Energy Transmission Easements

– A Commentary on Valuation used by Transmission Companies and Regulators

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Executive Summary

There are currently three access applications from energy transmission companies before the ACCC. Each has claimed that they are entitled to add to the regulatory asset base (RAB) an amount of money representing the amount "excluded" in the RAB from previous assessments of the assets used by the companies. In particular each has stated that the valuation of easements used for permitting the transport of the energy, was not in accordance of the ACCC draft statement of regulatory principles and therefore needs to be adjusted (specifically, increased).

It is quite clear that should the ACCC agree with the requests of the energy transport companies it will be in breach of a number of Code (Gas and Electricity) provisions, and further more will permit each of the companies to garner an unearned revenue windfall, paid for by consumers of gas and electricity.

There is no doubt that in the sale process of each of the companies, the values of easements were set prior to the sale and therefore this process defines accurately the market value of easements used by each of the companies

The ACCC must recognize that allowing the RAB to include the enhanced value of easements for GasNet, PowerNet and ElectraNet cannot be allowed.

1. None of the three transmission companies paid for the easements any more than the amount explicitly included for assets at the time of the sale of the assets. Thus, the sale process itself sets the value of the easements to be included in the RAB.
2. The Gas Code prevents the ACCC from adding to the initial asset base any amount other than the new investments.
3. The Electricity Code prevents the ACCC from using any amount for the initial asset base other than that included in the RAB set by the (previous) jurisdictional owner.
4. The Electricity Code requires the ACCC to only allow in the RAB the amount used by the jurisdiction to set the tariffs applying at the time of ACCC becoming the regulator.
5. To value easements at any amount in excess of the actual costs of acquisition is a travesty of the right granted by the community to over-ride the land rights of the owners of the land over which the easement has been granted.

Further, to escalate the value of easements above the actual costs of acquisition does not recognize the absurdity inherent in such an approach ("negative depreciation"), and which implicitly allows the asset owner increasing amounts of unearned income (monopoly rent) over time. The WACC return granted on the amount actually expended in directly acquiring the easement provides a fair return to the owner of the assets.

The Issue

There are currently three applications for access arrangements before the ACCC, by GasNet, PowerNet and ElectraNet, all of which seek the inclusion of the deprival value (DV) or depreciated optimized replacement cost (DORC) value of easements to be added to the regulatory asset base (RAB). In total the amount claimed as needed to be added exceeds $500M and if approved, will increase the revenue required by the three businesses by over $50M each year and the resultant effect will be a very significant increase in transportation tariffs.

Consumers are strongly of the view that inclusion of easement value at anything more than the un-escalated actual costs incurred in the acquisition of the easement, is an ambit claim and is totally inappropriate.

Features of Easements

In a paper by Dwyer and Lim[1] they argued that easements used by energy transmission businesses were over a range of land ownerships – private and public. Gaining access to easements over private land has been assisted by legislation and use of the land by the owner over most cases has not been greatly affected (eg grazing and crops still occur in these easements). Infrastructure licensees (of easements) should not be allowed to charge monopoly rents on easement rights, which have been provided at little or no costs though legislation overriding normal property rights.

Dwyer and Lim said:-

> "Those infrastructure owners who talk of the risks of regulation should be asked whether they wish to have *no* regulation. Do they wish to be sued as trespassers or have their infrastructure torn up by the thousands of landholders whose properties they lay their structures over? The logic of "no regulation" is negotiation logjam for infrastructure projects where, as in Papua New Guinea, any landholder can hold an infrastructure project to ransom. A situation of "no regulation" would deter investment more surely than a system of regulation which combines on the one hand free access to developers with a reasonable rate of return on invested capital. In this regard, the Position Paper at page 52 fails to understand what the "no regulation" option really is: it is reverting to the common law and allowing any landholder to block access for infrastructure developers across his property. For example, if I am content to use a mobile phone and do not care for pay TV, why should I as a landholder not seek to extract monopoly rents before allowing Telstra to run its lines across my land? It is not to the point for Telstra to argue it has an easement: that easement is the result of regulation in its favour - it is not a "no regulation" world if people are

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1 Does Access Regulation Deter Investment. Submission to the Productivity Commission Inquiry Into The National Access Regime July 2001, Dwyer T and Lim B.

> empowered by statute to come across my land without paying me for my consent."

In the same paper they go on to say

> "Just as legislatures have usually been zealous to prevent recalcitrant landholders extracting monopoly rents from the community by threatening to block socially desirable infrastructure projects unless paid exorbitant charges for access, so the same considerations require that legislatures be equally zealous to prevent the extraction of monopoly rents by the infrastructure licensees. This mutuality of social obligation was perhaps more clearly seen when it was State legislatures which granted State semi-government authorities easements and rights of way at no cost on the basis that they were non profit public utilities. In addition, some semi-government authorities, notably in water, were given rating powers to recoup towards their fixed capital costs some of the external benefits conferred in the form of added land values (yet externality seems strangely not to feature in the Productivity Commission's examination of optimal infrastructure regulation and pricing). Infrastructure owners cannot take the benefits of legislation overriding normal property rights in their favour while seeking to cavil at regulation preventing an abuse through monopoly rent seeking of the rights thereby conferred on them."[2]

There is legislation in each jurisdiction allowing for the compulsory acquisition of land and easements when required for the benefit of the community at large, and this legislation does not differentiate between private or public business need for the land or easement acquisition. The support of legislation has been seen as necessary to ensure that the common good of the community is not jeopardized by the acts of a relative few in the community, who may wish to oppose the developments or seek to acquire monopoly rents. Legislation ensured that the few affected by the need for the easement were recompensed in a way seen as acceptable *measured by the norms at the time of the acquisition.*

On 25 Jan 2000, the ACCC in its Final Decision on the TransGrid application for an access arrangement over its electricity transmission system noted it had commissioned consultant engineers SKM to review certain aspects of the TransGrid application. The ACCC stated in the Final Decision:-

> "SKM went on to comment that electricity easements have unique characteristics:
>
> - a registered [electricity] easement is a right to construct, operate and maintain a power line and does not involve ownership of the land under the line;

2 Op Cit.

- a registered easement is usually granted in perpetuity. The corporation thereafter does not have to provide for replacement of the "asset" in the future, nor to provide for depreciation;
- there are only minimal administration costs to the corporation associated with maintaining or operating the 'asset'. The original vegetation clearing and access track construction are included in the line cost. Regrowth control and access track maintenance are included in the cost of line maintenance as it is mainly performed to ensure safety and the security of the line;
- if the line is removed the value in the books cannot necessarily be recovered. If an easement is extinguished it may be possible to recover the compensation paid to the original [land]owner or some greater amount but even this is dependent on the present owner agreeing to pay it. In addition, some easements for future lines are in developing areas where rezoning of areas may take place. These may not be able to be used as planned for future lines due to environmental or political pressures.

SKM stated that these characteristics meant that it could be argued that the use of deprival value (including ODRC concepts where the value of the easement is based upon the value of the property over which it sits) is inappropriate in its application to this class of asset, particularly in the context of how a regulator should treat the issue of 'windfall' gains to the network generated by increases in the underlying property values."

The SKM observations are quite telling. Summarizing the points made:

- The easement is only granted for the purpose of transmission of a specific from of energy.
- The regulated business (present owner of the easement rights) cannot dispose of the easement whilst its transmission assets are in use in that easement.
- In the event that the regulated business was required to surrender an easement included in its portfolio, the easement would most likely either revert to the landowner or to another entity which was to transmit the same form of energy for which the easement was granted.
- It is unlikely that sale of an easement would recover the DORC value placed on the easement by regulated business (i.e. there is ultimately no deprival value).

It needs to be accepted then that a regulated business, on wishing to renounce the easement, would have as the only potential acquirers of the easement

1. the land owner (unlikely to pay for this, as the land use will continue as before), or
2. the acquirer of the electricity assets requiring the easement.

