ECCSA: Comments on ElectraNet SA Revenue Cap Application

Introduction

ECCSA welcomes the opportunity to provide its initial views on ElectraNet SA's revenue cap application to the Australia Competition and Consumer Commission. These comments address the material submitted by ElectraNet SA in its Revenue Cap application and the Information contained therein.

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, Holden, Mitsubishi, OneSteel, WMC, Amcor, Kimberly Clark and Pasminco.

In broad terms, ECCSA has gained the impression that the application by ElectraNet would seem to imply that the ElectraNet assets are in an extremely run down state and that a >30% increase in revenue cap is immediately required to remedy this situation, with further increases of a similar order required over the five year term of the access arrangement. These very large increases in revenues are to meet proposed substantial increases in capital as well as non-capital costs. Unfortunately, although the application contains a certain amount of qualitative discussion to support its claim, a deeper independent assessment is difficult to make due to the extraordinary lack of quantitative data and appropriate information.

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.

ECCSA has sought to comment on those matters where ElectraNet has provided information to enable considered commentary to be undertaken. However, there are significant elements where considered comment is not possible and these are noted, along with our reasoning.

Information disclosure

It is accepted that any service provider, as with all competitive enterprises, seeks to maximise its revenue stream and so provide its shareholders with the

largest sustainable dividend. Costing of a service must provide sufficient return to maintain the enterprise's medium term viability. If the return sought is too high, the enterprise will suffer as competitors are drawn into the market, but if the return is too low, the enterprise will experience a lack of funds to maintain its business. Thus in a competitive environment the disciplines of competition focus the approach of the service provider in developing its pricing structure, so as to allow it to continue to provide its service in the medium term, in the face of competitive pressures from any competitor. Market disciplines drive an enterprise to moderate its approach when developing its pricing structure.

However there are no such competitive pressures on monopoly enterprises and regulation becomes the surrogate for replicating a competitive market. Notwithstanding the shortcomings of regulation as a surrogate for competition, it is the agreed methodology for reviewing the electricity transmission system, and therefore must provide the competitive rigor normally faced by enterprises in competitive market. Thus, regulation must be equally as rigorous as the pressures of real market competition.

One of the key aspects of competent and rigorous regulation when reviewing a proposed access arrangement is to gain informed input from a wide range of sources. One of the key sources of that input is from the parties who use the regulated services and are the ultimate providers of the revenue sought by the service provider. Failure to achieve informed input will result in poor outcomes, bringing dissatisfaction to interested parties and generating disputes.

Should there be insufficient information provided by the service provider, or if this information is declared to be "confidential", then the ability of the "interested parties" to provide a countervailing argument to that posed by the service provider or even to undertake an independent evaluation, is severely limited. By allowing a monopoly service provider to limit disclosure of information necessary to interested parties to provide a competent response to an application for regulated revenues, the regulator can become exposed to perceptions of bias. Full disclosure of information to interested parties allows a strong and competent response to applications from regulated enterprises, and allows the regulator to act as an impartial umpire. On the other hand, as the amount of information disclosed reduces, the regulator can be seen by the regulated enterprise to take on the role of surrogate advocate for users. It is thus a disappointment that service providers elect to minimise information disclosure, rather than face robust argument before an impartial regulator.

ECCSA is deeply concerned that ElectraNet has made minimal effort to provide information to justify or establish the merits of its proposals to either the ACCC or interested parties.

An additional point needs to be noted by the ACCC. ElectraNet is aware that the information it provides to ACCC and users will provide the basis of the decisions and recommendations made in regard to the access arrangements. We believe that there is a need for ElectraNet to declare that the information

provided is correct and that it takes full responsibility for any material errors included within the information provided.

In particular, ECCSA notes that ElectraNet has not provided:-

- Information on electricity demand and volume, either in the recent past or over the period of the access application. There is no data on the expected load variations over time, or of the load profiles and anticipated changes for each of the major usage zones. This information is required to assess the appropriateness of the proposed large capex sought ($400m) as well as the size and allocation of opex requested ($71m pa). [For example ElectraNet needs to identify that the capex targeted for augmentation in a specific area is needed to accommodate the growth identified for that area.] The demand profile and changes are required to assess the appropriateness of the nodal pricing ElectraNet has advised it intends to implement early in the access period. This move to nodal pricing is an attempt to more accurately allocate costs incurred for usage of the assets, and reflect the allocation of efficient actual costs to those using the specific assets.

