

Energy Consumers Coalition of South Australia

Australian Energy Regulator

SA Electricity Transmission Revenue Reset

ElectraNet SA Application

A response

by

The Energy Consumers Coalition of SA

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CONTENTS	Page
Executive summary	3
1. Introduction	4
2. Forecasts of demand, consumption and input cost changes	7
3. ElectraNet regulated asset base	14
4. ElectraNet WACC	16
5. ElectraNet opex	20
6. ElectraNet capex	28
7. Service standards	35

Executive Summary

The Energy Consumers Coalition of South Australia (ECCSA) presents its views on the AER draft decision on the application from ElectraNet SA for a reset of the electricity transmission revenue in South Australia for the new access period AA4 commencing July 2013.

The ECCSA views on the revised application from ElectraNet are also provided but generally the ECCSA considers that the AER draft determination provides an appropriate revenue to ElectraNet for regulatory period AA4.

The ECCSA is pleased that AER and ElectraNet have accepted that the forecast growth in demand will be as forecast by AEMO in 2012, resulting in a considerably lower need for capex for growth assets. There is also agreement on the expected consumption of power so that clear comparisons of expected average tariffs can be made.

The ECCSA is concerned that the AER has persisted in its current and recognized flawed approach to setting the debt risk premium. This has resulted in consumers incurring significantly greater costs than is efficient. The ECCSA considers that the AER must change the debt risk premium to a value that is reflective of the costs that ElectraNet incurs.

The ECCSA considers that the AER approach to use the identified “efficient year” as the basis for setting opex allowances is appropriate. However, the ECCSA considers the AER has erred in not using this approach for setting the “routine maintenance” allowance. The ECCSA considers that if a “bottom up” approach is to be used then other elements of the opex and capex allowances must be reduced to reflect the increased attention that underpins the increase in the routine maintenance allowance. Service standard targets should be increased to reflect this increase in allowances.

The ECCSA considers that the allowances for capex determined by EMCa are consistent with actual capex requirements of ElectraNet. The ECCSA also notes that the AER considers that it is required to allow the capex associated with the replacement/refurbishment of the SA Water connections. The ECCSA approach of assessing the long term trend for replacement/refurbishment capex shows that even less capex for replacement/refurbishment is necessary for these elements than has been allowed by the AER and EMCa.

The downward trend of capex needs forecast for AA4 is seen by ECCSA as a trend that reflects the capex used in later years of AA3, which is a peak and that capex will return to longer term lower amounts in the future.

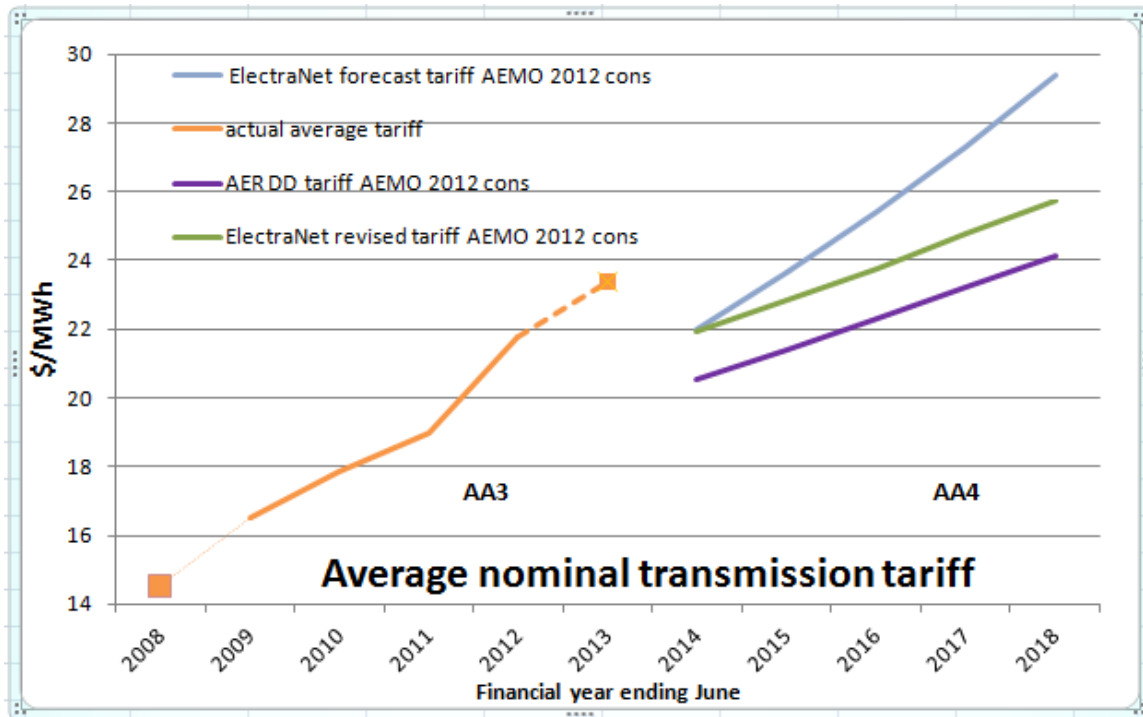
1. Introduction

The ECCSA welcomes the opportunity to provide comments on the AER's review of the revenue reset for the South Australian electricity transmission system.

In its initial application ElectraNet noted the pressures on consumers from the recent massive increases in electricity prices. Despite this it still sought a nearly 6% annual real increases in revenue on top of a real step change of over 4% between this regulatory period and the next. The impact of this increase was partly hidden because ElectraNet used overstated expectations for electricity consumption, resulting in an apparent reduction in the nominal average tariff.

The ECCSA highlighted that the consumption expectations were overstated and based on revised consumption expectations developed by AEMO, the outcome of the ElectraNet application showed significant increases in the average nominal tariffs over the next five years. Such an increase was not truly reflective of the ElectraNet recognition of concern for consumers.

The ECCSA observation was expanded upon by the AER and in the revised application by ElectraNet. The following chart shows the expected nominal average tariff for the next five years using the same expected consumption data but with the revenues sought by ElectraNet (initial and revised) and the AER draft decision.



Source: AER FD 2008, ElectraNet initial and revised applics, AER DD, NEM data

What the chart shows is that despite a significant reduction in the weighted average cost of capital (WACC) used for period AA4 compared to a much higher value in period AA3, average nominal tariffs based on the revised consumption data show little overall effect of the lower WACC, even using the assessed revenue allowed by the AER in its draft decision. The revised application by ElectraNet results in a further 10% greater cost for consumers than does the AER draft decision.

The growth in the cost of transmission by the end of period AA4 based on the AER draft decision allowed revenue will have risen by nearly three times the cost of living over the 10 year period!

Just on the headline cost, this is a massive impost on consumers.

The ECCSA recognises that- the lower WACC applying for AA4 is already being eroded by an increasing 10 year CGS used as the risk free rate. In practical terms, by the time the AER makes its final decision, the ECCSA expects that the 10 year CGS will be heading back towards long term levels, with the result that the average nominal tariff will exceed the levels seen at the end of period AA3.

The clear import is that the current low 10 year CGS is concealing the burgeoning other costs contributing to the allowed revenue.

In its response to the ElectraNet application, the ECCSA highlighted that this large increase in revenue for AA4 was occurring at a time when consumption is falling (and forecast to stay at low growth levels) and the forecast demand is also at levels below those seen during AA3 period.

This falling consumption and lower forecast demand have immense impacts on the constituent parts of the revenue requirements. At its most basic it means that there is little or no need to increase (or even maintain) previous levels of growth investment. Falling demand means there is less load placed on existing assets, thereby extending their useful lives. Whilst the AER draft decision seems to reflect some of these outcomes, the revised application, whilst reducing the investment for growth assets, still increases the replacement investment considerably.

