

# **Australian Competition and Consumer Commission**

**South Australia Transmission Revenue Cap 2003 – 2007/08 Draft Decision**

**PUBLIC FORUM**

**Friday 4 October 2002**

**Stamford Plaza**

**150 North Terrace**

**Adelaide SA**

**Minutes**

John Martin, a Commissioner with the Australian Competition and Consumer Commission (the Commission), chaired the public forum.

The forum commenced at 1.30pm Friday 4 October 2002.

*Attendees:*

*Commission Staff:*

- Sebastian Roberts
- Scott Haig
- Richard Miles

*Interested Parties*

The following interested parties spoke at the forum:

- Rod Davidson (Electricity Consumers Coalition of South Australia);
- Matthew Cole (SPI PowerNet);
- Roman Domanski (Energy Users Association of Australia);
- Phil Gall (TransGrid);
- John Dick (Energy Action Group);
- Terry Miller (Powerlink);
- Ian Stirling (ElectraNet);
- Scott Klose (TransEnergie);
- Stephen Clark (Transend); and
- Graham Holdaway (KPMG).

## **Rod Davidson (Electricity Consumers Coalition of South Australia)**

ECCSA notes that while it is made up of the large energy consuming companies in South Australia it maintains that whatever it does must be done to support all electricity consumers in the State. As such ECCSA see their comments to the Commission as being made on behalf of all energy consumers in South Australia.

### *The Weighted Average Cost of Capital (WACC)*

The ECCSA is very concerned at two aspects of the WACC:

1. the increasingly mechanical approach being taken to what they consider is a very complex issue. Whilst the very mechanical nature of the calculation leads to regulatory consistency, ECCSA believes that it provides no review and comparisons of the intermediate steps; and
2. the lack of benchmarking the actual outcome of the WACC calculation against any decision other than that made by Australian regulators. ECCSA states that the result of continuing this insular approach is that the results must reflect the essential circularity of the approach and lead to self fulfilling results. It believes that international benchmarking of the WACC would break this cycle.

ECCSA highlights three elements of the Commission's WACC decision on ElectraNet as needing wider benchmarking than that done thus far by the Commission:

1. the calculated equity beta - it believes that ElectraNet does not qualify as an average business, so the equity beta should be less than unity;
2. the market risk premium - it states that independent analysis shows that the equity risk premium should be 3 percentage points, not 6 (Mercer Consulting report); and
3. the return on equity - comparisons with international benchmarks show Australian regulators are giving higher returns (Pareto Associates report).

ECCSA consider that the choice of a risk free period of 5 years is appropriate and the support the Commission's international consultant, Lally, on this view.

ECCSA believes that if international benchmarking of the components of the WACC calculation was carried out, the resultant WACC would be significantly lower than that determined by the Commission in its draft decision.

### *The Regulated Asset Base (RAB)*

ECCSA have three concerns regarding the RAB development:

1. the Commission has permitted the inclusion of the GST spike effect and that this has increased the RAB by more than \$50m. ECCSA state that the Commission must exclude the GST spike from its CPI adjustment of the RAB;
2. ECCSA supports the Commission assessment of the exclusion of the so-called overlooked easement value. ECCSA state that the South Australian Government has already sold these easements at \$3.1m, and this value was accepted by

ElectraNet at that time. ECCSA believes that the Commission has no alternative than to value easements at the commercial value set and agreed between the South Australian Government and ElectraNet; and

3. ECCSA consider that the DORC method for valuing assets is inappropriate. However, if DORC is used then the WACC allowed must reflect that when comparing the WACC derived by competitive business.

#### *Capital Expenditure (capex)*

ECCSA agrees that there is a need for capex, and that the level of the capex injection needs to reflect the needs of consumers and the reliability of the assets used to provide the services paid for.

Traditionally, service providers detail the capex program they are proposing, the benefits that will flow and the cost and the timing of each project. ECCSA states that ElectraNet have elected not to do this, and instead have requested a very large amount of money to be spent over a range of non-specific projects.

The Commission has stated that despite some misgivings, they will include the bulk of the capex requested into the revenue stream and then review in five years time whether the capex spent was in fact prudent and economically sound. This places significant risks on both ElectraNet and consumers and places the Commission in an unenviable position at the next reset.

ECCSA is concerned that if the approved capex is not spent, or fails the regulatory test, consumers will be disadvantaged and will have to wait until the next reset for restitution. It questions whether restitution will recognise the use of their money that ElectraNet has had for the period. ECCSA consider that potentially ElectraNet could gain an additional interest on the unused capex funds of up to \$100m over the period and consider this to be unacceptable.

