ElectraNet SA

Access Arrangements Applications

Comments On *Meritec Asset review*
Meritec Capex review
Meritec Opex review
ElectraNet comments on submissions

COMMENTS BY ECCSA
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ECCSA: Comments on ElectraNet on review of submissions and the Meritec reviews on asset value, capex and opex.

The Electricity Consumers Coalition of South Australia (ECCSA) is a major energy end-user group formed with the specific purpose of reducing the current unreasonably high price for electricity to all consumers in South Australia. Its members are Adelaide Brighton, Amcor, Holden, Kimberly Clark, Mitsubishi, OneSteel, Mobil Refining Australia, Pasminco and WMC.

Introduction

ECCSA welcomes the opportunity to provide its views on the further commentary provided by ElectraNet and Meritec (consultant to the ACCC) on various aspects of the ElectraNet SA's revenue cap application to the Australia Competition and Consumer Commission.

In general terms, ECCSA found that the Meritec reviews provided some additional information which had previously not been disclosed by ElectraNet. This point underscores that the lack of a requirement to formally provide information to the Regulator and Interested Parties in a specific and detailed format, can allow the application to be confusing causing those directly interested in the application extreme difficulty in analysing the material. However, it must be stressed that ElectraNet has still not provided sufficient information for in-depth analysis of its application.

We would remind ACCC of the point made in our earlier submission:-

> "It is disappointing that an application such as ElectraNet's, which seeks to raise regulatory revenues by more than 30% is so significantly deficient in quantitative information and supporting material to justify the claims let alone enable independent assessment by stakeholders. The ACCC has a duty, under the National Electricity Code, to ensure that stakeholders, such as ECCSA, are provided with adequate information so that they are able to assess that the revenues sought are fair, reasonable, efficient and are cost reflective."

The additional information provided as a result of the Meritec reviews still does not provide sufficient information for the ACCC and interested parties to be satisfied that the costings claimed by ElectraNet or discussed in the Meritec reports, are appropriate to be included in the revenue cap. Thus, the views on information disclosure we espoused in our earlier submission still require fulfilment.

ECCSA has previously provided under separate cover its views on the level of WACC that should apply to the ElectraNet application (the Washusen report) and the reasons why ACCC should reject the application for inclusion of easements (the Easement report). For completeness both of these reports are attached to this submission.

ECCSA addresses its concerns with the Meritec reports below, as well as provides comment on the ElectraNet response to submissions.

ElectraNet Asset Valuation – Meritec review

1. The Meritec review essentially supports the value of RAB claimed by ElectraNet in its initial application. The views of interested parties or commentary by independent observers have been essentially ignored in the Meritec assessment and raises concerns about its independence and objectivity.

2. Meritec uses the ACCC draft SoRP as the basis for assessing the value of easements. Meritec has avoided advising ACCC that there is an alternative to the easement valuation approach used in the draft SoRP. There is no basis for allowing ElectraNet to revalue its easements, and the methodology used by Meritec is clearly unsound. These matters are addressed in the ECCSA Easement report separately submitted by ECCSA and attached to this submission.

   It is also a matter of concern that the ACCC's draft SoRP would appear to be regarded as a final document. Stakeholders have challenged the veracity of the statements on easement valuation, including the fact that the methodology is quite absurd (see Professor David Johnstone, Replacement Cost Asset Valuation and Regulation of Energy Infrastructure Tariffs – The Problems with DORC, December 2001, previously provided to the ACCC).

3. ECCSA agrees with Meritec that IDC should be excluded. ECCSA considered this amount should be excluded on the same basis as the claim for increasing the value for easements.

4. As mentioned above, there is little information provided about the inclusion of amounts previously excluded. Whilst ECCSA accepts that where assets were optimised out of the RAB but subsequently recommenced being used, there is an argument for their inclusion. ElectraNet does not provide sufficient information in its submission that this is the case.

5. Meritec accepts without question the roll forward calculation proposed by ElectraNet. It makes no reference to the inclusion of the "GST spike" which needs to the excluded from the calculation, as required by the "GST" legislation.

