



SPI POWERNET

A subsidiary of Singapore Power International

**SPI PowerNet's Response to the
ACCC Draft Decision on Victorian
Transmission Revenue Caps
2003 to 2008**

8 November 2002

**SPI PowerNet Pty Ltd
ABN 78 079 798 173**

EXECUTIVE SUMMARY

On 11 April 2002, SPI PowerNet (ABN 78 079 798 173) lodged its revenue cap Application with the ACCC for the purposes of clause 6.2.4(b) of the National Electricity Code (NEC) in respect of the non-contestable electricity transmission services to be provided by the Company in the state of Victoria over the period from 1 January 2003 to 31 March 2008.

Following a review of the proposed opex, capex and RAB by PB Associates and public consultation on both SPI PowerNet's Application and PB Associates' reports, the ACCC released a Draft Decision on 14 October 2002. As foreshadowed in chapter 7 of the Draft Decision, on 1 November 2002 the ACCC released a consultation paper on the draft service standards for SPI PowerNet. The ACCC has invited written submissions on the Draft Decision and the consultation paper and will convene a public forum at SPI PowerNet's request on 14 November 2002.

This is SPI PowerNet's Response to the ACCC's Draft Decision. In due course, SPI PowerNet may also respond to the submissions of interested parties on the Draft Decision and views expressed at the public forum.

In the main, the ACCC has accepted SPI PowerNet's proposals. However, the ACCC's Draft Decision represents a cut in SPI PowerNet's revenue of 7 per cent (\$19m) in 2003/04, taking into consideration the fact that the scope of services covered by the revenue cap is greater than under the current Victorian Tariff Order. The quantum of the P0 cut roughly equates to the value of these scope changes (related to the roll-in of non-contestable transmission services and the revised outage rebate scheme). By comparison to the revenue cap that SPI PowerNet proposed in its Application, the ACCC's Draft Decision is 12 per cent (\$35m) lower in 2003/04.

There are a number of aspects of the Draft Decision that SPI PowerNet believes should be revisited by the ACCC. SPI PowerNet's concerns centre around:

- the ACCC's reasons for totally or partially rejecting particular elements of SPI PowerNet's proposals being in some instances based on errors of fact, and when corrected would lead to a reverse conclusion;
- inconsistencies between aspects of the ACCC's Draft Decision on SPI PowerNet and the Draft Decisions issued by the ACCC in respect of ElectraNet SA and GasNet; and

- the ACCC's failure to address several key elements of SPI PowerNet's proposals.

SPI PowerNet prepared its Application with regard to the objectives, principles, form and mechanism for transmission revenue regulation as set out in the NEC and on the basis of specific guidance from the ACCC as to how it interprets the NEC in relation to sunk asset valuation. Regard was also given to prior ACCC revenue cap and NEC determinations, the ACCC's Draft Statement of Principles for Transmission Revenue Regulation (DRP), and relevant decisions by other utility regulators.

In so doing, SPI PowerNet endeavoured to meet the needs of transmission users and the wider community by effectively undertaking to:

- provide safe and reliable transmission services; and
- charge a price for those services that is competitive, fair and reasonable.

To date, with the exception of a small number of modifications, SPI PowerNet believes that nothing has come to light in the course of ACCC's review of its Application that would justify the ACCC in not accepting every aspect of SPI PowerNet's proposals. SPI PowerNet therefore stands by its Application and looks forward to working through the substantive issues raised in this Response using a process that respects the legitimate interests and rights of all stakeholders.

SPI PowerNet requests that the ACCC make the following sixteen amendments in its Final Decision on the Victorian Transmission Revenue Caps 2003-2008.

Requested amendment - 1

The allowance for self insurance should be included in the Final Decision because SPI PowerNet has agreed to meet the ACCC's requirements.

Requested amendment - 2

In the Final Decision, the proposed PI scheme should be focussed solely on average outage duration, placing 0.5 per cent of revenue at risk in total, split equally between average outage duration performance on transmission lines and transformers.

Requested amendment - 3

In the Final Decision, the historical loss of supply frequency data should be corrected for the July to June financial year basis (as per Table 3.1 of SPI PowerNet's Response) and the units (minutes versus hours) for outage duration measures and targets need to be made consistent with the data originally supplied.

Requested amendment - 4

In the Final Decision, the modifications proposed by SPI PowerNet should be adopted for the (service standards) definition of force majeure.

Requested amendment - 5

Remove the term “extreme events” in the Final Decision on service standards, relying instead in the Force Majeure definition.

Requested amendment - 6

Include in the Final Decision the service measure exclusion clauses proposed by SPI PowerNet.

Requested amendment - 7

The opex and capex carryover amounts proposed in SPI PowerNet’s Application should be included in the Final Decision.

Requested amendment - 8

For application at the 2008 reset, the ACCC should commit in the Final Decision to the rolling efficiency carryover mechanism for both opex and capex together with the arrangement for setting future expenditure benchmarks – as proposed in the NERA report.

Requested amendment - 9

An easement value of \$194.7m should be allowed in the Final Decision, representing compensation to land owners (with no separate allowance for solatium), land owners fixed costs and easement purchase management costs.

Requested amendment - 10

The remaining \$95.9m of SPI PowerNet’s proposed value for re-optimisation (\$271.8m), in relation to part recovery of foregone returns and depreciation, should be allowed into the RAB in the Final Decision.

Requested amendment - 11

The roll-in values for pre-2003 customer augmentations should be updated in the Final Decision to reflect the finalised costs provided separately to the ACCC.

Requested amendment - 12

The RAB should be amended in the Final Decision to include the land purchases listed in Table 5.1 of SPI PowerNet's Response.

Requested amendment - 13

The Final Decision in respect of the WACC should:

- adopt a 10 year risk free rate;
- sample the risk free rate over 10 trading days, and notify the timing of the sample to SPI PowerNet in advance;
- base the debt margin on a BBB+ benchmark credit rating for a stand-alone entity;
- set the debt margin using the latest market evidence of BBB+ 10 year corporate bond issues, with specific regard to the utility sector – at 18 October 2002 this margin was 180bp, excluding debt raising costs;
- include 14bp for debt raising costs, either in the debt margin or as a cash flow allowance within opex; and
- make a cash flow allowance, within opex, for equity raising costs at the rate of 40bp on the (regulated) value of equity.

Requested amendment - 14

The ACCC should address and accept SPI PowerNet's proposed RAB roll-forward arrangements in the Final Decision.

Requested amendment - 15

The ACCC should address and accept SPI PowerNet's proposed pass through rules, subject to minor modifications, in the Final Decision.

Requested amendment - 16

The ACCC should address and accept SPI PowerNet's proposed treatment of non-contestable augmentations over the period 2003 to 2007/08 in the Final Decision.

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1. INTRODUCTION AND PURPOSE

1.1 Application for Revenue Cap Determination and ACCC's Draft Decision

On 11 April 2002, SPI PowerNet (ABN 78 079 798 173) lodged its revenue cap Application with the ACCC for the purposes of clause 6.2.4(b) of the National Electricity Code (NEC) in respect of the non-contestable electricity transmission services to be provided by the Company in the state of Victoria over the period from 1 January 2003 to 31 March 2008.

The Application was subsequently modified in three respects:

- on 31 May 2002, SPI PowerNet notified the ACCC, through the regulator's consultants PB Associates, that the value of the re-optimisation sought in respect of foregone returns and depreciation should be reduced by \$21 million in light of the discovery of a spreadsheet error – this is reflected in PB Associates' RAB report; and
- on 31 May 2002, SPI PowerNet notified the ACCC via letter that the opex forecast should be increased (by approximately \$1 million pa) as a consequence of the cost allocation model being updated from 2000/01 to 2001/02 base data; and
- on 27 June 2002, SPI PowerNet notified the ACCC via letter of an amendment to the Company's Application to incorporate a minor augmentation (shared network) allowance (valued at approximately \$1 million pa) – the amendment was made at the request of VENCORP and is aimed at achieving greater administrative simplicity and flexibility in progressing small scale projects (less than \$100,000) to alleviate network constraints, which would otherwise have to be individually contracted for outside SPI PowerNet's revenue cap.

In addition, SPI PowerNet has made two supplementary submissions to the ACCC, based on:

- a briefing presentation from economic consultants NERA on the reasonableness and economic sense of SPI PowerNet's approach to re-optimisation – 18 July 2002; and
- a report from NERA on efficiency carryover mechanisms appropriate to SPI PowerNet – 25 October 2002.

Following a review of the proposed opex, capex and RAB by PB Associates and public consultation on both SPI PowerNet's Application and PB Associates' reports, the ACCC released a Draft Decision on 14 October 2002. As foreshadowed in chapter 7 of the Draft Decision, on 1 November 2002 the ACCC released a consultation paper on the draft service standards for SPI PowerNet. The ACCC has invited written submissions on the Draft Decision and the consultation paper and will convene a public forum at SPI PowerNet's request on 14 November 2002.

This is SPI PowerNet's Response to the ACCC's Draft Decision. In due course, SPI PowerNet may also respond to the submissions of interested parties on the Draft Decision and views expressed at the public forum.

1.2 Substantive Issues Arising from the Draft Decision

SPI PowerNet's Application sought the ACCC's endorsement of five key proposals:

- a definition of the revenue-capped services;
- target performance levels for the provision of those services;
- a CPI-X revenue cap to apply for the period 1 January 2003 to 31 March 2008;
- principles for an incentive mechanism to encourage efficiency gains in excess of those forecast at the time the cap is set; and
- implementation arrangements, which include pass-through rules and a roll-forward mechanism to guide the setting of future revenue caps.

In the main, the ACCC has accepted SPI PowerNet's proposals. However, the ACCC's Draft Decision represents a cut in SPI PowerNet's revenue of 7 per cent (\$19m) in 2003/04, taking into consideration the fact that the scope of services covered by the revenue cap is greater than under the current Victorian Tariff Order. The quantum of the P0 cut roughly equates to the value of these scope changes (related to the roll-in of non-contestable transmission services and the revised outage rebate scheme). By comparison to the revenue cap that SPI PowerNet proposed in its Application, the ACCC's Draft Decision is 12 per cent (\$35m) lower in 2003/04.

There are a number of aspects of the Draft Decision that SPI PowerNet believes should be revisited by the ACCC. SPI PowerNet's concerns centre around:

- the ACCC's reasons for totally or partially rejecting particular elements of SPI PowerNet's proposals being in some instances based on errors of fact, and when corrected would lead to a reverse conclusion;

- inconsistencies between aspects of the ACCC's Draft Decision on SPI PowerNet and the Draft Decisions issued by the ACCC in respect of ElectraNet SA and GasNet; and
- the ACCC's failure to address several key elements of SPI PowerNet's proposals.

The following table identifies the substantive issues arising from the Draft Decision and includes issues raised by the ACCC.

Table 1.1: Substantive Issues Arising from the Draft Decision

Draft Decision Element	SPI PowerNet Application	ACCC Draft Decision	Issue
<i>Expenditure allowance</i>			
Self insurance	Allowance for non-insured risk \$ Self-insurance premium for Towers and Wires	Quantum of allowance is justified, but must meet corporate governance pre-conditions	Raised by the ACCC: SPI PowerNet needs to make specified board resolutions and provide these to the ACCC.
<i>Performance standards and incentives</i>			
Service standards	Outage rebate scheme Service standards as determined as part of the SKM review	Accepted outage rebate scheme and proposed further financial performance incentives together with a number of measures and targets	ACCC financial incentive scheme overlaps the existing outage rebate scheme: SPI PowerNet already has 2% of its revenue at risk on network availability through the outage rebate scheme with VENCORP. ACCC's financial incentive scheme should therefore focus on forced outage duration.
<i>Efficiency incentives</i>			
Glide path in respect of Tariff Order period	Combined opex and capex glide path of \$9.4 million in 2003/04, reducing to \$1.7 million in 2007/08.	Not addressed	Draft Decision did not address: SPI PowerNet has been operating under incentive regulation for 5 years and had a reasonable expectation that it would be rewarded for achieving efficiencies.

Table 1.1: Substantive Issues Arising from the Draft Decision (cont)

Draft Decision Element	SPI PowerNet Application	ACCC Draft Decision	Issue
Glide path in respect of 2003 to 2007/08 regulatory period	Proposed the principle that there should be equal incentives for both capex and opex efficiency with a mechanism to be determined as part of finalising the DRP	Not addressed	Draft Decision did not address: Clarity as to incentive arrangements is critical to the success of incentive regulation.
<i>Regulatory asset base valuation</i>			
Easement valuation (1/1/2001)	\$79.7 million – HC of compensation \$152.1 – indexed transaction costs from 1997 report	\$79.7 million – HC of compensation \$0 – indexed transaction costs from 1997 report	Errors of fact: PB Associates did not say that acquisition costs (\$89.4m of the transaction cost total) were included in the lines valuation, nor did they say that owners fixed costs (\$24.7m) were included in the compensation figure of \$79.7m. The ACCC relies solely on these misapprehensions to justify its decision on these items.
Re-optimisation (1/1/2003)	\$153.7 million – net ODRC value of re-optimisation (straight line depreciation) \$95.9 million – foregone returns and depreciation on re-optimised assets since 1994	\$153.7 million – net ODRC value of re-optimisation (straight line depreciation) \$0 million – foregone returns and depreciation on re-optimised assets since 1994	Error of fact: ACCC says that SPI PowerNet's claim for foregone returns and depreciation does not follow the Draft Regulatory Principles (DRP). In fact, the NERA report, provided in a supplementary submission, shows that it is wholly consistent with the DRP.

