Thursday, 6 May 2010

The Manager
Company Announcements
Australian Stock Exchange Limited
20 Bridge Street
SYDNEY NSW 2000

Dear Sir / Madam

**AUSTRALIAN ENERGY REGULATOR FINAL DECISION FOR ETSA UTILITIES**

Please find attached the statement issued today by the Australian Energy Regulator in relation to its Final Decision for ETSA Utilities for the five year regulatory period which commences on 1 July 2010.

Yours faithfully,

**Alexandra Finley**
**Company Secretary**

**Spark Infrastructure Management Limited ABN 84 114 940 304**
Level 6, 255 George Street Sydney NSW 2000 Australia
T +61 2 9086 3600 F +61 2 9086 3666
www.sparkinfrastructure.com

AUSTRALIAN ENERGY REGULATOR

GPO Box 520
Melbourne VIC 3001

www.aer.gov.au

*Attention: Energy and utility writers*

# AER'S FINAL DECISION ON THE SOUTH AUSTRALIAN DISTRIBUTION DETERMINATION FOR ETSA UTILITIES

The Australian Energy Regulator today issued its final decision for South Australia's electricity distribution network service provider, ETSA Utilities, for the period 1 July 2010 to 30 June 2015.

The AER's role is to assess expenditure proposed by ETSA Utilities over this period. These expenditures contribute to the allowed revenues and, ultimately, prices. This is the first time the AER has made a determination for ETSA Utilities. Previous determinations were made by the Essential Services Commission of South Australia.

ETSA Utilities' distribution network provides electricity to over 800 000 customers across the vast majority of the state.

The AER approved a capital expenditure program of $1768 million over five years (in nominal terms) nearly one-third less than what ETSA Utilities originally asked for. However, this amount is still more than double that spent by ETSA Utilities over the 2005-10 regulatory control period.

"More than half of this expanded program is required to ensure the capacity of the network meets future demand from both new and existing customers, including meeting the continuing growth in peak demand. The load is growing as customers continue to install air conditioners and other appliances. In addition, there is a need to address risks associated with ageing assets to maintain reliability for customers. The cost of materials and labour and financing costs are also increasing," AER chairman Steve Edwell said today.

The AER has also approved operating expenditure of $1115 million, which is 60 per cent more than in the previous five years in nominal terms.

Mr Edwell noted that: "ETSA Utilities' operating costs largely relate to network maintenance associated with increased inspections and higher emergency response expenditure forecast due to increasing asset age and growth in the network."

ETSA Utilities' revenues will increase by 12.1 per cent in real terms in the first year, followed by 5.8 per cent in the subsequent years of the regulatory period. A factor underlying the revenue increase is the higher cost of capital of 9.76 per cent, which is 80 basis points higher than the current regulatory period, reflecting current and prospective financial conditions.

The substantial increase in allowed expenditure means network charges for retail customers will increase on average by 15 per cent in nominal terms in the first year, followed by 8.4 per cent in the subsequent years of the regulatory period.

The precise effect on retail charges will not be clear until ETSA Utilities submits its pricing proposal following the AER's decision.  The increases in 2010-11 will need to be adjusted as ETSA Utilities has over recovered revenue in the last year of the current regulatory control period and have to return the money to customers through lower tariffs.

Without this adjustment a typical household with annual electricity charges of $1,400 in 2009-10 could expect to pay 6 per cent or around $84 more in charges in 2010-11. With the adjustment the increase will be less.  Beyond 2010–11, further price rises for residential customers will be around 3.4 per cent or $52 each year (see note below).

In making its final decision, the AER took into account ETSA Utilities' revised proposal, submissions from interested parties and advice from independent experts. These documents are available on the AER's website, www.aer.gov.au.

ETSA Utilities is required to submit a pricing proposal to the AER by 27 May 2010, indicating how the required revenue allowances contained in the final decision will be recovered from customers in accordance with the rules.

For more information refer to the attached overview or to the relevant chapters of the AER's final decision for more detail.

