25 June 2007

Mr Chris Pattas
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Australian Energy Regulator
PO Box 1199
Dickson ACT 2602

BY EMAIL: aerinquiry @aer.gov.au

Dear Chris

SP AUSNET TRANSMISSION DETERMINATION

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide a submission to the Australian Energy Regulator (AER) on SP AusNet Transmission Determination Proposals for the period 1 April 2008 to 31 March 2014.

As you may be aware, the EUAA is a non-profit organization focused entirely on energy issues on behalf of large business-end users of electricity and gas. The EUAA currently has around 85 members. Membership ranges across many sectors of the economy, including mining, manufacturing, construction, commercial, property and service sectors. Many of the EUAA members operate across States and we have a significant membership base in Victoria, including the States largest energy users.

The Victorian electricity transmission system is critical to the proper functioning of the NEM, not just in the reliable bulk transportation of electrical energy but also in stimulating competition, trade and liquidity.

We expect the AER will take into consideration the impact transmission price rises will have on the input costs of major energy users, as well as the competitiveness of the Australian economy. All businesses in Australia face similar cost pressures to the businesses under review, but are not able to pass through such cost increases via prices set according to a regulatory determination. Normal business pressures mean

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that they might have a limited degree of flexibility in passing through some proportion of increased costs but must also look to make greater efficiencies in their operations or lose competitiveness and market share.

The current extremely high prices being seen in the NEM makes it even more important that the AER deliver a determination that limits any further price pressures.

The EUAA has formed the views in the attached submission on the basis of what is in the best interests of energy users. The EUAA is uniquely placed to provide the AER with such a view, given its involvement in both national and State energy policy issues, its involvement in some 25 regulatory reviews, the fact that its membership base is larger than any other user body and its position as the national association of larger energy users.

You should note that this submission has been prepared by the EUAA entirely from its internal resources and without funding assistance from the AEMC Advocacy Panel, due to a late decision by the Panel not to provide funding for our submission. Unfortunately, our input is therefore necessarily constrained, has been prepared without the benefit of engineering and other technical expertise, and has been complied in a very short space of time. It is also limited to the SP AusNet application and does not cover VENCorp's application. Nevertheless, we believe that our policy positions put forward in the enclosed submission are sound and factually based, and are in the interests of energy users.

We look forward to hopefully making further submissions on the SP AusNet and VENCorp assessment processes in the future.

If you have any questions about the submission or would like to discuss it further, please do not hesitate to contact Mr Jeremy Romanes, Manager – Policy & Regulation, on 03 9898 3900.

Yours sincerely

Roman Domanski
Executive Director

SUBMISSION TO AUSTRALIAN ENERGY REGULATOR REVIEW OF SP AUSNET TRANSMISSION DETERMINATION APRIL 2008 – MARCH 2014

25 June 2007

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EXECUTIVE SUMMARY

The EUAA welcomes the opportunity to provide comment to the AER on SP AusNet's 2008– 4 transmission revenue determination.

Average Victorian TUoS prices would increase from around $7.70 per MWh in 2008/9 (nominal) to around $11 per MWh (nominal) in 2013/14 as a result of this application being granted. This is a nominal increase of over 50 per cent in six years in nominal terms, or a real increase of around 40 per cent over the same period. Such a large increase is totally unacceptable to the EUAA and its members given the comments made in this submission about SP AusNet's failure to adequately justify their proposed expenditure, their inflated rate of return and apparent lack of any significant increase in service levels.

This level of price rise is very significant and would represent an unwanted and totally unwarranted increase. Medium and large users will need to meet this substantial increase in charges in addition to added costs for generation, where (for example) one year forward contracts for peak electricity have increased from $57 / MWh to close to $100 per MWh since the start of the year, and these price increases show no signs of abating.

We are of the opinion that the AER should subject the application to close scrutiny, recognizing that this review represents a transition between the old regulatory *ex-post* review regime and the new *ex-ante* environment, and that the outcome of this review may be setting the stage for the forthcoming reviews of other TNSPs.

It is particularly important that the AER adopt a stringent assessment process within this review. As the revenue reset period is to be extended to 6 years, the assessment will be 'locked in' for an extended period and will not be completely reviewed again until 2014.

We are concerned that in its revenue proposal, SP AusNet does not appear to have justified all of the steep increases in cost it proposes. Its claims are not always fully transparent and it has not detailed how regulatory obligations have impacted on costs. SP AusNet argues that the company is subject to escalating input costs, the need to replace much of its existing network infrastructure, and this is used to justify some significant expenditure increases. We do not agree that high labour and material costs should affect SP AusNet more than other companies that operate in a

competitive marketplace, and the adoption of a large asset replacement policy remains to be substantiated.

Companies in a competitive environment cannot simply increase prices otherwise market share will be lost as customers seek more efficient and lower cost suppliers. Such companies will only increase prices as a last resort after exhausting all means to increase their efficiency and productivity.

Regulated monopoly companies, on the other hand, have the luxury of going to a regulator to seek a cost pass through as a first step. The experience with incentive regulation in Australia to date is that regulators tend to grant energy network business excessively generous expenditures and that any efficiency gains can simply be used improve the profitability of the company.

In relation to *Capex*, the EUAA

- Is very concerned about the impact of once off rolling in of $118m worth of assets due to changes in the classification of those assets, and a further $23.2 million representing assets under construction
- Is concerned that SP AusNet's capitalization policy may result in users paying for assets before they are put into service
- Considers that the AER needs to closely examine the 55% step-change in he average level of non-augmentation capex over the next regulatory period, particularly in light of the massive over-spend incurred by SP AusNet relative to the capex allowance made in the last revenue determination.

In relation to *Opex*, the EUAA:

- Is concerned that there has been significant overstatement of the required levels of opex in the past, and, like the past, this application has been similarly overstated
- Is concerned that SP AusNet does not appear to have not fully explained the average 20% step-changes increase required in the opex allocation, relative to the previous period
- Is concerned that, In light of the asset replacement program proposed by SP AusNet, maintenance expenditure is increasing significantly
- Considers that a full investigation of the behaviour of wages growth over the next six years is required to inform the AER of the most appropriate way to compensate SP AusNet for its claims about rising labour costs

- Is concerned that the restructuring of SP AusNet's business into a separate service business is not necessarily in the interests of consumers and not very transparent thereby exposing the regulator and end users to risks of unknown costs

In relation to the *Weighted Average Cost of Capital*, the EUAA:

- considers that enshrining the WACC parameters in the Rules is poorly thought out and not in the best interests of electricity users
- considers that in the current circumstances where flexibility in application of the WACC parameters is available, the AER should be no more generous on these parameters than in the Powerlink decision

In relation to *Service Standards*, the EUAA considers that:

- placing 1% maximum annual revenue (MAR) at risk does not provide a sufficient incentive to encourage SP AusNet to observe (limited) service standards

1 INTRODUCTION

We appreciate the opportunity to provide comments for consideration in response to SP AusNet's transmission revenue proposal to the Australian Energy Regulator (AER).