ECCSA propose that in the absence of any detailed program of capex, that the amounts of capex approved by the Commission in the draft decision be included in the RAB. However, ECCSA considers that ElectraNet should be required to obtain annual approval from the Commission of the actual amounts of capex spent. If there is any under-expenditure then it argues that this amount should be deducted from ElectraNet's maximum allowable revenue (MAR) for the following year.

#### *Operational Expenditure (opex)*

Comparatively ElectraNet has consistently had a higher opex than the other large transmission companies in Australia. ECCSA believe that the inclusion of one international operator (TransPower) does little to provide a sound independent comparison.

ECCSA notes that the opex approved in the draft decision is approximately equivalent to ElectraNet past opex, adjusted for inflation. It is of the view that past performance can provide a useful guide as to what future opex should be.

ECCSA states that Australia is supposed to have an incentive-based regime for regulated businesses. However, by allowing ElectraNet to maintain its current level of

opex the Commission does not impose any incentive on them to find ways to improve performance. It states that in a competitive industry the cost of production falls in real terms. ECCSA also states that its members are continually being forced by competitive pressures to reduce their costs in order to stay in business and consider that ElectraNet should be subjected to the same pressures.

ECCSA believes that the opex allowance should be automatically reduced on an annual basis by at least CPI to replicate true competitive pressures.

In conclusion ECCSA:

- considers that the awarded WACC is too high;
- agrees with the draft decision on RAB, except that the GST spike effect needs to be removed;
- considers that the capex awarded is very high and needs better controls and annual adjustment; and
- considers that the opex awarded appears too high and is not well benchmarked and has little to drive efficiency improvement.

### **Matthew Cole (SPI PowerNet)**

SPI PowerNet (SPI) concentrated its presentation on the issue of WACC parameters, noting it would be making a more extensive presentation covering a wider range of issues in relation to its own draft determination. SPI acknowledges that setting the WACC is a difficult exercise, however it believes that the current draft decision does little to aid in resolving a number of outstanding issues.

SPI, ElectraNet and GasNet recently sponsored a WACC forum in an attempt to address a number of outstanding WACC issues. SPI is disappointed to see that the expert presentations made at the forum appear to have had no impact.

#### *The Risk-free Rate*

SPI argues against the Commission's use of the 5 year bond rate. SPI states that the 5 year term for the risk free rate reduces WACC by 25 basis points and that all other Australian regulators use the 10 year term. SPI notes advice from Professor Bob Officer that the use of a 5 year bond would be appropriate if the Commission provided a capital guarantee. However, SPI states that the Commission cannot provide this guarantee.

SPI considers that there are many well-established reasons in favour of using the ten-year bond rate such as:

- the long term nature of infrastructure investment (on average assets have lives of 50-70 years);
- it is consistent with the estimation basis for the market risk premium; and

- the market in ten-year bonds is much deeper and its estimates are more reliable.

Overall, SPI considers the Commission's position in using a term equivalent to the regulatory period is unsustainable.

SPI notes that the Commission has adopted a 40-day trading day sample period in the calculation of the risk free rate. SPI argues that a five to ten day period would be more appropriate as it would allow a TNSP to hedge and ensure that the information value is not unduly distorted. SPI asks that the Commission be flexible in its approach to calculating the risk free rate.

#### *Debt Margin*

SPI believes that the Commission needs to recognise that the debt margin is affected by the term chosen for the risk free rate and as such, the choice of a 5 year rate therefore has a double impact. SPI notes that currently BBB+ 5 year bonds are trading above the 130 basis points allowed in the ElectraNet draft determination. CBA spectrum prices the margin at 150 basis points for 5 years and 169 basis points for 10 years. Further SPI notes that the Commission's recent GasNet decision allowed debt raising costs of 8 basis points and equity raising costs equivalent to 48 basis points on the cost of equity but that these costs appear not to have been allowed in relation to ElectraNet.

#### *Gamma*

SPI states that the Commission has adopted a position of 0.5, however it notes that the Commission always includes a comment that the value should be closer to 1.0. SPI considers that such a comment:

- ignores official tax statistics indicating a figure of 0.5;
- assumes that businesses always pay out all their profits (when in reality few businesses pay out all their profits as dividends); and
- ignores that franking credits are a wasting asset (so it contends that it is very unlikely that gamma would ever be at or even close to 1.0).

SPI considers that Australia's capital markets are neither completely segregated nor completely integrated with world capital markets. In the absence of a financial theory to adequately address foreign ownership SPI considers the current use of 0.5 to be a pragmatic solution. This is based on advice from Professor Bob Officer.

