ElectraNet SA

Response to Meritec Operational Expenditure Review

19 August 2002

ElectraNet SA
electricity transmission network

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1. Introduction

ElectraNet SA submitted a revenue cap application to the ACCC on 16 April 2002 setting out its total revenue requirement for the five and a half year regulatory period from 1 January 2003 to 30 June 2008[1].

As part of its inquiry, the ACCC engaged Meritec to conduct a review that analyses and comments on ElectraNet SA's proposed opening asset value, capital expenditure and operation and maintenance expenditure allowances.

The ACCC published and invited comments on a Meritec report of its Operational Expenditure Review on 5 August 2002[2].

This paper provides ElectraNet SA's response to the Meritec report.

2. Synopsis

The key conclusions reached are summarised as follows:

- Meritec endorsed ElectraNet SA's proposed opex allowance for direct operational costs, but recommended significant cuts in the area of indirect (or non-network) operational costs. Meritec reached this conclusion because of a number of incorrect assumptions made in its process of mapping the proposed opex allowance to outdated 1999/2000 historical costs that were reported against completely different cost categories.

- Meritec incorrectly used 1999/2000 as the base year for its assessment, which was a particularly low expenditure year because of SA Government enforced restrictions in the lead up to the sale process and the diversion of significant resources to support the sale process and year 2000 computer rectification activities. The process followed by Meritec did not take into account real cost increases of $5.8 million or 17% between the years 1999/2000 and 2001/02.

- As a result of the above deficiencies, Meritec has inadvertently omitted costs to the value of $3 million per annum from the recommended opex allowance (based only on cost items that Meritec has endorsed in its report). These costs must be added to the recommended opex allowance.

- Meritec has also omitted a number of significant cost items to the value of $8.7 million per annum that were removed with insufficient or no justification other than they did not reconcile with their base cost model. These items represent real costs that must be incurred by ElectraNet SA and they should be included in the opex allowance.

- Meritec endorsed ElectraNet SA's proposed expenditure on asset refurbishment, but the ACCC directed Meritec to treat this expenditure as capex when most of it was included as opex in ElectraNet SA's revenue cap application. The ACCC direction has been made without any justification or reference to the current accounting practices of other TNSPs, Australian Accounting Standards or the appropriateness of capitalising this expenditure. A detailed review of the

1 "ElectraNet SA Transmission Network Revenue Cap Application 2003 – 2007/08", submitted to the ACCC on 16 April 2002.

2 www.accc.gov.au

refurbishment expenditure has identified $23.5 million of the refurbishment works over the regulatory period that must be expensed and not capitalised in order to comply with accounting standards. These costs must, therefore, be added back to the opex allowance even if the ACCC persists with its direction to treat refurbishment expenditure as capital.

The ACCC and interested parties must recognise that the cost items that Meritec has inadvertently excluded from their recommended opex allowance and those that were specifically excluded represent real costs that must be incurred by the business. Failure to include these will simply limit the funds available to make the necessary expenditures on asset maintenance, monitoring and control, asset renewals and refurbishment proposed in ElectraNet SA's Asset Management Plan and endorsed by Meritec. Failure to carry out this work on the network will be to the detriment of customer service and reliability.

3. Findings of the Meritec Report

Meritec found that ElectraNet SA has a sound asset management process in place consistent with good electricity industry practice.

> *"ElectraNet SA has an established, robust asset management process. It is sound and consistent with transmission network asset management practices elsewhere"[3].*

Meritec reviewed ElectraNet SA's current Asset Management Plan, which provides details on:

- Asset management drivers;
- Asset management processes including planning, asset creation, maintenance, operations and end of life treatment;
- Performance and asset age profiles;
- Proposals for capex asset augmentation and renewals; and
- Details regarding refurbishment, condition monitoring and other operating projects.

Meritec concluded that:

> *"ElectraNet SA's asset management plan is comprehensive in that it links asset management strategies to the required levels of performance and other drivers. The planning approach is satisfactory and the tools used appear to be effective"[4].*

Meritec has endorsed ElectraNet SA's asset management plan and the need for the operating expenditure itemised in the plan (although the ACCC has incorrectly directed Meritec to move all refurbishment projects from opex to capex).

We note that the direction by the ACCC to move all refurbishment projects from opex to capex has been made without any justification or reference to the current accounting

[3] "ElectraNet SA Operational Expenditure Review", Meritec report, July 2002, p1.
[4] Ibid, p18.

practices of other TNSPs, Australian Accounting Standards or the appropriateness of capitalising this expenditure. This issue is discussed further in Section 8 of this paper.

While Meritec endorsed ElectraNet SA's proposed opex allowance for direct operational costs (i.e. asset maintenance expenditure, monitoring and control) and asset renewals and refurbishment, it recommended significant cuts in the area of indirect (or non-network) operational costs (i.e. corporate costs, risk management and costs imposed by the regulatory environment).