Against this background, the outcomes of the AER draft decision seem inadequate and suggest that consumers should incur higher costs which are out of step with the changes being seen in the consumption and demand for electricity. The revised application from ElectraNet generally rejects the AER draft decision although it is noted that the growth capex claimed in the revised application is marginally less than that allowed in the AER draft decision.

Overall, the ECCSA is unable to accept that the proposed massive increases in costs can be justified when assessed against a background of falling consumption and the equally massive increases seen in the development of AA3 revenue. Whilst there is a fall in allowed revenue, this is entirely due to the significant step reduction in the allowed WACC.

The AER draft decision goes some way to addressing the concerns of the ECCSA regarding the financial impact that the ElectraNet application will have on consumers, but the revised application reverts in most aspects to the excessive (and unnecessary) claims made by ElectraNet in its initial application and must be firmly rejected.

2. Forecasts of demand, consumption and input cost changes

2.1 An overview of demand and consumption forecast changes

In its response to the ElectraNet application, the ECCSA noted that ElectraNet had over forecast expected growth in demand and in consumption. This over forecast provided justification for an increase in capex for augmentation and new connections and understated the expected increase in average nominal tariffs.

The ECCSA had noted that AEMO had released new data indicating considerable reductions in both peak demand and consumption in South Australia. The AER consultant (EMCa) also carried out an assessment of the expected growth in demand.

All of the independent assessments of demand growth are considerably below that assessed by ElectraNet, with reasonable correlation between the AER consultant and AEMO forecasts, with the AEMO forecast slightly lower than the EMCa forecast. The AER considered that the EMCa forecast was a better indicator of future demand than that of AEMO and used the EMCa forecast as the basis of its draft decision

ElectraNet commissioned its consultant to examine both the EMCa/AER forecast and the AEMO forecast. Resulting from this work, ElectraNet has reviewed its peak demand forecasts and revised its expectations downward to a level slightly below that of EMCa but still higher than that of AEMO.

The ECCSA has no greater ability to forecast expected peak demand in the future, but has a general view that AEMO not only has better access to information but has devoted considerable effort into assessing expected demands across the entire NEM. The ECCSA has a view that in the circumstances, its assessment is more likely to be correct than the views of consultants. In any case, AEMO is an official NEM institution and its work has a lot more authority, given its independence and resources. Moreover, if the AER applies AEMO forecasts for other network pricing reviews, there is an argument in favour of retaining consistency over the use of AEMO forecasts for all network pricing reviews. It is a curious decision by the AER not to retain its use of AEMO forecasts.

As a result of the lower expectations by ElectraNet of demand growth, ElectraNet has reduced its expected capex for growth and connections below

that assessed by the AER in its draft decision. The ECCSA considers that this entire process has resulted in a better outcome for consumers.

The expected consumption forecasts are also now consistent and provide a common basis for assessing the impacts of the revenue reset process on consumers.

2.2 Escalation forecasts for labour and materials

2.2.1 Wages cost growth

The AER draft decision made some changes to the approach used by ElectraNet in wage cost growth but accepted other aspects. The AER draft decision:

- Accepted the use of the Enterprise Agreement to forecast expected change
- Rejected the use of AWOTE as the basis for future price movements
- Rejected the exclusion of the “waste services” from the index.
- Rejected the labour price index calculated by BIS Shrapnel in favour of that produced by DAE.
- Excluded future productivity adjustments from the forecasts of future labour price index movements

The ECCSA considers that there has to be consistency by the AER in its approach to setting future movements in the cost of labour. In most of its recent decisions, the AER has not accepted the use of Enterprise Agreements¹ and used the DAE labour Price Indices unadjusted for productivity improvement. To offset the loss of the impact of productivity improvement, it has included this expectation as a direct adjustment to the labour forecast.

In its draft decision the AER accepted the ElectraNet Enterprise Agreement as the basis for increasing internal wage cost movements. It compared the ElectraNet EA with the EAs of other regulated firms operating in SA (APA and SAPN) and with the LPs of DAE and BIS Shrapnel. The ECCSA considers that benchmarking the EA between regulated firms is akin to a self fulfilling prophecy. If the AER is serious about comparing the ElectraNet EA it should compare this to all other EAs, not just of regulated firms. By comparing the ElectraNet EA to that of Envestra/APA and SAPN it is

¹ The AER has stated that these are unique to the regulated firm and do not reflect an industry wide benchmark

establishing a precedent that the AER will use a similar approach for Envestra/APA and SAPN. Therefore, these two firms will see that they will likewise be able to argue for the use of the EA as the basis for wage movements and negotiate with the Unions accordingly. The ECCSA considers that the AER will be creating an unacceptable future (upward) trend by allowing this approach to be implemented.

Compared to the DAE LPI, the ElectraNet EA is consistently 100 basis points higher for each year. When compounded, the impact at the end of the EA (2014/15) the EA results in 2014/15 being 450 bp higher than the compounded DAE LPI over a 4 year period.

The approach by the regulated firms has been to overstate the expected growth cost factors in their initial applications and in their revised applications, accept the parts of the AER decision they consider are to their advantage and reject those parts where they consider they can claim an increase in revenue. This is understandable but, from a consumer's viewpoint, likely to overstate the likely needs. The AER needs to recognise this in its assessments.

What is entirely lacking from any assessments by the AER, ElectraNet and the various consultants is the track record of the forecasts made. The ECCSA accepts that both the AER and the regulated firm rely on consultants to provide a forward looking assessment of future changes. The AER has asserted that DAE future estimates of labour price indices are more acceptable than those provided by BIS Shrapnel. The ECCSA affiliate Energy Users Coalition of Victoria (EUCV) actually examined the past performance of the two forecasters and commented on the outcome to the AER in its response to the 2012 Victorian Gas Distribution revenue reset review.

The EUCV commented (EUCV page 32):

“Accuracy of labour forecasts

As part of the analysis for the decision to use LPI in lieu of AWOTE, the AER provided a table of the past performance of Access Economics (DAE) and BIS Shrapnel (BIS) in forecasting actual labour movements (see for example table C2 in section 3 of the draft decision on Multinet).

This data is quite fascinating and from it the AER concludes that the LPI forecasting by DAE is more stable and exhibits less volatility than does BIS forecasting and so the AER considers the DAE forecasting is preferred.

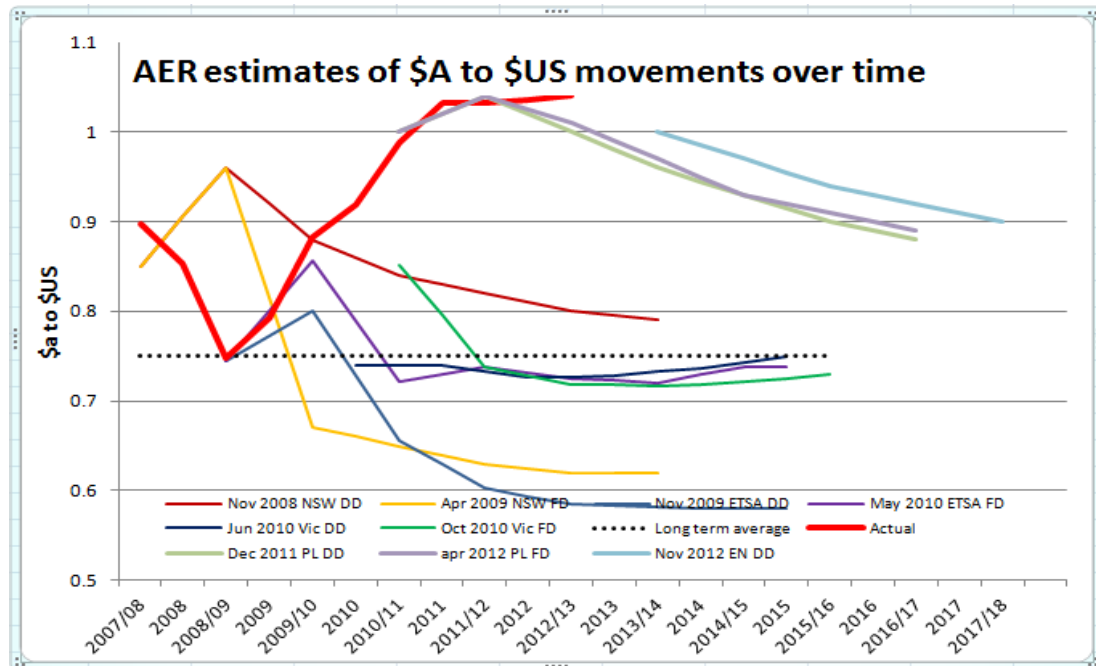
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What the AER does not do is to assess the actual accuracy of the forecasts over time. For example, the DAE forecast for EGW made in 2007 for year 2010/11 shows a small under-run compared to the actual LPI. Yet these forecasts are compounded – the forecast for 2010/11 is the compounded increase of all the previous years of data. When compounding is implemented, the actual increase in LPI for 2010/11 based on movements from 2007 implies labour costs in 2010/11 were 24% higher than in 2007. The DAE forecast for the same period shows an increase of 26% (the BIS increase is nearly 29%).

