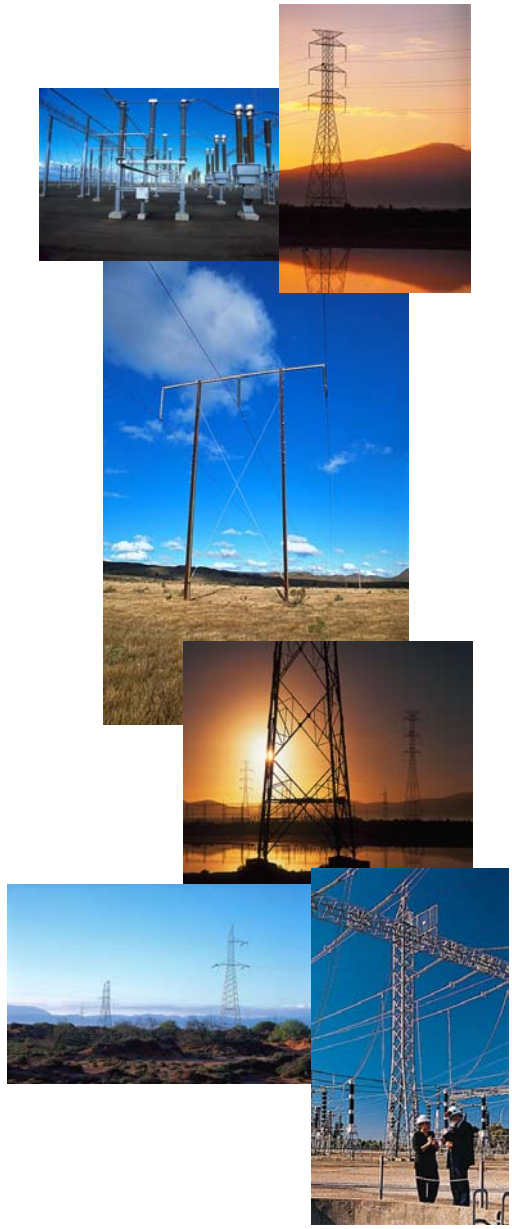
ElectraNet SA



Regulated Costs of Easement Acquisition

9 May 2002

ElectraNet SA
electricity transmission network

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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 of $994.4 million 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.

ElectraNet SA's revenue cap application proposed that this value for the cost of easements be discussed further with the ACCC during the review process.

This supplementary submission has been prepared for this purpose and presents a more detailed basis for the cost of easements ElectraNet SA is seeking to have included in its opening Regulated Asset Base (RAB).

2. Cost of Easement Acquisition for Transmission Lines

Historically, many asset valuations undertaken for, and by, the electricity industry have been based on the replacement cost of transmission lines, but with no or inadequate allowance for the cost involved in the selection and securing of line routes and the necessary easements.

Easement costs can be subdivided into compensation paid to property owners and establishment or transaction costs incurred by the utility in acquiring the easements.

Easement establishment costs typically include route selection, environmental impact assessments, public consultation, easement surveys, cultural heritage/ native title assessments, and legal and registration costs. These costs are real and tangible costs incurred by a utility in the process of securing routes for transmission lines.

A registered easement is usually granted in perpetuity and for this reason the easement holder does not have to provide for the future replacement of easements, or provide for their depreciation.

3. Easement Costs in the Jurisdictional Asset Valuation

The South Australian Department of Treasury and Finance wrote to the ACCC on 10 August 2001 setting out the jurisdictional asset valuation as at 1 July 1999. This letter makes the point that:

> *"Easements were incorporated into the RAB at book value (i.e. $3.1m) as asset valuations consistent with the approach set out in the ACCC's draft Statement of Principles for the Regulation of Transmission Revenues dated 27 May 1999 had not been undertaken. Independent valuations of the transmission easements suggest a substantially higher value than $3.1m".*

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

ElectraNet SA does not have verifiable records on what is covered by this amount. However, the $3.1 million included in the jurisdictional asset valuation is clearly inadequate and does not represent the value or actual cost of easements for 4,649 route km of transmission lines.

The book value of $3.1 million was attributed to Transmission Lessor Corporation (formerly ETSA Transmission) as part of the disaggregation of the vertically integrated ETSA Corporation and should not be confused with the historical cost of the easements. ElectraNet SA acquired the transmission line easements as part of its purchase of the transmission business from the South Australian Government in October 2000 and paid fair market value for them at that time.

