23rd April 2004

Mr Sebastian Roberts
General Manager—Electricity
Regulatory Affairs Division
The Australian Competition and Consumer Commission
GPO Box 520J
Melbourne VIC 3001

Email: electricity.group@accc.gov.au

Dear Sebastian

Energy Markets Reform Forum Comments On GHD Reports On TransGrid And EnergyAustralia

I enclose the Energy Markets Reform Forum submission on the GHD Reports on TransGrid and EnergyAustralia. We are concerned that limited time has been made available to comment on the GHD Reports.

Yours sincerely

Mark Gell
Chairman, Energy Markets Reform Forum

· Energy Markets Reform Forum ·
· GPO Box 2100 ·
· Sydney · NSW· 2001 ·
·Tel: 61 2 9262 5399 · Fax: 61 2 9299 7020 ·

ENERGY MARKETS REFORM FORUM

COMMENTS ON THE GHD REPORTS

ON

TRANSGRID AND ENERGYAUSTRALIA REGULATORY REVIEW

- **Capital Expenditure and Asset Base, Operational Expenditure and Service Standards**

SUBMISSION TO

AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

AND

REPORT TO NEM ADVOCACY PANEL

APRIL 2004

This submission by the Energy Markets Reform Forum is part funded by the NEM Advocacy Panel. Assistance in preparing the submission was provided by Bob Lim & Co Pty Ltd and Headberry Partners Pty Ltd. The views expressed herein are those of the Energy Markets Reform Forum.

TABLE OF CONTENTS

Executive Summary

The Energy Markets Reform Forum (EMRF) considers the current ACCC review process involving TransGrid (TG) and EnergyAustralia (EA) to be fundamentally flawed, thereby unreasonably disadvantaging electricity consumers in New South Wales. It is unfair to consumers because the TG and EA applications, and the ACCC's consultant's reports (on capital expenditure and the asset base, operational expenditure and service standards) have failed to provide the requisite degree of transparency to enable assessment and therefore justification that all cost claims (historic and future) are prudent and economically efficient.

This is despite very substantial cost overruns from the current regulatory period and even more substantial future cost claims in the regulatory period beginning 1 July 2004, which will significantly raise network charges in New South Wales.

Both companies (TG and EA) are undergoing the "first" reset of their revenue caps – that is, this is the <u>second</u> review of the two companies and consumers would have reasonable expectation (mistakenly as it would appear) that the current review would have a consistent and transparent set of regulatory accounts to enable a robust review to be undertaken in accordance with provisions in the National Electricity Code.

Electricity customers in other States would be deeply concerned, as the regulatory process and the outcomes of the current review will have important implications in terms of the precedents formed in regards to revenue rests for other transmission companies.

The EMRF is also concerned that the ACCC's consultant (GHD) has elected to advise that numerous and substantial costs associated with certain claims by TG and EA, cannot be assessed through lack of relevant information and documentation trail, yet clear statements are made that GHD will not recommend a change to the claims as it has insufficient information, implicitly supporting the claims!

The EMRF considers that the ACCC must not allow the 1 July 2004 starting date for the new regulatory period to divert it from undertaking a robust review as required by the National Electricity Code.

1. Introduction

TransGrid (TG) and EnergyAustralia (EA) were the first transmission companies to have revenue caps established by the ACCC in its 1999 Decision. Both companies are currently undergoing the "first" reset of their revenue caps. Accordingly, the regulatory processes and the outcomes of the current review will have important implications, not only directly for the customers of TG and EA, but also in terms of the precedents formed in regards to revenue resets for other transmission companies.

The current review has several standout features.

Firstly, both TG and EA have claimed very significant overruns in historic costs (from the current regulatory period) to be rolled into the 1 July 2004 Regulatory Asset Base.

Second, both TG and EA are seeking very substantial future capex and opex.

Third, both TG and EA have not supported their applications with sufficient documentation and data to enable the ACCC, GHD and customers of the two companies to assess that historic and proposed costs are prudent and economically efficient.

Fourth, as is clear from the GHD reports, there is substantial disquiet with this regulatory process, posed by problems arising from lack of documentation and linkages, delays in the production of information and data to the ACCC's consultants, and delays in responding to the ACCC's consultant's questions and inquiries, all of which have had the effect of preventing GHD from assessing that a substantial proportion of costs claims are prudent and economically efficient or from arriving at firm conclusions. Of concern is the proposed solution to the proper review of past and forecast expenditure, by reducing the "potentially … intrusive form of regulation".

Customers of TG and EA are adamant that only prudent and efficient costs that can be reasonably justified are considered in the setting of revenue caps. The ACCC has no alternative but to act in accordance with provisions of the National Electricity Code. The implications for subsequent revenue resets for other transmission companies are enormous, and undesirable precedents may be set.

We note that there is a real concern within EMRF members about the approach TG and EA use to allocate the revenue to various customer classes. In particular, the approach used by TG does not recognize that tariffs should predominantly be based on demand (MW) rather than volume (MWh) and so are skewed to the benefit of low load factor consumers. This approach does not provide the clear financial incentives to all consumers to manage their demand to optimize the capacity of the network.

We would request that the ACCC, as part of the revenue review, require both TG and EA to follow the recent process undertaken by Transend, which has requested public involvement in setting the approach to revenue allocation. This process is intended to be transparent and will allow the ACCC to subsequently satisfy itself that the allowed revenue has been allocated

- in a manner to truly reflect the actual usage made by each user of the system;
- which provides clear financial signals to optimize the use of the network; and
- the tariffs arising are economically efficient".

