



4 June 2003

Mr Gary Henry
Chairman
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Dear Mr Henry

ELECTRICITY DISTRIBUTION: VALUATION OF EASEMENTS

Origin Energy Limited (Origin) welcomes this opportunity to comment on the Queensland Competition Authority's (the QCA's) discussion paper on easement valuation for electricity distribution networks in Queensland.

Origin's presence in the Queensland electricity market involves generation activities through the Roma (76MW) and Mount Stuart (288MW) power stations and retailing electricity to customers consuming more than 200MW per annum.

The issue of the valuation of easements is important to Queensland electricity distributors, retailers and consumers and the decisions made by the QCA may have ramifications for other jurisdictions outside of Queensland. Origin is firmly of the view that easements are indeed a special class of asset whose treatment for inclusion in the regulatory asset base requires careful consideration. Specific comments on issues raised in the QCA's discussion paper are dealt with below.

1. Appropriate treatment of easements

Origin notes the QCA's reporting of the ACCC's findings (quoted from SKM's report) regarding characteristics of easements-

“Easements are rights acquired over land for use of that land in a specific way. In the case of electricity, a registered easement is a right to construct, operate and maintain a power line and does not involve ownership of the land over which the line passes.”¹

Given this statement, Origin would emphasise the importance of distinguishing easements as assets that should be legitimately included in the asset base for the purpose of developing a regulated return for a distribution or transmission network service provider (DNSP, TNSP), and costs that should be defined as operating and maintenance (O&M) costs only (such as maintenance of the easement and costs involved in maintaining access).

¹ QCA (2003), Electricity Distribution: Valuation of Easements, page 2.

Costs incurred in acquiring easements (such as compensation paid to farmers) might be regarded as part of the basis for historic valuation of the easement as an asset, however, annual fees paid to land owners for the use of the easement should clearly be regarded as O&M costs. Further to SKM's description of easement characteristics above, Origin understands that most DNSPs pay an annual fee for the use of land to landowners, who in turn, remain (generally) free to utilise easement land as agreed between themselves and the DNSP. Such a fee paid to a grazier should be considered an O&M cost when assessing the regulated return for the DNSP.²

In 2002, GasNet (the owners of the Victorian Principal Transmission System for natural gas) applied to the ACCC to include the value of easements in the capital base, assets that were valued at zero dollars when GasNet's predecessor acquired the Principal Transmission System. GasNet's consultants (GHD) valued easements excluded from the initial capital base through optimised depreciated replacement cost, a methodology that Origin considers inappropriate for easements.³ The re-opening of the capital base and the use of depreciated optimised replacement cost (DORC) was subsequently refused by the ACCC.⁴ This example serves to demonstrate the impact of changing the treatment of seemingly innocuous items such as easements can have on regulated tariffs. In GasNet's case, the inclusion of easements would have added around 9% to the 1998 capital base or approximately \$2.8m more in regulated income based on a post-tax weighted average cost of capital (WACC) set at 7.75%.

Origin would therefore argue that though less dramatic, a change in the valuation approach for special assets such as easements would place upward pressure on regulated tariffs (a DNSP is unlikely to put forward a valuation methodology that reduces easement value) and without any improvement in efficiency, would result in higher costs for consumers and retailers of electricity (see also section three below).

2. Options for the valuation of electricity easements

Origin believes that the appropriate valuation approach for distribution easements should be historical cost without indexation, if the easements can be defined as assets. The view that indexation is not appropriate in determining the value of easements under in the regulatory asset base (RAB) of a network is based upon features of the application of the WACC in determining price or revenue caps for network owners. Specifically, WACC parameters can include adjustments for CPI and therefore applying CPI to the historical cost of easements and then including this value in the RAB overstates the impact of general price levels on easement values.