4. Easement Valuation Methodology

The ACCC believes that the National Electricity Code requires it to value sunk assets (those assets generally in service on 1 July 1999) consistent with the jurisdictional asset base established in the jurisdiction. The ACCC has interpreted this obligation as follows:

> *"The Commission has construed the requirement to value sunk assets 'consistent with' the RAB established in the jurisdiction to mean 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 which was made by the jurisdiction".*[2]

The ACCC accepts that while the South Australian Government made provision for easements using book value, the SA Government acknowledged that its methodology for valuation of easements was inconsistent with the ACCC's draft Statement of Regulatory Principles (*Draft Regulatory Principles*). Such a valuation simply had not yet been undertaken at the time the jurisdictional asset valuation was established.

The ACCC's preferred approach to valuation of easements as outlined in its *Draft Regulatory Principles* is for the value to be based on the original actual cost to the utility of easement acquisition (historical cost escalated by CPI). ElectraNet SA disagrees with this approach. There are no grounds for the ACCC to value assets, including easement rights, other than in accordance with the National Electricity Code (NEC).

The NEC requires that assets be valued at deprival or replacement value, while the ACCC approach appears to suggest that irrespective of any change of ownership, easement rights may only be valued at historic cost rolled forward. This is similar to valuing a house not at its market value, but at the price paid by its first owner even though it may have had multiple owners since that time.

The ACCC is understood to prefer the historical cost approach to the valuation of easements over the normal replacement cost methodology used to value all other regulated assets because there is a likelihood that easement values linked to real estate values will grow over time at rates in excess of the rate of increase in CPI.

However, it is important to note that even if the ACCC's preferred approach was considered acceptable:

[2] Letter from the ACCC to ElectraNet SA on the subject of Valuation of Sunk Assets, dated 6 March 2002.

- This approach should only be applied to those easement costs, which are associated with compensation paid directly to property owners and not to easement establishment or transaction costs which are not linked to real estate values; and

- The easement values included in recent ACCC regulatory decisions are all based on a hybrid replacement cost approach and a similar approach should therefore be acceptable for ElectraNet SA.

A major flaw in using the historic cost approach based only on recorded easement compensation costs is that typically the amount paid in actual compensation did not reflect the full benefit received by the easement providers. In many instances, property owners were also provided with "in-kind" compensation of gates, fences and roads by utilities and anecdotal evidence would suggest that this compensation was substantially in excess of the actual compensation paid. None of these costs have been captured in transmission line valuations.

Historic cost records of compensation paid to property owners (where these records are available) are therefore unlikely to represent the true historic cost of compensation to the utility.

In summary, ElectraNet SA does not agree with the ACCC's historic cost approach to easement valuation. Even if this approach was adopted, it should only be applied to those costs that are linked to underlying real estate values (i.e. compensation paid to property owners). All other easement costs should be treated on a replacement cost basis, consistent with the NEC and the *Draft Regulatory Principles*.

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].

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

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

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 that time because it considered that, in Powerlink's particular circumstances, it could not vary from the jurisdictional asset valuation.

5.3 SPI PowerNet Application

In recognition of the ACCC's preferred approach, SPI PowerNet constructed a proxy historical cost value for its easements.

> *SPI PowerNet has extensive records on the actual cost of land compensation paid to owners for easements over their land; however, there are no records of the associated transaction costs at the time, although it is known that such costs were significant"*[5].

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 establishment or transaction costs of easement acquisition were taken from a 1997 A.T. Cocks (now operating as urbis) report indexed to 1 January 2001. The transaction costs so derived amount to $152.1 million.

In total, SPI PowerNet's imputed historic cost of acquiring easements included in its RAB is $231.8 million.

6. ElectraNet SA Easement Valuations

This section summarises independent valuations that have been carried out of ElectraNet SA's easements.

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

[5] "SPI PowerNet's Revenue Cap Application for the period 1 January 2003 to 31 March 2008", April 2002, p52.