Table 1.1: Substantive Issues Arising from the Draft Decision (cont)

Draft Decision Element	SPI PowerNet Application	ACCC Draft Decision	Issue
<i>Cost of capital</i>			
Term of the risk free rate and associated debt margin	10 year	5 year	Conclusion based on flawed assumption ACCC has relied on a paper by Martin Lally, which makes the critical assumption that a regulated company enjoys a capital guarantee from the ACCC. No such guarantee can be or is provided. In the absence of the assumption, a 10 year rate is required.
Benchmark credit rating	BBB+	A	Relies on an incorrect sample in determining the average credit rating for the (stand alone) benchmark entity: ACCC determined an average credit rating of A based on a sample of businesses including many of which were Australian government owned, and of the remainder most were not stand alone, being part of conglomerates. Looking only at stand-alone network businesses, the average rating is BBB+.
Allowance for debt and equity raising costs	Allowance for debt raising costs included in debt margin. No allowance made for equity raising costs.	No allowance for either debt or equity raising costs.	Inconsistent with GasNet Draft Decision: ACCC allowed 8bp in the debt margin for debt raising costs and 48bp over and above the CAPM estimate of the cost of equity for equity raising costs (to be included in the cash flows rather than the WACC).

Table 1.1: Substantive Issues Arising from the Draft Decision (cont)

Draft Decision Element	SPI PowerNet Application	ACCC Draft Decision	Issue
<i>Roll forward and implementation arrangements</i>			
RAB roll forward arrangements	Simple roll forward from 1 January 2003 to 1 April 2008. Revaluation and/or re-optimisation allowed, but no windfall gains or losses.	Not addressed	Draft Decision did not address: Roll-forward arrangements, which are fundamental to revenue cap decisions. SPI PowerNet may have to revise its Application if the ACCC does not endorse SPI PowerNet's proposal.
Pass through rules	Pass through of net additional cost of defined events in relation to: tax change; insurance, terrorism; and services standards.	ACCC reserved its decision	Draft Decision did not address: ACCC has neither accepted or rejected SPI PowerNet's proposal. Stakeholders are entitled to consultation on ACCC's Draft Decision. SPI PowerNet may have to revise its Application if pass through rules are rejected.
Treatment of non-contestable augmentation for the period 2003 to 2007/08	Interim pricing based on building block approach with the services to be included in the revenue cap at the 2008 reset.	Not addressed	Draft Decision did not address: Given the structural arrangements in Victoria, the ACCC needs to make a decision on pricing of new services not included in the revenue cap.

Source: SPI PowerNet's Application and ACCC's Draft Decision

1.3 Procedural Issues arising from the Draft Decision

SPI PowerNet understands that the Draft Decision is intended to provide SPI PowerNet and interested parties with an opportunity to comment on the ACCC's Draft Decision as to the revenue capping arrangements that should apply. In this context, the only reason that the decision is draft is that it is subject to comments from stakeholders. In all other respects, the Draft Decision should be complete.

However, as Table 1.1 indicates, in some areas the ACCC has reserved its position or has simply not addressed key elements of SPI PowerNet's Application. In view of this, SPI PowerNet believes that the ACCC is obligated to remedy these defects in its Draft Decision and to provide stakeholders with the opportunity to comment on the

ACCC's intended course of action prior to the ACCC making its Final Decision. How this should be achieved is a matter for the ACCC.

1.4 Recap on SPI PowerNet's Approach to Preparing the Revenue Cap Application

SPI PowerNet prepared its Application with regard to the objectives, principles, form and mechanism for transmission revenue regulation as set out in the NEC and on the basis of specific guidance from the ACCC as to how it interprets the NEC in relation to sunk asset valuation. Regard was also given to prior ACCC revenue cap and NEC determinations, the ACCC's Draft Statement of Principles for Transmission Revenue Regulation (DRP), and relevant decisions by other utility regulators.

In so doing, SPI PowerNet endeavoured to meet the needs of transmission users and the wider community by effectively undertaking to:

- provide safe and reliable transmission services; and
- charge a price for those services that is competitive, fair and reasonable.

Following recent trends, the revenue cap proposed was calculated using a post-tax nominal building block approach. As proposed, the revenue cap would maintain SPI PowerNet's financial viability and allow the Company to fund the asset management program that is critical to the performance of the transmission system.

To date, with the exception of the modifications referred to in section 1.1, SPI PowerNet believes that nothing has come to light in the course of ACCC's review of its Application that would justify the ACCC in not accepting every aspect of SPI PowerNet's proposals. SPI PowerNet therefore stands by its Application and looks forward to working through the issues detailed in Table 1.1 using a process that respects the legitimate interests and rights of all stakeholders.

1.5 Organisation of the Response

In view of the substantive and procedural issues identified above, this Response is organised to address:

- expenditure issues – Section 2;
- performance standards and financial incentives – Section 3;
- efficiency incentives – Section 4;
- the valuation of the RAB – Section 5;

- the cost of capital – Section 6; and
- roll-forward and implementation arrangements – Section 7.

For clarity, SPI PowerNet's requests for amendments to the Draft Decision are highlighted in each section, after the relevant discussion.

2. EXPENDITURE ISSUES

In the Draft Decision, the ACCC has accepted as appropriate the opex and capex programs proposed by SPI PowerNet for the period 2003 to 2007/08. PB Associates (for the ACCC) reviewed these programs and was satisfied that SPI PowerNet has in place sound asset management systems and that the proposed expenditure is justified having regard to the age of the network and other identified cost drivers.

The only issue in relation to expenditure raised in the Draft Decision concerns the treatment of non-insured risks. This is discussed below.

2.1 Non-insured Risks

The ACCC has recognised that an allowance for non-uninsured risks is an appropriate way to compensate a regulated business for those diversifiable risks for which insurance is either not available, or not available at reasonable cost.

Quite rightly, the ACCC requires that the risks so compensated are clearly defined and the circumstances in which the business will then bear those risks is unequivocal. SPI PowerNet is equally concerned to ensure that it has a clear, shared understanding of these matters which will enable it to properly manage the risks in its business going forward.

The ACCC has required the following before it confirms the requested allowance for uninsured risks:

- confirmation of the board resolution to self-insure;
- a report from an appropriately qualified insurance consultant that verifies the calculation of risks and corresponding insurance premiums;
- relevant self-insurance details that unequivocally set out the categories of risk the company has resolved to assume self-insurance for. This would need to clearly establish what the insured events and exclusions are so as to avoid any future debate as to whether or not an event was a self insured one and form the basis for actuarial assessment noted above.
- a regulated entity's resolution to self-insure would also be expected to explicitly acknowledge the assumed risks of self-insuring (ie in the event of future expenditure required as a result of an insurance event such costs would not be recoverable under the regulatory framework as the relevant premiums would have already been compensated for within the operating and

maintenance element of the allowed MAR and funded by users, eg if a 1 in a 100 year event occurs in year 1 then the business will need to have the financial ability to restore assets out of own resources).

SPI PowerNet is comfortable providing the material specified above. A draft of the necessary documentation has been provided to the ACCC, and any reasonable amendments required by the ACCC will be incorporated and the documents finalised and submitted by SPI PowerNet prior to completion of the Final Decision.

It should be noted that the scope of the non-insured risks in SPI PowerNet's Application are predicated on the RAB roll-forward arrangements and pass through rules proposed. As discussed in section 8 below, if the ACCC ultimately decides to reject SPI PowerNet's proposals in these areas, SPI PowerNet may have to revise its Application, including the allowance for non-insured risks.

Requested amendment - 1

The allowance for self insurance should be included in the Final Decision because SPI PowerNet has agreed to meet the ACCC's requirements.

3. PERFORMANCE STANDARDS

3.1 ACCC Proposed measurement framework

The ACCC released its draft proposal for Victorian service standards on 1 November 2002. Based on the review undertaken by Sinclair Knight Merz (SKM) for the ACCC, the key features of the proposal are:

- the introduction of five sets of measures for SPI PowerNet to report against, those being:
 - Availability;
 - Loss of Supply Event Frequency Index;
 - Average Outage Restoration Time;
 - Transmission Constraints (Intra-Regional); and
 - Transmission Constraints (Inter-Regional);
- targets for availability and average outage duration measures; and
- a performance incentive scheme placed on availability and average outage duration measures (0.25 per cent of the revenue cap at risk for each set of measures, 0.5 per cent in total).

The ACCC has indicated a preference have at least 1 per cent of revenue at risk, but in recognition of the existing availability incentive scheme (which places over 2 per cent of SPI PowerNet's revenue at risk) the ACCC has limited its scheme to 0.5 per cent of the revenue cap.

3.2 SPI PowerNet's Response

3.2.1 Measures

SPI PowerNet supports the introduction of the five measures proposed by the ACCC and has previously supplied, in the context of SKM's review, a detailed proposal for benchmarks and historical data for the first three measures, which the ACCC has accepted. SPI PowerNet will begin measuring the last two measures when NEMMCO has the systems in place to supply the relevant data.

3.2.2 Reporting

SPI PowerNet will report on its performance on an annual basis as required by the ACCC. However, SPI PowerNet maintains its view that it would be more meaningful for electricity consumers if reporting was on the basis of the Victorian transmission network as a whole. This would involve redefining the measures and targets to

include the effects of planning decisions by VENCORP and the performance of other asset owners in Victoria. If this is done, then SPI PowerNet believes that VENCORP, due to its overall planning responsibilities in Victoria, should be the TNSP responsible for reporting against the composite measures and targets for Victoria.

3.2.3 Performance incentive scheme

It is both SPI PowerNet's and VENCORP's strong view that the Network Availability Incentive Scheme recently renegotiated by both parties (after having been in place in Victoria for the last eight years) provides performance incentives that are consistent with and more powerful than those recommended in SKM's review, and puts a greater percentage of revenue at risk (2 per cent rather than 1 per cent). Of note, the scheme provides combined incentives to reduce the number, duration and criticality (peak, off peak and season) of outages, providing well-directed signals for transmission network outages to be programmed at non-critical times (away from peak load periods), and also weights the penalty payable according to the importance of the particular transmission elements.

SPI PowerNet's view is that it is undesirable for the SKM financial incentives proposal to be operated in parallel with the renegotiated Victorian Network Availability Incentive Scheme. However, SPI PowerNet recognises the ACCC's desire for a broader suite of incentives over the long term and for all TNSPs to operate under a similar scheme. In view of this, SPI PowerNet proposes two changes to the proposed incentive scheme.

First, the ACCC Performance Incentive (PI) scheme should be removed from the availability measures and the magnitude of the proposed incentive on the average outage duration measure increased from 0.25 per cent to 0.5 per cent of revenue. Specifically:

- Lines Average Outage Duration (+/- 0.25% revenue incentive); and
- Transformer Average Outage Duration (+/- 0.25% revenue incentive).

This avoids the overlap of incentives on availability from the combined ACCC scheme and Victorian availability scheme. An overlap would add little to the incentives already in place and could potentially provide conflicting incentives in certain circumstances.

Second, with VENCORP's agreement, SPI PowerNet proposes to report the outcomes from the Network Availability Incentive Scheme as part of the ACCC reporting

regime. This will make SPI PowerNet's performance on availability transparent to both the regulator and customers even though the ACCC's PI scheme would not be applied to this measure.

Requested amendment - 2

In the Final Decision, the proposed PI scheme should be focussed solely on average outage duration, placing 0.5 per cent of revenue at risk in total, split equally between average outage duration performance on transmission lines and transformers.

3.2.4 Other matters

Appendix 2 table of historical performance

Appendix 2 of the ACCC Services Standards position paper provides SPI PowerNet's historical performance for the loss of supply frequency index over the July to June financial years 1996/97 to 2000/01. However, the figures listed were supplied to SKM on a calendar year basis, therefore they represent performance for calendar years 1997 through 2001 inclusive. SPI PowerNet's outcomes for the July to June financial years used in Appendix 2 are reproduced below.