Further, the errors between the actual values and the forecasts show a consistent overestimation of future LPI values. The number of times the forecasters underestimated the actual LPI is 25% whereas the overestimates comprise 60% of the forecasts – the balancing 15% is where the forecasts were accurate. On this basis the forecasters are likely to overestimate the LPI 4 times more than they get it right and underestimate it 2 times more than they get it right.

These actual calculations and comparisons show that the forecasts are biased towards overestimation and so impose increased and unnecessary costs on consumers.”

The ECCSA has also noted that this is not just unique to labour price movements. Similar trends are obvious from the actual performance of consultants estimating future movements in the \$A to \$US. The following chart shows the actual forecasts used by the AER in its draft and final decisions based on information provided to it by consultants.



Source: RBA data, AER decisions

This again shows that the accuracy of forecasting results in a significant bias towards a forecast that has a significant bias in favour of the regulated firm.

The issue of consistently overestimating (ie bias against consumer interests) is exacerbated by the compounding effects of the bias as the EUCV comments in its response to the AER on its draft decision for the Victorian Gas Distribution reset, yet the AER has failed to assess the impacts (both direct and compounded) on the costs consumers are exposed to.

The ECCSA considers that the AER has erred in its draft decision and ElectraNet has overstated its needs in its revised growth forecast for wages. The ECCSA considers that:

- The DAE LPI forecasts should be used as these tend to be more accurate than those of BIS Shrapnel
- The AER should not allow the wages cost adjustment to be based on the ElectraNet Enterprise Agreement as the AER has previously not allowed this based on the fact that an EA is unique to a regulated firm and not typical of the industry
- Data collected by ABS should be used without attempting to interpolate and refine the data. Interpolation techniques are subject

to error and the outcomes are unlikely to be accurate. EGWWS data is collected rather than EGW for a good reason and it should be used as the basis for assessing industry wide movements rather than attempting to “refine” the data.

- The latest possible forecasts are more likely to be reflective of future movements than forecasts made earlier. The changes in demand and consumption demonstrate the common sense behind this observation.
- If improvements in productivity are excluded from the labour price index, then they must be included in the direct allowances. It is not acceptable to exclude expected improvements in productivity if there are to be made allowances for future real increases in costs.

2.2.2 Land cost growth

The ECCSA notes that the AER has allowed that land cost growth is an increasing amount of 8.1% pa for residential land, 5.4% pa for commercial land and 4.9% pa for rural land for the AA4 period. The AER has based this on the land price data identified for the period June 1989 to June 2011. The ECCSA accepts that over the past 20 years land prices have increased significantly and that the actual increases reflect these values.

However, the ECCSA is extremely concerned with using these high values for AA4 as they do not represent the current actual movements in land prices. Since the GFC, land prices have trended downwards and the most recent data indicates that prices are still trending negatively or are flat – they are certainly not increasing at the average annual rate of 7% pa.

The ECCSA finds it bizarre that the AER has allowed for land price growth that is demonstrably not in keeping with current land price trends. The ECCSA made this point in its response to the ElectraNet application yet the AER has seen fit to ignore such actual trend data and use long term historical trends.

2.2.3 Materials cost growth

In its response to the ElectraNet application, the ECCSA sought to have the weightings of the various materials cost escalators provided so that it could assess the reasonableness of the weighting. The ECCSA is aware that varying the weightings of the constituent parts is a method leading to an overstatement of the output escalator. Unfortunately, neither the AER nor ElectraNet in its revised application provide the weightings of the elements used for the development of the average weighted materials escalator.

The following table compares the real weighted average materials escalator provided from the three documents

Real cumulative material cost escalators	2013/14	2014/15	2015/16	2016/17	2017/18
Initial application	2.1	3.8	5.4	7.2	9.2
AER DD	1.0	3.4	3.7	4.4	5.3
Revised application	1.0	3.3	5.2	7.0	8.8

There is a marked difference in the cumulative effect of the ElectraNet claims and that of the AER draft decision. These are “real” expected increases in future costs (ie above the rate of general inflation) and to expect that, based on the ElectraNet revised application, materials costs over the next five years will increase by 23% in nominal terms, would appear to be excessive. The ECCSA is very concerned that the AER (and ElectraNet) have applied a mechanical approach to the setting of future price rises without assessing the likelihood that the outcome would appear to be unrealistic.

The analysis of the ECCSA and its affiliate EUCV have indicated that the forecasts of future movements in labour and \$A/\$US have been significantly overstated when examined in hindsight. This excessive conservatism has imposed costs on consumers that are not efficient. The AER needs to ensure that in its allowances there are not unnecessary costs included.

In its response to the ElectraNet application, the ECCSA commented that the AER must find an alternative approach to ensuring that allowances for costs reflect the actual movement of costs rather than what have been seen to be excessive cost allowances. The ECCSA proposed an alternative which the AER has seen fit to ignore, but has not identified a better method than the current unacceptable process which has consistently overcompensated regulated firms and created a new area for “gaming” the regulatory process.

The continuing reliance on having the costs during a regulatory period being only subject to CPI movements already leads to errors in forecasts. Other industries use different cost escalators to adjust their costs, so the continued use by the AER of CPI needs to be examined in more detail.

3. ElectraNet regulated asset base

The key elements of setting the future RAB and its development from the starting RAB and its roll forward are:-

- Starting RAB
- Capex included from the starting RAB
- Depreciation approved for inclusion
- Inflation adjustment (based on actual amounts)

The ECCSA notes that the AER draft decision revised downwards the ElectraNet assessment of the starting RAB for AA4 and the revised application calculates a starting RAB for AA4 halfway between the AER calculation and the ElectraNet initial application. In its revised application ElectraNet provides revised capex data from AA3 (reflecting the firming of estimated amounts for the last two years) and this might explain the difference between the AER assessment and the revised application.

The ECCSA assumes that the AER will reassess its calculations based on the revised actual and estimated capex allowances for the last two years of AA3.

3.1 Depreciation

The ECCSA notes that the AER has proposed the use of standard asset lives which it has applied widely across all transmission regulation. The ECCSA supports this as it reflects the concept of the assumed efficient provider of transmission services. Individual transmission service providers have the ability to use assets with lower asset lives if it wishes but benchmarking across all service providers provides a basis for what actual assets will provide the most efficient outcome overall.

The AER draft decision accepted the ElectraNet proposed asset lives except for one new asset type proposed by ElectraNet – transmission line refit (insulator replacement) where ElectraNet proposed a life of 15 years and the AER considered 27 years to be more appropriate. The ElectraNet revised application rejects this.

The ECCSA agrees with the AER that replacement of the element most likely to cause failure of an entire transmission line is likely to extend the overall life of the complete asset. This is an approach used consistently by other capital

intensive firms, where entire production lines are provided with extended lives through the replacement of elements that have a shorter life than the overall production line. It is by this method that production machines nominally rated for an economic service life of 20-30 years are still operating effectively many years after their notional economic lives. In some industries, these machines are still operating economically after 100 years through this process.

