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Rebecca Fenech

From: Michael Durrant <mdurrant@hwle.com.au>
Sent: Wednesday, 9 August 2017 1:26 PM
To: Madden, Craig
Cc: 'gpetersen@gtlaw.com.au'; De Ridder, Jonathan; Pattas, Chris; Innes, Nickolas; Toy, Peter; Wimpole, Madeleine; 'smuys@gtlaw.com.au'
Subject: Public lighting arbitration - ERP non-binding expert evaluation [SEC=UNCLASSIFIED] [HWLE-Matter.C0136510.635816]
Attachments: Non binding expert valuation - Public Lighting Dispute in South Australi....pdf

Dear Mr Madden

We refer to your letter dated 2 August 2017.

Please find attached a copy of the Expert Review Panel non-binding expert evaluation dated 9 September 2015.

Regards

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Partner



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Non-binding expert evaluation: Public Lighting Dispute in South Australia

Expert Review Panel Findings, 9 September 2015

1 Introduction

The Public Lighting Customers (PLC) (comprising the Local Government Association of South Australia (LGA) and the Department of Planning, Transport and Infrastructure (DPTI)), have lodged a notice of dispute under Part 10 of the National Electricity Law (NEL) regarding the provision of public lighting services (PLS) by SA Power Networks (SAPN) (the Dispute). The Dispute relates to the matter of SAPN's prices for the provision of PLS.

The Australian Energy Regulator (AER) by separate letters dated 19 September 2014 to each of PLC and SAPN (the Parties) proposed, and the Parties agreed, to voluntarily submit to case appraisal. As an output of the case appraisal, the appraiser recommended and the Parties agreed that certain questions arising in respect of SAPN's prices for the provision of PLS be referred to an Evaluation Review Panel¹ (ERP) for a non-binding evaluation. If the evaluation is accepted by the Parties it will be used as an input into direct negotiations between the Parties or into such further process as may be agreed between them. If any questions are not resolved by agreement between the Parties, the Dispute may proceed to access determination by the AER under Part 10 of the National Electricity Rules (NER).

The ERP notes that PLS provided by SAPN are regulated electricity network services under the NEL and, in particular, are negotiated distribution services for the purposes of the NER, including Part D, Chapter 6 of the NER. The ERP's understanding of the regulatory framework is set out further below.

As to the Parties to this dispute, the ERP notes that SAPN acquired its network assets and business through a privatisation process, conducted in the context of a regulatory regime which it could reasonably expect would allow it to recover at least its efficient costs of providing services over time. The ERP also notes the submission of the PLC parties that they are government bodies that have obligations to provide public lighting in the community and that they are not commercial parties that derive a commercial return or commercial value from the provision of public lighting to the community.

The questions that have been referred to the ERP for non-binding evaluation are in the next section. The ERP notes that the AER by letter dated 1 July 2013 has expressed certain opinions in relation to this matter that may be relevant to the evaluation of the ERP.

This document comprises the ERP's findings and conclusions on the identified areas in dispute. It was not proposed that the ERP would provide detailed written reasons, unless requested to do so by the Parties, and these findings do not provide detailed written reasons.

2 ERP understanding of the regulatory framework

The ERP understands that the PLS provided by SAPN are regulated electricity network services under the NEL and, in particular, are classified negotiated distribution services (NDS) for the purposes of the

¹ The ERP consists of Geoff Swier (chair), Luke Woodward and Shaun Dennison.

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NER, in accordance with a determination made by the AER.² The relevant AER determination is for the 2010-2015 period.

The prices of NDS are to be determined in accordance with Part D, Chapter 6 of the NER. NER Chapter 6 deals with the classification and economic regulation of distribution services.³ Chapter 6 is an integrated regulatory framework, which is divided into parts. Relevantly:

- Part B confers power on the AER to classify distribution services, to determine the forms of control for distribution services, and to make distribution determinations;
- Part D regulates the prices that may be charged by Distribution Network Service Providers (DNSPs) for the provision of services classified as NDS;⁴
- Part C sets out the building block approach to the regulation of services classified as *standard control services* and provides for the AER to publish a Post Tax Revenue Model (PTRM);⁵
- Part F regulates cost allocation and provides that a DNSP must comply with the Cost Allocation Method (CAM) that has been approved in respect of that provider from time to time by the AER under this rule 6.15;
- Part L deals with dispute resolution, including disputes relevantly in relation to NDS.

The Dispute has been lodged under Part 10 of the NEL.

The NEL contains the National Electricity Objective (NEO), which is the overarching objective of the NEL and the guiding principle for the AER (s 16(1)(a)) when it makes an access determination. The NEO is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to: (a) price, quality, safety, reliability and security of supply of electricity; and (b) the reliability, safety and security of the national electricity system.

Further, the NEL establishes certain revenue and pricing principles (RPPs)⁶, namely

- A regulated NSP should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in: (a) providing direct control network services; and (b) complying with a regulatory obligation or requirement or making a regulatory payment.
- A regulated NSP should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes: (a) efficient investment in a distribution system or transmission system with which the operator provides direct control network services; and (b) the efficient provision of electricity network services; and (c) the efficient use of the distribution system or transmission system with which the operator provides direct control network services.
- Regard should be had to the regulatory asset base with respect to a distribution system or transmission system adopted: (a) in any previous, distribution determination or transmission

² A classification forms part of a distribution determination and operates for the *regulatory control period* for which the distribution determination is made (NER Clause 6.2.3).

³ A *distribution service* is a service provided by means of, or in connection with, a *distribution system*. A *negotiated distribution service* is a *distribution service* that is a negotiated network service within the meaning of section 2C of the NEL.

⁴ Clause 6.2.7.

⁵ Clause 6.4.

⁶ Section 7A.

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determination or determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system or transmission system (as the case requires); or (b) in the Rules.

- A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.
- Regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in, as the case requires, a distribution system or transmission system with which the operator provides direct control network services.
- Regard should be had to the economic costs and risks of the potential for under and over utilisation of a distribution system or transmission system with which a regulated network service provider provides direct control network services.

These principles must be taken into account by the AER in an access determination in relation to an "electricity network service"⁷, which the ERP understands would encompass the NDS, such as the PLS. The ERP understands that PLS are accepted to be a *distribution service* and that the AER has classified PLS provided by SAPN to be NDS.⁸

The reference to a direct control network service in the RPPs is taken to be a reference to an "electricity network service"⁹, which the ERP understands would extend to the PLS.

A relevant pricing principle that was the subject of consideration in this matter was that regard should be had to the regulatory asset base adopted in a previous distribution determination, or determination or decision under the National Electricity Code, or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system. PLC contended that this principle did not apply in this matter. This is considered further below.

A DNSP, such as SAPN, must provide NDS on terms and conditions of access as determined under Chapters 4, 5, 6 and Chapter 7 of the Rules.¹⁰ The terms and conditions of access in relation to negotiated distribution services are: (i) the price of those services (including, if relevant, access charges); and (ii) other terms and conditions for the provision of those services.