Part I provides the EMRF comments on the GHD Report on TG, followed by Part II, which comments on the GHD Report on EA.

PART I TRANSGRID'S CAPITAL EXPENDITURE AND ASSET BASE, OPERATIONAL EXPENDITURE AND SERVICE STANDARDS

1. Introduction

The EMRF notes GHD's comments that:-

> *"The review relies on information provided by TransGrid with limited verification of the information by GHD". (page i)*
>
> "*TransGrid was provided with a draft copy of this report for review and comment on matters of fact. Subsequent to issue of the draft report, TransGrid provided further information as a response, and provided responses to earlier questions from both GHD and the Commission. Some of this information, GHD considers, should have been provided much earlier to clarify requests. GHD was unable to fully review or explore the implications of this documentation due to the short timeframe, and consequently the findings may be inconclusive in some cases". (page i).*

The EMRF considers that deficiencies in these areas must not prevent the ACCC from arriving at its own view of reasonable levels of prudent and efficient costs.

It is also quite apparent that TransGrid (TG) has used the fact that it has to announce its 04/05 tariffs by mid/late May of 2004. By delaying its responses to GHD and others, it may have successfully been able to use time pressure on the regulator, its advisers and Interested Parties in order to benefit itself. The EMRF believes that the ACCC must not be pressured in such a way and presented from undertaking a robust review therefore some penalty must be applied to TransGrid for failing to provide sufficient and accurate information to the regulator in a timely fashion.

The ACCC has permitted Interested Parties less than six working days to assess the GHD report on TG. The ACCC advises that further review and analysis is still being undertaken. Given the time constraints, it is obvious that further input by Interested Parties will not be possible. This is totally unsatisfactory.

2. Business Systems Efficiency

The GHD Report on TG's business management systems is clear that there is potential to reduce costs in project investigation, design and project management. Deficiencies in documentation and in reconciling projects and programs in TG's business strategies with budget costs for future refurbishment capex are also identified.

The EMRF considers that an efficiency savings factor should be applied in this area. These are issues of management and organization and should not pose significant difficulties to implement.

3. Historic Capex

Despite the limited sampling of projects totaling \$463m (reflecting the problems faced by GHD in obtaining information and data in an appropriate format from TG) GHD is unable to arrive at a conclusion on the efficiency of some \$301m (or about 63% of the sample). Thus, GHD effectively implies there are serious doubts about for some two thirds of the historic capex program.. Accepting that the claimed capex for 99/00 to 03/04 totals \$1066.9m, by extrapolation, this casts significant doubt potentially over nearly \$700m of actual capex. Bearing in mind that the ACCC approved \$881.59m (\$1999) for capex in the current period, not only has TG exceeded the capex allowance by well over \$100m (after allowing for inflation) there is grave concern as to the regulatory legitimacy of what was spent.

Further, some \$32m was deducted from regulated revenue, representing private use vehicles, vehicle resale revenue and unsubstantiated "other projects". In other words, in addition to some \$700m of capex actually spent but not justified, a further 7% of the projects in the sample investigated by GHD are not part of regulated revenues – a not insignificant figure.

The EMRF notes that the ACCC is conducting further investigations. But the material revealed by GHD thus far, is very disconcerting. For example, of the 5 projects sampled, GHD found that:-

- one project is significantly above costs in the economic evaluation.
- two other projects are significantly above costs and alternative generation options could have been viable.
- easement costs are more than double the 1999 allowance.

GHD also states that TG is building transmission works that are used exclusively by DNSPs even though DNSPs have made no capital contributions, meaning that TG's customers are cross subsidizing distribution asset users. The EMRF considers that these be identified and the costs removed from TG's revenue cap.

Overall the GHD assessments are very disconcerting and the EMRF recommends that:-

- ➔ **the additional investigations by the ACCC should be made available for public scrutiny; and**
- ➔ **on the basis of the investigations, unsubstantiated <u>and</u> excessive cost claims must be disallowed to be rolled into the starting 04/05 Regulatory Asset Base.**

To allow automatic rolling in of cost overruns into the RAB engenders a cost-plus culture in the business.

GHD observes that:-

> *"Given the limited sample for which conclusions could be drawn and the complexities of the conclusions in each project reviewed, drawing wider conclusions on the overall historic Capex was not appropriate. However, it was clear from the assessment that TransGrid has some difficulty in tracking project costs from project inception to completion, undertaking and providing adequate economic project justifications, and reviewing project costs after approval". (page 35)*

Notwithstanding what is effectively a disclaimer, the fact that given samples of projects which added over 50% of the approved capex for the 99/00 to 03/04 period, either the ACCC must draw some conclusions from the GHD report, or effectively accept that TG should be permitted to roll in the incurred capex, less the amounts specifically noted by GHD as not being appropriate. The EMRF is of the view that the approach by TG has been such that it expects the ACCC to roll in all of the capex incurred, despite the fact that it cannot prove that the capex was properly incurred. The ACCC must resist this approach and allow only roll forward of such capex as TG can prove was legitimately incurred on behalf of TG customers.