Thus, the value to the current beneficiary of the easement certainly can at most, only represent the cost to acquire the easement, and it is most unlikely to have a realizable sale value.

It should also be noted that the land interest (easements) granted to transmission companies is not subject to rent i.e. the landowner does not/cannot charge a rent for the land interest. Yet, these same companies are seeking to charge a rent (at inflated values) for a land interest acquired at minimal cost (mere disturbance compensation). Logic would suggest that if these companies wish to charge a rent, they should in turn be required to pay a rent to land-owners.

The inclusion into the RAB of the apparent value of easements used by transmission businesses has been hotly debated at times with those ultimately paying the cost of the easement believing that the easement should be valued at the actual costs incurred and no on-going rental payments to land-owners need be made, as no rent is paid to land owners by the transmission businesses.

This then leads to the very fundamental question of why an easement should be subsequently valued using commercial rates by regulated businesses?

The second fundamental question then becomes what should be used for the value of easements in the RAB if the actual costs are in dispute or where they cannot be identified as a long time may have elapsed since acquisition.

There are two responses to this question.

The first is that the National Electricity Code (NEC), which was developed by jurisdictions, addresses this issue in that it allows the governing jurisdiction to decide the amount it wants placed on the easements to be included in the RAB.

The second response is that the easement should be valued at the likely costs that would have been incurred *at the time of acquiring the easement,* with the recompense being that amount permitted *by the legislation applying at that time.* There is no basis for the acquisition costs to be escalated into current dollars, nor for the easement value to increase in line with adjacent land values.

The Deprival Value for easements should be zero

An easement is granted by State legislation in perpetuity for a specific purpose, recognized to be in the interests of the public at large. The laws

permitting this were framed by the representatives of the public, with due consultation. In the issue of easements the Courts uphold the right of the community to require individuals to cede certain rights over land ownership in the overall interests of providing for the good of the community.

In granting the right of easement, it is accepted that the owner is restricted in exercising certain rights of use of the land over which there is an easement. In the event of the renouncing of the easement the only beneficiary is the owner of the land. The easement rights for the particular purpose of the easement can be sold to another person, but only for the right to continue with the purpose for the easement originally granted.

The community does not expect that a holder of an easement should profit by the trading of easement rights, as the right was granted for a specific purpose seen to be in the overall interest of the community.

Legislation (which has changed over the years and from jurisdiction to jurisdiction) recognizes that a land owner should be entitled to recompense for the loss of some amenity over the land owned, and formulae have been developed to put a financial envelope around this compensation. This compensation is paid by the community either directly or indirectly for the reduction of amenity to the owner. Should the easement be no longer required then the full entitlement to the land should revert to the land owner, probably accepting that the compensation already paid has reimbursed the land owner for the loss of amenity for the period the easement was extant. As it is the community that initially required easement to be granted, it is therefore reasonable that the community should be the beneficiary of the renouncement of the easement right.

In simple terms, the community paid for the imposition of the easement and the community should be the beneficiary of its renouncement.

It would be in only very exceptional circumstances that an easement can be seen to have a financial value, when there is a willing seller no longer requiring the easement and a willing land owner seeing a benefit arising from the extinguishing of the easement. Such an example might be the land owner seeing that the relinquishment of an easement would allow greater use of the land covered by the easement, as in a near urban environment.

Thus, the holder of the easement can either sell the easement right (in this case the easement then only provides the acquirer the right to carry on a specific business using the rights permitted by the easement), or renounce the easement and except in the case the land owner wishes to purchase the easement right for gain, the deprival value of the easement value is effectively zero.

The different approaches used by GN, PN and EN for valuation of easements

In the two reports commissioned by the ACCC with regard to the ElectraNet and PowerNet revenue cap applications ((Meritec P/L and PB Associates respectively) it is apparent that the ACCC directed both independent reviewers to have due regard to the approach for valuing easements which is enunciated in its draft Statement of Regulatory Principles (SoRP). This draft statement relates to electricity transmission businesses regulated by the ACCC under the National Electricity Code.

GasNet

The valuation approach taken by GasNet (a gas transmission company) is in its submission on pages 33 and 34. GasNet states that the easement valuation principles enunciated in the ACCC SoRP should apply equally to both gas and electricity transmission and goes on to say:-

> The GHD valuation of easements involved estimating the land area covered by the easements and then estimating the average land values which the easements covered. The final figure of $40.15 million was arrived at by adopting average compensation rates, including injurious affection of 35% for "rural land" and 40% for "residential and industrial land".
>
> GasNet submits that the GHD valuation of GasNet's easements is consistent with the ACCC's Draft Regulatory Principles and should be adopted as the appropriate valuation of GasNet's easements.
>
> The validity of this valuation is supported by a subsequent valuation commissioned by GasNet. In 1999, A.T. Cocks Consulting valued the replacement cost of GasNet's easements at $108 million. This figure included fixed costs such as valuations, cost of negotiations, as well as injurious affection, solatium and damages compensation from construction. The actual cost of the purchase of the "interest" in the land (based on a percentage of freehold value) was determined as being approximately $43 million. Costs of negotiating Native Title are not included in these figures.

In summary, the GasNet proposal is predicated on a DORC assessment of easement value backed up by a secondary "independent" valuation. It is of interest to note that the valuation is based on assessed real land values discounted by estimated rates for "injurious affection". There is no attempt to verify the land value or demonstrate the validity of the discount for either of these amounts, nor to consider alternative methods for easement valuation. What is even more breath-taking is that a claim for 'injurious affection, solatium and damages compensation from construction' is being made, notwithstanding

that GasNet had not explicitly incurred these costs. As a gracious gesture, the 'costs' of negotiating Native Title are not included.

GasNet makes no attempt to identify what the actual costs were, or might have been based on the rules of the Land Acquisition Act applying at the time of the easement acquisition.

However, the only value allowable under the Gas Code to be included in the asset base is for "pipelines". The National Gas Pipeline Act[3] defines pipeline as

> "**pipeline"** means a pipe, or system of pipes, or part of a pipe, or system of pipes, for transporting natural gas, and any tanks, reservoirs, machinery or equipment directly attached to the pipe, or system of pipes, but does not include—
> *(a)* unless paragraph *(b)* applies, anything upstream of a prescribed exit flange on a pipeline conveying natural gas from a prescribed gas processing plant; or
> *(b)* if a connection point upstream of an exit flange on such a pipeline is prescribed, anything upstream of that point; or
> *(c)* a gathering system operated as part of an upstream producing operation; or
> *(d)* any tanks, reservoirs, machinery or equipment used to remove or add components to or change natural gas (other than odourisation facilities) such as a gas processing plant; or
> *(e)* anything downstream of the connection point to a consumer;

In this definition of pipeline there is no mention of easements (which are clearly not pipelines as defined) being permitted to be included as an asset and therefore to be included in the RAB.

It is emphasized here that under the reference tariffs principles provisions of the Gas Code, the determination of the initial capital base is based on a range using the DAC approach as the lower bound and DORC as the upper bound. The Gas Code, however, does not explicitly mention easements in the determination of the initial capital base. It is, therefore, wrong for GasNet to assert similarities between the regulatory treatment of electricity and gas transmission.

It is interesting to observe that GasNet, however, does recognize the difficulty in depreciation of easement value and notes that:-

> "As this is the first time easements will be included in the determination of Reference Tariffs the issue of updating the valuation for the period up to 1 January 2003 (and the associated "negative depreciation") does not arise. Going forward, easements will be depreciated at the same rate as the associated pipelines (on the basis that once the pipeline's life has ended, the life of the easement has also ended)."

It is noted here that in the case of easements with perpetual lives, normal depreciation concepts are irrelevant. Land or easements are not depreciated.

