ElectraNet SA

Revenue Cap Application

Submission on ACCC Draft Decision

11 October 2002

ElectraNet SA
electricity transmission network

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APPENDICES

1. Introduction

The Australian Competition and Consumer Commission (ACCC), in accordance with its responsibilities under the National Electricity Code (Code) is currently conducting an inquiry into the appropriate revenue cap to apply to the non-contestable elements of ElectraNet SA's transmission network.

The ACCC released a draft revenue cap decision on 11 September 2002 and held a public forum on the draft decision on 4 October 2002. The ACCC has invited written submissions in response to this document.

This submission sets out ElectraNet SA's response to the draft decision.

2. Overview of Draft Decision

The ACCC has taken a "tough" approach to the draft decision that is not in the best long-term interests of consumers. This approach appears to have been heavily influenced by the hype surrounding proposed retail price rises in South Australia and an incorrect perception that ElectraNet SA's operating costs are inefficient.

The draft decision does not provide a sufficient cash flow to fund the required capital investment program (even with the ACCC's smaller capital expenditure allowance). With this revenue stream ElectraNet SA would:

- Have resources to only do the *bare minimum* to meet Code requirements;
- Have to minimise capital expenditure; and
- Reduce the program of work set out in its Asset Management Plan (including asset maintenance, refurbishment and monitoring), which was endorsed by the ACCC's consultant Meritec.

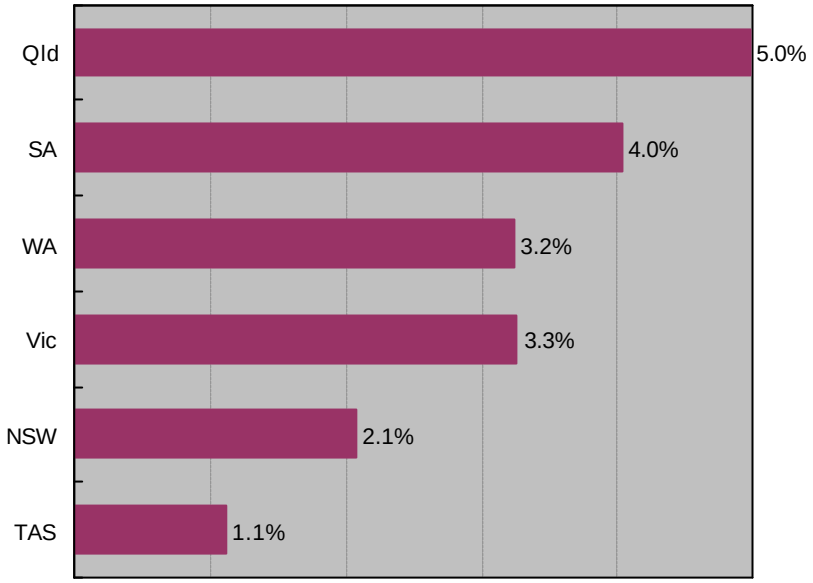
The consequences of these cuts will be detrimental to long-term customer price, service and reliability.

The draft decision fails to provide adequate incentives for investment and risks repeating yesterday's mistakes – lower prices today will mean higher prices tomorrow.

ElectraNet SA's objective is to provide sustainable high quality and cost efficient transmission services that meet South Australia's rapidly growing energy needs. Figure 1 shows that over the past decade demand growth in South Australia has been second only to Queensland.

This demand growth coupled with a shortfall in spending on the transmission network over the same period has resulted in the requirement for increased levels of spending on network infrastructure.

Figure 1: Average Annual Growth in Peak Demand (1991 - 2001)



ElectraNet SA's revenue cap application proposed a program of capital and operating expenditure to:

- Meet forecast economic growth in the State;
- Replace and upgrade vital network infrastructure;
- Increase interconnector capacity and allow connection of new competitive power sources; and
- Ensure the network contributes to, not constrains, economic growth.

The long-term benefits of this proposed expenditure far outweigh the relatively small cost to consumers:

- Increased competition in the energy market leading to downward pressure on electricity prices;
- Sustainable cost efficiencies; and
- Reliability of supply.

However, the draft decision makes significant cuts to both the capital and operating expenditure allowances proposed by ElectraNet SA.

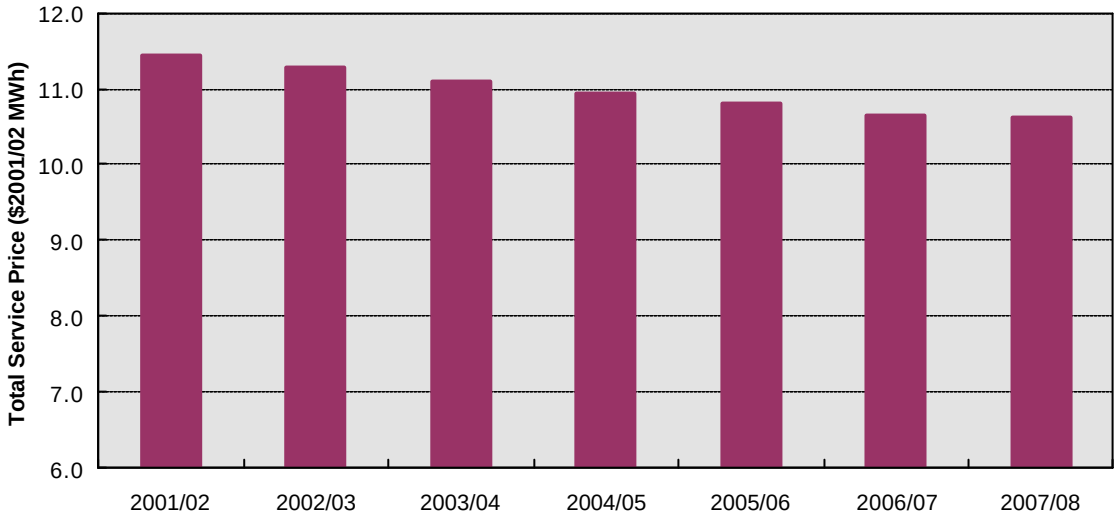
More importantly, the revenue stream does not provide a sufficient cash flow to support even this lower level of capital expenditure. This should not be surprising given that the revenue is similar to EPO levels despite a capital expenditure program that is almost double ($30m per annum higher than EPO levels) and increased operating expenses.

The draft decision does not provide a sufficient cash flow to support the ACCC's capital and operating expenditure allowances.

The draft decision delivers a real reduction in prices (c/kWh) compared to the EPO of approximately 7.3% over six years (refer to Figure 2). As has been explained this reduction in prices is not sustainable. These price reductions are being achieved despite the significantly higher level of investment required, even under the ACCC's proposed capital expenditure allowance.

In the end, customers will only get what they pay for. ElectraNet SA cannot be expected to make the significantly higher level of investment required without appropriate funding.

Figure 2: Real Price Impact of Draft Decision ($2001/02)

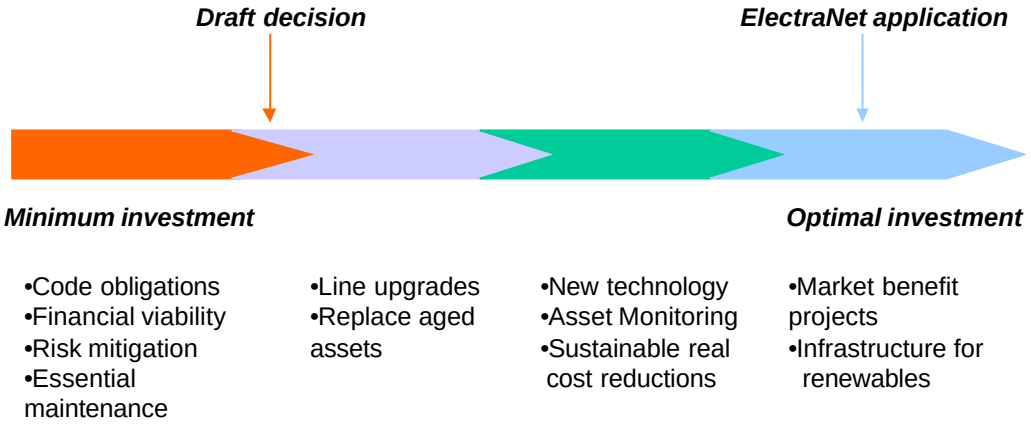


Sources: Revenue in 2001/02 is the underlying EPO revenue of $140.4m (excluding performance incentive scheme adjustments). Revenue figures for the remaining years are taken directly from ACCC's Draft Decision. Energy figures (MWh) are grid exit figures derived from the NEMMCO 2002 Statement of Opportunities.

The outcome of the draft decision is reduced funding at a time when additional capital investment (double EPO levels) and operating expenditure is required.

If the revenue stream allowed in the draft decision is not increased appropriately, ElectraNet SA will be forced to cut its capital and operating expenditure programs below the levels recommended by the ACCC's consultant Meritec in order to maintain its business viability and not overspend the opex allowance respectively. This will have an impact on customer service levels in the medium to longer term. Figure 3 illustrates the type of work that ElectraNet SA will have to reduce or eliminate from its proposed work program if the final decision replicates the draft decision.

Figure 3: Investment Consequences of Draft Decision



The ACCC's failure to provide the necessary incentives for investment will mean higher electricity prices in the longer term and declining reliability of supply.

3. Recent Regulatory Developments

The ACCC's final decision should be made in the context of recent developments in the regulatory policy framework established by Australian Governments. These developments include the:

- Federal Government's response to the Productivity Commission's report on the National Access Regime; and
- WA Supreme Court's Epic Decision.

The Productivity Commission's report and the Government's response recognise that the way economic regulation is being applied in Australia is leading to inadequate investment in essential infrastructure. In the Epic Decision the Court recognised that a misinterpretation of the Gas Code could result in providing inadequate incentives for investment.