The implication of the Electranet contention (that replacement of the insulators will only allow the transmission lines to operate until their economic life is reached) is not supported by the facts. Historically, large elements of transmission lines are still in service well beyond their notional economic life even though elements have been replaced in the intervening period. The AER assessment of the reality of what will occur for the transmission lines is a more likely outcome than that posited by ElectraNet.

The ECCSA also notes that in table 10.2 of the revised Electranet application, ElectraNet has proposed revised remaining asset lives (at 1 July 2013) consistently equal to or less than the AER draft decision. As the same notional date for measurement applies, the ECCSA is at a loss to understand why there is such a difference, noting that the actual capex for year 4 of AA3 is similar to the initial forecast used by the AER as is the estimated capex for year 5 of AA3. The ECCSA does not consider that the modest differences account for such significant changes in remaining asset lives.

4. ElectraNet WACC

In its response to the ElectraNet application, the ECCSA identified that the prime issue of concern was the setting of the debt risk premium. The ECCSA views on the AER approach to this are provided below

4.1 Averaging period

In the AER draft decision and the ElectraNet revised application, the AER and ElectraNet have used an averaging period for the setting of the risk free rate which is confidential. The averaging period used to determine the risk free rate moves away from the concept of using the latest single point in time as the source of the forward looking estimate of a rate of return. The longer the averaging period, the assumption is that the forecast will be less representative of the future price.

The ECCSA is of the view that detailed examination of the relation between the point estimate and the actual risk free rate is tenuous at best, averaging, whilst probably improving the estimate, imposes a lessening of volatility. In fact the longer the averaging period, the lower the volatility without compromising the forecast estimate. The ECCSA notes that its affiliate Major Energy Users has made this point succinctly in its response to the AER Better Regulation rate of return Issues Paper.

The ECCSA notes that under the current rules that apply to this revenue reset, ElectraNet has the right to set the averaging period for assessing the risk free rate to be used. What concerns the ECCSA is that this averaging period has been kept confidential and has not been released for assessment for its reasonableness. The AER should require this information to be released. In times of rising 10 year CGS yields (as is currently occurring) using a short averaging period provides a higher risk free rate than would occur during a falling yield. This very fact opens up the setting of the risk free rate to gaming by the party with the ability to set the averaging period.

An ability to “shade” the risk free rate value by varying the averaging period biases the outcome in favour of the regulated firm and therefore is not in the long term interests of consumers.

4.2 Debt risk premium

The main area of contention remaining in the setting of the WACC is the approach to developing the debt risk premium (DRP).

In its draft decision, the AER notes the ECCSA concerns regarding the setting of the debt risk premium and that the current approach used by the AER and ElectraNet (in both initial and revised applications) is flawed and provides an outcome that is not reflective of the actual costs for providing debt – the AER comments that the current process provides an outcome that is too high and the ECCSA sees that such an outcome results in an outcome that is not efficient and not in the long term interests of consumers.

The AER notes that the ACT requires the AER to carry out public consultation on the issue before implementing changes to the current process. The AER further points out that it is currently assessing better methods of identifying more appropriate levels of debt risk premiums through its Better Regulation process, but that its deliberations will not be used in this reset of ElectraNet costs.

Because the risk free rate is considerably below its long term average, the cost of debt calculated from the flawed approach is perhaps less significant than it might otherwise have been (other recent AER decisions have imposed much higher costs of debt than that allowed for the ElectraNet reset), but it still results in a higher cost of debt than is currently seen in the market for other capital intensive firms.

The AER is critical of the ECCSA analysis of actual debt costs incurred by regulated firms on the basis that it is unclear whether these costs reflect the benchmark term of 10 years adopted by the AER. The AER then points out it is inappropriate to use a 10 year risk free rate if the costs reflect a different term.

The ECCSA does not accept this AER criticism. The ECCSA calculated the actual costs of debt, related these to the amount of debt used to develop an actual return on debt achieved and identified the debt risk premium using the 10 year CGS applying in the same year. This is internally consistent as the CAPM uses a debt risk premium above the 10 year CGS which is calculated from the actual cost of future debt less the future risk free rate. The ECCSA approach merely assesses the actual outcomes in the year in which they relate.

The point the ECCSA was making is that the actual costs of debt incurred by regulated firms were considerably lower than those allowed by the AER in its regulatory decisions. Comparing actual outcomes with those previously forecast is an essential element of good regulation and reflects the observation of George Santayana²:

“Those who do not learn from history are doomed to repeat it”

The AER has consistently failed to assess whether its forecasts actually provided efficient outcomes. The analysis undertaken by the ECCSA, although simplistic, demonstrates that the AER, by not actually assessing actual outcomes by regulated firms, has failed in providing for the long term interests of consumers by continuing to use a methodology that can be seen to provide outcomes that are demonstrably inefficient.

4.3 Pass through events

The use of “pass throughs” is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Regulators have been inclined to accept this approach as they (rightly) fear that an allowance in the costs to accommodate this risk might be too high. However, there is a need to ensure that this transfer of risk is minimized and that the equity beta adjusted to reflect the reduced risk.

In its draft decision, the AER allowed for an expansion of the current basis for assessing “pass through” events. It has accepted the ElectraNet proposed “terrorism” pass through event but has proposed changes to the “natural disaster” and “insurance cap” events.

In its revised application, ElectraNet accepted the AER changes in relation to:

- “Natural disasters” but observed that perhaps the AER rewording was unnecessary.
- “Insurance cap” events but revised the AER rewording in two aspects.

The ECCSA is not convinced that the rewording is necessary or appropriate.

What is of significant concern to the ECCSA is the increase in risks that ElectraNet is seeking to pass through to consumers without this affecting the equity beta used in the WACC development. The ECCSA considers that to change the risk profile yet maintain the reward for accepting risks is inconsistent.

² [Spanish](#) born [American](#) philosopher, essayist, poet, and novelist, [1863-1952](#)

The AER assessed the additional pass through events under a number of criteria (AER DD page 271). What is missing from this listing is whether the inclusion of the pass through event impacts on the risk profile of ElectraNet.

At its most basic, the reason ElectraNet would seek the additional pass through would be because it identified a risk that it can pass to consumers. In practice, there are two aspects of risk transfer that must be addressed:

- Does the change retain the principle that the party best able to manage the risk bears responsibility for its management?
- Is the reduction in risk for one party, reflected in the reward that party receives?

The ECCSA considers that consumers are essentially unable to manage any of the risks facing a transmission service provider. It would only be appropriate to implement a pass through if ElectraNet was equally unable to manage the risk.