- ElectraNet's asset register and management plan. This will enable assessment of the capacity of the assets to provide the services anticipated over the regulatory period. Information is required to assess the levels of O&M required, as well as the capex proposed. ElectraNet asserts that 24% of its assets are over 40 years old. However, the type and size of assets falling into this category need to be detailed as certain assets have a life considerably greater than 40 years, whereas others of this age may well require replacement. There are also trade-offs involving capex and opex. Equally there may not be a need to renew such assets if their usage is declining, or if they are approaching redundancy.

- Quantitative data to support its contention for the massive injection of capex, i.e. there is a need to provide the underlying assumptions behind the many capex proposals and the cost/benefit analysis undertaken to demonstrate the need for the capex.

- Information on its recent performance; financial, benchmarks, load changes, benefits arising from previous capex, should be provided for comparison to the forecasts. Previous annual reports provide some of this data but there is insufficient breakdown of this data for detailed investigation and comparison.

- A detailed breakdown of the "regulated opex forecasts". Currently opex is categorised into six elements, each totalling an average of $12 million pa. None of these has been benchmarked against current

expenditure in these categories, nor benchmarked against any similar enterprises, local or overseas.

- Minimum service standards against which future performance are to be assessed.

- Benchmarking against comparable networks. ElectraNet has sought to demonstrate that its network is dis-similar to those in Victoria, NSW and Queensland, but makes no attempt to identify networks of similar nature. Within Australia, it is possible that the WA network has more in common with ElectraNet, and there are regulated networks overseas which have similar characteristics. However, even the Queensland network bears some resemblance to ElectraNet, and could be used for some relevant benchmarking. ElectraNet observes (paras 4 and 6 page 3-10) that independent benchmarking confirms its efficiency, but no such assessment is provided nor is relevant information available to enable independent evaluation, and verification.

Cost of Capital

The cost of capital is a much contested issue in Australian regulatory reviews. There have been attempts to justify (almost to absurd lengths) the CAPM used on which to establish a reasonable return on funds employed by a regulated monopoly enterprise. Throughout Australia and the world, independent reviews have been undertaken of the entire CAPM calculation, through to minute elements of the model.

Benchmark WACC against the "real" world

Comparisons of returns for regulated enterprises with those achieved by competitive enterprises can be done at the macro level, providing that comparable valuation methodologies for assets involved are used. We believe that the returns earned by enterprises operating in the competitive world should be greater than those for monopoly enterprises facing far less risk of achieving a reasonable return on funds employed. Thus, ElectraNet would need to compare its planned return against the average of similar enterprises with a high capital base (such as manufacturing enterprises), adjusting for the basis for valuing funds employed (i.e. competitive industry assesses its asset based on depreciated historical cost – better known as DAC, whereas ElectraNet has built up the value of its asset base utilising the optimised deprival value (ODV) or depreciated optimised replacement cost (DORC), both of which result in a higher asset valuation than the (properly depreciated) actual cost used by publicly listed enterprises. The comparisons must be made on the basis of established and common accounting practices, for example, treating asset revaluations as income (the academic and technical literature support this – see for example Walker, Bob and Betty Con Walker: Privatisation: Sell off or sell one? The Australian experience. (2002))

Risk free rate of return

We support the ACCC approach to utilising the 5-year Government bond rate as the basis of the risk free rate of return. This approach is based on the sensible premise that as the regulatory period is five years then a regulated rate of return should be assessed against a risk free rate of a similar duration. ElectraNet has countered this by commenting that

- Its financing arrangements are of a longer duration than the 5-year term. This may be so, but the purpose of using the CAPM approach for regulatory returns is to provide a "vanilla" WACC, allowing the regulated enterprises freedom to act to source their funds in the most cost effective way to their particular financial structure.

