements and assess that the weighting between rural and urban values is 75/25. Even small errors in these assumptions can lead to large variations in the final outcome.

The risks of errors will be of such magnitude that they have the ability to create major concerns to both SPA and consumers, and the AER should have made reference to this.

During the review of the service standards guidelines the MEU (an EUCV affiliate) commented that the TNSP has full control over the service standards and therefore a higher powered incentive was both feasible and practical, but the AER disagreed as it stated in its first proposal[1] for service standard guidelines, that:

> "The AER recognises that th[e] level [of 1%] of revenue at risk may be conservative over the long term. However as the operation of the service standards regime and parameters applied under the existing guidelines has not undergone any review, the AER is cautious about exposing TNSPs to additional risk or uncertainty by revising the revenue at risk upwards."

In its final decision on this matter, the AER declined to increase the amount at risk above 1%, stating that it wanted more time to evaluate the implications of increasing this risk.

The risk to SPA (and consumers) relating to the easements tax is much greater than the risk associated with service standards. The easement tax is about 20% of the MAR (see SPA proposal, table 11.7.1). The forecast of the easement tax is based on a number of factors – future land price movements and the Land Tax office assessment of land values. SPA has no control over these at all, and at best can only "guestimate" future values. Recent land values in Victoria have been rising at rates above the long term average, but could easily follow the recent trend in Sydney, where some land prices are falling.

A 10% error in the forecast of land prices (well within the error range already being seen) would result in a 2% change in the MAR. In its draft determination, the AER has not even considered this potential for error and the impact it would have on MAR. The movement of land prices is beyond the power of SPA to forecast with a high degree of accuracy or even manage. That being the case, SPA has developed an approach on this matter where its risk is reduced by increasing the amount included in the MAR for this easements tax – the higher the amount included the lower the risk of exceeding the actual amount. **The converse of this approach is that the higher the amount, the higher the risk that consumers will be giving SPA unearned income.**

The AER considers that 1% of MAR at this stage is too high a risk for a TNSP to accept even where this risk is in the control of a TNSP. To expose SPA and consumers to an even greater risk where neither have any control, is totally inappropriate

The EUCV considers that the AER must as a matter of equity, remove the potential for large errors in the revenue stream caused by this totally exogenous matter, over which no one has any ability to manage, nor should they take the risk of there being forecasting errors.

Because of this, the EUCV considers that the AER must modify its approach to the matter of easements tax. To achieve this it should either:

1. treat the easements tax as a pass through
2. include an estimate in the revenue stream by allowing adjustments to be made to reflect actual amounts. In this case the EUCV recommends that such adjustments be made each year along with changes made in settlements residue adjustments, or at the next reset.

In no way does the EUCV consider that either consumers or SPA should be exposed to the risks inherent in attempting to lock in revenue amounts for this element of the building block. Whilst the percentage risks might be considered relatively small, the quantum of the error will be too great.

5.7 Equity raising costs

The EUCV concurs with ACG that equity raising costs should apply only once, and that this once-off allowance should apply regardless of any subsequent ownership changes. As the EUCV notes in its submission on the AER consultant reports, it is doubtful whether there should have been any equity raising allowance in the last reset, as the state government had already established PowerNet as a corporation before it was privatized – this approach is consistent with decisions made in the UK when similar activities were implemented.

The EUCV accepts that equity raising costs should apply to new equity that is raised as part of the capex program, if indeed any equity needs to be raised.

Additionally, the EUCV points out that equity previously raised has been in part returned to SPA in the form of depreciation allowances. Depreciation is the return of capital and assuming the 40% notional equity share of the SPA capital base, of every $100 of depreciation returned to SPA in the building block allowances, $40 must be considered to be a return of equity. Thus in any subsequent analysis of the need for additional equity required by SPA, the AER should deduct $40 of every $100 of depreciation returned to SPA.

5.8 Debt raising costs

The EUCV accepts the principle that debt raising costs are a legitimate cost incurred by a business. Indeed, many of the EUCV members are consistent raisers of debt for the market on a rolling basis. The AER has taken the recommendation of ACG in regard to the cost of debt raising and reduced the amount claimed by SPA.