#### *Conclusion*

SPI considers that the Commission has varied little from its previous decisions and that some of the language in the draft decision is concerning. It believes that the Commission's position appears to be 'unenlightened' in the context of recent debate sparked by the Productivity Commission's review. SPI believes that there are a number of outstanding WACC issues that are very complex. It considers that the Commission should convene a roundtable of the relevant experts as part of finalising its decisions for ElectraNet, GasNet and SPI.

## **John Dick (Energy Action Group)**

EAG believes that the draft decision fails on the benchmark of clarity and that the Commission needs to improve the quality of its reports if it wants people to get involved in the process.

EAG believes that the Victorian Essential Services Commission determination for both Gas and Electricity provide a useful benchmark in providing clarity and transparency.

EAG believes that the regulatory framework results in consumers funding TNSPs to play the 'regulatory game'.

EAG believes that there is a need for a consistent set of regulatory accounts to be established across all jurisdictions. It believes that the current information available as part of the regulators forum does not suffice.

EAG has serious concerns with light-handed regulation. It states that the Commission approves an allowance for capex and opex and if the TNSP performs well the incentives are great. However, EAG considers that it encourages the TNSPs to ask for the maximum amount, with the possible rewards for TNSPs being profound.

EAG questions why Victorian capex levels are lower than that for South Australia. It believes that Vencorp seems to be optimising the network

EAG referred to the ESIPC statement that any project greater the \$1m has to undergo the regulatory test, however other options need to be considered. EAG believes that the issue of causer pays is not well addressed in the draft decision.

EAG notes that the returns achievable from superannuation funds are much lower than that of the networks (11% real). It believes that TNSPs are unique and should not be compared to the businesses on the Australian Stock Exchange. It states that the Commission determines a return, along with an opex and capex allowance, then the business is free to do what it wishes until the regulatory reset. By which time there will be a completely new set of staff reviewing the same issues, but with no idea what has happened in the past. EAG considered that the turnover of regulatory staff was a national problem.

EAG considers that the notion of asset risk is an artificial construct as every business is subject to 'Acts of God'. It also notes that TNSPs have prudential arrangement in place to counter the risk of retailer failure.

EAG supports the Commission's stance on interest during construction.

EAG is concerned over ElectraNet's growing focus on its out-sourcing of maintenance activities and the impact that this has on skill levels in the industry. It notes that ElectraNet's application makes no commitment to develop skills to ensure that SA customers end up getting a reliable supply. EAG believes that there is currently a limited skill base nationally and urgent investment is needed for training, such as the allowance that has been provided for in the SPI PowerNet application.

## **Phil Gall (TransGrid)**

TransGrid focuses on the importance of a strong transmission system to enhance wholesale market competition in the NEM. It also notes that a lack of appropriate development could also lead to lower power system reliability, particularly in regional areas such as the Riverlands in South Australia.

### *Requirements for efficient investment*

To ensure that efficient levels of regulated investment in transmission take place in the NEM, TransGrid consider that two requirements need to be met:

- investors need to be confident that they will receive a risk adjusted return on investment that exceeds their weighted average cost of capital; and
- the Commission must recognise the full level of the required investment as part of the asset base for the purposes of determining regulated revenue caps.

TransGrid considers that the draft decision works against efficient transmission investment on both counts to the detriment of customers, competition, and the long term integrity of NEM transmission networks.

TransGrid also considers that work is still required on the Commission's service incentive scheme to ensure that it is not punitive and does not expose transmission businesses to 'double jeopardy'.

### *Low levels of regulated returns*

TransGrid notes that the Productivity Commission, the Australian Gas Association, and the Australian Pipelines Association of Australia have all argued that it is in the national interest for regulated returns to err on the high side to ensure adequate stimulus for investment in network infrastructure. It notes the view expressed by these parties that the failure to invest in this infrastructure has more serious consequences than the possibility of small levels of monopoly rent. TransGrid believes that this is particularly the case in the NEM where weak interconnection is inhibiting competition.

TransGrid also refer to a presentation by Professor Frank Wolak at the Australian Conference of Economists in Adelaide on the day before the forum. It stated that Professor Wolak included a strong transmission grid as one of the three essential ingredients to delivering sustainable competition in electricity markets.

TransGrid questions why the Commission has had so little regard for the expert evidence at a recent WACC forum in Melbourne. TransGrid states that all the eminent speakers at that forum argued for the use of a 10 year bond rate as the basis for determining the risk free interest rate variable in the model for determining WACC. TransGrid notes that this is a complex issue and that there is a need to rely on the best possible advice. TransGrid would like Lally to respond in specific terms to the arguments put by the experts at the WACC forum and believes that his consultant should be made available in full. TransGrid states that regulatory transparency would normally require the Commission to explicitly outline the way in which it has relied on the Lally report in coming to its position on ElectraNet's WACC for regulatory purposes.



