INDEPENDENT PRICING AND REGULATORY TRIBUNAL
OF NEW SOUTH WALES

Review of Capital and Operating Expenditure of the NSW Electricity DNSPs

Clarifications Issued by Meritec on 17 October 2003
In response to questions raised by IPART's Secretariat

IPART's Secretariat wrote:

"Thank you for your final report on the review of capital and operating expenditure of the NSW electricity DNSPs. The Secretariat wishes to model the impact of your recommendations. To assist in this task could you please clarify your following recommendations?

Recommendation 1

"On page ix of the Executive Summary you say: 'The reduction proposed is equivalent to 10% and 9% for EA and IE respectively'.

Clarification Sought
"Are you recommending in the case of EA a 10% reduction in each of the years FY 2005-2009 or should the reduction be somehow weighted to the later years? The same question is asked [in respect of] IE's 9% reduction."

Meritec Response 1
The report was silent on how reductions should be spread over the review period in IPART's modelling. Uniformity of annual application would, however, be a reasonable starting-point in the absence of information requiring adjustment for committed or urgent projects.

The magnitude of the reduction and the interpretation of the figures of 10% and 9% are discussed in response No. 2 below.

Clarification Sought
"In the case of EA does your recommendation represent a $209.2 million reduction in capex in FY 2003 dollars over the 5 years to FY 2009?"

Meritec Response 2
Reference to a reduction of 10% in EA's case (9% in IE's case) is to projected capex expressed as a percentage of current network replacement cost. Since EA's estimate of projected capex amounted to 4% of current network replacement cost and since our recommendation is for 3.6% the reduction in this ratio in EA's case is 10%.

Note that this calculation relates to the full period analysed – viz. FY 2004-2014 – not to the forthcoming regulatory period, FY 2005-2009: see Table 7 of the report for the data and the calculation. Expressed a different way, the 10% reduction is in the ratio $Capex_n / FA_{2003}$ where

$Capex_n$ is the average annual capex during the period FY 2004-2014 and *FA_{2003}* is the current network replacement cost. The 6.2% reduction referred to for EA later in this response refers to a different quantity – dollars of proposed capex – and to a different period – FY 2005-2009 only.

Reductions for the period FY 2005-2009 are calculated as follows. The expenditure requested by EA for the period FY 2005-2009 is shown in the 'total' line in Table 16 of the report. It totals $2,097 million after rounding. The expenditure we endorsed for EA corresponds to 3.6% annually of the current network replacement cost of $10,927 million: that is, $393 million annually after rounding. Our estimate therefore totals $1,967 million over the five-year period FY 2005-2009 after rounding. The reduction for the period FY 2005-2009 is thus $130 million, not $209.2 million. This reduction amounts to 6.2% of EA's projected capex for the period FY 2005-2009 in dollar terms. Similarly, the expenditure requested by IE for the period FY 2005-2009 is shown in the 'total' line in Table 19 of the report. It totals $1,457 million after rounding. The expenditure we endorsed for IE corresponds to 4.1% annually of the current network replacement cost of $6,208 million: that is, $255 million annually after rounding. Our estimate therefore totals $1,273 million over the five-year period FY 2005-2009 after rounding. The reduction for the period FY 2005-2009 is thus $184 million. This reduction amounts to 12.6% of IE's projected capex for the period FY 2005-2009 in dollar terms.

Capex for years following FY 2009 would likewise be reduced by our recommendation.

Recommendation 2

"On page ix of the Executive Summary you say 'all capex projections for the period FY 2004-2014 have been presented in FY 2003 dollars but, for the reasons given in section 4.1 of the main text, it should not in our view be assumed that they will be inflated automatically by IPART for notional increases in construction and installation costs for the purpose of future assessment unless justification is provided'.

Clarification Sought
"Are you recommending that in addition to the 10% and 9% reductions in capex for EA and IE a further cumulative reduction of CPI over the 5 years? IPART is proposing to use a CPI of 2.5% so the additional cumulative reduction would be 13%."