Table 3.1: *Loss of supply frequency index, July to June financial years, 1996/97 to 2000/01*

	1996/97	1997/98	1998/99	1999/00	2000/01
>0.05 minutes/annum	0	3	0	2	2
>0.3 minutes/annum	0	0	0	1	1

Source: SPI PowerNet

In addition, the targets and performance for the outage duration measures were expressed in hours when they were supplied to SKM, however, they have been expressed as minutes in Appendix 2. For example, the target should be expressed as 10 hours (or 600 minutes) not the 10 minutes currently in the table.

Requested amendment - 3

In the Final Decision, the historical loss of supply frequency data should be corrected for the July to June financial year basis (as per Table 3.1 of SPI PowerNet's Response) and the units (minutes versus hours) for outage duration measures and targets need to be made consistent with the data originally supplied.

Force Majeure Definition

SPI PowerNet believes that a tighter definition is required for the damage limit above which force majeure will apply. Therefore, SPI PowerNet requests that the last clause on page 16 of the ACCC document be changed to the following:

“Force majeure, in this occurrence, specifically includes:

- The loss of or damage to two or more switchbays in a SPI PowerNet terminal station or substation.
- The collapse of four or more intermediate transmission line towers.
- The loss or damage to 11 or more control or secondary cables
- The loss of or damage to two or more transformers and capacitors, either single phase or three phase, connected to a bus.
- The loss or damage to a transformer, capacitor bank, reactor, static var compensator, or synchronous condenser, where loss or damage is not repairable on site according to normal practices.”

In addition, SPI PowerNet wishes to include the following additional clause:

“An outage which is requested by NEMMCO where the reason for that request is a breach of the NEMMCO Operational Guidelines that is caused by full or partial failure of any equipment that is not used by SPI PowerNet.”

Requested amendment - 4

In the Final Decision, the modifications proposed by SPI PowerNet should be adopted for the (service standards) definition of force majeure.

Extreme events

A number of the Performance Indicator Definitions have in their inclusions section the term "extreme events" without defining what "extreme events" are. Given that the definition of force majeure appears to effectively define what extreme events are to be excluded, this term may no longer be needed in the Performance Indicator Definitions. If the term is to be retained, SPI PowerNet requests that the ACCC clearly define the meaning so that SPI PowerNet can assess whether it would accept such events in the measures.

Requested amendment - 5

Remove the term “extreme events” in the Final Decision on service standards, relying instead in the Force Majeure definition.

Exclusions

All exclusion clauses for the first three measures should have the following standard clauses:

“Any outage caused by a fault, outage request or other event on a ‘3rd party system’ connected to the TNSP’s Network.”

“Any outage requested by a 3rd party for construction or demolition activities on land over which the TNSP has an easement.”

‘In relation to a loss of a double circuit tower, exclude the outage of one circuit following the restoration into service of the other circuit.’”

“An outage which is requested by VENCORP or a 3rd party to enable VENCORP or a 3rd party to augment the High Voltage Grid, or conduct tests on the High Voltage Grid, either itself or through a contractor.”

“An outage which occurs within a period during which a Connected Person does not require the Supply of electricity directly or indirectly from the High Voltage Grid, where that Outage does not affect the Supply of electricity to any other person.”

“An outage which is requested by NEMMCO except where the reason for that request is an act or omission of SPI PowerNet.”

“A full or partial failure of the Brunswick Terminal Station to Richmond Terminal Station 220 kV Cable system that is caused by damage to a part of the cable which is:

- (i) located on, under or overland that is not an SPI PowerNet site; and
- (ii) which is inflicted by a person other than SPI PowerNet.”

Requested amendment - 6

Include in the Final Decision the service measure exclusion clauses proposed by SPI PowerNet.

3.3 Conclusion

SPI PowerNet believes that its suggested modifications to the ACCC draft proposal represent an appropriate way forward on the issue of service measures and targets.

The Network Availability Incentive Scheme, when combined with the modified ACCC PI scheme, provides powerful and sophisticated incentives in relation to availability and outage duration.

4. EFFICIENCY INCENTIVES

In SPI PowerNet's Application, Chapter 5 was given over to a proposal for efficiency incentives. This related both to rewarding efficiencies achieved over the period 1998 to 2002 as well as to providing incentives for pursuing prospective efficiencies over the 2003 to 2007/08 period and beyond. Apart from one bullet point in the list of regulatory principles applied in the revenue cap (p.13), the ACCC's Draft Decision contains no discussion of efficiency incentives, does not address any aspect of SPI PowerNet's proposal for efficiency incentives, and makes no financial allowance in the revenue cap to recognise efficiencies achieved during the current regulatory period. SPI PowerNet understands that the ACCC is, however, now actively considering the merits of SPI PowerNet's proposal.

To aid the ACCC in this regard, SPI PowerNet recently engaged NERA to write a report on the design of an efficiency carryover mechanism linked to a process for setting future expenditure benchmarks appropriate to electricity transmission companies, and more particularly to SPI PowerNet's own context. This report was provided to the ACCC on 25 October 2002, and is included at Appendix A to this Response. While NERA's proposed design is discussed below, it is worth noting that most of the existing work on the design of efficiency carryover mechanisms (such as the ESC's) has taken place in the context of distribution as opposed to transmission networks. Although NERA has taken the ESC's approach as their starting point, in the transmission context the lumpy and cyclical nature of expenditure requirements necessitated some changes to the design.

Against this background, the purpose of this section is to:

- revisit the proposal for efficiency incentives made in SPI PowerNet's Application – section 2;
- summarise NERA's proposed design for an efficiency carryover mechanism and linked process for setting future expenditure benchmarks– section 3; and
- extend SPI PowerNet's proposal on efficiency incentives in light of the NERA report – section 4.

4.1 Overview of SPI PowerNet's Application on Efficiency Incentives

In its Application, SPI PowerNet highlighted the fact that, for some years now, it has operated its electricity transmission business so as to seek out and achieve cost

efficiencies while maintaining performance levels. A key driver of this performance has been the understanding that the revenue capping arrangements would:

- provide for some form of explicit incentive payment in relation to the efficiency gains made over the period 1998 to 2002; and
- define a specific mechanism for efficiency carry over to apply at the 2008 reset that will motivate further cost efficiency over the 2003 to 2007/08 period.

Ideally, the efficiency incentive mechanism applying for 1998 to 2002 would have been established at the beginning of the regulatory period. Nevertheless, confirmation of the arrangements applying to this revenue determination will be important not only for confirming principles that were discussed in relation to SPI PowerNet in 1997, as part of privatisation, but also for confirming the ACCC's commitment to providing a tangible incentive for efficiency moving forward.

If anything the need for credible regulatory commitment on this issue is now greater than over the initial regulatory period since the scope for further efficiencies is reducing as the significant early gains from privatisation have already been achieved.

4.1.1 Key Principles

In proposing specific mechanisms for efficiency carry over, SPI PowerNet said in its Application that it believes a key principle should be the equal treatment of cost reducing efficiency gains, irrespective of whether they arise from capital, operating or maintenance expenditure. Any arrangement that attempts to distinguish between different forms of cost is likely to encourage skewed and inefficient expenditure decisions.

SPI PowerNet maintained that it is no different from any other business in that there is often a degree of latitude available in the choice between operating and capital solutions to an asset management requirement. Distinguishing artificially between one form of expenditure and another introduces bias to what otherwise should be an over-riding principle of effectiveness in making resource allocation decisions.

Furthermore, SPI PowerNet submitted that there may be some discretion in relation to the extent to which particular expenditure requirements are capitalised. Again, a consistent approach to the treatment of out-performance in relation to both operating and capital expenditure benchmarks will ensure that accounting for and reporting of expenditure over time will not be distorted.

4.1.2 Link between incentives for cost efficiency and quality of service

In addition to the key principles discussed in its Application, SPI PowerNet demonstrated its awareness that, in the broader regulatory context, the incentives for cost efficiency should not conflict with the achievement of agreed quality of service outcomes. In particular, there should not exist a net financial incentive to reduce expenditure at the expense of performance.

Elsewhere in its Application, SPI PowerNet described the network availability incentive scheme that the Company has agreed with VENCORP and discussed the raft of contractual and regulatory performance measures and targets under which the Company operates (noting that ACCC is currently developing a NEM wide approach to service standards). In combination with the specific incentives for cost efficiency proposed in its Application, SPI PowerNet submitted that it would face a balanced set of incentives – to maintain and (in relation to network availability during peak periods) improve the quality of service, while pursuing cost efficiency. If approved by the ACCC, this balance would mean that the regulatory system would not encourage cost cutting at the expense of quality of service.

4.1.3 Mechanism for efficiency carry over into the 2003 revenue cap

In respect of the carry over of efficiencies achieved over the period to 2002, SPI PowerNet proposed in its Application a mechanism that works as follows.

- The value of the efficiency is determined as the difference between the cumulative expenditures over the period 1998 to 2002 (in 2003 \$) allowed for in the Tariff Order benchmarks and the cumulative expenditures actually made or forecast to the end of 2002 (in 2003 \$). Multiplying by the regulated WACC annualises the savings on the capital expenditure component. Dividing through by 5 annualises the savings on the operating and maintenance expenditure.
- This value is then “glide-pathed” for five years from 2003 so that in each successive year, commencing in 2003, SPI PowerNet retains the following proportion in real terms – 1, 0.8, 0.6, 0.4, 0.2. To account for the fact that the regulatory period is five and quarter years rather than five, the glide path is pro-rated between the six sub-periods to achieve an equivalent financial outcome.
- The glide path is a combined figure for capital and operating and maintenance efficiency.

SPI PowerNet said in its Application that this proposal is considered appropriate in the circumstances because it is comparatively simple. It could be argued that this mechanism would create an incentive for delaying efficiencies that may arise late in the regulatory period were it to be used to encourage efficiency in the 2003 to 2007/08 period. However, in respect of rewarding past performance over the Tariff Order period, there is now little that SPI PowerNet could do to affect its spending patterns. Nonetheless, the issue is one that SPI PowerNet anticipates the ACCC will consider in relation to the mechanism for incentivising prospective efficiencies and is addressed in NERA's report.

4.1.4 Proposed efficiency carryover based on 1998 to 2002 performance

Applying the efficiency carryover mechanism proposed in SPI PowerNet's Application produces a relatively small glide path that is added to revenue over the 2003 to 2007/08 period.

The build up of the carryover is presented in Table 4.1.

Table 4.1: Calculation of the efficiency carryover

Panel A

Cumulative expenditure over the period 1998 to 2002 on:	Actual 2002 \$m	Benchmark 2002 \$m	Annualised Difference 2002 \$m
Capital	130.7	190.1	5.6
Operating and maintenance	212.7	232.3	3.9
Total	na	na	9.6

Panel B

	Financial years ending 31 March (nominal \$m)					
	2003¹	2004	2005	2006	2007	2008
Glide path	2.5	9.4	7.7	5.8	3.8	1.7

¹ This is data for a three month period, 1 January 2003 to 31 March 2003.

Source: SPI PowerNet Revenue Cap Application, p.48

In relation to whether the difference between actual and benchmark expenditure is actually the result of efficiency, SPI PowerNet notes that PB Associates in its reports on SPI PowerNet's operating and maintenance expenditure and capital expenditure concluded very strongly that SPI PowerNet is an efficient transmission operator:

- "From 1995/96 to 1999/00, SPI PowerNet achieved a cumulative reduction of \$60m nominal due to reductions in staff numbers and a range of rationalising initiatives." (PBA Review of SPI PowerNet Operating Expenditure, p.3);

- “Independent benchmarks show SPI PowerNet to be a very efficient transmission operator.” (PBA Review of SPI PowerNet Operating Expenditure, p.3);
- “PB Associates considers that SPI PowerNet has comprehensive and effective procedures in place for Asset Management” (PBA Review of SPI PowerNet Capital Expenditure, p.4); and
- “PB Associates has concluded that although it initially appears that SPI PowerNet has deferred capital expenditure from the current regulatory period to the next, a major increase in capital expenditure has occurred in the 2002/03 FY, prior to the next regulatory period. There are several coincident factors that have led to the need to start a major and sustained capital expenditure programme from 2002 onwards and decisions to undertake projects would have had to meet the condition and other criteria outlined in SPI PowerNet’s Asset Maintenance Strategy plus supporting documents.” (PBA Review of SPI PowerNet Capital Expenditure, p.20)

4.1.5 Principles for efficiency carry over into the 2008 revenue cap

At the time of making its revenue cap Application, SPI PowerNet recognised that the efficiency carry over mechanism proposed for the 2003 regulatory period have some drawbacks if applied on a prospective basis and did not propose a particular mechanism for efficiency carry over into the 2008 regulatory period. SPI PowerNet understood that the ACCC intended addressing this issue as part of its process for finalising the Statement of Regulatory Principles during 2002. As input into this process, SPI PowerNet referred the ACCC to the key principles (see section 4.2.1 above) that an efficiency carry over mechanism should satisfy together with the discussion of the link between incentives for cost efficiency and quality of service (see section 4.2.2).

