ElectraNet SA
electricity transmission network

ElectraNet Pty Limited
ABN 41 094 482 416
ACN 094 482 416

PO Box 7096 Hutt Street Post Office, Adelaide, South Australia 5000 Tel (08) 8404 7983 Fax (08) 8404 7294

8 November 2002

Sebastian Roberts
Acting General Manager
Regulatory Affairs – Electricity
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

By email: sebastian.roberts@accc.gov.au

Dear Sebastian,

ElectraNet SA Operating Expenditure Allowance

This letter addresses a number of points relevant to ElectraNet SA's regulated opex allowance that were raised by you and your team in our meeting in Canberra on 23 October. It also summarises a number of points made by us at the meeting.

The marked difference in treatment of opex between the ElectraNet SA and SPI PowerNet draft decisions is unwarranted and inappropriate.

In the SPI PowerNet draft decision the ACCC accepted that SPI PowerNet is an efficient operator based on the results of ITOMS and Indec Consulting benchmarking. In stark contrast, the ACCC says in its ElectraNet SA draft decision that the ITOMS and Indec Consulting benchmarking is of little value.

SPI PowerNet was allowed a 2% contingency for unidentified risks, whereas a 2% efficiency dividend was imposed on ElectraNet SA.

For SPI PowerNet the ACCC approved a real increase in opex of 35% from 2001/02 to 2003/04 based on SPI PowerNet's submissions concerning real cost increases and changes of scope. In ElectraNet SA's draft decision the ACCC appears reluctant to accept detailed submissions demonstrating real cost increases and changes of scope, preferring instead to rely on high level benchmarking to determine what is reasonable. The ElectraNet SA draft decision made significant cuts to the required opex allowance and suggests that even this reduced level of opex may still be high (notwithstanding the detailed justifications that have been provided by ElectraNet SA and the significant 35% real increase allowed SPI PowerNet).

ElectraNet SA's final decision must be consistent with the approach to opex taken in the SPI PowerNet draft decision and take into account the real cost increases and changes in scope facing the business.

The draft decision fails to address deferred maintenance and minor works included in the refurbishment works that the ACCC has directed to be capitalised.

ElectraNet SA provided details in its 19 August 2002 response to the Meritec opex review (Attachment 3) that showed that approximately 40% of the total expenditure associated with line uprating projects that the ACCC has directed to be capitalised are actually deferred maintenance costs that must be expensed. We raised this issue again in our submission on the ACCC's draft decision.

At our meeting in Canberra on 23 October the question was raised as to whether the deferred maintenance element of refurbishment would already be part of the historical cost base. Appendix A demonstrates that these costs are not implicit in the historical cost base and should be allowed in the final decision.

Higher transmission prices in South Australia do NOT mean that ElectraNet SA's operating costs are inefficient.

When making comparisons with other TNSPs, differences in scope, scale and operating environment must all be taken into account. ElectraNet SA provided a report by Benchmark Economics with its submission on the draft decision that supports the conclusion that ElectraNet SA's costs are efficient when the cost drivers for transmission networks are properly taken into account.

In our submission we proposed a presentation of the findings of this report by its author, Margaret Beardow. Please advise if you think that this would be beneficial and if you would like us to make arrangements for such a presentation.

The most appropriate base level of regulated operating costs for determining ElectraNet SA's opex allowance is the actual costs incurred in 2001/02.

We provided our regulated financial statements to you on 31 October 2002, which report regulated opex of $39.0m in 2001/02. Our previous submissions have emphasised that the operating expenditures in the years prior to this were not typical of the costs required to operate a sustainable transmission business in South Australia due to constraints imposed on the business in the lead up to privatisation and immediately thereafter (refer to Appendix B).

The figures reported for the purpose of the SAIIR Performance Incentive Scheme are not regulated opex and should NOT be used in making comparisons. Lew Owens has supported this point and assured us that he is happy to clarify it directly with the ACCC if necessary (via a three way meeting involving ElectraNet SA). Please advise if you think it necessary to take up Lew's offer. In conclusion, the SAIIR Performance Incentive Scheme figures should not factor in any way in making the final decision.

The fact that ElectraNet SA has determined an opex requirement that is higher than 2001/02 operating costs does NOT mean that the opex allowance is inefficient or unjustified.