In the context of a dispute in relation to the PLS, as a category of NDS, the NER sets out relevant NDS pricing principles for the dispute.¹¹ The principles that appear most relevant to this matter are:

- the price for a NDS should be based on the costs incurred in providing that service, determined in accordance with the principles and policies set out in the CAM for the relevant DNSP;¹²

⁷ Section 16(2)(a)(ii).

⁸ AER Final decision South Australia distribution determination 2010–11 to 2014–15 May 2010, Appendix A, s A.12.

⁹ Section 16(3).

¹⁰ Clause 6.1.3.

¹¹ Clause 6.7.1.

¹² Clause 6.7.1(1).

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- the price for a NDS should be at least equal to the cost that would be avoided by not providing the service but no more than the cost of providing it on a stand-alone basis;¹³
- the price for a NDS should be such as to enable the DNSP to recover the efficient costs of complying with all regulatory obligations or requirements associated with the provision of the NDS;¹⁴
- the terms and conditions of access for a NDS should be fair and reasonable and consistent with the safe and reliable operation of the power system in accordance with the NER and for these purposes, the price for a NDS is to be treated as being fair and reasonable if it complies with NDS pricing principles.¹⁵

In addition, the NER provides¹⁶ that a DNSP must, when negotiating the terms and conditions of access to NDS, comply with: the provider's Negotiating Framework and the provider's Negotiated Distribution Service Criteria (**Negotiation Criteria**).

The Negotiating Framework must relevantly specify:

- a requirement for the provider and a Service Applicant to negotiate in good faith the terms and conditions of access to a negotiated distribution service; and
- a requirement for the provider to provide all such commercial information a Service Applicant may reasonably require to enable that applicant to engage in effective negotiation with the provider for the provision of the negotiated distribution service, including the cost information set out below; and
- a requirement for the provider: (i) to identify and inform a Service Applicant of the reasonable costs and/or the increase or decrease in costs (as appropriate) of providing the negotiated distribution service; and (ii) to demonstrate to a Service Applicant that the charges for providing the negotiated distribution service reflect those costs and/or the cost increment or decrement (as appropriate); and (iii) to have appropriate arrangements for assessment and review of the charges and the basis on which they are made; and
- a requirement for a Service Applicant to provide all commercial information the provider may reasonably require to enable the provider to engage in effective negotiation with that applicant for the provision of the negotiated distribution service.

SAPN has an approved Negotiating Framework and Negotiation Criteria.¹⁷ The Negotiation Criteria are in line with, but not identical to, NDS pricing principles in clause 6.7.1. In particular, clauses 5 and 6 of SAPN's Negotiation Criteria¹⁸, provide:

- The price for a NDS *must reflect* the costs that a DNSP has incurred or incurs in providing that service, and *must be* determined in accordance with the principles and policies set out in the DNSP's CAM.

¹³ Clause 6.7.1(2), subject to subparagraphs (3) and (4), which are not apparently relevant for current purposes.

¹⁴ Clause 6.7.1(7).

¹⁵ Clause 6.7.1(9).

¹⁶ Clause 6.7.2.

¹⁷ *ETSA Utilities Negotiation Framework* July 2010. The Negotiating Framework and the Negotiation Criteria are required to be approved by the AER, in accordance with clauses 6.7.3, 6.7.4 and 6.7.5.

¹⁸ Schedule 2, to *ETSA Utilities Negotiation Framework* July 2010.

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- Subject to criteria 7 and 8 (which the ERP understands are not relevantly applicable), the price for a NDS *must* be at least equal to the cost that would be avoided by not providing that service but no more than the cost of providing it on a stand-alone basis.

(Applicable textual differences between these criteria and clause 6.7.1 are highlighted in italics).

The ERP understands that SAPN has an AER approved CAM.¹⁹

A dispute as to the terms and conditions of access to a negotiated distribution service is an access dispute for the purposes of Part 10 of the NEL.²⁰ In determining an access dispute about terms and conditions of access to a negotiated distribution service, the AER must relevantly apply in relation to price (including access charges), the applicable Negotiation Criteria and have regard to the relevant Negotiating Framework.²¹

In addition, in determining an access dispute about the terms and conditions of access to a negotiated distribution service, the AER may relevantly have regard to other matters the AER considers relevant.

Part 10 of the NEL does not contain any relevant criteria or principles to be applied by the AER in an access dispute in relation to NDS. However, it is noted that the AER must terminate an access dispute if the AER considers that the electricity network service subject of the dispute could be provided on a genuinely competitive basis by a person other than the network service provider or an associate of the provider.

In so far as relevant to the role of the ERP in this matter, the ERP considers that it should have regard to the above regulatory context. In particular, the ERP considers that it should adopt an approach that is consistent with the requirement for the AER in the event that this matter is referred to it for determination, to apply the NEO and RPPs (as applicable) and SAPN's Negotiation Criteria, and have regard to SAPN's Negotiation Framework.

3 Questions for non-binding ERP evaluation and the ERP review process

The Parties have provided their position on the scope of evaluation questions.²² In our view the Parties substantively agreed on the evaluation questions other than one question. The Parties agreed that any other changes, refinements or additions to the question may be suggested by the ERP and then agreed by the Parties.

3.1 Questions for ERP evaluation

The ERP considers that the SAPN and the PLC reached substantive agreement on the evaluation questions as shown in the table below. We note that while the SAPN and the PLC drafting of these questions is different, the questions substantively cover the same matters.

¹⁹ *Cost Allocation Method September 2008*.

²⁰ Ch 6, Part L, Clause 6.22.1.

²¹ Clause 6.22.2(c).

²² Email from Shirli Kirschner, 1 April 2015.

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| PLC | SAPN |
|---|---|
| <ol style="list-style-type: none"> 1. For the purpose of establishing the price of PLS in South Australia, what methodology should be used? 2. What are the appropriate costs to be taken into account in the determination of PLS charges? 3. What is a cost 'incurred' in the context of the negotiated distribution service criteria and when is a cost incurred? | <ol style="list-style-type: none"> 1. The ERP is established to provide an opinion on an appropriate methodology for establishing the price of the public lighting service in South Australia, including an opinion on: <ol style="list-style-type: none"> a. what costs are appropriate to be recognised under the methodology; and b. when those costs may be considered to have been incurred. |

In addition the PLC proposed, but the SAPN did not agree to, the following question:

To the extent that the ERP considers it relevant to give a view, what information is required for a negotiated framework?

SAPN considered that this should be removed from the scope on the basis that it is difficult to see how this question is relevant to this phase of the process which is looking at methodology.

The ERP advised the Parties on 2 April 2015 that it considered the agreed scope of questions (section 2.1 above) was an appropriate basis for commencing the non-binding evaluation. The ERP did not propose any other questions at that stage and noted that we would consider our position on the non-agreed question during the review.

