Comments On

ACCC Draft Decision On

SPI PowerNet

And

VENCorp

Access Arrangements Applications

BY
ENERGY USERS COALITION OF VICTORIA
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Introduction

The Energy Users Coalition of Victoria (EUCV) is a major energy end-user group formed with the specific purpose of addressing the current applications for access arrangements by gas and electricity service providers in Victoria. Its members are Ford, Holden, OneSteel, Air International, Toyota and Unidrive.

EUCV welcomes the opportunity to provide its views on the draft decision (dated 24 September 2002) by ACCC on SPI PowerNet's revenue cap application. These comments follow on from the submissions already made by EUCV to the PowerNet application and a response to the comments by the ACCC consultants (PB Associates).

This response from EUCV addresses only the issues included in the draft decision, but cannot encompass points arising from the planned public pre-decision conference. We will respond separately on any issues raised at that forum which we consider need addressing.

In broad terms, EUCV sees the ACCC's draft decision as proposing to :-

- Reduce the WACC applicable to PowerNet's assets.
- Reduce the claimed valuation of easements to a notional "direct expenditure cost" in breach of provisions in the Electricity Code.
- Allow PowerNet to introduce a large Capex program, but fails to propose any controls on the program.
- Reduce only marginally the Opex requested, but fails to reveal any serious analysis of benchmarking to verify claimed costs.
- Negotiate with PowerNet during the balance of the review period to introduce benchmark performance standards with a penalty/bonus arrangement, effectively excluding users' input to this process.

The net result of the ACCC draft decision would be only to marginally reduce the current average transmission charges applying to Victorian electricity consumers. The EUCV observes that consumers expect significant reductions in tariffs but this has been frustrated by the ACCC unjustifiably endorsing the large capex program, the inclusion of a higher easement value than included by the jurisdiction and a significant increase in opex from current levels.

Regulatory Opaqueness, Information Disclosure and Benchmarking

EUCV notes that the ACCC's draft decision provides a little more information (albeit, modest) than that provided by either PowerNet or PBA during this regulatory review. We also note that in a number of areas the ACCC opines that the requests by PowerNet appear reasonable. This is insufficient substantiation of the many ambit claims by PowerNet. The ACCC is required to explain in more detail how it arrived at this view, particularly when the EUCV has substantial doubts as to the reasonableness of the original application.

In relation to this, we refer to the recent decision of the WA Supreme Court decision regarding the Offgar/Epic appeal. Arising from this decision, it is quite clear that the regulator may make "regulatory judgements" but that in doing so the regulator must clearly identify that it has taken each and every one of the various factors affecting the regulatory judgement into account. The Supreme Court decision notes that a fundamental part of the regulatory process is to document each aspect of the factors considered by the regulator and in doing so, the regulator is obliged to give an explicit explanation of its reasons for its view on each aspect. There is no doubt that the draft decision of the ACCC on the PowerNet application is deficient in a number of aspects where the ACCC has not clearly defined the reasons underlying its decision, and further, there is no doubt that the draft decision is lacking in the clarity and explanation expected of a regulator and clearly reaffirmed in the WA Supreme Court.

The draft decision contains considerable inconsistency in the presentation of data, which contributes to confusion and is simply a poor regulatory outcome. For example, in table 6.2 the ACCC presents data in nominal dollars (presumably including GST) but in table 9.3 we see apparently the same data being used, presented in $'02 excluding GST. In addition to this, there is relatively little correlation of the data presented between the PowerNet application and the draft decision.

Overall, we find the draft decision somewhat confusing and difficult to follow. In particular, there are many places where the ACCC does not even provide clear and concise explanations of how it has reached a particular decision, leaving the reader to deduce that "regulatory discretion" has been exercised.

In our earlier submission, we raised our concern with the lack of information provided by PowerNet. It must be noted that the amount of information provided from all sources still falls far short of that needed by consumers to verify that the amounts being granted do represent the "fair and reasonable" costs appropriate to the PowerNet activities.

To exemplify our concern of lack of information provided by the applicant, combined with a lack of “clear and concise regulatory discretion” we note the observation on page 5 of the draft decision:-

> “The Commission considers that in the absence of information to the contrary it is assumed that these payments represent the total paid ….”

This is quite an astonishing statement from the ACCC. Of great concern in relation to statements such as these, is that the onus of proof must lie with the applicant – this, the ACCC has not only failed to recognise, but it has not required the applicant to substantiate its claims. Further, we would point out that it is the obligation of the regulator to verify the factuality of the claims made, rather than just assuming that it is the case. As we demonstrate later in this submission, the actuality in the particular instance of easements is that the applicant paid considerably less than the amount assumed.

In particular, we note that despite our requests, there is no attempt to compare PowerNet costs against international benchmark costs. As we have noted repeatedly, to continue to benchmark performance against a small number of “competitors” all operating in the same electricity market, is a circular activity, and which ultimately leads nowhere. The light-handed regulatory approach adopted by the ACCC as its preferred approach requires rigorous benchmarking to replicate the underlying assumption of “competition by comparison” inherent in light handed regulation.

We quote from the 1996 Annual Report for PowerNet in the address from the CEO (Mr Keith Hoffman). On page 8 he notes:-

> “An operating and maintenance cost of approximately $1/Mwh is being achieved by the best performing international [transmission] companies.”