Indexation of the historical cost of easements (if in fact they satisfy the definition of an asset in the DNSPs portfolio and are not in fact O&M costs) is not justified

² In its submission prepared for BHP-Billiton Petroleum and the Electricity Consumers Coalition of South Australia, Bob Lim & Company and Headbury & Partners (2002) note that landowners cannot charge rent for land interests (easements). Their argument therefore questioned why transmission entities should charge (CPI escalated) rent for easements added to their portfolios for the relatively small cost of disturbance compensation. Refer to Energy Transmission Easements- a commentary on valuation used by transmission companies and regulators, page 7.

³ Refer to GasNet (2002), GasNet Australia Access Arrangement Information, pp. 3-4

⁴ ACCC (2002), Draft Decision: GasNet Access Arrangement 2002, pp. 36-37

according to BHP-Billiton Petroleum and the Electricity Consumers Coalition of South Australia:

“...the easement should be valued at the likely costs that would have been incurred *at the time of acquiring the easement*, with the recompense being that amount permitted *by the legislation applying at that time*. There is no basis for the acquisition costs to **be escalated into current dollars, nor for the land value to increase in line with adjacent land values.**”⁵

The context of this statement was in answer to how to establish easement value in the RAB if actual costs are in dispute or where insufficient records exist to support historical cost valuation; a problem identified by the QCA.⁶

Origin acknowledges the need to preserve the purchasing power of the DNSPs investment, however, it is not clear that as a special class of asset, easements should be subject to such preservation. The type of investment undertaken by a network service provider may be diverse and obscured by historic outcomes (including acquisition of easements by governments and the easements valued at zero cost). Further, the treatment of historic easement values under the WACC model may make provision for inflation over the entire asset base; additional indexation will amplify easement values in current dollars beyond the cash flows implied by the calculated WACC.

Market based valuation of easements should be rejected as a valuation methodology for the reasons put forward by the QCA on pages 4 and 5 of the discussion paper. The ‘market’ for easements is complicated not only by the limited alternative uses of easements, but also because of its single seller and single buyer (the landowner) nature. Further, the monopsonist (the landowner) purchaser of an easement will in many cases be unwilling to pay anything for the easement as they are likely to be currently engaged in the same activities regardless of the historic rights of land use conferred on a DNSP.

3. Transfers between market participants

Origin acknowledges that network owners and indeed regulators may wish to address components of the RAB from time to time if deficiencies are identified in the current structure. However, the inclusion of easements in a DORC framework will increase the RAB and regulated return without any improvement in the value of services offered to customers.

Furthermore, within a number of jurisdictions regulatory price ceilings and caps protect domestic consumers. Such price caps reduce or remove the ability of retail electricity businesses to ‘pass through’ regulated costs to final consumers. Therefore, not all increases in regulated costs are borne by consumers (particularly small consumers), but absorbed by both allowed maximum uniform tariffs and profit margins within the retail business. This outcome effectively creates a subsidy (paid for by retailers) for end-use consumers, who are unable to observe the total cost of their regulated supply charges.

⁵ Refer to [Energy Transmission Easements- a commentary on valuation used by transmission companies and regulators](#), page 7.

⁶ QCA (2003), op. cit., page 3.

This scenario is less prevalent in Queensland as there are no current plans to deregulate the market beyond the consumers using more than 200MWh of electricity per annum, however, decisions made by the QCA will influence regulators in other jurisdictions and Origin is concerned that unjustified increases in the RAB of a network service provider may result in a transfer of competitively earned profit to monopoly rents of distributors.

4. Conclusions

In summary, Origin believes the appropriate valuation methodology of easements that meet the definition of an asset (rather than O&M costs) should be historical cost. Indexed historic values are collected in the WACC model. Incomplete records to establish historic cost should not be used as a basis to switch to a market-based valuation model, but rather, should be dealt with a manner consistent with that recommended by BHP-Billiton Petroleum and the Electricity Consumers Coalition of South Australia on page 3 above. Indeed, market based valuation is not appropriate under any circumstances for this asset class for regulated monopolies, as inevitably it will result in a windfall gain to the service provider, which results in additional complications in markets where regulated costs cannot be fully passed through by retail service providers.

Should you have any comments or questions regarding this submission, please contact:

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Yours sincerely

(SIGNED)

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