6.1 Maloney Field Services Deprival Valuation

Maloney Field Services (MFS) conducted an assessment of the deprival value of ElectraNet SA's easements in 1997. This was done by considering the following components of costs and expenses, which arise at the time that ElectraNet SA (or any other TNSP) moves to acquire new easements:

- Survey costs in defining a transmission line easement and incorporating the collecting and recording of all appropriate cadastral data;
- Drafting costs in preparing an easement plan;
- Valuation fees incurred in assessing the compensation payable to land owners for easements;
- Personnel costs incurred in undertaking the negotiation process with land owners to obtain the necessary easements;
- Conveyancing costs in preparing and processing grants of easements through to registration;
- Lands Titles Office fees and other Government charges including all appropriate registration fees and charges;
- Reimbursement of professional fees incurred by land owners in obtaining legal and/or valuation advice in relation to easement acquisition proposals; and
- The monetary compensation payable directly to land owners for easement acquisition.

MFS assessed the total value of ElectraNet SA's 132 kV and 275 kV transmission line easements to be $131.7 million as at 28 February 1997 (excluding capital gains tax). This value includes the cost of compensation to land owners and establishment or transaction costs involved in acquiring easements.

The 1997 MFS valuation is the oldest available valuation of ElectraNet SA's easements. Using this valuation as a proxy for the historical costs of the easements and rolling forward to 1 July 1999 gives an easement value of $133.7 million to be included in ElectraNet SA's RAB as at that date. This approach is consistent with the approach taken by the ACCC in its TransGrid and Powerlink revenue cap decisions, and the approach proposed by SPI PowerNet to value establishment or transaction costs.

Based on an updated assessment by MFS at 30 June 2000, a total easement value of $153.4 million should be included in ElectraNet SA's RAB at that date (equivalent to $148.7 million at 1 July 1999).

ElectraNet SA proposes to use this proxy historical cost approach only for the cost of compensation to land owners. Easement establishment or transaction costs, which are not linked to underlying real estate values, should be valued on a replacement cost basis consistent with the NEC and the Draft Regulatory Principles.

A recent study of easement establishment or transaction costs has shown that this component of the MFS easement valuations was significantly understated.

6.2 Sinclair Knight Merz Replacement Cost Valuation

SKM recently completed a study of typical costs to acquire transmission line easements in South Australia[6]. The resulting assessment of ElectraNet SA easement acquisition values is more comprehensive and detailed than was available at the time of ElectraNet SA's revenue cap application.

In conducting this study, SKM called on its own transmission and valuation expertise, as well as seeking advice from independent specialist valuation consultants with experience in transmission line easement negotiations, to develop a bottom up approach to estimating easement acquisition costs on a replacement cost basis.

Only easement establishment or transaction costs were considered in the study with the cost of compensation to property owners excluded from the analysis.

The SKM study considered the following cost components, which accurately reflect the easement acquisition process as it is performed in practice.

These costs are not included in transmission line valuations conducted by SKM and were excluded from the jurisdictional asset valuation.

Route Selection

Route selection encompasses all activities required to establish a preferred route, or route options before a detailed evaluation of the potential environmental impact.

Some of the sub-activities include:

- Desktop study of options;
- Aerial photography;
- Route inspection;
- Land ownership investigation (crown or private);
- Discussions with statutory authorities on transport corridors;
- Initial cultural heritage/native title assessment;
- Evaluate comparative costing of alternative routes;
- Obtain statutory approvals; and
- Prepare route selection report.

6 "Easement Acquisition Assessment for ElectraNet SA", Sinclair Knight Merz Report, April 2002.

Environmental Impact Study

The Environmental Impact Study (EIS) is a detailed analysis of the impact of a selected route (or routes) on the environment. The EIS also considers the impact of the selected route on existing development in the nearby area. Typical sub-activities include:

- Identification of sensitive environmental areas;
- Assess land zonings and usage, e.g. tourist, residential, industrial etc;
- Assess noise during construction;
- Assess flora, fauna, endangered species etc;
- Assess water quality during construction;
- Assess transport corridor crossings;
- Assess social/community impact;
- Assess archaeological impact; and
- Prepare EIS report.

Cultural Heritage/Native Title Assessment

Cultural Heritage Assessment investigates the possibility of any cultural heritage or native title claims over the proposed easement. It involves discussions with local indigenous tribe leaders to locate sites of significant cultural importance along the proposed easement. Sub-activities include:

- Determine tenure history of land (freehold, leasehold etc);
- Identify parties who may be entitled to a claim;
- Meetings with traditional owners;
- Archaeological land survey;
- Negotiations with traditional owners; and
- Legal action (if required).

