19 August 2002

Mr Michael Rawstron
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

Dear Mr Rawstron

Submission regarding Meritec's review of ElectraNet's forecast operating expenditure

ElectraNet SA (ElectraNet) submitted its revenue application to the Australian Competition and Consumer Commission (ACCC) on 16 April 2002. The revenue application presented ElectraNet's expenditure forecasts and revenue requirements for the period 1 January 2003 to 30 June 2008. The ACCC subsequently appointed Meritec Pty Ltd (Meritec) to review ElectraNet's expenditure forecasts and ElectraNet's assessment of the regulated asset value.

Meritec's findings in relation to ElectraNet's operating expenditure are presented in a report to the ACCC, dated July 2002[1]. Transend welcomes this opportunity to comment on Meritec's report. Our particular focus in this submission is in relation to the broader issues of methodology, rather than the detail of ElectraNet's cost estimates. There are two particular issues on which Transend wishes to comment:

1. Approach to forecasting operating expenditure; and
2. Definitions of operating and capital expenditure.

This submission deals with each in turn. The paper concludes with some suggested remedies with respect to the latter issue.

1. Approach to forecasting operating expenditure

Meritec comment that[2]:

[1] Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002
[2] Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002, page 6

> …the inherent lack of un-predictability of significant operational events occurring such as lighting, storms and ageing equipment failure rates, needs to be recognised. In our opinion, it would be misleading to pretend that the projections are accurate within +/-10%.

However, it is not clear from Meritec's report whether this reference to +/-10% is a general observation regarding the accuracy of operating cost forecasts or a specific comment relating either to ElectraNet's initial cost forecasts or to Meritec's revised cost estimates. The issue is not explored in later sections of Meritec's report, even though it has important implications for Meritec's findings.

In particular, adopting an operating cost allowance towards the upper-end of the forecast range will reduce ElectraNet's exposure to lower profits. Under this approach, the risks of unexpectedly high operating costs are therefore borne by customers. Conversely, progressively lower operating cost allowances transfer increasing levels of risk from customers to ElectraNet. It follows that ElectraNet's risk profile (and the appropriate rate of return) is partly dependent on where the operating cost allowance sits within the forecast range.

Transend notes that the ACCC has commented on the approach to forecasting operating costs in its draft Statement of Regulatory Principles[3]:

> It should be noted that under CPI-X the TNSP is provided with the incentive to pursue operating and maintenance efficiencies, since any under performance would result in correspondingly lower achieved returns overall. However, the regulator would not normally seek to be over-zealous in setting the operating and maintenance forecasts (in line with aggressive assumptions on potential productivity savings) as this may be viewed as introducing unnecessary regulatory risk which would need to be compensated for through a higher regulatory rate of return.

Transend strongly supports the ACCC's view that the regulator should not be over-zealous in setting operating cost forecasts. However, it is not clear from Meritec's report whether such an approach is reflected in their cost estimates. It will be important to clarify this issue in the latter stages of this review. In future determinations, there might be a case for giving clearer guidance to consultants on this issue, keeping in mind the important objective of preserving company incentives to maintain service levels and drive cost-efficiency improvements.

2. Definition of operating and capital expenditure

Meritec's report makes several references to ElectraNet's change in capitalisation policy. Transend recognises that there are regulatory benefits in companies adopting "consistent" definitions of operating and capital expenditure. In particular:

- Consistent definitions across companies

[3] ACCC, draft Statement of Regulatory Principles, May 1999, page 94

- facilitate inter-company comparisons, thereby improving the scope for benchmarking company performance.

- Consistent definitions over time

  - ensure that expenditure is counted once and once only, thereby avoiding excessive or inadequate levels of remuneration; and

  - enable cost forecasts to be analysed against historic cost data.

In relation to the latter point, Meritec's report makes it clear that ElectraNet's change in capitalisation policy has made it difficult to analyse historic cost trends[4].

