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Memo

To Sarah Clancy, ACCC

From Bruce Mountain

Topic Opex efficiency

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Sarah

You asked us to investigate TransGrid's claim of a 25 real decrease in opex costs from 1995/6 to 2002/3, on the basis of the information currently available to us. If the claimed historic reduction in opex is correct, it would be appropriate to take this into account when considering any expected future efficiency improvement.

Following the meeting with TransGrid on Friday 1 October, the ACCC has been provided with historic annual accounts back to 1995/6. In its April 1999 report, as I explained in the meeting with TransGrid on Friday, PB Power cited TransGrid's annual reports as the source of their stated opex from 1995/6 to 1997/8. Phil Gall explained that as far as he was concerned it was not clear where PB Power had obtained their data from.

I have now reviewed the annual accounts against the numbers presented in the PB Power report and there is an exact match. In other words the PB Power numbers are indeed based on TransGrid's published accounts, as PB Power claim.

In their August response to the ACCC's Draft Decision, TransGrid claim that regulated opex in 1995/6 was $129.7m. They explained how they arrived at this number in their response to ACCC-040820-63-1. This calculates opex as Total Operating Expenditure less Depreciation less Financing Charges. However, they have failed to also subtract the Depreciated Value of Non Current Assets Sold. The Depreciated Value of Non Current Assets Sold has nothing to do with expenditure related to the operation of TransGrid's business in the relevant financial year – it is purely an accounting adjustment to write-down the remaining value of non-current assets that are sold before they are fully depreciated (i.e. to charge this amount to the profit and loss and account). Such an adjustment is necessary because the Proceeds from Sales of Non Current Assets is reflected in the calculation of Operating Revenue. If the adjustment was not made then the calculation of profit would wrongly reflect the revenue from the sale of assets, but not the cost of those assets sold.

Unless we have missed something, it seems clear that the calculation of opex should not include such depreciation adjustments. Once this error has been corrected, TransGrid's analysis would otherwise agree with their reported 1995/6 accounts and with the opex numbers quoted by PB Power. Accordingly I believe that the correct 1995/6 number for total opex (regulated plus unregulated) is $123.73m.

The next issue is to subtract from total opex, the expenditure associated with unregulated activities. In their reply to ACCC-040901-65-1, TransGrid say that the expenditure on unregulated activities in 1995/6 was "probably materially less than $300,000". They have based this on the reported revenue of $316 939.74 under an account heading called External Project Work in 1996. External Project Work is an account heading that was used in TransGrid's published accounts from 1997 to 2000.

The External Project Work (EPW) heading was only introduced in the 1997 accounts. However, in the 1997 accounts comparative figures for EPW were produced for 1996 – although the original 1996 accounts did not contain the cost category EPW. The 1997 accounts show that EPW revenue increased from just $0.314m in 1996 to $5.7m to 1997. We have no reason to believe that there was suddenly a change in business activity and "unregulated" work that would result in such a sharp jump in revenues from one year to the next. Accordingly, it seems reasonable to suggest that this is an accounting aberration i.e. that the revenue that was recorded under External Project Works (EPW) in 1997 did not cover the same activities as the revenue under this heading for 1996. This interpretation is supported by the sharp off-setting drop in "Sundry" revenue from $6.7m in 1996 to $1.9m in 1997.

Furthermore, we note that in the ACCC's 1999 Draft Decision, the ACCC reported that "TransGrid earns a relatively small proportion of its total revenues through unregulated work"[1] and it then described the way that costs are allocated between regulated and unregulated business "by way of a burden rate on labour for engineering consultancy and labour hire business which includes most indirect labour costs, depreciation and insurance but no allowance for financing or corporate overheads".[2] TransGrid also noted in a submission by IPART in September 1998 that "(unregulated services) account for less than 3% of TransGrid's total revenue".[3] Three percent of TransGrid revenues in 1996 equals around 3%*$396m = $11.88m. In this case, there is no way that the amount that was recorded under the heading EPW in 1996 i.e. $0.37m - can be taken to represent unregulated revenue. Again, unless we have missed something, it is not clear to us why in their answer to ACCC-040901-

[1] ACCC 1999 Draft Decision, Page 62

[2] Ibid page 62.