3.2 Specific issues identified in submissions

Having settled on the overarching questions for ERP evaluation, the ERP sought from the Parties' submissions on particular issues. In particular, the ERP invited the Parties to provide a submission that addresses the following matters related to the agreed evaluation questions:

- What is the appropriate pricing methodology for PLS in South Australia?
- What cost elements that each Party considered should be recovered as part of its preferred pricing methodology?
- Whether asset values should be based on a roll forward model and, if so:
 - How should the opening asset base for the current period be determined?
 - How should the asset base be adjusted for indexation, depreciation and asset disposals?
- Whether competition related business risks (such as asset stranding) are a relevant and material factor in determining costs?
- Whether opportunity cost for use of shared assets is a relevant factor in determining cost?

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Detailed and helpful submissions were received from the Parties (see Appendix 1).

These submissions identified some areas of agreement as well as more clearly identifying issues in dispute between the Parties. In particular, the submissions provided greater clarity of the particular areas of dispute in relation to particular inputs into the cost methodology for deriving or supporting public lighting prices.

The Panel identified these issues in its framework and agenda paper (**the Roundtable Agenda**) used for the Roundtable meeting of the Parties and the ERP on 29 July 2015. The Roundtable Agenda is attached as Appendix 2 and a summary of the Roundtable is attached as Appendix 3.

3.3 The Roundtable Conference

The issues the ERP identified in the Roundtable Agenda as in dispute between the Parties were:

- Certain issues as to the scope of the regulatory framework.
- The use of the PTRM as a building blocks model to derive a total revenue requirement.
- Whether economic or accounting cost concepts should be used in the asset role forward model for the asset base.
- The starting asset base value.
- Calculation of depreciation – the role of economic and financial accounting concepts.
- Taxation – in particular the tax treatment of transferred infrastructure (gifted assets) as income for tax purposes, and the consequent tax liability.
- Elevation charges for use of existing SAPN network infrastructure for the elevation of lighting assets.
- Operating margin for provision of Customer Lighting Equipment Rate (**CLER**) services and Energy Only (**EO**) services.

The ERP considers that the Roundtable between the Parties and the ERP further assisted in clarifying the issues of material divergence between the Parties and resolving some issues.

Subsequent to the Roundtable Conference, PLC provided a further submission and supporting material setting out the following contentions:

- the ESCOSA 2009 determination is not a sound basis for the pricing of PLS
- RPP 7A(4) does not apply to PLS services because it expressly applies in relation to the distribution system, and PLS is not part of the distribution system
- the ERP should critically review the PLC's claim of errors in the ESCOSA 2009 determination.

SAPN provided a submission in reply which also included further contentions on the elevation charge.

The debate between the Parties as to the scope of the regulatory framework, including the application of the NEO and RPPs, and interpretation of Part D, Chapter 6 of the NER and the Negotiation Framework and Negotiation Criteria, is best understood as providing the regulatory context or backdrop in which each of the Parties sought to support their particular position in relation to specific cost or other items used to support the overall PLS prices.

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There appeared to be some confusion as to the basis on which SAPN sought to support its charges. While the original SAPN charges were based on a building blocks model²³, in the context of the referred dispute to the AER, SAPN sought to support its charges based on the use of a building blocks model in conformance with the AER's PTRM. The Panel understands that SAPN adopted the use of the PTRM because it is a widely used and accepted method used in Australian energy economic regulation.

One aspect of this was that some of the items in dispute between the Parties (including elevation charges and operating margin on certain services) were not included in the PTRM model used by SAPN to support its charges.

It became apparent in the Roundtable that the most material issues in dispute between the Parties were not the use of the PTRM, but rather, the starting asset value, the treatment of depreciation, and the treatment of taxation charges, used by SAPN in the PTRM.

(a) Starting PLS asset base

In relation to the starting asset base (**AB**) for the PLS to be applied in its PTRM for PLS services, SAPN has used an asset value applied by the Essential Services Commission of South Australia (**ESCOSA**) in a December 2009 decision with respect to fair and reasonable PLS charges²⁴ (**the ESCOSA 2009 AB value**). SAPN has used the ESCOSA 2009 AB value in calculating the opening asset value for inclusion in the asset roll forward model that forms part of the PTRM used to establish an overall PLS total revenue requirement, which in turn is used to support SAPN's proposed PLS prices.

PLC considers that the asset roll forward model should be recalculated starting from 1 July 1999 using its proposed building blocks model (**the PLC model**)²⁵, which adopts as a starting AB value, a valuation of public lighting assets as at 30 June 1998 of \$37.07 million prepared by Sinclair Knight Mertz based on the optimised depreciated replacement cost (**SKM 1998 ODRC value**).²⁶ The SKM 1998 ODRC value was applied by the then South Australian Independent Industry Regulator (**SAIIR**), the predecessor agency to ESCOSA, in its 2000 decision in relation to public lighting charges.²⁷ PLC contends that use of SKM 1998 ODRC value, together with its proposed treatment of depreciation, would reduce SAPN's proposed written down asset value as at 30 June 2011 from \$39.75 million to \$15.72 million. PLC submitted that there are a series of errors in the ESCOSA December 2009 regulatory determination. PLC noted it had not accepted ESCOSA's adoption of the SAPN valuation, but recognising that ESCOSA would cease regulation of Street Lighting Use of System charges

²³ SAPN, Public Lighting Pricing Proposal Model "PL RAB Model Jul12 DTEJ LGA (July 2012)."

²⁴ ESCOSA, ETSA Utilities" Public Lighting Excluded Services Charges, Fair and Reasonable Determination, December 2009, Table 2.1 (\$40.71 million average asset value over 2008/09) and Appendix 1 (\$40.18 million asset value at 1 July 2009).

²⁵ Para 8.5 PLC submission.

²⁶ S2.4.2 Briefing paper prepared by SAPN. SAPN (then ETSA Utilities) leased the South Australian (SA) Distribution System (including Public Street Lighting Assets) from the SA Government. The lease was agreed on 11 October 1999 and finalised on 28 January 2000. In preparation for the lease, the SA Distribution System was re-valued by Sinclair Knight Mertz (SKM). SKM high level valuation of the Optimised Depreciated Replacement Cost (ODRC) of the public lighting assets (PLA) was \$37.07m as at 30 June 1998. The valuation was based on an average optimised replacement cost for residential lighting, main road lighting and for lighting columns.

²⁷ SAIIR, Public Street Lighting Tariffs: Final Report, November 2000.

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(SLUoS) shortly, and that is any resolution of a dispute was unlikely before that occurred, it did not pursue a formal challenge.²⁸

PLC contends that there has been significant over recovery of PLS charges. PLC's position in its submissions was that a nominal roll forward model with a real Weighted Average Cost of Capital (WACC) should be used applying the SKM 1998 ODRC value as a starting point.