The transmission system is critical to the proper functioning of the NEM, not just in the reliable bulk transportation of electrical energy but also in stimulating competition, trade and liquidity. Its importance goes beyond the direct costs of transmission use of system (TUoS) but also impact on the wholesale cost of energy when inter-regional transmission constraints are relaxed.

SP AusNet has submitted a lengthy and detailed application covering some complex issues. Its application provides a useful starting point for this review but it has some gaps and raises some important questions.

We are of the opinion that the AER should accept the positive aspects of SP AusNet's operations but also subject the application to close scrutiny, recognizing that the review process is in transition from an *ex post* to an *ex ante* review framework and that the outcome of this review may be setting the stage for the forthcoming reviews of other TNSPs. Importantly, the review is also for a period of 6 years and relates to transmission within Victoria's which plays an important role in delivering electricity to users in Victoria and the broader NEM.

Customers expect the AER to take into consideration the impact transmission price rises will have on the input costs of major energy users, as well as the competitiveness of the NEM and the Australian economy. We also expect the AER to recognize that all businesses in Australia face similar cost pressures to SP AusNet but are not able to pass through such costs via a regulatory determination; they might pass through some proportion but must also look to make greater efficiencies in their operations or lose competitiveness and market share.

Our submission addresses the key issues of concern to our members and we seek to ensure that these issues are considered by the AER prior to making its draft decision. It is our view that the revenue proposal has significant deficiencies and consequently cannot be approved without major amendments.

Our major issues discussed in this submission are:

Capital Expenditure (capex) in the current regulatory period has significantly increased compared with SP AusNet's previous forecasts used for setting the revenue cap for the current regulatory period. In addition, the current capex forecasts for the next regulatory period continue the trend of high rates of investment.

- The significant increase in Operation and Maintenance (O&M) expenditure over the current and next regulatory periods.
- The importance of SP AusNet's performance standards in servicing end users and the inadequacy of placing only 1% of revenue at risk.
- The likely increase in average TUoS charges faced by consumers as a result of the current revenue cap application.

SP AusNet does not appear to have justified all of the steep increases in costs. Its claims are not always fully transparent and it has not detailed how regulatory obligations have impacted on costs. SP AusNet argues that the company is subject to escalating input costs and this justifies expenditure increases. However, we do not understand why high labour and material costs should affect SP AusNet more than other companies?

In assessing the proposal, the AER needs to consider how companies in a competitive industry behave in response to such cost pressures. Do they simply raise prices by adopting a cost-plus approach? Or will they seek to:

- Increase productivity/efficiency;
- Seek innovative ways to manage the increases; and
- Absorb some cost pressures?

The Australian Financial Review[1] reported that Rio Tinto's Chief Executive Leigh Clifford:

> *"… suggests in the annual report that high oil and gas prices are here to stay and could ultimately improve efficiency. "These factors may represent a structural increase for costs in our industry, but we are constantly looking for ways to use energy more efficiently and improve productivity across all of our operations," he says."*

[1] The Australian Financial Review, *Soaring oil price fuels transport costs*, 20 April 2006

And, in our view, in the absence of a competitive market for transmission services, the AER as regulator needs to ensure SP AusNet does the same.

Companies in a competitive environment cannot simply increase prices otherwise market share will be lost as customers seek more efficient and lower cost suppliers. Such companies will only increase prices as a last resort after exhausting all means to increase their efficiency and productivity. Regulated monopoly companies, on the other hand, have the luxury of going to a regulator to seek a cost pass through as a first step and in relation to a future regulatory period where cost trends could change. Any efficiency, or windfall gains simply improve the profitability of the company. The AER needs to assess SP AusNet's application carefully in light of this.

The Federal Treasurer recently warned in relation to oil prices, that we should be vigilant against simply passing through cost increases as that would lead to an inflationary spiral, and that inflation can be contained as long as businesses do not increase their prices because of the rise in input prices.[2] The AER needs to ensure that higher costs faced by SP AusNet are addressed by higher efficiencies rather than just passing these costs through to customers.

We have seen companies absorbing large cost increases to achieve a competitive advantage. Virgin Blue resisted passing through the cost of higher oil prices to airfares, despite Qantas, its only competitor, imposing a fuel levy. Businesses in a competitive environment do not pass through cost increases unless absolutely necessary as doing so could erode a competitive advantage. This competitive behaviour, however, seems lost on regulated network businesses and seems to be absent from the SP AusNet application. As the regulator with responsibility for delivering a decision that mimics competitive markets and accords with the National Electricity Market objective, the AER needs to ensure that costs are managed efficiently and SP AusNet has an incentive to do this.

You should note that this submission has been prepared by the EUAA entirely from its internal resources and without funding assistance from the AEMC Advocacy Panel, due to a late decision by the Panel not to provide funding for our submission. Unfortunately, our input is therefore necessarily constrained, has been prepared without the benefit of engineering and other technical expertise, and has been complied in a very short space of time. It is also limited to the SP AusNet application and does not cover VENCorp's application. Nevertheless, we believe that the policy

positions advocated in this submission are sound and factually based, and are made in the interests of energy users.

2 The Australian, *Oil shock an inflation risk: Costello,* 20 April 2006

2 REGULATORY ASSET BASE AND CAPEX

2.1 Asset Base Roll Forward

We have previously made the AER aware that customer groups have always held the view that the historical Optimised Depreciated Replacement Costs (ODRC) method used to determine the asset base at the start of the sectors reforms overstates the value of assets. This continues to be a 'thorn in the side' of users that results in transmission prices already being higher than they should be.

While we agree that constant revaluations create uncertainty and adversely impact on the cost of equity, it is our view that the AER still needs to check that the roll forward is robust and justified. In this regard, the EUAA is concerned with the impact of once off rolling in of $118m worth of assets due to changes in the classification of those assets, and a further $23.2 million representing assets under construction. The Revenue Application notes a change of timing for recognition of expenses from "as commissioned" to "as incurred" under the *ex-ante* expenditure cap. This change should be accompanied by removal of interest payments during construction. There is no mention of current policy or whether this has changed in the cost estimates used in the submission. Confirmation is required that future capital forecasts do not include interest payments during construction.

The value of assets under construction will only get larger as the capex programme expands. There also seems to be a logical inconsistency with these assets under construction being depreciated even before they are completed and put into service! As a result of this change, customers are required to pay for these assets even before they provide any service! We urge the AER to review this capitalisation policy, especially since it does not comply with any accounting standards.