From statements such as these, it is quite apparent that Australian transmission companies can in fact source core cost information from their international counterparts. The fact that all of the Australian transmission businesses in regulatory applications continue to benchmark their performance only against themselves, indicates a lack of desire to be seen to be performing at a level below that of international best practice, rather than a difficulty in acquiring the data to make meaningful comparisons.

The monopoly infrastructure businesses must be seen in the same light as perhaps Australian industry was seen prior to the tariff reductions of the past decade or more. It requires the invisible hand of competition to be applied to any business for it to reach its optimum operating level. This point has yet to be reached by PowerNet, and as a result, PowerNet has not yet attained the point where it is operating at world’s best practice.

Arising from these comments, throughout the rest of this submission we will refer to the absence of the ACCC applying best practice in assessing its evaluation of the PowerNet application. It is only by applying best practice to PowerNet activities that consumers will ever see the benefits flow from the deregulation of the energy supply markets.

Cost of Capital - WACC

There is only a modest amount of detail that the ACCC has provided in its draft decision regarding the derivation of the WACC proposed for PowerNet. The ACCC appears to assume a significant level of "regulatory judgment" without providing clear debate on the issue, nor for benchmarking the results calculated.

A holistic view is needed

We reiterate the need for the final rate of return to be benchmarked, but it would appear that although the ACCC benchmarked aspects of the internal calculations, it has elected not to benchmark the overall calculation.

In our earlier submission we referred the ACCC to work carried out by Pareto Associates in benchmarking the final WACC. The WACC included in the draft decision is still well above the WACC granted by international regulators, operating in a similar risk and financial environment to that applying in Australia.

Pareto Associates has further developed on this work and it is has been published on the ESC of Victoria website[1], under its review of the gas distribution businesses. This additional body of work further develops the view that the WACC proposed by the ACCC in the draft decision is still far too high and unjustifiably so.

We note the approach to setting the WACC is becoming extraordinarily mechanical. Whilst this helps in regulatory consistency, it does not establish if this fits within the envelope of international practice. For a regulated business with a high certainty of achieving target cash flows, the WACC must approach a level where the ability of securing further funding for the business is approaching constraint. The results of the recent GasNet float do not indicate that this point has been reached.

At the public forum on the ElectraNet application, PowerNet and others advised that investment in infrastructure would be constrained if a high WACC was not granted. International comparisons provide a clear counterpoint to these statements. For example, as Pareto Associates notes, the regulated water businesses in the UK are securing much larger amounts of funding from the

[1] ESC Gas Access Review 2002, responses to draft decision, submission 12-2002, 23/8/02, from Customer Energy Coalition

financial markets then PowerNet seeks, at a regulated WACC well below the level suggested by the draft decision.

However, the final WACC is a function of the inputs. Because we see the final WACC as still too high, we have investigated elements of the ACCC calculation to identify where errors may lead to the still too-high result.

Risk free period

We concur that the risk free period should replicate the regulatory period. The 5 year bond rate incorporates assessment of the expectations and risks which are likely to occur over the regulatory period. We note the statements that the investment has been made over a longer period, and that the financing of the business needs debt provision of greater than the regulatory period.

What is consistently overlooked is that competitive business returns are benchmarked on shorter periods than the five years (even though they have invested for much longer terms), and they have to seek funding and/or debt turnover in the same way as do regulated businesses.

In analysing the comments by the regulated businesses it would seem that they consistently attempt to use their specific circumstances to argue for an increase in WACC, but argue for the regulator to take a light handed view where interrogation may result in a lower overall return.

The ACCC is correct to interpret the WACC assessment in isolation of how the regulated businesses may attempt to finance their operations. This view is supported by the Lally report commissioned by the ACCC.

We note the extensive references to the R R Officer report in the draft decision. In particular, we note the observation[2] that:-

> "… electricity companies are not in a position where they can simply walk away. When a company commits funds to purchase infrastructure asset, it is typically on a long-term basis. Even though it knows that the allowed rate of return on the asset will be reset at regular periods, it does not have the luxury of having those rates prescribed to it at the time the asset is purchased. Nor does it have the luxury of knowing that it can walk away from the asset if it finds such compensation unsatisfactory. Hence, Officer contends that the risk to the infrastructure owner is the risk faced by the purchaser of a long-term asset."

Members of EUCV would point out that, equally, they have made long term investments and the observation made by Officer applies even more so to them.

[2] Draft decision page 19

There is little chance that electricity consumers in Victoria will cease using electricity in favour of another form of energy as there is patently no serious alternative. As a counterpoint, for example, the auto manufacturers domiciled in Victoria see intense competition from overseas, but they have also made massive long term investments in their Australian plants and achieve profits less than those being granted PowerNet, a regulated business with a guaranteed income stream.

Equity beta

The draft decision calculates the equity beta (from an asset beta) and then compares the result for the "Infrastructure and Utilities" category of the ASX from a listing of equity betas provided by the AGSM centre for research[3]. Unfortunately the ASX no longer provides this category having moved to the S&P GICS method of categorisation.

The GICS category for "Utilities" includes electricity generators, energy retailers, gas pipeline companies and two companies having electricity distribution assets. It also includes a number of small niche companies involved in new technology. There are few companies included in the classification which have an effectively guaranteed cash flow, underwritten by electricity consumers.