ElectraNet Capex Allowance – Meritec review

1. The review by Meritec essentially supports the capex claims made by ElectraNet in its application, although it adds the rider that Meritec has

concerns that ElectraNet has the in-house capability to manage such a large capex program.

2. Other than the observation that the proposed capex is a massive increase from previous years, ECCSA has no view as to the amount of Capex that should be included in the forward revenue calculation providing that:-
    a. The amount of capex rolled forward has been demonstrated to be prudent and economically efficient.
    b. There is a mechanism for ensuring that capex allowed is or will be demonstrated to be prudent and economically efficient before it is allowed to be included in the RAB.
    c. Capex must be spent to achieve certain measurable benchmark performance criteria (eg a target equipment age profile).
    d. ElectraNet has the capability to efficiently manage the capital expenditure program,

3. However, the approach taken by ElectraNet (and then supported by Meritec) in demonstrating the need for the amount of capex, does leave ElectraNet to future risk should the ACCC decide that capex expended does not meet the "prudency and economic efficiency tests", which allow capital expenditure to be included in the RAB. Whilst it is clear and accepted that ElectraNet needs to balance the requirement for investment to meet the needs of the network with the availability of capital for investment in the network, for the ACCC to allow the incorporation of the capex into the RAB requires the acceptance for *specific* investments. We are of the view that the ACCC cannot accept incorporation of capex into the RAB unless the *specific* investment complies with the prudency and economic efficiency tests.

    ElectraNet highlights this problem in its comments on the Meritec review of the ElectraNet opex proposal. Here ElectraNet wants to include some capex as part of the opex program, as it is on this basis that the capex will be automatically accepted as a fully recoverable cost. However, Meritec rightfully points out that capex should not be included in the opex budget – capex must not be treated as opex!

    Therefore, ECCSA is of the view that ElectraNet should either:-
    a. Provide the ACCC all of the information necessary to give prior approval of the proposed capex as part of the revenue cap decision (this is the approach preferred by ECCSA) or
    b. Gain ACCC approval of each proposed capex prior to the commitment of the capex at the time of the planned investment, including a public forum for end user input to confirm the prudency and economic efficiency.

4. We note that Meritec accepts the load growth forecasts provided by ElectraNet, **but of concern to users is the planned massive investment program for such a relatively small amount of**

increase in load growth. The planned five year capex of $400M needs to be put into the context of the current RAB (~$800M excluding easements) and the amount of usage the system currently has. ElectraNet and Meritec make no attempt to identify where the growth is expected in the system with relation to the target expenditure. This is unacceptable and is an example of the paucity of the Meritec review in this area.

In our initial submission to the ACCC we stated:-

> "However, ElectraNet has provided little detailed explanation of what any of the capex will achieve, where it is to be expended, any relationship between local growth and current local capacity. Until more information is provided as to what, where and why, and the cost/benefit of the capital expenditure, there can be no sensible agreement made with ElectraNet as to whether the requested capex should be approved for integration into the regulated revenue."

Whilst reference has been made to the needs of the network in the annual planning reviews of ESIPC and ElectraNet, the underlying concerns that users have, are still not addressed by Meritec in its report.

5. We note the references to the studies and forecast needs of the network by the South Australian Electricity Planning Council and NEMMCo. We would remind the ACCC that whilst it is accepted that these reviews are carried out in good faith, there has been no attempt by these bodies to seek end user input into these reviews. The reviews do not include cost/benefit analyses (let alone least cost approaches) such as the ACCC is required to carryout for expenditure of capital to be incorporated into the RAB.