Public Consultation

Public consultation is the process of raising community awareness of the proposed project, and dealing with any community concerns. Typical activities are:

- Stakeholder identification;
- Prepare timetable of key events;
- Prepare briefing material for public meeting;

- Place media announcements;
- Attend and conduct public meetings including Local Government meetings;
- Establish and maintain public call centres;
- Focus groups, draft Discussion Papers and Management Plans; and
- Obtain Local and State Government statutory approvals.

Acquisition of Easements

Acquisition of Easements specifically comprises surveying the proposed easement (includes pegging the easement) as well as land valuation (by both the utility and property owner), negotiations with property owners, legal and settlement costs. The SKM model assumes that 95% of easements will be settled through negotiation with the property owner, 4% of easements will be resumed, and 1% will be acquired through legal action. The specific activities are:

- Real property survey (includes pegging the easements);
- Property owner consultation;
- Specific negotiation with property owners;
- Land valuation by utility;
- Independent valuation by property owners;
- Register the survey at Title Office;
- Settlement through negotiation (95%);
- Settlement through resumption (4%); and
- Settlement through legal action (1%).

Summary of SKM Valuation

The replacement cost for each of the above cost components was assessed by identifying the costs that remain fixed irrespective of the length of the easement and those costs that are dependent on the length of the easement or the number of private and crown properties that the easement traverses.

In summary, the SKM assessment of easement establishment or transaction costs to be included in ElectraNet SA's RAB is $111.5 million as at 1 July 2001 ($104.3 million rolled back to 1 July 1999).

This assessment replaces the $123.0 million included for easement establishment costs in ElectraNet SA's revenue cap application, which was based on an earlier high-level valuation by SKM.

The above assessment excludes cultural heritage/ native title assessment costs, which have been treated as a new cost category and not applicable to ElectraNet SA's sunk assets at 1 July 1999.

7. Easement Value for ElectraNet SA's Regulated Asset Base

ElectraNet SA has constructed a 1 July 1999 easement value of $215.3 million to be included in its opening RAB. This value, which is summarised in Table 1, is a summation of:

- Easement establishment or transaction costs of $104.3 million derived from an assessment of replacement cost by SKM (2002 valuation); and
- A proxy historical cost of $111.0 million for compensation paid to property owners derived from an assessment by MFS (the indexed land owner compensation component of the 1997 (oldest available) valuation of $131.7 million).

This treatment of easement values is consistent with the requirements of the NEC in using replacement cost to value easement establishment or transaction costs. In recognition of the ACCC's preferred approach, compensation paid to landowners, which is linked to underlying real estate values, has been valued by indexing the oldest available valuation. This is the same approach taken by the ACCC in its TransGrid and Powerlink revenue cap decisions.

The 1 July 1999 easement value of $215.3 million is consistent with the easement values included in the RABs of TransGrid ($321 million in 1999 dollars) and Powerlink ($114 million in 1999 dollars[7]), and the RAB included in SPI PowerNet's revenue cap application ($212 million in 1999 dollars).

Table 1: ElectraNet SA Cost of Acquiring Easements

Cost Components	Value at 1 July 1999 ($m)
Easement Establishment or transaction costs from 2002 SKM report	104.3
Compensation paid to land owners from 1997 MFS report	111.0
Total	**215.3**

[7] Note that Powerlink were seeking an additional $84 million for easement establishment costs, which the ACCC could not allow in Powerlink's particular circumstances due to constraints placed upon it by the NEC.

8. Conclusions

This supplementary submission to ElectraNet SA's 16 April 2002 Revenue Cap Application presents a more detailed basis for the cost of easements ElectraNet SA is seeking to have included in its opening RAB.

It is essential that an appropriate allowance for the cost of easements be added to the jurisdictional asset valuation to ensure that ElectraNet SA is provided with a "*sustainable commercial revenue stream*[8]", as required by the NEC.

ElectraNet SA has constructed a 1 July 1999 easement value of $215.3 million to be included in its opening RAB. This replaces the value included in ElectraNet SA's revenue cap application, which was based on preliminary work available at that time.

The derivation of the proposed easement value is entirely consistent with the requirements of the NEC and the approach taken by the ACCC in its TransGrid and Powerlink revenue cap decisions.

[8] National Electricity Code, Clause 6.2.2(b).