(b) Depreciation

In relation to the calculation of depreciation in the roll forward model, SAPN contends that depreciation should be based on the weighted average economic life of its assets of 28 years using straight line depreciation.²⁹ Whereas, PLC contends that the Australian Tax Office's (ATO) depreciation schedules and rulings should be applied to the assets used by SAPN³⁰ resulting in weighted average asset lives of 15 year using straight line depreciation.³¹

(c) Taxation

In relation to taxation, SAPN submitted that the fair value of transferred infrastructure (gifted assets) is assessable income for tax purposes, creating an immediate tax liability that is offset by taxation depreciation deductions over time.³² PLC submits that tax on gifted assets is a cost of acquiring the assets rather than cost *incurred* in providing PLS.³³

(d) Corporate overhead

SAPN has also included an allowance for corporate overheads in accordance with its AER approved CAM. PLC has questioned the basis for the allocation of corporate overheads to SAPN PLS costs. In particular PLC contends that SAPN must demonstrate to PLC that its allocation of overheads is compliant with the SAPN CAM.³⁴ PLC undertook its own calculation of overhead amounts.³⁵

(e) Elevation charges

While not part of SAPN's PTRM modelling, SAPN contends that it was appropriate to allow for elevation charges in the context of PLS services. SAPN states that one of the shared asset principles is that a DNSP should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of the standard control services. SAPN also contends that an elevation charge is more likely to encourage competitive entry and noted that an elevation charge had been previously allowed by ESCOSA (2009) and SAIIR (2000).³⁶ Whereas PLC contends that an elevation charge amounts to

²⁸ Para 8.14 PLC submission; Letter from TTEG (Craig Marshall, Principal Consultant) to ESCOSA (Pat Walsh), 13 January 2010.

²⁹ Pg 12 SAPN Submission.

³⁰ Para 8.36 PLC submission.

³¹ Para 8.15 PLC Submission.

³² Section 4.5 SAPN reply to PLC submission, pg 10.

³³ PLC Submission 24 April, para 4.22.

³⁴ Section 4.32(b) PLC Submission.

³⁵ Section 7.8 PLC Submission.

³⁶ Page 17-18 SAPN Submission.

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'double dipping' of revenues where costs of providing poles are already fully recovered through Distribution Use of System (DuOS) charges.³⁷

(f) Operating margin

While also not part of SAPN's PTRM modelling, SAPN submits that there should be an operating margin cost allowance for provision of CLER and EO services. SAPN considers that because there is no relevant asset base associated with these services, an operating margin may be appropriately calculated by reference to the average profit that a business may be expected to earn if carrying out similar activities.³⁸ Whereas, PLC contends that no extra operating margin should be included as SAPN will receive a return on its capital assets³⁹ being a 22% profit on the \$8.452 million per annum Total PLS Charge proposed by the PLC. The ERP understands that PLC in effect contends that any required profit for SAPN to provide CLER and EO services is covered by returns on street lighting assets recovered through charges for SLUoS services.

4 ERP findings

4.1 General observations on methodology, appropriate costs, and costs incurred

The ERP notes that neither Part D, Chapter 6 of the NER nor the Negotiating Criteria mandate the use of any, nor any specific, methodology for determination of PLS prices. The ERP considers that an appropriate methodology for determination of PLS prices is one which is capable of transparently and consistently deriving prices which are consistent with the NER and the Negotiation Criteria.

The only pricing principles directly relevant are:

- **Prices should be based on reflect costs incurred and determined in accordance with SAPN's CAM** - the price for a NDS [should be based on/must reflect] the costs incurred in providing that service, [and must be] determined in accordance with the principles and policies set out in the CAM for the relevant DNSP⁴⁰
- **Prices may be between avoided and stand-alone costs** - the price for a NDS [should be/must be] at least equal to the cost that would be avoided by not providing the service but no more than the cost of providing it on a stand-alone basis.⁴¹

These principles can be satisfied with the adoption of a building block methodology, but they do not mandate such a methodology or a particular building blocks model.

As to the general questions raised on what are appropriate costs and when are they incurred, the ERP considers that these questions are best addressed in the specific context in which they are relevant (which the ERP has addressed in its specific findings below), not at a general abstract level. The only general observation that the ERP would make is that where the principles refer to costs and costs incurred in the context of the broader regulatory regime, the ERP considers that it is relevant to consider the economic costs of providing the services, not simply accounting or general ledger costs.

³⁷ Section 7.55 PLC Submission.

³⁸ Page 9 SAPN Submission.

³⁹ Section 7.73 PLC Submission.

⁴⁰ Clause 6.7.1 (1) NER and SAPN Negotiation Criteria 5.

⁴¹ Clause 6.7.1 (2) NER and SAPN Negotiation Criteria 6.

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4.2 PTRM as an appropriate methodology for establishing the price of PLS in South Australia

The ERP considers that the PTRM is an appropriate methodology for establishing the price of the PLS in South Australia because it is a reasonable method for SAPN to propose and the PLC has not established that it is unreasonable to adopt the PTRM for determining the PLS prices in South Australia.

The ERP considers it is reasonable for SAPN to propose the PTRM as:

- It is a well-accepted method (amongst a number of other methods) for applying the building blocks approach.
- It is the prevailing method used in Australian energy economic regulation.

Further the ERP notes that PTRM has the characteristic that it tends to promote stable prices over time.

The PLC proposed an alternative methodology being to not index the asset base and apply a pre-tax nominal WACC on the basis that it:

- **Is simple and based on shared information** - the methodology under Part D, Chapter 6 has a simplicity to it ... which is consistent with the essential nature of the framework (good faith negotiations between parties); that timeframes provided for in the Negotiation Framework are consistent with a straightforward process of negotiation on the basis of shared information; and that this is an intentionally less complex methodology than the PTRM (which is required to be applied to Standard Control Services).
- **Supports verification (audit) of SAPN's depreciated asset value** - by not indexing the asset base in its modelling, PLC considers it can ensure written down value (WDV) of the public lighting assets reflects the value on SAPN's balance sheet.

The ERP agrees that the PLC's model is an accepted method for applying the building blocks approach and is also a reasonable method.

The ERP agrees with the PLC that an appropriate methodology must be based on shared information and that it must be possible to use such a method to verify or audit SAPN's depreciated asset value.

The ERP considers that through proper application of the PTRM and by use of agreed depreciation charges and other model inputs (inflation, capital additions, disposals) that it is possible to transparently verify SAPN's WDV for public lighting assets for each year to the current year starting from an agreed opening asset value in a given year. For example, it is conceptually feasible for SAPN and PLC to use the PTRM to determine an agreed current WDV for public lighting assets starting with either the SKM 1998 ODRC value or the ESCOSA 2009 AB value, and using agreed depreciation charges and other agreed information.

The ERP disagrees with the PLC that it is a requirement that the methodology must enable the WDV of PLS to reflect the value on SAPN's balance sheet for each year.

The ERP notes that it is standard practice in Australian economic regulation for regulated energy businesses to establish regulatory accounts that use the PTRM to determine WDV asset values in any year starting from an opening asset value. Such regulatory accounting procedures are well accepted by all stakeholders as providing a robust and transparent basis for determining prices for regulated

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services, and often there are differences between values recorded in financial accounts and regulatory accounts.