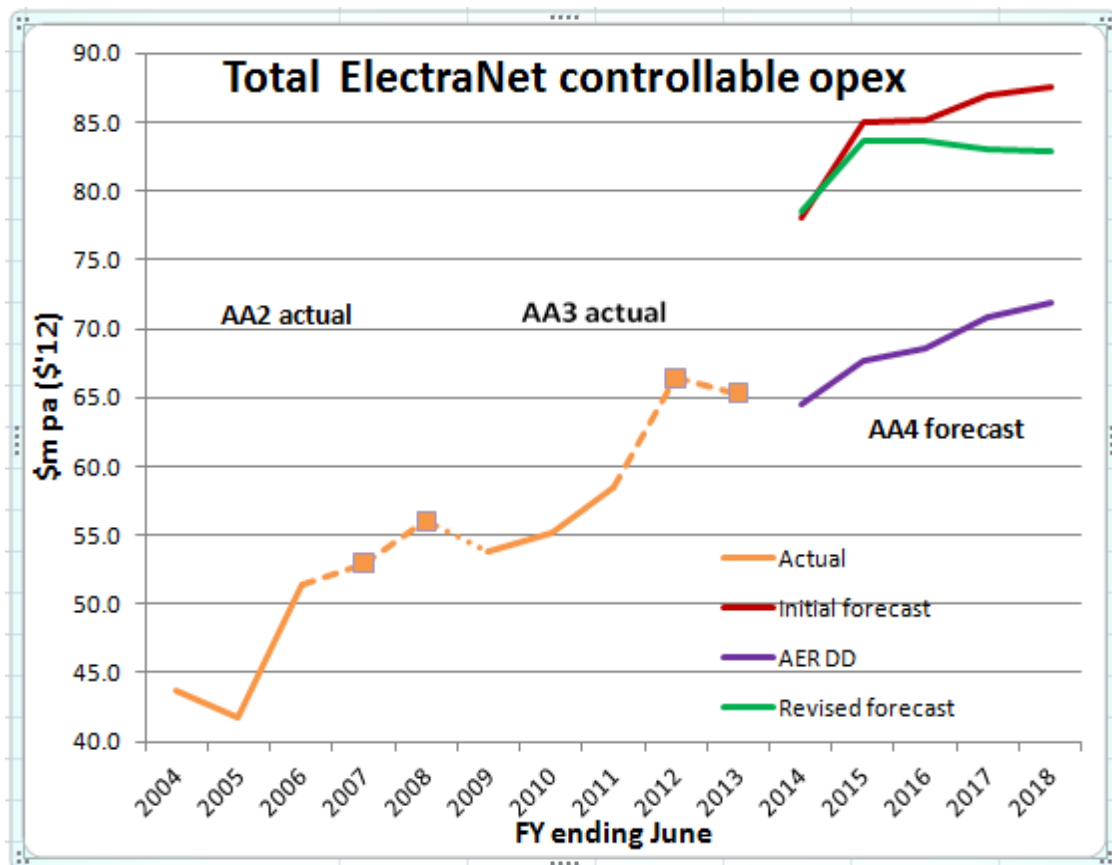
If ElectraNet is provided with a pass through that limits its risk, then the party accepting the risk (in this case consumers) should see that the costs it incurs are reduced for accepting the increased risk. In this case, the AER has reduced the risks faced by ElectraNet but not ensured that the benefits of the reduction have flowed to consumers.

5. ElectraNet Opex

Forecast total opex claims from ElectraNet average \$85m pa for AA4, whereas current total opex in AA3 averages (assuming the two last years' estimates are valid) about \$60m pa. In AA2 annual average opex averaged under \$50m pa.

5.1 An overview of AA4 opex

The following chart has been developed from data in ElectraNet's application 2007, the AER final decision on ElectraNet 2008 the ElectraNet initial application, the AER draft decision and the ElectraNet Revised application. The chart shows the actual controllable opex for periods AA2 and AA3 combined with the three forecasts for opex in AA4 (ElectraNet's initial and revised applications and the AER draft decision)



Source: ElectraNet applies (2007, 2012) and revised applic 2013, AER FD 2008, AER DD 2012

An overview of the controllable opex shown in this way highlights the difference between using a zero base approach to setting future opex and

using the incentivised base year approach with step changes. The continual use of “zero based” calculations removes the comparisons essential to ensure that allowances are efficient. As the EBSS is designed to incentivise more efficient opex, exclusion opex assessments from this driver, reduces the value of the incentive program.

The ECCSA members all recognise the difference between the two approaches and that a bottom up assessment will inevitably lead to higher claims for opex but a top down approach (as used by the AER) reflects the imperatives of maintaining price competition.

The ECCSA considers that the AER is correct to assess future opex on a base year with adjustments basis. The outcome of the AER approach indicates that the opex allowance for AA4 shows considerable consistency with the actual opex that has been incurred in the past.

5.1.1 The base year

The approach used by ElectraNet for estimating opex was a mix of revealed costs and bottom up development. Under the Efficiency Benefit Sharing Scheme (EBSS) incentive program, the service provider is provided with an incentive to reduce its opex to the efficient level. This provides the regulator with the ability to use historic performance (moderated by changes) to set future opex allowances. The service provider is incentivised to increase its opex for the year the regulator considers reflects the efficient year – usually the last full year in the regulatory period.

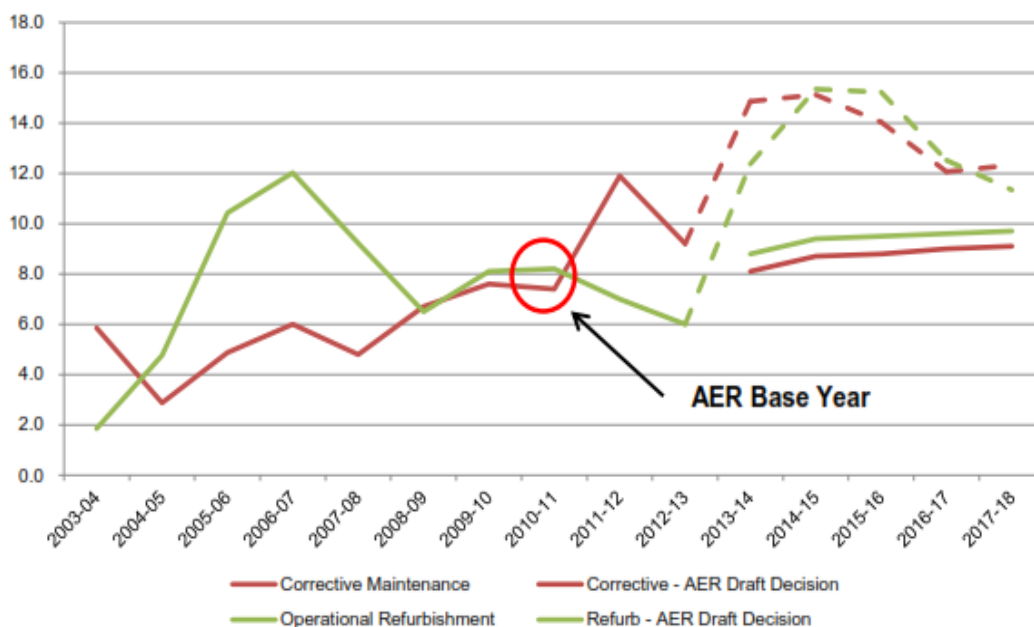
In its application for AA3, ElectraNet sought to use a considerable amount for its opex to be calculated on a zero base. The ECCSA did not support this approach but it was permitted by the AER. As a result there was a step increase in controllable opex allowance between AA2 and AA3 of some 25%. The arguments allowed by the AER for this zero base approach are no longer valid, yet much of the increase in opex sought by ElectraNet for AA4 reflects this same approach. The ECCSA is pleased that the AER has generally rejected this zero base approach as ElectraNet has been subject to an incentive to reduce its opex to the efficient boundary.

In its draft decision for AA4 the AER advised that its approach was to use the third year of AA3 as the efficient year because year 4 of AA3 indicated that its costs were above the efficient level based on trend analysis. The ECCSA raised its concerns that the efficient year was not year 4 of AA3 as the actual costs showed a step increase when compared to both years 3

and 5. The ECCSA considers that the AER is correct to use year 3 of AA3 as the efficient year because trend analyses support this.

ElectraNet comments that the AER was incorrect in changing the base year because of the “lumpy nature: of corrective maintenance and operational refurbishment and provided the following figure (figure 7.1) in its revised application demonstrating this fact.

Figure 7-1 Comparison of forecast and historical maintenance expenditure (\$m 2012-13)



Source: ElectraNet revised application

In fact, analysis of the average costs over regulatory period AA3 shows that the over the entire period, corrective maintenance cost \$8.46m pa and operational refurbishment cost \$7.16m pa. Both of these average figures sit very close to the actual values seen in the base year identified by the AER. The AER extrapolation for AA4 is therefore consistent with the five year averages for these elements adjusted for escalation and growth. Further, the actually incurred opex for AA2 period shows that average costs for opex increased by 20% between AA2 and AA3 implying that there were offsets in other opex to allow management of the “lumpy nature” referred to.