What is not clear to EUCV is that debt is secured on a rolling basis but for a significant duration. Typically, debt is secured on a 6-8 year period. The reason for not securing debt for longer periods is that there is a premium required on longer term debt to accommodate the forward risks of interest rate movements, whilst shorter terms reduce the medium term certainty of the cost of the debt so secured.

As debt is secured for given periods, EUCV considers that the debt raising cost would at most be a once-off cost for each regulatory period. Therefore, the EUCV is concerned that the approach used by the AER assumes that the debt will be raised every year, rather than every 6-8 years as in the norm for most businesses. Thus the debt raising costs should either:-

1. **apply the 8.3 bp on average amount of the debt in the RAB once in each period, or**
2. **apply the 8.3 bp on one sixth of the debt in the RAB each year of the six year period**

The EUCV considers that applying the 8.3 bp to all the debt in the RAB for each year of the period does not recognise the fact that debt is secured for much longer periods than annually.

5.9 Availability Incentive Scheme

SPA seeks to have paid to it by consumers an amount of the rebate payable by SPA to VENCorp for providing a guaranteed availability. If availability increases the rebate payable reduces. This rebate scheme is additional to the AER service standard incentive scheme which includes for availability as well. Implicitly, this means that the SPA overall incentive arrangements are greater than the 1% of RAB that the AER has required in its guideline on incentive payments.

The AER notes that the AIS is a hang over from the time when the Victorian transmission scheme was not regulated as it is now. It seems to be an unnecessary duplication to have two schemes in operation

The EUCV considers that the AIS should be removed and there be only one service standard incentive scheme.

The EUCV notes that the AER has identified that the standards of performance under the AIS are such that an incentive payment will inevitably flow to SPA. Thus the scheme set points are inappropriate for an incentive scheme. Equally, the AER notes that SPA has had to make payments to VENCorp as a result of the scheme, and that these are a cost to SPA.

If the AER is unable to remove the AIS in favour of its own service incentive arrangements, the EUCV agrees that the amount for the rebate should reflect the current ability of SPA to achieve the desired outcome. The EUCV notes that this is ~$1.4m pa, with this being the amount the AER proposes to include in the revenue. EUCV agrees with this approach, and suggests that the AER adjust its incentive scheme to ensure that the 1% of RAB at risk to provide service performance does not breach the AER guideline.

6. Approach to pricing

The EUCV notes that SPA is not to be subject to the new pricing guidelines, and further, as VENCorp develops the pricing structures, the SPA approach has a reduced impact on the final structure of pricing.

Notwithstanding these observations EUCV considers that now that SPA is aware of the new guidelines, it be given the opportunity to implement them.

Certainly, EUCV considers that there is sufficient time available to VENCorp to implement the new guidelines, rather than using the now superseded past approaches permitted.

It is noted that the SPA regulatory period will be for six years (not the more common five year period) and therefore there should be an effort made to incorporate the new guidelines due to the long period between resets. It would be a pity if the new guidelines were not implemented when there is ample opportunity to do so within the time frames permitted.

7. Service standards

SPA has proposed the following new settings for its service standards.

	Current Period							Proposed			
	Target	**2003**	**2004**	**2005**	**2006**	**avge**	**weighting**	**collar**	**Target**	**cap**	**weighting**
Availability Measures	**%**								**%**		
Total Circuit Availability	99.2	99.3	99.27	99.34	99.26	99.30	0.1	98.38	98.68	98.8	0.2
Peak Critical Availability	99.9	99.8	99.97	99.95	99.88	99.90	0.075	98.51	99.28	99.7	0.2
Peak Non-critical Availability	99.85	99.8	99.57	99.86	99.79	99.76	0.025	98.87	99.36	99.6	0.05
Intermediate Critical Availability	99.85	99.5	99.8	99.75	99.56	99.65	0.025	97.11	98.49	99.2	0.025
Intermediate Non-critical Availability	99.75	99.3	99.39	98.21	98.77	98.93	0.025	97.25	98.62	99.3	0.025
Loss of Supply Event Index	**No.**								**No.**		
>0.05 min per annum	2	3	2	5	5	3.75	0	7	4	3	0.125
>0.3 min per annum	1	0	0	2	3	1.25	0	4	3	2	0.125
Average Outage Duration	**hour**								**hour**		
Lines	10	9.98	2.73	7.542	33.38	13.41	0.125	12	7	4	0.125
Transformers	10	7.66	4.862	6.644	7.692	6.71	0.125	10	7	6	0.125