3 Gas Pipelines Access (SA) Act 1997, schedule 1, Part 1

If properly maintained, such items have a perpetual life. Valuing easements at DORC and applying depreciation (such as the so-called "negative depreciation") will mean that depreciation charges will in time significantly exceed original costs.

In Walker and Walker[4] reference is made to the NSW Auditor-General's report to Parliament in 1990 in relation to the revaluation by the Sydney Water Board and other agencies, and the effect of those revaluations on reported 'costs':

> It is the flow-on effect of additional depreciation charges following asset valuation which is my major concern. This effect is displayed by increased costs and depressed operating results in Income and Expenditure Statements. My concerns in this area are that costs will be overstated, that increased prices will be more easily justified and that depreciation charges will in time exceed original cost.", Walker and Walker (2000, p 98)

PowerNet

The valuing approach taken by PowerNet (a electricity transmission company) and reviewed by PB Associates shows that the asset valuation for easements follows a recorded cost basis, with actual costs being escalated by 100% of CPI, and other associated costs being estimated.

Whilst PBA recognized that the recorded costs provided substantiated a high level of the payments to landowners, they noted there was no record of other costs and therefore assumed that they had been incurred but not recorded. That such costs may have been "expensed" as normal operating expenditure was not considered. Based on the historical approach to such issues, and the fact that there were detailed records made of "payments to landowners" but not of internal costs, it is most likely that these costs were either not incurred or were indeed considered as part of the normal running expenses of the business and recovered as normal "opex" costs and never capitalized into the asset register. Operating expenses are included in the annual revenue stream recovered under the tariff.

In its review of the proposal by SPI for inclusion of easements, PBA seems to support the SPI approach for escalating the costs of easement compensation. This approach fails to recognize that that the easements were acquired as part of the sale process of PowerNet to GPU and that the value of easements was implicitly defined by an amount included within the asset valuation *at the time of acquisition.* For PBA to assess that the easements have a greater value than that included at the time of the sale is incorrect, as this would mean that

4 Walker, Bob and Betty Con Walker (2000) *Privatisation: Sell off or sell out? The Australian experience,* ABC Books, Sydney

the subjective valuation methods used are more appropriate than the valuation put as part of a sale process.

Thus the only legitimate costs for inclusion into the asset base would be the amounts included in the sale process, or as a distant alternative, the recorded costs although there is no case for escalating these by the CPI for to do so provides a perpetual 'free lunch' in economic terms.

ElectraNet

In its initial submission ElectraNet (an electricity transmission company) stated that only $3.1M had been included in the RAB for easements by the jurisdiction.

ElectraNet stated that it needed to include in the RAB the amount of $123M assessed by SKM in 1998 (following on from a review by Hill Michael Associates in 1995) for the "replacement cost of easements" and which had been excluded from the RAB. These amounts were based on a DORC approach to asset valuation. They noted that the SKM assessment excluded "easement compensation costs". The methodology described assumes that all easements acquired to date reflect an approach to easement acquisition which includes the cost for the widest range of all possible issues which might confront an easement acquirer in today's climate. Such an approach would result in the highest possible DORC value.

ElectraNet provided further argument for increasing the value of easements in a subsequent submission (dated 9 May 2002), stating that previously excluded costs (easement compensation costs) were valued by Maloney Field Services at $131.7M in 1997. MFS used a "deprival" valuation technique.

Using these various reports as a basis, ElectraNet in its additional submission has stated that their assessment of the value of the easements should be $215.3M (as at 7/99).

In the subsequent submission on easement valuation ElectraNet advises that the recorded costs would have excluded the full benefit provided the land owner, including "in kind" recompense such as gates, fences and roads. ElectraNet fails to note that such other expenses might never have occurred or would have been "expensed" as part of normal operating expenses, and therefore recovered within the tariff at the time.

In its review of the asset base on behalf of ACCC, Meritec notes that:-

> "All parties acknowledge that the initial asset value was a totally inadequate reflection of the value of such easement assets within the network."

This statement is not only inaccurate but also inappropriate, as "all parties" affected by the Meritec work, were not consulted on this issue, such as those

representing consumers. We would have thought that Meritec is not required to comment on the adequacy or otherwise of what is included in the RAB to underpin the EPO. To reflect independence it should only advise the ACCC on the appropriateness of the costs and claims made by ElectraNet. This raises very substantial concerns about the terms of reference provided by the ACCC to Meritec in relation to the consultancy.

The Meritec review of the ElectraNet asset base accepts the costing approach implicit in the MFS calculations. However, as is the problem with DORC/Deprival valuations, so much of the computation is predicated on assumptions which cannot be proven. Meritec makes no comment as to the subjective nature of this approach to easement valuation. They do, however, refer to the work of PB Associates with regard to the PowerNet easement issue, but fail to comment on the PBA acceptance of the actual cost approach to easement valuation used by PowerNet.

There is no doubt that the issue of whether easements should be included in the RAB, and at what level. There are three access applications before the ACCC and each has a different approach to addressing the issue of easements. The only common thread between the three, is a claim to increase the RAB above the value clearly included for easements by the jurisdiction selling the assets, prior to the sale of the assets, and already included in the RAB.

There is conflict as what to allow for easements

There is a need to address the essential conflict between the ACCC direction in its draft SoRP, that of IPART/ERTF (NSW) and QERU (Queensland) who allowed for a different approach giving a modest easement value, and ORG/ESIRU/EPD (Victoria) and ERSU (SA) who effectively assessed easements at a negligible amount**.**

However to assess how the valuation of easements is to be treated requires review of the National Gas Code and the National Electricity Code.

An overview of approaches used

The ACCC has issued its draft statement of regulatory principles (SoRP), which still has to reach a final position on a number of issues, including valuation of easements. Many stakeholders, including the Business Council of Australia, had expressed strong reservations in the ACCC's draft approach. The ACCC has never debated the easements issue with consumers. For example, in response to concerns about its apparent DORC approach to easements, the ACCC has pointed to its intention to consult stakeholders when its promised valuation statement is prepared prior to December 2002. Until then it is assumed that nothing has been set in concrete.

There is also a need to review the approaches taken by the various State jurisdictions prior to regulatory control for transmission assets being transferred to the ACCC's jurisdiction.

The Victorian Regulator has valued easements at zero, whilst the NSW IPART values easements at actual costs. It is instructive to note IPART's[5] comments:-

> "….the Tribunal recognizes that the easements are required by the DNSP to provide electricity services. Electricity easements are generally granted in perpetuity. Gradual growth in load and the difficulty and expense of negotiating a new easement means that they are almost never replaced. Indeed, a network is for more likely to seek to alter the terms of an existing easement to allow a different sized wire to be erected rather than to extinguish the easement and negotiate a new one. The restrictive nature of easements (e.g., being as easement only for electricity distribution lines) may mean that they do not have value to any other entity.
>
> The Tribunal considers that including a market value for existing easements in the initial asset base is of no economic benefit. In addition, price shocks of this magnitude are unacceptable. Should new easements have to be acquired the expenditure will be considered on the same basis as the other elements of capital expenditure.
>
> The issue of the treatment of easements highlights the difference between the assessment of the DORC from the perspective of a potential new entrant and that of the incumbent. For the incumbent, existing easements formally acquired will not need to be replaced. Hence, such costs will not form part of the forward looking costs of maintaining and replacing existing capacity. A new entrant would need to acquire new easements. However, the costs of acquisition of new easement at current property values would need to be factored into the optimization of the network in this case. Hence, it would be inappropriate to limit the optimization by assuming current paths are used".

The National Gas Code Clauses 8.10 and 8.12

The Gas Code states that for existing pipelines there needs to be consideration of a number of asset valuation methodologies, the basis of tariffs set in the past and the reasonable expectations from earlier regulatory regimes. However, there is no explicit consideration of easements.