ElectraNet SA is facing real cost increases and changes in scope of work. At our meeting in Canberra on 23 October, you requested a summary of what made up the increased opex in our application. Appendix C has been prepared in response to this request (note this information has been provided previously in our responses to the Meritec opex review and the draft decision).

As noted in our submission on the draft decision, even if only Meritec's recommended cost items are included (those explicit in the Meritec report), the opex allowance should be $44.4m (in $2001/02 and excluding grid support) compared with the $43m allowed in the draft decision.

Meritec also endorsed the costs associated with refurbishment that the ACCC directed to be capitalised. As discussed earlier this included $4.3m per annum (on average) of deferred maintenance and minor works that must be expensed (these costs are not included in the historic cost base). Including this amount, the opex allowance based on Meritec's recommended cost items becomes $48.7m (in $2001/02 and excluding grid support) compared to the $43m allowed in the draft decision.

ElectraNet SA maintains the view that the costs above this amount that were not endorsed by Meritec have not been given proper consideration. In particular, costs that are not controlled by ElectraNet SA such as increases in the market rate for maintenance service providers. These costs are legitimate and failure to allow them will result in reductions in expenditure in other areas "endorsed" in the ACCC's draft decision.

Finally we note again that ElectraNet SA's unit costs are efficient with 75% of total regulated operating costs either fixed or based on competitive market prices.

Please don't hesitate to call me on 08 8404 7983 if you would like to clarify or discuss any aspect of this letter.

Yours sincerely,

[Sgd] Rainer Korte

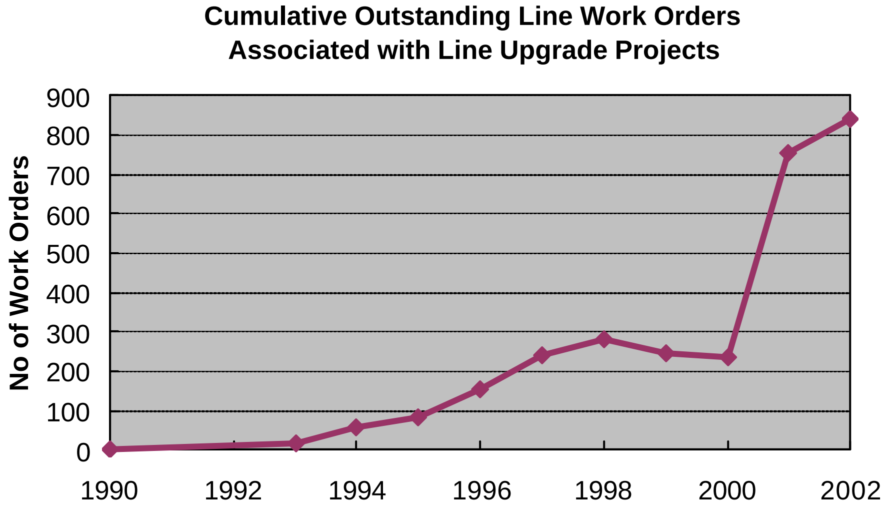
Rainer Korte
MANAGER REGULATION

Appendix A: Refurbishment Expenditure

ElectraNet SA provided details in its 19 August 2002 response to the Meritec opex review (Attachment 3) that showed that approximately 40% of the total expenditure associated with line uprating projects that the ACCC has directed to be capitalised is actually deferred maintenance that must be expensed and cannot be capitalised. We raised this issue again in our submission on the ACCC's draft decision.

At our meeting in Canberra on 23 October the question was raised as to whether the deferred maintenance element of refurbishment would already be part of the historical cost base.

The following graph demonstrates that these costs are not implicit in the historical cost base. The graph shows the accumulation of outstanding maintenance work orders against all of the lines identified for refurbishment in the asset management plan.



These work orders are logged in ElectraNet SA's Maintenance Management System (details can be provided if required) and have been held over on the basis that they would be carried out during line uprating projects and have, therefore, been included in the line uprating cost estimates. This was done on the assumption that the line uprating would be carried out under operational refurbishment and expensed and, therefore, it did not matter that the work was captured under refurbishment rather than maintenance.

It should be noted that ElectraNet SA has carried the increased risk of this deferred maintenance in order to provide the benefits of economies of scale to the end customer. It is also clear that the accumulation of these work orders means that the cost of maintenance on those lines has been less than normal in recent yeas (this needs to be taken into account in historical cost comparisons).