These recent events serve to clarify the intent of the regulatory regime. A report by KPMG (included as Appendix C) finds that in order to be consistent with the intent of the regulatory regime, the ACCC's final decision for ElectraNet should:

- Place greater emphasis than in the draft decision on the need to provide adequate incentives to invest. This can be achieved most effectively by ensuring that the cost of capital used adequately addresses the commercial and regulatory costs and risks associated with infrastructure investment (consistent with the Government's policy) and, by implication, adequately recognising in the regulated asset base the value of assets used in the provision of regulated services.
- Adopt an approach to regulation that regulates 'by exception' and only seeks to alter ElectraNet SA's proposals where they are demonstrably inconsistent with the outcomes that might be expected in workably competitive markets, or to remove demonstrably large rents; and

- Rely more heavily on the incentives qualities the ACCC attributes to its approach to capex and opex.

These conclusions are underscored by overseas experience that is beginning to show that the current approach to regulation of electricity networks is not providing the right incentives for investment. For example, the following extract from a Reuters report dated 2 October 2002 (in relation to the U.S.A).

> *"The nation's 158,000-mile electricity transmission system has not kept pace with growing consumer demand for power, projected to rise by 25 percent over the next 10 tears, according to the US Department of Energy.*
>
> *Annual spending on electric transmission has been falling by about $120 million a year for the past 25 years.*
>
> *"It's clear that the decline in transmission spending is affecting electric reliability and the economy". Brendan Kirby, director of power research at Oak Ridge, told Reuters".*

The ACCC's final decision should be consistent with the Government's policy direction and provide adequate incentives for investment.

4. Transmission Cost Comparisons

One of the reasons for the ACCC's "tough" approach to the draft decision appears to be an incorrect perception that ElectraNet SA's costs are high and inefficient. This perception appears to have been created at least in part from inappropriate benchmarking of ElectraNet SA's costs against those of other TNSPs.

During the review process, ElectraNet SA has provided a significant amount of material explaining why efficient costs in South Australia are higher than in other States, a key reason being differences in the operating environment that ElectraNet SA has no control over.

The importance of identifying the impact of the operating environment on costs cannot be stressed too greatly if benchmarks identified are to provide credible performance comparisons. ElectraNet SA restates the following view expressed by the Productivity Commission:

> *"The usefulness of benchmarking as a guide to relative performance depends critically on an ability to compare like with like, or to make allowance for differences in operating environment that may be outside a utility's control*[1]*"*

Like with like comparisons remain elusive. Performance comparisons tend to draw on an arbitrary assortment of indicators. The ACCC's draft decision makes comparisons on the basis of: ratio of operating and maintenance costs to asset values, energy throughput (GWh), capacity (MW), line length (km) and number of substations. However, these measures by themselves do not take account of differences in scale or business operating conditions.

[1] Sayers, C. and Shields, D. 2001, *Electricity Prices and Cost Factors,* Productivity Commission Staff Research Paper, AusInfo, Canberra, August.

To assist in establishing a better understanding of the major cost drivers for transmission networks, ElectraNet SA commissioned a report by Margaret Beardow of Benchmark Economics, a specialist in energy market structures, incentive-based pricing and performance measurement (report included as Appendix D). Margaret has more than 20 years experience in the energy industry, working with both the private sector and government, including a period as an Associate Commissioner with the Trade Practices Commission.

Key findings from the report include:

- Comparisons must distinguish between costs and prices. The revenue cap determined by the ACCC is based on the *cost* of the network. Price represents the use of the system, rather than its cost. Price is derived by spreading the total cost of the network across its annual usage. The report shows that when costs (e.g. $/MW) and not prices ($/MWh) are compared, ElectraNet SA can compare favourably with similar networks.

- ElectraNet SA confronts the lowest use of system in Australia. For each MW of capacity installed, only 52% is used, on average, compared to around 73% for Queensland and 62% for New South Wales – resulting in higher average prices in South Australia.

- There is a recognised link between production costs and output scale. Comparing performance using normalisers such as MW, km, GWh is not appropriate without adequately adjusting for the scale of the network. Larger scale networks will generally enjoy lower costs and hence prices.

- Networks may have efficient costs relative to inputs provided, but factors beyond their control, including load factor and energy density, could affect the "price" outcome.

- ElectraNet SA is disadvantaged by its relatively small scale, its low level of average use relative to peak demand (load factor), and a low level of energy density.

- ElectraNet SA has a low energy density, 70% below SPI PowerNet. That is, with a network approximately equal in length to that of SPI PowerNet, ElectraNet SA transports four times less energy. This has a significant adverse impact on its prices relative to others.

- ElectraNet SA has the lowest load factor of the Australian networks, which also has a significant adverse impact on its prices relative to others.

- ElectraNet SA is one of the smaller Australian networks and is disadvantaged by the relatively higher level of investment that is required to provide its network service capability.

- ElectraNet SA has a total cost per MW installed of around $43,000 compared to $48,000 for Powerlink, a comparison that does not lend support to the claim that ElectraNet SA has relatively high and inefficient costs (Powerlink's network is most similar to ElectraNet SA's of the NEM states).

- The relatively higher transmission prices in South Australia (ElectraNet SA's price is around $3 per MWh above that of Powerlink, calculated as revenue per MWh transported) are a function of the nature of its market, rather than the performance

of the transmission network (the difference in prices is largely a function of energy density).

- Opex would be expected to show a close link to the underlying asset base. However, caution is needed in the use of the opex/assets ratio, as the outcome will depend as much in the value of the assets as the level of opex (factors that may impact include different asset valuation methodology, asset ages, voltage levels).

- Lower load factors are associated with relatively higher levels of opex/MW. ElectraNet SA would, therefore, be expected to have a higher opex/MW than other States.

In summary, the Benchmark Economics report supports the conclusion that ElectraNet SA's costs are efficient when the cost drivers for transmission networks are properly taken into account.

To further assist the ACCC, ElectraNet SA proposes a presentation of the findings of the report by its author prior to the ACCC making its final revenue cap decision.

5. Cost of Capital

ElectraNet SA has presented detailed arguments for the required cost of capital in its application based on expert advice from the Network Economics Consulting Group (NECG). These include arguments for the ACCC to change its treatment of some WACC parameters compared with recent revenue decisions. The following sections address the most contentious issues raised by the draft decision.

5.1 Regulatory Transparency

ElectraNet SA together with SPI PowerNet and GasNet jointly sponsored a forum on key WACC issues that was held in Melbourne on 24 June 2002. The purpose of this forum was to provide an opportunity for the ACCC and interested parties to hear first hand from experts (including NECG, Professor Bob Officer, NERA and investment bankers) and for interested parties to participate in the debate on key WACC issues.

The ACCC did not take full advantage of the opportunity to participate in this forum attending only in an observer capacity.

In its application ElectraNet SA emphasised that the arguments presented "*must be considered on their merits and cannot simply be dismissed if regulatory transparency is to be achieved. The ACCC must, where it adopts alternative treatments, present a strong case for these including detailed arguments supported by learned articles and analysis*".

The ACCC has failed to take up this challenge and the draft decision does not properly address the weight of argument presented. The ACCC has not made available for scrutiny the expert advice upon which it has based its decisions.

ElectraNet SA believes that the ACCC should immediately make this expert advice available and provide the opportunity for it to be critiqued, and convene a roundtable of the relevant experts as part of finalising its decisions for ElectraNet SA, SPI PowerNet and GasNet.

5.2 Risk free rate of return

All the experts at the WACC forum referred to above presented arguments for why the 10-year bond rate should be used in determining the risk free rate rather than the 5-year bond rate. The unanimous conclusion on this point was that the ACCC essentially stands alone on this issue and should change its position. All other Australian regulators use 10 years.

The ACCC has relied upon advice from Lally in maintaining its position. ElectraNet SA understands that a critical assumption in the Lally paper upon which the 5-year bond rate position depends is that the ACCC can provide a capital guarantee, which it clearly does not and cannot provide.

The ACCC's position on using a term equivalent to the regulatory period is unsustainable.

The weight of evidence suggests that the ACCC should change its position and use the 10-year bond rate in making its final decision.

5.3 Cost of debt

The debt margin depends on the term chosen for the risk free rate. In its application ElectraNet SA claimed a debt margin of 172 basis points over the 10-year risk free rate based on capital market advice in February 2002.

Based on the 5-year term used in the draft decision, the current debt margin applicable to a BBB+ rating for 5-year funding is trading well above the 130 basis points allowed in the draft decision. Table 1 summarises the debt margins quoted by the four major Australian trading banks in late September/ early October 2002 (letters from the banks are included as attachments).

Table 1: Margins above 5-Year Bond Rates for BBB+ and BBB Rated Debt

Bank	BBB+	BBB
National Australia Bank	152 – 157 bps	166 – 176 bps
Westpac Institutional Bank	155 bps	175 bps
ANZ Investment Bank	153 – 158 bps	168 – 175 bps
Commonwealth Bank of Australia	157 bps	171 bps

As a minimum, based on the figures quoted by the banks, the ACCC should adjust the debt margin in its final decision to 158 basis points above the 5-year bond rate, including 8 basis points for issuance fees.

We note the draft decision does not make any allowance for debt raising costs. This is completely inconsistent with the ACCC's GasNet draft decision. These

debt raising costs are actual costs paid to financial institutions with the raising of any debt and cannot be ignored by the ACCC. Making an allowance for debt raising costs is consistent with what the ACCC allowed in its GasNet draft decision.

5.4 Interest rate risk

Further to the above, the ACCC has not properly addressed ElectraNet SA's claim of compensation for the interest rate risk it faces on new capital expenditure. The capex program occurs throughout the regulatory period and funding of it occurs progressively with the consequent need to borrow funds at the prevailing interest rates at the time. Meritec did not allow the cost of managing this risk in the recommended opex allowance for no reason other than "*hedging was not allowed in Powerlink's case*". The draft decision is silent on this matter.