> *"Meritec believes that the preparation of the core opex forecasts by ElectraNet SA is reasonable however a number of adjustments to non operations and maintenance elements of the proposed opex plan are required. These adjustments are based on the information available to Meritec at the time"[5].*

Meritec also claimed that:

> *"When compared to previous reported operational expenditure a number of items of operational expenditure proposed by ElectraNet SA appear to have been accounted for in more than one location. They have therefore been removed from the recommended opex provisions".*

There has been no double counting of items in the operational expenditure proposed by ElectraNet SA. Meritec reached this conclusion because of the process it has followed in comparing the proposed opex allowance with the 1999/2000 historical costs of Transmission Lessor Corporation, which were reported against completely different cost categories. This process has confused the differences in costs between 1999/2000 and 2001/2002 with new cost items sought by ElectraNet SA. In simple terms, Meritec appear to have assumed that the new cost items sought by ElectraNet SA were double counted because Meritec's reconciliation process failed to recognise the differences in underlying costs between 1999/2000 and the adjacent financial years.

As a result of this process, Meritec has excluded a number of significant cost items from the recommended opex allowance. These deficiencies must be addressed if the opex allowance is going to be sufficient to allow ElectraNet SA to make the necessary expenditures on asset maintenance, monitoring and control, asset renewals and refurbishment proposed in its Asset Management Plan and endorsed by Meritec. Failure to address these deficiencies will be to the detriment of customer service and reliability.

4. Meritec's Approach

There do not appear to be any solid grounds for Meritec using the 1999/2000 financial year costs of Transmission Lessor Corporation as an appropriate base for assessing ElectraNet Pty Ltd's operating expenditure allowance for the regulatory period from 2003 to 2007/08. The ACCC was provided with the financial statements of ElectraNet Pty Ltd for the 2000/01 financial year (the latest available at the time of the Application), as well as detailed justifications in support of the Application.

5 Ibid, p38.

Nevertheless, Meritec attempted to reconcile operating costs in ElectraNet SA's revenue cap application with costs that appear in the previous owner's (Transmission Lessor Corporation) 2000 annual report.

> *"In evaluating all of the categories of the Opex application we have tried to link costs from the submitted application spreadsheet to costs that appear in the companies annual report on a line by line basis. An example of this is Grid Support that appears in ElectraNet's 2000 annual report as $1.8m and $1.4m for 2000 and 1999 respectively and is shown in the application as $4m.*
>
> *Where a direct line by line comparison has not been possible allocations have been based on similar appearing categories while at the same time keeping a running total to ensure that double counting of items does not occur but at the same time trying to apportion historical costs over the application'[6].*

While Meritec has reviewed the details of ElectraNet SA's proposed opex allowance, the approach followed in its report is convoluted and the mapping of ElectraNet SA's proposed opex allowance to Transmission Lessor Corporation's historical costs lacks transparency because:

- ElectraNet SA's proposed opex allowance has been developed using functional cost categories; and
- Meritec has attempted to reconcile these functional costs to outdated 1999/2000 historical costs, which were reported on a completely different basis and against different cost categories;
- The 1999/2000 historical costs used in Meritec's assessment are not representative of the business costs in preceding or subsequent financial years or of current business costs; and
- The historical operating costs used by Meritec are also incomplete because they do not include valid operating costs of the business, which were treated as abnormal expenses in the financial accounts[7]. These expenses must be taken into account, irrespective of their accounting treatment (subsequent changes to Australian Accounting Standards have abolished the abnormal expense category and require these costs to be identified as "significant items").

Meritec has found it necessary to qualify its assessment of the proposed opex allowance with a number of assumptions, some of which are plainly incorrect[8]. For example:

> *"Materials costs also appear to be budgeted lower than has historically been the case. However it is assumed that the reason for this difference is that historically ElectraNet provided contractors with materials but the existing*

6 Ibid, p20.

7 The 1999/2000 Annual Report shows operating expenses of approximately $2m which were treated as abnormal including voluntary separation packages, computer rectification costs associated with year 2000, costs associated with the repair of transmission lines and towers resulting from severe storm damage, update of inventory records and superannuation adjustments.

8 As the ACCC is aware, ElectraNet SA fully cooperated with both Meritec and the ACCC during the review and supplied copious amounts of data as well as responses to numerous questions and data requests. ElectraNet SA wishes it to be known that the qualifications Meritec has added to its assessment, such as in the examples given here, were not due to any omission or lack of response by ElectraNet SA to questions or data requests from Meritec.

maintenance contracts require the contractor to supply all required plant and materials"[9].