A third point concerning the PTRM and the non-indexation approach was advanced by PLC advisor Mr Mountain during the Roundtable meeting. He drew attention to the difference between the PTRM and the non-indexation methodology in terms of fair recovery of expenditure over time.⁴² As noted, the PTRM tends to provide stable prices over time, but has the characteristic that depreciation is recovered later in the economic life of the assets. The non-indexation methodology has the characteristic that it results in more rapid depreciation compared with the PTRM. Application of the non-indexation approach may result in WDV of the public lighting assets now being lower than calculated by the PTRM. The ERP notes that the PLC did not develop this point further and did not advance any arguments concerning the fairness of the recovery of expenditure over time and further that the SAPN was not provided with any opportunity to reply. The ERP therefore has not considered this point further.

4.3 What are appropriate costs and factors to be taken into account in the determination of PLS charges

The ERP considers that the appropriate costs for inclusion within a building block methodology, such as the PTRM are:

- depreciation and return on capital applied to a rolled forward asset base calculated as per the PTRM
- corporate income tax
- direct operation and maintenance costs
- an allowance for corporate overheads as allocated by the CAM.

The ERP also considers, as discussed further below, that total revenue relating to PLS may appropriately include:

- an operating margin included in deriving CLER and EO prices; and
- elevation charges.

Each of these costs is discussed further below.

4.4 Depreciation and return on capital calculated as per the PTRM

The ERP considers that, consistent with the use of the PTRM, an appropriate return on capital allowance is derived by applying a real post tax WACC determined in accordance with the NEL⁴³ to the rolled forward AB determined consistently with the AER's asset roll forward model that forms part of its PTRM model. This model includes indexation of the AB for inflation (based on actual inflation and Reserve Bank of Australia forecasts).

(a) Starting AB

⁴² Mr Mountain, Line 5 Pg 26 Transcript of proceedings, Non-binding expert evaluation Roundtable meeting 29 July 2015.

⁴³ The ERP understands that the Parties agree to the use of the AER determined WACC value used for SAPN prescribed services.

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The application of the PTRM requires determination of a point in time at which an opening AB is established, which is then rolled forward to take account of capital expenditure, disposals and depreciation. The point in time at which an opening AB for PLS prices should be determined and the value of the opening AB is one of the most significant areas of dispute between the Parties.

The ERP considers that it is reasonable for SAPN to use the ESCOSA 2009 valuation as it is the opening asset value applied by the applicable independent regulator in the most recent relevant regulatory determination. The ERP considers that it is generally desirable that there is consistency in the application of regulatory asset values over time, and that it is in general undesirable to reopen or revisit an asset value that has previously been determined. The ERP considers that to reopen a regulatory asset value can potentially undermine confidence in the regulatory framework and undermine incentives for efficient investment. The ERP considers this principle is reflected in s 7A(4) of the RPPs.

The ERP notes that PLC contends that this principle does not apply in the current context. This position, which was advanced orally at the Roundtable, was based on a textual argument as to the application and implications of the definitions of the term "distribution system" in the NEL and NER, as relevant to s 7A(4).

The ERP notes that the NEL specifically requires that the AER must take into account the RPPs when making an access determination relating to a charge for an electricity network service.⁴⁴ The ERP understands that the context in which this Dispute has been referred to the AER for an access determination under Chapter 6 of the NER is that the PLS is an NDS and that NDS are a category of electricity network service. It is not the role of the ERP to adjudicate on a matter of legal construction in dispute between the Parties. For the ERP's part, whether bound to take into account the principle in s 7A(4) (namely that regard should be had to a prior relevant regulatory determination of a regulatory asset base) as a matter of law or not, the ERP considers that generally this principle is a sound principle and appropriate in this context.

Nonetheless, the ESCOSA 2009 AB value has not been accepted by PLC as the starting asset value in the PTRM. In negotiation between Parties, it is relevant to take account of and consider arguments that may be advanced as to why the ESCOSA 2009 AB value should not be applied, including where it can be shown to result in over recovery of costs. The ERP does not consider that there is a binding rule that requires the use of the ESCOSA 2009 AB value, and where the PLC can demonstrate that the ESCOSA 2009 AB value would result in cost over recovery, then that would be a relevant consideration in deciding whether to apply it.

The ERP considers that it is not appropriate to make a finding on the appropriate point in time at which the opening AB for PLS prices should be determined. The ERP considers that if the PLC wishes to, in its negotiations with SAPN, it is open to PLC putting forward evidence that the ESCOSA 2009 AB value will result in an over recovery of costs.

The ERP considers that it would be desirable, if PLC wishes to (a) verify the calculation of the current WDV of public lighting assets, and (b) contend that the ESCOSA 2009 AB value will result in over recovery, with the appropriate regulatory expert assistance, for PLC to:

⁴⁴ Section 16(2)(a)(ii).

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1. use the AER's PTRM to roll forward the asset base based on the SKM 1998 ODRC value and other agreed parameters (depreciation charges, capital additions and reductions)
2. to identify the extent of any difference in the current WDV of PLS assets between a starting AB value using that valuation as compared to the ESCOSA 2009 AB value
3. identify precisely the reasons for any difference in the valuation.

In particular, it could be desirable to identify the precise extent to which particular items, such as column pre-payments or the use of the different asset lives, account for the difference in starting AB values.

If, for example, differences of opinion between SAPN and PLC as to asset lives is the principal driver of any difference in the asset values, then resolution of this one issue may go a long way to resolving the areas of dispute between the Parties.

The ERP considers that approaching the issue in this way should enable the Parties to accurately identify the precise areas of disagreement between themselves based on a common methodology, and may provide an improved basis for the Parties to then reach a commercial agreement on these matters. While the ERP encourages the Parties to come to an agreement on this issue, where they cannot do so, the process the ERP has set out above will provide a sound foundation for the resolution of any dispute by either separate expert evaluation or determination by the AER.

(b) Depreciation – asset lives

The ERP considers that, consistent with the use of the PTRM, an appropriate depreciation allowance should enable asset costs to be recovered over their economic life and be calculated using the straight line method.

The ERP does not consider depreciation based on asset lives simply derived from tax schedules is appropriate. Nor does the ERP consider that asset lives used in determining PLS prices should necessarily be drawn from the values used in SAPN accounts. The accounting and economic regulatory treatment and duration of asset lives can, and does frequently, differ.

The ERP has not been requested to determine, and has not determined, the appropriate asset lives for SAPN's public lighting assets. The ERP notes that any dispute as to the proper economic life of SAPN public lighting assets could be resolved through independent expert advice or determination.

4.5 Corporate income tax

The ERP considers that corporate income tax including any tax liability arising from the fair value of transferred infrastructure to provide SLUoS (gifted assets) should be included as a cost but only recovered once. That is, it should be recovered within PLS prices if it is not already recovered from other parties (e.g. councils, or developers).

