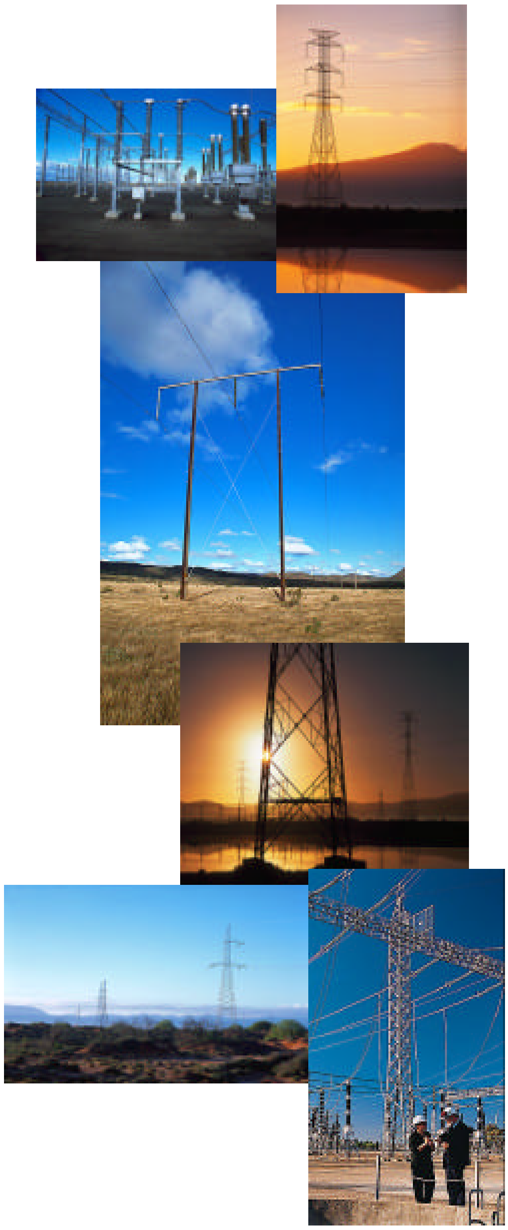
ElectraNet SA



Response to Meritec Asset Base Review

24 July 2002

ElectraNet SA
electricity transmission network

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1. Introduction

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

ElectraNet SA made a supplementary submission to the ACCC on the Regulated Cost of Easement Acquisition on 9 May 2002[2].

As part of its inquiry, the ACCC engaged Meritec to conduct a review that analyses and comments on ElectraNet SA's proposed opening asset value, capital expenditure and operation and maintenance expenditure allowances.

The ACCC published and invited comments on a Meritec report of its Asset Base Review on 11 July 2002[3].

This paper provides ElectraNet SA's response to the Meritec report.

2. Scope of Response

ElectraNet SA's response is focussed on the single issue of Meritec's recommended treatment of easement acquisition costs, which is covered in Section 5.3.2 of the Meritec report.

Easement costs are made up of two distinct components: compensation paid to property owners; and acquisition costs (also referred to as establishment or transaction costs), which are incurred by the utility in acquiring easements.

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

3. Valuation Methodology

In its *Draft Regulatory Principles*, the ACCC discussed various asset valuation methodologies and listed a number of pitfalls associated with valuations based on historic cost. The conclusion drawn was that:

> *"Therefore, the Commission will not consider historic cost as an asset valuation methodology"[4].*

ElectraNet SA agrees with this conclusion, which is consistent with the requirements of the National Electricity Code. There are no grounds for the ACCC to value assets, including easement rights, other than in accordance with the Code.

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1 "ElectraNet SA Transmission Network Revenue Cap Application 2003 – 2007/08", submitted to the ACCC on 16 April 2002.
2 "Regulated Cost of Easement Acquisition", ElectraNet SA supplementary submission to the ACCC, 6 May 2002.
3 www.accc.gov.au
4 *Draft Regulatory Principles*, p42.

The ACCC proposed that it would adopt a historic cost approach "*as the basis for the treatment of easements in the guideline on DORC valuations which the Commission will develop*"[5]. However, these guidelines have not yet been developed and are, therefore, not available to provide guidance on how easements should be valued.

It is important to recognise that even if the reasons given in the *Draft Regulatory Principles* for signalling a historic cost approach to easements are accepted, they can only apply to the cost of compensation paid to property owners and NOT to the costs of easement acquisition. Easement acquisition costs are not linked to property values and are not recoverable when an easement is resold.

The acquisition cost component of easements must be valued on a replacement cost basis in the same way as other network assets. Meritec have correctly recommended this approach to the valuation of easement acquisition costs in their report.