However the fact is that interest rates change on a daily basis and the ACCC fixes a rate of return for the whole of the regulatory period based on interest rates prior to the commencement of this period. This action exposes the business to interest rate risk on the allowed capital expenditure. In its application, ElectraNet SA asked for an allowance for the cost of establishing options to manage this risk. Whilst we believe that an allowance for these costs provides the optimal solution, we note that Meritec and the ACCC have denied this request.

As a minimum position, ElectraNet SA should be allowed the costs of hedging this exposure using swaps to match the revenue based on the ACCC's WACC and the corresponding bond rate.

Hedging this risk would involve the establishment of swaps at the time the bond rate is set by the ACCC. However, given that these swaps will be hedging risk that does not start until the capital expenditure is undertaken throughout the regulatory period, the start date for the swaps will be staggered throughout this period. The current yield curve indicates that interest rates are likely to rise in the near future. To reflect the cost of starting the swaps at a later time when rates are expected to be higher, the financial markets will charge ElectraNet SA additional margins to accommodate the deferred starts for these swaps. The current charges for these deferred starts as at 11 October 2002 are:

Table 2: Margins above Swap Rate

Deferred start date	Additional margin over swap rate
July 2003	+ 0.08%
July 2004	+0.26%
July 2005	+0.35%
July 2006	+0.45%
July 2007	+0.54%

These additional margins are verifiable with any banking institution as they represent current market rates.

The average of these additional margins is 0.34% per annum. When applied to the whole of the forecast debt levels (based on the capex program), this additional cost adds an incremental 5 basis points to the debt cost margin allowed in the draft decision.

Hedging interest rate risk is standard business practice. The reality is that the modelling undertaken as part of the regulatory process assumes that the current risk free rate applies to future investments – clearly this does not reflect reality.

The ACCC should add an incremental margin of 5 basis points to the cost of debt for managing the interest rate risk on future capital expenditure.

5.5 Summary

The weight of evidence suggests that the ACCC should change its position and use the 10-year bond rate in making its final decision. However, even if the ACCC persists in using the 5-year bond rate, the debt margin in the final decision should be adjusted to a minimum of 163 basis points, including 8 basis points for issuance fees (as was allowed in the GasNet draft decision) and 5 basis points for managing interest rate risk on future capital expenditure.

ElectraNet SA will not undertake investment projects when the market price average funding costs are beyond those allowed by the ACCC (otherwise ElectraNet SA will incur losses).

6. Opening Asset Base

6.1 Optimisation

The ACCC's draft decision disallows ElectraNet SA's claim to have approximately $13m of previous optimised assets reintroduced to the regulatory asset base. The reasons given are as follows:

> *"As previously mentioned, the Commission has limited discretion in revaluing the jurisdictional asset base. That where a judgement was made by the jurisdiction in establishing the RAB, and where that judgement is still applicable, the Commission cannot substitute its own judgement for that made by the jurisdiction. Therefore, the Commission is unable to make any adjustment to the RAB in regards to optimisation as a judgement was made by the jurisdiction"* (underlining added).

While the jurisdiction did make a judgement with regard to optimisation at the time the jurisdictional asset base was established, this judgement is clearly no longer applicable. The jurisdictional valuation included the results of a 1998 optimisation study conducted by Sinclair Knight Merz. However, significant load growth and new generation connections in the interim mean that assets that were previously optimised out of the RAB are now being utilised and should be justifiably reinstated in the RAB

ElectraNet SA's claim to reintroduce assets to the RAB was based on the findings of a recent optimisation study conducted by Sinclair Knight Merz[2]. The ACCC's consultant Meritec endorsed these findings.

The approximately $13m of previously optimised assets should be allowed back into the RAB in the ACCC's final decision. Not doing so would be clearly inconsistent with the ACCC's own arguments.

Approximately $13m of previously optimised assets should be allowed back into the RAB in the ACCC's final decision.

6.2 Valuation of Easements

The ACCC has not accepted the easement values requested by ElectraNet SA, nor those recommended by its consultant Meritec. The ACCC has insisted that easements should only be valued on the basis of the actual amounts paid.

The draft decision has used an easement value of $3.1m consistent with what was allowed in the jurisdictional asset valuation. However, the draft decision acknowledges that:

> *"… given the explicit written qualifications by the South Australian Treasury and Finance Department the Commission may have to exercise the discretion to consider other options".*

The $3.1m easement valuation is clearly inadequate and the ACCC's requirement to provide evidence of actual costs or receive no recognition for easement value is unreasonable.

The South Australian Minister for Energy in a letter to the ACCC dated 5 September 2002 states:

> *"It is recognised that there is a need to include a fair and reasonable value of the easements in the asset base."*

The Minister continues that in the absence of historic cost data:

> *"the South Australian Government proposes that the ACCC adopt an approach that discounts the easement values in Victoria for the difference in real estate values, and values the easements in South Australia accordingly."*

The submission included as Appendix B develops a fair and reasonable value for historic easement compensation costs of $27.5m at 1 July 2001, based on the recommendation of the Minister (compared to $79.7m allowed in Victoria – ElectraNet SA has a line length of 5,576 km compared to 6,552 km in Victoria).

This figure is derived from historic costs recognised by the ACCC in its draft decision for SPI PowerNet, the relative number of easement ownerships and ABARE derived rural price indices.

[2] 2001 Optimisation Review – Final Report, SKM, February 2002.

The ACCC should adjust the opening RAB in its final decision to include $27.5m at 1 July 2001 for the fair and reasonable cost of easement compensation.

7. Capital Expenditure

The draft decision makes significant cuts to the capital expenditure program proposed by ElectraNet SA, excluding significant projects that are important to economic development in South Australia. ElectraNet SA strongly disagrees with the rationale behind making these cuts.

However, ElectraNet SA is not seeking an increase in its capex allowance unless adequate funding is made available. The revenue stream in the draft decision will not even allow ElectraNet SA to fund the lower level of capital expenditure proposed by the ACCC.

The following points were made earlier in this submission:

- The draft decision does not provide adequate incentives for investment; and
- The revenue stream allowed in the draft decision would constrain ElectraNet SA to take a minimalist approach to investment and find ways of cutting capital expenditure below the levels allowed by the ACCC.

The Robertstown to Monash 275 kV line is a prime example of the consequences of the draft decision.

The ACCC has excluded the cost of this line from the capex allowance because:

> *"The Commission understands that the NEMMCO approved version of SNI does not pass through Monash but is to be constructed from Buronga in NSW to Robertstown in South Australia. As such the agreement with TransGrid to build, own and operate a Robertstown to Monash component of the SNI project does not appear to form part of the NEMMCO approved version of SNI. The Commission considers that uncertainty exists as to whether or not this version of SNI, if modelled, would result in the same outcomes as the version approved by NEMMCO as passing the regulatory test. Unless it can be demonstrated to the Commission that this version of SNI is the version approved by NEMMCO, the Commission considers that TransGrid remains the sole proponent of SNI. Therefore, at this stage, the Commission considers that the Robertstown-Monash 275kV component of Project 1.36 should be excluded from ElectraNet's capex requirement".*

The documentary evidence clearly shows that all the line works associated with SNI (including taking the line right up to Monash) were explicitly included in the project approved by NEMMCO. This point has been confirmed with the ESIPC and we understand that TransGrid will be providing the ACCC with details of the supporting evidence.

On this basis, the Robertstown to Monash line should be added to the capex allowance. However, ElectraNet SA will be unwilling to make this investment unless the final decision provides adequate incentives, including a revenue stream that is

sufficient to fund the total level of capital expenditure required without adversely affecting the financial viability of the business.

Encouraging efficient transmission investment of this kind, related to promoting competition in the wider electricity market by relieving transmission constraints, is precisely what the Productivity Commission report and Government's recommendations seek to address. Stronger interconnector capacity and stronger transmission networks in general lead to more competitive market outcomes and lower electricity prices.

The Robertstown to Monash line should be added to the capex allowance. However, ElectraNet SA is not seeking an increase in its capex allowance unless adequate funding is made available.

8. Operating and Maintenance Expenditure

The draft decision concludes that $43m is an appropriate opex allowance (excluding grid support), consistent with the recommendation of the ACCC's consultant Meritec. However, the draft decision expresses concern that the opex allowance may be high.

> *"The Commission however notes that $43m is significantly higher than the amount reported to the SAIIR by ElectraNet and that by most measures appears higher than those of other TNSP's in Australia. Therefore, the Commission will re-examine the opex allowance before its final decision".*

This concern is based on comparisons with ElectraNet SA's historical operating costs and benchmarking comparisons against other TNSPs. These comparisons are considered in the following sections.

8.1 Historical Operating Costs

There appear to be two issues relating to historical costs. Firstly, there is the matter of the O&M costs that ElectraNet SA has reported to the SAIIR for the purposes of the Performance Incentive (PI) scheme. Secondly, and more importantly, there appears to be confusion about what historical opex numbers should be used as a guide to establishing the opex allowance for the regulatory period.

Relevance of PI Scheme Costs

The draft decision makes the statement that for the purposes of assessing ElectraNet's opex allowance to establish its MAR, the lower O&M figures reported to the SAIIR for the PI scheme are more appropriate (than the regulated operating costs reported in accordance with SAIIR and ACCC Information Requirements Guidelines).

ElectraNet SA is extremely concerned about these statements in the draft decision and the apparent misunderstanding concerning both the nature and relevance of the PI scheme O&M costs to establishing a historical reference for determining ElectraNet SA's opex allowance for the forthcoming regulatory period.

The Transmission Code defines operating costs for the purposes of the PI scheme as:

> *"Those operating and maintenance costs which are regulated costs included in the determination of ElectraNet's maximum allowable revenue" (underlining added)*

ElectraNet SA has interpreted this to mean that it was appropriate to only include those costs that were within the scope and extent of activities and costs contemplated at the time the EPO was established – i.e. those costs included as part of the revenue determination at that time.