- Its assets have a life beyond the 5 year regulatory period, and that the assessment of its value as an enterprise should be longer than 5 years. These statements may be true, but it should be noted that enterprises in true competition have their performance assessed over shorter periods than the 5 year window proposed, despite these enterprises having an expectation of a longer life due to the value of their assets. Some funds managers review corporate performance on a three month window, although most would assess performance over a 2-3 year period. Regulated enterprises would seem to be generously treated in comparison to enterprises in competitive markets whose revenues are not guaranteed in any way.

- Investment in infrastructure is a long term proposition, indicating the need for a longer outlook. Such a statement completely overlooks that many investments in the competitive world are made with a long term perspective (there are a number of manufacturing enterprises that have existed longer than ElectraNet), but these enterprises still need to comply with the market signals appropriate to their operation. In this regard it should be noted that such competitive enterprises do not have their sunk capital valued at replacement costs!

What ElectraNet has decided to overlook is that it has a guaranteed revenue stream for the next five years, and if it maintains its assets in a good operational order, it will have the right to guaranteed returns in future years. This is the risk free feature of being a regulated monopoly. There are many enterprises in Australia that would like to have this certainty of revenue without the risk of variable revenue they face on a daily basis. ElectraNet has also decided to overlook the fact that it can also exceed the regulated revenue cap by over-achieving cost efficiencies or growing the market.

Interest rate risk

The financing of the ElectraNet activities is totally at its own discretion. For it to be allowed to lay off the costs of some of this risk onto consumers outside of the risk margin on the risk free rate is entirely inappropriate. If these risks are to be added to the costs consumers are expected to fund, then the benefits should equally be passed onto consumers. The proposal put by ElectraNet exposes consumers to the downside of ElectraNet's approach to

financing, without consumers being able to benefit from the upside. This introduces a new meaning to the term “risk-free” for enterprises such as ElectraNet.

It should be noted that the risk free interest rate proposed for use in the CAPM approach already factors in likely movements in forward interest rates, and this is exemplified by the bond rate forward cost curve showing a rising trend.

The ACCC should reject this blatant attempt at “risk dumping” and inflating operating expenses to enable ElectraNet to optimise the benefits for its financing approach. It is appropriate to note that industry in the competitive environment has exactly the same risk with regard to interest rate movements; they manage the risks, and don’t or can’t pass them onto their customers!

It should be further recognised that ElectraNet is not proposing to offer a reduction in tariffs to consumers as a result of the benefits ElectraNet have gained from the fall in interest rates since January 2000.

Market risk premium

ElectraNet provides considerable discussion as to the market risk premium that should be applied to the CAPM calculation. What is deficient in the analysis is that the numbers apply to the **average of all risk-taking enterprises.** ElectraNet operates in a very low risk monopoly regime with a guaranteed revenue stream (with an ability to recover even higher revenues if it over achieves in its projected efficiency savings) and in an environment where sales are effectively underwritten by the mass of electricity consumers who have no short term alternative to taking electricity. To assume that ElectraNet should have a market risk premium which is even above the bottom of the MRP range is absurd, when comparisons of cash flow risks are made with real risk taking enterprises.

ECCSA is of the view that ACCC should set the MRP at the bottom of the range of all acceptable MRP’s.

Asset Beta

ECCSA is of the view that the asset beta for ElectraNet should reflect an industry where there is a guaranteed revenue stream with an extraordinarily and very inelastic market. To present electricity transmission companies as having a higher systemic risk than gas distribution companies (which are more exposed to by-pass) is entirely unfounded due to the inelastic nature of electricity consumption. Historically electricity transmission enterprises have shown a remarkably stable cash flow from their operations.

We note that ElectraNet considers that as it is a “small firm” it should be entitled to the “small firm” enhanced return. ElectraNet is not a small firm. It has assets, revenue and profit that takes it well up into the ranks of the larger companies listed on the ASX. It may be smaller than its equivalents in Victoria, NSW and Queensland, but this in itself does not rank it as a small

firm. In a later section on cost of debt ElectraNet highlights that it is of such a size that its debt requirements could not be handled by the Australian debt market, which would indicate that it is far from being a “small firm”.

However, we do note that ElectraNet believes that it should have a higher asset beta due to its high gearing. As the decision to gear high is one for the enterprise this aspect should not be considered. But the higher debt margins and debt servicing requirements should not simply be “pass-on” to consumers without the ACCC having due regard to industry norms (see below).