4. Sydney CBD Project

The EMRF notes the very substantial cost overruns with the Sydney CBD project, which is significantly different to that proposed in the Regulatory Test – as evidenced by items such as larger capacity 330kv cable, third transformer and SF 6 equipment (page 33). The EMRF in its earlier submission had pointed to TG's expansion of the Haymarket sub-station airspace to accommodate future commercial development. A close investigation is clearly warranted here in order that TG's customers are not required to pay for costs associated with unregulated activities. In the case of the Sydney CBD/Haymarket project, it would appear, prima facie, that unregulated costs may have been rolled into regulated costs.

5. Future Capex

The EMRF is disappointed that:-

> *"GHD was not required to provide an overall assessment of future Capex. The process also did not include independent analysis or verification of TransGrid's load forecasts. These forecasts were developed by TransGrid based on information provided by the NSW electricity Distribution Network Service Providers and TransGrid's own information on economic growth and other demand drivers. The load forecasts are supplied to NEMMCO and used in producing a Statement of Opportunities each year". (page 38)*

The EMRF is concerned with TG's capability to deliver a very substantial future capex programme of over $1.4 billion, some $400 million over the amount spent in the current regulatory period.

This concern is expressed against the background of the GHD Report's primary findings of:-

- significant project cost overruns;
- inefficient business development programmes;
- inadequate data and information availability;
- development of transmission networks used by Country Energy with no capital contribution; and
- significant questions about cost allocations between regulated and unregulated activities.

TG has suggested that its new RAB is $2,777m. The forecast capex is $1,413m, equating to some 50% of the starting RAB. This is a major capex program and there is little information provided either by TG or the review by GHD to provide any indication as to the appropriateness of the amount of capex sought. In light of the instructions the ACCC has given to GHD It would appear that the ACCC is proposing that TG be given a high degree of flexibility for setting its proposed capex for the next period, and that it is implied there be minimal assessment of the capex level and what is proposed for capex.

This, combined with the concerns expressed by GHD about the TG processes for assessing and proving the need for the capex and the costs associated, give great concern to all consumers that the regulatory processes are going to be even more in favour of the regulated businesses to the financial detriment of consumers.

GHD states in its analysis of the Augmentation projects:-

> *"While the project costing basis appears reasonable at the planning stage (i.e. based on similar previous work or generic costs), from the few projects sampled the trend appears to show that the capital costs allocated in the budget are increasing as the project costs are refined by detailed assessment. GHD has requested more details for specific project cost increases to try and understand the reasons behind this and has generally found the increases are due to project scope refinement and detailed costing".* (page 43)

Notwithstanding the following rider that GHD believes the new TG improvements in project development and costing provide a degree of confidence that TG forecasting will improve, this still has to be demonstrated. Until TG has proven its systems will give the necessary level of confidence, the ACCC approach to "light handed" oversight of future capex raises significant concerns to consumers.

6. Opex

The approved opex for the 99/00 to 03/04 period averaged $104.6m, rising by 6.5% over the period. The 02/03 allowance was $106.25m and the actual spend, was $113.8m (see table 7-1), an overspend of 7.1%. GHD makes no attempt to refer to the ACCC allowances in its comparisons, preferring to work off TG actual opex.

A large proportion of this over-run could be attributed to an excess in payment of overtime and allowances. TG advises that this was a result of bushfires over the 02/03 summer and to minimizing downtime of the network at expected peak usage periods.

Consumers accept that it is their interests that networks incur some premium time to ensure a maximum of uptime when the network is likely to be more heavily loaded, and so paying a premium to ensure this occurs is acceptable. The issue then becomes one of assessing how much of the premium cost was embedded in the original allowance, and whether the premium paid returns a dividend. GHD has assessed this premium as $2.1m pa and also assessed that there is the cost of some non-core work force that should be deducted. On this basis, GHD assesses that the "Revised Efficient Opex Base" should be $108.32m. This shows a good correlation with the ACCC approved allowance.

The EMRF notes that GHD believes there is a significant "disconnect" between RAB and opex. The EMRF concurs. It is the experience of EMRF members that capex is usually justified by a *reduction* in opex, although when new assets are added (eg for a new factory or facility) there will be a related increase in opex to service the new assets. Capex used to refurbish or renew should reflect a significant opex reduction. Depending on the mix between augmentation and refurbishment/renewal capex, so the opex change will vary. Thus, to create any mathematical comparison between RAB and opex requires as a minimum analysis of the mix of capex elements, the age and type of the assets involved and an understanding of the difference in opex requirements between different designs of plant. With so many variables, we agree with the GHD conclusion that using a "maintenance unit" as the basis for setting opex has so many drawbacks as to make its use inappropriate.

The proposed increases from current levels recommended by GHD are relatively modest and although the EMRF in principle finds the justification of the increases less than compelling, it is accepted that with the large capex program proposed, that the increase in opex related to augmentation (with its new plant and equipment which does require a net increase in opex) might well be more than offset by the reductions in opex related to refurbishment and replacement capex and general efficiencies introduced.

In particular, the 2% efficiency savings incorporated appears to be modest at best and we note that GHD appears to be of the view that this efficiency saving is conservative, with a potential 5% being achievable. The proposed reduction using the modest 2% gives an overall reduction of $36.7m over the period. Increasing this to 5% would result in a saving of over $90m. Incorporating this figure into the TG allowable opex would effectively hold the TG opex at current levels. The EMRF members have to operate in an environment where opex increases are not commercially viable, so there is a strong belief that TG opex should remain at current levels.