Note: Distribution charges on average represent 40 per cent of the cost of supplying electricity to residential customers, although this may differ between states. Typically these customers do not see distribution charges in their electricity bills. Instead, the charges are included in retail tariffs charged by electricity retailers, such as AGL and Origin. The change in distribution charges proposed in this decision will be incorporated into retail tariffs from 1 July 2010 onwards. To calculate nominal figures an expected inflation rate of 2.52 per cent per annum was used over the next regulatory control period.

**Media inquiries**
**Mr Steve Edwell, AER chairman, (03) 9290 1421, or 0423 047 554**
**Ms Lin Enright, director, media unit, (02) 6243 1108 or 0414 613 520**
**General inquiries**
**Infocentre: 1300 302 502**
**NR 03/10**
**6 May 2010**

# Overview

## Introduction

Under the National Electricity Law (NEL) and the NER, the AER is responsible for the economic regulation of electricity distribution services provided by distribution network service providers in the National Electricity Market.

This is the first electricity distribution determination made by the AER on the price control regime to apply to ETSA Utilities. The previous determination that applied to ETSA Utilities for the period 2005–2010 was made by the Essential Services Commission of South Australia (ESCOSA).

In making its decision and distribution determination, the AER has taken into account ETSA Utilities' revised regulatory proposal, submissions from interested parties, advice from consultants and updated economic information and forecasts.

The AER's determination for ETSA Utilities provides for distribution charges to increase by an average of 9.5 per cent per year in nominal terms over the next five years. This increase in network charges will flow through retail electricity prices to residential customers. A price rise of 6 per cent in 2010–11 will result from higher network charges. In the remaining four years of the regulatory control period, retail prices are expected to rise by 3.4 per cent. Further explanation of the AER's decision and the context in which it was made is provided below and in greater detail through the chapters of this decision.

## Key expenditure drivers and considerations

Energy use patterns in South Australia are a significant factor contributing to network expenditure over the next regulatory control period. The need to ensure that the network can withstand customer demands at peak times is contributing to the increase in network costs, driven predominantly by the use of air conditioners during summer heatwaves. This is despite customers consuming less energy, on average, as a result of a number of energy efficiency programs and increased penetration of photovoltaic systems. For example, over ETSA Utilities' network, maximum demand is forecast to grow on average by 2.4 per cent per year, while energy sales are forecast to decline by an average of 0.7 per cent per year over the next regulatory control period. The outcome is that the revenue required for ETSA Utilities to maintain the integrity of the network, supply reliability and services to customers over the 2010–15 regulatory control period is applied to a smaller volume of energy sold.

The AER has accepted ETSA Utilities' maximum demand forecasts included in the revised regulatory proposal, however, the AER is not satisfied that the energy sales forecast provides a realistic expectation of the demand forecast required to achieve the capital and operating expenditure objectives. The AER considers that ETSA Utilities' revised total energy sales forecast over the regulatory control period is understated by around five per cent. However, the energy sales forecast adopted by the AER is considerably lower than what was expected in the draft decision and reflects updated estimates for economic activity and energy use in South Australia. As noted below, this also has an impact on the level of network charges.

## Revenue allowance

The AER has established the annual revenue requirement for ETSA Utilities based on the AER's approved capital and operating expenditure allowances. ETSA Utilities' total revenue for the 2010–15 regulatory control period is $3525 million (nominal).

This revenue allowance comprises in the main a return on capital, return of capital (depreciation), operating expenditure, and a tax allowance. It also includes a capital expenditure carry over from the 2005–10 regulatory control period. The return on capital and depreciation represents over 60 per cent of the revenue allowance, with operating expenditure accounting for 32 per cent and the tax allowance 5 per cent.

ETSA Utilities' allowed revenues will increase in nominal terms by 13 per cent in 2010–11 compared to the preceding year. For the remaining four years of the regulatory control period, ETSA Utilities revenues will increase in nominal terms by an average of 7 per cent per annum. If the weighted average cost of capital parameters had remained the same as those applied in the current regulatory control period the increase in ETSA Utilities' revenue in 2010–11 would be about 10 per cent lower. The significant annual increases in revenues over the 2010–15 regulatory control period are explained largely by the increasing capital expenditure program and higher operating expenses associated with a growing but aging network.