> Meritec has been unable to undertake any meaningful historical cost comparison pre-1999 due to ElectraNet being unable to provide data on a comparable basis within the time available. Due to changes in their capitalisation polices and accounting treatments ElectraNet was only recently able to assist in providing some comparative data back to 1999/00.

From a regulatory perspective, Transend acknowledges that it is important that cost forecasts can be shown on a consistent basis with historic data. It is unfortunate that Meritec has not been able to obtain this information to date. However, a change in capitalisation policy does not preclude comparisons with historic data. In Transend's view it is a matter for the regulated company and the regulator to ensure that historic and forecast data is presented on a comparable basis.

Notwithstanding the potential benefits of adopting a consistent capitalisation policy (across companies and time), Transend's view is that ElectraNet has a legitimate case for revising its capitalisation policy. Meritec's report explains that ElectraNet wishes to expense certain asset refurbishment and replacement items, such as transmission line rating upgrades, in order to avoid asset stranding risk[5]:

> ElectraNet has put forward the argument that expenditure of this nature is subject to revaluation risk. That is, the mechanism used for the determination of the asset base used to calculate the revenue cap makes no distinction between a line that has had this type of expenditure and one that has not. Therefore, even if such expenditure were allowed as capex in a review such as this, it would be likely to disappear when standard asset values were applied in the next ODRC valuation.

In other words, ElectraNet is concerned that prudently incurred expenditure would be stranded by the ODRC valuation methodology if that expenditure were treated as capital. Such an outcome would be detrimental to customers in the medium term because it strongly discourages companies from undertaking certain types of expenditure. The issue points to a serious flaw in the ODRC methodology, which only imperfectly addresses the issue of whether expenditure has been prudently incurred[6].

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[4] Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002, page 20

[5] Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002, page 39

[6] In other words, the ODRC methodology takes a helicopter-view of the existing network, rather than scrutinising whether capital additions have been prudently incurred.

Transend notes that the ACCC has directed[7] Meritec to consider all renewal and refurbishment expenditure as capital expenditure. Following this direction, Meritec has deleted all such costs from the ElectraNet's operating cost forecasts. Essentially, the ACCC's approach has the effect of imposing a revised capitalisation policy on ElectraNet. However, it is not clear whether this capitalisation policy is consistent with ElectraNet's previous capitalisation policy or the capitalisation policies adopted by other transmission companies.

In fact, the recent Powerlink determination indicates that the ACCC accepted that certain renewal and refurbishment expenditure should be treated as operating expenditure on the advice of PB Associates. In particular, the ACCC commented[8] (emphasis added):

> PB Associates notes that Powerlink has developed a set of guidelines for the classification of expenditure between capex and opex. All expenses necessary to place an asset in service are treated as capital. The policy states that site preparation, survey costs, site clearing and dismantling associated with a capital project are also treated as capital. Expenditure that contributes to a unit of plant being restored to the condition when first acquired or which reduces future deterioration of the unit of plant but does not significantly extend its life is classified as operating expenditure. PB Associates considers these guidelines for classifying capex and opex are appropriate and are being applied in a consistent manner.

In the light of PB Associates' advice, the ACCC concluded[9]:

> PB Associates' examination of the classification of opex was also comprehensive and detailed. The Commission is therefore satisfied in line with the consultant's recommendation that cost are assigned appropriately and consistently.

Meritec's report also addresses the "unit of plant" issue, but reaches a contrary conclusion to PB Associates. In particular, Meritec explains that ElectraNet uses unit of plant definitions as the basis for determining whether expenditure should be classed as operating or capital expenditure. However, Meritec concludes that[10]:

> Meritec disagrees with this definition as it could mean that instead of replacing the mechanism on an otherwise serviceable disconnector the entire disconnector is replaced, or should a bushing require replacement on a transformer the entire transformer is replaced.