> ***Initial Capital Base - Existing Pipelines***
> 8.10 When a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the following factors should be considered in establishing the initial Capital Base for that Pipeline:

5 Pricing For Electricity Networks And Retail Supply-Report. Volume 1. June 1999

(a) the value that would result from taking the actual capital cost of the Covered Pipeline and subtracting the accumulated depreciation for those assets charged to Users (or thought to have been charged to Users) prior to the commencement of the Code;
(b) the value that would result from applying the "depreciated optimized replacement cost" methodology in valuing the Covered Pipeline;
(c) the value that would result from applying other well recognized asset valuation methodologies in valuing the Covered Pipeline;
(d) the advantages and disadvantages of each valuation methodology applied under paragraphs (a), (b) and (c);
(e) international best practice of Pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries;
(f) the basis on which Tariffs have been (or appear to have been) set in the past, the economic depreciation of the Covered Pipeline, and the historical returns to the
Service Provider from the Covered Pipeline;
(g) the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code;
(h) the impact on the economically efficient utilization of gas resources;
(i) the comparability with the cost structure of new Pipelines that may compete with the Pipeline in question (for example, a Pipeline that may by-pass some or all of the Pipeline in question);
(j) the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase; and
(k) any other factors the Relevant Regulator considers relevant.

In the case of new pipelines easements are also not explicitly recognized.

Initial Capital Base - New Pipelines
8.12 When a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that has come into existence after the commencement of the Code, the initial Capital Base for the Covered Pipeline is, subject to section 8.13, the actual capital cost of those assets at the time they first enter service. A new Pipeline does not need to pass the tests described in section 8.16.

Again there is no clear direction that easements should be included in the valuation of pipelines, and to do so is therefore an *interpretation* of the Gas Code and the definitions in the Gas Act. At best, the implication of the Gas Code might be that easements (of existing and new pipelines) should be valued at un-escalated actual cost or preferably what was previous practice in the jurisdiction.

The ACCC has previously valued easements under the Gas Code at actual costs incurred

The National Electricity Code (NEC)

Within the NEC there is no differentiation between existing or new assets. Land needed for assets (eg substations) is clearly delineated away from any reference to easements.

Code provisions related to this issue are:-

6.2.2 Objectives of the transmission revenue regulatory regime to be administered by the ACCC

The *transmission* revenue regulatory regime to be administered by the *ACCC* pursuant to this *Code* must seek to achieve the following outcomes:

6.2.2 (c) prevention of monopoly rent extraction by *Transmission Network Owners* and/or *Transmission Network Service Providers* (as appropriate);

6.2.2 (g) reasonable recognition of pre-existing policies of governments regarding *transmission* asset values, revenue paths and prices

6.2.2 (i) reasonable regulatory accountability through transparency and public disclosure of regulatory processes and the basis of regulatory decisions

6.2.3 Principles for regulation of transmission aggregate revenue

The regime under which the revenues of *Transmission Network Owners* and/or *Transmission Network Service Providers* (as appropriate) are to be regulated is to be administered by the *ACCC* from 1 July 1999 in accordance with the following principles:

6.2.3(d)(4)(iii) subject to clauses 6.2.3(d)(4)(i) and (ii), assets (also known as "sunk assets") in existence and generally in service on 1 July 1999 are valued at the value determined by the *Jurisdictional Regulator* or consistent with the regulatory asset base established in the *participating jurisdiction*

6.2.3(d)(5)(iv) relevant previous regulatory decisions made by authorised persons including:

A the initial revenue setting and asset valuation decisions made by *participating jurisdictions* in the context of industry reform pursuant to the Competition Principles Agreement

ACCC draft SoRP 27 May 1999

“Sec 3.4

A DORC valuation may be performed as part of the regulatory review. If this were used as the basis for [the current asset value] rather than the value based on depreciation of previous asset values there may be a windfall capital gain or loss involved. This is not intended ... .”

“Sec 4.2

Overview of Chapters 4 and 5

In order to determine the TNSP’s return for each regulatory review the Commission will need to track asset values as shown in Figure 4.1.”
[Figure 4.1 describes new RAB as being derived from the opening value of assets less depreciation over the period plus capital expenditure less asset disposals equals closing value of assets]

The draft SoRP goes onto address easements in the following terms

“*Easements*

Also creating concern is the relevant treatment of non-system assets, in particular easements. Easements are essentially access corridors which have been granted to the TNSPs, however once granted there is an issue as to how they should be valued. It is questionable what their value in an alternative use is? In obtaining these corridors compensation has in some circumstances been paid to land owners or there are lease arrangements on the land acquired for the easement.

Another issue is whether it should be assumed that the network is built instantaneously to a configuration that is optimal for existing and projected demand, or whether it should be assumed that the network has grown incrementally - as it would in the normal course of business to meet current and prospective demand. For consistency it would seem appropriate to value the optimized portfolio of easements as an integral part of the broader optimization assessment.

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. However, such assets do not deteriorate in the same way as mechanical assets and it would not seem to be appropriate to write–off the assets over time. Indeed, some easement rights may be resold at a price exceeding their initial cost. Such a capital gain would reflect a return in addition to the normal regulatory rate of return on assets. This raises issues regarding the rate of return that should apply to such assets and how such assets should be reflected in the RAB on a continuing basis.

The normal DORC methodology would assign values to such assets reflective of their market value. Given the strong link with real estate values there is a likelihood that the value of easements will escalate continuously over time, at times in excess of the rate of increase in the CPI. The question is how to introduce such assets into the regulatory framework in a consistent way. One consistent approach would require:

- The contribution to the RAB be based on the actual cost to the TNSP of obtaining the easement rights updated periodically in line with what would be the DORC based valuation of easements. On the basis of legislated mechanisms for purchase of easements both of these valuations would normally be in line with what was considered the loss of amenity to the previous owner of conceding the easement right (that is its social cost).

- To the extent that easement valuations are judged to vary over time, the variations in value should be reflected in depreciation allowances linked with the asset in precisely the same way as other assets. If the easement appreciates in value over time then the allocated depreciation would be negative in nominal terms and serve to offset the higher capital returns associated with an appreciating asset value.

- If the easement right is resold, the RAB value should be close to the sale price given the basis for valuation updates. Hence, the issue of return associated with possible capital gain, and its effect on overall regulatory return, disappears. Should there be a residual capital gain or loss it will be hopefully small enough in magnitude to be accommodated by depreciation adjustments to the regulatory asset base at the start of the next review period in a way similar to that used to account for errors in depreciation associated with forecast capital expenditure that does not take place as planned.

The advantage of this approach is that the valuation remains comparable to costs faced by a potential entrant while maintaining cost of service pricing which takes full account of the social cost of the resources employed. Inclusion of the easement value within the RAB provides the incentive for the TNSP to acquire easement rights to expand the network as required. If the value in the alternative use of the easement (its social value) exceeds the cost of alternatives such as underground cabling – the TNSP has an incentive to realize its market value and adopt the lower cost alternative since the DORC basis for the RAB means that it will only reflect the lower cost alternative.

The Commission is attracted to this approach and proposes to adopt it as the basis for the treatment of easements in the guideline on DORC valuations which the Commission will develop."

The ACCC SoRP is still a draft document and regardless of what it states, the ACCC is still required to address issues in accordance with the Electricity and Gas Codes.