In its assessment, PB proposed that these be modified to increase the service standards, and the AER has accepted these as the basis for its draft decision. In its submission to the consultants' reports, the EUCV noted that on past performance SPA would have received near maximum bonus in most years of the current period, and the EUCV commented that this is not the intention of an incentive scheme. In its view, an incentive scheme requires the incentivised party to have to strive to get a bonus, and not just receive it effectively by fiat, which would apply if the set points are too low.

The following chart tabulates the current standards, the SPA proposal and the AER/PB proposal.

	SPA current			**SPA Proposed**			**AER Proposed**		
	collar	**Target**	**cap**	**collar**	**Target**	**cap**	**collar**	**Target**	**cap**
Availability Measures		**%**			**%**			**%**	
Total Circuit Availability	98.65	99.2	99.5	98.38	98.68	98.8	98.41	98.73	99.05
Peak Critical Availability	99.4	99.9	99.95	98.51	99.28	99.7	98.76	99.53	99.92
Peak Non-critical Availability	99.53	99.85	99.95	98.87	99.36	99.6	98.95	99.53	99.81
Intermediate Critical Availability	99.53	99.85	99.95	97.11	98.49	99.2	97.71	99.09	99.78
Intermediate Non-critical Availability	99.5	99.75	99.85	97.25	98.62	99.3	97.94	99.10	99.68
Loss of Supply Event Index		**No.**			**No.**			**No.**	
>0.05 min per annum	n/a	n/a	n/a	7	4	3	9	6	3
>0.3 min per annum	n/a	n/a	n/a	4	3	2	4	1	0
Average Outage Duration		**hour**			**hour**			**hour**	
Lines	20	10	3	12	7	4	11.1	6.4	1.6
Transformers	15	10	3	10	7	6	9.3	6.9	4.5

The EUCV points out that the AER proposed standards are lower than the current standards, ie that SPA will be required to provide a lower standard of service than consumers currently are entitled to.

The reasons given for expecting a lower standard of service in the next period is that SPA will be carrying out a larger amount of capital works than it did in the current period. This is to a degree inconsistent with the facts. The AER permitted capex program is much the same as the capex program applying in the last three years (ie years commencing 2005, 2006 and 2007). Examining the performance in two of these three years shows that SPA would receive a bonus based on the current benchmark performances. As the standards are proposed to be reduced from current performance, then an even greater incentive bonus would apply using the proposed reduced standards in years where the capex program is much as it will be in the new period.

Consumers are prepared to pay for above standard performance but do not consider that reducing standards is in their interests, especially when considering that the circumstances are little different from the activities seen in years 2005 and 2006.

The AER should not reduce the performance standards unless there is a clear and equitable reason to do so. The protestations of SPA that their large capex program will cause a greater number of outages in order to complete the works loses credibility when the capex program imposed by the AER is little different from that of the most recent years.

The investment of past capex is intended to improve the standard of service. It seems that the investment of $100m pa over the past three years has not resulted in such an outcome. In fact this investment seems to have resulted in lower service standards.

The EUCV considers that the AER and its consultant have accepted the views of SPA that they should not be expected to provide the same performance as they delivered in 2005 and 2006. In fact its own performance has put the lie to this excuse.

At worst, the current service standards should be retained or should be enhanced to reflect the amount of capital works carried out over the recent years.

It is of grave concern that the AER proposes to allow SPA to almost automatically collect a bonus which SPA is almost certain to attain based on recent past performance. To allow this is to depreciate the value of any performance incentive scheme.