The argument by ElectraNet is that individual elements need to be adjusted because of the variation year on year of elements. The AER top down approach does not examine the year on year effects on specific elements but looks at all opex holistically and sees an average trend. As such the top

down assessment looks at the total needs rather than individual element needs.

However, EMCa (the AER consultant) did examine the opex more from a bottom up assessment, and came to a similar conclusion to that from the AER top down approach giving support to the AER draft decision

The AER also benchmarked ElectraNet average performance for AA3 against other transmission providers (AER appendix B). The opex performance comparison was based on the 5 year average to 2010/11 and these values indicate that ElectraNet is near the average performance trend line of all five NEM TNSPs. This reinforces that the average performance prior to 2011/12 year (ie based on year 3 of AA3) is likely to be reflective of more efficient performance than year 4 of AA3.

The ECCSA agrees with the AER that both benchmarking and trend analysis shows that year 3 of AA3 is more appropriate to use as the benchmark year than year 4 of AA3.

The ECCSA also adds that unless the effect of the EBSS is reflected in future opex allowances, then the purpose of incentive regulation is being marginalized. The ECCSA notes that its affiliates have recognized similar approaches used by other regulated firms – that they seek the benefits of the EBSS yet consistently seek to have some or all of their future opex allowances developed from a bottom up approach rather than using the revealed outcomes from that have been subject to incentives.

The ECCSA is of the view that actual outcomes, moderated by step changes and cost escalation and growth, provide a much better basis for setting future allowances than using new bottom up assessments. This reflects what occurs in firms subject to competition when setting future prices for their services and products.

5.1.2 Deviations from base year

The average annual opex for each regulatory period together with the ElectraNet initial and revised applications and the AER draft decision are provided in the following table. The purpose of the table is to identify which elements of the opex build up relate to the base year (ie top down assessment) and which reflect other methods for their assessment. The data for this table is sourced from ElectraNet applications (2007 and 2012) and the AER draft decision.

Average annual opex (\$m '12)	AA2 actual	AA3 actual	Applic AA4	AER DD AA4	Rev applic AA4	Implied EMCa AA4	E'Net zero base calc?
Routine maintenance		11.58	16.2	16.18	16.2	15.7	Yes
Corrective maintenance		8.56	13.78	8.74	13.68	9.6	Both
Operational refurbishment		7.16	12.96	9.4	13.34	9.8	Yes
Network optimisation		0	2.66	0	0.98	2.6	Yes
Maintenance support*		9.74	14	9.7	10.68	9.7	No
Network operations*		7.94	9.44	8.06	8.76	8.3	No
Asset manager support*		8.94	8.74	10.36	11.34	10.4	No
Corporate support*		5.84	6.78	6.28	7.34	6.0	No
Total controllable opex	49.1	59.76	84.56	68.72	82.32	72.1	
Self insurance		2	1.5	1.36	1.36		Yes
Network support		6.28	8.32	8.32	8.32		Yes
Debt raising		0	1.26	1.16	1.22		Yes
Total opex		68.04	95.64	79.54	93.26		

Except for the routine maintenance allowance, the AER draft decision reflects the efficient base year adjusted for inflation and step changes. The step increase of 40% in routine maintenance and 30% increase in operational refurbishment allowed by the AER are excessive and would appear to be inappropriate.

The Implied EMCa assessment is based on the EMCa table 22 in its report to the AER which examines the opex from the view point of the ElectraNet application (ie more of reviewing a bottom up assessment). Apart from the reductions which are specific, the ECCSA has made some assumptions to convert the EMCa adjustments to develop the table above. ECCSA made adjustments in opex efficiency and growth by applying the savings in proportion the initial application values. The EMCa reduction for support (maintenance, asset manager and corporate) was pro rated to the initial application values and corrected for observations made by EMCa and the AER. On this basis the major variations between the EMCa allowances and the AER allowances relate to the allowance for corrective maintenance and network optimization.

ElectraNet appears to have paid little attention to the AER analysis in its draft decision and consistently seeks a greater allowance for each element of controllable opex other than that for routine maintenance. The ECCSA is

intrigued that Electranet has sought increases in three of the eight elements of controllable opex above what it claimed in its initial application and only reduced its overall claim by 2.5% from what it claimed in its initial application.

5.1.3 The AER draft decision

In general, the ECCSA considers that the AER approach to setting the allowance for opex into AA4 reflects good regulatory practice. The identification of a base year opex which demonstrates efficient levels of opex and adjustment of this to reflect future changes (price escalation, growth and step changes) is an appropriate control mechanism that is comparable to the approach used by firms operating in a competitive environment where prices are set by competition and therefore costs must be controlled to ensure continuing profitability.

In contrast, ElectraNet has assessed the majority of its forecast opex needs from a bottom up approach that does not reflect the efficiencies generated in AA3.

The one concern that the ECCSA has with the AER proposed opex, is that it has accepted the ElectraNet forecast for routine maintenance which is a step increase of 40%. In addition to this large increase, the AER also allowed a 31% increase in the related operational refurbishment and a 15% increase in the related asset manager support elements of opex. The increases in these three elements constitute nearly all of the increases allowed by the AER between the AA3 average opex and the AA4 AER average allowed opex.

Agreement to a step increase of such a magnitude warrants considerable explanation yet the AER discussion on the topic is relatively modest. It is based on the assumption that the increases in routine maintenance (and other related elements) should result in greater reductions in other elements of the opex and capex areas.

The ECCSA agrees that an increase in routine maintenance that is associated with the new approach to asset management could well provide a net benefit to consumers yet there are no obvious savings identified to offset the large increases that have been granted. The AER needs to provide definitive information that increasing the costs of the new asset management process is element by such a large proportion is coupled with savings in other areas to demonstrate that increasing the allowance is efficient and provides a net benefit. In fact the AER has allowed increases

in other elements of the opex which reflect the normal growth that might be expected rather than any definitive outcomes.

The outcomes from an increased cost in routine maintenance should result in lower corrective maintenance, operational and capital refurbishment and an increase in service standards.

What is seen from the AER draft decision is that replacement and refurbishment capex has increased, corrective and refurbishment opex have increased and service standard targets are virtually unchanged or lower compared to ElectraNet performance in AA3. There is no obvious benefit that consumers see from the increased opex allowances.

5.1.4 The ElectraNet revised application

ElectraNet has paid scant heed to the AER draft decisions and the accompanying AER consultant report. What is even more concerning is the ElectraNet has only implemented reductions in three categories and sought increases in three other categories. The overall impact of the AER draft decision has been for ElectraNet to reduce its opex claim by only 2.5%.

The benchmarking by ElectraNet in its initial application was relatively cursory. The AER benchmarking in the draft decision provided strong guidance that ElectraNet 2010/11 opex performance was about average but not approaching the efficient boundary. The benchmarking studies in the EMCa report are redacted as being confidential.

On the premise that the opex in 2010/11 is seen as efficient, conventional practice is that the efficient opex should be used for the regulatory allowance with adjustments made for scale, cost escalation and step changes (generally as the AER has done subject to ECCSA comments made in section 5.1.3 above). ElectraNet has not done this in either its initial application or in its revised application and has shown a preference for using bottom up assessments.

The ECCSA considers that the revised application contains many of the errors and inconsistencies the ECCSA observed in its response to the initial ElectraNet application.

5.2 Concluding observations on opex

ElectraNet has carried out a “bottom up” development for over half of its controllable opex. Its revised application makes a very modest reduction (2.5%) in the forecast of controllable opex. In contrast the AER approach based on a top down review (as would be expected of an incentive based approach to opex) has close correlation with the bottom up review of controllable opex that was undertaken by its consultant (EMCa). This gives confidence that the outworkings of the AER and EMCa are more likely to reflect a reasonable forecast for opex in AA4.