Cost of debt

ElectraNet has provided some support for its claimed debt premium. However, a review of the implied debt premiums (as determined by actual interest rate securities for enterprises with a guaranteed revenue and inelastic demand, such as banks) indicates that the debt premium sought by ElectraNet is at the high end of the range.

Further, ElectraNet adds that if the ACCC decision that the 5-year bond rate should apply as the basis for its regulatory return, it then must source its debt on a five year maturity. Again, it would seem that ElectraNet has confused the regulatory return with how it wishes to establish its financial arrangements.

A recent review of debt available for the risky business of gearing equity for the express purpose of acquisition of shares, shows that the cost of debt claimed by ElectraNet would seem place its business activities in the same category as share acquisition. There is no doubt that the guaranteed revenue stream which underpins a regulated business such as electricity transmission would be provided with a much lower debt rate than that available for share acquisition.

Gearing

ElectraNet agrees with the ACCC that 60% gearing is appropriate for setting the regulatory return as it is the current industry norm. This not surprising as ElectraNet has advised ECCSA late in April, that its gearing was actually about 80%, giving it the benefit of an implied higher yield on its equity element.

This observation is consistent with the actual gearing used by many other companies holding exclusively regulated assets. Gearing used for infrastructure with guaranteed revenue (such as dedicated cogeneration schemes) consistently lies at the 70% level or higher, and it would appear that with over seven years experience with the newly regulated Australian gas and electricity infrastructure, the gearing level of 60% which was used in the early days of regulation would appear to be a very conservative assessment.

ECCSA is of the view that with the prevailing high levels of gearing possible for regulated infrastructure, there is a strong case for the ACCC to review the gearing levels assumed for the past 6-7 years. Gearing at 70% would appear

to replicate the actual financing environment for regulated enterprises more appropriately than the current level of 60%.

A review of the publicly advertised debt available for purchasing of shares shows a level of gearing for such a high risk business at 70% is the norm, with even 75% offered. An electricity transmission business with its large asset base, stable business and secure cash flow should be recognised as being able to gear above the now very conservative level of 60%.

Asymmetric risk factors

We note that ElectraNet has identified certain aspects of its business where it would appear to have some exposure, which it believes are not included in its risk premiums. However, it is inappropriate for ElectraNet to attempt to isolate specific risks which are normally borne by competitive enterprises as part of their normal trading, and then to seek a risk premium of a similar magnitude to the average premiums encountered by enterprises in a competitive environment.

We would advise that such risks as noted by ElectraNet are either minimal or should already be absorbed in the risk premium. Alternatively, ElectraNet should be allocated a lower risk premium to allow for the separate costing of these risks.

We would however comment on some of the specific risk areas noted by ElectraNet:-

- The use of gas has little impact on electricity consumption due to the inelastic market for electricity, and ElectraNet has noted that it expects electricity demand to increase over the regulatory period (although it has not sought to quantify the increase). Thus the likelihood of asset stranding from growth in gas demand is unlikely.

- ElectraNet purchased the right to the transmission assets knowing the valuation placed on the assets as part of the EPO. Any review by ACCC will only impact on the next regulatory period rather than that involved with the current application, therefore the ElectraNet claim of the risk of regulatory change has no validity for this application.

- The impact of the CoAG review (as with possible changes to other government policies) will not impact on the current application. However, we are not opposed to trigger mechanisms to re-open the ElectraNet access proposal if this is what ElectraNet wish.

- ElectraNet was aware of the intrinsic characteristics of the network when it purchased the right to the assets and consumers should not be expected to underwrite any shortcomings in ElectraNet's commercial decisions.

- The review of the ACCC's Draft Regulatory Principles should not affect the current review, as the completion of the review of the Regulatory Principles is scheduled for later completion than the review of this application.