4.2 NERA’s Proposed Design for an Efficiency Carryover Mechanism

Since making its Application in April 2002, SPI PowerNet has commissioned NERA to write a report on the appropriate design of an efficiency carryover mechanism for electricity transmission, and more particularly for SPI PowerNet. As mentioned at the beginning of this section, the NERA report was submitted to the ACCC on 25 October 2002 and is included in this Response, at Appendix A.

The executive summary of NERA's report is reproduced in Box 4.1 below.

Box 4.1: Executive summary of NERA report on efficiency carryover design

This paper is intended to inform the Australian Competition and Consumer Commission's (ACCC) consideration of the appropriate design of an 'efficiency carryover mechanism' to be incorporated into SPI PowerNet's regulatory framework. The focus of the proposal relates to the carryover to be applied at the 2008 reset and beyond.

Role of an Efficiency Carryover

An efficiency carryover mechanism allows a regulated business to 'carryover' some or all of the efficiency gains (or efficiency losses) made in the current regulatory period into the following regulatory period(s).

There are three key objectives for an efficiency carryover mechanism:

1. Non-distorting incentives for the timing of efficiencies;
2. Non-distorting incentives for the type of efficiencies; and
3. Appropriate magnitude of incentive for efficiencies.

However, the appropriate form of efficiency carryover mechanism needs to be considered as part of the wider regulatory framework. In particular, it is important to consider the interaction between the efficiency carryover mechanism and the process adopted by the ACCC for setting expenditure benchmarks in future regulatory periods. Incentives for cost savings arising out of an efficiency carryover mechanism can be reversed or destroyed by a poorly set out process for determining future expenditure benchmarks.

The ESC's 'Rolling-Carryover' Mechanism

An important context for our analysis is the existence of the efficiency carryover mechanism which has been adopted by the Victorian Essential Services Commission (ESC) as part of the regulatory framework applying to both the Victorian electricity and gas distribution businesses.

Our analysis in this paper is that the ESC's mechanism achieves the objectives of not distorting the timing of investment, and provides an appropriate magnitude of incentives for business' to make efficiency gains.

In relation to not distorting incentives for the *type* of efficiency, the ESC's mechanism allows businesses to retain the same proportion of gains from a saving in operating expenditure or a once-off saving in, or deferral of, capital expenditure. However, businesses retain a lower proportion of any *recurrent* savings in capital expenditure. Businesses may therefore have an incentive to substitute capital expenditure for operating expenditure.

We note that this potential bias is not peculiar to the ESC's carryover mechanism, and also arises under the standard 5 year revenue/price cap. Our proposal for the carryover mechanism to apply to SPI PowerNet allows for a specific adjustment to the regulatory asset base where the business/regulator can make a strong case that the cost saving/increase is ongoing in nature, in order to address this potential bias.

Box 4.1: Executive summary of NERA report on efficiency carryover design (cont)

Setting Benchmarks for Future Periods

In this report we set out two rules for the setting of expenditure benchmarks under an ESC type efficiency carryover. These rules are required so as not to undermine the incentives of an efficiency carryover mechanism. In particular, we argue that in the absence of a 'last year' problem :

- benchmark expenditures should be based on the best estimate of likely expenditure at the beginning of the regulatory period less any observed deferral of expenditure from the previous regulatory period; and
- benchmark expenditures should not extrapolate past trends in costs into the future – except to the extent that a portion of those trends can be identified as being driven by factors beyond the businesses control (such as factor cost changes and an ageing asset base).

In order to be able to rely more heavily on revealed cost information in setting future benchmarks, there needs to be a presumption that past costs are a good guide to future costs. This will be the case where the level of costs is stable from year to year and there are no discrete changes in costs from one regulatory period to the next. However, outturn costs may not be considered a good guide to future costs where costs tend to be lumpy and variable, where costs exhibit a cyclical trend or where there are changes in the underlying cost drivers or obligations placed on the business, or changes in external input costs.

Proposed Efficiency Carryover Mechanism to apply to SPI PowerNet

We propose the application of the following rolling carryover approach for SPI PowerNet:

- the carryover of efficiency gains for five years following the year in which the gain is made;
- the adoption of a symmetrical approach in carrying over both efficiency gains and efficiency losses (ie, spending in excess of benchmarks);
- the carryover amount calculated in relation to both operating & maintenance and capital expenditure, in relation to the expenditure benchmarks only, ie, no allowance for an efficiency carryover in relation to SPI PowerNet's network augmentation expenditure, on the assumption that appropriate incentives will be built into contractual arrangements; [original emphasis]
- adjustment of the benchmark forecasts in calculating the carryover amount to take account of any cost differences arising from changes in legislated or regulated obligations during the period together with changes covered by the revenue cap's pass through arrangements;
- an efficiency gain (loss) for operating expenditure calculated as an increase (decrease) in recurrent operating expenditure;
- an efficiency gain (loss) in capital expenditure calculated as the regulatory WACC, multiplied by the difference between that year's capital expenditure and the original benchmark forecast plus an additional adjustment for expenditure savings that are found to be ongoing in nature; [original emphasis]
- the efficiency gain (loss) for the last year of the regulatory period to be assumed to be zero, and:

Box 4.1: Executive summary of NERA report on efficiency carryover design (cont)

- for operating expenditure the future benchmarks will be set without regard to any observed efficiency savings in the last year of the regulatory period; and
- for capital expenditure, the benchmark capital expenditure assumed for t-1 is used in determining the opening asset base for year t, with a subsequent adjustment to take account of the difference between outturn and benchmark capital expenditure in t+6.

This approach largely mirrors the ESC's approach. The key area of difference is the inclusion in our proposal of an additional adjustment in the calculation of the carryover associated with ongoing capital expenditure savings.

Proposed Approach to Setting Future Benchmarks for SPI PowerNet

We propose that the approach to setting future expenditure benchmarks for SPI PowerNet should comply with the two 'rules' set out above.

The 'lumpy' and cyclical nature of SPI PowerNet's operating costs means that setting opex benchmarks will be necessarily more complex than for businesses which face a constant operating cost trend. In particular, the ACCC will need to consider:

- what operating expenditure in the penultimate year is not expected to be repeated in the next regulatory period, and, conversely, what expenditure is necessary in the next regulatory period which was not required in the earlier period – to address the 'lumpiness' of SPI PowerNet's operating costs;
- any trends in operating expenditure, as a result of ageing assets. Although the current part of the cycle is one with increasing operating costs, ultimately we would expect that costs will fall (and the cycle will start again), as older assets are replaced;
- the changes in business scope/obligations between the regulatory periods; and
- changes in other factors beyond SPI PowerNet's control, such as exchange rate changes and changes in insurance costs - these cost factors may be increasing or decreasing.

Source: Efficiency Carryover Design, NERA October 2002, pp. i-iv

4.3 Extension of SPI PowerNet's Proposal in light of the NERA Report

As noted at the beginning of this section, SPI PowerNet understands that the ACCC is actively considering the issue of efficiency carryover but has not yet reached a position on the proposal made in SPI PowerNet's Application. In light of the NERA report, SPI PowerNet extends its proposal to include NERA's recommendations for prospective efficiency carryover and setting of future expenditure benchmarks.

SPI PowerNet's proposal in respect of carrying over efficiencies achieved over the 1998 to 2002 period remains unchanged, and is as discussed in sections 4.2.3 and 4.2.4 above. As NERA note in their report, their proposal "applies to the long-run mechanisms, and does not imply that the same approach is necessarily appropriate

for the 1998 to 2002 period.” (p.37) Although mentioned above in section 4.2.4, SPI PowerNet emphasise that PB Associates (for ACCC), in their reviews of operating expenditure and capital expenditure, consistently concluded that SPI PowerNet’s asset management practices are efficient, which provides support for SPI PowerNet’s claim for efficiency carryover.

Requested amendment - 7

The opex and capex carryover amounts proposed in SPI PowerNet’s Application should be included in the Final Decision.

In respect of future arrangements, expanding on the proposal in its Application to take up NERA’s recommendations, SPI PowerNet proposes a prospective efficiency carryover approach that involves:

- the carryover of efficiency gains for five years from the year in which the gain is made;
- the adoption of a symmetrical approach in carrying over both efficiency gains and efficiency losses (ie, spending in excess of benchmarks) – the principle of symmetric treatment is important in ensuring that the incentive properties of the regime are maximised;
- the carryover amount calculated in relation to both operating and maintenance and capital expenditure, in relation to the expenditure benchmarks only (ie there need be no allowance for an efficiency carryover in relation to SPI PowerNet’s network augmentation expenditure, on the assumption that appropriate incentives will be built into contractual arrangements);
- the adjustment of benchmark forecasts in calculating the carryover amount to take account of any cost differences arising from changes in legislated or regulated obligations during the period together with changes covered by the revenue cap’s pass through arrangements;
- an efficiency gain (loss) for operating expenditure calculated as an increase (decrease) in recurrent operating expenditure;
- an efficiency gain (loss) in capital expenditure calculated as the regulatory WACC, multiplied by the difference between that year’s capital expenditure and the original benchm forecast plus an additional adjustment for expenditure

savings that are found to be ongoing in nature (as set out in section 3.5 of NERA's report);

- the same approach to the “last year” as adopted by the ESC, ie the efficiency gains (loss) for the last year of the regulatory period will be assumed to be zero, and:
 - for operating expenditure the future benchmarks will be set without regard to any observed efficiency savings in the last year of the regulatory period; and
 - for capital expenditure the benchmark capital expenditure assumed for t-1 is used in determining the opening asset base for year t, with a subsequent adjustment to take account of the difference between outturn and benchmark capital expenditure in t+6.

In concert with this, SPI PowerNet proposes that the benchmarks to be set in the 2008 reset for both capital expenditure and operating expenditure should be based on the best estimates of future expenditure needs. This is in recognition of the cyclical and “lumpy” nature of many of SPI PowerNet's costs and the fact that external factors may lead to increasing or decreasing costs between regulatory periods. There are two equally valid approaches to setting expenditure benchmarks in this way – top down (which starts with the best estimates of future expenditures) and bottom up (which starts with outturn expenditure in the penultimate year of the current regulatory period, and is similar to the ESC's stated approach). While SPI PowerNet believes that both approaches should be used, in order to demonstrate the robustness of the expenditure benchmarks, the Company believes that the top down approach is simpler to understand.

The top down approach involves adjusting the best estimates of future expenditures required over the next regulatory period to:

- remove any observations of efficiencies achieved in the final year of the last regulatory period (as not doing this would implicitly deny the regulated business an efficiency carryover associated with any such savings); and
- remove any costs that will be incurred that represent deferral of expenditure already allowed for in previous regulatory periods.

In setting expenditure benchmarks, SPI PowerNet concurs with NERA's view (p.39) that “the ‘lumpy’ and cyclical nature of SPI PowerNet's operating costs mean that

setting benchmarks will be necessarily more complex than for businesses which face a constant operating cost trend. In particular, the ACCC will need to consider:

- what operating expenditure in the penultimate year is not expected to be repeated in the next regulatory period and, conversely, what expenditure is necessary in the next regulatory period which was not required in the earlier period – to address the ‘lumpiness’ of SPI PowerNet’s operating costs;
- any trends in operating expenditure, as a result of ageing assets. Although the current part of the cycle is one with increasing operating costs, ultimately we would expect that costs will fall (and the cycle will start again), as older assets are replaced;
- the changes in business scope / obligations between the regulatory periods; and
- changes in other factors beyond SPI PowerNet’s control, such as exchange rate changes and changes in insurance costs – these cost factors may be increasing or decreasing.”

Requested amendment - 8

For application at the 2008 reset, the ACCC should commit in the Final Decision to the rolling efficiency carryover mechanism for both opex and capex together with the arrangement for setting future expenditure benchmarks – as proposed in the NERA report.

5. REGULATORY ASSET BASE VALUATION

Based on guidance from the ACCC, SPI PowerNet proposed in its Application a regulatory asset base (RAB) for the purposes of calculating the return on capital and depreciation elements of the revenue cap. The 1994 valuation that underlies the Victorian Tariff Order was rolled forward by adjusting for capital expenditure, depreciation, retirements and inflation over the period to 2003. On a basis consistent with the original valuation approach, a value was placed on assets omitted from the 1994 valuation and, where necessitated by changes in circumstance, values were revisited (i.e. re-optimisation due to increased utilisation of the transmission system). In addition, assets relating to services that will only become revenue capped from the start of the new regulatory period were included in the RAB from 1 January 2003.

