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# Comments on Total Cost Review - Draft report – June 2003

Prepared for: Independent Pricing and Regulatory Tribunal

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Australian Inland would like to submit the following points in response to the Total Cost Review – Draft Report dated June 2003 prepared by Meritec Limited.

The responses relate to specific sections of the report and to points raised in the document titled “Total Cost Review: Points of Clarification for Discussion with the DNSP’s” dated 10 July 2003. It should be noted that at this stage there has not been any direct personal contact from Meritec to Australian Inland in relation to the above-mentioned document.

At the end of the specific points on the Total Cost Review there are some additional comments that refer to possible impacts of the proposed Weighted Average Price Cap in the 2004 Network Pricing Determination on Australian Inland network prices and network revenue.

## Detailed Responses

- In table 2, it perhaps should be noted that the Losses figure of 10.5% relates to the non-CRNP customers load only (a realistic representation of the overall network). If the Perilya mine consumption (metered at 220kV and hence apparently zero distribution losses) is included in the calculation total losses reduce to 6.5% approx.
- In table 7 there is an item categorised as “Reliability improvement”. In the template, this category was entitled “Reliability and Quality improvement”. Some of the AI projected expenditure relates to network augmentation required to address already identified Quality issues - mainly voltage levels below service standards. Perhaps this expenditure should have been categorised as “Growth”.
- It is also noted that the “Annual expenditure as % of Network Replacement cost” figure compares total CAPEX including non-system expenditure to the 2002 ODRC Valuation figures, which only valued electrical network assets. This means that the % figure appears high.
- In Table 8 the projected line costs are incorrect, they should have been \$17m not \$18m, and projected other costs should have been \$34m not \$37m. The correct figures make AI’s total OPEX figures look worse, with overspend actually 21.6% rather than the reports stated 13%. However if you look at the inflation for the period, which according to Meritec was 10-13% AI was actually approx 11% over the projections in real terms. However if you remove line costs (regulated transmission charges outside the control of the DNSP) from both projection and actual then expenditure was 2% under projections after inflation.
- “Other” OPEX increased sharply (\$1.8 million) in the 2001-02 year because a period of using prepaid superannuation contributions (commencing 1996) was exhausted. This was not wholly predictable as the decision as to the requirement to resume employer contributions was made by the Superannuation fund. It was revised on an annual basis and depended on performance of the fund.
- Information requested by Meritec related to a breakdown of the significant components of other Opex. The following table provides the cost by categories for the years 1999 to 2002 where the expenditure is over \$50,000 per annum. The balance of other Opex is made up of numerous smaller categories.

Function		1999	2000	2001	2002
<b>Superannuation</b>	\$'000			255	1,480
<b>Accounting and Administration</b>	\$'000	722	876	921	868
<b>Information Technology</b>	\$'000	164	173	173	260
<b>Directors' Expenses</b>	\$'000	117	128	122	149
<b>Fringe Benefits Tax</b>	\$'000	77	54	54	65
<b>Admin Buildings - M&amp;R, Operat'g</b>	\$'000	73	122	51	62
<b>Telephones</b>	\$'000	66	77	60	58
<b>Advertising, Annual Report, etc</b>	\$'000			70	54
<b>Taxes (replaced by GST post 2000)</b>	\$'000	287	169		

- The report states that AI's actual 1998-03 figures were inflated in line with EA's inflation schedule. This was due to a misunderstanding of the presentation of the figures. Inspection shows that the figures in the draft report are (correctly) not inflated. Perhaps this was corrected in the tables after the misunderstanding was pointed out to Meritec, but the note not removed from the text.
- Two things stand out when looking at the 1998 CAPEX projections. Firstly, there were no costs allocated to "other" expenditure in any category, except for \$120,000 listed for power quality monitoring. This means that actual expenditure of approx \$5 million on vehicle fleet alone over the period had no corresponding projection in 1998. The \$5 million is misleading in itself as all trade-in values are treated as income, and thus do not represent the actual cost to the company. It may be the case that when the 1998 figures were assembled, it was assumed that trade in values would balance the expenditure, which although plausible at that time, would not have been correct from an accounting perspective.
- A further \$2.2 million was spent on other non-network assets including buildings (mainly share of costs of head office expansion/refurbishment) and IT equipment/systems. None of this was accounted for in the 1998 projections. If projections equaling expenditure in these items alone had been correctly included, overall projections would have considerably exceeded actuals.

It is noted that AI were not alone in failing to project non-system Capex, and that the instructions for completing the 1998 questionnaire were not particularly comprehensive. Perhaps this omission was rectified in the final 1998 determination, and if so, perhaps the final figures would provide a more realistic comparison in this area.

Secondly, growth related CAPEX was projected to fall to next to nothing for the last 2 years of the 1998 - 2003 period. This was presumably based on the simplistic, projected zero growth model, which as stated previously did not account for the real system growth, which actually occurred in significant parts of the network. If the average growth expenditure in the first three years projections had been maintained through the period, the total projected (after inflation @ Meritecs lower end 10%) would have been \$20.4m compared to an actual of \$20.7m. Although the reported actual Growth related expenditure was below the projected figures, this is because much of the projected expenditure (including substantial Radio Network installation costs) that were projected under "Growth" were re-categorised into "Safety, environmental etc". The actual total of both categories combined is significantly above the corresponding projected figures.