We would point out that for companies having stable cash flow (such as property, food, alcohol and tobacco) are more akin to the electricity transmission business. These cash flow stable companies have an equity beta at half that suggested is appropriate for PowerNet. The Pareto Associates analysis of UK regulatory decisions supports that an equity beta for PowerNet should be of a similar magnitude. We contend that rather than an equity beta of 1.0 being used for the ElectraNet WACC calculation, a figure of 0.5 is more appropriate and comparable to the business type.

Market (equity) risk premium

The regulated businesses have consistently argued that an equity risk premium of 6.0 is on the low side of appropriate. However many of the consultants commissioned to evaluate the MRP have been advising the regulated businesses, and there has been a lack of clear independence.

One attempt to provide independence, is to review over a long period, the ASX accumulation index (as a surrogate for competitive industry), compared to CPI and the bond rate. This indicates that over time the difference between the ASX accumulation index and the bond rate is of the order of 3-4% points different. Being based on historical data, this assessment, however, must be seen in the light of a backward looking view.

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[3] Draft Decision table 2.2

The ESC of Victoria commissioned an independent report on the market risk premium from Mercer Consulting to assess a forward looking view of what an equity premium is in regard to investment. Their analysis indicates that the MRP is certainly lower than 6.0 and could well be 3.0, replicating the historical differential between bond rate and the ASX index. The consistency of the empirical data of ASX versus bond rate and the observations of Mercer, are replicated by observations of an MRP of 3% used in overseas jurisdictions (for example see recent Offwat and Offgem decisions).

We note the view of the ACCC assessment that the MRP lies between 5.0% and 7.0% and that it proposes to use the mid point. The ACCC goes on to say that this level is consistent with other ACCC regulatory decisions. It is disturbing to observe regulators failing to examine independent evaluations of what comprises a true MRP for competitive industry. We would concur with the view of the ACCC stated in the draft decision on the ElectraNet application that an MRP of 6.0 is "…on the high side …"[4].

Unfortunately the draft decision is lacking in any meaningful debate as to what constitutes an appropriate MRP for the PowerNet business. We believe that the WACC being comparatively too high is in part related to the ACCC acceptance of a higher than needed MRP, and recommend that it be reduced to 3%.

Asset valuation methodology

The ACCC has continued the practice of using the depreciated optimised replacement cost (DORC) methodology for its asset valuation. EUCV continues to maintain that this is inappropriate and leads to large cash over-recoveries for businesses that are allowed to use this valuation approach.

As the ACCC has carried out some benchmarking of WACC elements from the competitive business environment, it needs to recognise that when comparisons are made, competitive business uses the depreciated actual cost (DAC) for benchmarking its returns. f the ACCC persists in using the DORC values, then it needs to adjust the comparisons of the WACC elements to reflect the overstatement of asset value from using DORC.

Summary

There is no doubt that when the WACC is benchmarked on an international basis, it is higher than it needs to be. We believe that the WACC should be in the range of 5.0 and 6.0 for it to be appropriate to the business type that PowerNet is involved in.

[4] ACCC draft decision on ElectraNet application, page 19

Regulatory Asset Base

There are two major concerns we have with the Draft Decision.

Easements

The draft decision values easements at $79.7 million. This amount is based on the historic compensation paid to private land owners on the acquisition of the easement rights[5]. This so-called historic compensation amount was deduced by Urbis (under a contract with PowerNet) after the assets were acquired from the Victorian government in 1997.

In the last Annual Report on PowerNet which is publicly available (that of 1996), the value of all land assets is noted to be $78,716,000. The notes referring to this value indicate this is comprised as $38,000 of land at cost and $78,678,000 of land at directors' valuation. There is no other entry relating to land values.

There are two important issues relating to this valuation for land assets. The first is that this is the basis used by the jurisdiction for the setting of the tariffs under the tariff order. The second is that this is the basis for land values agreed *at the time of purchase* of all the transmission assets by GPU from the Victorian Government.

Included in the sale was land for future terminal station sites. Whilst valuation of easements has been noted by many parties as being difficult (the easement being only a right to encompass an electricity transmission system) the ownership of actual land is quite readily assessed. PowerNet valued the land associated with the future terminal station sites sites as worth $25.2 million, and the ACCC has accepted this valuation. Using the economic depreciation rates[6] permitted by the ACCC the 1996 value for this land would be $25.48 million. Thus, the 1996 valuation for easements and other owned land, is the difference between the figure in the annual report (ie $78.7 M) and the value for the future terminal stations (ie $25.5 M), which is $53.2 million.

Thus, at best the value for easements is $53.2 million as at the time of the sale of the assets.

The ACCC notes[7] that:-

> "… in the absence of information to the contrary [that PowerNet paid $79.7 million for easements] it is assumed that these payments represent the total paid directly to the landowners as compensation for the acquisition of the easements."

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[5] Draft decision page 45
[6] Draft decision page 33
[7] draft decision page 45

In fact, GPU PowerNet paid only the valuation of land included in the purchase price, for the easements. This is the value for these assets set by a willing seller and a willing buyer. There can be no better basis than this for setting a value for an asset.