The ACCC, in its Draft Decision, has accepted in large part the valuation of the RAB proposed by SPI PowerNet. The only exceptions concern the values ascribed to easements and re-optimisation. SPI PowerNet believes that the ACCC's Draft Decision in these regards is based on errors of fact, which when corrected would lead to a different conclusion. While these very major issues are the focus of this section, there are two much smaller items that also need to be addressed: final values for the roll-in of pre-2003 customer augmentations to be included in the revenue cap; and correction of figures for land purchases between 1994 and 2000.

This section is organised to deal with each of these issues in turn:

- easements – section 5.1;
- reoptimisation – section 5.2;
- final valuation of excluded services rolling into the RAB – section 5.3; and
- corrected figures for land purchases –section 5.4.

5.1 Easement Valuation

In its draft decision, the ACCC has allowed \$79.9m for the value of easements based on the historic cost records for land compensation provided by SPI PowerNet. This differs from the PB Associates (PBA) *Review of SPI PowerNet Asset Base*, undertaken for the ACCC, which concludes that a \$194.7m easement value is justified. Specifically, the ACCC has not accepted PBA's recommendation that \$24.7m for land owners' costs reimbursed by SPI PowerNet (and its predecessors) at time of purchase or \$89.4m for the capitalised costs of managing the easement

purchases (including valuation fees, legal costs and survey costs) be allowed into the RAB. The ACCC's stated reasons for their decisions and SPI PowerNet's response are outlined in the following sections.

5.1.1 Land owners' costs

In not allowing the land owners' cost component (related to legal and other valuation expenses) of the SPI PowerNet easement valuation the ACCC states that:

"The Commission considers that in the absence of information to the contrary it is assumed that these payments [the \$79.9m] represent the total paid directly to the landowners as compensation for the acquisition of the easements." (p 45, ACCC Draft Decision)

The available evidence presented to both PBA and the ACCC clearly contradict this statement. While the Company's records on the reimbursement of land owners' costs are limited to less than 10 per cent of easements, the existing evidence shows owners costs were settled separately from compensation without exception. Indeed, SPI PowerNet can categorically state that land owners' costs are not included in compensation costs recorded on any of its available easement registration records. SPI PowerNet provided a sample of these records that clearly show settlement of land owners' costs separate to the compensation recorded on the easement record (seven sets of documents were provided on the 29 April and 31 May 2002). This evidence was accepted by PBA in its *Review of SPI PowerNet Asset Base*.

Furthermore, SPI PowerNet believes that this was standard practice because the easement records were often finalised (with their recorded compensation value) and registered at the State Titles Office well before land owners' costs were submitted and settled. If the ACCC has retained valuers for advice on easement issues then those valuers should be able to verify this statement.

SPI PowerNet provided a detailed brief on these issues to PBA on 14 June 2002 (a copy was provided to the ACCC).

In the absence of evidence to the contrary, SPI PowerNet considers that these costs must be included in the easement valuation for the Final Revenue Determination.

5.1.2 Easement purchase management costs

In not allowing the capitalised management cost component of the SPI PowerNet easement valuation the ACCC states that:

“The transmission line replacement costs used for valuation purposes can be expected to include all planning and other costs associated with identifying and securing the line route. This would include all acquisition costs such as the costs of landowner negotiations, environmental impact [not included in SPI Costs] and cultural heritage reports [not included in SPI Costs] as required. The Commission considers that there would be no reason why transaction costs could not be charged against the replacement cost of the line.” (p 46, ACCC Draft Decision)

There is no basis for this statement and it contradicts standard valuation practice. PBA expressed the same concerns in the course of its *Review of SPI PowerNet Asset Base*. In response, SPI PowerNet provided a letter from SKM (dated 28th May 2002) stating that the line replacement costs used in the 1994 valuation report did not include the above costs. The ACCC was provided a copy of this letter and the relevant paragraphs are set out below:

“Further to your request, we provide the following comments and advice regarding particular issues identified in the PB Associates report “Review of SPI PowerNet Asset Base” dated 21 May 2002 [this was a draft document].

This section states:

‘However transmission line replacement costs used for valuation purposes can be expected to include all planning and other costs associated with identifying and securing the line route. This would include the costs of landowner negotiations, environmental impact and cultural heritage reports as required.’

Section 4.3.3 of the SKM report entitled “Valuation of Victorian ESI Transmission and Distribution Assets - September 1994” (1994 SKM Valuation Report) describes the basis of engineering and administration costs components for the valuation. Our practice would have been to include in the allowance for design the engineering survey of the centre-line for the transmission line, but not an allowance for the tasks described in the preceding paragraph.

Up until very recently, SKM had not included allowance for planning, identifying and securing the line route, and costs of landowner negotiations, environmental impact and cultural heritage reports in transmission line replacement costs used for valuation purposes. The general rationale for this approach was that historically utilities had undertaken these tasks as a separate project under a separate cost account, and in many instances much of this effort had been expended to secure easements many years in advance of transmission line design and construction.” (extract from SKM letter 28th May 2002)

SPI PowerNet believes this evidence (ultimately accepted by PBA in their final report) negates the basis of the ACCC’s decision to disallow these costs. It should also be noted, that the cost estimate provided does not include amounts for Native Title Disputes, Heritage Studies and extensive Environmental Assessments that were not

likely to have been necessary or incurred when the majority of the easement portfolio was purchased.

In the absence of evidence to the contrary, SPI PowerNet believes that costs associated with the management of easement purchases must be included in the easement valuation for the Final Revenue Determination.

5.1.3 Solatium

Following PBA's recommendation, the ACCC has rejected the solatium component (\$38.0m) of SPI PowerNet's easement valuation on the basis that the \$79.7m of compensation to land owners would include such costs. This is consistent with PBA's conclusion that:

"SPI PowerNet provided some documents to substantiate the claim that [land owners] fixed costs were paid separately to compensation payment. However, it has not provided any document to substantiate that solatium was paid separately to compensation." (p.17)

SPI PowerNet does not intend to pursue the issue of solatium further at this time. While SPI PowerNet has substantiated the need for each of the other easement components to be provided for (compensation, land owners fixed costs and easement purchase management costs), no documentary evidence is available to demonstrate the extent to which solatium was paid or, where it may have been paid, whether or not this was captured in the compensation amount recorded on the easement creation document.

5.1.4 ACCC Concerns with hybrid methodology

The ACCC expresses concerns that SPI PowerNet's hybrid methodology, which combines an (inflation adjusted) historic cost of land compensation with 1997 estimates of transaction costs, conflicts with its preferred approach of pure historic costs (although this was not actually applied in the TransGrid Revenue Decision).

This concern, as the ACCC has explained, arises from the fact that compensation costs can be expected to rise over time, at a rate considerably faster than inflation, in line with the value of the underlying property. This makes modern replacement cost for easements much higher than the inflation adjusted historic cost. Specifically, the ACCC states:

"As mentioned in section 3.5.3, SPI PowerNet states in its revenue cap application that it has adopted the Commission's preferred approach, which is an easement value based on the actual cost to the network of obtaining

the easement rights escalated by CPI. However, the SPI PowerNet valuation of easements used a hybrid approach that was not based on historical values.” (p 45, ACCC Draft Decision)

In response, SPI PowerNet notes that:

- SPI PowerNet’s use of a 1997 ODRC value for transaction costs is likely to be lower than the (inflation adjusted) historic transaction costs, since transaction costs, unlike land compensation costs, may well have declined in real terms over time;
- in the absence of complete records for transaction costs the hybrid approach was the only feasible and fair approach available; and
- the cost estimates and supporting evidence provided are the closest to the ACCC’s preferred historical cost approach ever submitted by a TNSP. Indeed, previous TNSP decisions have included values that have not been an historical cost at all (TransGrid) or have been based on estimates extrapolated from very poor quality records (Powerlink) or no records at all (ElectraNet).

Taken together the above points leave SPI PowerNet confident that its hybrid valuation is robust and is in fact likely to be below the true (inflation adjusted) historic cost of purchasing its easement portfolio.

5.1.5 Conclusion

SPI PowerNet considers it has supplied ample evidence to justify the \$194.7m valuation PBA recommended be attached to easements. To its knowledge, no contradictory evidence has been advanced by any party to date.

SPI PowerNet has previously brought to the attention of the ACCC that, in the absence of any records in NSW, the ACCC allowed TransGrid to claim and be granted \$345m (in 2001 dollars) for its easement portfolio. It would seem a perverse regulatory outcome were SPI PowerNet to be penalised for providing too much information rather than too little.

SPI PowerNet therefore expects the full \$194.7m value of easements to be approved in the ACCC’s Final Decision.

Requested amendment - 9

An easement value of \$194.7m should be allowed in the Final Decision, representing compensation to land owners (with no separate allowance for solatium), land owners fixed costs and easement purchase management costs.

5.2 Re-optimisation

In its Draft Decision, the ACCC has accepted \$153.7 million of SPI PowerNet's proposed re-optimisation, but rejected the remaining \$95.9 million related to the capitalisation of part of the foregone returns and depreciation on the re-optimised assets.

In its Application, SPI PowerNet proposed (based on the Draft Statement of Regulatory Principles- DRP) that a transmission owner should be allowed to recoup the rate of return and depreciation allowance that it had been denied in respect of the portion of the network that was optimised out, provided that so doing would not:

- cause the present value of future network charges to exceed the replacement cost of the relevant assets (which, theoretically, may trigger network bypass); or
- otherwise cause customers to cease their use of the transmission system.

If these conditions are met then SPI PowerNet is confident that allowing assets to be optimised back into the RAB at their written down value when optimised out, carried forward at the cost of capital (but without depreciating the asset), represents fair value for electricity customers.

The ACCC has contended that SPI PowerNet's proposed re-optimisation is not consistent with the DRP. The relevant part of the DRP (Statement s4.5) states that:

“Assets which are optimised out of the regulatory asset base will be carried forward at the rate of return. If they are optimised back into the regulatory asset base, their value will be the lessor [sic] of the carry forward value or depreciated replacement cost.

Where assets are reinstated into the asset base the Commission will take into account past levels of recovery (that is, the written down value when removed from the regulatory asset base).” (p.54)

In interpreting this statement, the ACCC has stated that:

“Following s4.5, it may be considered that depreciated replacement cost may be higher than the carried forward value ie the lessor [sic] of the two values. In such situations it should be the carried forward value, that is the lessor [sic] of the two values. The Commission considers that this would be

a rare exception and in most cases it will be depreciated replacement cost. Hence the Commission will proceed on a depreciated replacement cost valuation of \$153.7 million.” (Draft Decision, p.46)

In reaching its Draft Decision, the ACCC has apparently overlooked the NERA briefing presentation on the issue of re-optimisation that SPI PowerNet provided to the ACCC on 18 July 2002. This presentation, which is included in this Response at Appendix B, together with a follow up presentation (also included at Appendix B) resolve two key issues in relation to the issue of re-optimisation:

- the consistency of SPI PowerNet’s proposal with the DRP – NERA has shown very clearly that SPI PowerNet’s proposal is indeed consistent with the DRP. This is because the term “depreciated” in “depreciated replacement cost” has a special meaning in the context of the DRP. Whereas the ACCC in its Draft Decision implicitly assume that the term refers to straight-line depreciation, in fact the DRP proposes and then prescribes the use of “competition depreciation”. This is a sophisticated form of annuity depreciation, which has sound economic properties in so far as depreciated replacement cost defined according to competition depreciation represents the value of an existing asset to consumers given the alternative of purchasing a new asset to perform the same function. Compared with the value of an asset determined with respect to straight-line depreciation, the value of an asset determined with respect to competition depreciation will generally be higher¹; and
- the economic sense of SPI PowerNet’s proposal – having regard to the fact that the DRP imposes the requirement that only the lesser of depreciated replacement cost and the carry forward value is included in the RAB, NERA’s conclusion is that “it would appear that SPI PowerNet’s approach to optimisation is unreasonably harsh on investors and is likely to result in too low a value, rather than too high, in the current context.” (Briefing Presentation July 2002) NERA puts forward sound economic reasons for why, in fact, re-optimised assets should simply be allowed back into the RAB at their depreciated replacement cost value (where that value is determined with respect to competition depreciation rather than straight line).

¹ This is assuming a positive cost of capital, relatively constant or falling real replacement costs, relatively constant or increasing useful lives for replacement assets and similar maintenance costs associated with new and existing assets.

In light of NERA's review of this issue, SPI PowerNet believes that there are strong grounds for the ACCC to accept the remaining \$95.9 million of SPI PowerNet's proposed re-optimisation into the RAB. In so doing, it is important to note that this will not make SPI PowerNet whole in relation to the re-optimised assets. Because of the operation of the "lesser of" provision in Statement s4.5, SPI PowerNet would not recover \$66 million of foregone returns and depreciation under its proposal. This is because the carry forward value for many re-optimised assets exceeds the depreciated replacement cost calculated consistent with the DRP. This property of the re-optimisation methodology means that there remain significant and permanent penalties to over-investment in the transmission network.

