

20 July 2012

Mr Paul Dunn  
Director  
Australian Energy Regulator  
GPO Box 520  
MELBOURNE VIC 3000

Email: [Paul.Dunn@acr.gov.au](mailto:Paul.Dunn@acr.gov.au)

Dear Paul

### **VEGETATION MANAGEMENT OPEX STEP CHANGE**

I refer to the recent meeting with the Australian Energy Regulator (**AER**) and CitiPower and Powercor Australia (**Businesses**) on 18 July 2012. In particular the discussion that took place with respect to the procurement of the vegetation management services.

#### **1 Procurement of 2008 contract**

In 2008, the Businesses conducted a tender evaluation for the procurement of vegetation management services.

The Businesses concluded that there were significant benefits in the existing relationship with VEMCO.

The benefits identified in maintaining the existing relationship with VEMCO, included the following:

- VEMCO was the only vegetation management service provider offering a lump sum contract for the provision of vegetation management services in Australia. The Businesses reviewed various other models, including agreements based on a schedule of rates, and found the contractor was rewarded for undertaking increased levels of clearing without performance linkage to overall compliance.
- the Businesses would avoid any unnecessary transaction costs and compliance risk associated with changing its provider. The transaction costs incurred in changing to an alternative vegetation management service provider would be significant. In particular, significant costs would be incurred for an alternative vegetation management service provider to resource itself in order to deliver the required vegetation management services.

#### **REGISTERED OFFICE**

40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499  
Address all Correspondence to: Locked Bag 14090, Melbourne VIC 8001 Australia  
CitiPower Pty ABN 76 064 651 056 General Enquiries: 1300 301 101 [www.citipower.com.au](http://www.citipower.com.au)  
Powercor Australia Ltd ABN 89 064 651 109 General Enquiries: 13 22 06 [www.powercor.com.au](http://www.powercor.com.au)

- VEMCO had a proven history of delivering on the compliance clearance requirements in a cost effective manner. This was clearly illustrated by the fact that the Businesses in 2008 were paying less in real dollar terms on vegetation management services than in 1996, whilst for virtually all other companies vegetation management costs had increased in real terms.
- VEMCO maintained they had developed a unique tendering and evaluation model which actually ensured competitive subcontracting pricing. This was supported by the fact that LinePro (a key subcontractor) had won other cutting contracts independent of VEMCO, including ETSA.
- there are significant economies of scale and economies of scope achieved by having one service provider for both CitiPower and Powercor Australia.

## 2 Procurement of Deeds of Variation

The Businesses did not go out to tender for the Deeds of Variation.

The Businesses concluded that any option other than negotiating an efficient price with the existing vegetation management service provider, VEMCO, would pose an unacceptable risk to achieving the bushfire risk mitigation and vegetation clearance compliance requirements.

The reasons why the Businesses did not go out to tender, included the following:

- on December 2008, the Businesses had agreed to enter an initial three year term with VEMCO from 2009 to 2011. On 29 June 2010 the *Electricity Safety (Electric Line Clearance) Regulations 2010 (2010 Regulations)* came into effect. If the Businesses terminated the contract with VEMCO in response to the enactment of the 2010 Regulations it would be required to pay VEMCO a significant pay-out.
- the scale and complexity of the vegetation management program requires at least a 9 month tender process. It was not feasible for the Businesses to conduct such a tender process in response to the enactment of the 2010 Regulations.
- the ability for an alternative vegetation management service provider to resource itself in such a short time frame was not feasible.
- a significant investment in field, office and management resources was required to ensure compliance with the 2010 Regulations. A vegetation management contractor would need certainty in order to up scale its capability.
- it is impossible and not commercial to contract out just the services for the vegetation management step changes. The operational activities undertaken by any vegetation management service provider do not compartmentalise themselves to individual elements of the step change. This is because in practice, the activities themselves are not discrete elements but part of a larger exercise undertaken at an individual site.

### 3 Future procurement of vegetation management services

The existing agreement with VEMCO concludes at the end of 2014. As a consequence to retain their position as the vegetation management contractor to the Businesses, they will need to be successful in the tender process that will commence early 2014. In such circumstances, it would be irrational for VEMCO to seek to extract rents from the Businesses in the lead up to that tender process as it may prove prejudicial to their chances of renewing the contract post 2014.

It must be remembered that tree clearing compliance requirements and the consequent impacts of bushfire risk is of critical importance to the reputation and commercial viability of the vegetation management service provider.

### 4 Cost incentives

It would be completely irrational behaviour on the Businesses to not negotiate with its third party vegetation management service provider the most competitive outcome. The Businesses, not VEMCO, manage the risk of under recovery from the AER. Further, the Businesses are incentivised under the efficiency benefit sharing mechanism to ensure it achieves the vegetation management services at the least cost. Entering into a contract that was imprudent or inefficient would have penalised the Businesses for a period of 6 years. Such behaviour can not be rationalised, particularly where VEMCO is an unrelated party to the Businesses.

### 5 Revised incremental allowance

The Businesses are seeking a lower incremental allowance through the remittal process compared to the incremental allowance it sought as part of the appeal process. The Businesses submission of 25 June requests the following revised incremental allowance with respect to changes in the 2010 Regulations.

\$'000 2010	2011	2012	2013	2014	2015	Total
CitiPower	(1,379)	2,226	3,351	1,740	1,397	7,333
Powercor Australia	(7,550)	4,934	15,693	2,350	958	16,385

Table 1: Revised incremental allowance sought through remittal process for costs due to changes in 2010 Regulations.

The total revised incremental allowance sought through the remittal process is approximately \$14 million (real \$2010) less than the appeal amount. The Businesses sought \$38 million through the appeal process and now given actual costs incurred the Businesses have revised its proposal to \$24 million (real \$2010).

### 6 Confidentiality

In respect to confidentiality, the Businesses will advise next week on what information provided to the AER is confidential. VEMCO has claimed that some of the information provided in the submissions on the 25 June 2012 and the 16 July 2012 are confidential.

Further, the Businesses note that the attached model to the 16 July 2012 submission specifies SP AusNet's unit rates for line clearance. This information is subject to confidentiality undertakings required by SP AusNet, Jemena and United Energy as per the Australian Competition Tribunal proceedings.

If you have any queries regarding this letter please do not hesitate to contact Renate Tirpcou on [rtirpcou@powercor.com.au](mailto:rtirpcou@powercor.com.au) or 03 9683 4082.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Richard Gross', with a long horizontal flourish extending to the right.

**Richard Gross**  
**GENERAL MANAGER REGULATION**