TransGrid sought help from customer groups in arguing for the need for higher regulated returns. TransGrid note that without their support, transmission investment in Australia would follow the patterns in the US, New Zealand, and elsewhere where transmission congestion was keeping prices high, increasing price volatility risk, and even threatening longer term system reliability.

#### *Inclusion of transmission augmentations in the RAB*

TransGrid notes that if transmission projects, such as the Robertstown to Monash 275 kV line and connection to Monash Substation, are not included in a transmission company's asset base by the Commission then they cannot be built. TransGrid also considers that NRG Flinders and TransEnergie are likely to have strong incentives to persuade the Commission not to include certain projects.

TransGrid asked customers to become more active in supporting the need for projects, such as the Robertstown to Monash development, to be included in the ElectraNet determination if they wanted energy prices in South Australia to fall.

TransGrid also endorses the Commission's position to rely on independent advice in regards to the Riverland augmentations. In response to statements by TransEnergie at the forum, TransGrid stated that the NEMMCO SNI decision did include the Monash to Robertstown augmentation, and that it would be detailing the basis for this position in its formal submission.

#### *Service Standards*

TransGrid notes that if reliability performance targets are set at levels at or near best practice that improvements beyond that were much more difficult to achieve than declines in service levels. It believes that if this approach was applied it would result in a penalty scheme not an incentive scheme. TransGrid maintains that transmission companies should be rewarded for achieving and maintaining 'best practice' and should only be penalised when performance falls below 'acceptable practice'.

TransGrid also warned about creating a 'double jeopardy' situation for transmission companies. It stated that this occurs when investment needed to deliver reliability and reduced congestion was prevented by low levels of regulated return and the non-inclusion of these investment projects in the regulated asset base, only to see the transmission companies penalised when service targets were not achieved.

### **Roman Domanski (Energy Users Association of Australia)**

#### *Overall reaction*

EUAA is pleased that ElectraNet's opex, capex and returns have been pruned to some extent. It considers ElectraNet's application to be the most excessive application that it has come across to date. Although it considers that the draft decision improves on the outcome that consumers would have faced had the application been accepted, the EUAA strongly believes that the Commission has not yet adequately scrutinised ElectraNet's application nor set the MAR to include challenging but achievable targets for the next regulatory period.

EUAA believes that the WACC is still too high and that there remains insufficient incentives to reduce expenditure. It believes that the Commission needs to adopt a view that the relevant audience includes customers. EUAA is also concerned that the draft decision says nothing about the price impacts that will result.

#### *Rate of return and cost of capital*

EUAA considers that the rate of return represents approximately 40-45% of the MAR and therefore has a significant impact on final prices. It believes that there exist strong incentives for gaming by TNSPs. For example an increase of 10 basis points would result in an increase of \$0.75m pa. EUAA believes that regulators must balance the interests of the business and the consumers in setting the WACC. Currently it believes that consumer input is inadequate.

EUAA states that it has examined the rates of return provided in the UK and the US and note that they are much lower than those seen in Australia. It believes that UK and US regulators see energy utilities in very similar terms but that Australian regulators take a different view. EUAA considers that Australian regulators see the same types (and size) of utilities differently and see our utilities as much less efficient (and more costly to finance) than in the UK and US. EUAA believes that the ElectraNet draft decision continues the above trend.

It also believes that this raises serious doubt on how well Australian regulators are doing their job of protecting consumers. It questions whether Australian consumers paying more as a result of inefficiency or poor regulatory assessment. EUAA considered the draft determination to be 'par for the course' along with other Australian regulatory decisions, no better and no more challenging. The EUAA wants to see regulation evolve in Australia but does not consider that it is and questions whether regulators are protecting customers.

EUAA considers that Australian regulators are setting WACCs that are far higher than either the UK or the US (and penalising customers). It believes the main reason for this is the acceptance of a market risk premium of 6% compared to that adopted in the UK and US (3%). EUAA questions why there is a need for such a large premium? It states that the ElectraNet draft decision continues this trend. EUAA believes that overseas regulators recognise that equity risk premiums have declined and forward-looking rates are far lower than historical ones.

EUAA believes that an efficient and challenging Vanilla WACC would be between 4.5% and 5.5% (real, post tax) compared to the 6.3% in the draft decision. EUAA calculates that the difference means \$60-\$130m to ElectraNet's customers.

#### *Asset valuation issues*

EUAA supports the Commission treatment of easements. It also strongly supports the rejection of ElectraNet's other attempts to have the value of assets rolled forward changed (eg. IDC's and the re-admission of assets previously optimised). It believes that acceptance of these items would force customers to bear the costs of decisions made by ElectraNet's new owners and would result in an unacceptable rate shock.