O&M costs that have been reported for the purpose of the PI scheme are, therefore, fundamentally different from the regulated opex that has been reported in accordance with SAIIR and ACCC Information Requirements Guidelines because of:

- Timing differences resulting from the 1 April to 31 March reporting period for the PI scheme; and
- The exclusion from the PI scheme O&M costs of regulated opex that was outside of the scope contemplated at the time the EPO was established.

The items and reasons for exclusions were subject to audit by external auditors (PricewaterhouseCoopers) who also audited ElectraNet SA's end of June regulatory accounts. Accordingly, the veracity and accuracy of the information provided is without question. The regulated opex excluded from the PI scheme is nonetheless regulated and appropriate opex incurred by the business.

Most importantly, any disagreement concerning the figures reported for the PI scheme should have no bearing on establishing an appropriate historical reference for determining ElectraNet SA's opex allowance for the regulatory period (for the reasons given above).

O&M costs reported for the purpose of PI scheme are NOT the same as regulated opex and cannot validly be used as a guide to establishing ElectraNet's opex allowance for the regulatory period.

Relevance of Historical Operating Costs

As noted earlier, even apart from the PI scheme O&M costs, there appears to be confusion about what historical opex numbers should be used as a guide to establishing the opex allowance for the regulatory period.

Opex consists of both recurring and non-recurring costs. The draft decision implies that all non-recurring ("one off") costs should be excluded from the opex allowance. This means that these costs would be fully absorbed by the business while customers receive the full benefit of these initiatives.

For example, ElectraNet SA undertakes numerous maintenance, repair and condition assessment projects, restructuring initiatives and investigative works that are not on going on an individual basis (i.e. the projects undertaken change). The view that appears to be espoused in the draft decision is that

there is some doubt as to whether these costs can be viewed as legitimate. Such a view is without foundation and not supported by proper analysis.

The draft decision quotes historical opex figures going back to 1997/98 and notes that opex has been steady since that time despite inflation, capex and privatisation. However, the figures quoted by the ACCC are misleading. The establishment of a stand-alone transmission business as part of industry disaggregation and privatisation has understandably required an increase in efficient opex costs. In 1997/98 the transmission business was still part of the vertically integrated ETSA Corporation and was not allocated the full cost of services provided to it. The same is true of 1998/99, the year in which disaggregation took place. Base costs in 1999/00 and 2000/01 were also constrained lower than normal due to:

- The "forced" reduction of opex levels by the SA Government in the lead up to the sale of the business; and
- The post privatisation period in which opex levels were kept low by the new owners as they assessed the business and were mindful of both the opex allowance provided under the EPO and the imminent revenue reset.

Operating costs for the financial years 1997/98 through 2000/01 were significantly lower than current cost levels for the reasons given. For this reason the ACCC should use 2001/02 costs as the starting point for determining ElectraNet SA's opex allowance for the regulatory period (together with the new and increased cost items recommended by Meritec).

Operating costs in the years prior to 2001/02 were not typical of the costs required to operate the stand-alone transmission business in South Australia and cannot be relied upon as a guide to establish ElectraNet SA's opex allowance.

8.2 Current Operating Costs

As explained earlier opex levels were constrained low in 1999/00 and 2000/01. Regulated opex in 2001/02 is the most appropriate basis for establishing ElectraNet SA's opex costs for the regulatory period (together with new and increased cost items). ElectraNet SA's Regulatory Financial Statements prepared in accordance with the ACCC's Information Requirements Guideline show that regulated opex in 2001/02 was $39.1m. ElectraNet SA's external auditors have confirmed this figure.

ElectraNet's base level of regulated operating costs for determining an opex allowance for the MAR is most accurately determined from 2001/02 figures.

8.3 Meritec Opex Allowance

ElectraNet provided detailed information to the ACCC and Meritec concerning cost increases and new cost items that will be incurred during the forthcoming regulatory period. Meritec followed this approach by adding to 1999/00 historical costs to arrive at its recommended opex allowance.

However, Meritec's reliance on 1999/00 costs was flawed for the reasons given earlier. ElectraNet SA demonstrated in its response to the Meritec Opex Review that Meritec failed to recognise significant cost items because of its reliance on the 1999/00 costs. Adjusting for actual costs in 2001/02, the opex allowance even based on Meritec's recommended cost items should be $44.5m (in $2001/02 and excluding grid support) compared with the $43m allowed in the draft decision. Further the $44.5m does not allow for cost items that Meritec, inappropriately in our view, omitted. The additional costs items that were excluded from Meritec's opex recommendation include:

- Increases in maintenance service provider contract rates following a competitive tender process ($0.7m);
- Hedging costs to offset the risk of increases in future increases in interest rates above the WACC assumptions in order to enable the level of investment contemplated under the capex program ($2.4m);
- Fulfilling an obligation to fully fund the employee superannuation scheme. ($2.5m);
- A more realistic escalation of operating and maintenance costs linked to the increase in the size of the asset base and the aging of the existing assets than used by Meritec. The escalators used by ElectraNet SA were also used by Powerlink in their application approved by the ACCC ($1.2m); and
- An oversight by Meritec associated with their assessment of other refurbishment costs whereby costs that they used under this line displaced other legitimate costs associated with site clean up costs (approved by the ACCC in its Powerlink revenue determination) and project management of the allowed refurbishment costs under opex ($1.9m).

These costs are legitimate and some have actually been allowed by the ACCC in past determinations. The ACCC must re-consider its position on these items, as failure to do so will result in reductions in expenditure in other areas "endorsed" in the ACCC's draft decision.

8.4 Benchmarking Comparisons

The Benchmark Economics report included as Appendix D (refer to Section 4) supports the conclusion that ElectraNet SA's opex is efficient when the cost drivers for transmission networks are properly taken into account.

8.5 Refurbishment Expenditure

The draft decision based on Meritec's recommendations makes no allowance for the approximately $4.3m per annum of refurbishment costs that the ACCC has directed to be capitalised, but which cannot be capitalised because they are either maintenance expenditures (broken insulator strings, conductor repairs and structural repairs) or replacement of parts of assets that are not capitalised even for accounting purposes (refer to details in Attachment 3 of ElectraNet SA Response to Meritec Opex Review).

ElectraNet SA is concerned that the draft decision has failed to address this issue and appears to have taken a view that is contrary to Australian

Accounting Standards when ElectraNet SA explicitly raised this significant issue with the ACCC. Furthermore, ElectraNet SA notes that its proposed capitalisation policy is virtually identical to the policy approved by the ACCC in the Powerlink revenue determination.

The Commission has proposed that refurbishment projects be quarantined from asset re-valuation for a period of 15 years and that the expenditure may be depreciated over that period. ElectraNet SA can demonstrate that the remaining life of the assets to be refurbishment is between 7 – 8 years rather than the 15 years proposed by the ACCC. If the ACCC maintains that this expenditure is to be capitalised (despite being inconsistent with previous revenue determinations), then the ACCC should at least allow the refurbishment work to be depreciated over a shorter life of say 10 years, which more accurately reflects the remaining life of the assets to be refurbished.

The ACCC is proposing to capitalise maintenance costs and impose a capitalisation policy on ElectraNet SA that is inconsistent with past revenue determinations.

8.6 Consequences of Inadequate Opex Allowance

ElectraNet SA has explained previously to the ACCC and interested parties that costs excluded from the opex allowance nonetheless represent real costs that must be incurred by the business. Failure to include these will simply reduce the funds available to make the expenditures on asset maintenance, monitoring and control, asset renewals and refurbishment proposed in ElectraNet SA's Asset Management Plan and endorsed by Meritec. Failure to carry out this work on the network will be to the detriment of customer service and reliability and will raise maintenance costs in the future.

8.7 Conclusions

The historical operating costs included in the draft decision are not relevant to establishing an appropriate level of costs for determining ElectraNet SA's opex allowance. Operating costs in the years prior to 2001/02 do not represent current costs and were not typical of the costs required to operate the stand-alone transmission business in South Australia (costs in previous years were low because they were prior to disaggregation or constrained because of the sale process).

Any disagreement concerning the figures reported for the PI scheme should have no bearing on establishing an appropriate level of costs for determining ElectraNet SA's opex allowance for the regulatory period because O&M costs reported for the purpose of PI scheme are NOT the same as regulated opex.

2001/02 regulated operating costs are the most appropriate base from which to determine ElectraNet SA's opex allowance. Adopting this base, the opex allowance in the draft decision still falls short of fully allowing for the cost items recommended by Meritec (by $1.5m per annum). ElectraNet SA considers that the proposed allowance is some $9m below what is required.

Failure to make an adequate opex allowance in the final decision will simply reduce the funds available to make the expenditures on asset maintenance, monitoring and control, asset renewals and refurbishment proposed in

ElectraNet SA's Asset Management Plan and endorsed by Meritec – to the detriment of customer service and reliability.

9. Total Revenue

The revenue cap in the ACCC's draft decision must be appropriately increased in the final decision to:

- Be sufficient to allow the business to fund the capital expenditure program (taking into account any additions made to the capex allowance) while at the same time providing the business with a *"fair and reasonable risk-adjusted cash flow rate of return"*, as required by the NEC[3]; and
- Make adequate allowance for the efficient costs of operating the business.

The principal options for achieving this outcome are an appropriate increase in the WACC, adequately recognising the value of assets used to provide regulated services, and depreciation profiles. Addressing the matters raised in the following subsections will also be helpful to achieving the above objectives.

9.1 Modelling Capital Additions

The ACCC's draft decision fails to address the alternative and more accurate approach to modelling capital additions proposed by ElectraNet SA. The following extract is taken from ElectraNet SA's revenue cap application.