Without better information being made available, the EMRF reluctantly accepts that the GHD recommendation is at the high end of the acceptable range for the TG opex, but we would suggest that the opex efficiency saving should increase from 2% compounding to at least 4% compounding.

7. Service Standards

It is accepted that TG performance is generally superior to other TNSP's. The TG performance is in stark contrast to that recorded by EA who demonstrate a substandard level of performance.

The EMRF agrees in principle with the concept that the TNSP's should be incentivised to maximise uptime, as this should provide consumers with some hedging against generators exercising market power. The proposal of a cap/collar/floor bonus/neutral/penalty arrangement does provide a reasonable basis for rewarding good performance, although limiting the penalty/bonus to +/- 1% does not provide a significant exposure to the business.

We noted the GHD observation that TG has a superior performance compared to other TNSP's but this should not be used to permit TG to easily gain a bonus – we believe a continuous improvement approach is required to all businesses. Thus, the historic and proven performance of TG should be used as the foundation for the incentive scheme, and the GHD recommendation of modestly lifting the targets from current performance levels is supported.

8. Concluding Remarks

- Generally, GHD has approached its task in unenviable circumstances, with a mass of information being provided but missing the essential elements required for a robust regulatory review. This absence of data has been compounded by the approach taken by TG (and EA) to delay providing the information required quickly and in a form which can be readily used. As a result the GHD reports are full of disclaimers, observations about inability to make recommendations, excluding comments about certain elements due to lack of information, and so forth. As a result the EMRF is concerned that GHD has elected not to advise that the costs associated with certain claims by TG (and EA) should implicitly be accepted. This has been observed by the clear statements that GHD will not recommend a change to the claim as it has insufficient information. Thus, TG (and EA) have been able to get costs and claims accepted by not providing the necessary information
- One of the key requirements of the NEC (and the declared approach by the ACCC) is the need by the businesses to justify the cost claims by reference to local and international benchmarks. In previous decisions the ACCC has developed these benchmarks itself. The absence of any benchmarking by the applicants and by GHD has been notable. This is unacceptable as regulation is intended to be based on competition by comparison. That GHD had to develop its own starting points for recommending the forward opex is an indictment on both applications.

PART II ENERGYAUSTRALIA CAPITAL EXPENDITURE AND ASSET BASE, OPERATIONAL EXPENDITURE AND SERVICE STANDARDS

1. Introduction

The ACCC's current revenue cap review of EnergyAustralia (EA) for the period 1 July 2004 to 30 June 2009 is its second review, the first having been conducted in 1999/2000. In this current review, EA is seeking a very substantial increase of 55.7% (in nominal $ terms) in regulated revenues, compared with the previous regulatory period.

Yet, it is astonishing that EA has not been able or prepared, to provide a sufficient level of transparency of its claims, or to provide a documentation trail to support its claims. Amazingly this is the unequivcoal conclusion of the ACCC's consultant's (GHD) review of EA's application in relation to past capex, future capex, past opex, future opex, and even service standards. GHD states that effectively they have not been able to sufficiently substantiate EA claims. The bulk of the GHD report is directed at trying to establish where the starting points for RAB and opex should be!

One of the most blatant issues required for substantiating the increases in RAB and opex, is the approach taken by EA to re-allocate assets between transmission and distribution networks. This raises a major issue for concern in that by transferring assets between classes, there is the very real opportunity for EA to "rebadge" assets and costs and so have them included in <u>both distribution and transmission networks</u> as the two are over-sighted by different regulators. It is beholden on both regulators to confirm that the asset shifting by EA has not resulted in a net benefit to EA, or that electricity users in this State (particularly customers of EA) are not forced into paying twice for the use of the same network assets.

Customers of EA's networks are adamant that all EA cost claims must be made transparent and independently justified as prudent and efficient. There is a scarcity of data and and almost no financial substantiation of the costs provided in the application or in subsequent discussions with the regulator or its consultant to justify the bulk of EA claims for increases.

All cost claims that cannot be adequately established as prudent and economically efficient must not be rolled into the opening Regulatory Asset Base at 1 July 2004. To do otherwise, would be in contravention of the National Electricity Code, and would render the current review as meaningless.

2. GHD's Summary Conclusions

EA's customers – who are expected to pay for the significant revenue increases claimed – strongly object to learn of the GHD summary conclusions of EA's capex and opex claims:-

> ***"Capex***
> *GHD are not able to form a firm conclusion of the overall efficiency of EnergyAustralia's Capex program, both historic and forecast for the reasons outlined below. Consequently, GHD is also not able to conclude on the pudency of the opening RAB.*

Reasons GHD are not able to respond effectively to the Terms of Reference are:-

- *The linkage between Board Approval and inclusion of a project in the ACCC application has not been demonstrated.*
- *The documentation to fully support capital cost estimates has not been provided.*
- *Working papers and Board submissions that can demonstrate rigour of justification for any particular project to be included in the ACCC application have not been provided.*
- *For future projects, GHD can find no evidence that the new capital governance framework has been rigorously followed". (page i).*

> *"There is evidence from the Business Cases that Final Cost Estimates, Board Approval, Development Approval and Detailed Civil and Electrical Designs are prepared as part of the process, however GHD has not been provided with a reasonable level of documented project details".(page ii).*

> ***"Opex***
> *GHD was not able to access a suitable level of linked data to enable a detailed evaluation of EnergyAustralia's past and future Opex. As such, GHD undertook a driver analysis and applied the findings for those drivers to EnergyAustralia's actual and proposed Opex figures, thus generating a recommended level of Opex". (page ii).*

3. Expenditure – Related Business Systems Review

The EMRF agrees with the GHD review of EA's business systems and practices but requests that information and data be made available to support what is considered by GHD to be "best practice" assessment of EA's systems. What are the Key Performance Indicators and have EA's systems been compared with comparable overseas and domestic organisations? There does not appear to be any supportive material provided by GHD to enable EA's customers to make independent assessments.