EUAA considers that the use of an ODRC methodology means the asset value will be substantially inflated.

#### *Operational expenditure*

EUAA believes that the draft determination opex decision lies half way between the opex proposal and what has historically been the case. It states that opex accounts for close to one third of the maximum allowable revenue and therefore deserves to be thoroughly scrutinised using historical trends, international and national benchmarks. The EUAA believes that the Commission must set challenging benchmarks for ElectraNet as it sees little evidence of this in the draft decision. Otherwise it considers that end-users are susceptible to excessive prices.

EUAA states that evidence from regulatory reviews so far is that TNSPs continually propose excessive opex amounts and then consistently outperform regulatory benchmarks, pocketing the difference.

EUAA believes that the historical trend for opex appears to be downward sloping, yet under the draft decision there is a large step increase. Overseas experience is that actual opex declines overtime with efficiencies.

EUAA questions how a large increase in opex is consistent with a large increase in capex.

#### *Capital expenditure*

EUAA states that the capex allowance approved is only \$33m less than that requested by ElectraNet but results in a 46% increase in ElectraNet's capital base. It questions whether the Commission has adequately assessed capex.

EUAA believes that the Commission is correct in moving \$62m in refurbishments from opex to capex.

EUAA state that ElectraNet claims that the capex is necessary due an old network and demand. EUAA believes that this equates to the dubious 'bow wave' argument, well known in regulatory gaming.

EUAA considers that the capex seems excessive given that the network is lightly loaded, except for peaks, and that there is no indication that the capex proposed is optimal or whether alternatives have been considered.

EUAA questions whether it is reasonable to allow capex proposals with a probability as low as 12% (primarily augmentations to allow connection of wind generation) is reasonable as it will subject consumers to a great deal of uncertainty.

Further the EUAA is concerned that other large projects put forward by ElectraNet will be paid for by all South Australian customers when only a limited number of individuals will directly benefit from them.

### *Service standards*

EUAA notes that the code requires the Commission to take service standards into account in the revenue cap. It considers that the work done by SKM on behalf of the Commission in developing a set of service standards for TNSPs is an inadequate approach to the issues. The EUAA considers that the current review is ‘one giant leap forward for the Commission, yet one very small step for end-users’.

### *Transmission prices*

EUAA states that the draft decision imposes a 25% nominal (or 11% real) increase in transmission prices but that this is not readily transparent from decision. However, if the Commission adopted efficient benchmarks for WACC and opex it would result in considerable savings for customers (ie. half the increase proposed by the Commission or no increase at all). EUAA requests that the Commission clarify the impact upon transmission prices in its final decision.

### *Conclusion*

EUAA considers that the Commission needs to:

- reassess its WACC decision and make it more realistic in terms of benchmark and justifiable returns;
- examine opex more closely and prune it so that efficiencies are achieved over the period;
- examine capex more closely, question whether the proposals are even achievable, and make a more reasonable decision on projects where the beneficiaries are clear or probabilities are low;
- develop improved service standards for ElectraNet; and
- clarify the impact of the draft determination on transmission prices.

### **Terry Miller (Powerlink)**

Powerlink’s primary concern is with the apparent tampering with established principles, in particular what appears to be an arbitrary and inappropriate classification of refurbishment costs between opex and capex. Powerlink’s main aim in attending forum was to urge the Commission follows sound, established principles.

### *What is refurbishment?*

Powerlink state that refurbishment refers to the overhaul of aged assets and may be treated as either capex or opex:

- Refurbishment that is capex – upgrades or extends life (eg. replacing an aged transmission line);

- Refurbishment that is opex – does not extend the life of an asset or upgrade capacity (eg. replacing components to achieve the design life and capacity);

Powerlink considers that the draft decision is not consistent with Australian accounting standards.

Terry Miller presented a high voltage insulator by way of example of a component typically replaced as part of operational refurbishment. He states that capitalisation to this level would result in the network asset base increasing to millions rather than thousands of discrete assets.

#### *Sticking to principles*

Powerlink considers that the above distinction is consistent with Australian accounting standards.

It considers that the Commission got it right with its Powerlink determination. In this decision the Commission and its consultants concluded that Powerlink's split between opex and capex was correct and consistent.

Consider that it is important that the Commission is seen to apply its principles consistently across all decisions, and does not deviate from accounting standards and accepted practices. In particular Powerlink does not want the Commission to 'sacrifice the consistent application of established principles on the altar of expediency'.

### **Ian Stirling (ElectraNet SA)**

#### *Changing regulatory environment*

ElectraNet states that regulation has reached a watershed and that recent decisions have underlined a lack of investment incentives (eg. EPIC decision in WA, Productivity Commission recommendations, and Commonwealth Government's response). It believes that the SA transmission revenue cap decision presents an opportunity to get the incentives right for investment.