The new owners must have carried out a "due diligence" assessment of the assets included in the sale process – to do less would imply incompetence by the team bidding for the assets. This due diligence did not reveal that the easement value should be higher than that stated by the Victorian government. PowerNet effectively paid $53.2 M for all of the easements that it holds. This was the value placed on easements in the sale process, and by PowerNet proceeding with the purchase PowerNet has tacitly confirmed this is the true value of its current easements. Thus, it is clear that PowerNet has implicitly advised the ACCC that the value of easements is contrary to the supposed value for easements assessed by the historic acquisition costs.

What this assessment also does is to set the implicit jurisdictional value placed on the easements for the purposes of setting tariffs. As noted in the Electricity Code the ACCC is required to comply with the jurisdictional valuation for assets for the purposes of future tariff setting.

It has been argued by the regulated businesses that, at the time of acquisition of the assets, the value included in the RAB for easements was understated. However the RAB had been established by the Victorian government (in its role aa previous jurisdictional regulator) at a certain amount – regardless of what value may have been allocated to specific elements comprising the RAB. The ACCC is permitted only to vary the RAB set by the previous jurisdictional regulator by adjusting for inflation, for optimisation of asset usage, and by permitting the inclusion of "new assets" acquired subsequent to 1 July 1999[8].

There is no argument provided by PowerNet that easements were never included in the purchase of the assets – thus there is no argument that the RAB set by the jurisdiction does not include for all easements, regardless of the value assigned them. If PowerNet is of the view that the amount allowed in the RAB for easements is too low, it is incumbent on PowerNet to identify where there is a compensating over estimate in value for another element of the RAB. To increase the RAB purely because there may have been an incorrect assignment of value between elements is both conceptually wrong and does not comply with the requirements of the Code.

In the view of EUCV, the issue of the easement value is now quite clear. In its role as the previous regulator, the Victorian government implicitly valued its transmission easements at $53.2M and included this value for setting tariffs

[8] National Electricity Code 6.2.3(d)(4)(iv)

through the Tariff Order. This valuation fulfils the requirement of the Electricity Code for subsequent asset value setting by the ACCC. The Victorian government subsequently sold the easements as part of the overall sale of the assets to the new owners of PowerNet, for an implied value of $53.2M, setting a clear and agreed commercial value on these assets.

As both the previous regulatory value and the commercial value are coincident, the ACCC has no need to exercise any discretion with regard to easement value. That PowerNet has supposedly identified the land acquisition costs aggregated to $79.7 million is immaterial, as a subsequent value was placed on the assets by the previous regulator (the Victorian government) and by PowerNet itself (through the purchase process).

If the ACCC uses any other value than that set by the jurisdiction and the overt process for purchase of assets, then it will be providing PowerNet with unearned income. For the ACCC to accept any other value than this is in clear contravention of the National Electricity Code and clearly open to appeal for its decision to be set aside.

The ACCC would be aware of the "Easements" paper[9] prepared on behalf of BHP Billiton and the Electricity Consumers Coalition of South Australia, referred to in our earlier response and forwarded to the ACCC separately. This paper specifically addressed the claims by GasNet, ElectraNet and PowerNet to increase their RAB by the inclusion of the easements at a value greatly at odds with that set by the jurisdictions and at the value the easements were acquired. It also sets out the obligations required of regulators in the case of Code provisions relating to easements valuation set by jurisdictions.

The GST spike

In our earlier submission we noted that the GST spike needed to be eliminated from the roll forward of asset value. The ACCC makes passing reference[10] to the fact that this issue was raised but makes no further comment.

It would seem that the ACCC has exercised "regulatory judgment" by not addressing this issue. As mentioned above a regulator is explicitly not permitted to exercise regulatory judgment without explaining why it has reached a specific view on an issue related to the review process.[11]

The ACCC is not permitted to ignore an issue raised by an Interested Party and not explain why it has elected to do so. Consumers are firmly of the view that the

[9] Energy Transmission Easements – A Commentary on Valuation used by Transmission Companies and Regulators, July 2002, Prepared by Bob Lim & Co and Headberry Partners on behalf of BHP-Billiton Petroleum And Electricity Consumers Coalition of South Australia

[10] Draft decision page 40

[11] WA Supreme Court decision on Offgar vs Epic September 2002

ACCC is permitting PowerNet to “double dip” and that if it were private enterprise that was using the introduction of the New Taxation System (GST), the ACCC itself would be required to analyse the right of the business to do so.

Summary

In the draft decision, the ACCC has valued easements above the acquisition price and above the value set by the previous jurisdiction. The value of easements should be $53.2 million.

We continue to maintain that the inflation adjustment method allowed by the ACCC is incorrect and must exclude the impact of the GST spike in the CPI figure. If the ACCC considers that the GST spike must remain in the calculation, it must explain why PowerNet is permitted to do so.

Capex

EUCV agrees that PowerNet needs to expend on capital items to ensure reliability of the network, to accommodate demand growth, to comply with Codes of good practice and the Electricity Code.

As we stated in our submissions, we are unable to assess whether the amount claimed by PowerNet is appropriate, sensible or feasible due to its elected approach of assessing capex needs on a high level approach. PBA confirms that this high level approach does not provide sufficient detail for the regulator to assess the merits of the capex proposal needs to be proven to comply with the regulatory tests.