Bearing these points in mind there are no grounds for an asymmetric premium to be applied to the ElectraNet return

WACC calculation

The ACCC should develop its own WACC assessment on the basis of the points made above, particularly those surrounding ElectraNet's claims for a higher WACC based on higher risk margins. Further, as suggested in the earlier part of this submission, ACCC should benchmark the WACC calculated by it with returns achieved in competitive industry of a similar capital investment structure (i.e. high capital investment, such as manufacturing industries) to assess that the returns to a monopolistic and secure revenue flow enterprise, such as ElectraNet, do not exceed (indeed should be less than) those achieved by enterprises engaged in competitive markets.

Market inelasticity

ECCSA has referred a number of times to the inelasticity of the electricity market. It is appropriate therefore to explain why this is so.

Electricity is used principally for power transference (stationary motors), for illumination (lighting), and localised heating (infrared heating). In each of these uses it has virtually no competition. It is also used for space and water heating (where it competes with oil, gas and wood) and space cooling (where it has some but minimal competition from gas). It is little used for power transference involving mobile power transference (automobiles) where oil (petrol) has the largest market share.

Thus for ElectraNet to say that electricity is at risk from competition from gas patently overlooks the fact that essentially electricity has its own market but that it also attempts to compete in markets perhaps better served by other forms of energy such as heating.

It should be noted that at the domestic level the cost of electricity (per unit of energy) is four times the cost of gas, and at an industrial level the cost differential is of a similar magnitude. Despite such wide cost disparities electricity is penetrating markets served by gas due to its intrinsic benefits of convenience and ease of use and lack of combustion products which have to be exhausted when using gas, whereas gas has not penetrated the markets where electricity has become the only source of energy for the needs.

Where ElectraNet can claim some competition from gas is in the area of localised power generation fired by gas. However if closer examination is made of the economics of localised gas fired generation, then it becomes

quite obvious that electricity transport from large low cost power stations to the large majority of electricity users, is a remarkably stable enterprise.

ECCSA would be pleased to explain this view in more detail, but that a number of ECCSA members have actively reviewed the benefits of localised power generation and have not moved to this option, stands testament to the cost efficiency of large remote power stations connected to consumers by the ElectraNet transmission system.

Asset Base

ElectraNet shows markedly different asset values in its annual reports compared to those claimed in Table 5.3 of its revenue cap application. Asset values in ElectraNet's annual reports for (years ending 30 June) for 1997/98 were $637 million, $688 million in 1998/99, and $708 million in 1999/2000. These differences need to be reconciled and stakeholders provided with explanations.

It is also noted that capex since the purchase of the rights to the assets by ElectraNet has been quite substantial and a cost/benefit assessment needs to be provided to ensure that investments have been prudent and can be economically justified.

Asset revaluation

Of great concern to ECCSA is ElectraNet's claim for a massive asset revaluation and asset growth in the two years since the valuation underpinning the sale of the lease of the assets.

ECCSA does not accept that there is a case for amending the jurisdictional asset base valuation. Any errors and omissions were matters for the South Australian Government and the purchasers of ElectraNet to resolve at the time of the purchase of the lease, and should not automatically be passed-through to consumers to make good.

The regulatory asset base established in the South Australian Government Electricity Pricing Order as of 1 July 1999 cannot be legally adjusted. Therefore, rolling-forward the jurisdictional asset base (to included capital additional and disposals, depreciation and inflation) will provide the regulatory asset base valuation to apply on 1 January 2003. No other method to arrive at the asset base at 1 January 2003 is permitted under the National Electricity Code.

Accordingly, ECCSA considers that the ElectraNet claims for an upward adjustment of $44.6 million in 1998/99 to account for interest during construction must be rejected. Omission of that amount alleged by ElectraNet was a matter for it to pursue with the South Australian Government.

Similarly, the claim for an easement adjustment of $123 million (revised to $215.3 million in a later submission) which ElectraNet claims was omitted

from the jurisdictional asset base should have been pursued by ElectraNet with the South Australian Government. ElectraNet purchased the asset rights on the basis of a $3 million value for easements. The matter should rest there. To claim an upwards adjustment of $215 million which consumers have to now pay for because of an "error" by the South Australian Government is akin to passing on ElectraNet commercial risks to customers.