> *"The ACCC approach to modelling capital additions rolls assets into the regulated asset base on the last day of the year in which they are brought into service. This is equivalent to making the assumption that all assets come into service on the last day of the financial year. The return on capital is calculated using the opening asset value and a return on half of the capital additions is added to the asset base to compensate for the fact that capital additions actually come into service progressively throughout the year (even this assumption is conservative because most projects are commissioned by December each year to meet summer peak demands).*
>
> *An alternative and more accurate modelling approach that is used by other regulators is to add the appropriate return on capital additions to the total revenue requirement for the year in which they are made.*
>
> *The two modelling approaches can be shown to be equivalent in NPV terms. However, the ACCC approach has significant cash flow implications during the regulatory period and given the large capital investment program that must be funded, it is essential that the alternative modelling approach be adopted for ElectraNet SA".*

Given the implications of forecast cash flows on ElectraNet SA's credit rating and the fact that ElectraNet SA's rating is at risk from any adverse cash flow impacts, the ACCC should allow the modelling approach proposed by ElectraNet SA to bring forward cash flows at no additional cost to end users in the long term.

[3] Clause 6.2.4(c).

The ACCC should adopt the alternative approach to modeling capital additions proposed by ElectraNet SA to improve cash flows and hence the financial viability of the business during the regulatory period.

9.2 Opex Efficiency Dividend

The draft decision applies an efficiency dividend of two per cent per annum to ElectraNet SA's operating expenses.

We note that the ACCC does not appear to have applied an efficiency dividend in its other TNSP decisions (including the recently released SPI PowerNet draft decision). The motivation for applying one to ElectraNet SA appears to be the incorrect perception, addressed earlier in this submission, that ElectraNet SA's costs are inefficient. However, it has been shown previously that this perception does not withstand a careful examination of the cost drivers for transmission networks. When these are properly taken into account, ElectraNet SA costs are shown to be efficient (Benchmark Economics report in Appendix D).

ElectraNet SA is essentially an asset management company. The majority of ElectraNet SA's total opex (75%) is either fixed or based on competitive market prices. Services that ElectraNet SA goes to the market for include:

- Transmission line and substation maintenance;
- Vegetation clearance;
- IT and telecoms maintenance;
- Property services;
- Internal audit; and
- Legal services.

On top of this ElectraNet SA's corporate costs (which make up the majority of the remaining 25% of total opex) compare favourably with other network businesses and are contained in real terms within the regulatory period.

There is little scope for further efficiency improvements. The higher opex ElectraNet SA has requested for the forthcoming regulatory period is primarily to meet the increased volumes of work required on the network consistent with the Asset Management Plan that was endorsed by the ACCC's consultant Meritec.

The efficiency dividend on opex should be removed from the ACCC's final decision.

10. Financial Indicators

The financial indicator analysis presented in the draft decision concludes that:

"The Commission is satisfied that ElectraNet's likely credit rating will be above investment grade and will not adversely affect its ability to access capital

> *markets. Based on its analysis, the Commission considers that the trend, when assessed against the background of ElectraNet's strong business profile, indicates that the final revenue stream set out above will not adversely affect the ongoing financial viability of the network".*

The draft decision recognises the limitations of this analysis, but implies an expectation that the analysis is conservative.

> *"Once again the Commission would like to emphasise the limitations of applying a model that was designed for competitive businesses to TNSPs that have an almost guaranteed revenue stream".*

However, in ElectraNet SA's case the opposite is true. The reality is that the draft decision does not allow sufficient revenue to fund the required capital expenditure and puts ElectraNet SA's BBB+ credit rating at risk.

One reason for this discrepancy is the dividend payout ratio assumed by the ACCC in its analysis. The ACCC has in past decisions estimated the dividend payout ratio based on the actual circumstances of the business. However, the draft decision makes no mention of the payout ratio of 86% provided in ElectraNet SA's application, which is based on actual payout commitments of the business. Instead the following assumption is made:

> *"…for the purpose of calculating ElectraNet's financial indicators and in the absence of more recent information, the Commission considers it would be appropriate to assume a positive dividend payout ratio and therefore has adopted a ratio of 50".*

The ACCC must adopt a more realistic dividend payout ratio in its analysis to reflect the actual circumstances of ElectraNet SA's business.

The setting of credit ratings is primarily based on forecast cash flow analysis and the corresponding cash flow ratios. ElectraNet SA's forecast cash flows based on the draft decision only just meet Standard and Poors' requirements for a BBB+ rating and we have been advised that our rating is "on a knife-edge" and that any adverse events may precipitate a downgrading to BBB.

The state of ElectraNet SA's cash flow position is significantly worsened by the treatment of refurbishment work as capex. Whilst ElectraNet SA has the same outgoing cash flows required to undertake the work, the cash inflow from revenue is deferred over the remaining life of the assets. This worsens ElectraNet SA's forecast cash flow position dramatically.

To help avoid the risk of downgrade to BBB, the ACCC should at least allow the refurbishment work to be depreciated over the shorter life of 10 years (rather than 15 years), which more accurately reflects the remaining life of the assets to be refurbished – improving ElectraNet SA's cash flow position (refer to Section 8.5).

11. Service Standards

11.1 ACCC Service Standards Review

ElectraNet SA notes that the draft decision includes historical data, definitions of performance measures and force majeure, and performance targets and characteristics that are based on an early version of SKM's report and recommendations to the ACCC.

The draft decision does not reflect the comments made by ElectraNet SA and others in the later stages of the ACCC's Service Standards Review. However, the ACCC's final decision should reflect SKM's final report and recommendations.

ElectraNet SA requests the opportunity to review a revised version of the decision service standards chapter once SKM's final recommendations have been incorporated.

11.2 Setting Performance Targets

The success of any performance incentive scheme will depend largely on whether the scheme creates the right incentives. ElectraNet SA understands that the proposed performance targets have been set on the basis of historical performance over recent years. This gives rise to the following concerns:

- Performance targets set in this way do not take into account that ElectraNet SA's capex program during the regulatory period will be double what it has been in recent years. This means that more plant outages will be required to accommodate the capital works program. Higher levels of construction will also increase the likelihood of inadvertent plant outages.

- If performance targets are already at or near best practice then further improvements are much more difficult to achieve than a decline in performance.

ElectraNet SA believes that these factors create an imbalance in the incentive properties of the scheme with penalties more likely than rewards. These factors should be taken into account in setting performance targets for the final decision.

Targets in the final decision should be set to achieve an appropriate balance between rewards and penalties.

11.3 Incorporating Performance Outcomes into the MAR

The draft decision states that the penalty/reward from the incentive scheme will lag the performance period by one year. That is the MAR in year two will include the penalty/reward for the performance achieved in year one.

According to the draft decision, the MAR is calculated as follows:

$$MAR\ t = AR\ t + AR\ t\text{-}1 \times St\text{-}1$$

The implementation described won't work because performance in year one and hence *St-1* won't be available until after the completion of the financial year, well after the date by which *MARt* must be calculated and transmission prices published (the Code currently specifies 15 May).

ElectraNet SA proposes that *St-1* be determined from performance in the previous calendar year. For example performance in 2003 would factor into the MAR calculation for 2004/05. We consider that this is more desirable than introducing a two year lag.

12. Conclusions

ElectraNet SA's revenue cap application was built on a comprehensive analysis of the future requirements of the transmission network in South Australia. Detailed asset management plans have been developed to ensure that growth in customer electricity demand is satisfied while maintaining the ongoing reliability of the transmission network. These plans were endorsed by the ACCC's consultant Meritec.

ElectraNet SA's revenue cap must provide the necessary funding for the major investment program that is required to upgrade and expand the network during the regulatory period, without jeopardising the ongoing financial viability of the business and thereby adversely affecting transmission network services in South Australia.

The ACCC's draft decision fails to meet this objective. It does not provide a sufficient cash flow to fund the required capital investment program (even with the ACCC's smaller capital expenditure allowance). With this revenue stream ElectraNet SA would:

- Have resources to only do the *bare minimum* to meet Code requirements;
- Have to minimise capital expenditure; and
- Reduce the program of work set out in its Asset Management Plan (including asset maintenance, refurbishment and monitoring), which was endorsed by the ACCC's consultant Meritec.

The consequences of these cuts will be detrimental to long-term customer price, service and reliability.

The revenue cap in the ACCC's final decision must be increased appropriately. The principal options for achieving this outcome are (as detailed in this submission):

- Appropriately increasing the WACC (cost of debt, 10 year bond rate);
- Adequately recognising the value of assets used to provide regulated services (optimisation and easement value);
- Depreciation profiles (including reducing the life of refurbishment assets from 15 years to 10 years);
- Adopting the approach proposed by ElectraNet SA for modelling capital additions bringing forward cash flows; and
- Removing the proposed efficiency dividend.

Appendix A

Debt Margins from the Major Australian Trading Banks

26 September 2002

Wholesale Financial Services

Telephone (03) 8641 2769
Facsimile (03) 8641 4194

Level 32
500 Bourke Street
MELBOURNE VIC 3000

www.nabmarkets.com

Mr Geoff Teitzel
Executive Manager Finance
ElectraNet SA
PO Box 7096
Hutt Street Post Office
Adelaide SA 5000

Dear Geoff

Debt Capital Markets Pricing

I am pleased to provide you with indicative pricing for an ElectraNet A$ medium term note ("MTN") issue for a volume of between A$500 million to A$700 million. Pricing is subject to market conditions at the time of issuance.