ElectraNet believes that the challenge is to understand the nature of South Australia's electricity system, and its implications for cost outcomes for all market participants.

Stated that ElectraNet's objective is provide a high quality, cost efficient transmission services that meet SA's rapidly growing energy needs with average annual growth in peak demand during the period of 1991-2001 of 4.0%.

#### *ElectraNet's proposal*

ElectraNet considers that it has proposed investment to meet forecast economic growth in the State, replace and upgrade vital infrastructure, increase interconnector capacity and allow connection of new competitive power sources.

ElectraNet states that this proposed investment addresses shortfall in spending on transmission assets over past 10 years and that ESIPC has confirmed that investment of the order proposed by ElectraNet is needed.

ElectraNet states that outcomes involve choice and believe that the Commission has made a choice on behalf of customers. ElectraNet consider that the Commission's draft decision has got the incentives wrong and that the Commission did not fully understand the peculiarities of the ElectraNet network.

ElectraNet states that it has absorbed growth in its network and believes that it runs its network harder than any other network. ElectraNet also states that there had been a lack of investment in the network in the 1990's and that the proposed investment in their application was not large.

ElectraNet believes that Mertec's conclusion regarding wind generation was not credible in light of a previous report on wind generation that they had prepared for ESIPC.

#### *Consumer benefits*

ElectraNet considers that the long term benefits far outweigh the relatively small cost of the proposed investment. Long term benefits were considered to be increased competition in the energy market leading to lower electricity prices, sustainable cost efficiencies and reliable supply.

ElectraNet believes that the Commission's failure to provide incentives for investment will mean higher electricity prices in the longer term and declining reliability of supply. It also believes that it clearly faces double jeopardy in relation to the impact of the draft decision and the SKM developed service standards.

ElectraNet considers that the Commission was repeating yesterdays mistakes and that lower prices today mean higher prices tomorrow.

#### *Commission's draft decision*

ElectraNet considers that the decision represents a revenue stream that is virtually unchanged from the Electricity Pricing Order (6% real price reduction) despite a significantly larger capex program (\$150m more) and higher operating costs.

It believes that the revenue stream will not support the scope of work implied in the Commission's draft decision (let alone ElectraNet's application) and therefore that something has to give. ElectraNet states that you get what you pay for and therefore it will respond to the incentives provided and as a result certain projects such as market benefit projects and infrastructure for renewables will not proceed.

ElectraNet states that it is facing higher operating costs and that the consequences of not accepting these higher costs is that maintenance will suffer.

#### *ElectraNet considers its costs to be efficient*

ElectraNet considers that the draft decision appears to be heavily influenced by a perception that ElectraNet's costs are inefficient despite putting hard facts in front of the Commission demonstrating otherwise. However, it believes that this perception fails to recognise two factors that shape comparative price outcomes: the nature of the electricity market in South Australia and the difference between price and cost.

ElectraNet notes that a low load factor raises prices and that it must provide capacity of 2833MW to meet consumer's peak demand. However, during a normal year only an average of 52% of this capacity is used but the cost of meeting 100% of peak demand has to be spread across the energy consumed. By comparison ElectraNet notes that Queensland consumes an average of 73% of the capacity provided and that this lowers the revenue required for each unit of energy and hence lowers transmission prices.

ElectraNet believes that, when comparing performance, it is essential to distinguish between costs and prices. It states that costs relate to capacity provided, but prices to energy consumed.

ElectraNet states that low energy density means South Australia requires more assets to provide the same level of transmission service as other states. In turn, the higher asset base drives higher opex as opex relates directly to assets maintained. ElectraNet states that it would be expected to have costs 70% higher than Powerlink because it has more lines to maintain per MWh. It states that opex per MWh for ElectraNet is only 55% above that of Powerlink.

ElectraNet considers that it can not be directly compared with other transmission companies because of its low average load factor and its low energy density. It believes that these differences in its operating environment need to be taken into account in order to compare like with like. It considers that when cost drivers are properly taken into account its costs are efficient.

ElectraNet notes that it still has problems with the Commission's treatment of refurbishment.

ElectraNet states that 75% of its total opex costs are based on competitive market prices (eg. maintenance, vegetation clearance, IT and telecommunications maintenance, property services, internal audit and legal services). It believes that there is no better way of getting a competitive price than going to the market. As such it considers that there is little scope for further efficiency improvements.

ElectraNet states that over 97% of its total capital costs are based on competitive market prices. It also notes that a turnkey approach is used, projects are bundled to achieve economies of scale, there are multiple service providers and that their contracts place performance incentives on service providers.