The *Draft Regulatory Principles* clearly did not contemplate these costs in its discussion of easement valuation. It appears that the distinction between easement compensation and easement acquisition costs may not have been understood at the time or that it was assumed that the latter costs would be treated in the valuation of transmission line system assets.

Either way the *Draft Regulatory Principles* is clear in its statement that:

> *"To the extent that the acquisition of easements requires expenditure by the TNSP it would be improper for the regulator to ignore their existence or deny a reasonable return on the funds employed"*[6].

Easement acquisition costs are real and tangible costs that have been incurred in the process of securing routes for transmission lines and must be appropriately recognised in ElectraNet SA's opening asset base.

4. Easement Acquisition Costs

4.1 Meritec's Recommendation

In Section 5.3.2 of their report, Meritec recommended an allowance of $36 million be introduced to the asset base before July 2000 to recognise easement acquisition costs; based on a valuation by Maloney Field Services (MFS) in 2000.

Meritec discounted the MFS unit rates because they claimed:

> *"a provision has already been made for the costs that are more in line with asset establishment than easement acquisition"*[7].

Meritec stated that:

> *"In our opinion an allowance for the route selection, environmental impact assessment and approvals was incorporated in the HMA 1995*

[5] Ibid, p46.
[6] Ibid, p45.
[7] "ElectraNet SA Asset Base Review", Meritec report to the ACCC, July 2002, p31.

valuations and retained through the SKM (Sinclair Knight Merz) 1998 review[8]".

Meritec concluded, therefore, that these components of easement acquisition costs are already included in the jurisdictional asset valuation.

4.2 Why Meritec is Wrong

Meritec is wrong for two reasons:

- Contrary to the claims made by Meritec, the jurisdictional asset valuation does not include any route selection costs or any other components of easement acquisition costs; and
- Given that Meritec has correctly recommended that easement acquisition costs should be valued on a replacement cost basis, then the valuation should be based on the more recent and comprehensive valuation conducted by SKM rather than the earlier MFS valuation.

<u>Easement Acquisition Costs excluded from Jurisdictional Asset Valuation</u>

In relation to the first point, ElectraNet SA provided Meritec with information to counter its claims in a paper "Clarification of Transmission Line and Easement Costs", dated 9 May 2002. This paper, which is included as an attachment to this response, draws the following conclusions:

> *"A review of the available documentation and discussions held with SKM has confirmed that the jurisdictional asset valuation made no allowance for any costs associated with easement acquisition, including route selection costs. This conclusion holds irrespective of whether route selection costs were or were not included in the 1995 HMA valuation"*;

and

> *"This conclusion means that the easement establishment or transaction costs that are included in SKM's April 2002 assessment can be appropriately added to the jurisdictional asset valuation without any double counting of route selection or any other costs. This has been confirmed with SKM".*

Further information was subsequently provided by SKM including the following statements:

> *"SKM has reviewed the above-mentioned document[9], and concurs completely with its contents and observations...*
>
> *SKM's project manager for the 1998 Electranet valuation review was Mr Kerrod Beaton, who is still engaged by the company, and is actively involved in transmission line valuations for transmission companies across Australia. Mr Beaton is also involved in the continuous updating of the SKM asset valuation database, and has recently confirmed that*

8 Ibid, p25.
9 ElectraNet SA paper "Clarification of Transmission Line and Easement Costs", 9 May 2002.

> *no elements of easement acquisition or route selection costs are included, or were ever included in SKM valuations.*
>
> *SKM can categorically and unequivocally confirm that its transmission line asset valuation database does not include any elements of route selection or easement acquisition costs. The database is constructed on the clear assumption that the transmission line is to be constructed on an existing easement.*
>
> *If the SKM valuation of 1998 is considered to be the jurisdictional asset valuation, then we can confirm that all aspects of route selection and easement acquisition costs are excluded."*[10]

Advice to the ACCC from the South Australian Department of Treasury and Finance[11] makes it clear that the jurisdictional valuation for transmission lines (at 1 July 1998) was the 1998 SKM valuation (and not the HMA or any other valuation).

Meritec's claim that some easement acquisition costs are already included in the jurisdictional valuation of transmission lines is clearly not consistent with the facts. There can be no question that route selection, EIS and public consultation costs were excluded from the jurisdictional valuation and that these costs need to be added.

There is no basis, therefore, for discounting the SKM or MFS unit rates in determining an appropriate value for easement acquisition costs.

Appropriate Valuation of Easement Acquisition Costs

Meritec reviewed easement acquisition cost models developed by both SKM and MFS and recommended a valuation based on the MFS model because "*The MFS modelling of easement acquisition costs is based on many years experience with the valuation of easements in SA*".