6. In a private communication from Pareto Associates, Dr J Washusen notes that

> "… the need for the asset replacement "Bow Wave" [a greatly increased capex requirement as proposed by ElectraNet] is unobservable in real life.
>
> Below are graphs taken from Ofwat's and Ofgem's 1999 decisions. Both these can quite accurately be interpreted as showing that the cost of replacing aging utility infrastructure can be incorporated into sensible programs. The UK water & sewerage industry programs are very interesting. There has been absolutely phenomenal investment (~AU$60 billion over the last decade) in new and replacement infrastructure - **and dramatic increases in service quality -** without any sign of a Bow Wave (apart from that imagined by utilities in the pre-decision "gaming").

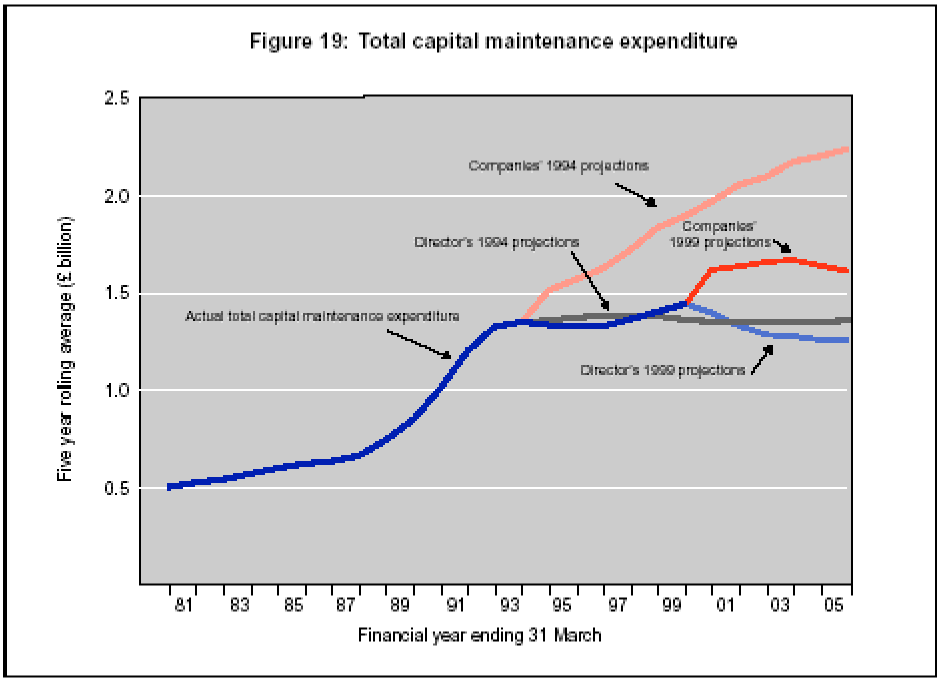
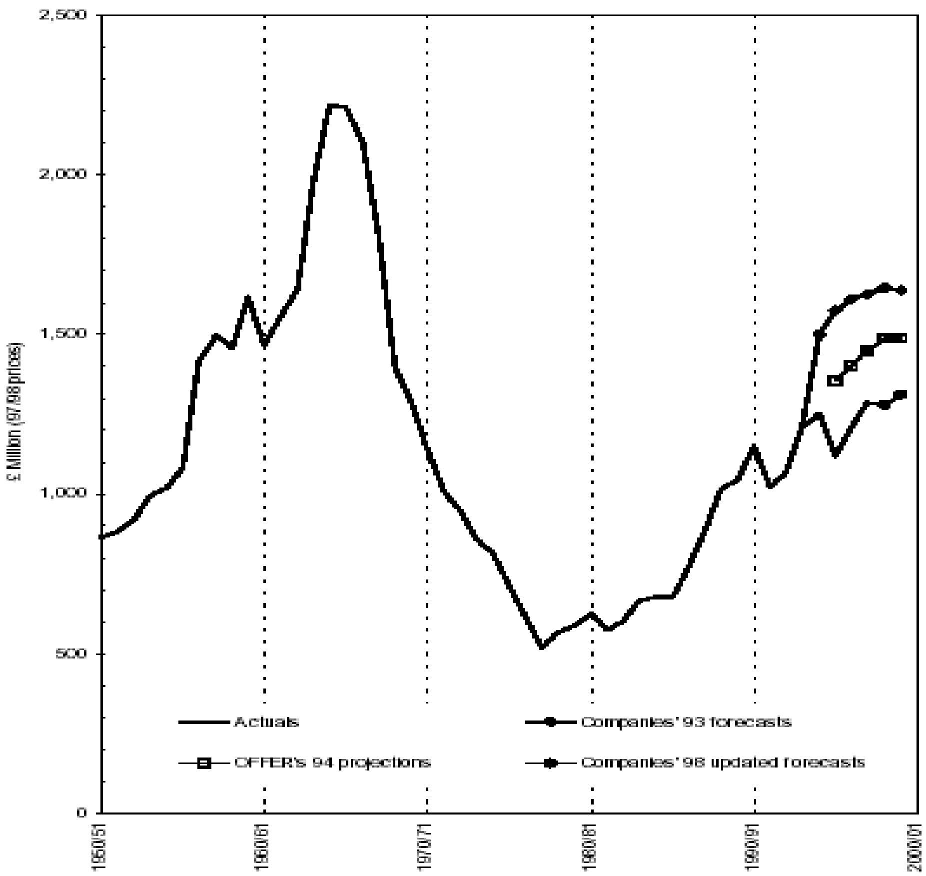