2.2 Capital Expenditure

Based on the available documents submitted by SP AusNet for this review, we understand that SP AusNet's Capex forecast has been based on the following:

- the key drivers identified in SP AusNet's Asset Management Strategy and cost
- estimation processes (Asset Performance and Failure Risk, Increasing Network Utilization; Increasing Fault Levels; Operational Availability and Reliability Performance; Compliance with Legislation, Rules and Regulations and

Technological Change)

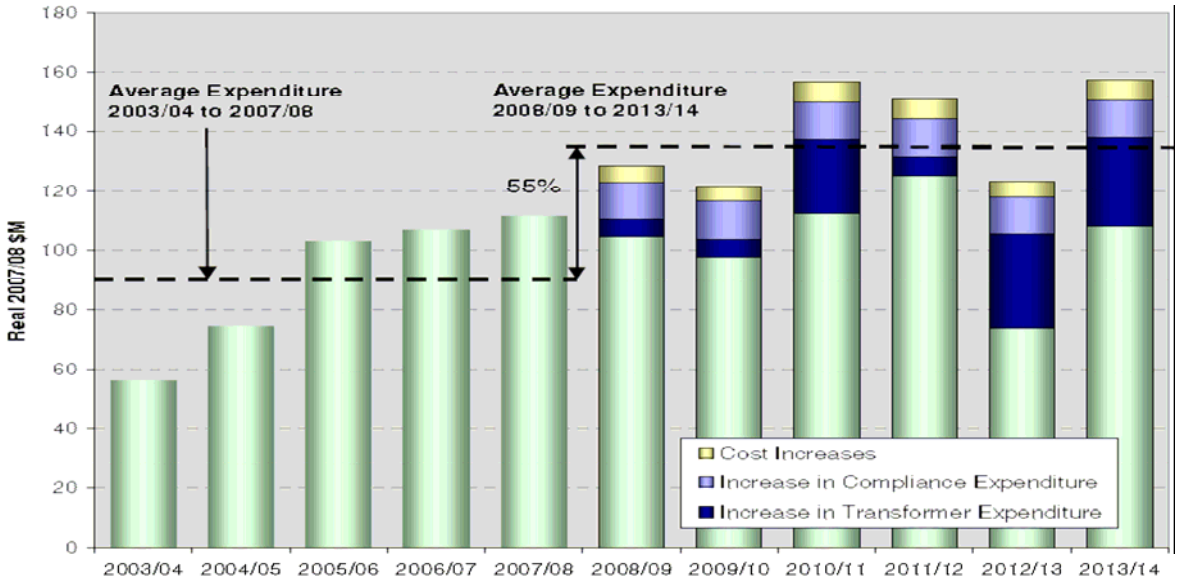
- the service and compliance outcomes to which SP AusNet is subject
- the project cost and scoping estimation factors that are expected to influence costs
- the impact of external factors that are beyond SP AusNet's control (mainly increases in labour and commodity prices).

In general, the reasons given for increased capital expenditure within SP AusNet's submission could be reasonable, and reflect similar issues being raised by other networks around Australia. However, the submission details explaining the cost increases are generally in narrative form (qualitative) and the actual value of the increases need substantiating, especially given their size and impact on charges.

Recognizing this, customers users may be prepared to accept allowances for a generous level of investment in transmission infrastructure if they can be assured of offsetting benefits in higher reliability and lower wholesale energy market prices. However, allowing for this, Transmission Network Service Providers' (TNSP) costs still need to be "efficient" and subject to close regulatory scrutiny and the AER will have a critical role in balancing these factors.

Figure 2.2.1 taken from page 55 of the SP AusNet submission, shows SP AusNet's historical and forecast non-augmentation expenditure.

Figure 2.2.1 SP AusNet's Non-Augmentation Expenditure
2003/04 to 2013/14 (Actual and Proposed*) (Real 2007/08 $M)



* Actual to December 2006, forecast to 2013/14.
Note: Capex as commissioned (6 months IDC excluded)
Source: SP AusNet

Figure 2.2.1 shows a significant jump 55% real increase over the next period in capex expenditure levels, and this is particularly marked in years three, four and six of the coming period. The drivers of the pattern of capex spend (for example, the extreme variability in transformer-related expenditure) are less clear, and timing issues will need to be fully investigated by the AER as the delaying of a large dollar value of projects that are scheduled for the middle of the regulatory period until the end of the period represents a significant opportunity for SP AusNet to gain (and game) addition returns on its regulated revenue stream.

Additionally, the real 55% increases in capex expenditure highlighted by the above graph needs to be fully investigated and understood by the AER. The EUAA considers that there could be some significant savings and synergies in compliance costs in particular for a newly merged entity, although there do not appear to be any 'savings' reflected in SP AusNet's submission in this regard.

2.2.1 Ongoing Capex

Some $348 million of ongoing works on current projects has been identified (Table 6.2, p58). It is unclear whether these projects and costs are included in the project

list used as the basis for forecasts, or if they are treated separately. This should be clarified.

2.3 *Ex-ante* Capital Cap

The rationale behind adopting an *ex ante* cap in chapter 6A of the NEL is that this will impose greater discipline on TNSPs capital expenditure, and also provide certainty to users in terms of capex and hence future regulated TUoS. There are, however, a couple of potential weaknesses in this approach:

- The proposal, and hence accepted value, is based on forecast growth and project costs. If growth or delivered costs are lower (and the probability should be equal that it be higher or lower if we are using the forecast growth figures), then in theory TNSPs could spend in excess of what is strictly "prudent", up to the accepted cap. (To overcome this, would require a detailed *ex-post* assessment on top of the current *ex-ante* assessment). That is, the *ex-ante* cap does not necessarily guarantee only prudent levels of future expenditure.