Under the PTRM, corporate income tax is a cost that is recoverable as a discreet building blocks component. Consistent with this treatment the tax liability arising from the fair value of transferred infrastructure (gifted assets) is a cost that SAPN is entitled to recover, but only once.

The ERP understands that:

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- councils decide whether or not to gift assets - developers hand over completed infrastructure including electrical lighting to the council and the council chooses whether or not to hold on to the assets or to gift them to SAPN⁴⁵
- SAPN has no power to compel the council to pay the tax cost and would need a specific agreement to that effect.⁴⁶

During the Roundtable, the PLC contended that SAPN may already be claiming tax costs from developers.⁴⁷ If this is occurring then the tax liability for gifted assets should not be included as a cost. This is factual question that should be established.⁴⁸

4.6 Direct operation and maintenance costs

There is no dispute in principle that direct operation and maintenance costs are a cost incurred. There was significant dispute over the appropriate quantum of direct operation and maintenance costs. This matter is outside the scope of the questions asked of the ERP.

4.7 Corporate overheads costs

Again there is no dispute in principle that corporate overhead costs are a cost incurred but there was dispute over the appropriate quantum of such costs. The ERP considers that SAPN should, subject to resolving any issues of confidentiality, provide the underlying cost allocation information to PLC so that PLC can understand the basis of allocation of overhead costs to PLS, in accordance with the CAM.

4.8 Operating margin

The ERP considers that an operating margin can be appropriate for inclusion in setting CLER and EO prices, provided it is correct that (as claimed by SAPN) there are no asset related costs in provision of these services.

The ERP notes the PLC contention that "high profits" on total PLS charges means an operating margin is not appropriate. The ERP considers the PLC position is reasonable in the context of negotiation. The Parties could reasonably agree not to include an operating margin for CLER and EO as part of broader negotiated trade-offs. But as discussed below, there are good economic reasons why an operating margin can be included as a cost incurred and attributed to provision of CLER and EO services.

The ERP notes that the cost allocation principles in the NER require the costs which are directly attributable to the provision of services to be allocated to the relevant category of distribution service.⁴⁹ Although the NER does not require the cost allocation principles to be applied to the determination of different types of negotiated service, the ERP considers that the full allocation of attributable costs to each negotiated service is generally in line with good economic and business practice. In other words, in the absence of agreement to the contrary, the price of each negotiated service should be cost reflective, and ideally there should not be cross subsidisation of attributable cost between negotiated services.

⁴⁵ Mr Walker, SAPN Line 14 Pg 86 Transcript of proceedings, Non-binding expert evaluation, Roundtable meeting 29 July 2015.

⁴⁶ Mr Walker, SAPN Line 26 Pg 86 Transcript of proceedings, Non-binding expert evaluation, Roundtable meeting 29 July 2015.

⁴⁷ Para 7.65 (b) PLC submission.

⁴⁸ As noted above Mr Walker of SAPN stated that it is councils not developers that chose to gift assets to SAPN.

⁴⁹ Clause 6.15.2 (3) (i) NER - Cost Allocation Principles.

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The ERP considers that a profit element should be an attributable cost incurred for each negotiated service; otherwise there may be little or no incentive for SAPN to provide the service.

In any event, the ERP considers that such an allowance could be applied consistently with the Negotiation Criteria, provided that the final charges are between floor and ceiling costs. That is, the ERP considers that it would be relevant to have regard to, and make an allowance for an operating margin, even if it was not considered to be itself cost based.

If it is correct that provision of CLER and EO services involves no assets as stated by SAPN, then the ERP considers it appropriate that an operating margin be charged. The ERP agrees with SAPN that an appropriate operating margin could be set by reference to the average profit that a comparable efficient business may be expected to earn if carrying out similar activities.

4.9 Elevation charges

The ERP considers that elevation charges may appropriately be included where there is a cogent basis (for example, supported by expert economic or other evidence) that such a charge would promote the National Electricity Objective (long term interest of consumers) through improved economic efficiency in provision, or use, of PLS.

(a) Regulatory framework

The ERP has considered the guidance provided by the current regulatory framework, noting that PLS is now regulated under a different regulatory framework to that which applied to the previous SAIIR and ESCOSA determinations. The relevant aspects of the regulatory framework are:

- whether elevation charges could be a cost incurred⁵⁰ as defined by Part D, Chapter 6 of the NER
- the shared asset principles in the NER⁵¹
- the NEO (long term interest of consumers).

These are discussed below.

Costs incurred

The principles for access to NDS include that the price for a NDS should be based on the "costs incurred" in providing that service. The ERP considers that the regulatory framework is based on economic concepts⁵² and therefore costs incurred can potentially be interpreted, depending on the context, as meaning the following types of economic cost:

- avoidable cost - the cost that may be incurred by SAPN due to the existence of lights on the poles
- incentives - a cost to provide an appropriate incentive for a supplier to provide a service

⁵⁰ Clause 6.7.1 (1) NER.

⁵¹ Clause 6.4.4 NER.

⁵² The National Electricity Objective is... "an economic concept and should be interpreted as such. For example, investment in and use of electricity services will be efficient when services are supplied in the long run at least cost, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities." South Australia House of Assembly, Hansard 9 February 2005.

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- competitive headroom - costs that would provide an incentive for a competitor to enter all or part of the PLS market.

The concepts of opportunity cost and the need for providing incentives to SAPN have been previously recognised by SAIIR⁵³ and ESCOSA.⁵⁴

Shared asset principles

The shared asset principles in the NER include that "DNSPs should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of those services."⁵⁵ The ERP considers that this principle is relevant to this dispute.

Competition in the market for PLS services

SAPN also contends that it was consistent with the classification of the PLS as NDS to facilitate pricing which is more likely to encourage competitive entry. SAPN contends that "a competitor providing PLS would face elevation costs and it is appropriate to create some headroom that recognises that such costs exist".

The ERP accepts in principle that promoting competitive entry could be a relevant factor in setting the elevation charge.

(b) Conclusion

As discussed above the ERP considers that an elevation charge could, consistent with the economic regulatory framework in the NEL and the NER, recognise:

- the avoidable cost incurred by SAPN due to the existence of lights on its electricity poles
- a cost to provide an incentive for the supplier to provide the service
- headroom to promote competitive entry.

The ERP considers the next question is whether there should be an elevation charge to reflect any or all of these factors.

The ERP considers that the appropriate test for whether any of the above factors should be recognised in an elevation charge (and also for setting the quantum) is whether this would promote the NEO (long term interest of consumers) through improved economic efficiency in provision, or use, of PLS.

The ERP notes that SAPN's submission proposing the elevation charge did not give sufficient attention to how providing for an elevation charge would promote the NEO.

The ERP considers that an elevation charge may be appropriately included but there should be a cogent argument that such a charge would promote the NEO through improved economic efficiency in

⁵³ Para 159, ETSA Utilities Public Lighting Excluded Services Charges, Fair and Reasonable Determination, The Essential Services Commission of South Australia, December 2009.