3.1 Labour Productivity

The EMRF notes that GHD considers that:-

> *"Productivity improvement opportunities abound for EnergyAustralia, based upon the level of their current systems relating to business expenditures and performance".(page 6).*

However, GHD further states without direct comment or assessment that:-

> *"There was a significant increase in the employee base, rising by 12.4% from 1999/00 to 2002/03".(page 8).*

The EMRF strongly considers that the ACCC must determine a sufficiently robust efficiency factor for EA, based on comparisons with best practice systems.

3.2 Asset Management Plan

The EMRF notes GHD states that:

> *"At present EnergyAustralia does not have a single document that outlines the Asset Management Plan for the entire organisation – a sign that the development of their asset management program is still underway". (page 11).*

EA has now been under regulatory oversight for five years. How long should a regulator allow comfort to a business which has not addressed the need to provide specific data to allow the regulator to properly review and then set its revenue? Yet, customers of EA are expected to fully fund capex and opex cost overruns (i.e. expenditures above the levels determined at the previous regulatory review) with no clear evidence of productivity or efficiency improvements let alone justification that they are prudent and efficient.

3.3 GHD Conclusion On Business Systems

GHD concludes that:-

> *"…EnergyAustralia started the previous RP with generally weak systems and data, with a correspondingly reduced capacity to make decisions. The level of performance in this respect was below that which would be expected of a prudent operator. The weaknesses have been identified and steps are underway to rectify some of these inadequacies, with some definite improvements currently in evidence. The Asset Management system and the procurement strategy being introduced are expected to reap significant benefits for EnergyAustralia in the long term, with some of the effects impacting during the upcoming RP'.(page 14).*

The EMRF considers that the GHD assessment of EA's Business Systems is disappointing in that it fails to identify and clearly detail the areas where inefficiencies should clearly not be accepted in the claims for regulated revenues, as well as providing guidance (and qualification) on the efficiencies and productivity improvements possible in the next regulatory period, based on GHD's supposed analytic process:-

> *"…[the] approach is a development of analysis processes extensively used by GHD to undertake asset management and expenditure reviews, and draws from the approach detailed in the International Infrastructure Management Manual 2001, which was endorsed by the relevant Ministers of the Australian and New Zealand governments as appropriate for use by infrastructure businesses." (page 8).*

4. Regulatory Asset Base and Historical Capital Expenditure

The EMRF notes that:-

- GHD concludes that *"EnergyAustralia have not specifically applied the regulatory test, other than as part of joint application with TransGrid in the case of the Sydney CBD upgrade". (page 16).*
- *An overall capex overspend of $57.2m in the current regulatory period compared with the ACCC's 1999 Allowance, with substantial variations from project costs identified in 1999.*
- *Significant cost overruns for some projects, such as the Haymarket Project.*
- *Significant and substantial information deficiencies such that "GHD found that the linkages between the initial Value Management phase and subsequent phases of the Capex program were not easily traceable and there was not a coherent documentation process in place". (page 33).*
- *GHD concludes that "In all cases, there is a lack of information on the development of costings (although GHD have requested this information – refer Appendix C). GHD have also requested but have not received information that would demonstrate a detailed or robust economic analysis/appraisal of options. Consequently, GHD are not able to form an opinion on the efficiency of the expenditure and therefore cannot conclude on the overall efficiency of the historic Capex program nor provide validated advice on the opening asset base".(page 35).*

It is of great concern that despite EA being a regulated business for some five years, there has been no clear evidence that EA has embraced the needs of the business to provide an adequate "paper trail" to substantiate its capex and opex needs. For GHD to so often cite the statement :-

> *"There is no evidence that any of the new capital governance processes …has been formally followed on this project"*

highlights the fact that EA has not provided and still fails to provide any appropriate controls to its capex program.

For EA still not to have appropriate controls and authorizations for capex is tantamount to an attitude which the ACCC must not accept. EA must be required to provide substantiation **in an appropriate and substantiable form** before the ACCC should accept such costs into the RAB.

Against the above, customers of EA have substantial objections to fully meeting EA's historic capex cost claims. The ACCC cannot, and must not permit "lack of documentation" to be a de facto justification for historic capex overruns. It is regrettable that GHD has not provided guidance (or quantification estimates) of reasonable allowable overruns claims. Without such confirmation, the ACCC cannot reasonably accept inclusion of the claimed capex into the RAB.