The deferred maintenance element of refurbishment that the ACCC has directed to be capitalised is, therefore, NOT part of the historical cost base.

In summary, the draft decision made no allowance for the approximately $4.3m per annum of refurbishment costs that the ACCC has directed to be capitalised, but which cannot be capitalised because they are either maintenance expenditures (broken insulator strings, conductor repairs and structural repairs) or replacement of parts of assets that are not capitalised even for accounting purposes (refer to details in Attachment 3 of ElectraNet SA Response to Meritec Opex Review).

Not increasing the opex allowance to include these costs will place increasing pressure on ElectraNet SA's ability to carry out this work and to deliver the program of work set out in its Asset Management Plan that was endorsed by the ACCC's consultant Meritec.

We also note that at our meeting on 23 October we provided you with remnant life information associated with the planned refurbishment works, which demonstrates that depreciating the capitalised refurbishment expenditure over a life of 10 years is more appropriate than the 15 years specified in the draft decision. Otherwise the assets to which the refurbished assets are attached will on average be written off earlier than the assets themselves.

Appendix B: Historical Cost Comparison

ElectraNet SA has stated many times that the historical cost base used by both Meritec and the ACCC is inappropriate and that operating costs in the years prior to 2001/02 were not typical of the costs required to operate a sustainable transmission business in South Australia because of spending constraints applied by the previous owner in the lead up to privatisation and by the new owners in the period immediately following privatisation. In our application, we have also noted that the current level of expenditure is not sustainable.

The figure below serves to illustrate the effects of the opex constraints in the lead up to and immediately following privatisation. The figure clearly demonstrates an increase in the backlog of substation work orders since 1997. Although the increase has levelled off, the residual level is significantly higher than before privatisation. This has contributed to the decline in performance demonstrated by ITOMS benchmarking for substation assets.

To compound the problem going forward, Meritec has reduced the amount allowed for network maintenance by approximately $3m per year over the regulatory period. This is despite ElectraNet SA implementing many improved efficiency measures including going to the market for a 5-year contract that achieves economies of scale through bundling of previously smaller contracts. This outcome will place considerable pressure on ElectraNet SA's ability to address the large backlog of work orders and to limit its further increase. Unless the final decision includes an adequate opex allowance our prediction is that the level of backlog will increase further resulting in a falling level of network reliability.

Increased maintenance service provider costs and other cost increases MUST be allowed unless the ACCC is prepared to accept a deteriorating level of network reliability.

Appendix C: Increases in Regulated Opex Allowance over 2001/02 (all figures in $ 2001/02)[1]

	$ Million		Description of Cost Item
Opex allowance sought by ElectraNet SA	61.4	2.5	Funding of employee superannuation
	58.9	1.2	Cost escalation linked to growth in asset base
	57.7	1.9	Site reparation and asset disposal costs associated with all capex projects. These costs are definitely not captured in asset valuation databases and must be expensed. They were part of "Other Refurbishment Projects".
	55.8	0.7	Increase in maintenance service contract unit costs despite going to the market for competitive prices.
	55.1	2.4	Costs to hedge risks of movement in interest rates during the regulatory period (on relation to capital expenditure program)
Opex allowance based on Meritec's endorsed cost items	52.7	4.3	Deferred maintenance and minor works included in the refurbishment costs directed by the ACCC to be capitalised, which may not be capitalised
	48.4	1.0	Additional resources required as a result of changes to the NEM and increased compliance costs.
ACCC draft decision $47m*	47.4	2.2	Self-insurance allowance for risks that are either not possible or uneconomic to insure.
	45.2	0.6	Directors fees/expenses associated with a private sector company
	44.6	0.6	Increase in insurance premiums due to hardening of the insurance market
	44.0	5.0	Operating projects to improve efficiencies, reduce risk and improve reliability identified in ElectraNet SA's Asset Management Plan. Note these projects were bundled together under "Other Refurbishment Projects" by Meritec – displacing the site reparation and project management costs that existed under this expense category in our application.
2001/02 regulated accounts	39.0		

Additional costs sought by ElectraNet SA and either overlooked or not recommended by Meritec

Additional costs sought by ElectraNet SA and endorsed by Meritec

* Includes $4m of grid support.

1 Refer to ElectraNet SA Response to Meritec Operational Expenditure Review, Attachment 2 (19 August 2002) and ElectraNet SA submission on the ACCC draft decision.