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Mr Michael Rawstron
General Manager
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Dear Mr Rawstron

ELECTRANET SA CAPEX REVIEW – MERITEC CONSULTANCY REPORT

NRG Flinders appreciates this opportunity to provide comment on the Meritec Capital Expenditure Review, which forms a key component of the South Australian transmission revenue cap review process.

Operating Expenditure

It is noted that Meritec, at the direction of the ACCC, has proposed that approximately $80m in refurbishment and replacement expenditure included as operating expenditure in the ElectraNet application should be transferred to the capital expenditure forecast. This expenditure was originally put forward as operating expense in order to avoid revaluation risk. ElectraNet's response to the Meritec report appears to reiterate this concern.

However, it is unclear as to why prudent refurbishment expenditure should be subject to any greater optimisation risk than other forms of capital expenditure. In this regard, it is noted that ElectraNet has indicated that moving this proposed expenditure from opex to capex without a firm guarantee of recoupment will result in the expenditure not being made. This is somewhat surprising given the specific security and reliability criteria that apply to the South Australian transmission network, noting that the assets in question are argued to be at the end of their physical and economic lives.

Load Forecasts

Meritec has proposed that the proportions allocated to the low and medium load growth scenarios should be adjusted to 25% and 75% respectively for consistency with the original Roam analysis. This corrects what appears to be an undue emphasis on the medium scenario, for which a weighting of 80% had been proposed.

In this regard, it has been noted that capital expenditure will be subject to on going monitoring by the ACCC and "clawback" at the end of the regulatory period. However, any risk of overestimation in the capex forecast will be borne directly by network users during the regulatory period and funded through regulated charges. Furthermore, Meritec has noted the difficulties and risk of price shock inherent in the use of the clawback mechanism for large adjustments at the end of the regulatory period.

In this regard, NRG Flinders would query whether any clawback allowance has been made in the forecasts for any underspent capital expenditure from the current regulatory period.

Probabilistic Forecasting

While the probabilistic forecasting approach appears to provide a robust and accepted method on which to base capex projections, as noted by Meritec, it results in a band of statistically plausible expenditure for the regulatory period ranging from $250m - $500m based on weighted scenarios, around the mean of $374m. While statistically defensible, it is unclear whether the averaging process inherent in the probabilistic approach might be disproportionately influenced by extreme scenarios.

Notwithstanding the acceptance of this approach, consideration might therefore be given to the use of a deterministic method, which produces the most likely scenario, to complement the probabilistic approach and provide a useful benchmark for comparison. Given the lead times involved, it might be expected that a significant proportion of the capex program would presently be in the detailed design phase, enhancing the use of this approach.

It is also unclear that the mutual exclusivity of competing generation proposals has been accounted for in the alternative scenarios modelled. Whilst a wide range of individual generation projects might be considered feasible, a scenario in which many or all competing proposals come to fruition simultaneously is clearly unrealistic. This needs to be borne in mind when assigning probabilities to generation scenarios, certain combinations of which are unlikely to be plausible for this reason.

Excluded expenditure

Meritec has proposed to exclude from the capex forecast certain expenditure driven by the prospect of significant wind generation development. While negotiated charges paid by generators for required augmentations will form part of the annual regulated revenue requirement, the exclusion of this expenditure appears appropriate due to the reasons outlined above, namely the mutual exclusivity associated with competing generation proposals and the fact that network users would bear the uncertainty attached to these proposals if these projects were to be included in the capex forecast.

On the basis of information published by ElectraNet, it appears that a significant proportion of the projects identified to date are being developed to satisfy the 'market benefit' criteria under the regulatory test, as opposed to reliability driven augmentations. Of the large (>$10m) capex proposals listed in the Meritec report, it is noted that market benefit projects account for some 43% of raw expenditure (or 23% on a proposed roll-in basis). The need to satisfy the market benefit test adds to the uncertainty associated with the likelihood and timing of these projects. It is also noted that Code consultation has yet to commence for a single project at this time (either reliability or market driven) less than five months before the start of the regulatory period, adding to this uncertainty.

Meritec has expressed concern over the feasibility of the proposed capex program, given the increasing demands for TNSP resources across the NEM and the magnitude of the increase above recent levels. Whilst expenditure levels have averaged around $20-$40m pa in recent years, an average capital expenditure level of $68m has been proposed for the forthcoming regulatory period. This may increase the uncertainty of delivery, and hence the risk of subsequent clawback.

These additional factors suggest the need for conservatism and caution in the approval of a large step increase in capital expenditure. In view of these issues, the exclusion of the proposed expenditure would appear appropriate.

Augmentations to Monash/Robertstown

Meritec has proposed to exclude from the capex forecasts proposed expenditure associated with components of SNI, namely the construction of Monash-Robertstown and Monash-SA Border transmission lines, and has proposed that projected expenditure be limited to substation works at Monash, albeit deferred to 2007/08. It is noted that the information recently published by ElectraNet SA in its Annual Planning Review also appears to be limited to the Monash substation works.

ElectraNet has indicated that it has entered into an agreement with TransGrid for the construction of the Monash-Robertstown line. Nevertheless, TransGrid has remained at all times the proponent of this project for the purposes of the National Electricity Code. It is therefore unclear why or on what basis TransGrid as responsible proponent under the Code should require ElectraNet to fund these works from its regulated revenue base.

NRG Flinders would therefore query why this expenditure should not belong within the revenue base of the proponent, should SNI proceed, regardless of the construction arrangements.

On this basis it would appear logical not to include the proposed works in the capex forecast, as it is unclear why ElectraNet should be required to fund this expenditure.

Conclusions

In summary, NRG Flinders submits that:

- It is unclear why prudent and justified refurbishment expenditure should be at greater risk of optimisation and should not form part of the capex forecast;
- The adjustment of load forecast proportions appears to correct the undue emphasis placed on the medium growth scenario, acting to reduce the risk of clawback;
- It should be clarified as to whether any clawback allowance has been made in the forecasts for any underspent capital expenditure from the current regulatory period;
- The exclusions proposed appear balanced and justified considering the large step increase in expenditure proposed, the uncertainty associated with regulatory consultation and approval processes, the mutual exclusivity associated with competing generation proposals and the fact that network customers will bear the risk of any overestimation in capital expenditure;
- It is unclear how ElectraNet SA can be required to fund network augmentation works for which another TNSP is the proponent under the National Electricity Code. In the absence of a clear rationale for this, the exclusion of Monash/Robertstown transmission line expenditure from the capex forecast appears appropriate.

Should you have any queries in relation to this submission, please feel free to contact the undersigned on (08) 8372 8706.

Yours sincerely

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