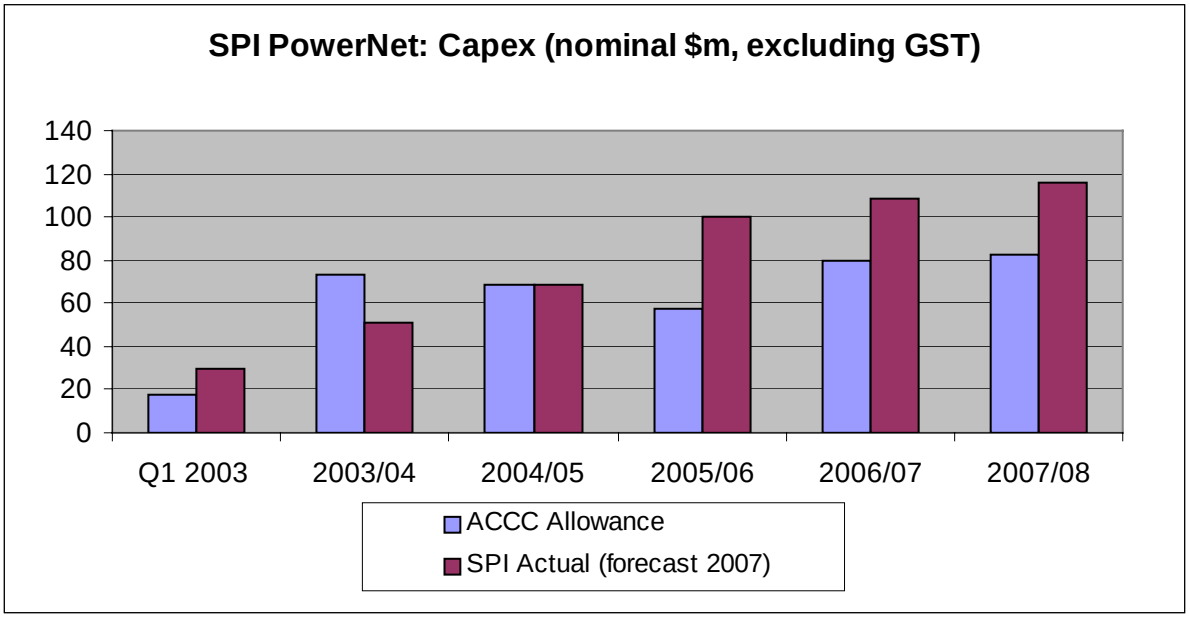
- If growth is higher than expected, TNSPs are likely to hold back on projects not included in the *ex-ante* approved budget, until they can be approved in the next regulatory period. That is, flexibility to adapt is constrained during a 6 year planning horizon, which given historical experience with the accuracy of load forecasts, is not necessarily a prudent approach.

2.4 Historical Capex

In its 11 December 2002 Decision for the current regulatory period, the ACCC determined that SP AusNet's forecast of capex between the first quarter of and 2007/2008 would total $378.64 million in unadjusted (nominal) terms.

According to the figures provided in its revenue cap application (page 101), SP AusNet states that it has spent $474.3 million in nominal terms, which does not include a further $118 million for previously excluded assets, and a further $23.2 million for work-in-progress due to the change in recognition policy for capex not commissioned. This is illustrated in Figure 2.3.

Figure 2.4.1 SP AusNet Capex 2003 – 2007



Source: SP AusNet Cost Information Templates

In nominal terms, SP AusNet has indicated that it would be actually spending a total of 162% of the original allowance made by the AER / ACCC, forecast at the commencement of the current regulatory period.

Electricity consumers, including our constituents, would be concerned with a regulatory arrangement that simply allows the monopoly regulated entity to over spend its allowed capex by such a huge margin and then bill its customers the difference during the following regulatory period by rolling in the increased costs to its asset base, asserting that the overspend was efficient.

An analysis of the timing of the capex shows that most of this additional expenditure occurs (or is expected to occur) in the latter half of the regulatory period. In the first 3 years, between 2003 and 2004/2005, average capex was roughly equal with the ACCC's revenue allowance. In the final three years of the regulatory period (and drawing on estimates for expenditure for 2007/8 as included in the SP AusNet application), capex spending was, on average, $35 million (nominal) above the ACCC's allowance, without consideration of the work-in-progress and roll-in adjustments.

The reasons for this excess expenditure need to be carefully investigated by the AER in its last chance to review this expenditure in an *ex-post* environment before moving to a fully *ex-ante* framework, and made public so that end users can be confident that

the increase is justified. For example, it may be that some increase in expenditure is justifiable. On the other hand, we would be extremely concerned if SP AusNet were to simply ramp up capex in the second half of the next regulatory period to increase its opening RAB in the next regulatory period resulting in higher revenues.

At a minimum, and in accordance with procedures for reviewing expenditure on an ex-ante basis, the AER should commission an engineering consultant to undertake a rigorous study of the reasons for the large increase in capex and evaluate the efficiency of all of the capex that SP AusNet has or will spend in the current regulatory period.

This needs to go beyond what is "reasonable" to what is "efficient" in terms of SP AusNet's privileged role as a monopoly TNSP in Victoria.

SP AusNet, as the asset owner, must have the incentive to manage and maintain its assets so as to minimise the total life cycle cost. Allowing SP AusNet to simply roll into its asset base any cost increases would undermine and negate the whole concept of incentive regulation. Incentive is based on the premise that, should the TNSP achieve efficiencies that lead to lower capex spend in any period, it would be able to keep the benefits of this lower expenditure. As claw back is considered to diminish the incentives for the TNSP to be innovative and efficient, so too would simply rolling in overspending of a large nature.

Consumers expect detailed assessments, transparency and consistency in this regard.

2.5 Proposed Capex

To justify its application, SP AusNet should be asked to provide a detailed statement of the scope and timing of their proposed capex program that should be subjected to detailed scrutiny by suitably qualified engineering consultants and be benchmarked against comparable businesses both here and overseas. This should identify the purposes for this expenditure and provide a proper allocation of costs to the respective beneficiaries of each project or class of development work. This approach will enable the AER to critically assess SP AusNet's claims and set a capex level, which is justified, feasible and acceptable to electricity consumers.

As represented in section 5.3 of their application, SP AusNet's historical capex expenditure over the last five years has averaged $90.4 million ($2007/08) while

proposed capex in the coming regulatory period averages almost $140 million when computed on the same basis. This is effectively an increase of $50 million spending on capex projects *per year* and users will require a full explanation for these increases, and require them to be subject to rigorous investigation by the AER.

2.5.1 Cost Increases

SP AusNet has not provided any indications of whether unit costs are in line with industry practice, in particular, ensuring that specifications and construction standards compare to good industry practice within the rest of Australia and overseas (where relevant).

The application notes that wages and material costs have increased significantly, and that this accounts for a large proportion of the overall capex increase sought. A breakdown of the drivers for the increased capex, and their relative contributions, is needed to accurately determine this. We urge the AER to ensure this is done.

We are aware that material costs associated with transmission lines have significantly increased above the rate of CPI in recent years.