FIGURE 4.2: DISTRIBUTION BUSINESS CAPITAL EXPENDITURE (1997/98 PRICES)



These plots should give consumers comfort that UK-style "incentive" regulation can work because the introduction of **effectively regulated incentives** chopped the top off the "imaginary" Bow Wave.

Both Ofwat and Offer were advised that due to ageing, the assets needed replacement. Regulators required the utilities to prepare 20+ year asset management plans aimed at eliminating [the] cyclic demand for capex (the Bow Wave effect) by capping the demand for capex.

[We need to remember the] the examples of Morwell and Hazelwood [power stations]- less than World Class when they were built 30-50 years ago, but still going strong; not to mention the [privately owned] Anglesea [power] plant."

What this work by Dr Washusen highlights is that rather than regulators accepting the propositions put by the utilities, the capex approvals need to be made in context with the need to smooth capex in an informed way by requiring the utilities to prepare a long term publicly available asset management plan, and for the regulators to ensure that capex does not become another vehicle for the regulated businesses to increase the costs of providing the regulated service.

7. ECCSA recommends that the ACCC should look closely at the capex proposed by ElectraNet to eliminate the unnecessary "bow wave" effect, and to require the approved capex to be structured in such a way that smooths the capex requirement over the long term and eliminates future lumpiness in the age of assets.

ElectraNet Opex Allowance – Meritec review

1. Meritec effectively proposes that the opex allowance should be similar to past years (allowing for inflation). This constitutes a large reduction in the proposed opex budget sought by ElectraNet.

2. Meritec attempts to relate current opex proposals with the past opex incurred by ElectraNet. This task is made needlessly difficult by the lack of information provided by ElectraNet. However, from Meritec comments it seems that much of the massive opex increase from previous years is related to an ElectraNet desire to include significant amounts of capex under the opex budget. Meritec is correct in excluding capex from the approved opex budget.

3. Of concern is the ElectraNet comment that the opex budget did in fact include for extensive capex, and that exclusion of this capex from the opex budget will result in it not being spent, as ElectraNet is concerned *that the ACCC will not subsequently approve it for inclusion in the RAB*.

   This further highlights that the ElectraNet approach to capex assessment for automatic inclusion in the RAB by the ACCC is fundamentally flawed and therefore the ACCC should require ElectraNet to be more specific about its views as to the capex needs of the network.

4. Of equal concern is that Meritec accepts that benchmarking of ElectraNet operating expenses can only be attempted in a marginal fashion, with little meaningful comparison being undertaken. If the regulator accepts that such minimal benchmarking is sufficient for it to fulfil its obligations, then it has failed in its primary responsibility to implement the "competition by comparison" aspect of regulatory control.