Materials costs have not been reduced from $1.5m to $0.16m as assumed by Meritec. Materials costs were spread throughout the functional cost categories included in ElectraNet SA's Application. The Meritec analysis does not make adequate allowance for these costs. Another example is the assumption made with respect to insurance costs:

"…the historical cost of insurance premiums must have been included in the Network Maintenance or Corporate budget as no separate line item for insurance can be found in the ElectraNet Annual Reports"[10].

This assumption is also incorrect. Historical insurance costs were definitely not included in Network Maintenance or Corporate budgets. They were included in the Annual Report under Other Services – Other, a cost category that Meritec does not appear to have included in its analysis. It appears, therefore, that historic insurance costs of $1.2 million have been excluded from the recommended opex allowance.

The analysis presented in the following section overcomes the difficulties of the Meritec approach and provides greater transparency to demonstrate the appropriateness of the costs included in ElectraNet SA's proposed opex allowance.

5. ElectraNet SA Analysis

5.1 Cost Differences Between 1999/2000 and 2001/02

The analysis presented in this section explains the differences between ElectraNet SA's current costs and the 1999/2000 costs used as the base in Meritec's assessment. Attachment 1 shows that there have been real cost increases of $5.8 million or 17% in the two years from 1999/2000 to 2001/02It must be recognised that 1999/2000 was a particularly low expenditure year because of SA Government enforced restrictions in the lead up to the sale process and the diversion of significant resources to support the sale process and year 2000 computer rectification activities. These factors limited the amount of maintenance work that could be undertaken and created an artificially low year for many cost items.

Compared with the more typical expenditure in the previous 1998/99 financial year the real cost increase in 2001/02 costs is only $1.8 million or 5%. This increase was largely due to increases in externally imposed costs such as grid support, transmission licence fees and insurance premiums despite the real increases that have occurred in internal and external labour rates.

Benchmarking carried out in 2001 in both the network maintenance (ITOMS benchmarking which involves all Australian and New Zealand TNSPs as well as other international best practice transmission companies) and non-network areas (INDEC Consulting) shows that ElectraNet SA's current opex costs are efficient.

9 "ElectraNet SA Operational Expenditure Review", Meritec report, July 2002, p22.
10 Ibid, p27.

The INDEC Consulting study in 2001 compared ElectraNet SA's corporate and overhead costs with the benchmarks established in the Victorian ORG Distribution Pricing Review; the most recent applicable and independent benchmarking that has been carried out for regulated network businesses in Australia. INDEC Consulting found that ElectraNet SA's

> *"benchmark ratios are in accordance with best practice in the recently privatised Victorian rail and electricity distribution assets"*[11].

5.2 Increase in Opex Allowance Over 2001/02 Costs

Attachment 2 shows a breakdown of the costs included in ElectraNet SA's proposed opex allowance, which represent increases over 2001/02 costs. These are shown in two parts:

- Those cost items that have been recognised by Meritec and included in their recommended opex allowance; and
- Costs that have been specifically excluded by Meritec.

The analysis in Attachments 1 and 2 supports an opex allowance of $58 million compared with the $46 million recommended by Meritec (refurbishment expenditure that the ACCC has directed be transferred from opex to capex has been excluded from this analysis – the treatment of this expenditure is discussed separately in Section 8 of this paper)[12].

The analysis shows that even if only those cost items recognised by Meritec are included Meritec's recommended opex allowance of $46 million must be increased to $49 million to correct for manifest errors in their assumptions.

As noted earlier, the process followed by Meritec has confused the differences in costs between 1999/2000 and 2001/2002 with new cost items sought by ElectraNet SA. In simple terms, Meritec appear to have assumed that the new cost items sought by ElectraNet SA were double counted because Meritec's reconciliation process failed to recognise the differences in underlying costs between 1999/2000 and the adjacent financial years.

What this means is that Meritec has inadvertently omitted costs to the value of $3 million per annum from the recommended opex allowance, which must be included to be consistent with Meritec's own assessment of cost items.

Meritec has also omitted a number of other significant cost items to the value of $8.7 million per annum that are discussed in the following section. These are valid cost items that have been removed with insufficient or no justification.

It is important to understand that these items represent real costs that will be incurred by ElectraNet SA irrespective of whether the ACCC includes them in the opex allowance. Excluding these items will simply reduce the funds available to make the necessary expenditures on asset maintenance, monitoring and control, asset renewals and refurbishment proposed in ElectraNet SA's Asset Management Plan and endorsed by Meritec. We again

[11] "Stand-Alone Indirect Cost Model", report by INDEC Consulting, December 2001, p5.

[12] The $46 million includes grid support costs of $3.7 million actually incurred in 2001/02. The Meritec report recommended an opex allowance of $44.4 million in 2003/04 based on grid support costs of only $2 million.

remind the ACCC and interested parties that if ElectraNet SA is not provided with the necessary funds to carry out this work on the network there are likely to be adverse impacts on customer service and reliability.