### *Conclusion*

ElectraNet considers that the draft decision delivers an inadequate revenue stream and that:

- it will only be able to do the bare minimum to meet Code requirements as a result of significant amounts of capex being removed from its proposed capex program;
- as costs incurred are substantially based on competitive market prices, cuts in opex allowance will result in cuts in planned asset maintenance and monitoring work; and
- it will have to cut back its Asset Management Plan program, a program endorsed by the Commission's consultant, Meritec.

ElectraNet contend that the cuts would be detrimental to customers in the long-term customer price, service and reliability. It states that the role of the transmission network is to facilitate competitive market outcomes and therefore that transmission networks are part of the solution.

### **Scott Klose (TransEnergie)**

TransEnergie limits its comments to capex to support the Riverland network. It supports the Commission's decisions to exclude from ElectraNet's capex program the construction of a Robertstown to Monash line and a Monash to SA border line.

TransEnergie requests that the Commission reconsider its decision to defer rather than exclude, the \$9.8m capital expenditure for the Monash substation component of Project No. 1.36m.

TransEnergie states that ESIPC has confirmed (based on earlier Meritec studies) that Murraylink has sufficient power transfer capacity (through a network support agreement) to provide the necessary level of support to the Riverland until at least 2007/08.

TransEnergie believes that Meritec has incorrectly assumed that it would be unable to enhance the network's capacity to meet voltage requirements after 2007/08. It believes that Murraylink can in fact provide the necessary support for an additional five years (until 2012/13) because more recent load forecasts show lower load growth in the Riverland and relatively low cost capital expenditure on shunt capacitors could defer the need to construct a new transmission line.

TransEnergie states that the revised load figures show that the load levels that previously occurred in 2007/08 do not now occur until after the summer of 2009/10 and that the installation of shunt capacitors for enhanced reactive support could defer the proposed ElectraNet works by a further 2 years (5 years in total).

TransEnergie believes that the substation works component of Project No. 1.36 should also be excluded from ElectraNet's capex allowance as TransGrid is the proponent of SNI and any additional work to accommodate the SNI – Monash connection should form part of SNI costs. It also believes that the alternative TransGrid proposal is based on SNI connecting in and out of Monash substation, but this connection has not been approved as part of the SNI regulatory process.



TransEnergie urges the Commission to reconsider its decision to defer, rather than exclude, the \$9.8m capital expenditure for the Monash substation component of Project No. 1.36 on the basis that no new 275kV lines have been approved for connection at Monash.

TransGrid disputed that SNI (NSW to Monash to Robertstown proposal) is not the original proposal assessed and approved by NEMMCO as passing the regulatory test.

### **Stephen Clark (Transend)**

#### *Capex allowance*

Transend notes that the Commission has excluded projects to facilitate distributed generation on the following grounds:

1. the high cost of such projects while the benefits are unclear - believed that this was a pre-emptive assessment of whether projects will pass the regulatory test and that if they do pass the regulatory test then they should be included in the regulated asset base;
2. the Code is unclear about who is to actually pay for such augmentations – believes that the code is clear about who should pay, beneficiaries pay for such augmentations and currently that is customers;
3. locational signals may be lost if generators are not required to pay – Transend believes that again the code is clear that beneficiaries pay and that it currently that is customers; and
4. the overall size of the program provides ElectraNet with the ability to re-prioritise – Transend consider that the real issue is the uncertainty and that project probabilities can be adjusted. It believes that the regulatory test should not be pre-empted.

Terry Miller (Powerlink) stated that it is the quantum of capex that needs to be reviewed and that it is not the Commission's role to look at whether or not a particular project may pass the regulatory test.

#### *Contingency amounts*

Transend notes that the Commission has excluded any contingency amounts from ElectraNet's capex allowance. It considers that the alternative is to include all possible scenarios of the future (including those with extremely low probabilities). It believes that a contingency amount is a practical compromise.

#### *Capex/opex definition*

Transend believes that the Commission should not get overly prescriptive and that any treatment should be cost neutral in the long term.

#### *Opex allowance*

Transend notes the Commission's statement that it prefers to focus on the total opex rather than individual cost components. It believes that the Commission must take business conditions into account:

- Energy density;
- Load factor (demand and supply side);
- Scale;
- Reliability.

Transend believes that the Commission needs a rigorous framework for benchmarking and by which it can examine individual cost components. It also considers that there is no real discussion as to what weightings have been used in discussion of benchmarking ratios.

### **Graham Holdaway (KPMG)**

Mr Holdaway was critical of the Commission's approach to revenue determinations. He believes that there are two main reasons for the price shock in SA: governments have not invested enough in generation and in the transmission network. He considers that the Commission may compound the error with its draft decision. He also stated that the decision has not done anything to reduce peak demand while the Electricity Pricing Order (EPO) had features that addressed load management issues.