The AER needs to determine:

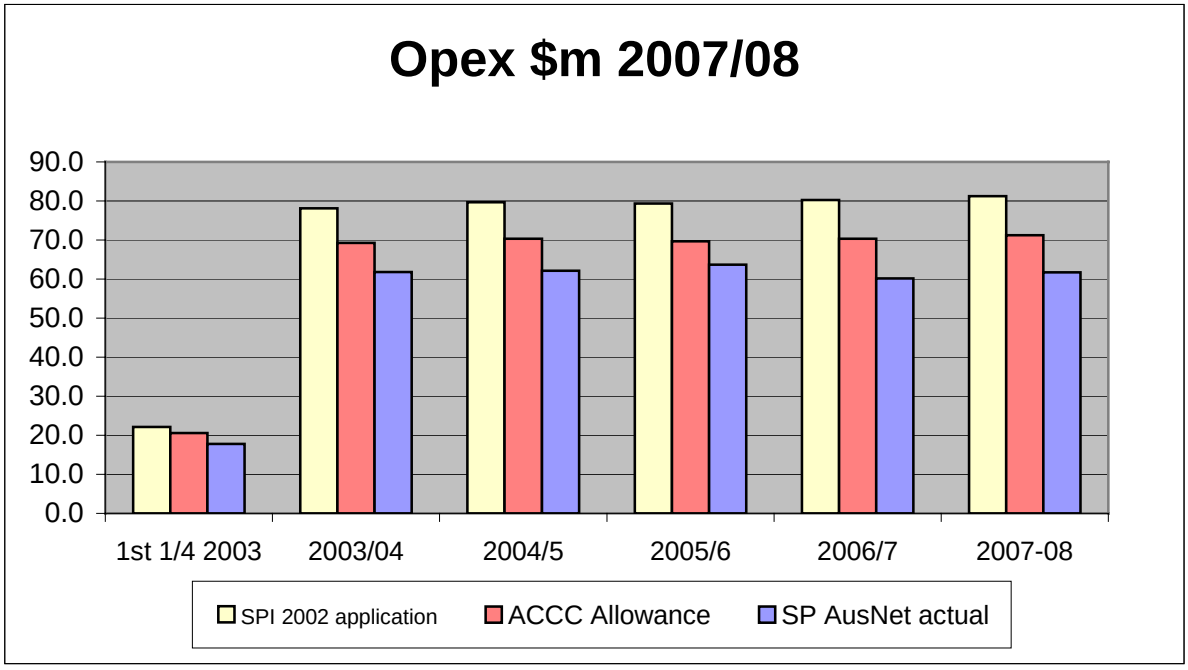
- How relevant and material these cost increases are?
- Are they realistic?
- How would more competitive industries address similar increases in their costs?

3 OPERATING AND MAINTENANCE EXPENDITURE

3.1 Historical Opex

The EUAA makes the following comments on SP AusNet's historical opex expenditure, and has drawn the following information from SP AusNet's own submission and historical documents.

Figure 3.1.1: Historical comparison: opex expenditure



Source: SP AusNet application page 81 (ACCC Allowance and SP AusNet Actual), SPI PowerNet application (11 April 2002) page 8 for SPI 2002 application, adjusted for inflation

In December 2002, the ACCC approved expenditure totalling $371.4 million ($2007/08) over the five years and three months of the last revenue cap period.

According to SP AusNet's own submission, its expenditure over this period amounted to only $331.6 million, calculated on the same basis, as represented in the above graph.

This can be contrasted with the April 2002 SPI PowerNet application of $421 million (adjusted to $2007/08) that does not include any allowance for management fees (dealt with below).

There seems to be a trend appearing in regulatory price reviews that, in the initial years immediately after a price review decision is made, operating costs are lower or in line with the regulatory decision and in the later years, these costs seem to invariably increase to justify the higher expected expenditure 'step change' that is argued for in the next regulatory period. In the current submission, there is a significant step change in proposed opex levels and the AER should be aware of this trend and take steps to prevent any attempts to game the regulatory process.

At face value SPI PowerNet's claim represents an over-estimate of its expenditure in the previous regulatory period of approximately $40 million, or more than 10% more than its actual expenditure over the period, and $90 million less than its original claim. Effectively SP AusNet incurred expenditure that was 21% below that which was originally forecast.

Whilst this could be taken as an efficiency impact that is consistent with the incentive regulation regime, the magnitude of the difference would equate to a very significant – probably too large to believe – efficiency impact.

Alternatively, the previous revenue determination could have incorporated a substantial degree of 'fat' in the allowance to SP AusNet. This would be unacceptable to end users in any circumstances as they would be paying for monopoly fat, which is contrary to the regulatory regime. In the current environment where customers are facing record high prices for electricity, there is an even more serious need for the AER to ensure that regulated revenue increases that are borne in large part by industrial and commercial customers are contained.

The EUAA accordingly encourages the AER to make thorough enquiries with SP AusNet to ensure that it correctly understands the fundamentals associated with SP AusNet's operating structure, to ensure that it does not approve such a manifestly generous allowance to SP AusNet in the context of the current review.

3.2 Future Opex

SP AusNet's future opex claim measured against the allowance provided to it in the current regulatory period and actual opex out-turns for the current period is illustrated in the following diagram for the purposes of comparison.

Figure 3.2.1: Historic and future opex: actual / proposed versus ACCC allowance

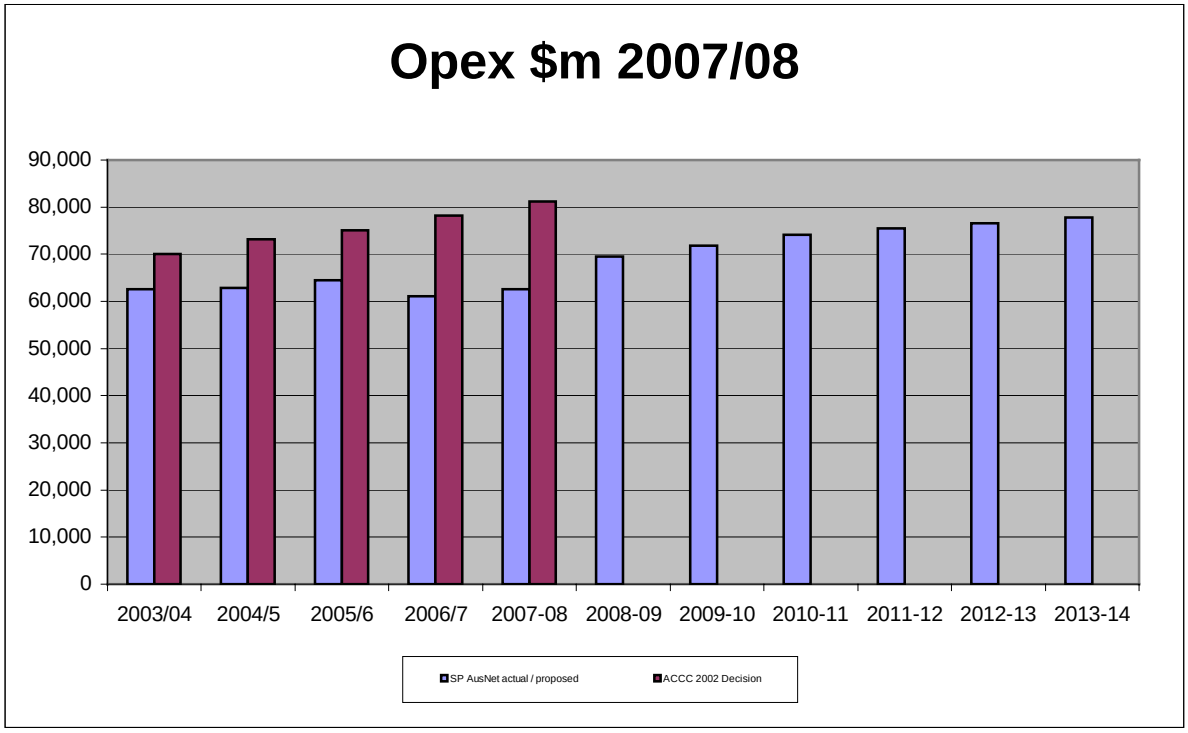


Figure 3.2.1: sourced from SP AusNet application: Opex Model

As can be seen from the above figure, and from SP AusNet's own application (Figure 6.2.1), average annual expenditure in real terms is expected to rise by 20% as compared to average annual expenditure over the previous period, from just under $62.7 m for the last regulatory period to $74.2 m for the next regulatory period, in constant $2007/08.