Requested amendment - 10

The remaining \$95.9m of SPI PowerNet's proposed value for re-optimisation (\$271.8m), in relation to part recovery of foregone returns and depreciation, should be allowed into the RAB in the Final Decision.

5.3 Final Valuations of excluded services rolling into RAB

In their report on SPI PowerNet's proposed RAB, PB Associates noted that some of the roll-in values for pre-2003 customer augmentations were not based on finalised costs. At the time, SPI PowerNet accepted this comment and undertook to provide the ACCC with these finalised costs after the Draft Decision. A finalised set of roll-in values has been provided to the ACCC separate to this Response.

Requested amendment - 11

The roll-in values for pre-2003 customer augmentations should be updated in the Final Decision to reflect the finalised costs provided separately to the ACCC.

5.4 Corrected historic capex numbers

The following land purchases were omitted from previous capex figures provided to the ACCC. While not highly material from a revenue setting perspective their inclusion in the RAB is important for a complete and accurate allocation of the revenue cap to transmission customers.

Table 5.1: Omitted land purchases between 1994 and 2000

Land	Date of purchase	Value
Haywood Terminal Station	28/07/1995	38,291
Hazelwood Terminal Station	01/07/1996	170,000
Wangaratta Depot	27/08/1997	24,718
Yallourn Terminal Station	01/07/1998	66,000

Source: SPI PowerNet

Requested amendment - 12

The RAB should be amended in the Final Decision to include the land purchases listed in Table 5.1 of SPI PowerNet's Response.

6. COST OF CAPITAL

In its Draft Decision, the ACCC has determined the cost of capital and tax allowance using essentially the same framework as that proposed by SPI PowerNet – the vanilla WACC together with a separate allowance for tax reduced by the value ascribed to franking credits. In applying this framework, however, the ACCC has not accepted a number of SPI PowerNet's proposals and has indicated that it has some reservations about certain elements, while still using the parameter values proposed. Taken together with views expressed by customer representatives in the course of several recent regulatory proceedings, SPI PowerNet wishes to respond to ACCC's Draft Decision on WACC in the areas where it varies from SPI PowerNet's proposal and to pre-empt arguments that are likely to emerge in the course of the consultation process.

In so doing, SPI PowerNet has asked Professor Bob Officer of the Melbourne Business School to update the expert report on which SPI PowerNet's Application was based (Appendix F) to consider both the ACCC's analysis of WACC issues together with that of interested parties. SPI PowerNet has already supplied to the ACCC, as part of its response to the ElectraNet Draft Decision, Professor Officer's critiques of two papers by Associate Professor Lally concerning the term of the risk free rate and the appropriate treatment of dividend imputation in the cost of capital.

Based on Professor Officer's advice, together with advice from financial market practitioners, SPI PowerNet is concerned that the ACCC's Draft Decision in relation to the cost of capital requires modification in so far as it (variously):

- relies on unrealistic assumptions;
- does not reflect the latest market data²;
- is not consistent with modern finance theory; and
- is at variance with the direction being endorsed by the Commonwealth Government in the wake of the Productivity Commission's review of Part IIIA.

² This is not a criticism of the Draft Decision, per se. SPI PowerNet simply wishes to emphasise that some inputs to the WACC are dynamic in nature and will change their values in the time between a draft and final decision, eg. the debt margin. Furthermore the WACC ultimately determined would generally be more consistent and accurate if all inputs were measured contemporaneously.

Against this background, this section addresses the following specific aspects of the cost of capital together with the tax allowance:

- the term of the risk free rate – section 6.2;
- the sampling period for the risk free rate – section 6.3;
- the benchmark credit rating – section 6.4
- the debt margin – section 6.5;
- debt and equity raising costs – section 6.6;
- the treatment of dividend imputation – section 6.7; and
- the overall approach to setting the WACC – section 6.8.

SPI PowerNet's concluding remarks on the issues of capital financing and taxation are provided in section 6.9.

6.1 The term of the risk free rate

In the Draft Decision the ACCC has adopted a 5¼ year 40 day moving average as its estimate of the risk free rate. The argument for using a 5¼ year rate instead of the more conventional long term 10 year Commonwealth Government bond rate is that it matches the term of the regulatory period. The Draft Decision goes on to state that: *“There exists significant debate, however, over the term that should be used in regulatory decisions. It has been suggested by some that it is appropriate to adopt a rate that is linked to the regulatory period, while others argue that the use of longer-term rates represents a more appropriate measure.”* (p.20)

Reflecting the ongoing nature of this debate, the Draft Decision notes that *“the Commission welcomes further input regarding the most appropriate surrogate for a risk-free rate of return.”* (p.20) SPI PowerNet welcomes the ACCC's open stance in this regard. However, SPI PowerNet believes that the ACCC is not treating this matter with the urgency that it deserves. While the ACCC has many revenue cap decision to make each year, across a variety of industries, SPI PowerNet has to live with the outcome of this current process for five years.

There is a twofold impact of choosing this shorter bond rate, as compared to the benchmark 10 year rate:

- first, it reduces the return on equity and the return on debt by approximately 25bp (this being the difference between 5 year and 10 year Commonwealth Government securities on average); and
- second, it reduces the return on debt still further, by reducing the debt margin (which is a function of the term assumed for the risk free rate) by approximately the same amount (this is discussed further in the debt margin section below).

Taken together, the impact of the ACCC's Draft Decision on the risk free rate is to reduce the WACC by at least 40bp (note that the effect on the debt margin has only a 60 per cent effect on the WACC due to the gearing assumption).

While there has been a long running debate with the ACCC about the merits of selecting a bond rate with a term equal to the regulatory period, it is notable that other Australian utility regulators use the 10 year bond as their benchmark. As was remarked upon at the WACC forum sponsored by SPI PowerNet, ElectraNet SA and GasNet on 24 June 2002, the ACCC essentially stands alone on this issue.

In the context of the revision of the Access Arrangements for GasNet, the ACCC commissioned a paper by Associate Professor Martin Lally entitled "Determining the risk free rate for regulated companies". Lally's conclusion is that the risk free rate should indeed be chosen to align with the regulatory period. In its 14 August 2002 Draft Decision on GasNet, the ACCC appears to have relied (solely) on Lally's paper for maintaining its use of a five year bond rate.

In view of this, SPI PowerNet asked Professor Bob Officer to review and critique the Lally bond rate paper. Officer's critique was provided to the ACCC as part of SPI PowerNet's response to the ElectraNet Draft Decision and is included at Appendix C together with Officer's updated paper entitled "A weighted average cost of capital for a benchmark Australian Electricity Transmission Business" – the original version of this paper, dated 28 February 2002, was submitted as an appendix to SPI PowerNet's revenue cap Application to the ACCC.

Officer's finding is that: *"In short, all of Lally's examples for using a five year bond rate are equally applicable to using the changes in the ten year rate of each regulatory period and yet this rate is the rate consistent with the MRP and therefore consistent with the CAPM. The Lally approach is not consistent with the CAPM ... "* (Officer Critique of Lally)

Lally's conclusion, and therefore the ACCC's, would only be correct if the regulator provided the utility with a capital guarantee. That is, if the utility was absolutely sure that its investment would be returned in full. In reality, the ACCC cannot make such a guarantee (certainly the framework provided by the National Electricity Code in concert with the Trade Practices Act 1974 does not allow for it) and even if the ACCC tried it would not be credible in the context of the investment horizon of electricity transmission (up to 70 years).

This point is not new – it was made by Officer in the paper lodged as part of SPI PowerNet's revenue cap application (refer p.32) and was made again in the course of the 24 June WACC forum. Indeed, the experts who know and understand it invariably conclude that the term of the risk free rate should match the term of the underlying investment in the assets of the business, regardless of the fact that the business is subject to 5-yearly regulatory reviews.

Furthermore, there are many well established reasons (refer to Officer's critique of Lally, Officer's paper included in SPI PowerNet's revenue cap application and the recent update of that paper) in favour of using a 10 year basis for the risk free rate:

- the long term nature of infrastructure investment;
- consistency with the estimation basis for the MRP; and
- greater reliability of estimates because the market in 10 year bonds is much deeper than for shorter term Commonwealth Government Securities.

Against this background, SPI PowerNet believes that the ACCC's Draft Decision on SPI PowerNet, as with its Draft Decisions on ElectraNet SA and GasNet, is based on an assumption (that there exists a capital guarantee) that could never hold. The ACCC therefore has no support for using a five year risk free rate. The Lally analysis that the ACCC is relying on has been shown by Officer to be empty, in so far as it actually provides as much support for the use of a 10 year rate as for a 5 year rate. In fact, Lally implies that the ACCC is offering a capital guarantee, for example: *"Finally, Officer (2002b) argues for the ten rather than the five year rate because the regulated firm cannot walk away if compensation is inadequate. Clearly, if the ACCC fails to adjust allowed prices in the light of prevailing interest rates, then the argument for the five year interest rate evaporates."* (Lally, section 2.3)

In view of the many well established reasons cited both here and in previous regulatory proceedings, the ACCC should adopt a 10 year basis for the risk free rate

in its Final Decisions for SPI PowerNet, ElectraNet SA and GasNet, and indeed in all subsequent utility decisions.

6.2 Sampling period for the risk free rate

As was noted above, the ACCC has based its Draft Decision on a 40 trading day sample of the risk free rate. SPI PowerNet believes that this sample period is too long having regard to both theoretical and practical considerations. A 5 to 10 trading day sample, with the timing to be notified in advance to the utility, would be more appropriate because it:

- is more tractable should the utility seek to hedge over the sample period – while not impossible, a 40 trading day sample is a lot more difficult to hedge, from an administrative viewpoint, than a shorter period such as 5 to 10 days³; and
- does not unduly distort the information value of the sample, relative to the theoretical ideal of taking a one day sample – refer to Officer’s comments on the risk free rate (p.36 of his updated report), in which he notes that subjective judgement is involved in this decision but recommends 5 trading days on this basis.

In the current market, with both government and corporate bond yields subject to some volatility, SPI PowerNet’s preference is for the sample to be set on the basis of 10 trading days.

Ultimately, however, there is no basis for believing that a utility would be systematically advantaged or disadvantaged by the length of the sampling period, as long as the utility can hedge appropriately over the sample period. In view of this, SPI PowerNet believes that the ACCC should be flexible on this issue, because the decision made will not systematically advantage or disadvantage consumers. In this regard it is notable that there is in fact some diversity amongst Australian regulators in terms of the length of the sample period they use. For example, the Victorian Essential Services Commission uses 20 trading days.

6.3 Benchmark credit rating

Although it has not always been explicit in many previous regulatory decisions, an assumption has to be made about the credit rating of the benchmark entity in order to

³ However, given the time available for the current decision, a 40 trading day sample cannot in fact be accommodated on a prospective basis.

determine the debt margin over the risk free rate. Rating agencies such as Standard and Poors publish the correlation between ratings such as AA, A and BBB and ranges for a number of financial ratios in specific industry contexts such as energy (electricity and gas) transmission. However, interesting though these correlations are, they are difficult to use in the context of the building block model because an initial assumption is required about the credit rating in order to generate the relevant financial ratios. It turns out that the assumption made can become a self-fulfilling prophecy.

Using an external reference point such as the credit rating for a stand-alone transmission company can break this circularity. Fortunately, there are two very obvious benchmarks available in this regard – GasNet, which is rated BBB, and ElectraNet SA, which is rated BBB+. Both companies are currently before the ACCC for price/revenue cap determinations.

A stand-alone basis is important because this provides for complete capture of the relevant risks. If a business were instead owned by a conglomerate or a government then the risk faced by debt holders is generally perceived to be lower because it is assumed that the parent company, and more particularly the cash flows derived from their diversified holdings (or taxing power in the case of governments), will prevent or mitigate loan default. However, such risk does not disappear, it is simply transferred to equity holders and needs to be captured by reference to the stand-alone cost of debt finance.

In its Draft Decision on SPI PowerNet, the ACCC has not sought to use a stand-alone reference point and has instead stated that the benchmark credit rating should be A, based on the claim that this is the average credit rating for the electricity industry. SPI PowerNet takes issue with the ACCC's selection of an A credit rating benchmark in two respects. First, it is not consistent with the stand-alone benchmark being used to determine other inputs to the building block model – as noted above, a stand-alone benchmark needs to be used in order to fully capture the relevant risks for inclusion in the WACC.

Second, the claim that the average credit rating of the electricity industry is A is only true if government owned businesses with a more or less explicit government guarantee are taken into account. SPI PowerNet understands from the ACCC that the evidence used to determine the A rating average was the public ratings of a range of energy companies sourced from Standard and Poor's 'Australia and New

Zealand Credit Stats 2002', May 2002. The table of ratings supplied to SPI PowerNet by the ACCC is reproduced below, reorganized to highlight key aspects of the data and to exclude the many entities that do not have a public rating.