5. Forecast Capital Expenditure

The EMRF notes GHD's assessment that:-

> "*Although the formal Board approval process of individual projects is carried out after consideration by the Capital Investment & Utilisation Sub-Committee [as outlined in advice from Energy Australia dated 22 March 2004], it would seem reasonable for the Board or its Sub-Committee to have a role in deciding which projects were to be included in the ACCC application for future Capital Expenditure.*
>
> *It is understood that many projects have both a transmission and distribution component. In providing justification for* ***the transmission part of the project to***

be included in the ACCC application *GHD would have expected the whole project to be presented together with the* ***basis*** *on which the Transmission component was justified and its costs segregated from the total project.*

The written information provided in support of these projects is limited. It was not provided during the discussion phase in December.

None of the proposed projects was supported initially by a comprehensive series of documents highlighting:

- *The basis on which the project was initiated.*
- *Detailed load analysis before and after the project will be completed.*
- *Detailed cost estimates showing the assumptions used and the basis on which the cost had been include in the ACCC application*
- *A rigid analysis of alternatives other than an initial value management study considering option (with only some priced). After accepting an option at the value management there was no reconsideration of alternatives as more detailed costing became available that may have changed the ranking of the adopted scheme.*
- *An audit trail of documents showing how the proposed projects received Board approval to be included in the ACCC application*
- *The regulatory test has not yet been formally applied in any of the future projects. It is understood that it will be applied within a year of the projects being implemented.*

The review process was intended to include:-

- *Reviewing adequacy of EnergyAustralia's Capex methodology with a focus on efficiency of expenditure. Consideration was given to internal and external factors impacting on future Capex requirements.*
- *Checking the link between EnergyAustralia's load forecast and individual growth projects, and how this affects the timing of implementation and the capacity of the augmentation.*

- *Specific review of regulatory test applications selected by the Commission for augmentation projects, including reviewing the modeling, justification and assumptions in project selection, cost and timing of the projects.*
- *For non-augmentation projects, selecting key investment categories/projects and reviewing the relevant business case justification or asset management strategy from which they derive and whether this meets needs at least cost.*
- *Checking the consistency between the Capex allowance provided in the Application and the documentation supplied.*

The process did not include independent analysis or verification of EnergyAustralia's load forecasts.

As indicated above, information to satisfy these processes was not available for any of the project".(pages 36 & 37).

Furthermore, it is noted that:-

"Similarly, because of the lack of the detailed estimate, there was no clear method by which the split of cost estimates between distribution (IPART) and Transmission (ACCC) could be verified". (page 38).

"*The reasons GHD has not been able form an opinion on this project [Tomago Project, $4.5m] can be summarised as follows:-*

- *Although the various Planning reports have identified critical issues of loading on the Tomago, Newcastle and Waratah substations and arrived at recommended capital projects that overcome short and long term limitations in handling increased loads in the area, there is a lack of rigour in the cost estimates.*
- *The documentation to fully support the capital cost estimates has not been provided.*

- *GHD would have expected to see some working papers and Board submissions prior to this project being included in the ACCC application. No such papers have been provided.*
- *There is no evidence that any of the new capital governance process as summarised in 3.8 above has been formally followed on this project. Based on the information provided the project is beyond the Justify & Plan stage and certainly has passed through the Develop Feasible Options stage. At this point there should be some evidence of Approval by the Manager, Asset & Investment Management or Board Sub committee. No such approval has been provided*
- *GHD would expect at least to see preliminary designs and estimates and some form of engineering scope documentation. The 2002 Planning Reports and the Outline Business Case dated 24/12/03 is the only documentation provided to GHD". (pages 42 & 43).*
- *EA's total capex proposal for 2005/09 has been significantly raised from $154.3m to $189.9m (see letter of 3 February 2004 to the ACCC) with limited information provided, prompting GHD to raise substantial concerns about EA's planning and forecasting process.*

The EMRF notes the GHD observation that:-

> *"None of the past or future capital expenditure projects have been formally reviewed in accordance with the steps outlined in the Capital Governance Framework as outlined…. There is no evidence of any projects being subjected to a post implementation review."*

Without such controls actually operating, how can the ACCC permit EA any capex in the next regulatory period? Whilst it is accepted in principle that capex is needed for EA to continue to provide the services it offers, without there being any proven controls on the exercise of the capex program, the ACCC must not permit EA free rein.

The EMRF is adamant that customers of EA will be opposed to any capex forecasts being accepted without justification that they are prudent or efficient, and that there is a documentation trial. Moreover, in view of the late transfers of distribution networks to transmission networks, the ACCC must seek to reconcile the relevant assets concerned with IPART, which is currently completing its review into the NSW distribution businesses. It is noted that IPART draft decision proposes to reject a proportion of EA's initial capex claims.

6. Operational Expenditure

The EMRF notes GHD's assessment that:-

> *"Data issues dominate this regulatory review. GHD have concluded that EnergyAustralia do not collect the information useful and necessary to undertake a regulatory review to meet the requirements of the Terms of Reference above. An organisation operating within a regulatory environment such as this should be able to access and provide this information.*
>
> *Accordingly, the review of EnergyAustralia's Transmission Opex has proven a substantial challenge. The terms of reference provided by the ACCC, summarised within Section 6.1.1, have been very difficult to meet.*
>
> *GHD found that EnergyAustralia has a "whole of business" approach to recording information in its systems. EnergyAustralia do not have an activity based costing system nor do they record information specifically for each regulatory authority. The transmission activities are not ring fenced. Refer Section 3 for details.*
>
> *Moreover, EnergyAustralia informed GHD that maintenance was not accurately recorded against assets. EnergyAustralia do keep maintenance information by Opex activity.*
>
> *GHD would have expected that EnergyAustralia would keep records to demonstrate to the regulators that EnergyAustralia were operating a prudent and efficient business, and that EnergyAustralia could explain and justify the differences between the approved and actual Opex and how joint costs were allocated". (page 53).*