ElectraNet makes much of its supporting claims by reference to a South Australian Government letter of 10 August 2001 which is said to have "confirmed these material omissions". Whilst the ECCSA formally requests that the letter should be made publicly available for scrutiny as ElectraNet claims it sustains its right to the revaluation, we consider that its impact could well be disregarded as its impact should not influence the basic approach to asset valuation implicit in the Code.

The effect of the increased valuation of easements and IDC

ElectraNet notes that the valuation of easements included in the current RAB is $3.1M and that an amount of $3.9M was included for financing construction. Both of these amounts were included in the RAB at the time ElectraNet was purchased by the current owners and it was on this RAB valuation that ElectraNet was purchased.

ElectraNet has requested an additional $163.7M ($123M for easements and an additional $40.7M for interest during construction) in its original submission. It then provided a supplementary submission requesting the easement valuation be increased to $215.3M. ECCSA contends that adding an implied value for easements is not only incorrect but inappropriate (refer to comments made above).

However should the ACCC permit the increase in asset valuation requested by ElectraNet (ie a total of $255M) then, over the next twenty five years, the return on the additional amount allowed would equal two thirds of the lease purchase price of $930M paid for ElectraNet on a nominal basis or on the more conservative NPV basis, it would effectively "gift" to the shareholders of ElectraNet nearly one third of the purchase price.

Inconsistencies with the asset base roll forward

As well as the amounts for the opening asset values, the amounts for capex and depreciation in table 5.3 bear little relationship to the actual values included in the audited balance sheets for equivalent years. There needs to be either an explanation as to why the audited figures are incorrect, or a reconciliation calculation demonstrating that table 5.3 replicates actuality.

Implicit in the asset base roll forward calculation, but hidden within the calculation of economic depreciation, is the inclusion of the impact of the GST introduction. This has had the effect of over-inflating the asset base roll forward, and needs to be deleted.

ElectraNet has requested the inclusion of assets (valued at $12.9M) optimised out of the asset base by the previous owner, but now stated as being needed by ElectraNet. There is no substantiation of what these “readmitted” assets are, why they are now required, their location or what service they will perform. These assets effectively fall into the category of capex and so details are required for the resuming of the assets to be clearly shown with demonstration of the cost/benefit they provide, just as if they constitute capex. ECCSA formally requests that the SKM review be made available for public scrutiny.

Capex

ElectraNet has advised of the need for $400M in capex to be expended over the 5 year regulatory period of the application. The current value of the ElectraNet assets (refer to the 2000 Annual report) was $708M. The proposed capex injection is over half of the current value of the assets in place.

It must be recognised that capex is applied at a local level – it is not “smeared” over all existing assets. Thus an explanation of capex needs requires an explanation of the specific needs of the locale where the capex is targeted. 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.

Current asset valuation of substations is $303M and ElectraNet proposes to spend $227M of its capex (some two thirds of the total) on substations. ElectraNet has indicated that its assets have an age profile indicating a significant proportion (perhaps as high as 30%) of its substation assets will approach their “end of life” during the period of the application. This would appear to be the total extent of the justification of the capex needs. ElectraNet has not provided any cost/benefit analyses for any of the proposed refurbishment. Equally ElectraNet has claimed the need for additional opex due to the aged nature of the substation assets. One of the prime reasons for capex is to reduce opex needs.

On a small graph, ElectraNet has indicated that the expected demand might increase by as much as 25% over the period from 2000 to 2008. Total volume forecasts are not provided. The implication of the information provided is that the increase in demand is evenly spread over the whole of the network. However, as there is no data provided on the location of where this demand growth is likely to be (NEMMCo advice is that the growth in demand is primarily related to air-conditioner load in the Adelaide region exhibiting needle peaks rather than an increase in the volume of electricity used). ECCSA accepts that transmission assets need to be sized to accommodate demand but as noted above the actual location and magnitude of demand growth at each location is essential if users are to understand and

acknowledge the magnitude of the capex that is needed to be allocated for the system.

ElectraNet should provide data on load growth by location, and current capacity at each location, to substantiate the need for capex to augment the system

Depreciation

There is inconsistency between the amounts for depreciation shown in Annual reports for 1999 and 2000 to the amounts shown for depreciation in Table 5.3. Depreciation allowances in previous years were $24M (97/98), $28M (98/99) and $26M (99/00). ElectraNet should explain the differences, and why amounts from the audited accounts for previous years should not the used in preference to the table 5.3 numbers. ECCSA believes that audited accounts are an excellent basis for establishing the appropriate depreciation for the asset base.