Table 6.1: Standard and Poors Credit Rating data, May 2002

Company	Long term rating outlook						
	AA+	AA	AA-	A+	A	A-	BBB+
<i>Stand-alone business</i>							
Electranet Pty Ltd.							X
United Energy Ltd						X	
<i>Conglomerate owned – not rated on a stand-alone basis</i>							
Citipower Trust ^a							X
ETSA Utilities Finance Pty Ltd						X	
Powercor Australia, LLC						X	
<i>Foreign government owned - not rated on a stand-alone basis</i>							
SPI PowerNet Pty Ltd				X			
<i>Australian Government owned – not rated on a stand-alone basis</i>							
Country Energy		X					
Delta Electricity			X				
Energy Australia		X					
Ergon Energy Corp Ltd	X						
Integral Energy		X					

a Since being purchased by CKI, the Citipower trust is now rated A-, like CKI's other Australian utility companies, ETSA Utilities Finance Pty Ltd and Powercor Australia LLC.

Source: ACCC private communication

Upon close examination of the data relied on by the ACCC, it is clear that when the Australian government owned businesses (which are not rated on a stand-alone basis) are excluded, the average rating for the electricity industry is between A- and BBB+. It should be noted that SPI PowerNet should also be excluded from the analysis of the average stand alone rating because the Company's parent, Singapore Power, is rated AAA. Singapore Power's ultimate owner is the Government of Singapore.

It is worth noting that the non-government owned businesses in Table 6.1 are essentially pure electricity network businesses (either distribution or transmission). Powercor, ETSA utilities, Citipower and United Energy do not have retail arms, with the relevant former franchise retail businesses either being owned by Origin Energy or AGL. This makes the average credit rating for these businesses relevant to the task of setting a benchmark credit rating.

However, as the headings inserted into Table 6.1 indicate, the only businesses in the ACCC sample that are (reasonably) stand-alone in nature are ElectraNet SA (BBB+) and United Energy (A-). When combined with evidence of stand-alone network businesses in the gas industry (Envestra, GasNet and AlintaGas, rated BBB), there is ample support for adopting BBB+ as the benchmark credit rating for use in electricity transmission revenue caps.

To date, the ACCC has provided little if any analysis to support using a different benchmark credit rating as between electricity and gas transmission. In the GasNet draft decision the ACCC has endorsed a BBB+ rating benchmark, which is consistent with the ESC's recent final decision in respect of the Victorian gas distributors. However, in adopting a BBB+ benchmark, the ESC has noted that this provided for regulatory consistency with the BBB+ benchmark that it recently adopted in respect of electricity distribution.

SPI PowerNet believes that the ACCC should interpret the available (albeit limited) evidence with a mind to achieving regulatory consistency, and adopt a credit rating benchmark for electricity transmission of BBB+.

6.4 Debt margin

In the Draft Decision, the ACCC allowed SPI PowerNet a debt margin (exclusive of debt raising costs) of 120bp over the risk free rate (five and a quarter years). This is 10bp lower than the debt margin determined by the ACCC in Draft Decisions for ElectraNet and GasNet. In each decision, the ACCC has relied on different data sources and has also adopted different benchmark credit ratings – A for SPI PowerNet, BBB+ for GasNet and (apparently) BBB+ for ElectraNet.

Although the Draft Decision does not make it clear, SPI PowerNet understands that the ACCC has relied on CBA Spectrum data as reported by Standard and Poors for the end of June 2002 to determine the debt margin based on an A rating.

In the ElectraNet Draft Decision, the ACCC relied on Reserve Bank of Australia (RBA) data that indicates a range of 90 to 140bp in relation to bonds issued by firms with credit ratings from A to BBB (which gives rise to the uncertainty over what credit rating the ACCC used in ElectraNet's case). SPI PowerNet understands that these corporate bonds have terms between 2 and 4 years, 2 years less on average than the 5 year term that the ACCC is seeking for its benchmark. In reaching its determination, while no further evidence was presented, the ACCC concluded that "a

benchmarked industry wide cost of debt, in the region of 90 to 160 basis points above the nominal risk free rate of return is appropriate for ElectraNet.” (p.17)

In the GasNet Draft Decision, the ACCC has relied on two pieces of evidence:

- ABN Amro data on debt margins for a range of BBB+ Australian bond issues with varying maturities– as at 5 July 2002, the ACCC noted that the data indicate a debt margin of between 125 and 129 bp for a 5 year maturity; and
- CBA Spectrum data published by Standard and Poors – this showed a debt margin of 132bp for a BBB+ 5 year maturity as at the end of June 2002.

In the SPI PowerNet Draft Decision (and with words to similar effect in both the GasNet and ElectraNet Draft Decisions), the ACCC made the statement that it “will continue to monitor capital markets for further evidence that the debt margin is increasing or decreasing.” (p.64) SPI PowerNet supports the ACCC’s approach in this regard because, just like the risk free rate, debt margins can vary significantly over time, even in the couple of months between draft and final decisions.

To aid the ACCC in refreshing its data on the debt margin, SPI PowerNet would like to draw the ACCC’s attention to the following information on 10 year BBB+ debt margins (drawn from Officer’s updated report, p.16):

- Westpac (14 October 2002) – 161 to 171 bp;
- National Australia Bank (10 October 2002) – 184-189 bp;
- ANZ (3 October 2002) – 190bp; and
- CBA Spectrum (16 October 2002) – 169bp.

These debt margins are exclusive of debt raising costs. The first three are margin quotes are specific to regulated utility debt issues, while the last is generic.

As noted earlier, SPI PowerNet believes that the risk free rate should be based on a 10 year rather than a 5 year bond, which flows on to the debt margin being defined on a 10 year basis. This would be consistent with the ESC’s recent Final Decision for the Victorian gas distributors, which used a 10 year BBB+ debt margin of 165bp (excluding debt raising costs). Based on the average of the available evidence, SPI PowerNet believes that the appropriate 10 year debt margin is approximately 180bp (excluding debt raising costs).

6.5 Debt and equity raising costs

In its Draft Decision on GasNet, the ACCC allowed for:

- debt raising costs of 8bp – this was based on estimates of bank fees of 5bp and swap costs of 3bp, which SPI PowerNet understands were both sourced from Westpac; and
- equity raising costs equivalent to 48bp on the value of equity, which were allowed for in the cash flows, separate to the CAPM estimate of the post-tax nominal return on equity – this was based on a US study of capital raising costs by Lee et al⁴, which was referred to in GasNet’s submission.

However, even though these are benchmark allowances, quite divorced from the capital financing activities of GasNet, the ACCC did not make these same allowances for SPI PowerNet or ElectraNet. SPI PowerNet supports the ACCC in making allowances in its GasNet Draft Decision for both debt and equity raising costs, and believes that the same types of allowances should be made in all such regulatory decisions, with the quantum to be determined based on evidence available at the time.

Since providing indicative debt raising costs to the ACCC, Westpac has updated its estimates (see the 14 October 2002 letter from Westpac included in Officer’s updated WACC report at Appendix C). Based on these updated estimates, SPI PowerNet requests the ACCC to make an allowance for debt raising costs of 14 bp in the Final Decision. This comprises 8bp for placement (bank) fees and 6bp for swap costs, based on a BBB+ credit rating benchmark.

Although debt raising costs have often been implicitly included in the cost of capital via the debt margin, SPI PowerNet notes that such costs should probably be included as a cash flow allowance. This is because debt raising costs are arguably unrelated to non-diversifiable risk. Indeed, this is the approach that Officer has taken in his updated paper (refer footnote 5 on p.16).

Regarding equity raising costs, SPI PowerNet has reviewed the study by Lee et al and considers that a lower percentage allowance for equity raising costs is appropriate compared to that for GasNet. This is because SPI PowerNet has a

⁴ Lee, I., Lochhead, S., Ritter, J and Zhao, Q, 1996, The costs of raising capital, *The Journal of Financial Research*, Vol XIX, 59-74.

higher regulatory asset value than GasNet, and hence a higher (regulatory) value of equity. The allowance for equity raising costs in GasNet's case was based on Lee et al's estimate of total direct costs of 7.06 per cent of the value of equity for an equity raising of between US\$100 million to US\$199.99 million.

In the Draft Decision, the ACCC determined a RAB value for SPI PowerNet of \$1,815.56 million as at 1 January 2003. Based on the benchmark 60/40 ratio of debt to equity, the equity share of this RAB value is \$726.22 million. At the current exchange rate (7 November 2002, \$US/\$A = 0.5642) this translates into US\$409.73 million. In the Lee et al study this equity value falls in the US\$200 million to US\$499.99 million band, which is associated with total direct costs of 6.53 per cent.

As noted by the ACCC in the GasNet Draft Decision, "Given that equity only needs to be raised once, it is appropriate to spread the equity raising cost over the life of the asset." (p.89) For this purpose, the ACCC used a life of 60 years in GasNet's case. Although it would be possible to argue for an asset life greater or less than this in SPI PowerNet's case, given the long-lived nature of electricity transmission assets and the ongoing nature of the business, SPI PowerNet considers that 60 years would also be an appropriate period over which to amortise equity raising costs in its context.

Using the real vanilla WACC of 6.02 per cent from the (SPI PowerNet) Draft Decision, SPI PowerNet has calculated an annual allowance of 40bp (more precisely 40.55bp), 8bp lower than that allowed to GasNet. SPI PowerNet requests that the ACCC make an allowance for equity raising costs in the Final Decision at this rate, based on the RAB as determined by the ACCC at that time.

6.6 Treatment of dividend imputation

In the Draft Decision, the ACCC has continued to value franking credits at 50 per cent (gamma of 0.5), consistent with its previous decisions and those of other Australian regulators. However, the ACCC has also contended that "gamma should be at or close to one for most companies rather than the currently employed figure of 0.5." (p.24) The ACCC did not act on its contention because it acknowledges that a *"consensus view has yet to be reached amongst Australian academics and practitioners for making an adjustment to the rate of utilisation of tax credits. Therefore the Commission considers that it is inappropriate for it to lead in this area. Hence, in line with recent Commission decisions a gamma of 0.5 will be used in this*

decision.” (p.24) The ACCC makes essentially the same statement in the ElectraNet Draft Decision.

While SPI PowerNet certainly agrees with the ACCC that there is as yet no consensus on gamma, and supports the continued use of the estimate of 0.5, the Company believes that the reasons cited by the ACCC in support of an estimate closer to one are not persuasive. In particular,

- the latest studies of dividend imputation show a figure of 0.45 (refer to Officer’s updated paper at Appendix C)
- official tax statistics indicate a figure of 0.5;
- in reality few businesses pay out all of their profits as dividends; and
- franking credits are a wasting asset, so it is very unlikely that gamma would ever be at or even close to one.

In the context of the GasNet Draft Decision, the ACCC commissioned Associate Professor Martin Lally to write a paper entitled “The cost of capital under dividend imputation”. Lally concludes in this paper that if the ACCC is to continue to use the domestic version of the CAPM then it should adopt a gamma of one. Alternatively, if the ACCC moves to the international CAPM then gamma should be zero.

SPI PowerNet asked Professor Bob Officer to critique this paper by Lally, and his findings, which were provided to the ACCC as part of SPI PowerNet’s response to the ElectraNet Draft Decision, are included together with his updated report on the cost of capital at Appendix C. Officer’s key observation is that in reality Australia’s capital markets are neither completely segregated from nor completely integrated with the world capital markets. This means that neither of Lally’s polar solutions is literally relevant.

The problem is, however, that there is no finance theory that adequately deals with the phenomenon of imperfectly integrated capital markets. Officer concludes that compromise is required and that the current approach of using the domestic version of the CAPM together with a cash flow tax allowance reduced by the average rate of utilisation of franking credits (0.5) is a pragmatic means of approximating the actual situation.

6.7 Approach to setting WACC

Over the course of this year, there has been a renewed focus on how the objectives of utility regulation should be expressed. Following the Productivity Commission's review of Part IIIA and the Commonwealth Government's response to it, it now seems clear that the job of utility regulators is to ensure (together with meeting other objectives) that the rate of return to utility owners is at least sufficient to attract and maintain required investment. In this enlightened environment, which recognises the asymmetry of community costs in relation to under and over investment, it was disappointing to read that the ACCC has not updated its approach.