End users are entitled to be sceptical about this claim for a further significant step-change in expenditure levels, given the very generous over-allowances made to the regulated entity in the previous regulatory period and the substantial cost savings made by the regulated business in the previous period relative to those allowances, as discussed in Section 3.1 and illustrated by Figure 3.1.1. Clearly given SP AusNet's levels of historic actual opex out-turns, a significant step change in expenditure of an

average of 20% for the next period appears to represent an ambit claim by the regulated, and this claim requires careful scrutiny by the AER.

In particular, the AER needs to examine carefully the basis of SP AusNet's claim that there are a number of factors that contribute to increase operating expenditure being required in the next regulatory period. In particular, SP AusNet mention:

Maintenance expenditure: according to SP AusNet, this is associated with asset failure risks that are associated with an ageing asset base. Firstly, the EUAA queries how SP AusNet have arrived at the conclusion that their asset base is ageing, given that their asset base at the end of the current regulatory period is expected to be $2,081.7m ($2007/08) and expenditure on non-augmentation capex in the next regulatory period is proposed at $815.4 m ($2007/08); and represents a 55 percent real increase in the capital program for the period 2008/09 to 2013/14. As a result, and depending on the age profile of SP AusNet AusNet's existing assets, the EUAA is intrigued that SP AusNet is arguing that the age of their asset base is increasing. In an environment where there is significant non-augmentation expenditure on new assets that require less maintenance in the next regulatory period, the EUAA would expect that asset maintenance expenditure might be expected to remain stable, or even fall in the next period, yet this does not seem to be the case here: asset maintenance expenditure is schedule to increase from $32.88 million in 2007/08 ($2007/08) to $37.1 million in 2013-14 ($2007/08) according to SP AusNet's application documentation.

Labour costs: The EUAA notes that SP AusNet has forecast growth in wages over the next regulatory period of 2.83% above inflation. The EUAA notes the arguments for and against the use of such a figure in the light of the Access Economics report on wage cost escalators commissioned for the AER for the Powerlink Final Decision, and the BIS Shrapnel report commissioned by Powerlink for that decision. Given the controversy surrounding the selection of the wage escalator, and its importance in determining the opex allowance for regulated businesses, the EUAA considers that the EUAA should again seek professional opinion about the correct wage cost inflator to use for the SP AusNet decision.

3.3 Structure of the regulated business

The EUAA notes the changed structure of the regulated entity since the last revenue cap determination. In particular we direct the AER to the re-configuration of SP AusNet's gas and electricity distribution businesses, and electricity transmission

businesses who are now reliant on a new management entity, SPI Management Services, for the provision of many of the management and administration functions.

The EUAA is concerned that implementation of this new management structure makes it increasing difficult to unravel the financial arrangements that exist between the regulated entities and the management company. To this end, we note the extensive enquiries that the AER has already made of SP AusNet, and the EUAA can only conclude that the AER also faces significant information asymmetries in attempting to comprehend this relationship.

In particular, the EUAA considers that the establishment of this new management structure may make a comprehensive review of the costs associated with the transmission business much more difficult, and this may have significant adverse consequences for the AER determination.

In order to assess the efficacy of the arrangements between SP AusNet's transmission business and SPI Management Services, the AER should be looking to establish whether:

- the management structure provides value for money in the services that it provides to the regulated business
- has a transparent and easily understandable financial relationship with the regulated business
- does not impose costs on end users that would not be borne if the regulated business was managed in a conventional fashion

SP AusNet has provided the AER with sufficient information to enable the AER to make an accurate assessment of the appropriateness of the basis of remuneration of the management company

The EUAA notes that in correspondence to the AER dated 30 April 2007, SP AusNet comments that the management arrangements have been set up to allow 'flexibility' in the way that the management company provides services to the regulated entities. The EUAA considers that the meaning of 'flexibility' in this case is very unclear - does this also refer to 'flexibility' in the way that the management company provides services to external parties? How are management costs allocated between regulated businesses?

In relation to the 'Management Fees' included within the opex budget for SP AusNet in the upcoming regulatory period, the EUAA notes that SP AusNet expenditure figure for the pervious (2003 – 2008) regulatory period includes $21.24 million ($2007/08) in management fees that was not allowed for in the original application, and this figure rises to $50.4 million in the coming revenue period, computed on the same basis.

If management costs are spread between the regulated businesses on the basis of 'effort' as described in that letter, can end users be satisfied that they are not paying a disproportionate share of costs, or that costs are not being double counted between regulated entities? This is particularly important as the regulatory periods for each of the electricity transmission, electricity distribution and gas distribution businesses are different, and spread between different regulators. This makes it difficult for one regulator to obtain a comprehensive, clear picture of the source and application of funds (management fees) at any particular point in time.

Finally, the EUAA notes the incentive arrangements that have been put in place and which appear to provide the management company with incentives to reduce costs within the regulated businesses. The EUAA believes that cost savings that can be achieved by the regulated businesses should be shared between those businesses and end users, rather than shared between the regulated businesses and management companies, through this type of incentive arrangement.

The EUAA also notes that 'management service charges' that are included within the management fee appearing in the opex proposals appear to incorporate a component of fixed increases not related to incurred management costs (see page pages 197 and 198 of the SP AusNet Prospectus and Product Disclosure Statement, lodged with ASIC on 4 November 2005) and the EUAA questions whether it is appropriate to allow fees such as these to be included within the opex allowance for the regulated business.

Additionally, the EUAA would expect that any move to such a structure would be expected to be predicated upon actually delivering lower costs or delivering productivity within the regulated business. The EUAA has difficulty ascertaining the existence of this from SP AusNet's application. The AER should ensure that the allowed opex reflects an efficient level of costs regardless of the management structure used. The AER has a vital role in ensuring that the management and fee structure that surrounds SP AusNet is tested to ensure this.