[3] Special Reference on Electricity By The Premier of NSW: Submission to IPART by TransGrid, September 1998.

65-1, TransGrid has claimed that the revenue under EPW in the 1996 accounts represents the revenue associated with unregulated services, when it seems clear that this not the case.

In their April 1999 report PB Power produced numbers for the revenue and cost of TransGrid's unregulated business. The source of this information is not referenced, although they do refer to a TransGrid "business plan" after a table on page 11 of their report that contains numbers on the cost and revenue of non-regulated business. We have been unable to obtain business plans submitted as part of the 1999 revenue reset from the ACCC's archives. We suggest that it would be useful to request TransGrid to resupply copies of all business plans submitted to the ACCC during the 1999 revenue reset and in particular the September 1998 proposal. However, in the absence of this information, for the reasons discussed above, PB Power's claim of $2.37m cost of unregulated business, attached to $3.12m of revenue from non-regulated business in 1995/6 seems at least plausible – although it nevertheless a good deal lower than the "less than 3%" figure – i.e. $11.9m that what TransGrid claimed in 1998. Nevertheless in the absence of information to the contrary, we satisfied to proceed on the basis that PB Power's claim of Regulated Operating Expenses (being total opex less unregulated opex) of $121.4m in 1995/6 is credible.

The next issue to consider is whether there were any changes in accounting policy which may have affected the reported operating expenditure from one year to the next. In this regard we note that PB Power's April 1999 report, the ACCC's 1999 Decision and the 2000 Final Decision all mentioned a change in accounting policy from 1998 to 1999 that resulted in the capitalisation of overheads related to investment activities. In the meeting with TransGrid on 1 October 2004, Phil Gall confirmed that overheads are capitalised as a fixed proportion of capital expenditure.

However, in their reply to ACCC-040820-63-2, TransGrid say that there was no change in accounting policy that has affected the reporting of opex since the formation of TransGrid in 1995, other than the change of the capitalisation threshold. This is clearly contradicted by PB Power's April 1999 Report and the ACCC's 1999 Draft and 2000 Final Decisions. In particular, the 1999 Draft Decision repeated PB Power's claim that "*TransGrid in the past had only capitalised direct labour cost and had not made any allowance for other associated costs such as overheads, supervision etc*. *The revised approach is considered appropriate and TransGrid have confirmed their direction with independent advice.*"[4] As far as we are aware TransGrid did not refute this claim at the time of the revenue reset. For example, in their response to the ACCC's Draft Decision, TransGrid made no mention of this significant issue.

This conflicting information leaves us with a quandary. Essentially we need to decide which of PB Power's and TransGrid's claims are credible. On balance we consider that it is more reasonable to believe PB Power's claim former because their claim was open to public scrutiny and if it was wrong TransGrid had plenty of opportunity to point this out at the time.

[4] PB Power, 1999. Page 9.

Furthermore we consider that it is highly unlikely that PB Power would have invented this claim, and even less likely that they would have put on record that the change in accounting policy had been confirmed with “independent advice”, if this was not indeed so.

Moving on, the next issue therefore is how the reported opex numbers since 1998 should be adjusted to take account of the change of accounting policy. PB Power reported a $5.2m reduction in capex from 1997/8 to 1998/9 attributable to the capitalisation of overheads. In 1998/9 the reported cash expenditure in Property, Plant and Equipment was $52,875m. The quotient of these two figures is 9.8%. The reported cash expenditure on Property, Plant and Equipment is known in the annual accounts from 1995/6 to the 2002/3. Applying the same proportion of 9.8% of reported expenditure on Property, Plant and Equipment in 2002/3, gives an adjustment in that year of 9.8% of $240,355m = $23.64m. In other words, to properly compare the 1995/6 and 2002/3 reported opex numbers, the 2002/3 numbers need to be augmented by $23.64m to ensure a like-with-like comparison. The same proportionate adjustment needs to made in all years from 1998 onwards.