The EMRF notes with concern the above assessment, particularly the information deficiencies, the absence of ringfencing, and what appears to be an absence of a robust system enabling cost allocations between regulated and non-regulated activities, and in regard to the former, between transmission and distribution activities. In the absence of these, it is clearly easy for costs shifting to be undertaken. A possible example may perhaps be found in GHD's reference to EA's Olympic expenditure:-

> *"EnergyAustralia was a sponsor of the Sydney Olympic 2000. In their 2000-01 Annual Report (pages 6/7), EnergyAustralia said that it had invested $120 million in new infrastructure and spent a significant amount of time and money. GHD would see this money as a donation and not a charge on Opex. Unfortunately, GHD have not been able to establish how much was spent". (page 60).*

If the amounts are 'donations' then the should no be incorporated into the revenue cap

6.1 Opex Starting Point

GHD's recommended opex starting point of $26.9m ($0.6m less than EA's proposal) is too generous. GHD states that:-

> *" [it] was not able to access a suitable level of linked data to enable a detailed evaluation of EnergyAustralia's past and future Opex. As such, GHD undertook a driver analysis and applied the findings for those drivers to EnergyAustralia's actual and proposed Opex figures, thus generating a recommended level of Opex."*

This approach is of great concern to the EMRF. EA appears to have provided a major obfuscation to anyone attempting analysis of its opex. It has unilaterally decided that it will adjust its original asset definition and its global ORC allocation. As GHD observes:-

> *"…the revised allocation process results in a far more favourable outcome for EnergyAustralia…,"*

Countering this is a need for ACCC and IPART to ensure that by making such changes, EA is not able to use these unilateral changes and the ability to allocate between two regulatory decisions, to the detriment of consumers.

EA states what it considers to be its preferred opex for the coming period based on the new definitions and allocation. To verify the EA claim GHD has then had to carry out significant financial allocations and adjustments to identify what it considers as "apples for apples" comparison. Based on this adjustment GHD then elected to accept that the apparent past actual opex with some minor adjustments should be used for the starting point for the new regulatory period. The difference between the GHD comparable actual opex and the ACCC originally approved opex (adjusted for the new allocation and new asset charges) appears on table 23 of the GHD report and averages some $6.96m per annum to the benefit of EA. That is, as GHD has elected to use EA actual opex costs rather than the approved ACCC costs as the starting point for the opex for the new regulatory period, GHD has granted EA an unsubstantiated increase in opex of $6.96m pa, or an average increase of 53%. This is unacceptable!

GHD then notes that it can quantify some of the impact of additional superannuation (although SKM provides no justification of the expenditure), of additional insurance, and of environmental legislative changes. There are a number of other changes which GHD and EA cannot quantify. Resulting from this listing, GHD concludes that as it cannot quantify the supposed benefits from these other qualitative assessments, then they are acceptable. This approach is tantamount to saying that the actual costs are acceptable because there is no way to quantify (and therefore prove) the elements which are alleged to create the difference of an average $6.96m pa between approved opex and actual opex.

Whereas the ACCC had provided a declining opex with time (to replicate efficiencies) the EA and GHD approach notes there was a consistent increase in actual opex as shown in figure 7. Thus, the efficiencies that the ACCC believed should apply to opex have been disregarded because GHD has elected to follow the unacceptable premise of

> *"…that where it is unclear whether expenditure is prudent or not, or where an appropriate and reasonable assessment could not be made, no variation has been recommended by GHD." (page 66)*

Thus, where there is no proof, GHD implicitly accepts the opex as being reasonable. In addition the ACCC forecasts a reducing opex (to fall by 11% over the last period), whereas GHD has implicitly accepted the opex should rise by 18% over the period. GHD then uses this inflated past opex as the starting point for the new opex under its "driver analysis". In fact the differential between the ACCC "approved starting point" of $13.150m is some $7.8m below the "GHD calculated starting point" of $20.986m. This is an extraordinary difference and GHD makes no attempt to justify whether such a large differential is justified, other than to imply that it must be legitimate because it appears that EA spent this opex. Customers of EA who have to pay for such unsubstantiated claims are adamant that the ACCC must draw a firm line here. All costs must be (reasonably) substantiated.

6.2 Future Opex

The EMRF considers that:-

- EA's proposed IT capex and opex of $25m pa and $33m pa respectively appears high. While it is accepted that this expenditure is apparently across the whole of the transmission and distribution elements, extreme care must be taken to ensure that this expenditure is dedicated to the networks business and not EA's retail activities. For investment of this magnitude there must be an identifiable benefit that arises from such large amounts of cash. The ability (or rather the demonstrable lack therefore) of EA to be able to clearly point out the return that investment of such amounts will achieve, is of great concern. Traditionally a commercial enterprise would require investment to give a 10-15% return from such investments and therefore the recommended efficiency gains even at the higher end of the range of 1-5%p.a. stated as reasonable by GHD, are really unacceptable.
- It is accepted that Reliability Centred Maintenance (also referred to as condition based maintenance) is preferable to time based assessments, and there is an expectation that this approach will result in lower opex needs over time. However, the EMRF is concerned that the allowance for this opex increases over time considerably. At the same time we are seeing an increase in capex and thus there is no trade off between capex and opex being seen – in fact it is the reverse. It seems that by increasing capex we axiomatically must see an increase in opex!