However, given that Meritec has correctly recommended that easement acquisition costs should be valued on a replacement cost basis, the valuation should be based on the more recent and comprehensive valuation conducted by SKM.

The SKM costs are the most recent, and comprehensive, set of easement acquisitions costs sourced from the most recent transmission line projects across Australia.

While MFS has extensive experience with the valuation of easements in South Australia, their expertise is in the role of property consultant and valuer. Managing Director Barry Maloney acknowledged in meeting with Meritec, urbis, ACCC and ElectraNet SA during the review process that route selection, environmental and public consultation costs would not have been adequately recognised in the MFS 2000 valuation.

[10] "ElectraNet SA Asset Valuation Review", SKM File Note, 8 June 2002.
[11] Letter from the Department of Treasury and Finance to the ACCC on the subject of ElectraNet SA's Regulatory Asset Base, 10 August 2001.

One would expect, therefore, the MFS valuation to understate the replacement cost of easement acquisition, even in 2000.

5. Conclusions

Easement costs are made up of two distinct components: compensation paid to property owners; and acquisition costs, which are incurred by the utility in acquiring easements.

The ACCC's *Draft Regulatory Principles* does not appear to recognise easement acquisition costs in its discussion of easement valuation. It is important to recognise that even if the reasons given in the *Draft Regulatory Principles* for signalling a historic cost approach to easements are accepted, they can only apply to the cost of compensation paid to property owners and NOT to the costs of easement acquisition. Easement acquisition costs are not linked to property values and are not recoverable when an easement is resold.

The acquisition cost component of easements must be valued on a replacement cost basis in the same way as other network assets. Meritec have correctly recommended this approach to the valuation of easement acquisition costs in their report.

However, Meritec are wrong in claiming that some easement acquisition costs are already included in the jurisdictional valuation of transmission lines. This claim is not consistent with the facts.

The jurisdictional asset valuation is based on an asset valuation by SKM in 1998. SKM has stated unequivocally that its transmission line asset valuation database does not include any elements of route selection or easement acquisition costs and that all aspects of these costs were excluded from the 1998 valuation.

There can be no question, therefore, that route selection, EIS and public consultation costs were excluded from the jurisdictional valuation (along with other easement acquisition costs) and that these costs need to be added.

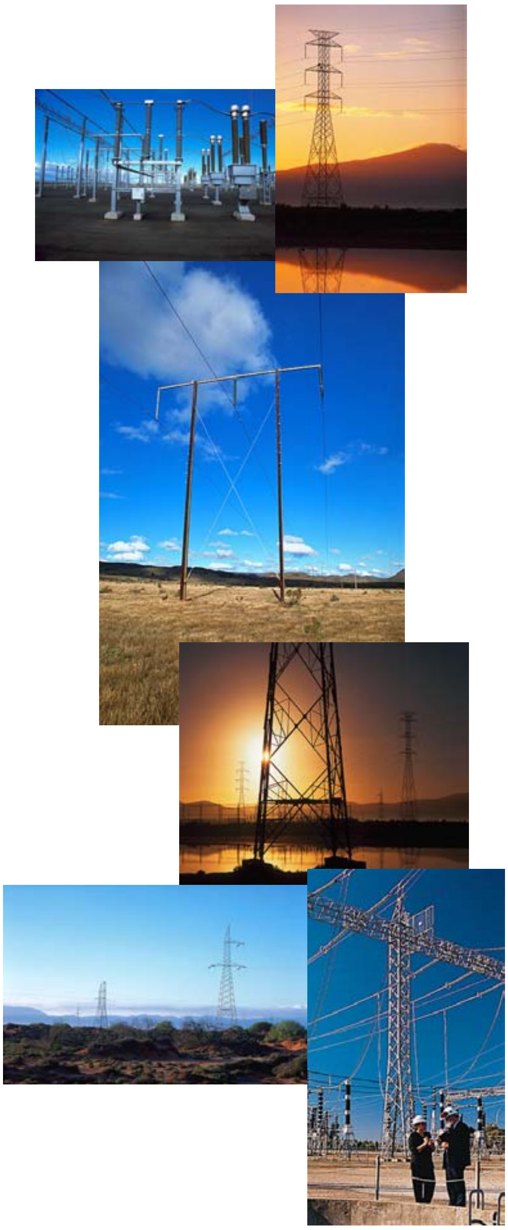
There is no basis for discounting the SKM or MFS unit rates in determining an appropriate value for easement acquisition costs.

Meritec's invalid discounting of unit rates understated the valuation of easement acquisition costs at $36 million (should be $47 million) based on the MFS cost model; and at $54 million (should be $87 million) based on the SKM cost model.