6. Cost Items Omitted by Meritec

In addition to the $3 million per annum that was omitted on cost items recognised by Meritec, Meritec also omitted a number of other cost items without any apparent reason other than they did not reconcile with their base cost model. A description of each of these items and the justification for including them in the opex allowance follows.

6.1 Hedging Costs for New Investment

ElectraNet SA included in its opex allowance an amount for the cost of swap options to protect against interest rate risk on new capital investment. Meritec removed this item on the basis that hedging was not allowed in the Powerlink revenue cap decision. However, the issue of hedging costs was simply not raised in Powerlink's case. No decision was made on whether the expenditure is valid and Meritec has failed to address this question in their report.

A criticism that was raised in submissions from interested parties was that, in their view, the risk free rate factors is the best estimate of future fluctuations and that hedging protects ElectraNet SA against the downsides, but with no offsetting benefits to customers.

Such a position ignores the fact that interest rates are floating and set on a daily basis and that the ACCC fixes a rate of return for the whole of the regulatory period based on interest rates prior to the commencement of this period. This action exposes the business on two primary fronts. Firstly, the rate granted is ex-post for the business and not capable of direct replication and, secondly, the rate given is not adjusted for any differential between fixed and floating interest rates.

Furthermore, ElectraNet SA's exposure is in the future. The capex program occurs throughout the regulatory period and funding of it occurs progressively with the consequent need to borrow funds at the prevailing interest rates at the time. The purpose of swap options is to enable ElectraNet SA to lock in the allowed rates, as much as possible, and thereby still undertake its capex program at future dates within the financing parameters set by the ACCC.

Hedging interest rate risk represents standard business practice. In any case, hedging is not costless and the regulated business has no way of revisiting this during the regulatory period. The simple reality is that the modelling undertaken as part of the regulatory process assumes that the current risk free rate applies to future investments – clearly there are hedging costs associated with ElectraNet SA legitimately protecting its exposure to movements over this time. The removal of hedging costs of $2.4 million per annum from the opex allowance is, therefore, unjustified.

ElectraNet SA is willing to assist with the understanding of this issue by engaging investment banks and ratings agencies to provide advice to the ACCC on the risks faced and lack of appropriate compensation provided under the Capital Asset Pricing Model.

6.2 Maintenance Service Contract Costs

Following the expiry of its maintenance contracts, ElectraNet SA went to the market in 2001/2002 to seek tenders for the provision of maintenance services. After extensive tender evaluation and negotiation, the new contract was awarded to the lowest cost tender that complied with the specified requirements. Despite this, the new contract schedule of rates is 11% higher than the previous rates. Meritec has been made aware of these increased maintenance costs, but has not acknowledged this increase at all in its assessment. If this deficiency of $0.7 million per annum is not addressed then maintenance levels must be reduced by 11% to comply with the approved level of funding made available by the ACCC. Given that ElectraNet SA's maintenance costs have already been benchmarked against Australian and International transmission companies as best practice, any reduction in maintenance will have detrimental effects on service reliability.

6.3 Other Associated Refurbishment Costs

In their recommendation, Meritec have replaced the costs associated with the expense line "Other Associated Refurbishment Costs" with the amount equivalent to all of the Operating Projects included in ElectraNet SA's Asset Management Plan endorsed by Meritec. While this may appear at first glance to be an increase in the recommended opex allowance, Meritec have in fact simply picked up the Operating Project costs associated with minor works (from the Asset Management Plan), but in the application these costs were already included under the cost categories of risk management, other refurbishment costs and monitoring and control. As a consequence, the following expenses amounting to $1.9 million per annum appear to have been inadvertently omitted:

- Site reparation costs which represent the costs of disposal of equipment and clean up costs at the end of capital projects, which are clearly not included in any asset valuation.
- Project management costs associated with managing the additional refurbishment and operating projects.

6.4 Escalation of Costs due to Increases in Asset Base

Meritec have recommended that increases in Network Service related costs should be indexed to 25% of the increase in asset base. ElectraNet SA has incorporated the following indexation factors in its application:

- Field maintenance costs of additional new assets increasing in direct proportion to increases in the asset base.
- No increase in field maintenance costs of existing assets despite the rising average age of ElectraNet SA's assets adding to maintenance requirements. This will require ElectraNet SA to fund these increased maintenance costs from any savings that can be achieved from adopting new technologies for additional new assets.
- Indexation of internal labour costs for the management of the maintenance function to 25% of the increase in asset base, which is appropriate and in line with international best practice.

Cost escalation resulting from growth in the asset base adds $1.2 million per annum.