	Re-offer Margin to Commonwealth Government Bond	
Rating (S&P)	**5 years**	**10 years**
A	+ 116 – 121 bps	+168 – 173 bps
A-	+126 – 131 bps	+178 – 183 bps
BBB+ (ElectraNet S&P Rating)	+144 – 149 bps	+193 – 198 bps
BBB	+158 – 168 bps	+240 – 250 bps
BBB-	+197 – 212 bps	+288 – 303 bps

Issuance Fees

The following fees are payable:

- MTN Placement (Dealer) Fees - for a 'BBB+' issuer MTN placement fees are typically 0.07% p.a. of the issue amount, payable by the Issuer at the time the MTNs are placed
- Legal documentation and Austraclear Fees - total fees of 0.01% p.a. – 0.015% p.a. are payable by the Issuer for legal work and to register the MTNs in Austraclear

26 September 2002

Market Overview

- The corporate bond market has experienced a widening in credit spreads for most corporates as a result of the recent equity market volatility.

- Issuance of 'BBB' rated credit in 2002 has dimished significantly from the previous 3 years as a result of investors adopting a more risk adverse investment strategy given the volatile market conditions.
- Traditionally electricity utilities rated in the 'BBB' sector have accessed the corporate bond market through the issue of credit-wrapped bonds.

Given ElectraNet's underlying credit rating of BBB+ and the requirement to raise between $500m to $700m with a tenor of 5 years or 10 years, it is recommended that the credit wrapped market is considered by ElectraNet. Going forward, it is expected that this market will continue to provide utility issuers with a 'BBB' underlying rating with an effective source of funding.

Yours sincerely

George Polites
Director
Debt Capital Markets

Westpac Institutional Bank

Corporate Securities
Level 5, 255 Elizabeth Street
Sydney NSW 2000
Telephone: (612) 9284 9437
Facsimile: (612) 9284 8270
Email: jbrien@westpac.com.au

3 October 2002

EMAIL

Mr Geoff Teitzel
Executive Manager Finance
ElectraNet SA
Level 1, 122 Frome Streeet
ADELAIDE SA

Dear Geoff,

Thank you for your inquiry as to Westpac's expectations as to where ElectraNet may issue bonds into Australia's Domestic Capital Markets. The following table details issuance levels and associated costs at various credit ratings. Please note these levels should be treated as indicative only, as the market's appetite may change on a day to day basis. These levels reflect Westpac's current expectations for the issues as described.

Rating	A	A-	BBB+	BBB	BBB-
5 year MTN					
Maximum Volume (AUD)	$500m	$500m	$500m	$100m	Uncertain
(1) 5 year bond / swap spread	+0.35%	+0.35%	+0.35%	+0.35%	+0.35%
(2) Margin to 5 year CGS (1+2)	+1.24%	+1.34%	+1.43%	+1.62%	+1.86%
(3) Placement Fee (per annum)	+0.06%	+0.06%	+0.08%	+0.08%	+0.08%
(4) Swap Risk/Credit Charge (per annum)	+0.03%	+0.03%	+0.04%	+0.05%	+0.06%
(5) All-In Spread to CGS (2+3+4)	+1.33%	+1.43%	+1.55%	+1.75%	+2.00%
10 year MTN					
Maximum Volume (AUD)	$500m	$500m	$500m	Uncertain	Uncertain
(1) 10 year bond / swap spread	+0.37%	+0.37%	+0.37%	+0.37%	+0.37%
(2) Margin to 10 year CGS (1+2)	+1.56%	+1.71%	+1.73%	+1.91%	+2.21%
(3) Placement Fee (per annum)	+0.06%	+0.06%	+0.08%	+0.08%	+0.08%
(4) Swap Risk/Credit Charge (per annum)	+0.03%	+0.03%	+0.04%	+0.05%	+0.06%
(5) All-In Spread to CGS (2+3+4)	+1.65%	+1.80%	+1.85%	+2.04%	+2.35%

Note the Placement Fees and Swap Credit/Risk Charges are the only non-variable elements in the total costs. Irrespective of the volume or margins achieved in final pricing, these must be paid on the full volume of funds raised. Both are per annum fees.

In terms of volume and rating, the domestic bond market will only take up to A$250m for a BBB+ rated entity. Once below this rating, the volume decreases substantially to a

Westpac Institutional Bank

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maximum of $100m for BBB. Additionally, in order to achieve a term beyond 5 years (for any rating within the BBB range), ElectraNet will need to seek a Credit Wrap for its notes. This will allow volumes of up to $500m for out to 10 years by enhancing the rating to AAA. We can then access a wider investor base that has demonstrated appetite for maturities out to 10 years. It is important to note that in Australia, no utility borrower has achieved this volume or longer duration without a credit wrap.

Please feel free to call me on (02) 9284-9437 if you would like to discuss these levels further, or if I can provide any further information.

Yours sincerely,

.....

Jennifer Brien
Associate Director, Corporate Securities

ANZ Investment Bank

ElectraNet Pty Ltd

Indicative Issuance Parameters 03/10/2002

Indicative margin to BBSW & CGS

Indicative pricing range for current A$ MTN issuance by ElectraNet (margin to A$BBSW & CGS) are as follows:

Rating	A		A-		BBB+		BBB		BBB-	
Spread	BBSW	CGS	BBSW	CGS	BBSW	CGS	BBSW	CGS	BBSW	CGS
5yr	72	112	80	120	100	140	117	157	140	180
7yr	89	129	100	140	117	157	141	181	170	210
10yr	112	152	124	164	150	190	180	220	215	255

Indication represents the following considerations:

- bond/swap spreads at an average of 0.40% across all tenors;
- issuance volume to clear in market – these are tabled below (for example A$200 million at BBB+ for 5 years);
- stable market conditions for issuance;
- indicative spreads are not "all-in" pricing for ElectraNet – pricings will need to account for:
  1. dealer fees of 5 yield basis points p.a., &
  2. incidental fees of 3 yield basis points or greater, including:
     - → programme establishment / arrangement costs;
     - → legal fees (for issuer and programme dealers);
     - → registry & paying agency fees, programme management fees, settlement fees;
     - → information packages, printing & materials;
     - → roadshow expenses and travel.

For volumes in excess of the clearing volume ElectraNet will need to pay a premium of at least 5 to 10 bps depending on volume sought and capacity of market to absorb the required volume:

Rating	A	A-	BBB+	BBB	BBB-
Spread	CGS	CGS	CGS	CGS	CGS
5yr	117 to 123	125 to 130	145 to 150	162 to 167	185 to 190
7yr	134 to 139	145 to 150	162 to 167	186 to 191	215 to 220
10yr	157 to 162	169 to 174	195 to 200	225 to 230	260 to 265

Indicative issuance volume

Indicative clearing volume range for current A$ MTN issuance by ElectraNet are as follows:

Volume	A	A-	BBB+	BBB	BBB-
5yr	A$500m	A$300m	A$200m	A$150m	A$100m
7yr	A$300m	A$250m	A$100m	A$75m	A$75m
10yr	A$200m	A$100m	A$100m	A$50m	A$50m

Please call if you require any additional information.

Regards,

Damon Colbert
Associate Director, Originations & Syndications
Primary Markets Group
ANZ Investment Bank

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Mr Geoff Teitzel
Executive Manager Finance
ElectraNet SA
52-55 East Terrace
Adelaide, South Australia 5000

24th September 2002

Dear Geoff

Based upon CBASpectrum research, as at close of business 23 September, we have calculated the following fair value spreads to the interpolated Commonwealth Government bond curve.

	CBA Spectrum to Bond	
S&P Rating	**5 Year**	**10 Year**
A	127 bps	144 bps
A-	138 bps	155 bps
BBB+	149 bps	168 bps
BBB	163 bps	184 bps
BBB-	188 bps	214 bps

In addition to the above issuing spreads, there is a 5 basis points pa fee payable to the Lead Managers of the issue. Establishment expenses would also add a further 3 basis points pa.

You will appreciate that the corporate bond market is very thin for the lower rating grades. Given current market conditions, the prospect of actually issuing BBB+ or lower rated credits beyond 5 years is very limited.

Yours sincerely

Peter Harrington
Senior Manager, Primary Markets

Appendix B

Historic Easement Compensation Costs based on SPI PowerNet Costs

ElectraNet SA

Historic Easement Compensation Costs based on SPI PowerNet Costs

11 October 2002

ElectraNet SA
electricity transmission network

Table of Contents

1. Introduction

ElectraNet SA submitted a revenue cap application to the ACCC on 16 April 2002 setting out its total revenue requirement for the five and a half year regulatory period from 1 January 2003 to 30 June 2008[1].

ElectraNet SA's opening asset base as of 1 January 2003 was derived by rolling forward the South Australian 1 July 1999 jurisdictional asset valuation and making adjustments to correct material omissions from the jurisdictional asset valuation. The most significant adjustment made was adding an appropriate value for the cost of easements.

However, the ACCC has disregarded all efforts made by ElectraNet SA to establish a fair and reasonable value for easements. In its draft decision the ACCC states:

> *"The Commission, as stated in the DRP, prefers to value easements on actual costs suitably indexed for timing differences. ElectraNet, however, has stated that it is unable to provide actual (historical) costs.*
>
> *It is not the Commission's role to supplement ElectraNet's application. Therefore the Commission has used the (same) figure of $3.1m in its draft decision. When indexed to current period the amount is calculated to be $3.4m."*

ElectraNet SA's reiterates that it is not in a position to provide actual (historic) costs of compensation paid as significant portions of the easements held by ElectraNet SA predate not only ETSA Transmission but also the Electricity Trust of South Australia having been established by the Adelaide Electric Supply Company in the 1920's and 1930's.

Clearly the ACCC's requirement to provide evidence of actual costs or receive no recognition for easement value is unreasonable.

The South Australian Minister for Energy in a letter to the ACCC dated 5 September 2002 states:

> *"It is recognised that there is a need to include a fair and reasonable value of the easements in the in the asset base."*

The Minister continues that in the absence of historic cost data:

> *"the South Australian Government proposes that the ACCC adopt an approach that discounts the easement values in Victoria for the difference in real estate values, and values the easements in South Australia accordingly."*

This submission develops a fair and reasonable value for historic easement compensation costs based on the recommendation of the South Australian Minister for Energy.