MFS acknowledged that route selection, environmental and public consultation costs would not have been adequately recognised in their 2000 valuation.

The SKM model is based on the most recent, and comprehensive, set of easement acquisition costs sourced from across Australia and provides the most appropriate basis for establishing a value for easement acquisition to be included in ElectraNet SA's opening asset base.

ElectraNet SA



Clarification of Transmission Line and Easement Costs

9 May 2002

ElectraNet SA
electricity transmission network

1. Introduction

The ACCC has commenced its review of ElectraNet SA's revenue cap application for the five and a half year regulatory period from 1 January 2003 to 30 June 2008.

Meetings involving ElectraNet SA, the ACCC and consultants Meritec and urbis were held over the two days 1-2 May 2002 to review the asset base aspects of ElectraNet SA's application.

One issue that was raised in connection with the valuation of easement establishment or transaction costs was whether any of these proposed costs[1], which have been determined from recent work undertaken by Sinclair Knight Merz (SKM)[2], are already included in the valuation of transmission lines.

The purpose of this note is to address the particular concern raised.

2. Discussion

ElectraNet SA's opening asset base for the purpose of its revenue cap application has been determined from a roll forward of the jurisdictional asset valuation, as required by the ACCC. The jurisdictional asset valuation was derived from a valuation of ElectraNet SA's assets by SKM as at 30 June 1998[3].

The SKM valuation reviewed an earlier 1995 valuation by Hill Michael and Associates (HMA) making appropriate adjustments based on:

- Changes in Modern Equivalent Asset unit rates since 1995;
- Additions and retirements since 1995; and
- Depreciation since 1995.

The HMA report includes typical easement acquisition and route selection costs (including environmental impact assessment and informing the government and public of the need for the line and possible options), but makes it clear that:

> *"The ETSA brief requested that easement costs be excluded and the database collates easement costs separately"[4].*

There exists some uncertainty about whether the route selection costs identified in the HMA report were excluded as well as the easement costs.

However, even if the HMA transmission line valuation included route selection costs this does not change the important conclusion that these costs were excluded from the jurisdictional asset valuation, which was based on the results of the 1998 SKM valuation and not the earlier HMA valuation.

1 "Regulated Costs of Easement Acquisition", ElectraNet SA supplementary submission to the ACCC, 6 May 2002.
2 "Easement Acquisition Assessment for ElectraNet SA", Sinclair Knight Merz Report, April 2002.
3 "ElectraNet SA – Regulatory Asset Base", Letter from the South Australian Department of Treasury and Finance to the ACCC, 10 August 2001.
4 "Valuation of ETSA Transmission Assets", Final Report by Hill Michael & Associates Pty. Ltd., 15 August 1995, p37.

The SKM 1998 valuation compared the base transmission line unit costs used in the HMA valuation and the SKM asset valuation database[5].

The report of the SKM 1998 valuation states that the SKM unit costs do not include easements. ElectraNet SA has verified that the SKM unit costs in this report are identical to those included in an asset valuation report prepared by SKM at around the same time for six major Transmission Network Service Providers. This report is very explicit and states that:

> *"The costs of line route selection, environmental impact assessment, easement survey, and easement negotiation and compensation were not included. The costs are the costs to build a line on an existing easement[6]".*

These statements make it very clear that the transmission line unit costs in the SKM asset valuation database are based on using an existing easement and therefore make no allowance for any costs associated with easement acquisition, including route selection.

SKM used its 1998 unit costs (excluding all easement acquisition and route selection costs) to assess whether any adjustment was required to the HMA 1995 unit costs and therefore the 1995 transmission line valuation.

Consequently, the jurisdictional asset valuation clearly excluded easement and route selection costs because it was derived from the SKM 1998 valuation, which excluded these costs.

This conclusion means that the easement establishment or transaction costs that are included in SKM's April 2002 assessment can be appropriately added to the jurisdictional asset valuation without any double counting of route selection or any other costs. This has been confirmed with SKM.

3. Conclusion

A review of the available documentation and discussions held with SKM has confirmed that the jurisdictional asset valuation made no allowance for any costs associated with easement acquisition, including route selection costs. This conclusion holds irrespective of whether route selection costs were or were not included in the 1995 HMA valuation.

It is essential that an appropriate allowance for the cost of easements be added to the jurisdictional asset valuation to ensure that ElectraNet SA is provided with a "*sustainable commercial revenue stream*[7]", as required by the National Electricity Code.

5 "ETSA Transmission Asset Valuation", Final Report by Sinclair Knight Merz to the South Australian Government, September 1999, p8
6 "Asset Valuation Guidelines", Final Report by Sinclair Knight Merz, July 1999, p29.
7 National Electricity Code, Clause 6.2.2(b).