In its assessment above, there are a number of incorrect assumptions made:-

- The ACCC approach on easements runs contrary to the stated aim in section 3.4 (windfall gains are not intended) and in section 4.2 (carry forward of the previous regulated asset valuations)

- ACCC equates the value of easements with the value of land, and then sees that the easement value would increase with the general trend in land values. This assumption is incorrect as it assumes that the cost of easement acquisition is based on the cost of land. In fact the cost of easement acquisition is related to the rules applying under State legislation for the compulsory acquisition of land and certain rights over land. Thus, to equate easement value with that of land bought and sold on the open market is fallacious. As noted above GasNet recognised this issue and stated that at the end of the economic life of the pipeline, the easement has no value
- An easement value does not depreciate nor escalate in proportion to the value of land generally. Its cost (and therefore value) varies with the rules applying under State legislation for land and land right acquisition.
- The sale of an easement right can only be for its relinquishment (to the land owner) or to a party looking to use the easement *for exactly the same purpose* as the easement holder initially acquired the easement. Whereas land can be freely traded (subject only to zoning restrictions), easements do not exhibit the same flexibility of ownership or usage.

In its second last paragraph on easements in the SoRP, ACCC states that:-

> Inclusion of the easement value within the RAB provides the incentive for the TNSP to acquire easement rights to expand the network as required.

This statement has enormous implications and makes rash assumptions. It must be remembered that an easement is only granted by the community for the overall benefit of the community at large, it is not granted for the acquirer to be incentivised to acquire more easements. Further, the granting of an easement is not a precursor to network expansion, it is only intended to facilitate the expansion of a network as and when such expansion is needed by the community. Thus, easement valuations should not be used as a vehicle for incentivising network service providers.

The approach implied by the ACCC then immediately leads into another major conflict – that of acquisition of monopoly rents.

Although assumed by the ACCC to be permitted, it is arguable that the approach to asset valuation in the Gas Code *at best* essentially only permits the asset owner to include only the actual cost of easement acquisition into the RAB. It certainly does not permit the easement cost to be escalated by adjacent land values and therefore only permits the asset owner to gain a return on the actual cost of acquiring the easement.

However, the approach taken in the SoRP (presumably to apply only to electricity easements) clearly anticipates that the TNSP will see growth in the

value of the easement and permits a return on the inflated values. However, the ACCC is required under the NEC to ensure that there is no monopoly rent included in the electricity revenue (NEC 6.2.2 (c)). Thus, in its approach to valuation of easements the ACCC must ensure that in granting a return on an asset which has not been previously incorporated in the asset base, that its inclusion does not allow the asset owner any unearned income. Further, during the life of the easement, the ACCC should not allow the TNSP to gain an unearned increase in the value of an asset (such as by negative depreciation). To allow either of these circumstances to occur will permit the monopoly asset owner to levy a monopoly rent.

Further, the SoRP does not reflect the approach which may have been the desire of the jurisdiction within which the asset is held. Both the Gas Code and Electricity Code are very specific in what the *maximum* values which can be used, but there is no limit as to the lowest value that can be put on an asset. Under both Codes it is the prerogative of the asset owner to elect to discount the RAB value applied to the assets it owns. As in the case of GasNet, ElectraNet and PowerNet, each jurisdiction elected to discount the value of the easements at the time the initial regulatory asset base was fixed. It was on this basis that the assets were subsequently sold. It is not the prerogative of the ACCC to decide that the jurisdiction was incorrect in the level of any discount it may or may not have applied to the asset value. It is a requirement of the ACCC to continue to recognize the 'policies' of the jurisdictions and to continue the valuation practices initiated by them, *as is explicitly stated by the Codes.*

The ACCC alleges that applying a DORC valuation to easements ensures that there is equivalence between an existing monopoly provider and a potential new entrant. This statement completely overlooks that a new entrant would not attempt to exactly replicate an existing transmission asset and most likely could not do so. Therefore to allege that an existing transmission asset owner should be permitted to value easements based on existing locations is fallacious as a new entrant would never want nor be able to access the exact same land, and would not attempt to do so.

Further this statement of regulatory principles runs in the face of the Gas Code which only by a liberal interpretation, implies that new entrants might value easements at actual cost, and once built an asset can only be valued rolling on from the asset value used in the previous period, subject to specific adjustments. Thus, the SoRP might well allow an existing asset owner to continue to appreciate its easement value as implied by DORC, but its new entrant competitor would not be permitted the same right as it is bound to include only the direct costs involved in acquisition of easements.

<u>The DORC valuation method</u>

At the theoretical/conceptual and practical levels, the ACCC has been attacked by Professor David Johnstone for its adoption of the DORC asset valuation methodology[6]:-

> "It would seem that by advocating DORC on grounds of general economic principle, regulators find themselves painted into a corner when it comes to valuing easements. The supposed theoretical basis for DORC is that it captures the cost of a new entrant or system replication. If this oft recited argument is to be taken seriously, it cannot be opportunistically set aside for certain assets where its consequences are ridiculous and politically unsustainable. Moreover, if the truly apt economic principle is to set capital costs at the highest level short of those achievable by a new entrant, then DORC must necessarily include the price that a new entrant would pay for all necessary easements. This is clearly acknowledged by the Queensland Competition Authority (2001, p.142):
>
> > A new entrant is typically defined as a business installing a new gas reticulation network in an existing area where there is no existing network owned by the new entrant. In this situation there are no existing easements, pipelines, network layouts and so on. Costs incurred would therefore include all project management, design, easement, construction and restoration costs.
>
> Qualifying these remarks, the QCA (2001, p.151) restated (i) the IPART observation that easements would never need replacement, and (ii) that inclusion of easements in the RAB on some current replacement cost basis would increase tariffs very significantly. The Commission's conclusion upon such contradictory indications was to expressly defer any pronouncement on easement valuation, averting the issue with the observation that "[t]he appropriate valuation method for easements is currently the subject of much discussion Australia-wide, especially in electricity". That regulators insist on one hand that they have developed an appropriate and coherent economic logic for regulatory asset valuation – namely DORC – while at the same time expressly awaiting discovery of the particular single all-appropriate valuation rule for easements, is of itself indicative of the general intellectual pretence and fragility of their pronouncements on asset valuation.
>
> The ACCC, cornered by the competing (mutually exclusive) objectives of adhering rigorously to their own professed DORC new-entrant-exclusion doctrine while at the same time avoiding politically unforgivable "tariff shock", came to similarly vacillatory determinations on easements. The essence of the ACCC proposal on DORC is that easements be carried in RAB at actual cost modified in some non-descript way over time "in line with" DORC:
>
> > Given the strong link with real estate values there is a likelihood that the value of easements will escalate continuously over time… The question is how to introduce such assets into the regulatory framework in a consistent way. One consistent approach would require: [t]he contribution to the RAB be based on the

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6 Replacement Cost Asset Valuation and Regulation of Energy Infrastructure Tariffs. The Problem with DORC. Professor David Johnstone, December 2001.

> actual cost to the TNSP [service provider] of obtaining the easement rights updated periodically in line with what would be the DORC based valuation of easements. (ACCC 1999a, p.45)

Apart from being virtually incomprehensible, this proposed valuation rule is revealing for its unexplained rejection of DORC and recourse to actual cost. The problem not acknowledged is that inclusion of easements at DORC would typically, particularly if easement values are equated with neighboring land values, lead to a 50% or greater increase in RAB, and thus in transmission tariffs (Weickardt 1999, pp.2-3). IPART (2001) has found cases in its jurisdiction where the RAB would approximately double with easements included at estimated (unavoidably subjective) replacement cost. In one case of a potential 70% increase in RAB (and consequent tariff increase of 25-30%), its openly stated view is that such material tariff shock is "unacceptable" (IPART 1999d, Vol.1 p.60).