[1] "ElectraNet SA Transmission Network Revenue Cap Application 2003 – 2007/08", submitted to the ACCC on 16 April 2002.

2. Victorian Historic Easement Compensation Costs

The SPI PowerNet application together with the urbis report contained therein and the ACCC's PB Associated Review of Asset Base provide the following information on easements and the historic cost of compensation in Victoria.

Line Length (circuit km)	6,552	
Ownership Count	7499	
Historic Cost not indexed ($m)	18.0	
Historic Cost indexed ($m)	79.7	PB Associates / ACCC recommendation
Rural %	76%	Derived from urbis/SPI report
Urban %	24%	"

A value $79.7m was recommended by PB Associates for historic easement compensation costs at 1 July 2001.

3. Equivalent characteristics of the SA Transmission Network

The equivalent figures for the South Australian transmission network are as follows.

Line Length (km)	5,576	
Ownership Count	5075	SKM Easement Valuation on Ownership Basis
Historic Cost not indexed ($m)	3.1	
Historic Cost indexed ($m)	3.4	ACCC draft decision
Rural %	78%	Derived from SKM Easement Valuation on Ownership Basis
Urban %	22%	"

4. Applying the Victorian Costs to South Australia

The Victorian and South Australian transmission networks are broadly comparable for the purposes of establishing easement costs with:

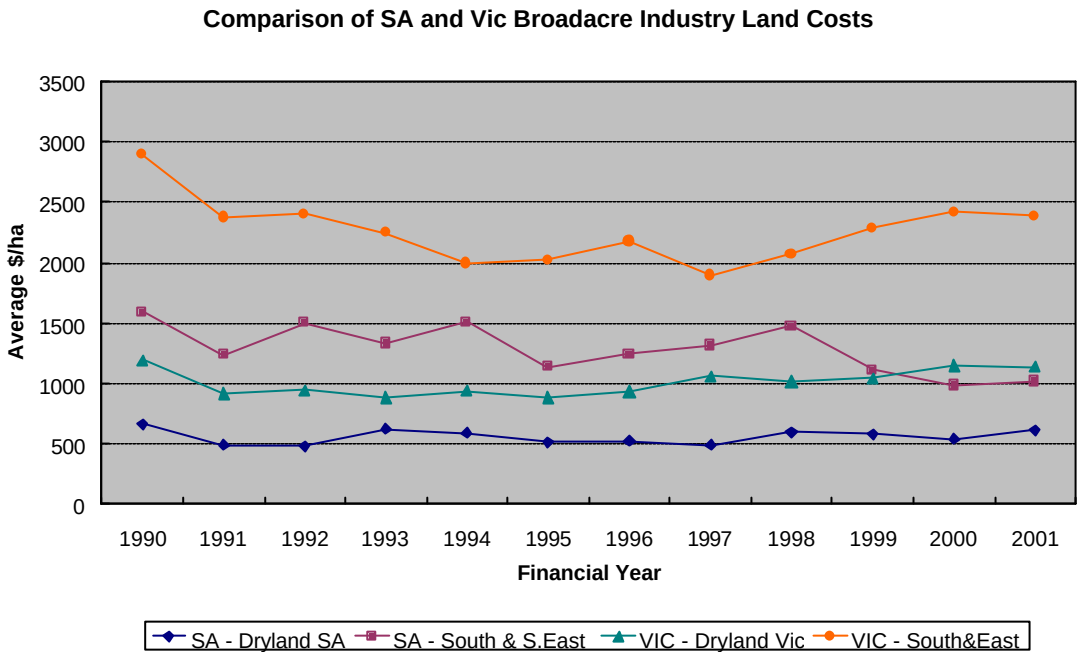
- Similar line length (particularly when the higher proportion of double circuit lines in Victoria is considered),
- Similar transmission system age and development profile,
- Similar number of easement ownerships and
- Identical rural/urban easement ratio.

A simple prorating on the basis of the number of easement ownerships suggests an upper bound of $53.9m for South Australian historical easement compensation costs.

To account for variations in land price between the states a detailed analysis of ABARE broadacre farming land values over the period 1990 – 2001[2] has been used to

[2] ABARE AgSurf (http://agsurf.abareconomics.com) query on Broadacre Industry average improved value of land and average land area. SA Murray, Yorke Peninsula and Eyre Peninsula are considered as SA Dryland. SA South and South East include Fleurieu Peninsula. Vic. Central North, Wimmera and Mallee considered as Vic Dryland, Vic.South and East (Gippsland).

establish relativities. The following graph compares the relative costs of SA Dryland and Victorian Dryland, and SA South and South East (including Fleurieu Peninsula) and Victorian South and East.



The analysis shows that South Australian rural real estate prices fall within a plausible range of between 42% and 60% of those in Victoria. Applying these figures, historical easement compensation costs in South Australia are within the range $22.6m to $32.3m, the average of which is $27.5m.

5. Treatment of Easement Values in ACCC Regulatory Decisions

The ACCC has to date made revenue cap decisions for the New South Wales and Queensland transmission networks. The revenue cap for the Victorian transmission network is currently under consideration in the same timeframe as ElectraNet SA's revenue cap application.

This section summarises the treatment of easements in the New South Wales and Queensland decisions and the SPI PowerNet revenue cap application.

5.1 New South Wales TransGrid Decision

In its TransGrid decision, the ACCC considered it appropriate to:

> *"…include TransGrid's existing easements in the regulated asset base at their historic purchase cost rolled-forward to 1 July 1999. In the absence of properly documented historic cost records, the Commission has used the values identified in the oldest available valuation as a proxy for those costs, being the ODRC value determined during the 1996 GHD valuation"*[3].

[3] "NSW and ACT Transmission Network Revenue Caps 1999/00 – 2003/04", ACCC Final Decision, 25 January 2000, p61-62.

On this basis, easement and land value of $321 million was included in TransGrid's RAB as at 1 July 1999.

5.2 Powerlink Queensland Decision

In its Powerlink decision, the ACCC adopted the 1 July 1999 QERU asset valuation as the starting point for Powerlink's opening regulated asset base. This included an easement valuation based on what was called a historical cost roll forward approach, but which was in fact a summation of previous easement valuations escalated forward plus additional easements acquired subsequent to these valuations[4].

On this basis, easement value of $114 million was included in Powerlink's RAB as at 1 July 1999.

Powerlink was seeking to have an additional $84 million of easement establishment or transaction costs included, which would have increased the easement value in its RAB to $198 million. The ACCC did not allow this addition at the time because it considered that, in Powerlink's particular circumstances, it could not vary from the jurisdictional asset valuation.

5.3 SPI PowerNet Application

The extensive records available to SPI PowerNet allowed it to adopt a historic cost approach to value the cost of compensation paid to land owners. SPI PowerNet is the only TNSP that has had such extensive records available. The CPI indexed value for easement compensation paid to land owners is $79.7 million at 1 January 2001.

The subsequent review of SPI PowerNet's application by PB Associates for the ACCC recommended the adoption of a value of $79.9m at 1 July 2001.

6. Conclusions

This submission develops an estimate of fair and reasonable historic easement compensation costs using the approach recommended by the South Australian Minister for Energy in a letter to the ACCC dated 5 September 2002.

On this basis, ElectraNet SA has determined that $27.5m would be a fair and reasonable amount to include in its opening RAB at 1 July 2001 for the historic cost of easement compensation.

This figure is derived from historic costs recognised in the PB Associates Review of SPI PowerNet's asset base, the relative number of easement ownerships and ABARE derived rural price indices.

ElectraNet SA requests that the ACCC adjust the opening RAB in its final decision to include $27.5m at 1 July 2001 for the cost of easement compensation.

[4] "Queensland Transmission Network Revenue Cap 2002 – 2006/07", ACCC Final Decision, 1 November 2001, p33.

Appendix C

KPMG Report on ACCC Draft Decision

KPMG

Response to the ACCC's Draft Decision on the South Australian Transmission Network Revenue Cap 2003-2007/8

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Contents

1 Introduction

This is a response to the Australian Competition and Consumer Commission's (ACCC) Draft Decision on the South Australian Transmission Network Revenue Cap 2003-07/08 (the Draft Decision).

This report has been prepared by KPMG and the views expressed in it are those of KPMG.

KPMG has been and is an adviser to ElectraNet SA (ElectraNet).

1.1 Outline of the paper

This paper is organised as follows:

- Section 2 outlines recent events that have clarified the approach that regulators should adopt to implementation of the regulation of energy infrastructure;
- Section 3 identifies the key issues that have emerged from this process; and
- Section 4 examines the implications both for the ACCC's general regulatory approach and specifically for the ElectraNet Draft Decision.

2 Clarification of the regulatory regime

The Productivity Commission (PC) has for some time expressed significant reservations with the way in which economic regulation is being applied in Australia. In the past two months, however, these reservations have received even more authoritative recognition in the form of the:

- Federal Government's response to the PC's report on the National Access Regime; and
- WA Supreme Court's Epic Decision.

We consider that these developments will mark a turning point for Australian economic regulation and that they signal a need for regulators to seriously reconsider the current direction of regulatory practise.

2.1 Inquiry into the National Access Regime

An important element of National Competition Policy reforms of the 1990s was the establishment of a National Access Regime (the Regime) via Part IIIA of the Trade Practices Act (the TPA). This allows third parties to seek access to the services of certain essential infrastructure facilities on reasonable terms and conditions.

The reforms provided for a review of the Regime following 5 years of operation.

The PC completed this review and strongly supported the retention of the Regime. However, it highlighted the need to modify implementation of the Regime and made 33 recommendations to improve its operation. In particular, it identified as a *"threshold issue, the need for the application of the regime to give proper regard to investment issues"* and *"the need to provide appropriate incentives for investment."*[1]

The Government has decided to make changes to the TPA which *"endorse the thrust"* of the PC's recommendations.[2] In particular, the Government will modify the Regime along the following lines.