## Network charges

In nominal terms, ETSA Utilities' distribution charges will increase by 15 per cent in 2010–11 compared to the preceding year and by 8.4 per cent in the subsequent years of the regulatory control period. This is a reduction to the distribution charges sought by ETSA Utilities, which would have resulted in an increase of 18.5 per cent in 2010–11, 8.6 per cent in 2011–12 and 13.3 per cent in the remaining years of the regulatory control period.

The final distribution charges were affected by an updated, 7 per cent lower, energy sales forecast provided by the Australian Energy Market Operator which has resulted in an increase in distribution charges compared to the AER's draft decision.

The precise effect on retail charges will not be clear until ETSA Utilities submits its pricing proposal following the AER's decision. The increases in 2010–11 will need to be adjusted as ETSA Utilities has over recovered revenue in the last year of the current regulatory control period and has to return the money to customers through lower tariffs.

The specific circumstances faced by ETSA Utilities which justify these price increases are discussed in this decision. Briefly, based on the typical residential customer's annual retail electricity charges of $1400 in 2009–10, and without the above adjustment, that customer can expect to pay 6 per cent or around $84 more in charges in 2010–11. Beyond 2010–11, further price rises for residential customers will be around 3.4 per cent or $52 each year. It should be noted that factors other than distribution charges will influence the level of retail prices including changes in wholesale electricity prices.

The increase in retail electricity charges in the first year is a result of the substantial increase in allowed capital and operating expenditure, and higher cost of capital than in the current regulatory period.

### Capital and operating expenditure

In its draft decision the AER confirmed the need for an increase in capital works expenditure for ETSA Utilities over the next regulatory control period, with capacity augmentation and customer related expenditure being significant components of the capital works required over this period.

This increase in expenditure, driven by the continuing growth in peak demand, customer numbers and ageing assets over the next regulatory control period, has been confirmed by the AER’s consideration of ETSA Utilities’ revised proposal, submissions from interested parties, further advice from consultants and updated economic information and forecasts. While the AER is satisfied that an increase in expenditure is required, consistent with its draft decision, it does not consider that ETSA Utilities has justified the full extent of its capital expenditure proposal.

In the draft decision, the AER reduced ETSA Utilities’ net forecast capital expenditure allowance to $1819 million (a reduction of 28 per cent compared to its original proposal). In response to the matters raised in the draft decision, ETSA Utilities revised its forecast capital expenditure for the next regulatory control period to $1985 million (nominal).

After assessing ETSA Utilities’ revised regulatory proposal against the capital expenditure criteria in chapter 6 of the NER, and taking into account the advice of its consultants, the AER has accepted some elements of ETSA Utilities’ revised forecasts for the low voltage capacity upgrade program, certain asset replacement expenditure and the network control project. Nevertheless, the AER considers that ETSA Utilities’ proposed capital expenditure is still $217 million greater than an efficient level.

The AER’s determination results in an 11 per cent reduction in ETSA Utilities’ proposed revised capital expenditure and is also three per cent lower than the AER’s draft decision. The further reduction in total allowed net capital expenditure compared to the draft decision is driven by changes in cost escalation rather than additional reductions to the scope of the capital expenditure work programs.

In particular, the AER considers that expenditure for the low voltage network upgrade program, asset replacement, the network control project and the substation security and fencing program proposed by ETSA Utilities in the revised proposal do not reflect efficient costs.

The draft decision did not approve ETSA Utilities’ proposed operating expenditure allowance. ETSA Utilities’ operating costs largely relate to network maintenance with increased inspections and higher emergency response expenditure forecast due to increasing asset age and growth in the network. The AER determined that the efficient allowance was 11 per cent lower than proposed. The AER determined that certain operating costs, such as vegetation management and non-operating cost allowances like self insurance and debt and equity raising costs were not efficient.

In the draft decision, the AER reduced ETSA Utilities’ forecast operating expenditure allowance to $1091 million (nominal). In response to the matters raised in the draft decision, ETSA Utilities submitted a revised regulatory proposal which incorporated most aspects of the AER’s draft decision and revised its forecast operating expenditure to $1166 million (nominal).