On a more general level, the EUAA is very suspicious about the value and actual purpose of such management structures. These could merely provide a 'front' to disguise costs and prevent regulators from revealing these hidden costs. The EUAA's suspicions are heightened by the experience of the ESC in relation to a similarly disguised structure used by Alinta/United Energy during the recent Electricity Distribution Price Review in Victoria, whereby the latter claimed that it could not reveal such costs and appealed an ESC ruling to infer a cost structure.

As with any assessment of opex, the regulator's assessment of external services should be robust and transparent with the regulated entity required to reveal the same details as for internally provided services. Given the apparent trend to such service structures, the AER needs to ensure that this happens and forces SP AusNet to reveal all relevant details of SPI Management Services.

WEIGHTED AVERAGE COST OF CAPITAL

Return on capital (WACC X Asset Value) accounts for a significant percentage of SP AusNet's annual revenue requirements over the next regulatory period. This aspect of any regulatory determination always provides strong incentives for ambit claims and exercise of 'strategic behaviour' by regulated entities during regulatory reviews (i.e. gaming of the process, setting of parameters and associated information).

The EUAA again puts on record is position that the decision by the Australian Energy Markets Commission (AEMC) to enshrine WACC parameters into the National Electricity Rules is poorly thought out and will not serve the interests of end users or the market objective well. We believe that the determination of the WACC is an integral part of any regulatory review and there should be consultation on it.

We provide the following comments on specific components of WACC in the following sections.

3.4 Risk Free Rate

The nominal risk free rate must be determined using a procedures set down in clause 6A.6.2(c) or (d) of the National Electricity Law. The EUAA notes that SP AusNet has applied this procedure in determining the notional risk-free rate that will apply for the purposes of the Final Decision.

The EUAA welcomes the AER's considerations on the risk-free rate outlined in the recently released Powerlink Final Decision that, in the face of some academic opinion appearing to suggest that the current method for determining the risk-free rate requires revision, the determination of the rate has considerable implications for the market and any review should be conducted in an environment where the issue can be comprehensively reconsidered. The EUAA looks forward to making a submission to such a review.

As an aside, and, consistent with the EUAA's submission into the Powerlink Draft Decision, the EUAA considers that, in the context of re-examining the methodology used to determine the risk-free rate or any other WACC parameters, it is crucial to re-assess the bond term used to determine the risk-free rate. The use of ten-year bonds as mandated by the current Rules ignores the fact that refinancing of debt can readily be undertaken in a financially mature market like Australia. Given the five

yearly regulatory cycle, it is more appropriate for 5 year bond rates to be used as refinancing can occur to coincide with the regulatory cycle.

3.5 Market Risk Premium (MRP)

Although the Market Risk Premium (MRP) is set at 6% by virtue of the operation of section 6A.6.2(b) of the NEL, the AER should be aware that that customers have never agreed that 6% is an appropriate MRP value. Customers have always contended that a 6% MRP is based on backward looking historical data, which tells us what the MRP was in the past but may have little relevance to how markets might behave in the future in the presence of significantly lower inflation and interest rates, for example. We note that whilst other WACC parameters are forward looking, the estimation of the MRP remains the only WACC parameter that still relies on backward looking historical trends.

The AER should note that UK regulators have all adopted a forward-looking market view in estimating the MRP. UK regulators adopt substantially lower values for the market risk premium (of 3.5% - 4.0%) than do Australian regulators, who all adopt values around 6.0%.

Recent regulatory decisions using an MRP of 6% grossly inflate the returns on equity above the level required by the market. Australian regulators should consider adopting a forward-looking MRP value, as implemented by overseas regulators, which would also be more consistent with the methodology applied in determining the other WACC parameters.

3.6 Equity Beta

The EUAA notes that the AER is locked into accepting a beta value of 1.00 by virtue of the operation of section 6A.6.2(b) of the NEL.

However, in principle, and consistent with the EUAA's previous submissions, the EUAA strongly believes that an equity beta of 1.0 is far too high for a regulated monopoly with guaranteed level of revenue.

By definition, the market as a whole has an equity beta of 1.00. Applying an equity beta of 1.0 for a regulated monopoly with guaranteed level of revenue implies that the AER believes that TNSPs are as risky as the market as a whole. This is incongruous when 99% of its revenue is guaranteed and total compensation for its

costs of service assured by the regulatory arrangements. We cannot emphasis strongly enough that there is no risk in this business!

Accordingly, the equity beta set by the AER for SP AusNet should be significantly less than one.

This position is supported by the Allen Consulting Group, which, in its report to the ACCC, *Empirical Evidence on Proxy Beta Values for Regulated Gas Transmission Activities*, dated July 2002, suggested an equity beta of under 0.7 for Australian gas transmission companies based on Australian market data.

Prior to handing over its energy responsibilities to the AER, the ACCC had also suggested that it was willing to consider equity betas as low as 0.35 (see discussions on the draft Statement of Regulatory Principles[3]). In addition, we note that the ACCC agreed in the GasNet case before the Australian Competition Tribunal that an equity beta of 1 was overly generous. That the ACCC had chosen to ignore its own consultant's advice and its own research into this matter in its past decisions is regrettable and has imposed additional costs on consumers.

Needless to say, these inflated WACC parameters are even more damaging in the current environment of extremely high electricity prices.

We note the ACCC statement in its Final Decision on Transend's transmission revenue application indicated that in future regulatory decisions it would incorporate equity betas, which reflect market information more accurately[4]. However, this promise does not seem to have been delivered yet?

The EUAA looks forward to expanding on this position closer to the review of the WACC parameters scheduled for conclusion by July 2009.

3.7 Debt Margin

The method for calculating the debt risk margin is set under clause 6A.6.2(e) of the NER, using government bonds, bonds with a BBB rating and maturity of 10 years.

3 ACCC *Discussion Paper, Review of the draft Statement of Principles for the Regulation of Transmission Revenues*, 2003,p.78

4 ACCC, Tasmanian Transmission Network Revenue Cap 2004-2008/9: Decision, 10 December 2003

There is no prescribed alternative method for the determination of the margin, although the EUAA notes that the methodology used in the Powerlink Decision differed from the methodology prescribed in the Rules.

In the absence of following the method prescribed in the Rules, the EUAA considers that the debt margin used for SP AusNet should be no more generous than that used for the Powerlink decision.

In the Powerlink draft decision, the 20-day moving average benchmark debt margin over the government bond yields for the relevant 20-day period for 'BBB+' rated corporate bonds with a term of 10 years was 1.14 per cent (effective annual compounding rate). The AER assumed that Bloomberg BBB bonds approximated 'BBB+' fair yields due to the estimation technique employed and the market being disproportionately weighted with longer term 'BBB+' rated bonds.