6.5 Funding of Employee Superannuation

The employee superannuation scheme for ElectraNet SA employees is currently not fully funded. This is one of the reasons that the historical labour costs used by Meritec are unrealistically low and cannot be used to predict future costs without adjusting for this factor. ElectraNet SA has a legal obligation and is committed to fully funding its scheme within five years. This would be a reasonable expectation of any responsible employer and certainly should be an expectation of the Federal Government. This commitment did not exist in 1999/2000. ElectraNet SA has included the required allowance of $2.5 million per annum to fund this shortfall as part of the internal labour rates in its application.

7. Costs Subject to Pass Through

ElectraNet SA notes that the Meritec report has not made any recommendations relating to the proposed pass through of costs outlined in ElectraNet SA's revenue cap application. ElectraNet SA maintains that these items should be treated as pass through events by the ACCC. Although Meritec did not address the pass through items raised by ElectraNet SA, they did recommend the pass through of existing costs as discussed in the following sections.

7.1 NEM Imposed Costs

ElectraNet SA's opex allowance included $1 million per annum for NEM Imposed Costs, which has been budgeted for the following specific purposes:

- Additional resources required to meet the ongoing requirements of NEM changes including the regulatory test and public consultation processes associated with new network investment, transmission pricing, development of constraint equations and other regulatory requirements; and
- Upgrading NEM metering installations to bring them up to the standard required by the Code.

Meritec recommended that additional costs imposed on ElectraNet SA resulting from the NEM changes be allowed, but subject to pass through to ensure that ElectraNet SA only recovers costs actually incurred.

ElectraNet SA finds this recommendation surprising given that these are internal costs that will be incurred by ElectraNet SA over a wide range of functions. ElectraNet SA has generally sought to minimise reliance on pass through in its application on the basis that it does not provide any incentive to improve efficiencies. In our view pass through should only be applied to external costs of an uncertain nature beyond the reasonable control of ElectraNet SA.

ElectraNet SA recommends that the $1 million per annum for specific identified NEM Imposed Costs be included in its opex allowance and that pass through only apply to other unidentified and material NEM Imposed Costs that may have to be incurred during the regulatory period.

7.2 Grid Support

Meritec recommended that the costs associated with grid support be subject to a pass through arrangement so that ElectraNet SA is fairly compensated for such costs only when they occur.

ElectraNet SA made this proposal in its application for new and additional grid support however ElectraNet SA is willing to accept the proposal that all grid support, including all existing arrangements be subject to a pass through. ElectraNet SA will provide the ACCC with details of its existing grid support costs for full inclusion in the revenue determination. It is noted that the Meritec report has assumed a figure of $2 million per annum, which will have to be adjusted for actual grid support costs to be passed through.

8. Treatment of Refurbishment Expenditure

Meritec has reviewed in detail and endorsed ElectraNet SA's proposed expenditure on asset refurbishment, but the ACCC has directed Meritec to treat this expenditure as capex when most of it was included as opex in ElectraNet SA's revenue cap application. This issue is discussed in Section 8.0 of the Meritec report.

The direction by the ACCC to move all refurbishment projects from opex to capex has been made without any reference to the current accounting practices of other TNSPs, Australian Accounting Standards or the appropriateness of capitalising this expenditure.

Firstly, some 40% of the costs incorporated with the line uprating projects are effectively deferred maintenance including replacement of broken insulator strings, conductor repairs and structural repairs. Accounting standards do not allow the capitalisation of these costs.

Secondly, it is important to recognise that ElectraNet SA's proposed treatment of asset refurbishment expenditure is consistent with Powerlink's current practice, which was effectively endorsed by the ACCC in its revenue cap decision for Powerlink[13]. It is also consistent with the range of practice of other Australian TNSP's.

Thirdly, ElectraNet SA's proposed treatment is based on advice from asset valuation specialists Sinclair Knight Merz (SKM) in relation to whether or not expenditure would be recognised in future asset valuations using the Optimised Depreciated Replacement Cost (ODRC) and Modern Equivalent Asset Valuation (MEAV) methodology adopted by the ACCC.

SKM's advice has guided ElectraNet SA to proposing a change in its capitalisation policy effective from 1 January 2003, which results in some expenditure being treated as opex when in the past it would have been treated as capital.

This change in policy is based on the fundamental principle of capital asset maintenance – i.e. ElectraNet SA will only capitalise expenditure that it will have the opportunity to recoup. This requires that the expenditure be added to the regulated asset base and for it to be recognised in future asset valuations. To do otherwise would

[13] ACCC Final Decision, "Queensland Transmission Network Revenue Cap 2002-2006/07", 1 November 2001.

ultimately result in ElectraNet SA losing value for its shareholders, which is clearly unacceptable.

Replacement of assets below the unit of property (level of detail) recognised in engineering consultant valuation databases will not be recognised in future asset valuations. ElectraNet SA cannot be expected to capitalise this expenditure for regulatory purposes and will not do so if it means that it cannot recoup the expenditure made.