⁵⁴ Para 163 *ibid*.

⁵⁵ Clause 6.7.1.

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provision, or use, of PLS. The ERP considers that where appropriate, such argument needs to be evidenced based. For example, it is not sufficient to argue conceptually that the market for PLS is competitive, but rather it is necessary to provide credible evidence to support this position.

4.10 Information

The ERP notes that in the Roundtable it was identified that further information in relation to corporate overhead costs (as noted above) should be reasonably capable of being provided by SAPN to PLC to aid the negotiations.

5 Potential next steps

Appendix 4 summarises the potential next steps proposed in this report.

The Evaluation Review Panel

9 September 2015

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Appendix 1 – Submissions

- 1 PLC Outline of submissions (16 March 2015)
- 2 Briefing Paper: Prepared by SAPN (24 April 2015) and annotated by PLC (6 May 2015)
- 3 SAPN Submission (25 April 2015)
- 4 PLC Reply to SAPN Submission (6 May 2015)
- 5 SAPN reply to PLC Submission (7 May 2015)
- 6 PLC Letter to Shirli Kirschner – Submissions in respect of ESCOSA 2008 decision and attachments (David Hitchcock, 6 August 2009)
- 7 SAPN submission on ESCOSA 2009 determination and elevation charge (28 August 2015)

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Appendix 2

Non-binding expert evaluation: Public Lighting Dispute in South Australia

Roundtable Meeting Agenda (Final)

Roundtable meeting

The Evaluation Review Panel (Panel) has started work on its expert evaluation. A Roundtable meeting has being scheduled for 29 July

Opening submissions

The proposed format for the Roundtable meeting is for the Parties to provide up to 20 minutes of oral submissions outlining the key elements of their submission.

In the opening submission the Panel would be assisted if each of the Parties identified what it considers to be the key issues in dispute between them and how that is relevant to the questions on which the Panel is to provide its expert evaluation.

The Panel would also be assisted by a discussion around the issues and questions set out below.

Regulatory framework for determination of PLS prices

General issues regarding the regulatory framework

The Panel understands that the parties agree that the NEO applies to the determination of Public Lighting Service (PLS) prices.

The Panel also understands that the Revenue and Pricing Principles (RPPs) are required to be applied by the AER in determining PLS prices in the event of a dispute. *Is that correct?*

What are the implications if any of the application of the NEO and the RPPs to the determination of PLS prices?

The role of economic and financial accounting cost concepts

The Panel is interested in views on the respective role of economic and accounting cost concepts in the application of the regulatory framework for PLS.

The Panel notes that National Electricity Law (NEL)/National Electricity Rules (NER) regulatory framework is generally considered to be an economic regulatory framework. For example, the second reading speech for the NEL noted that National Electricity Objective is "an economic concept and should be interpreted as such...".⁵⁶

⁵⁶ South Australia House of Assembly, Hansard 9 February 2005.

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What are the implications, if any, of the regulatory framework in terms of whether accounting or economic cost concepts are to be used to determine PLS prices?

Do costs incurred in Chapter 6 include opportunity or economic costs, or only direct financial expenditures? And if so, why?

Total revenue requirement

Building blocks model

The Panel understands that both parties agree that a building blocks model should, or can fairly and reasonably, be used to calculate total revenue to derive PLS prices. *Is that correct?*

The Panel is generally familiar with the Australian Energy Regulator's (AER's) Post Tax Revenue Model (PTRM) and other building block models. The Panel understands that such building block models reflect economic cost concepts.

Are there building block models based on accounting costs?

What are the implications, if any, for particular cost items included in a building block model for determining PLS prices of using economic or accounting cost concepts?

Note: the Panel has identified some specific issues in relation to the use of accounting or economic costs in a building blocks model below.

Use of the PTRM

The Panel understands that SAPN seeks to support its PLS prices by reference to the PTRM.

The Panel understands that PLC objects to the use of the PTRM on the basis that:

the PTRM is not a required methodology under Part D of the Chapter 6 of the NER,⁵⁷

- it is a complex model;⁵⁸
- it is a real WACC rate of return model in which CPI indexation is applied to the asset base;⁵⁹
- it was introduced late in the process, in place of earlier building block models.⁶⁰

Is the Panel's understanding of the respective parties position correct?

What are the pros and cons of the PTRM method?

⁵⁷ Para 4.14 PLC Submission, Reply to SAPN Submissions

⁵⁸ Para 4.12 PLC Submission, Reply to SAPN Submissions

⁵⁹ Para 7.6-7.10 and 7.13-7.17 PLC Submission, Reply to SAPN Submissions

⁶⁰ Para 4.15 PLC Submission, Reply to SAPN Submissions

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Return on and of capital

Use of an asset roll forward model for calculating return on (WACC) and of (depreciation) capital

The Panel understands that both parties agree that the return on and of capital should be calculated based on a building block model incorporating an asset roll forward model of capital expenditure (the asset base). *Is that correct?*

Should economic or accounting cost concepts be used in the asset roll forward model for the asset base?

In regard to the calculation of the capital expenditure in calculating the total PLS prices, the Panel notes that:

- The PLC submission appears to place significant weight on the need for PLC to examine financial accounting information in relation to capital expenditure from SAPN's general accounts and balance sheet.⁶¹ The Panel understands PLC's submission to be that it is only capital costs drawn from SAPN's accounts that are to be included in calculating the asset base and that a nominal WACC is to be applied. *Is that correct?*
- The Panel understands SAPN's position to be that it is appropriate to establish an asset base based on economic concepts. This includes the use of indexation to escalate the asset base each year so that the value of the assets is recorded in the asset base in real terms (and not in historic cost terms) and the application of a real WACC. *Is that correct?*

In this regard, the Panel understands that financial accounting concepts are not generally used in Australia for rolling forward the asset base. Rather, methods from regulatory economics are used for rolling forward the asset base. *Is the Panel's understanding correct?*

What are the implications, if any, for capital cost items included in the regulatory asset base model of using economic or accounting capital cost concepts?

What are the pros and cons of indexation for escalating the asset base each year and use of real WACC?

The starting asset base value

The Panel notes that:

- ESCOSA determined the asset base in its December 2009 fair and reasonable determination which SAPN has used in calculating the opening asset value for inclusion in the asset roll forward model that forms part of the PTRM used to determine the PLS total revenue requirements and prices
- PLC has submitted that in January 2010 it disputed ESCOSA's acceptance of SAPN's modelling and value of the asset base but recognising ESCOSA would cease regulation

⁶¹ For example, Para 8.12 PLC submission states that: *Numerous information requests made of SAPN by the PLC have sought to establish the basis for SAPN's capital costs and to verify SAPN's balance sheet value and actual depreciation.* Further, para 8.13 PLC submission states that: *The PLC contend that SAPN's modelling to establish the Total PLS Charge is critically and materially flawed and does not reflect SAPN's costs incurred in providing the PLS.*

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of SLUoS services in a few months and any resolution of a dispute on that basis was unlikely within that period⁶²; and

- PLC considers that the asset roll forward model should be recalculated starting from 1 July 1999 using the PLC model⁶³ which would reduce SAPN's proposed written down asset value at as 30 June 2011 from \$39.75 million to \$15.72 million.