Mr Holdaway believes that the Commission needs to review the draft determination in light of the following:

- the productivity Commission has for some time expressed reservations with the way in which regulation is being applied (eg. the National Access Regime);
- the Commonwealth government is to make specific changes to the TPA (Part IIIA) which clearly 'endorse the thrust' of the PC's recommendations; and
- the WA Supreme Court's Epic Decision provides an interpretation of the National Gas Code which is consistent with the Government's proposed changes to Part IIIA.

Mr Holdaway believes that the way that things are currently being regulated is not in the public interest. He considers that the Draft Regulatory Principles and the draft decision need to be reworked so that everyone gets what they thought they would get when competition policy was initially established.

Mr Holdaway noted that the federal government has announced its intention to:

- change the TPA Part IIIA to guide implementing regulators;
- insert an objectives clause along the following lines – 'the objective of this part is to promote the economically efficient operation and use of, and investment in, essential infrastructure services, thereby promoting effective competition in...' He

believes that the Commission has taken a wrong interpretation of narrow definitions and instead should have the object of workable competition rather than perfect competition;

- insert pricing principles – set prices to generate revenues that are ‘at least sufficient to meet the efficient costs of providing access’ and ‘include a return on investment commensurate with the regulatory and commercial risks involved’; and
- allow for merit review of Commission decisions by the Australian Competition Tribunal.

Mr Holdaway states that the WA Supreme Court’s Epic Decision:

- provides guidance to regulators on how to apply object clauses; and
- defined what the economic terms in the National Gas Code mean (for eg. references to competition mean ‘workable’ or ‘effective’ competition not perfect competition and references to efficient mean that which would be found in ‘workably’ competitive markets. He notes that similar terms are in the National Electricity Code.

Mr Holdaway believes the implications of the federal government’s response to the PC and the Epic Decision to be:

- there is no one right answer, regulators should be less ambitious and err on the side of investment in the presence of uncertainty;
- it is inappropriate to set revenues that are based on a perfect competition benchmark and just sufficient to ensure continued operation;
- the specific circumstances of the business need to be taken into account including regulatory and commercial risks (not just CAPM risk) and possibly including past investment costs; and
- regulators should avoid forensic reviews of businesses’ proposals, merely ensuring that they are not inconsistent with workable competition (ie. regulate by exception).

Mr Holdaway states that the ElectraNet Draft Decision:

- applies the ‘just sufficient’ revenue paradigm – equivalent to the risk adjusted market rate of return required to maintain investment;
- applies the ‘perfect market’ hypothesis – assumes that the benefits of accelerated depreciation are passed onto customers immediately when estimating the effective tax rate;
- ignores ElectraNet’s particular circumstances in setting opex and capex benchmarks; and

- does not carry forward the innovative elements of the current EPO and, in carrying forward the performance standards scheme, had turned it from three quarters incentive to three quarters penalty.

Mr Holdaway believes that the Commission should rewrite its Draft Statement of Regulatory Principles so that they are consistent with 'workable' rather than 'perfect' competition benchmarks and so that they encourage investment in necessary essential infrastructure (in line with Government's statements).

He also considers that the Commission should review all of its draft decisions to ensure that they are consistent with the Government's and the Court's interpretation of the regulatory instruments.

Mr Holdaway was asked several questions.

Roman Domanski (EUAA) asked if he was aware whether or not regulators were interpreting the Epic Decision differently. Mr Holdaway said that he was aware that they were. Mr Domanski considers that Australian regulators did not believe that the Epic Decision had any great implications for their regulatory frameworks.

Bob Lim (ECCSA) stated his view that claims regarding non-investment were being overstated. He also considered that in regards to the objectives clause, although the legitimate interests of business have to be considered, so to do the legitimate interests of consumers.

Roman Domanski also believed that the claims of non-investment were being overstated and referred to hundreds of millions of dollars of investment approved in various price sets by various regulators.

Mr Holdaway considered that approval did not mean spend and particularly did not mean spend in an optimal way.

David Headberry clarified that ECCSA was not opposed to capex proposals per se only ones that did not contain the what, wheres and whys. Mr Headberry stated that he believes that there is a point where investment stops but that this point has not been reached as yet.

### **Other questions**

Commissioner Martin asked ElectraNet if it had any thoughts as to demand management solutions. Ian Sterling stated that it was not ElectraNet's role to develop demand management solutions rather that it is a policy issue for governments.

Commissioner Martin reminded interested parties that the deadline for submissions was 11 October 2002 and closed the forum.