That the ACCC holds rigidly to DORC as a point of economic principle, yet does not implement it for all assets when the resulting tariffs are "too high", invites intellectual skepticism. It is difficult to avoid the inference that the entire DORC opus owes its existence to the broad (albeit not fail-proof) political acceptability of its answers, rather than to the veracity of its theory. Another telling aspect of the ACCC's confusion in regard to easements is the suggestion that revaluations taking place over time in easement book values should be treated as income in the way described by the modified tariff formula in Section 3 of this paper (derived on the basis of NPV=0). More astonishingly, it is suggested that this is true of other assets as well:

> To the extent that easement valuations are judged to vary over time, the variations in value should be reflected in depreciation allowances linked with the asset in precisely the same way as other assets. If the easement appreciates in value over time then the allocated depreciation would be negative in nominal terms and serve to offset the higher capital returns associated with an appreciating asset. (ACCC 1999a, p.46)

The proposition here is that all asset revaluations be regarded as income; that is, subtracted from the cash tariffs received by the service provider in the period of the revaluation. This would make sense if the ACCC decided to invoke the "no free lunches" principle in place of its new-entrant-exclusion logic. However, no such intention is evident in other ACCC statements on asset revaluations. The appearance of such a glaring inconsistency is indicative of the contortions forced on the ACCC by its willing but not ready application of DORC to easements".

It is quite clear that there is extensive confusion as to what value to allow for easements in the RAB. There is however one clear direction that flows through both Codes. The value for easements that should be included is that which is explicitly stated by the jurisdictions to be included prior to ACCC becoming responsible for regulatory control. To use any other methodology is incorrect, and exposes the ACCC to perverting the explicit requirements of the Codes.

Previous decisions of ACCC with regard to easements

There have already been a number of precedents set by ACCC with regard to the valuation of easements.

Moomba-Sydney Pipeline, MAPS (ACCC 12 September 2001 FD)

The ACCC accepted the valuation of assets by Epic which excluded any allowance for the cost of easements. However, in recognition of the potential for future claims for recompense under the Native Title Act, the ACCC stated (FD section 2.2.6):-

> The Commission has accepted the arguments put forward by several parties of the need to recognize additional costs associated with meeting native title requirements.

This highlights the approach by ACCC that the direct costs associated with easement acquisition should be the only amount included in the RAB.

Eastern Australia Pipeline EAPL (ACCC DD 19 December 2000 DD)

The Commission undertook its own in-house assessment of the replacement costs of the MSP and proposes that ORC should be based on the Venton & Associates Pty. Ltd report, but reduced by the amount of the contingency factor.

The only reference to easements in the Venton report (section 4.4) states

> The estimate takes note of the recent change to energy transportation pipelines that identify them as "Permitted Future Acts" under the Native Title Legislation. This simplifies the approval process, and requires identified Native Title Claimants to be compensated in the same manner as other affected landholders.
>
> The amounts allowed in the estimates for the project approvals represent a reasonable cost for the activities.

It is therefore quite clear that in reviewing the EAPL application, ACCC considers that the only value to be placed on easements is the direct cost involved in their acquisition.

Central West pipelines (FD 2000), GasNet "Interconnect" (FD 2000) and GasNet SWP (FD 2001)

In each of the decisions involving these three pipeline systems, the ACCC accepted that the costs involved with acquiring easements were either

apparently not included (there was no specific mention), or more likely were included at cost and proposed to be depreciated at the same rate as the pipeline.

TransGrid (ACCC 25 January 2000 FD)

ACCC did recognize that in setting the value for TransGrid assets NSW Treasury (ERTF) included a significant amount in the asset base for easements. This amount was included by IPART (the jurisdictional regulator prior to ACCC) in its decision.

ACCC stated (section 3.6 on easements, FD) that:-

> Accordingly, for the purpose of the present decision, and bearing in mind the need of the networks to be allowed to earn an adequate return on their investments and the desirability that customers should not be required to face an immediate price shock, the Commission considers it appropriate to include TransGrid's existing easements in the regulated asset base at their historic purchase cost rolled-forward to 1 July 1999.

TransGrid, although a corporatised entity, has always been wholly owned by NSW government, and still is. It would appear that the NSW government desires to inflate the TransGrid assets by incorporating an ODV assessment of easements as a form of indirect taxation. As TransGrid is required to provide a dividend to the NSW government for the assets it manages, by adding an inflated estimate of the cost of acquisition cost of easements, the community is being charged (or taxed) by its representative (NSW Government) a return on the easements used by TransGrid. Thus any inappropriate over-recovery from setting the revenue cap reverts to the representative (i.e. government) of the NSW based consumers.

The revenue structure applying to TransGrid prior to the advent of the ACCC's regulatory control incorporated an amount for easements in the RAB and the tariffs developed included for this amount.

PowerLink (ACCC 1 November 2001, FD).

The ACCC did recognize that in setting the value for PowerLink assets the Queensland Treasury (QERU) included a significant amount in the asset base for easements. This amount was included by QERU (the jurisdictional regulator prior to ACCC) in its decision.

The ACCC (section 3.6) stated that:-

> The Commission has been advised that, in setting a revenue cap for the initial regulatory control period, the Commission is required to value sunk assets at the value determined by the Jurisdictional Regulator or consistent with the regulatory asset base established in the jurisdiction, provided that this value does not exceed deprival value.

> Further, the Commission's power to require the opening asset value to be independently verified through a process agreed to by the NCC is limited to verifying that the opening asset value does not exceed deprival value.

PowerLink, although a corporatised entity, has always been wholly owned by the Queensland government, and still is. It would appear that the Queensland government desires to inflate the PowerLink assets by incorporating an ODV assessment of easements as a form of indirect taxation. As PowerLink is required to provide a dividend to the Queensland government for the assets it manages, by adding an inflated estimate of the cost of acquisition cost of easements, the community is being charged (or taxed) by its representative (Queensland Government) a return on the easements used by PowerLink. Thus, any inappropriate over-recovery from setting the revenue cap reverts to the representative of the Queensland based consumer.

Summary of previous decisions

On taking regulatory responsibility over TransGrid and PowerLink, the ACCC rightly complied with the NEC requirements to recognize the policies of the participating government (Clause 6.2.2(g)) with regard to asset value, to accept the valuation placed on the assets by the jurisdictional regulator (Clause 6.2.3(d)(4)(iii)) and the decisions on asset values made by the participating jurisdictions (Clause 6.2.3(d)(5)(iv)).

In the case of the gas pipelines, the ACCC used the principle of actual costs involved.

In each case the ACCC recognized that to vary significantly from the previous regulated tariff structure, would introduce an unwelcome price shock to either the regulated business or to the consumer.

The specifics and history of easement valuation - GasNet, PowerNet and ElectraNet

GasNet,

The jurisdiction (Victoria) made a conscious decision to exclude the value of easements. There is a clear statement of intent by Energy Projects Division of Treasury (the representative of the Victorian Government) included in the GasNet submission which states that easements were not to be included in the asset valuation. It is not the province of GasNet, ACCC or consumers to attempt to second guess the reasons behind this decision. It is sufficient only to state that this was the desire of the Victorian government before it sold the asset.

Subsequent to this decision the tariffs set by the ACCC (and applying before the sale of GasNet) clearly excluded a DORC valuation of all easements, but

did include for a small amount which apparently reflected an assessment of the acquisition costs previously incurred.

There is no basis on which the ACCC is permitted under the Gas Code, nor under any assumption that implies the Victorian Government ever intended it to be so, that easements for GasNet activities should be valued on a DORC basis.

GasNet acquired its assets with the value of easements clearly identified in the revenue and tariffs set by ACCC. It did not pay for the costs identified in its current ambit claims for easements. If the ACCC approves the incorporation of the value of easements requested by GasNet it will be granting GasNet a windfall of some $4M pa unearned income (or monopoly rent) with the right to increase the value of the easement by CPI each regulatory reset and to incorporate negative depreciation on the easement value in perpetuity.