  Of equal concern is the bland statement that the reason for the increasing requirement for maintenance opex over the new period is the driver of moving from Time based to Condition based maintenance. This would appear to be a distortion. Time based amounts of opex (see table 25) are forecast to rise by 70% over the period and the comparable condition based amounts for opex are forecast to rise by under 40% over the period. Thus, to assert that the need to provide additional maintenance opex over time is not a result of the change to RCM at all. It would appear (again) that by EA not being able to justify any of its claims for increases, and by its obfuscating, it has (by default) "negotiated" an unacceptably high opex gain.

During the past period EA expended extensive opex in ensuring the Olympics was undisturbed, and subsequent to that time there was a marked reduction in maintenance opex (see GHD table 16). Implicitly in the current allowance the ACCC provided for maintenance opex across all EA assets. EA now states (with the support of GHD) that maintenance opex should increase from the already inflated average past maintenance opex level of $11.68m (see table 16) by 14% (to $13.28m – see table 24) immediately and increasing over time to have increased by a massive 56% (to $18.2m) by the end of the period. Little justification is provided to support this contention.

- GHD's assessment that the 2003/04 forecasts insurance expenditure of $4.7m may be an over-estimate must be taken into account by the ACCC. GHD observes that insurance premiums may have peaked, and that the 03/04 allowance may be over-estimated. Thus, the risk on the amount included in the opex has been truncated in favour of the business.
- GHD observes that SKM notes that Enerserve direct labour rates are one of the highest surveyed. Enerserve is a subsidiary of EA and EA has contracted with Enerserve for nearly 20% of its opex budget. EMRF would point out that for the regulatory opex to be granted EA must demonstrate arms length negotiations have led to the award of this contract, and that competitive prices have been sought and received.
- The GHD recommendations are for future opex to be revised downwards to be consistent with the 1999 ACCC opex decision. GHD identifies many aspects where there is a lack of documentation to justify the increase in opex, but then GHD implicitly accepts the EA forecast. It is our view that EA's opex claims should be accepted only in areas where they can be justified.

- Overall, GHD:-
    - has attempted to reconcile a quantum shift in allocation by valuation and asset class which could be used by EA as a method to recover costs by "rebadging" between distribution and transmission
    - has rejected the implied starting point set by the ACCC in the last review even allowing for the shift in reallocation,
    - has implicitly accepted the new starting point requested by EA (subject to a minor reduction only)
    - has stated that the shift to RCM requires that EA should have additional opex over time, yet attributes the reason for the increasing need for opex to the shift from time based monitoring. Whilst the change to RCM is supported, the increasing provision of opex because of this is not supported
    - has identified a number of aspects offered by EA as qualitative reasons for increasing the forecast opex over time, but with limited quantitative analysis to support the amounts claimed
    - has noted that where there was insufficient quantitative support provided to sustain an amount to be included, that the EA claim should be permitted, and
    - has agreed to opex increasing over time, rather than recommending an incentive approach of opex reduction over time as previously set by the ACCC.

The implication of the GHD review is to allow EA to increase its opex from the adjusted currently approved level of opex of $13m pa to increase immediately to $21m pa (a 60% increase) rising to $27m pa (over a doubling of opex by the end of the period). To be granted this massive increase EA has provided little substantiation other than qualitative reasons (and obfuscation) which they cannot quantify, but further the increases have not been substantiated by either EA or GHD to have medium long term costs benefits that have been quantified.

The Regulatory Test in its application to capex provides a serious attempt to enable the regulator to quantify the benefit that comes from investment. In the case of opex it appears that the business has no requirement to substantiate any increases in terms quantifiable future benefits.

To double the approved level of opex based on minimal justification is totally unsustainable and unacceptable.

7. Service Standards

The EMRF notes the GHD assessment that limited data on EA's Service Standards is available. Again, the data and information deficiencies, so overwhelming in this Application are quite exceptional for a regulated organization going through a second review by the ACCC. The absence of an incentive scheme for service performance is also surprising.

EA has achieved the performance average of 95.8%. There is no attempt to compare this level of circuit availability with any other TNSP. Circuit availability of TNSPs is usually measured at being about 99%. Thus EA's, current performance is very poor and should be penalized

Given the comprehensive management and systems changes already underway in EA, it seems reasonable that an increased target level higher than the 96.1% recommended by GHD, is very low, and should be increased to about 99%. There should be no delay in introducing the incentive scheme. In the meantime, a range of other service performance standards measurements should be introduced immediately.

8. Concluding Remarks

The EMRF considers it remarkable that information deficiencies and a somewhat pervasive absence of a documentation trail in relation to historic and future projects have arisen in this, the second review of EA by the ACCC. This in not an acceptable situation for customers of EA, who are faced with more than a 50% price increase.

The EMRF considers that the ACCC must discharge its regulatory duties and only accept cost claims that have bee assessed to be prudent and efficient. Any regulatory 'gaming' by EA must not be rewarded.

It is regrettable that the GHD report has largely failed to proved estimates or quantification of the costs claims by EA.

The ACCC must also formally advise EA of the GHD Report findings, especially in relation to the information and data deficiencies and the lack of process to underpin and justify funds for investment.