The approach taken by PowerNet creates significant challenges to consumers, the regulator and to PowerNet itself. In normal circumstances service providers are required to detail the capex program they have in mind, quantify what benefits will flow, the cost of each activity and the timing of each. This creates certainty in the minds of consumers and of regulators that the future projects have an acceptable cost benefit (comply with the regulatory tests), and timing. For the business it means that the capex has received regulatory approval and gives a high degree of certainty to getting the capex rolled into the RAB.

PowerNet elected not to do this, and instead has requested a very large amount of money to be spent over a range of projects. This creates uncertainty for all concerned. More significantly, there is no way anyone, let alone the ACCC can attest to the investments as efficient. Inefficient and over-investments are economically distorting.

Despite the fact that PowerNet is proposing to increase its capex program by nearly four times current levels, the ACCC has blithely accepted the proposed

capex program. This is in distinct contrast to its views on ElectraNet's capex program (of a similar magnitude) where the ACCC has stated some misgivings about the ability of ElectraNet to manage such a large capex program and as a result, the ACCC will include the bulk of the capex requested into the revenue equation and then review in five years time whether the capex spent was in fact prudent and economically sound. Whilst the ACCC approach on the ElectraNet capex program places significant risks on both ElectraNet and consumers (and places the ACCC in an unenviable position at the next reset) it is an attempt to provide some control over the capex program. The ACCC in its draft decision on PowerNet places no such constraints on PowerNet. This is unacceptable to consumers who ultimately fund the capex program.

We note the statement of the chairman of the Electricity Consumers Coalition of SA (ECCSA) at the ElectraNet public forum regarding the matter of capex:-

> "We are concerned that if the approved capex is not spent, or demonstrably fails the regulatory tests, consumers will be disadvantaged and will have to wait to the next reset for restitution. But will that restitution recognize the use of our money ElectraNet has had for the period.
>
> For example in the unlikely event that all of the capex granted is not spent, or does not pass the tests, then ElectraNet will have been given the use of these capex funds embedded in the allowed revenue for the five year period. If these funds were invested by ElectraNet this would give them an interest return of over $6 million for the first year, about $13 million in the second year, reaching nearly $35 million in the final year of the regulatory period. In total ElectraNet would have gained interest on the unused capex funds of up to $100 million over the period. This is unacceptable."[12]

We would note the same concerns apply to the PowerNet proposal and the financial reward PowerNet would receive would be even higher than that ElectraNet would garner. Consumers would prefer not to have PowerNet acting as a "bank" (even allowing for the imposition of interest on any unused capex funded under the new tariffs) and would rather have the benefit of capex under-run reflected immediately in tariff reductions.

To counter the detriments of the "high level" approach noted above but retain the flexibility that the approach provides PowerNet, we propose that the following be used.

1. The amounts of capex approved by the ACCC in the draft decision should be included in the RAB calculation. This amount is not to be exceeded in any one year unless the prior approval of certain

[12] ECCSA chairman Mr R Davidson at the ACCC public forum on ElectraNet application, 4 October 2002

carryover from the previous year can be substantiated to the ACCC satisfaction.

2. Annually, PowerNet must gain formal ACCC approval of the actual amounts of capex spent on projects that meet the regulatory tests, and this approved amount reconciled to the nominal amount approved.
3. If there is an under-run of capex in any one year, then the under-run is to be deducted from the nominal RAB and the allowable revenue for the following year be adjusted.
4. This approach will require annual adjustments to the revenue cap (and hence tariffs) but they can be treated as "negative pass through events" just as the approved revenue is adjusted six monthly as other pass through costs are accommodated.

We accept that this approach will add some degree of uncertainty in tariffs, but reductions in tariffs are more welcome to consumers than increases. However, of greater importance is that this approach reduces risks to all parties at the minor expense of an annual review of actual capex incurred.

Summary

PowerNet is proposing to carry out a massive capex program. There is significant doubt as to whether all the projects included in the "high level" assessment will comply with the regulatory tests. Consumers have raised very valid concerns at the approach proposed by PowerNet and these have been echoed to a degree by the ACCC and its consultants.

Because there is the lack of a detailed program for capex injection, there is considerable doubt as to the efficacy and appropriateness of the capex requested. The amount of the capex claimed in relation to the RAB is quite high. If the ACCC permits PowerNet to embark on the capex program allowed in the draft decision, it must be accompanied by appropriate controls. EUCV has proposed controls which are not overly intrusive, give consumers a degree of protection and provide a degree of certainty to PowerNet.

Operating and maintenance expenditure (Opex)

Comparing PowerNet to competitive business

At the public forum on ElectraNet, the chairman of ECCSA commented that:-

> "Much is said about Australia having an incentive based regime for regulated businesses. By allowing ElectraNet to maintain its current level of opex does not impose any incentive on them to find ways to improve performance. In competitive industry the cost of produce falls in real terms

> (for instance compare the reduction in the cost and the improved quality of cars and computers over the years).
>
> ECCSA members are continually being forced by competitive pressures to reduce their costs in order to stay in business – to continue with the same market share. What the ACCC has done with its opex approval is permit ElectraNet to maintain its current lifestyle without imposing any financial pressure to permanently reduce its costs of operations."[13]

These comments apply equally to members of EUCV.