Notwithstanding the important issue of consistency between regulatory decisions, Transend has reservations regarding Meritec's argument. The concern identified by Meritec is more likely to arise if all renewal and replacement expenditure were treated as capital expenditure. Treating these costs as capital would discourage the renewal of an asset's components because the expenditure would not be captured in subsequent ODRC valuations.

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7 Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002, pages 11 and 23

8 ACCC, Queensland Transmission Network Revenue Cap: Decision, 1 November 2001, pages 68 and 69

9 ACCC, Queensland Transmission Network Revenue Cap: Decision, 1 November 2001, page 72

10 Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002, page 19

In relation to the broader issue of ElectraNet's revised capitalisation policy, Meritec make two further observations[11]:

> Further, treatment of these costs in this way will result in customers incurring the full cost of those works over the regulatory period, instead of a charge for WACC and depreciation if they were capitalised.
>
> It should also be noted that if these costs were to be allowed as operating expenses, then some mechanism would be required to ensure that the resulting enhancements to the assets involved were not included as an increase in their value during subsequent asset base reviews.

In relation to the first point, Transend considers this to be a very short-term consideration compared to the medium to long term detriment of failing to remunerate prudent refurbishment and replacement expenditure.

With regard to Meritec's second point, Transend believes that this could be readily addressed through the ACCC's information requirements in subsequent revenue determinations. Therefore, whilst the issue raised is of legitimate regulatory concern, Transend does not envisage that a further regulatory mechanism would be required as Meritec suggests.

In summary, Transend is concerned that the ACCC's direction to Meritec regarding the definition of operating and capital expenditure does not address ElectraNet's legitimate concerns regarding asset stranding. It is important that the ACCC adopts an approach which provides transmission companies with appropriate incentives. Moreover, the regulatory approach should be consistent between regulatory decisions.

3. Suggested Remedies

Transend's view is that the concerns raised by ElectraNet remain valid. ElectraNet's method for managing this issue is to amend its capitalisation policy. Transend has considerable sympathy with this approach given that it follows logically from the ODRC valuation methodology. However, if the ACCC does not sanction this approach, other mechanisms for managing this issue need to be considered.

In Transend's view, there are four alternative approaches that the ACCC could adopt to address this form of stranded asset risk:

a. increase the WACC appropriately; or

b. provide a guarantee that replacement and refurbishment expenditure will be separately recognised and included in the regulated asset base; or

[11] Meritec Pty Ltd, ElectraNet SA Operational Expenditure Review, July 2002, page 39

c. revise the ODRC methodology to ensure that refurbishment and replacement expenditure is properly included; or

d. significantly reduce the frequency of ODRC re-valuations, thereby reducing the "stranded asset" risk.

In relation to the first option, Transend considers that an increased WACC would be an imprecise method of addressing this particular concern. As such, it is only likely to provide a partial solution.

The second option is potentially viable, although the mechanism for including the replacement and refurbishment expenditure in the regulated asset base would need to be worked through. In particular, the interaction between the ODRC valuation and the refurbishment and replacement expenditure would need to ensure that all prudent expenditure was recovered once and once only. It is likely that the separate category of replacement and refurbishment expenditure would need to have its own asset life. The transmission company may wish to accelerate the rate of depreciation if there were a risk of asset stranding.

The third option would seek to address the concern directly by revising the ODRC methodology. Whilst the issue can be partially addressed by applying the ODRC methodology at a more disaggregated "plant" level, it is questionable whether this would address the entire issue. A more fundamental review of the ODRC methodology might therefore be required.

The fourth option indirectly addresses the weaknesses in the ODRC methodology by reducing its impact through less frequent revaluations. This has some merit, and would also reduce the costs of regulation, but would again only represent a partial solution.

Transend's initial preference would be to combine options b and d. However, we recognise that this is an important issue which the ACCC will need to consider carefully as part of its deliberations in the forthcoming revenue determinations. Transend would be pleased to discuss this submission further at the ACCC's convenience.

Yours sincerely

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