- Include a clear objects clause:

  "The objective of this part is to promote the economically efficient operation and use of, and investment in, essential infrastructure services thereby promoting effective competition in upstream and downstream markets…"

- Insert pricing principles:

  "The Australian Competition and Consumer Commission (ACCC) must have regard to the following principles:

[1] Productivity Commission, 'Review of the National Access Regime', Report No. 17, 28 September 2001, page xxii.

[2] The Commonwealth Government, 'Government Response to Productivity Commission Report on the Review of the National Access Regime', Interim Response, 28 September 2001, page 1.

(a) that regulated access prices should:

(i) be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services;

(ii) include a return on investment commensurate with the regulatory and commercial risks involved…

- Include a provision for merit review of decisions by the ACCC on proposed undertakings.

The Government is making amendments to the Trade Practises Act to *clarify* the Regime and to provide further guidance to regulators, rather than fundamentally *change* it. It is therefore not the Regime itself that Government has decided is the problem; the problem has been the implementation of the Regime by the relevant regulators.

The PC and the Government have clearly recognised that the way economic regulation is being applied in Australia is leading to sub optimal patterns of investment in essential infrastructure.

2.2 The Epic Decision

On the 23 August 2002 the Western Australian Supreme Court made a decision in regard to the matter of *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees & Anor* [2002] WASCA 231 (the Epic Decision).

The Epic Decision concerned the interpretation of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Gas Code) and its application to Epic Energy's Dampier to Bunbury Natural Gas Pipeline by the Independent Gas Access Regulator of Western Australia. The Full Court of the WA Supreme Court accepted the basis of Epic's action.

A number of important principles emerge from the Epic Decision. In particular, it questions whether it is appropriate for regulators to rely on the notion of a perfectly competitive market in justifying their decisions. The WA Supreme Court held that a perfectly competitive market was not the appropriate standard for regulators to replicate in the context of the Gas Code. According to the Court, references to competitive markets should be interpreted as references to *workably competitive* rather than perfectly competitive markets. In other words, regulation should aim to mimic the outcomes found in workably competitive markets.

The Epic Decision therefore provides a strong endorsement of the PC's view that an objective of 'zero monopoly profit' is neither a realistic nor appropriate target for regulators to aim for.

The Court also provided some important guidance on the:

- application of objects clauses; and
- issues a regulator can take into account when making a final decision.

Like the PC and the Government, in the Epic Decision the Court also recognised that a misinterpretation of the Gas Code could result in inadequate incentives for timely investment in energy infrastructure.

3 Issues for economic regulation

The Government's response to the PC's Review of the National Access Regime and the Epic Decision raise a number of important issues for the economic regulation of energy infrastructure. In a number of material respects it requires changes to the ACCC's current approach to regulation as it is reflected in the ElectraNet Draft Decision. These are described below.

3.1 There is no one right answer

The central theme of the clarification of the regulatory regime is that there is no one identifiable right answer to the regulatory 'problem'. The implication of this insight is that, faced with uncertainty and the disproportionate costs associated with inadequate investment in energy infrastructure, regulators should err on the side of investment in making regulatory decisions.

Moreover, attempts to use such a framework (as if there were one right answer) can only lead to ever more intrusive regulation further discouraging investment.

The WA Supreme Court also found that regulators are required to have regard to the particular circumstances of each individual pipeline (perhaps including past investment costs), rather than adopt a 'one size fits all' approach derived from a strict application of economic theory.

3.2 Applying a perfectly competitive market benchmark is inappropriate

Australian regulators often use the notion of a perfectly competitive market to frame and justify their decisions. This notion is explicit in comments by regulators such as providing revenues that are "just sufficient" to finance the forward looking costs of the business, or in providing revenues which "eliminate monopoly pricing."

This notion is also implicit in the approach to estimating each of the revenue building blocks, and the components thereof. The clarification in the regulatory regime reasserts that such an approach is inappropriate.

3.3 A different regulatory approach is necessary

The clarification of the regulatory regime suggests that a different approach to regulation is feasible and, more importantly, necessary. This could involve, for example, regulators taking an approach that is based more on the 'rule of exception'. In other words, they could only seek to alter proposed Access Arrangements or Price Submissions where they are demonstrably inconsistent with the outcomes that might be expected in workably competitive markets (as the WA Supreme Court found), or to remove demonstrably large rents (as the PC suggested). This would constitute a move toward more light handed regulation, which would be more consistent with the original intent of the Regime.

In the first instance, it will be for regulators to decide whether to adopt a more a light handed approach. Regulators may, however, be inclined either to argue that they have already taken the necessary steps, or they may be reluctant to adopt approaches that differ substantially from the current building block, cost based approach. The full impact of the clarification of the regulatory regime might therefore only be felt after more regulatory decisions have been tested in the Courts.

3.3.1 The ESC's response to the clarification of the regulatory regime

The ESC's Final Decision on the 2003 Victorian Gas Access Arrangements (GAAR) is the first major regulatory decision subsequent to the recent clarification of the regulatory regime. It therefore may provide an early indication of how regulators might choose to respond to it.

Although the ESC only had a limited amount of time to consider the implications of the recent clarifications prior to making its Final Decision, it recognised the importance both of the Government's changes to the Regime and the Epic Decision. In particular, the ESC noted that the guidance provided by the WA Supreme Court is *"the most authoritative assessment available"*[3] of the interpretation of the Gas Code and the Tariff Order requirements. The ESC therefore argued that the judgement is *"fundamental since it is directed at the specific provisions of the Gas Code that the Commission is bound to apply",*[4] and stated that it had *"considered its implications carefully in making its Final Decision."*[5] Given this, it is worth noting what the key changes were between the ESC's Draft and Final Decisions.

The ESC argues in the Final Decision that it has given affect to the Epic Decision's interpretation of the Gas Code in "assessing total revenue" via its "incentive based" approach. Specifically:

"The Commission has not conducted a detailed, firm specific assessment of forecast capital and non-capital costs. Rather, it has relied on adopting a less intrusive, inferential approach that draws on the incentive properties of the current and prospective Access Arrangements to encourage distributors to reveal the efficient cost of providing the regulated services. On that basis, the range of matters over which the Commission might otherwise needed to exercise discretion in evaluating the distributors' proposed expenditure benchmarks has been reduced. By giving relatively more emphasis to revealed cost information, the Commission believes it has improved its ability to balance the distributors' legitimate business interests in seeking to maximise returns and the legitimate interests of users in having lower tariffs over the long term."[6]

It is apparent, however, that:

- The ESC's approach to "assessing total revenue" in the Final Decision differs markedly from the approach it used in the Draft Decision:

  "A central theme in the objectives for reference tariffs is the pursuit of economic efficiency. One outcome required for economic efficiency is that the reference tariffs provide sufficient revenue to ensure that the provision of gas distribution continues (and investment funds continue to be attracted to the industry). A second required outcome is that prices are not at a level that unnecessarily reduces investment and employment in upstream and downstream industries. In reconciling these objectives, the Commission

[3] Essential Services Commission, Review of Gas Access Arrangements: Final Decision, October 2002, page 65.

[4] Essential Services Commission, Review of Gas Access Arrangements: Final Decision, October 2002, page vii.

[5] Essential Services Commission, Review of Gas Access Arrangements: Final Decision, October 2002, page 65.

[6] Essential Services Commission, Review of Gas Access Arrangements: Final Decision, October 2002, page 66.

considers it appropriate for reference tariffs to be set at a level that is <u>just sufficient</u> [our emphasis] *to ensure continued service provision."*[7]

- Notwithstanding the ESC's change of view in regard to the approach it has taken to assess total revenue, it is apparent that the Final Decision is not substantially different to the Draft Decision (either in the approach taken – it still applies the building blocks - or the outcome).

It is therefore difficult to avoid the impression that the ESC's explanation of how its Final Decision is consistent with the Epic Decision is an argument of convenience, established after making the substantiative decision.[8]

For the ESC, at least, the Epic Decision would appear to have had no practical implications for its decision (ie. it was already doing it). Unfortunately, this conclusion is reinforced by the ESC's actions during the PC's Review of the Regime. During the review, the ESC questioned the PC's views and analysis. For example, it argued that: *"Regulators must be careful to avoid any undue leaning towards the provision on (sic) investment incentives (to the extent of allowing access prices in excess of the long run costs of service provision."* By contrast, in its Draft Decision the ESC stated that it *"generally concurs with the sentiments expressed by the Productivity Commission",* and that it has endeavoured to develop and incorporate these guiding principles into its recent decisions.[9]

To the extent that the ESC sets a precedent for the response of other regulators, it is likely that they will argue they have been making decisions that are consistent with the clarification of the regulatory regime all along. Such an approach is likely to mean that further legal action would be necessary for regulators to alter their approach along lines more consistent with Government policy and the original intent of the regulatory regime.

3.4 Implications for the assessment of WACC

The key principles emerging from the Government's response to the PC's Inquiry and the Epic Decision also pose a number of questions for the approach that regulators have adopted for determining WACC and its role in revenue setting.

3.4.1 Allowed returns have been inadequate

It is apparent that the allowed rates of return on investment have been reduced substantially in recent times. To facilitate a trend analysis of the rates of return offered by Australian regulators we have compiled the WACC outcomes set by various regulatory determinations in the gas and electricity sector. This information is illustrated in Figure 1 below.

[7] Essential Services Commission, Review of Gas Access Arrangements: Draft Decision, July 2002, page 44.

[8] This is not to say that the new justification that the ESC provides is inconsistent with the intent of the regulatory regime, it may however not be sufficient (or the outcome might not be sufficient) to comply with it.

[9] Essential Services Commission, Review of Gas Access Arrangements: Draft Decision, July 2002, page ix.