SP AusNet in their submission has indicated that the equivalent observed average over the twenty trading days between 30 October 2006 and 24 November 2006 for BBB-rated bonds is 115 basis points.

Accordingly, the EUAA considers that a debt margin of 115 basis points must form the very upper bounds of considerations relevant to determining the debt margin, if the methodology specified in the Rules cannot be applied. This is significantly lower than the 125 basis points argued for in SP AusNet's submission, which, from the EUAA's perspective, is not sustainable.

4 SERVICE STANDARDS AND PERFORMANCE INCENTIVE

The EUAA believes that it is important that electricity users obtain a reasonable level of service from the transmission system. We welcome steps taken to require TNSPs to implement some (limited) service standards, but believe that further steps are needed to establish a more effective and meaningful system of incentives for service.

The AER should already be aware of our strong views on the need for regulated transmission entities to be provided with incentives or service standards, particularly related to the impacts on the energy market (for example, due to outages for scheduled maintenance). This is axiomatic given the large impact, relative to transmission costs, that the actions of transmission companies can have on energy prices and their risk premiums.

We have also previously recommended that performance incentives for transmission entities would be more effective if applied uniformly across the NEM. Completing reviews and revenue re-sets for all regulated TNSPs at the same time would best do this. This highlights once again that the current arrangement of piecemeal review of individual TNSPs at different times is costly, inefficient and substantially reduces the benefit to end users of regulation. The benefits we see in aligning the regulatory review include:

- Enabling better benchmarking of cost and performance
- Consistent service standards for all TNSPs
- Consistency with the MCE's desire to have a common regulatory standard across jurisdictions
- Avoid some of the costs of conducting individual reviews

We urge the AER to ensure the alignment of regulatory reviews for all TNSPs to be undertaken at the same time.

Traditionally, TNSPs have achieved fairly high reliability levels. Consumer complaints regarding reliability are largely directed at distribution networks rather than the transmission system. However, an area where the transmission system has a significant impact is the effect planned and forced transmission network outages have on the pricing of energy in the wholesale electricity market. Inappropriately timed outages on the transmission system could significantly affect energy prices in the various energy market nodes leading to increased risk faced by retailers (and consumers). This results in a higher premium charged to consumers as retailers

seek to cover their exposure through higher cost one way hedge products. Accordingly, effects of transmission outages on the wholesale electricity market should be taken into account in assessing the performance of TNSPs, including SP AusNet.

The AER needs to resolve this question of outage scheduling as a matter of priority. While there seems to be two sides to this debate: one advocating the predictability of outage scheduling and the other promoting outage scheduling in response to spot pool prices, it is possible that a combination of both positions may produce the best result? That is, outages may be scheduled on a number of option dates, with the final decision made in response to forecast spot pool prices in the pre-dispatch or reserve margins in the short-term PASA.

In its previous five revenue cap decisions (PowerNet 2002, ElectraNet, Transend, EnergyAustralia and TransGrid), the ACCC has placed 1% of allowed revenue at risk for under performances. This implies that 99% of the TNSP's revenue is guaranteed regardless of the level of performance. In the extreme event that SP AusNet's performance deteriorates dramatically, consumers are still required to fund 99% of the allowed revenue.

Clearly, the commercial financial incentive of placing just 1% of revenue at risk does not provide a strong incentive for SP AusNet to meet required service standards. .

That 99% of full revenue is achieved by just meeting the average historical performance level shows just how much the regulatory framework protects the TNSPs. In the normal competitive environment in which most of SP AusNet's consumers operate, just meeting the average historical performance level would not guarantee past market share. Enterprises in a competitive economic environment must constantly improve their performance just to maintain their position. Only when its performance improvements are greater than its competitors would an enterprise begin to enjoy growth in revenues. Incentive regulation is meant to mimic the competitive market place and the AER needs to apply this competitive discipline to the businesses it regulates.

In previous decisions, the ACCC had structured its performance incentive scheme to achieve "revenue neutrality", whereby the TNSP's revenue over the regulatory period would be largely unaffected should the TNSP meet its historical performance levels. Consumers, however, would expect that, with consistently increasing capex and opex, TNSP's performance would generally be improving. As a result, the

performance incentive scheme would serve to provide up to a 1% increase in revenue to the TNSP on the back of investments that consumers are already paying for, with little downside. Meaningful "stretch factors" need to be applied to ensure that consumers are not simply paying an incentive bonus for the better performance that the increased investments would, in any event, bring.

5 CUSTOMER IMPACT

5.1 Average Transmission Prices

For consumers, the main impact of the AER's determination on this and every other transmission issue is what this application means for prices.

In its submission, VENCorp have forecast that average Victorian TUoS prices will increase from around $7.70 per MWh in 2008/9 (nominal) to around $11 per MWh (nominal) in 2013/14. This is a nominal increase of over 50per cent in six years, or a real increase of around 40 per cent. Such a large increase is totally unacceptable to the EUAA and its members given the comments made in this submission about SP AusNet's failure to adequately justify their proposed expenditure, their inflated rate of return and apparent lack of any significant increase in service levels.

This level of price rise is very significant and would represent an additional unwanted and totally unwarranted increase. Medium and large users will need to meet this substantial increase in charges in addition to added costs for generation, where (for example) one year forward contracts for peak electricity have increased from $57 / MWh to close to $100 per MWh since the start of the year, and these price increases show no signs of abating.

The rises in TUoS charges represent nominal cost increases of between 7% - 10% on a yearly basis. These cost increases are significantly above the inflation rate and draw attention for the need for the regulator to closely scrutinize SP AusNet's entire expenditure program to ensure that, where possible, the impact on energy users and -the economy that will result from these levels of cost increases is minimized.

5.2 Regulatory Framework

On a related issue, and consistent with the EUAA's submission on the SP AusNet revenue cap application, SP AusNet and other TNSPs are generally regulated via a revenue cap. As such, these monopolies face little, if any, volume risk both in terms of energy, maximum demand, or variation in customer numbers.

Should a business consumer reduce electricity consumption due to lower production or closure of the business, say due to the current very high electricity prices, all other consumers have to pay more transmission charges to "compensate" for the reduced revenue. In the event that a consumer leaves (eg a mine ceases operations due to

high power prices), the cost of transmission services for other consumers would rise accordingly to restore SP AusNet's revenue target. Even if performance falls and the quality of its services deteriorates leading to a lower demand, SP AusNet's revenue, under this regulatory arrangement, is assured with the transmission charges rising to compensate for the losses in volumes. This provides very little incentive for SP AusNet to produce a quality product to retain consumers and maintain volume.

This contrasts to price caps faced by some distribution Naps (eg in Victoria and New South Wales), whose regulated charges are based on average prices. These distributors at least face the prospect of lower/higher revenues should volumes, demand or consumer numbers fall/rise below forecast.