Simply moving asset refurbishment expenditure from opex to capex without a firm guarantee that ElectraNet SA can recoup this expenditure will result in the expenditure not being made. This will have a serious detrimental impact on customer service and transmission network reliability.

For example, if ElectraNet SA cannot proceed with expenditure to increase the clearances and thereby rating of old transmission lines (this expenditure is not recognised in a MEAV and 40% of it is effectively deferred maintenance), then constraints would need to be applied to some lines during summer high load conditions. This would affect both customer supplies and generator access and would likely result in significant wholesale energy price rises during these constraints.

One option that may provide the assurance necessary to capitalise the refurbishment expenditure is to have it separately identified so that it can be added to the regulatory asset base at cost at a future asset valuation. In other words ElectraNet SA would require a guarantee from the ACCC on the “ring fencing” of this expenditure and its subsequent exclusion from asset valuations in the future.

However, the direction by the ACCC to move all refurbishment projects from opex to capex has been made without any detailed consideration of the appropriateness of capitalising the various cost components. Attachment 3 provides details of the expenditure that has been directed from opex to capex.

From an accounting standards point of view, only expenditure that effectively increases the life of an asset or that provides a future economic benefit should be capitalised. Maintenance expenditure must not be capitalised. This is a fundamental accounting principle that must be adhered to.

ElectraNet SA has carefully reviewed the asset refurbishment expenditure to determine which components of this expenditure may be transferred to capex in the event that the ACCC persists with its direction. Accounting standards require that the following cost components be treated as opex and not as capex:

- Maintenance costs representing approximately 40% of the total project costs associated with replacing broken insulator strings, conductor repairs and structural repairs that were included in line uprating projects; and

- Protection and controls and telecommunications expenditure to replace parts of assets that are not capitalised for accounting purposes.

Therefore, even if the ACCC persists with its direction to move refurbishment expenditure from opex to capex, these components must be added back to the opex allowance recommended by Meritec. The Attachment shows that $23.5 million must be added back to opex over the regulatory period.

9. Conclusions

This paper has been prepared in response to the Meritec report on the Operational Expenditure Review of ElectraNet SA and reaches the following conclusions:

- Meritec endorsed ElectraNet SA's proposed opex allowance for direct operational costs (i.e. asset maintenance expenditure, monitoring and control) and asset renewals and refurbishment.
- Meritec's recommendation for significant cuts in the area of indirect (or non-network) operational costs (i.e. corporate costs, risk management and costs imposed by the regulatory environment) is unfounded. There has been no double counting of items in the opex allowance proposed by ElectraNet SA as claimed by Meritec.
- Meritec reached this conclusion because of a number of incorrect assumptions made in the process of mapping the proposed opex allowance to outdated historical costs that were reported against completely different cost categories.
- Meritec incorrectly used 1999/2000 as the base year for its assessment, which was a particularly low expenditure year because of SA Government enforced restrictions in the lead up to the sale process and the diversion of significant resources to support the sale process and year 2000 computer rectification activities. The process followed by Meritec did not take into account real cost increases of $5.8 million or 17% between the years 1999/2000 and 2001/02.
- As a result of the above deficiencies, Meritec has inadvertently omitted costs to the value of $3 million per annum from the recommended opex allowance (based only on cost items that Meritec has endorsed in its report). These costs must be added to the recommended opex allowance.
- Meritec has also omitted a number of significant cost items to the value of $8.7 million per annum that were removed with little or no justification other than they did not reconcile with their base cost model. These items represent real costs that must be incurred by ElectraNet SA and they should be included in the opex allowance.
- Meritec recommended that additional costs resulting from NEM changes and grid support costs be allowed, but subject to pass through to ensure that ElectraNet SA only recovers costs actually incurred. However, the specific costs included in ElectraNet SA's proposed opex allowance in these categories are known costs. Pass through should only be applied to external costs beyond ElectraNet SA's control. To do otherwise means that customers are less likely to receive the benefit of the most cost efficient outcome. Specific known costs should be included directly in the opex allowance and removed from the Meritec recommendation to treat these items as a pass through.
- Meritec endorsed ElectraNet SA's proposed expenditure on asset refurbishment, but the ACCC directed Meritec to treat this expenditure as capex when most of it was included as opex in ElectraNet SA's revenue cap application. The ACCC direction has been made without any justification or reference to the current accounting practices of other TNSPs, Australian Accounting Standards or the appropriateness of capitalising this expenditure. A detailed review of the refurbishment expenditure has identified $23.5 million of the refurbishment works over the regulatory period that must be expensed and not capitalised in order to

comply with accounting standards. These costs must, therefore, be added back to the opex allowance even if the ACCC persists with its direction to treat refurbishment expenditure as capital.