What are the implications, if any, of NEL revenue and pricing principles 7A(4) to the value of the starting asset base? Does it apply?

Are the other relevant precedents for recalculating an asset base determined by a previous regulator under an earlier regulatory framework? What are the implications, if any, of doing so?

Calculation of depreciation – the role of economic and financial accounting concepts

SAPN has applied economic depreciation in its model.

The PLC contends that the ATO's depreciation schedules and rulings be applied to the assets used by SAPN to provide PLS.⁶⁴

Is it appropriate to use estimated economic asset lives or ATO depreciation schedules to determine depreciation rates?

What are the implications of this approach in the context of the application of the NEO? Is the use of the ATO's depreciation schedules consistent with the NEO?

Is it relevant to consider the extent to which different approaches impact on whether customers over time may pay an equitable share of depreciation charges over the life of the asset?

Should the previous basis (i.e. pre 2010) of determining depreciation in calculating total revenue for the setting of PLS prices be taken into account?

Taxation

SAPN submits that the fair value of transferred infrastructure (gifted assets) is assessable income for tax purposes, creating an immediate tax liability that is offset by taxation depreciation deductions over time.⁶⁵

PLC submits that tax on gifted assets is a cost of acquiring the assets rather than cost in providing PLS and is not a cost incurred.⁶⁶

The Panel notes that typically regulators provide regulated entities an allowance for taxation costs legitimately incurred by businesses, including on gifted assets.

Discuss the pros and cons for this position.

Are the other relevant Australian precedents for treatment of taxation on gifted assets?

⁶² Para 8.14 PLC submission

⁶³ Para 8.5 PLC submission

⁶⁴ Para 8.36 PLC submission

⁶⁵ Section 4.5 SAPN reply to PLC submission, pg 10

⁶⁶ PLS Submission 24 April, para 4.22

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Elevation charge

SAPN proposes an elevation charge whereas PLC considers that the elevation charge is not incurred in providing PLS.

SAPN states that assessing prices for public lighting against a methodology that includes an allowance for the opportunity cost associated with lights on electricity poles will assist in creating an environment in which SAPN has an incentive to use assets in an efficient way.

How material is this issue to the dispute between the parties?

Does the elevation charge reflect an opportunity cost?

If the elevation charge is not based on or does not reflect a cost incurred, can it be fairly and reasonably be taken into account? (Assuming final prices are between the stand alone cost ceiling and avoidable cost floor)

What in practical terms is the incentive on SAPN to use its assets in an efficient way?

If there was no elevation charge how would this change SAPN's behaviour?

If an elevation charge was to promote provision of SAPN assets in an efficient way, should the payment be contingent on some measure performance that provides actual incentives and improved value to the PLC customers?

Operating margin

SAPN has included a margin in its Customer Lighting Equipment Rate (CLER) and Energy Only (EO) prices. SAPN justifies its approach based on ESCOSA reference to providing persuasive and probative evidence of intangible assets in provision of services.⁶⁷

PLC submits that the WACC should apply across all assets⁶⁸ and that no additional operating margin should apply.

How material is this issue to the dispute between the parties?

Does SAPN use assets in the provision of CLER and EO prices which are included in the asset base used to determine the total PLS revenue requirement?

Does the operating margin reflect an opportunity cost?

If the operating margin is not based on or does not reflect a cost incurred, can it be fairly and reasonably be taken into account? (Assuming final prices are between the stand alone cost ceiling and avoidable cost floor)

The Evaluation Review Panel

15 May 2015

⁶⁷ Annotated Briefing Paper, 24 April page 17

⁶⁸ PLC Submission 6 May, paras 9.1-9.4

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Appendix 3 – Roundtable Meeting

The roundtable was held 29 July 2015 by video conference. The parties were in Adelaide and Melbourne. The meeting commenced at 10.00 am AEST and finished at 2.30 pm AEST. (Break for lunch at 12.30 pm).

The parties each presented opening submissions (20 minutes) followed by discussion of each of the topics in the Roundtable Agenda.

The meeting discussion was transcribed.

Attendees

| | |
|------|-------------------------------|
| PLC | David Hitchcock (LGA) |
| | Paul Gelston (DPTI) |
| | Carolyn Vigar (legal advisor) |
| | Bruce Mountain (consultant) |
| | Craig Marschall (consultant) |
| SAPN | Tom Walker |
| | Grant Cox |
| | Damien Harby |
| | Catherine Dermody (counsel) |
| ERP | Geoff Swier (chair) |
| | Luke Woodward |
| | Shaun Dennison |
| | Shirli Kirschner, advisor |

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Appendix 4 – Potential next steps

The following table summarises the potential next steps proposed in this report.

| Item | Description | Ref |
|---|--|---------|
| Determine point in time at which an opening AB is established | <p>PLC to consider whether they wish to (a) verify the calculation of the current WDV of public lighting assets, and (b) contend that the ESCOSA 2009 AB value will result in over recovery.</p> <p>If so, then with the appropriate regulatory expert assistance, the Parties should:</p> <ol style="list-style-type: none"> 1 Use the AER's PTRM to roll forward the asset base based on the SKM 1998 ODRC value and other agreed parameters (depreciation charges, capital additions and reductions); 2 Identify the extent of any difference in the current WDV of PLS assets between a starting AB value using that valuation as compared to the ESCOSA 2009 AB value; 3 Identify precisely the reasons for any difference in the valuation. | 4.4 (a) |
| Depreciation - asset lives | <p>Calculate depreciation allowance to enable asset costs to be recovered over their economic life using the straight line method.</p> <p>Any dispute as to the proper economic life of SAPN public lighting assets can be resolved through independent expert advice or determination.</p> | 4.4 (b) |
| Corporate Income tax | <p>Calculate corporate income tax based on including any tax liability arising from the fair value of transferred infrastructure to provide SLUoS (gifted assets), with this amount to be only recovered once.</p> <p>Clarify whether tax liability for gifted assets has been claimed by SAPN from developers.</p> | 4.5 |
| Corporate overheads costs | <p>SAPN to provide underlying cost allocation information to PLC so that PLC can understand the basis of allocation of overhead costs to PLS, in accordance with the CAM.</p> | 4.7 |
| Operating margin for setting CLER and EO prices | <p>Parties to consider whether or not to include operating margin for determining CLER and EO prices as part of broader negotiated trade-off.</p> <p>If operating margin for CLER and EO prices is to be included then consider setting this by reference to the average profit that a comparable efficient business may be expected to earn if carrying out similar activities.</p> | 4.8 |
| Elevation charges | <p>SAPN to consider providing a cogent basis (for example, supported by expert economic or other evidence) that an elevation charge would promote the NEO through improved economic efficiency in provision, or use, of PLS.</p> | 4.9 |