   To drive the regulated business to replicate competitive outcomes requires many appropriate benchmarks to be compared. For the regulated business to be assessed as if in a competitive environment, requires the business to attempt to perform in the upper quartile of similar businesses – acceptance of performance at the average or lower is clearly not what is expected by the Code or by users who have to pay for the inherent inefficiencies implicit in suboptimal performance. If Meritec is unwilling or unable to source the needed extensive comparative benchmarks, then it has failed in its obligations to the ACCC.

ElectraNet response to ECCSA submission

We note that ElectraNet elected to respond to assertions made by a number of parties to its revenue cap application. However, it must be stated that there is little in the ElectraNet response which we see highlights any gross inaccuracies in our original submission.

After due consideration, we have elected to respond to some of the more obvious inconsistencies in the ElectraNet comments as ElectraNet does make some assertions which we believe require a response. We do this in order to assist the ACCC in its assessment of the application.

Comparative costs

ElectraNet makes assertions that their costs should be higher than those of the transmission entities in other States, and selectively uses quotations from submissions to demonstrate agreement with this view.

What ElectraNet avoids stating is that the costs it is seeking for year 2003 are to be nearly twice those costs applying in other States, *with the costs to rise further thereafter* . Whilst ElectraNet argues that the South Australian network should be considered a more expensive operation than others in Australia, with its current average cost structure at 30% more than the next most expensive transmission network (Queensland), ElectraNet provides strongly biased argument that its claimed cost structure is appropriate.

The way to either prove or disprove ElectraNet's claims is by wide and eclectic comparisons of performance and of costs, which ElectraNet and Meritec have both failed to do.

WACC forum
ElectraNet refers to the outcomes of the forum jointly sponsored by ElectraNet, PowerNet and GasNet. It is worthy of note that the "experts" selected by the joint sponsors all have a view which matches that of the sponsors. There were no independent "experts" invited to present who would put a view different to that of the sponsors. Specifically, end users were not invited to nominate speakers for the forum in order to present a counter view. Because of this ECCSA and other end users are of the view that any conclusions drawn by ElectraNet from the forum must be considered biased and suspect.

WACC levels
ECCSA has previously submitted to the ACCC a copy of a paper prepared by Pareto Associates reviewing the levels of WACC approved by other regulators, specifically referring to a regulator who uses an approach very similar in detail to that used by the ACCC, viz Ofwat of the UK. This paper clearly details the levels of WACC granted by Ofwat to water businesses in the UK who are required to have a major investment program, similar to the one ElectraNet claims it must have. The water businesses affected by the Ofwat decisions have been granted WACC's well below that sought by ElectraNet, and despite this apparent disability they are consistently able to gain the necessary funds for the required capital investment. This actual outcome clearly demonstrates the ElectraNet supposition that being granted a lower WACC than that sought will severely affect its ability to raise investment capital.

WACC and asset values
ElectraNet accuses ECCSA of confusing WACC and asset valuation methodology. ElectraNet accepts that the returns it should gain should reflect those gained by competitive industry. However, as one of the key measures of return is "return on assets", the valuation of the assets is critical to compare the return gained. Competitive industry uses as its measure for asset value, "depreciated actual cost", which regulated businesses consistently oppose using – it would seem this is the case as "DAC" gives a lower asset value than the regulated businesses' preferred "DORC" approach.

It is worthy to note that another measure for assessing return is that of "return on sales". Comparisons between regulated businesses and competitive businesses using this measure show regulated businesses enjoy a very large premium when measured against "return on sales". ECCSA accepts that this measure perhaps does not fully recognize the investment in assets used to generate those sales, but it is a measure widely used by competitive industry.

Thus, the methodology of asset valuation is an integral element of assessing return on assets. ECCSA maintains its view that the WACC value should reflect the method used for assessing asset value.