After assessing ETSA Utilities’ revised proposal against the operating expenditure criteria in chapter 6 of the NER, the AER considers that ETSA Utilities’ proposed operating expenditure is $51 million greater than an efficient level. The AER’s determination of $1115 million (nominal) results in a 4.3 per cent reduction in forecast operating expenditure.

In particular, the AER considers that the following aspects of the operating expenditure proposal do not reflect prudent and efficient costs:

- the application of the economies of scale escalation for network growth to the operating expenditure in relation to emergency response activities
- the impact of ETSA Utilities’ ageing network on maintenance and repair and emergency response operating expenditure
- the debt raising costs
- the self insurance allowance.

The approved operating expenditure includes the reclassification of some self insurance costs that the AER considers should have been included in ETSA Utilities’ controllable operating expenditure. The AER has accepted that certain business as usual costs, which were included within ETSA Utilities’ self insurance proposal are acceptable, however, were not suitable for self insurance. This has resulted in the reclassification of $23 million in proposed self insurance costs to controllable operating expenditure.

The AER was also not satisfied that the materials and labour cost escalators used to forecast capital and operating expenditures reflected current economic conditions and considered that the escalators used by ETSA Utilities were likely to overstate future costs. The AER applied its own real materials and labour cost escalators based on recent forecasts.

### Regulatory rate of return

The AER determined a nominal vanilla WACC of 9.76 per cent for ETSA Utilities. This is approximately 30 basis points lower than in the draft decision. The AER has not accepted ETSA Utilities’ revised proposal to maintain the imputation credit factor (gamma) at 0.5. The revised WACC is based on more recent financial market conditions which reflect an easing of debt risk premiums. Current debt risk premiums, however, are still well above the historic average.

### Implementation of new incentive schemes

This decision also implements three incentive schemes:

- the service target performance incentive scheme – which encourages ETSA Utilities to maintain or improve its service performance in terms of the number and incidence of outages on their network

- the efficiency benefit sharing scheme – which is designed to provide a fair sharing of operating cost efficiency benefits and losses between ETSA Utilities and network users

- the demand management incentive scheme – which is designed to provide incentives for ETSA Utilities to pursue and implement efficient non-network solutions to address growing demand on its network.

### Alternative control services

Arrangements for establishing metering charges are also provided for in the decision. This is a result of the AER's decision to classify alternative control metering services to facilitate competition by reducing the barriers to entry faced by other providers of metering services in the South Australian market. This is the first time that a separate, weighted average price cap control mechanism is to be applied to metering services provided by ETSA Utilities and will result in these charges being unbundled from the distribution use of system charges, leading to a more cost reflective and transparent pricing outcome for customers.

## Review process

The AER's distribution determination for the South Australian electricity DNSP, ETSA Utilities, for the 2010–2015 regulatory control period has been made under the relevant provisions of the NER and NEL. The AER must also consider a number of transitional requirements for South Australia that are set out in chapters 9 and 11 of the NER.

The AER released its draft decision for ETSA Utilities in November 2009. ETSA Utilities submitted its revised regulatory proposal in January 2010 indicating where it did not agree with the draft decision. The AER received a total of 20 submissions on the draft decision and ETSA Utilities' revised regulatory proposal. The AER's consideration of these submissions forms part of this decision.

In this decision the AER specifically addresses those aspects of the draft decision which have not been accepted in ETSA Utilities' revised regulatory proposal or in a submission by another party. Where an aspect of the draft decision was not addressed in the revised regulatory proposal or submissions, then the draft decision is confirmed in this decision.

The AER's detailed examination of ETSA Utilities' regulatory proposal and revised regulatory proposal was informed by advice from Parsons Brinckerhoff Strategic Consulting (PB). In addition to PB, the AER also engaged Energy Management Services to review the deliverability of ETSA Utilities' regulatory proposal and sought the assistance of the Australian Energy Market Operator in reviewing ETSA Utilities' demand and energy sales forecasts.

In making its distribution determination, the AER assessed ETSA Utilities' regulatory proposal to determine if it was in accordance with the requirements of the NER.

Expert engineering consultants, as well as financial and economic experts assisted the AER in making its assessment. The AER also considered the past performance of ETSA Utilities and the effectiveness of their policies and procedures, both in terms of past performance and in the development of its regulatory proposal.