PowerNet has maintained that they need increased opex to maintain the assets they so recently purchased. The proposed opex in the draft decision has been stated by the ACCC to be an increase over past opex:-

> "SPI PowerNet states that a significant reason for the increase in opex is the expansion in the scope of its regulated business, such as the transfer of the Victorian Network Switching Centre to its asset base from 1 January 2003. The ageing of the asset population is also a key reason for increased opex."

What the ACCC fails to accept in this statement from PowerNet, is that even if the costs of transferring the Victorian Network Switching Centre are removed from the opex calculations the increase in opex for 03/04 is still over 40% above the actual 01/02 opex figures. Thus, the ACCC implicitly accepts that a 40% increase in opex is justified by the increase in the average age of PowerNet assets of some two years. This is patently absurd.

In this regard it is worth reverting to the PowerNet Annual Report of 1996. In the report the CEO notes that they had achieved an opex result of $1.24/Mwh for the year (transmitting some 38,500 Gwh), but this was unacceptable as they state their:-

> "… current objective is to achieve a target of $1.05/Mwh by 1998."[14]

From the data in the PBA report on opex (table 3) and the volume detailed by VENCorp in their application (Figure 7.2), PowerNet actually achieved the benchmark of $0.9/Mwh (in $01/02 terms). For the ACCC to grant PowerNet opex of $1.29/Mwh (excludes VNSC allowance) for year 2004 is excessive.

In the draft decision the ACCC notes that PBA found that:-

> "… SPI one was comparable with PowerLink and more efficient than TransGrid"

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[13] ECCSA chairman Mr R Davidson at the ACCC public forum on ElectraNet application, 4 October 2002
[14] PowerNet annual report 1996 page 8

This is in stark contrast to the ACCC Draft Decision on ElectraNet where the ACCC assesses the performance of ElectraNet, Powerlink, PowerNet and TransGrid over a number of different benchmarks. These benchmarks were opex/line length, opex/sub-station, opex/asset base, opex/MW peak, and opex/Gwh. In only two of these measures is PowerNet identified as being a better performer than the other four transmission companies. This is despite the PBA expectation that PowerNet would have lower opex due to its natural advantages, which PBA commented:-[15]

> "However, it should also be noted that some external factors affecting operating expenditure and reliability are favourable to SPI PowerNet compared with other states. For example, the network covers a comparatively small area, a very high proportion of network is either in, or close Melbourne, the network contains only a limited number of radial spurs and there is no light 110kV system."

With its natural advantages PowerNet should be the lowest cost performer in all categories. Notwithstanding this, the ACCC is proposing a significant increase in opex.

When comparing the performance of each of the transmission businesses it is important to note that the other three Australian businesses already have to provide network switching, and the age of the TransGrid and ElectraNet systems are as old, if not older than the PowerNet assets. Thus when considering its natural advantages and the state of the comparative networks, there is an expectation that PowerNet opex should be significantly lower than their comparators' opex. This is not the case.

The ACCC observes there is potential for further cost savings in opex[16] by implementation of the asset management review recommendations. But the ACCC then accepts the PowerNet observation that only innovation will lead to further cost savings[17]. The very clear implication of these statements is that the opex level currently achieved by PowerNet is at the correct level. However, a little later the ACCC accepts the fact that an increase in opex is appropriate[18]. The first two observations are totally at odds with the final conclusion drawn by the ACCC. It would seem that the ACCC has again exercised its "regulatory judgment" on this issue, but fails to explain why and how it could reached the conclusion that it has.

The basis for much of the PowerNet capex is related to replacement and refurbishment of existing assets. To justify such a high level of capex for these reasons requires a significant reduction of opex to sustain the financial justification

[15] PBA report on PowerNet opex, page 3
[16] Draft decision page 64
[17] Draft decision page 64
[18] Draft decision page 65

for the capex – this is just common business practice – yet the ACCC blithely accepts the unchallenged statement from PowerNet, that the increase in opex is related to the large capex program.

Competitive pressures are needed on regulated businesses for them to reach best practice. We believe that the opex allowance should start at past levels and be automatically reduced on an annual basis by at least the CPI to replicate true competitive pressures.

Failure to provide an impetus for improved cost performance will not drive regulated businesses to achieve the performance needed of businesses exposed to the world markets.

Double dipping of opex

Unfortunately the ACCC draft decision provides little debate let alone justification as to what constitutes reasonable opex, and blindly accepts the limited PowerNet assertions.

PBA notes that over the period of 1996 to 2000, PowerNet reduced its expenditure by over $60 million due to rationalisations and other measures[19]. The report adds that these savings were achieved by not carrying out certain tasks, such as tower refurbishment[20].

Thus, it would appear that PowerNet had opex included in its current revenue cap for certain activities, which it then failed to carryout. It would have booked these savings as profit and now declares the savings as unsustainable.

It now appears that this work is in fact needed and PowerNet has added it to the future opex. This is clearly a method for requiring consumers to pay for the same task twice. Rigorous benchmarking of past performance and against international best practice is the only way to ensure that regulated businesses are not able to use such techniques of regulatory gaming.

Benchmarking supplied

A key purpose of international benchmarking is to avoid the circularity of benchmarking by comparing only against a few (local) benchmarks. In our previous submission we refer to the importance of international benchmarks. Generally the ACCC acknowledges the desirability of international benchmarking as part of assessing reasonable opex levels.