Risk free return and debt duration
ECCSA is accused of confusing duration of trading with efficient business financing. Nothing could be further from the truth. ECCSA recognizes that ElectraNet expects to continue trading for many regulatory periods hereafter and that its approach to financing its business must reflect this. What ElectraNet fails to recognize is that the review is to set the *pricing of services* for a given (and fixed) period. The pricing must reflect the conditions that are endemic for this period, and not based on an anticipated whole life of the business.

ElectraNet comments that the debt profile must reflect a situation where:-

> "efficient financing of debt is likely to equate the debt period to the life of the asset"

ElectraNet expects to operate for many years. It is neither likely that lenders will grant ElectraNet lending facilities for the life of the assets, nor is it likely ElectraNet would or should seek debt in this form. Debt rates continually move and a proactive borrower will actively trade its debt to maintain the minimum debt profile over the short to medium term. Thus, there should be a clear uncoupling of debt periods and regulatory price setting periods.

Interest rate risk
ECCSA notes ElectraNet's concern that it should be entitled to protection should interest rates vary from that set by the regulator. This view overlooks the fact that already there is a premium built into the "risk free rate" for this very risk. "Risk free rate" for the short term (say 90 days) is lower than the "risk free rate" for 5 years. This premium allows for the potential of interest rate movements during the forward cycle, and to allow ElectraNet for additional protection against interest rate movements is to allow ElectraNet a "double dip"

Market risk premium (MRP)
ElectraNet accuses ECCSA of being confused (again!). ElectraNet opines that ECCSA should not refer to the MRP being set at the lowest level, as ElectraNet implies that MRP is a fixed premium. In fact MRP is only an assessed figure. The absurdity of ElectraNet's comments can be related to the WACC forum where one of the issues discussed was "what level should the MRP be".

ECCSA noted that the MRP should be fixed at the lowest appropriate level as the risk profile of the ElectraNet business is one of very low risk. By ECCSA making this proposition it recognizes that to allow the incorporation of a higher end estimate of MRP, would be adding additional and unnecessary conservatism into the WACC calculation.

Systemic risk
There is no doubt that the risk profile for an electricity transmission network is very low. ElectraNet comments that gas transmission is a real threat to its business (this is the only significant threat noted) but it must be stated that the costs of installing embedded gas fired generation places little risk to the

volume of electricity carried by transmission companies, and by having a revenue cap, transmission companies essentially have little exposure to volume risk over the medium to long term.

ECCSA maintains that the asset beta used in the CAPM calculation must reflect this very low risk profile.

The Electricity Pricing Order (EPO)
ElectraNet refers to the EPO as being a prime cause for the need for increased capex and the overall run down state of the network. ElectraNet states that the allowances in the EPO were and are insufficient for proper operation of the network and therefore should not be used as a basis for assessing future needs. ElectraNet provides no extrinsic or quantitative data supporting this assertion.

In fact, a review of the Annual Reports of ElectraNet applying prior to privatization of the assets finds no mention of any lack of funds or any resulting deterioration of the network. The current "notional owners" of ElectraNet similarly made no reference to such a state of affairs prior to and post acquisition.

Conclusions and Recommendations

In its submission summary ECCSA commented:-

> "ElectraNet has made a submission to the ACCC for its regulated return to be increased by over 30% immediately, with it rising by another 30% during the term of the regulatory period. To sustain this claim it has provided a relatively modest submission … However there is very [little] explanation or argument supporting the massive increase in RAB, capex and opex. There is virtually no quantitative argument or benchmarking provided demonstrating that its claims are appropriate."

ECCSA has seen little from the work done by Meritec which provides additional information to allow it to reasonably assess the outcomes of the review. This is a serious deficiency and raises many questions about the current ACCC review process, especially in the areas of information disclosures and the transparency and accountability of the application and associated commissioned reviews. The response by ElectraNet to submissions made by interested parties also does little to provide this additional information.

However, at a macro level ECCSA cannot see there is anything provided by Meritec or ElectraNet which sustains the ElectraNet claim for any increase in the current revenue cap, and in fact ECCSA maintains that there is a strong argument for the current revenue level to be reduced.