The ACCC and interested parties must recognise that the cost items that Meritec has inadvertently excluded from their recommended opex allowance and those that were specifically excluded represent real costs that must be incurred by the business. Failure to include these will simply reduce the funds available to make the expenditures on asset maintenance, monitoring and control, asset renewals and refurbishment proposed in ElectraNet SA's Asset Management Plan and endorsed by Meritec. Failure to carry out this work on the network will be to the detriment of customer service and reliability.

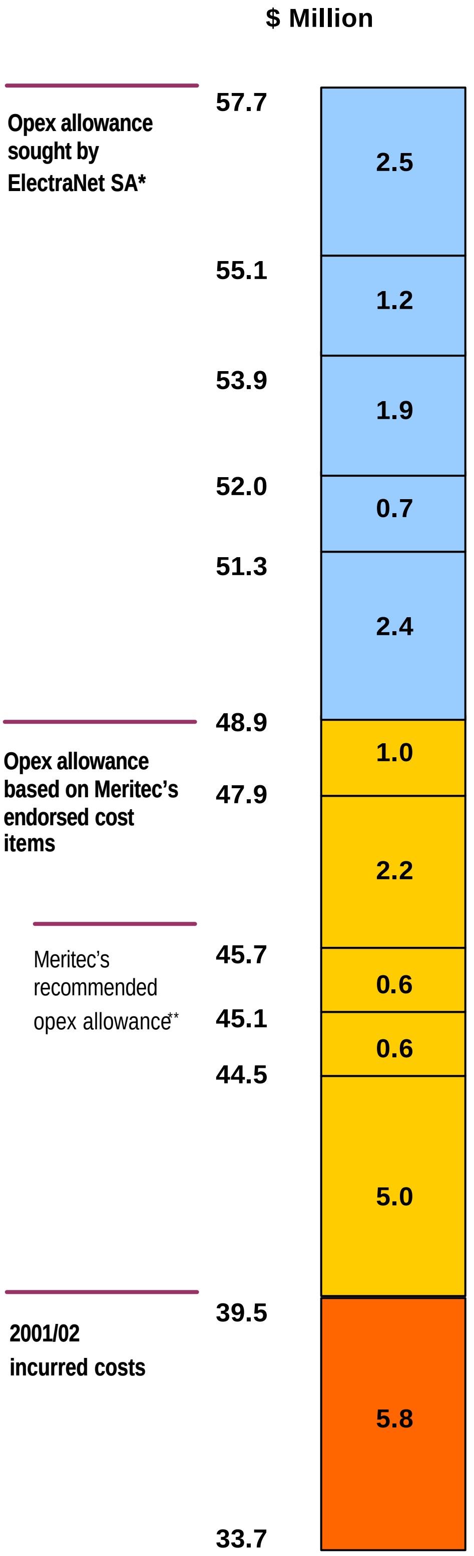
Attachment 1: Regulated Opex Changes from 1998/99 to 2001/02 (all figures in $ 2001/02)

Cost Category	1998/99 ($m)	1999/00[A] ($m)	2000/01 ($m)	2001/02[B] ($m)	Average ($m)	Change B-A ($m)	Explanation of Change between 1999/00 and 2001/02
Internal labour	11.5	9.7	11.4	10.0	10.7	0.3	Filling of vacant positions
Consultants and contractors	4.0	2.2	3.2	3.6	3.3	1.4	Low year in 1999/00 due to diversion of resources to Year 2000 computer rectification activities and SA Government sale process (5).
Materials	2.8	2.0	1.3	2.0	2.0	0	
Line maintenance contracts	4.0	2.9	4.4	4.3	3.9	1.4	Low year in 1999/00 due to diversion of resources to Year 2000 computer rectification activities and SA Government sale process (5).
Substation maintenance contracts	4.0	4.2	3.8	4.0	4.0	-0.2	
IT and telecoms maintenance contracts	3.6	2.0	2.6	2.6	2.7	0.6	Low year in 1999/00 due to diversion of resources to Year 2000 computer rectification activities and SA Government sale process (5).
Grid support contracts	1.5	2.0	3.1	3.7	2.6	1.7	Additional grid support from second gas turbine at Port Lincoln
Other service contracts	0.7	1.0	5.0	2.2	2.2	1.2	Ongoing increases in business costs following privatisation (6).
Other services	2.8	5.8	6.3	7.1	5.5	1.3	Most significant cost increases were transmission licence fees ($0.5m), insurance costs ($0.2m), and asset management service fees ($1.0m)
Abnormal items	2.8	1.9	5.5	0.0	2.5	-1.9	Abnormal items differ depending upon circumstances in each year.
Total	**37.7**	**33.7**	**46.6**	**39.5**	**39.4**	**5.8**	

Notes:

(1) 1998/99 figures are from ETSA Transmission Corporation 2000 Annual Report, p40-42.
(2) 1999/2000 figures are from Transmission Lessor Corporation disaggregated profit and loss statement included in Regulatory Financial Report to the SAIIR for the year ended 30 June 2000.
(3) 2000/01 figures are taken from Transmission Lessor Corporation and ElectraNet Pty Ltd disaggregated profit and loss statements included in Regulatory Financial Reports to the SAIIR and ACCC for the year ended 30 June 2001.
(4) The 1998/99, 1999/2000 and 2000/01 figures have been escalated using the All Groups Index (weighted average of eight capital cities) for the June quarter published by the Australian Bureau of Statistics.
(5) 2001/02 figures are unaudited ElectraNet Pty Ltd figures from ElectraNet SA's Finance group.
(6) Decline in opex in 1999/00 was also due to: (i) Government enforced restriction on expenditures in lead up to sale process; and (ii) new owner enforced restrictions in period immediately following the sale for familiarisation of business purposes.
(7) Includes tax/ accounting, corporate governance, and other services required to satisfy owners' requirements. Services provided by relevant industry and technical experts.

Attachment 2: Regulated Opex Allowance for 2003/04 (all figures in $ 2001/02)



Cost Item	Comment
Funding of employee superannuation	Item overlooked by Meritec – refer to Section 5.5 of this paper
Cost escalation linked to growth in asset base	Item overlooked by Meritec – refer to Section 5.4 of this paper
Associated refurbishment costs	Item overlooked by Meritec – refer to Section 5.3 of this paper
Increase in maintenance service contract costs	Item overlooked by Meritec – refer to Section 5.2 of this paper
Hedging costs for new investment	Item specifically excluded by Meritec – refer to Section 5.1 of this paper
NEM imposed costs	Item endorsed by Meritec (p30) – refer to Section 6.1 of this paper.
Self insurance provision	Item endorsed by Meritec (p28)
Directors fees	Item endorsed by Meritec (p26)
Insurance cost increase	Item endorsed by Meritec (p27)
Other associated refurbishment projects (Operating Projects)	Item endorsed by Meritec
1999/2000 incurred costs	Abnormally low expenditure year due to SA Government sale process and Year 2000 activities – refer to Section 4.1 of this paper

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

Additional costs sought by ElectraNet SA and endorsed by Meritec

Difference between 1999/2000 and 2001/02 costs

* Does not include the components of asset refurbishment that the ACCC directed to be treated as capex, but must be added back to opex – refer to Section 7 of this paper.

** $46.1m including grid support costs of $3.7 million actually incurred in 2001/02. The Meritec report recommended an opex allowance of $44.4 million in 2003/04 based on grid support costs of only $2 million.

Attachment 3: Transfer of Asset Refurbishment Expenditure from Opex to Capex (all figures in $2001/02)

Expenditure Component	Description	Jan-Jun 2003 ($'000)	2003/04 ($'000)	2004/05 ($'000)	2005/06 ($'000)	2006/07 ($'000)	2007/08 ($'000)
Line uprating work	Work necessary to operate lines at 80^{o}C whilst maintaining statutory clearances. Includes deferred maintenance costs for reinsulation and structural reinforcement.	30	2,471	7,517	4,925	8,803	1,060
		18	1,482	4,510	2,955	5,282	636
Minor equipment replacement	Replacement of minor equipment consisting mainly of current transformers	25	277	1,015	4,232	1,032	1,764
		25	277	1,015	4,232	1,032	1,764
Protection and controls	Upgrades of protection and control relays	50	2,349	2,025	1,825	500	4,350
		0	0	0	0	0	0
Circuit breakers	Replacement of old circuit breakers due to technological obsolescence	1,855	3,117	931	374	35	689
		1,855	3,117	931	374	35	689
Instrument transformers	Replacement of old instrument transformers	2,662	1,352	140	117	196	2,657
		2,662	1,352	140	117	196	2,657
Telecommunications	Replacement of parts of old telecommunications equipment due to technological obsolescence	810	1,880	0	0	1,060	0
		0	1,260	0	0	0	0
Transfer from opex to capex directed by the ACCC		**5,432**	**11,446**	**11,628**	**11,473**	**11,626**	**10,520**
Transfer directed by the ACCC as adjusted by ElectraNet SA		**4,560**	**7,489**	**6,596**	**7,678**	**6,545**	**5,746**
Difference = Amount that must be added back to Meritec opex recommendation (as a minimum)		**872**	**3,957**	**5,032**	**3,795**	**5,081**	**4,774**

(Shaded) Amount directed by the ACCC to be transferred from opex to capex adjusted by ElectraNet SA to exclude maintenance expenditure and replacement of parts of assets that are not capitalised for accounting purposes.