The ACCC implies that its review has incorporated international benchmarking. The benchmarking studies provided by PowerNet refer only to service levels

[19] PBA report on opex page 3

[20] PBA report on opex page 2

related to line performance and sub-station performance. In each of these studies the latest performance measure recorded applies only to 2001. The opex incurred by PowerNet in achieving these performance levels is significantly below the opex levels now sought by them and as proposed by the ACCC. There has been no international benchmarking of opex carried out to support the draft decision. The ACCC fails to explain why international benchmarking is not required in for comparison of PowerNet's opex.

There is no in-depth analysis to demonstrate that the opex claimed by PowerNet has been subject to rigorous "competition by comparison" which is the key tool of regulators following the "light handed" approach. The ACCC must explain why it does not require this rigorous comparison feature for its review.

The ACCC has permitted an increase in opex for non-insured identified risks and a contingency for unidentified risks. EUCV asks the ACCC why are these costs allowed to be added when previous opex amounts already included for these?

Summary

The stated goals of PowerNet in 1996 were to reduce the then perceived high levels of opex. They achieved their goal by 1998 and continued to maintain this cost performance until current times. At the same time they improved their service performance levels significantly as shown by the ITOMS comparisons.

The ACCC has stated that in the time from 2001 to 2003, due to the reintroduction for responsibility for the VNSC (at an operating cost of $3.3 million), the introduction of some $30 million of new assets and the increase in age of the network by two years, PowerNet should be permitted to increase its 2001 actual opex by over $20 million.

Even assuming that the growth in demand has had an impact on PowerNet opex (rather than the more appropriate addition of assets), in 1998 PowerNet was operating its network for about $0.9/Mwh[21]. Using this real benchmark performance and VENCorp median demand growth the new opex should equate to about $44 million for year 2003, which with the addition of the VNSC responsibility becomes a number still some $20 million below the ACCC proposed opex.

The ACCC has failed to analyse PowerNet's own past performance benchmarks, and has not costed the impact of the so-called reasons for requiring additional opex. If the ACCC proposed opex is permitted, then PowerNet opex costs will be equivalent to $1.28/Mwh, higher then the unacceptable level identified by PowerNet prior to the sale to GPU.

[21] $38.5M (PBA table 3) divided by a demand of 43500 Gwh (VENCorp figure 7.1), $01/02

Further in the absence of detailed costing information substantiating the claimed increases, the ACCC has not carried out the in-depth cost comparisons by benchmarking. What benchmarking that has been carried out indicates that the proposed allowances for opex are significantly above what rigorous benchmarking would permit. By not carrying out a rigorous review of activities to be included in past periods and benchmarking proposals for the new period, the ACCC would seem to be condoning PowerNet being paid twice for the same work - a "double dip" by PowerNet.

Service standards

EUCV notes with pleasure the proposal to add a service standards requirement as part of the draft decision. This clearly follows on from the transmission service standards program being run concurrently by the ACCC.

We recognise that the inclusion of the service standards now provides the essential balance required of the regulatory bargain (that of a certain funding for a certain achievement).

However the decision of the ACCC to negotiate the level of any penalty/bonus with PowerNet rather than having this process exposed and transparent does provide some misgivings to consumers.

Implementation of high standards of service is integral to moving towards firm supply across interconnects and away from the Electricity Code target of "best endeavours". We believe that the ACCC proposal is a good step in the right direction and should be strongly endorsed, although the process leaves a lot to be desired.

Conclusions and Recommendations on the PowerNet draft decision

We believe that the ACCC draft decision is fundamentally flawed and quite inadequate.

On review we believe that the draft decision proposes:-

1. A WACC which is too high. Our analysis indicates a WACC of between 5.0 and 6.0 would result from applying more appropriate values for intermediate elements of the calculation.
2. A RAB which excludes the impact of the GST spike and when this is removed will reduce the RAB by some $100 million. A value for easements which is too high. The correct value for easements is $53.2 million. We do not consider the ACCC has any discretion to move from this value.

3. A capex value that is extraordinarily high. However in the absence of detailed capex proposals, we recommend that the ACCC apply controls on the capex, such as annual reviews and adjustments to the RAB to reflect actual capital expenditure rather than leave the adjustment to the end of the regulatory period.
4. An opex which is little changed from the amount claimed by PowerNet, and is still too high when compared to past opex and when benchmarked to other electricity businesses. We see little justification for the opex to be greater than that achieved in the current period and accordingly we believe that the opex should be at least 30% lower than that proposed in the draft decision.
5. An opex amount which includes for work which was included in the current period revenue and therefore should not be carried forward into the new period.

As a footnote we must make an observation regarding the KPMG presentation made at the ElectraNet public forum alleging that there must be sea change to the regulatory environment arising from the WA Supreme Court decision regarding Offgar and Epic. EUCV has reviewed this decision and we have reached a different conclusion – that is, that the decision places an overt obligation on the ACCC to provide more explanation of how it arrives at a decision.

In summary, we see that the decision has clarified the regulator's role, requiring the regulator to be more overt in:-

- Explaining in detail the bases on which it has exercised regulatory judgment, ensuring that it explains fully its views on each of the factors it is required to assess, and that it clearly and fully explains why it has elected to take one position over another, especially when there are conflicting objectives.
- Ensuring that each of the objectives embodied in Codes or legislation is addressed, particularly paying attention to and balancing the conflicting objectives of both consumers and service providers.