This ‘free lunch’ was never contemplated under the Gas Code

The Gas Code is quite specific about the roll forward of the RAB. The ACCC decided at the last review (in 1998) what should be the RAB. What GasNet is seeking is for the ACCC to admit that the ACCC made an error in setting the RAB at that time. However what GasNet fails to accept is that ACCC in conjunction with the jurisdiction decided what the RAB was to be in 1998. The jurisdiction sold the assets of GasNet based on the easement value embedded in the RAB

<u>ElectraNet,</u>

ERSU (the division within South Australian Treasury which established the separation of assets of the vertically integrated ETSA) set the asset base for the South Australia transmission assets, including an amount of $3.1M in the asset base, apparently to reflect the actual costs incurred to acquire the easements used by ElectraNet.

ERSU subsequently developed tariffs in its Electricity Pricing Order (EPO) for the newly corporatised ElectraNet with the tariffs being based on the asset value established by it. The EPO for the state-owned distribution and transmission networks did not include for the now claimed value of easements and the annual reports for ElectraNet (whilst it was a state owned enterprise), valued the assets at the amount set by ERSU.

The ElectraNet assets have been subsequently leased to private enterprise on an extended leasing arrangement. At the time of the sale of the lease, the RAB was clearly set by the jurisdiction, clearly excluding an ODV or DORC value for the easements. The RAB, however, did include for land needed for the operation of the assets.

The EPO tariffs continued as they were after the sale of the lease of the distribution and transmission assets. The new owner of the ElectraNet assets purchased the asset lease based on the EPO as it stood, and the valuation of the assets as set by ERSU.

This constitutes a clear statement of intent that the SA Government did not want the ODV (or DORC) of easements to be included in the RAB. Further the tariffs applying before the sale of the assets, and even after them, do not include for the ODV (or DORC) of easements.

As acquisition of the easements does not require significant outlays of funding due to the legislation permitting compulsory acquisition when needed, and as many of the easements lie over public and crown land and do not require formal purchase, the valuation of easements on a DORC basis when little cost has been incurred, would permit ElectraNet a monopoly rent or unearned income.

ElectraNet has alluded to discussions with ACCC regarding the incorporation of easement valuation to be added to the RAB, implying that ACCC has tacitly agreed to this. ElectraNet owners advise that they have purchased the easements at DORC as part of their purchase price for ElectraNet. This was allegedly part of the premium over actual equity value. ElectraNet owners paid $930M for an equity of $459M, (refer 6/2000 balance sheet which comprises an asset valuation of $708M, and easements valued at $3M). The recent sale of the CitiPower distribution business in Melbourne was thought to be worth 1.6 times RAB, but was reported to be sold at 1.65 times RAB (Age 20/7/02). The purchase price paid by the new owners of ElectraNet was at a multiple of 1.23 times[7] RAB (significantly lower than the normal multiples paid for similar assets), so for ElectraNet to claim that the easements were not included in the purchase price would seem to be somewhat dissembling. Thus at the time of purchase it is clear that easements were valued at the amount included in the ElectraNet accounts, and in the RAB.

The ACCC has advised that it has commissioned an independent report regarding the asset base for ElectraNet but this report is yet to be released (as at 27 June).

If the ACCC has given tacit agreement to ElectraNet prior to ElectraNet acquisition about valuing easements at ODV, then the ACCC would appear to have not consulted to assess why ACCC would value assets contrary to the jurisdictional determination.

The new owners (lessees) of the transmission assets have not provided any substantiation that the SA government intended for them to include the value

7 This calculation uses the table 5.3 in ElectraNet submission, disallowing the amount included for IDC, and rolling forward the 98/99 opening asset value to end 00/01, and excluding readmitted assets and easement values. If the closing asset value for 00/01 as in table 5.3 is used, the multiple becomes 0.99, indicating an acquisition price of less than RAB.

of easements into the RAB, so there is no justification for the ACCC to allow this amount into the RAB.

As the ODV of easements was clearly excluded by the SA Government from its sale of the lease of the ElectraNet assets, the inclusion of the ODV of easements into the RAB would provide the new owners of ElectraNet an unearned benefit of some $25M pa, in effect an unearned and unpaid for monopoly rent applied on the users of the assets.

ACCC has provided ECCSA with copies of letters relating to the issue of valuation of ElectraNet easements – one from SA Department of Treasury and Finance dated 10 August 2001 to ACCC, and one from ACCC dated 6 March 2002 to ElectraNet.

In the letter to ElectraNet, the ACCC states that:-

> While the South Australian Government has made provision for easements using book value, this does not appear to represent a judgment that book value is the appropriate methodology for the valuation for easements. …. Statements by the South Australian Government made in 1999 (and confirmed in 2002) indicate that it had not rejected the principles of the DRP, rather, it simply did not have time to apply these principles before finalizing the RAB.

Whilst one can ponder what might have been the drivers behind a decision made at the time, the ACCC does not have the authority, under either of the Codes, to elect to change the actual outcome of the decision of the jurisdiction, especially after the decision of the jurisdiction has been given force by legislation (under the EPO).

However, of great concern is the following comment made by the ACCC:-

> In these circumstances, it appears to be more accurate to say that no judgment has been made on the methodology for valuing easements …[and] that it can depart from the [jurisdictional] valuation.

This extraordinary statement defies the fact that the jurisdiction had indeed made an attempt at valuation of easements (albeit not on the basis the ACCC might have decided was appropriate), had included it in the asset base for setting tariffs and then sold the lease of the assets with that same value embedded in the sale price. At a very commercial level as the jurisdiction has made a decision and then acted on that decision by the sale of the asset then the ACCC has no alternative but to accept the decision made on asset value by the jurisdiction.

In the letter from the SA Treasury and Finance, the jurisdiction states :-

> Easements were incorporated into the RAB at book value (ie $3.1M) as asset valuations consistent with the approach set out in the ACCC's draft

Statement of Principles for the Regulation of Transmission Revenues dated 27 May 1999 had not been undertaken.

The letter adds that independent valuations of easements suggest a substantially higher figure than that used in the RAB. The jurisdiction is obviously aware that there is contention as to the easement valuation, but it does not suggest to the ACCC that the ACCC methodology should now be used. There is no suggestion in its letter to ACCC that the SA Treasury and Finance considers the present valuation is incorrect. Most tellingly, the jurisdiction does not advocate the ACCC making any change to the amount allowed for easements in the RAB by the jurisdiction.

In a later paragraph the letter adds (bearing in mind that the letter is dated after the sale of the asset lease when effectively ElectraNet is privately owned):-

> ElectraNet SA believes that the National Electricity Code (NEC) allows ACCC to have some discretion with respect to the RAB, and that the RAB should be adjusted to provide a fair and reasonable allowance for the valuation for easements and “Interest During Construction”.

Of course ElectraNet would say it believes the asset base should be increased, but it is appropriate to observe that ElectraNet sees that the ACCC needs *to have some discretion with respect to the RAB.* If ElectraNet believes that ACCC must value easements as desired by ElectraNet, then why state that discretion by ACCC is required?

In its submission, ElectraNet notes that as the EPO requires SAIIR to give consideration to assets that were not included in the EPO (including easements) then ElectraNet concludes that even though this requirement has been excluded from the future review by ACCC of ElectraNet assets, this exclusion must be an oversight. The fact that it has explicitly been included in the review of distribution assets, the exclusion from transmission assets is more likely to be a deliberate act rather than one of oversight (similar to Victoria, in the case of GasNet and PowerNet). We consider that the exclusion of the requirement for ACCC to review easement valuation is tantamount to a direction to ACCC <u>not</u> to turn aside the previous actions of the jurisdiction.

Between 1995 and 1999 when ERSU set the RAB for the EPO, there have been a number of assessments made on the value of ElectraNet easements (Hill Michael Associates, SKM and Maloney Field Services). Despite these assessments being available for ERSU to include them in the RAB,_ERSU elected to remain with the recorded cost of $3.1M for easements. This must be taken as a clear statement of intention of the jurisdiction that it deliberately elected not to incorporate a DORC basis for easement value.