In its submission ElectraNet has observed that depreciation amounts need to be adjusted for inflation, but then provides no calculations for their derivation. However the amount of depreciation allowed in developing the new asset base (table 5.3) appears to be significantly understated but in the new depreciation allowance schedule (tables 7.1 and 7.2) the amounts are of a similar size to the previous actual amounts, and again ElectraNet provides no calculations or explanations for their derivation.

Without the benefit of calculations, the amounts included for depreciation appear too high and make no allowance for depreciation of the capex spent during the period.

Operating and maintenance expenditure (Opex)

As with a number of earlier aspects of the ElectraNet submission, there is little quantitative data provided which allows for a competent review of the large increase in opex sought by ElectraNet.

ElectraNet states in its submission (page 8-1) that its opex only comprises "… about 3% of end use customer bills." ECCSA would point out that regardless of the relative value of costs to be added to the regulatory bargain, every cost must be sustainable, efficient and reasonable. ElectraNet advises on page 8-3 that benchmarking shows its costs performance places it as "…a leading performer amongst transmission companies worldwide." No benchmark figures are provided to support this statement.

According to annual reports for 1999 and 2000 operating expenditures were $41M (6/98), $41M (6/99) and $34 (6/00). The amounts sought in the new period range around $71M pa in current dollars. There is little explanation for the increased amounts claimed other than to advise that ageing assets need more opex (but this is at odds with recent previous opex figures), that

reliability might suffer (but this is equally an issue for all other transmission companies, and ElectraNet's actual recent performance belies this statement), ElectraNet needs a massive capex injection (which should reduce opex), and that insurance premiums might rise.

ElectraNet provides one performance benchmark to demonstrate its need for increased opex. ECCSA would comment that care is needed in using just one benchmark, when other benchmarks indicate performance may be adequate. We understand the ITOMS assessment measures actual downtime for each plant item. If there is significant redundancy built into the design of elements of the network, then allowance for greater downtime can be tolerated due to the greater capital invested. Thus there is a need to balance a number of elements when placing reliance on just one benchmark. Of interest is that ElectraNet's relative position on the ITOMS scale has deteriorated so markedly in only the last two years, the time since the right to the assets was sold.

ElectraNet refers to a benchmarking study comparing it to a study undertaken of distribution networks and rail systems. From it ElectraNet draws the conclusion that it compares well these apparently unrelated businesses. We believe that ElectraNet should be compared to its equivalents, such as the transmission businesses in Australia and overseas.

It is noted that ElectraNet identifies a number of aspects where it contends its network is different to other networks, but does not provide any figures which can be used in comparison. We would contend that in many ways ElectraNet can be compared to the Queensland system and perhaps the WA system, but with overseas networks as well.

An initial review of the apparent differences ElectraNet highlights, leads us to comment on the cost drivers ElectraNet has listed to sustain its claim for increased opex.

- Whilst a peaky load profile has an impact on the sizing of equipment it has little impact on the extent of opex required.

- South Australian does have a low load duration profile but this again is more reflected in the sizing of equipment rather than implying a higher opex is justified.

- South Australia does have a low load density, but comparisons with other states such as Queensland and WA can be made as they also have low load densities.

- The relationship of geographic area for ElectraNet coverage is similar to its equivalents in WA and Queensland.

- PowerNet in Victoria would appear to have an older network, so comparisons are still possible.

- Loading on the SA-Vic interconnector is high during the summer months and is needed to be available to minimise generators raising prices at this time, but as with generation assets, most of the maintenance of the interconnector can be scheduled during the autumn and spring when the need for the interconnector is much lower.

- As mentioned earlier while ElectraNet is a smaller business than its equivalents in NSW, Queensland and Victoria, it is still a large business compared to most businesses in Australia. The new WA transmission business and Tasmania's Transend will be of a similar size or smaller.

- While ElectraNet is required under its licence to meet certain performance standards, it has not been demonstrated that the operating performance of ElectraNet has achieved a performance level exceeding the equivalent operations in other States.