At the ElectraNet forum our assessment was discussed with Commissioner John Martin and ACCC staff, who concurred with our interpretation of the decision.

In this regard, we note there are a number of aspects of the draft decision on which the ACCC has not fully examined the issues and/or explained its reasons for taking a particular view.

Draft Decision on the VENCorp revenue cap

The ACCC has in principle approved VENCorp to carryout some $143 million of new capital works relating to the Victorian transmission network. This is in addition

to the $360 million accepted for capex in the PowerNet revenue cap. In total this comprises $500 million of new and refurbishment works over the next five years on a network valued at $1.8 billion - an overall increase in value of nearly one third!

We observe that the ACCC is proposing to effectively accept the application by VENCorp for its revenue cap. EUCV is concerned that the operation of VENCorp would appear to add little value but does add unnecessary cost to Victorian electricity consumers. We see that the tasks undertaken by VENCorp are just as competently handled for other electricity regions by the asset owners and by NEMMCo. On this basis we oppose the approval of the VENCorp application by the ACCC. Equally, we recognise that the unique Victorian approach to the transmission asset management is embodied in Victorian legislation and that the ACCC is required to accept the reality of this absurd approach to operation a transmission network.

Notwithstanding this view, we have some specific comments regarding the approach taken by VENCorp to augmentation of the Victorian transmission assets. In particular, we draw the ACCC's attention to certain practices of VENCorp which can result in consumers paying a higher price for network augmentation than they otherwise would under more conventional management practices :-

- VENCorp is a "no liability" entity, and as such is able to pass through to consumers the costs of its errors, mistakes, poor management and poor performance of its duties. This is in contrast to other regulated entities which have close regulatory oversight of their operations and have to accept responsibility for their actions.

- For it to call tenders it must be assumed that VENCorp can and has developed the optimum network solution. Once tendered alternative lower cost solutions are not permitted. VENCorp establishes its tender criteria based on VENCorp assumptions and these assumptions are not subject to regulatory review either now or in the future. This is in contrast to other regulated entities where subsequent reviews can reverse the impact of earlier decisions.

- Because tendering is seen as implicitly a competitive arrangement, it is assumed that VENCorp has and continues to minimize costs of the capex program. As VENCorp can pass through its costs, it has no driver to ensure that its costs are optimized.

- There is little transparency in the VENCorp process. Details of the contracts are not publicly available, and the number of tenderers is not disclosed. For tendering to be competitive requires a significant number of sincere tenderers to actively participate in the process. This adds concern that the process does not result in a competitive solution.

- VENCorp tenders appear to have some unique features – they are "take or pay", build own operate arrangements and usually run for 20 years.

  - The "take or pay" obligation passes all volume risk to consumers, allowing no subsequent optimization as required by the National Electricity Code.
  - A "BOO" scheme usually requires third part financing of non-recourse debt, increasing the BOO scheme WACC above that set for regulated entities.
  - A project which has only a guaranteed life of 20 years will need to depreciate the assets acquired in a 20 year period – debt providers will require this feature. Regulated entities have their assets depreciated over 40-70 years depending on asset type, making the "competitive" approach a higher priced option for consumers

- A 20 year contract provides substantial opportunity for the contractor to improve its financial position due to changed circumstance during the course of the project. There is no incentive for VENCorp to minimize such claims, nor is there any subsequent regulatory oversight to ensure VENCorp is competently performing its obligations to consumers with relation to each contract it has awarded.

- Contracting transmission services provides a substantial benefit to the incumbent provider through its ability to marginally cost significant elements of the contract price, and control variations to the contract through its ability to control the project interfaces. Thus, the incumbent regulated entity can enhance returns for augmentation to its network through this contracting approach. However if the augmentation was undertaken as a regulated activity, the returns are set and the costs for carryout the work are not only permitted on a marginal cost basis, the future risk for optimization and contract interfaces lies with the provider. This is a far better outcome for consumers.

Summary

There is a generally held view that by contracting out network augmentations on a so-called competitively tendered basis will result in a lower cost to consumers. This broad assumption has yet to be debated with those who ultimately pay for the results of the approach.

As part of the approval of the VENCorp application, the ACCC must require VENCorp to be more transparent in its dealings and to demonstrate that its approach does in fact provide a lower cost result to consumers. In particular the ACCC must require VENCorp to ensure that the tenders awarded provide a lower

cost than that achieved by allowing incumbent service providers to augment under the rules applying to a regulated NSP.

In particular, VENCorp must be required to demonstrate that :-

- VENCorp has identified the lowest possible cost option for achieving the results of the augmentation by way of a transparent process
- Augmentation by the incumbent NSP will result in a higher cost than by the tender process
- Core details of contracts awarded are disclosed, including the number of competent tenders received for any work
- Asset depreciation is included for the asset life and not the contract life
- Tenders from incumbent service providers include only for marginally costing opex, rate of return and interface costs
- The returns granted the contractor do not exceed the WACC granted to the adjacent regulated entity
- VENCorp has staff responsible for awarding and running contracts who are competent to do so and have significant experience as a contractor to ensure contract variations are properly controlled