Inflation was not cited as an explanation for any overspend, however it was assumed that this would automatically be taken into account when attempting to analyse the figures.

NSW wage and salary increases appear to have run at approximately 1% above CPI over the period. AI was not immune to this pressure and real wage increases were incurred during the period).

In response to the comment that DNSP's should have attempted to control CAPEX overspend by seeking reductions in other expenditure, it should be noted that a significant number of CAPEX projects were deferred for either part or all of the reporting period, to allow previously unidentified (for the period in question) projects to proceed. These included:

1. Install 66/22 Zone Substation Dareton area - \$2 million – deferred into the current period.
2. Mobile Radio System Southern Region - \$ 400,000 – deferred for 3 years
3. Mobile Radio System Northern Region - \$ 1.3 million – deferred for 2 years
4. 66kV Voltage Regulator Menindee - \$400,000 – deferred 2 years and changed to Capacitor installations.
5. Upgrade Broken Hill CBD Kiosk Substations - \$200,000 – deferred to current period
6. Many smaller projects not individually identified in the major projects listing.

All the works deferred to the current period will have to be completed within the next few years to maintain the integrity of the Network.

- It has not been possible to quantify, the procedural development and implementation costs associated with the Electricity Supply (Safety Plans) Regulation 1997 – implemented during the 1998 – 2003 period. However it was almost certainly underestimated, and would have contributed to increased OPEX over the period.
- A significant part (approx \$2 million) of the Vehicle Fleet CAPEX related to major overhauls and replacement of Elevating Platform Vehicles and Crane Borers. This expenditure was in part required because of Regulatory change in the NSW OHS Act 2000 and Regulation 2001 and changes to vehicle registration rules.
- The figure in Table 13, which compares 2004 projected expenditure to 2003 expenditure, is based on estimates of 2003 expenditure. Examination of 2003 estimated expenditure shows that the estimated direct + indirect expenditure is 4% less than the 2001-2002 actual. Preliminary end of year figures show that the actual 2003-04 expenditure is significantly above the estimated figures. If Meritec wishes to make a valid comparison between projections and actual figures, the final 2002-03 figures will be available during August. Once these figures are available, the 108% figure in the report is likely to drop close to, or even less than 100%.
- There has been a major revision to projected CAPEX since the figures were submitted in late April.

The most significant change has been an increase in the 2003-04 projection of just over \$6 million. This relates to the cost of purchasing and installing standby diesel generators for partial backup supply to the Northern Region, and is expected to be offset by the sale of the existing Gas Turbine gensets (recently transferred into AI ownership). This amount has been budgeted on the direction of the NSW Treasury Department.

The Network CAPEX programme has been revised in response to this major change, and now is as follows (Categorised according to the Treasury Dept SCI guidelines):

<b>Program</b>	<b>2003/04</b>	<b>2004/05</b>	<b>2005/06</b>	<b>2006/07</b>	<b>2007/08</b>
<b>Growth Requirements</b>	4.67	2.59	1.68	1.95	1.67
<b>Renewal of Assets</b>	2.32	1.84	2.10	1.15	1.05
<b>Regulatory Compliance</b>	6.36	0.41	0.26	0.23	0.28
<b>Total</b>	<b>13.37</b>	<b>4.83</b>	<b>4.05</b>	<b>3.34</b>	<b>3.00</b>

It should also be noted that AI had no maintenance or operating responsibilities relating to existing gas turbines, but will incur OPEX on these activities when the diesel sets are in place. This additional OPEX has yet to be evaluated, and is not included in the OPEX projections.

OPEX in both periods included inspection of private line poles, but not maintenance. In both cases, the \$ amounts are small.

P30 - In light of other DNSP's responses, using the same definitions AI would probably have no "stores of significant size". A clear definition of "significant" should be supplied to the DNSP's.

P21 & 15 - States AI growth projection is zero. Actual sales growth projection supplied is between 1.5% and 3.2% in total sales, and between 2.25% and 8% when the CRNP customer is excluded from the projection. The footnote that growth would be 1.5% excluding the large CRNP customer, and the low key comments regarding growth not being homogenous does not adequately address the requirement for growth CAPEX to cope with an up to 8% growth projection on parts of the Network.

## **Additional Area of Concern**

Australian Inland has some concerns with the proposed Weighted Average Price Cap (WAPC) regulatory framework that is to apply in the 2004 Network Pricing Determination.

The situation that concerns AI, relates to the single very large CRNP customer "Perilya" which consumes approximately 30% of the total energy consumed by AI's customers. In any mining community there is potential volatility in the continuing load and energy consumption due too a multiplicity of factors such as, worldwide commodity/metals prices, transport costs, energy prices, exchange rates, environmental costs and labour costs, apart from continuing economic availability of the raw product. The size of this one customer relative to the total network is however quite unique to this organization.

As this potential volatility is tied up in one single customer there is considerable volume risk associated with this one customer. Therefore there are considerable risks to network revenue collection dependant an how the WAPC is applied to the Network prices in this area.

Australian Inland believes that this issue is worthy of some individual discussion with IPART, to consider the implications and risks that any unforeseen change in consumption at this single large customer would have on the revenue collection for this organization. This meeting should consider what alternatives are possible to manage or mitigate any such risk.