"The Commission's regulatory regime attempts to ensure that the return on capital allowance in the revenue cap is equivalent, and only equivalent, to the risk adjusted market rate of return required to maintain investment." (p.23)

6.8 Concluding remarks

SPI PowerNet believes that there are a number of aspects of the ACCC's Draft Decision on SPI PowerNet that need to be revised, in particular the term of the risk free rate, the benchmark credit rating, the debt margin and the allowance for debt and equity raising costs. If the ACCC is looking for ways to demonstrate to utility investors that it has recognised the more explicit direction that is now to be provided to it by the Commonwealth Government, then it must at the very least take up the comments in this Response, specifically:

- set the WACC based on a 10 year risk free rate;
- adopt a BBB+ benchmark credit rating based on a stand-alone entity;
- allow for the debt margin using the latest market evidence of BBB+ 10 year corporate bond issues, with specific regard to the utility sector; and
- include an allowance for debt raising costs of 14bp (either in the cost of capital or as a cash flow allowance) and an allowance for equity raising costs of 40bp (provided outside the cost of capital as a cash flow allowance).

In addition, as SPI PowerNet said at the ElectraNet Public Forum, many of the outstanding issues on the cost of capital, such as the term of the risk free rate and the appropriate treatment of dividend imputation, are highly complex. If the ACCC is not persuaded by the arguments made in this Response, then SPI PowerNet urges the ACCC to convene a workshop of the relevant experts, including in particular

Associate Professor Lally, on whose work the ACCC is apparently relying. In the timeframe for finalisation of the SPI PowerNet, ElectraNet and GasNet decisions, SPI PowerNet believes that at the very least the ACCC should engage Lally to respond to the critiques that have been made of his work, and publish this response as soon as possible. It would be unproductive to leave unresolved significant differences of view on an issue as material as the WACC.

Based on the values for each variable as at 18 October 2002, SPI PowerNet believes that the Vanilla WACC (post-tax nominal WACC) should be 9.08 per cent (excluding debt raising costs) or 9.16 per cent (including debt raising costs). Note that the proposed allowance for equity raising costs of 40bp is for inclusion as a cash flow through the opex allowance – it is therefore excluded from the vanilla WACC in Table 6.1 below.

Table 6.1: Proposed WACC parameters and variables

Parameter/Variable/Outcome	Proposed value
<i>Parameters</i>	
Gearing (D/V)	60 per cent
Asset beta ¹	0.58
Equity beta	1.0
Debt beta	0.30
Debt margin	180bp
Debt raising costs	14bp
Market risk premium	6.0
<i>Variables</i>	
Risk free rate – nominal 10 year government bond	5.60
Real risk free rate – indexed 10 year government bond	3.60
<i>Outcomes</i>	
Expected inflation ²	2.00
Nominal cost of debt (excluding debt raising costs)	7.40
Nominal cost of debt (including debt raising costs)	7.52
Post-tax nominal cost equity	11.6
Vanilla WACC (excluding debt raising costs)	9.08
Vanilla WACC (including debt raising costs)	9.16

1 Asset beta is an average of the equity and debt betas weighted in proportion to gearing

2 Calculated via the Fisher Equation from the risk free rate and the real risk free rate.

Requested amendment - 13

The Final Decision in respect of the WACC should:

- adopt a 10 year risk free rate;
- sample the risk free rate over 10 trading days, and notify the timing of the sample to SPI PowerNet in advance;
- base the debt margin on a BBB+ benchmark credit rating for a stand-alone entity;
- set the debt margin using the latest market evidence of BBB+ 10 year corporate bond issues, with specific regard to the utility sector – at 18 October 2002 this margin was 180bp, excluding debt raising costs;
- include 14bp for debt raising costs, either in the debt margin or as a cash flow allowance within opex; and
- make a cash flow allowance, within opex, for equity raising costs at the rate of 40bp on the (regulated) value of equity.

7. IMPLEMENTATION OF THE REVENUE CAP

Successful implementation of the revenue cap requires an accompanying set of arrangements that provide a solid basis for the subsequent reset, avoid disputes and allow efficiency incentives to achieve their objectives. In its Application, SPI PowerNet set out its proposals for implementation arrangements, which included:

- roll forward of the Regulatory Asset Base (RAB) for the reset in 2008;
- pass-through of the financial effect of events outside the Company's control or influence; and
- treatment of non-contestable augmentations occurring over the period 2003 to 2007/08.

It should be noted that these are an integral part of SPI PowerNet's Application, with many inputs to the revenue cap calculation being dependent on the proposed implementation arrangements. However, the Draft Decision essentially does not address these items. In view of this, this section is designed to reiterate and reinforce SPI PowerNet's proposal and to highlight the significance of these aspects of the revenue capping arrangements.

7.1 Roll-forward of the RAB for the Reset in 2008

A clear understanding of how the RAB will be treated at the 2008 revenue reset is very important to the integrity of the regulatory system. To address this, SPI PowerNet proposed in its Application a simple roll-forward arrangement.

- The RAB value at 1 January 2003 should be rolled forward to 1 April 2008 by adding actual capital expenditure plus indexation less regulatory depreciation (based on actual capital expenditure) year by year.
- Revaluation and/or re-optimisation on 1 April 2008 should be allowed; however, in the event that the (rolled forward) RAB exceeds the revalued/re-optimised value this gap should be closed over the regulatory period via an accelerated depreciation allowance. This is consistent with the way that SPI PowerNet has constructed the revenue cap for 2003 to 2007/08 in that no self insurance costs for stranding risk or accelerated depreciation has been included.

In the Draft Decision, the ACCC has not provided any indication as to how it intends the RAB to be set from 2008, neither accepting nor rejecting SPI PowerNet's

proposal. This leaves SPI PowerNet exposed in relation to a number of risks, for which no allowance has been made in the draft revenue cap:

- refurbishment expenditure and “brownfields” capex may be reduced in value or ascribed no value in the course of a valuation based on a “greenfields” modern engineering equivalent approach to revaluation – this is in spite of the fact that such expenditure is in fact necessary and efficient;
- existing assets may be written down in value due to falling real replacement costs; and
- some assets may be subject to partial or total asset stranding – however, it is very difficult to identify which assets will actually be stranded, at least not with any certainty.

If the ACCC decides not to make any commitments in relation to how the RAB will be rolled forward in 2008, then SPI PowerNet (consistent with the caveat at p.2 of its Application) requests that the ACCC allow SPI PowerNet to alter its Application so as to:

- reclassify all refurbishment capex as opex;
- accelerate rates of depreciation on assets to eliminate the possibility of the rolled-forward value of the RAB exceeding the (straight line depreciated) ODRC in 2008⁵; and
- propose a non-insured risk allowance in respect of stranding risk.

Although SPI PowerNet does not believe that this is the best solution for electricity consumers, unless credible regulatory commitments are made by the ACCC, consistent with SPI PowerNet’s Application, it is the only way that SPI PowerNet can protect its investment.

SPI PowerNet can see no reason why the ACCC could not make the necessary commitment to RAB roll-forward in 2008. Indeed, in the ElectraNet Draft Decision,

⁵ SPI PowerNet notes that there is in fact a major technical issue in relation to future revaluations using ODRC. As pointed out by NERA in Appendix B, from an economic standpoint ODRC should not be determined with respect to straight line depreciation. Instead, ODRC should be calculated on a forward looking (present value) basis so that it represents the value to consumers of the existing assets compared to replacing those assets. This approach to ODRC is consistent with the ACCC’s Draft Regulatory Principles, which prescribe the use of competition depreciation.

the ACCC gave an undertaking not to optimise refurbishment capex for a period of 15 years.

Accordingly, SPI PowerNet's requests the ACCC in its Final Decision to accept the RAB roll-forward proposed in SPI PowerNet's Application.

Requested amendment - 14

The ACCC should address and accept SPI PowerNet's proposed RAB roll-forward arrangements in the Final Decision.

7.2 Pass-throughs for Identified Events

While SPI PowerNet has made every effort to forecast accurately the components of the revenue required to provide its revenue-capped services, there are a number of factors that are outside its control or direct influence but which affect the revenue requirement to a significant degree. For such factors, SPI PowerNet proposed a pass-through arrangement that would be triggered by identified events, and detailed pass-through arrangements were proposed in legal form at Appendix G of the Application. The key aspect of the arrangements is the identification of events that could trigger a pass-through application. There are four categories:

- service standards event – changes to the scope, standard or risk of the revenue-capped services that SPI PowerNet is required to provide as a result of: changes to the *National Electricity Code* (NEC); decisions by NECA, NEMMCO or the ACCC; or changes to legislation or regulation that SPI PowerNet is required to comply with;
- change in taxes event – changes in way or rate at which a relevant tax is calculated or the imposition of a new tax;
- terrorism event – an act of terrorism, which includes threats associated with terrorism; and
- insurance event – changes in the availability and extent of cover and cost of insurance relative to that forecast as part of the revenue cap.

In its Draft Decision, the ACCC notes SPI PowerNet's proposed rules, and reserves its view until the Final Decision. In subsequent interaction with the ACCC, the Company has been advised that "it is not necessary to depart from the Commission's current approach of giving consideration to pass through Applications as they arise on a case by case basis".

In SPI PowerNet's view, that is an unsatisfactory response for the following reasons:

- The ACCC's "current approach" to pass-through is not documented and SPI PowerNet therefore has no way of judging what the "current approach" is and how it would address risks which manifest in SPI PowerNet's business and which are not compensated in any way in the revenue cap;
- SPI PowerNet's Application has been carefully constructed around clear analysis and compartmentalisation of risk. The risks detailed in the proposed pass through rules are not covered elsewhere, and the nature of those risks is such that it would be extremely inefficient if SPI PowerNet had to bear them – this is because they are of low likelihood but high potential cost, and completely unpredictable; and
- if the ACCC is to make a decision in response to SPI PowerNet's proposal, SPI PowerNet must be given proper opportunity to consult, which will be impossible if the ACCC's view is not expressed until the final decision is issued.

SPI PowerNet believes that the ACCC must reach a definitive view in relation to the proposed pass through rules, and express that view publicly so that there is time for proper consultation, and if necessary, a revision of SPI PowerNet's Application.

To this end, SPI PowerNet notes that the ACCC, in its GasNet Draft Decision, recently allowed, with some minor amendments, a very similar set of pass through rules to those proposed by SPI PowerNet. Although there are differences between the Gas and Electricity Codes, in fact neither code makes mention of pass through rules. It would therefore appear to be up to the ACCC's discretion, in satisfying the objectives and principles set out in each Code, to determine whether and in what form a pass through mechanism is allowed.

Against this background, SPI PowerNet requests the ACCC to accept the pass through rules (essentially) as proposed in SPI PowerNet's Application, consistent with the position that the ACCC has taken in the GasNet Draft Decision – "The Commission acknowledges that the proposed mechanisms are likely to be cost-effective and agrees to them in principle." (p.xiii)

Requested amendment - 15

The ACCC should address and accept SPI PowerNet's proposed pass through rules, subject to minor modifications, in the Final Decision.

7.3 Treatment of Non-contestable Augmentations during the Period from 2003 to 2007/08

Chapter 3 of SPI PowerNet's Application explains that augmentations to regulated services occurring during the 2003 to 2007/08 regulatory period are excluded from the revenue cap. This approach has been adopted because SPI PowerNet does not have the role of planning augmentations and cannot with any certainty predict augmentations determined by other parties – that is, VENCORP with respect to augmentation of the shared network in Victoria and connected customers with respect to the connection assets. Many such augmentations are contestable, and as such take effect through contract, outside the revenue cap.

For all new non-contestable augmentations, a process is needed that recognises their regulatory status, providing an interim price and a process through which they are included in the revenue capped services at the next reset. This will provide all parties, including SPI PowerNet's customers and the ACCC, with the same certainty as applies to the services subject to the revenue cap.

SPI PowerNet proposed in its Application a treatment for within-period augmentations (Appendix I). In its Draft Decision, the ACCC did not address this element of SPI PowerNet's proposal. However, given its importance, SPI PowerNet urges the ACCC to address and endorse the proposed treatment in its Final Decision.

The key elements of this treatment are as described below.

- Where a service is non-contestable, having regard to the NEC definition, SPI PowerNet and its customer will write this into a network agreement or connection agreement.
- Contestable services provided by SPI PowerNet shall not form part of the revenue-capped services, at any time.
- For the duration of the prevailing (2003 to 2007/08) regulatory period, non-contestable services shall be the subject of a supplemental network or connection agreement. The derivation of charges for the service shall be on the basis of:

- the building block revenue model as determined by ACCC for the revenue capped services;
 - operating and maintenance charges based on incremental cost;
 - efficient establishment cost for the new services (as agreed in the network or connection agreement); and
 - the Vanilla WACC applied using the parameters as determined by the ACCC but with updated variables.
- Charges for the 2008/09 to 2012/13 regulatory period in respect of non-contestable augmentations undertaken over the 2003 to 2007/08 period shall be determined via allocation of the next revenue cap in accordance with the charging allocation principles of the NEC. That is, the associated assets will be included in the RAB from 1 April 2008 and the costs of service provision will be captured within the overall revenue cap.

Requested amendment - 16

The ACCC should address and accept SPI PowerNet's proposed treatment of non-contestable augmentations over the period 2003 to 2007/08 in the Final Decision.