In summary, there is no doubt that the (SA) jurisdiction consciously included an amount in the RAB which they consider represented the book value of the easements. It is the prerogative of the jurisdiction to set its value for the assets,

provided they do not exceed the DV assessment. It is obvious that ACCC considers the book value is less than the DV. Accordingly, the ACCC has no alternative but to use the value of easements used by the jurisdiction prior to the transfer of regulatory control to ACCC.

PowerNet,

ESIRU on behalf of the Victorian Government set the initial tariffs for PowerNet under the Victorian ESI Tariff Order of 1995. The structure of the asset development by ESIRU excluded the value of easements from the asset base of PowerNet. The written down value of the assets at the time of sale was $542M, clearly excluding the value of easements claimed by PowerNet

Subsequent to the setting of the asset base for PowerNet, the Victorian Government sold the PowerNet assets to GPU, who subsequently sold them to SPI. As a fundamental part of the sale process the Victorian government established a set of rules (the Tariff Order) which was to apply to the charges and operation of the PowerNet assets.

The tariff order set the tariffs to apply to both the distribution and transmission elements of the Victorian electricity assets. The tariffs set under the order did not include a significant amount for the value of the easements.

PowerNet notes that in its valuation of easements it has excluded the value of easements over public and crown land, stating that it has only valued easements acquired over private land. The independent report commissioned by the ACCC (PB Associates) into PowerNet's asset base implies that the historical cost of the easements as declared by the Victorian government at the time of the sale was $18M. However the only actual historical costs available indicate that the total cost of the easement acquisition was $18M. PowerNet has assumed that other costs possibly were involved but not recorded. On the basis of this assumption it has (via ATCocks now called Urbis) stated that the maximum of all other costs allowed under the Land Acquisition and Compensation Act of 1986 would have applied, notwithstanding that most of the easements were acquired prior to this time.

PowerNet has claimed that the value of assets was omitted from the RAB. There is little doubt that this was a deliberate action by ESIRU, as in the case of the GasNet assets it was a deliberate action to value easements only at recorded costs and so there is reason to believe that it was a deliberate action in the case of the PowerNet assets. Either way, the result is the same – the regulatory approach taken by the governing jurisdiction (the Victorian Government) was to include only the direct costs for the value of easements in the RAB, and not to use the DORC value that might be assessed.

The purchase of PowerNet assets was made in full knowledge that the DORC valuation for easements was excluded from the RAB, as well as from the declared financial asset valuation. If GPU acquired the PowerNet assets with the express agreement of the Victorian government that the easements were

to be included in future RAB settings, then GPU/SPI should provide this evidence. As GPU acquired the assets prior to the ACCC SoRP then it cannot claim (as has ElectraNet) that has any prior agreement with ACCC on this issue.

In summary, there is no doubt that the (Victorian) jurisdiction consciously included an amount in the RAB which they consider represented the book value of the easements. It is the prerogative of the jurisdiction to set its value for the assets, provided they do not exceed the DV assessment. It is obvious that ACCC considers the book value is less than the DV. Accordingly, the ACCC has no alternative but to use the value of easements used by the jurisdiction prior to the transfer of regulatory control to ACCC.

Conclusions

In a number of its decisions (gas and electricity) the ACCC has been clear that one of its over-riding concerns is that the regulated business should:-

> … be allowed to earn an adequate return on their investment[8]

There is general acceptance that the asset owner should be granted a return *on the investments they make*.

However, it is equally quite clear that to inflate the asset base by an amount which the asset holder has not paid for (either in an open sale process or by expenditure of funds that has been recouped by other means) should not be included as an asset for which a return is granted.

There is no doubt that these propositions are accepted by consumers who provide the revenue to the regulated businesses. Other regulators (such as IPART and ORG) also accept those propositions.

However, in the case of easements which the ACCC has commented may "have negative depreciation[9]" ie will appreciate above the cost of acquisition, and require no continuing attention to maintain the easement, consumers do not agree that ACCC should put its so-called "economically sound" principles ahead of the need to recognize that the easement holder has not provided significant funding to acquire the easement. To allow the easement holder a return on what the ACCC recognizes may be an appreciating asset, is tantamount to allowing easement holders a "double dip" into the purse of the community at large. Land does not depreciate over the medium to long term, so there is no legitimate or rational reason why easements (land interest) should be treated differently. This is tantamount to Professor David Johnstone's 'reductio ad absurdum of DORC'.

GasNet in its submission provides a useful insight into the life and depreciation of an easement[10]

> "As … easements will be included … the issue … for the period up to
> 1 January 2003 (and the associated "negative depreciation") does not arise.
> Going forward, easements will be depreciated at the same rate as the associated pipelines (on the basis that once the pipeline's life has ended, the life of the easement has also ended.)"

GasNet has identified another of the problems with inclusion of easements valued at DORC in the RAB, that of negative depreciation experienced by land values.

8 ACCC FD on TransGrid 2000, section 3.6 on easements
9 Depreciation is defined as an "(allowance made in valuations estimates and balance sheets, for) wear and tear Oxford Concise dictionary seventh edition. Thus the concept of negative depreciation implies an enhancement of the asset, which in the case of easements is patently not the case.
10 GasNet submission page 34

The ACCC must comply with the codes.

The ACCC is required to operate its gas and electricity regulatory decisions only within the requirements of the Gas and Electricity Codes. If the ACCC desires that its regulatory decisions should run counter to the explicit (or even implicit) directions of the NEC then it must carry out a detailed and transparent process to change the wording of the Code, and not rely purely on its own assessment as to what it considers is an appropriate approach to valuation of easements. In this regard the SoRP must be considered only to apply in those circumstances where the NEC is silent.

Reading the SoRP, there is conflict between the specific commentary on valuing easements (which allows the implication to be drawn that easements might well be treated as proposed by PowerNet and ElectraNet), with the earlier point that there is to be a smooth transition between one regulatory period and the next, with particular reference to assessments by jurisdictional regulators.

Further, the ACCC states that the asset value roll over is to follow the process of asset roll-forward from previous plus capex less depreciation less disposals to give a new asset value. Adding in “omitted assets” after the event does not follow from this approach.

Moreover, the ACCC must comply with the NEC which states that the asset value given by the jurisdictional regulator must stand, and that the ACCC should recognize the views of the jurisdiction.

If the ACCC wishes to go against the views of the jurisdiction, it must then follow an open and transparent process (NEC 6.2.2(i)) which it hasn’t.

Finally, adding in the easements at commercial rates adds a continuing windfall profit (monopoly rent) to the new private owners of the assets which was not intended by the government sellers. If the ACCC persists in valuing easements on the so-called commercial basis of DORC, then it is failing in applying NEC clause 6.2.2(c) which specifically requires the ACCC to seek to prevent monopoly rent extraction. For the ACCC to permit a transmission service provider a return on an asset on which they paid a known (modest) amount but then to include an unearned windfall asset increase, is to grant the service provider a monopoly rent.

In the case of the TransGrid and PowerLink decisions it is the jurisdictions who continue to benefit from the enhanced valuation of easements, but in the case of ElectraNet, GasNet and PowerNet to vary the asset valuation away from that set by the jurisdictions for the purpose of sale of the asset, will allow the new owner to obtain a windfall which does not ultimately return to the consumers but which is captured (at no cost) to the benefit of private companies. In effect what will happen is that the community will have used its

powers to require acquisition of the easements at nominal cost, the State will have sold the easements at this same cost and the ACCC will allow the private owner an unearned asset value (a windfall which increases the value of the business) plus a return on the increased asset value (an annual windfall).

ACTION SUMMARY

The ACCC must recognize that allowing the RAB to include the enhanced value of easements for GasNet, PowerNet and ElectraNet cannot be allowed.