The major area of concern that the ECCSA has with the AER forecast of opex for AA4 is that there is an assumption by the AER that the bottom up assessment of routine maintenance is efficient. This might be the case if the results of the increased routine maintenance reflected lower opex in other categories, lower capex requirements and an improvement in service standards. Unfortunately, none of these appears to have occurred putting doubt on whether the AER is correct in allowing an increase in routine maintenance.

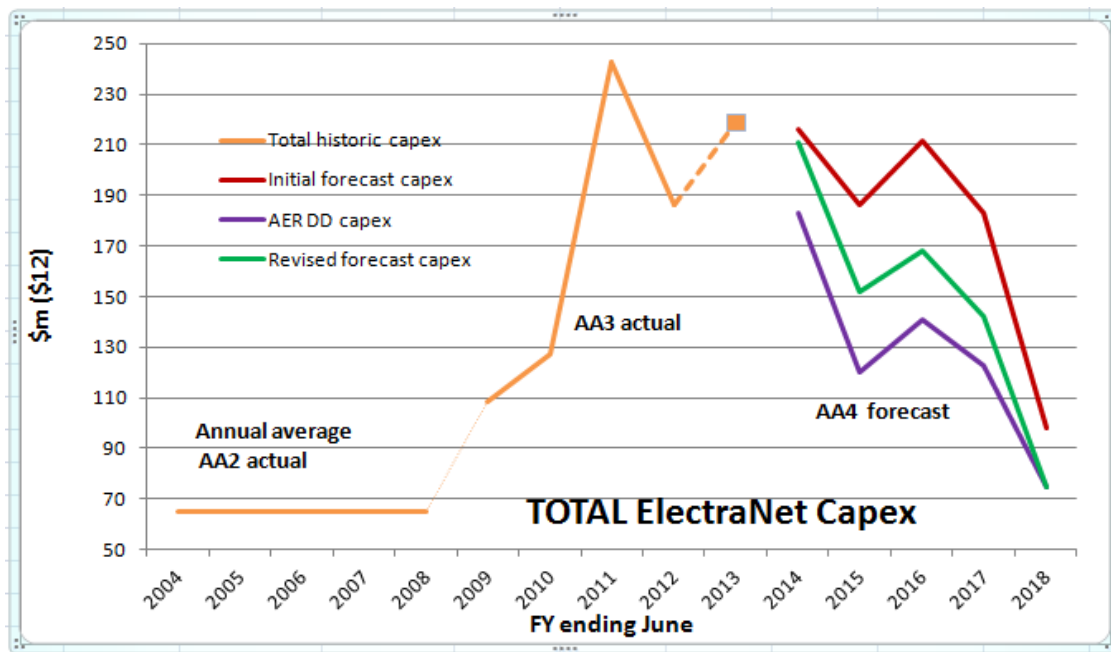
6. ElectraNet Capex

ElectraNet sought capex of \$894m over the next five years in its application for period AA4. The amount of capex for AA4 was similar to that actually incurred in period AA3.

6.1 An overview of AA4 capex

The AER consultant considered that only \$530m was required but the AER draft decision considered more than this was appropriate and determined that \$642m was efficient. Subsequently ElectraNet revised its capex needs to \$748m – a reduction of 16% from its initial forecast but still 17% above the AER “efficient” capex.

The following chart shows the historic capex with the two ElectraNet forecast (initial and revised) and the AER draft decision.



Source: ElectraNet applies, AER FD 2008, AER DD

The singular difference between the two ElectraNet forecasts (initial and revised) relates to the acceptance that the forecasts for demand and consumption will be much lower than ElectraNet assumed when it developed its initial application. Other aspects of the ElectraNet revised application show that its initial assessment has not been significantly modified by the AER draft decision or the comments of the AER Consultant (EMCa). This is

of concern to consumers as it implies that ElectraNet is still seeking to over invest in the SA transmission network. Whilst the cost to consumers in the short term of this high capex for AA4 is relatively modest, the long term costs to consumers will be significant.

The following table summarizes the average ElectraNet historic capex and the four forecasts of capex for AA4 – ElectraNet initial and revised capex, the EMCa assessment for capex and the AER draft decision. capex

Average annual capex (\$m '12)	AA2	AA3	Applic AA4	AER DD AA4	Rev applic AA4	Implied EMCa AA4
Augmentation		72.36	23.58	19.74	17.62	8.8
Connection		25.18	26.64	20.36	17.72	8.0
Replacement		47.48	79.6	52.32	68.64	52.5
Refurbishment		0	10.84	8.42	10.72	8.5
Strategic Land/Easements		5.96	13.16	2.7	7.9	3.2
Security/Compliance		12.52	11.46	11.4	13.04	11.4
Inventory/Spares		3.16	3.68	3.6	3.78	3.6
Total Network		166.7	168.98	118.52	139.46	96
Business IT		8.32	8.74	8.74	9.06	8.7
Building/Facilities		1.6	1.08	1.08	1.1	1.1
Total Non-network		9.9	9.86	9.86	10.18	9.9
Total capex	65	176.64	178.82	128.38	149.64	106

The Implied EMCa assessment is based on the EMCa table 14 in its report to the AER which examines the opex from the view point of the ElectraNet application (ie more of reviewing a bottom up assessment). The ECCSA has made some assumptions to convert the EMCa adjustments to develop the table above. As with opex, where the reductions are not specific, ECCSA made adjustments by applying the savings in proportion the initial application values and corrected for observations made by EMCa and the AER. On this basis the major variations between the EMCa allowances and the AER allowances relate to the allowance for augmentation and connections.

The outturn of this analysis is that Electranet has reduced its forecast needs for augmentation and connections below the capex the AER considered was appropriate. Electranet should be recognized for concluding its revised assessment for these two elements are less than the AER assessment.

Intriguingly, EMCa considers that capex for augmentation and connections should be much lower than the AER ultimately used in its draft decision. The fact that both EMCa and ElectraNet came to a conclusion that the AER draft assessment was too high, puts doubt on the reasons that the AER uses to explain why it gave less than full support to the detailed examination of the capex by EMCa.

There is a degree of consistency between actual costs in AA3, the ElectraNet initial and revised applications, the AER and EMCa regarding capex allowances for inventory/spares, business IT and building/facilities, although ElectraNet has revised upwards its business IT expectation by 3.6%.

There was consistency between AA3 actual costs, ElectraNet initial application, AER and EMCa with regard to security and compliance, but ElectraNet has ignored this and upwardly revised this capex element by 14%.

The revised assessments for capex effectively ignore the AER and EMCa assessments for replacement, refurbishment and land acquisition although ElectraNet makes a significant reduction in replacement capex and land acquisition capex,

6.2 The reasonableness of the capex claim

The increase in capex between AA2 and AA3 was driven by demand growth, assets nearing their economic life and increased security. As a result the average capex increased by nearly three times.

When comparing the AA2 capex with the EMCa estimated capex for AA4, there is considerable correlation – the actual capex increased by real escalation and growth factors reasonably reflects the EMCa assessment for AA4. In AA2, growth capex was just over 40% of total capex and replacement/refurbishment of a similar proportion³.

In AA3, ElectraNet did face considerable growth pressures and exceeded allowances for growth assets – growth capex constituted some 60% of the total capex. This means that the actual investment in non-growth assets was some \$66m pa. Accepting that growth in AA4 will be moderate at most, and allowing for real cost increase and growth reinforces the view that the EMCa assessment is consistent with the costs seen in AA3.

³ Table 4.2 ElectraNet application for AA3

The ECCSA is of the view that the EMCa assessment of capex needs for AA4 has a high degree of correlation with what occurred in AA2 and AA3 and reflects the lower growth that is forecast for AA4.

The major difference between the EMCa assessment and the AER draft decision lies with the treatment of the capex needs to address the SA Water connection assets. The ECCSA does not have better information as to the legitimacy of all consumers contributing to the connection assets of a specific end user, but accepts that “grandfathering” is accepted in the Rules.