Finally, an adjustment needs to be made for the increased opex as a result of the acquisition of Snowy Hydro’s transmission assets. TransGrid have claimed that the ACCC’s decision allowed opex to Snowy of $3m per year, and therefore that to ensure a like-with-like comparison, TransGrid’s reported opex should be adjusted by $3m from the time that these assets were acquired. We have not verified the claim that the ACCC had allowed $3m for the Snowy Assets. However, even if the ACCC had allowed this amount, we believe that TransGrid’s actual costs would increase by very much less than this in view of the economies of scale and scope, and the ability to avoid a large part of the overhead cost, that as a separate owner of these assets, Snowy Hydro would have had to sustain. The issue of the correct opex adjustment for Snowy was raised in our meeting with TransGrid on 24 September 2004 and TransGrid undertook to respond to this. Until this response arrives, I have assumed an annual opex increase of $1m per year following the acquisition of the Snowy Hydro assets.

Conclusions

Taken together, the adjustments and corrections identified in this note mean that for the period 1995/6 to 2002/3, TransGrid’s opex has decreased by 5.8% in constant currency, as described in the calculation in Appendix A. In other words, in our view TransGrid’s claimed *decrease* in opex from 1995/6 to 2002/3 of 25% in real terms is not sustained by the facts. Furthermore, as our analysis in Appendix A shows, TransGrid has significantly *increased* opex in real terms by 12.6% between 1999 and 2004. The difference between TransGrid’s calculation and our analysis appears to be attributable to:

- accounting errors (such as the inclusion of the Depreciated Value of Non-Current Assets Sold in the claim for operating cost; and a misrepresentation of the value of unregulated business operating costs in 1995/6);

- a serious inconsistency between a stated accounting change publicly disclosed in the course of the 1999 revenue reset, and TransGrid's current claim that no such change in accounting policy had occurred.

It may be the case that the "true" calculation (in accounting terms) of the percentage change in opex will be different to the 5.8% real decrease that we have calculated. This could be attributable to one of three factors:

- a more accurate calculation of the cost of the unregulated business in 1995/6, and a more accurate calculation of the adjustment for the capitalisation of overheads: In the case of the former, we believe that the data suggests that the actual figure for unregulated opex in 1996 could be substantially lower than the $121m estimate produced by PB Power. This could mean that the actual change in opex costs from 1995/6 to 2002/3 would be substantially increased from the 5.8% decrease that we have calculated;
- a more accurate calculation of capitalised overheads: We have based our calculation on information verbally communicated by Phil Gall to the ACCC at the meeting on 1 October We can not tell whether a more precise calculation would materially affect the result we have derived;
- a more accurate calculation of the incremental overhead attributable to the acquisition of the Snowy Hydro transmission assets. This is unlikely to make much difference.

Appendix A

95/6	96/7	97/8	98/9	99/00	00/01	01/02	02/03	03/04	
			61	195	171	229.2	225	251.3	Actual capex from accounts to 02/03. From Revenue Reset fo
									PB Power data from 95/6 to 98/9. TransGrid 2004 Revenue R
$121	$115	$114	$100	$100	$102	$103	$114	$117	thereafter.
		$5	$6	$19	$17	$22	$22	$25	Adjustment for change in capitalisation policy in 1998/9
							-$1	-$1	Adjustment for acqusition of Snowy Hydro transmission
$121	$115	$109	$106	$120	$119	$125	$135	$141	TG total after change in capitalisation policy and Snowy in mo
119.8	120.2	121	122.3	126.2	133.8	137.6	141.3	144.8	Price Index
$121	$114	$108	$104	$113	$106	$109	$114	$117	TG total in constant currency
	-5.84%	-11.11%	-14.74%	-6.56%	-12.42%	-10.03%	-5.83%	-4.03%	% change starting from 95/6
		-5.60%	-9.45%	-0.76%	-6.99%	-4.45%	0.01%	1.92%	% change starting from 96/7
			-4.08%	5.12%	-1.47%	1.22%	5.94%	7.96%	% change starting from 97/8
				9.59%	2.72%	5.52%	10.45%	12.55%	% change starting from 98/9
					-6.27%	-3.72%	0.78%	2.70%	% change starting from 99/00
						2.56%	7.05%	8.97%	% change starting from 00/01