ElectraNet states that it requires nearly twice the level of opex spent in 1998, 1999 and 2000. It categorises its needs into

- Network maintenance. It provides one benchmark to imply that its previous performance is excellent but provides no comparative costings to support an enhancement of funds requested, nor does it compare future allowances with past expenditure. It states the need for additional opex due to an increase in assets used, however it should be noted that a large proportion of the asset increase comes from a claim to include the value of easements into the asset base.

- Network refurbishment. There is no data or comparisons provided for any analysis which supports the level of opex requested, nor does it compare future allowances with past expenditure.

- Network monitoring and control. There is no comparative data provided to support the level of opex requested, nor does it compare future allowances with past expenditure.

- Corporate costs. ElectraNet refers to a study comparing it to electricity distribution businesses and rail systems in Victoria. It provides no comparisons to other transmission businesses, nor does it compare future allowances with past expenditure.

- Risk management. There is no comparative data provided to assess the reasonableness of the amount stated, nor does it compare future allowances with past expenditure.

- Imposed costs. There is no comparative data provided to assess the reasonableness of the amount stated, nor does it compare future allowances with past expenditure.

- Pass through costs. ElectraNet should detail how theses risks were managed in previous times and the costs involved.

Overall ElectraNet has claimed nearly a doubling of its opex and proposes excluding certain pass through costs which were included in the actual costs of previous years. There is little or no quantitative comparative data provided, either from the past activities of ElectraNet or from organisations carrying out similar activities.

Service standards

ElectraNet has provided an amount of qualitative commentary on the importance of useful, measurable and comparative technical benchmarks. It refers to the current ACCC program to develop consistent, useful and measurable benchmarks for the comparative study of transmission businesses. ECCSA supports the establishment of universal performance benchmarks and has already contributed to the ACCC study.

We consider that in the interim, ElectraNet should be required to comply with the standards set by the NEC and the terms of its SA licence, as well as with the comparative performances of the other transmission businesses. There must be a penalty imposed on ElectraNet for failure to meet these standards.

However ElectraNet makes no reference to performance benchmarks for its investment activities, such as capex and opex. ElectraNet needs to be able to demonstrate that the allowances permitted to be incorporated in the regulated costs, do in fact result in the outcomes stated. ElectraNet must develop and institute performance benchmarking which clearly demonstrates that the opex and capex allowed has been sensibly and wisely spent.

Conclusions and Recommendations

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 (some 167 pages) of which nearly half is devoted to demonstrating there is a need for an increase in WACC. However there is very modest 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.

There is no doubt that the submission from ElectraNet provides inadequate disclosure of the information required to satisfy either the ACCC or end users of the amounts ElectraNet claims as being needed to sustain the South Australian transmission system.

It would appear that there a number of “ambit” elements within the application, such as the roll-in of easement costs, IDC and readmitted assets. Its claim for such a high WACC would permit ElectraNet a return exceeding those granted

other similar businesses in Australia, and probably those gained by businesses in a competitive environment as well.

Regulation is at best a surrogate for ensuring the rigours of competition are applied to the regulated business. Benchmarking against world's best performance is the only way a regulated business can be subject to the rigours of competition. ElectraNet has provided almost no benchmarking to sustain the costs claimed as part of its new revenue cap.

But underlying the whole of the submission, there is a major lack of detailed quantitative substantiation and comparative data, and the submission even excludes comparison with its own historic performance.

We therefore formally recommend the ACCC require ElectraNet to provide substantiation to demonstrate that the many anomalies throughout its submission (some of which are identified by ECCSA above) are more fully investigated. In particular we require ElectraNet to provide:-

1. More and appropriate benchmarking data
2. More and appropriate comparative data, including ElectraNet historic costs
3. Build up of the many costs used to support its claims and the calculation tables included in the submission
4. Substantiation for its implicit claim that it should receive a WACC exceeding that for enterprises in the competitive environment
5. Quantitative data demonstrating the cost/benefit of the capex claimed both past and future, to show compliance with the requirement for prudent investment
6. Quantitative data demonstrating the appropriateness of a doubling of the opex needed to run the transmission business