6.3 Replacement and refurbishing

In AA2, ElectraNet underspent allowances in terms of growth investment by some 40%⁴ but overspent the allowance for replacement and refurbishment by 78% - and overall under-run allowances for these elements by \$48m. Of note is that the actual capex for replacement and refurbishment in AA2 was an average of \$30m pa nominal (\$38m pa real).

In AA3, Electranet underspent allowances for replacement and refurbishment by 20% but overspent on growth investment by 8%. Average expenditure on replacement and refurbishment was \$45m pa nominal (\$47.5m \$'12)

There is some consistency between the replacement and refurbishment actual expenditure in AA2 and AA3 after escalation of costs and growth are factored in. This means that the allowance for AA4 for these elements should be about \$57m pa using the same cost escalators and growth calculated by the AER.

The ECCSA sees that the allowance for AA4 for replacement and refurbishment should be of a similar value after adjusting for escalation of real costs, giving an allowance about \$57m pa (using the same cost escalators and growth factor used by the AER in its draft decision).

The AER and EMCa have both considered that \$61m pa is an appropriate allowance which is 7% higher than historical costs for replacement and refurbishment.

In all the applications by ElectraNet (for AA2, AA# and now AA4) Electranet has stated that replacement and refurbishment is needed for their assets which are approaching the end of their economic lives. The past performance of ElectraNet of the needed expenditure for this work shows considerable

⁴ Table 4.3 ElectraNet application for AA3 page 34

consistency and the ECCSA does not see then need for greater amounts of capex for AA4 than has been seen as required in the past.

6.4 The delivery of capex for AA3

The ECCSA sees that the AER has followed the ElectraNet proposal for front end loading the capex requirement. This results in higher costs being incurred in the early years. It also provides ElectraNet with the perfect conditions to increase its profitability by deferring the capex and retaining the cash benefit of under-running capex in the early years.

The benefits of capex deferral do not accrue to consumers if the total amount of capex allowed in the period is actually used. ElectraNet improved its profits by some \$50m by deferral of capex in AA3 and the ECCSA is very concerned that this approach will again be used by ElectraNet

The ECCSA considers the AER must look very closely at the capex program to ensure that consumers provide ElectraNet with an unearned benefit through capex deferral.

6.4 Land acquisition capex

The ECCSA notes that both they and EMCa have reviewed the proposed land acquisition program and consider the ElectraNet program to be inefficient. ElectraNet's revised application reduces the amount of acquisition considerably but still proposes a program that is four times the allowance the AER considers is appropriate.

The ECCSA can appreciate that ElectraNet does need to acquire land to provide for future growth. What concerns the ECCSA is that the timing of the need for the land and its size are still quite indeterminate. Acquiring land now might mean that costs will be lower than in the future, but the cost of holding that land is a cost that consumers carry. It has not been demonstrated the premature acquisition of land is more efficient than the acquisition at a later time when the need is fully determined.

The real cost escalators include for land escalation at a very high rate, so from the current consumer viewpoint, premature acquisition of the land will not provide a benefit to future consumers but will be an ever increasing cost to current consumers.

The ECCSA agrees with the AER (and EMCa) that acquisition of land that is not going to be needed in AA4, should not be allowed in the capex program.

6.5 Contingent projects

The ECCSA is concerned with the issue of contingent projects. Initially ElectraNet sought to include \$2,547m of contingent projects in the determination. EMCa considered that at most \$851m might be justifiable under modified circumstances and the AER concluded that \$666m was reasonable provided alternative triggers were implemented. The ElectraNet revised application seeks \$1,540m for contingent projects.

The AER needs to readdress the entire concept of contingent projects. There is now considerable debate as to what might happen at some stage in the future. Accepting that there is already considerable disquiet over the costs of providing network services, rather than NSPs being able to nominate certain projects to be acceptable providing certain trigger conditions apply, the regulator needs to impose controls similar to those that face firms in a competitive environment.

When conditions change in the market place, firms do modify their capex requirements so that capital is directed to projects that will provide the best outcome for the shareholders. The fundamental reality behind this approach is that capital availability within the firm is limited, and this limitation is driven by business fundamentals rather than the desire of the firm to increase capital expenditure.

The principle behind the contingent projects is that these projects will occur **in addition to** the amount of capital already seen as appropriate for the needs over the next five years. The ECCSA does accept that conditions might change and the network might have to expend more capital, but the first point of addressing the need should be to access the capital already made available and there be reprioritizing for the best use of the capital available. It should not be axiomatic that consumers have to pay for increased capital needs.

Just as firms in the competitive environment have to prove, **at the time**, their need for more capital and that the available capital needs are insufficient, so too should regulated networks have to prove that they have appropriately reprioritized their capital works program and that there is a real need for additional funds.

6.6 Concluding observations of capex

The ECCSA considers that the allowances for capex determined by EMCa are consistent with actual capex requirements of ElectraNet. The ECCSA also notes that the AER considers that it is required to allow the capex associated with the replacement/refurbishment of the SA Water connections.

ElectraNet has recognized in its revised application that there is a much lesser need for growth assets than it allowed for in its initial application and as a result has reduced its capex needs to below that considered appropriate by the AER.

However, ElectraNet's revised application seeks increased allowances in some categories of capex than sought in the initial application – the ECCSA finds this difficult to accept and considers the increases are not warranted

ElectraNet has reduced other elements of its proposed capex program but not to the extent that EMCa and the AER considered appropriate. The ECCSA approach of assessing the long term trend for replacement/refurbishment capex shows that even less capex for replacement/refurbishment is necessary for these elements than has been allowed by the AE and EMCa.

The downward trend of capex needs forecast for AA4 is seen by ECCSA as a trend that reflects the capex used in later years of AA3 is a peak and that capex will return to longer term lower amounts in the future.

7. Service standards

The ECCSA notes the AER in its draft decision addressed many of the points raised by ECCSA in its response to the ElectraNet application. The ECCSA recognises that ElectraNet has accepted most of the AER decision changes to the STPIS targets except for the weightings for events >0.05 system minutes and outage duration.

The ECCSA notes that ElectraNet, although commenting the inappropriateness of not making adjustment in targets to recognise the impacts of capital works, still accepts the AER draft decision. In this regard, the ECCSA observes that the capital works for AA4 will be less in value to those experienced in AA3. Based on this observation and using the arguments of ElectraNet, the service targets for AA4 should be higher than the average of those actually achieved in AA3. This observation is reinforced by the view expressed by the AER that they had previously allowed reductions in targets when capex programs increase compared to those in the previous period which provided the basis for the service performance targets.

On this basis, the ECCSA considers that the AER has erred in not adjusting the service targets to reflect the lower capex program for AA4 when the targets are based on performance in AA3 where a larger capex program was implemented.

ElectraNet considers the AER is wrong in not accepting its proposed weightings. The ECCSA notes that under the new STPIS, the AER will establish standard weightings and remove the ability of the service provider to change the weightings. The ECCSA agrees with the AER's new proposal as allowing the service provider the ability to change weightings introduces the ability to "game" the regulatory process by the service provider increasing the weighting where it considers it has a better chance of beating the target and earning a bonus. Weightings should reflect the value consumers place on the service being provided – not by the service provider deciding what consumers might want. The ECCSA considers the AER draft decision weightings more reflect the interests of consumers.

The ECCSA also notes that the AER has varied the STPIS methodology in a recent decision but this changed methodology does not apply to this revenue reset review. One of the key changes to the targets was to implement a rolling target based on recent performance and to average actual performance over two years to reduce the volatility in the actual performance (and hence incentive payments). The value of the changes results in recent trends in performance

being integrated into targets rather than using a set of data that towards the end of a regulatory period will have limited relevance to targets set.

The problem the ECCSA has with the STPIS for ElectraNet is that recent trends in performance indicate better performance in recent years but due to averaging over a longer period, targets are likely to be more achievable and bonuses paid. The approach to setting targets under the new STPIS overcomes this problem