Meritec Response 3
The effect of applying CPI to estimates of future expenditure expressed in today's dollars (real terms) would be to inflate them to put them into nominal terms. Conversely if CPI is not applied to estimates in today's dollars there may be a reduction in nominal terms in the future. We assume that is what you refer to.

To avoid a possible misunderstanding we re-state our view that neither CPI nor any other inflationary index should be applied automatically to capex projections expressed in today's dollars (real terms) to derive projections for future years in nominal terms. Firstly, for the reasons explained in Section 4.1 of the report, CPI is not an appropriate index to apply to capex of the type projected. Secondly, we question whether any indexation should be applied to capex automatically, in advance, in the way suggested as (a) the correct adjustment can only be conjectured; and (b) the adjustment, if made, may be for costs that do not arise.[1] The point is discussed in Section 4.1 of the report. A retrospective adjustment, should one be found

[1] Some costs are expected to fall.

necessary, would in our view be a more desirable approach. That way a claim for cost increases could be prepared by the DNSPs, if thought necessary, after the end of the period, based on a documented case. In the meantime there will be an incentive for them to examine the cost of capex carefully and to control and minimise costs where possible.

Clarification Sought
"Please clarify whether the cumulative CPI reductions also apply to CE and AIEW."

Meritec Response 4
No adjustment of the type proposed for EA and IE is proposed for recommended for CE or AIEW; but our recommendation regarding indexation generally is applicable to all DNSPs.

Recommendation 3

"On page ix of the Executive Summary you say: 'EnergyAustralia's opex be adjusted to reflect an increase of no more than 10% in nominal terms from FY 2003 to FY 2009."

Clarification Sought
"Are you recommending a reduction in EA's forecast opex of $45.3 million (in nominal terms) over the 5 years to FY 2009 which is equivalent to 18% reduction from EA's FY 2003?"

Meritec Response 5
EA's total projected opex for FY 2003 as presented in Table 17 in FY 2003 dollars is $258 million. The effect of our recommendation, if adopted, would be that EA's opex in FY 2009, expressed in FY 2003 dollars, would not exceed this amount by more than 10%. In other words EA's opex in FY 2009, expressed in FY 2003 dollars, would not be more than $ 284 million compared with EA's estimate of $300 million (see the table). Obviously, although our report does not say so, it is expected that opex in the intermediate years would be similarly constrained.

The intent of the recommendation is that EA's opex in FY 2009 should not be higher in real terms than its opex in FY 2003.

Correction Required
The recommendations in Section 5.5 of the report, repeated in the Executive Summary, refer incorrectly in bullet point (ii) to "…of no more than 10% in nominal terms …" in this regard. The reference should be to 'real' terms. Note that the interpretation is stated correctly in the preceding bullet point (c) which reads: "We saw no reason for opex movements in real terms…"

Clarification Sought
"Are you recommending that there is an 18% reduction in each of the years FY 2004 to FY 2009?"

Meritec Response 6
No. The reduction in EA's FY 2009 opex will be less than that (it will be a minimum of around 5% based on the answer to the preceding question).

Clarification Sought
"Given that FY 2004-2009 projections were in real terms, should this have been expressed in real terms and not nominal terms?"

Meritec Response 7
Yes. See above under the heading: 'Correction required'.

Clarification Sought
"We take it that you mean that there should be an annual increase that would get EA's opex to 10% above the FY2009 figure. If this is the case, does this mean that EA's opex would be reduced in each year?"

Meritec Response 8
We have expressed a maximum level for EA's opex in FY 2009 as a percentage of the opex it projected for FY 2003. Our projection is in real terms as noted above. EA's opex may therefore rise assuming EA spends at least as much as we have indicated (it is not under an obligation to do so). The Secretariat could model that increase.

Clarification Sought
"Again, should this increase be evenly spread over the period or should it be more heavily weighted at one end of the period?"

Meritec Response 9
The report was silent on how increases should be spread over the review period for the same reason as for capex. However uniformity of annual application would be a reasonable starting-point.

Recommendation 4

"On page xi of the Executive Summary you say: 'Before automatically adjusting the projections in future assessments for notional changes in the cost of materials, labour or plant, the cost of opex should be examined to check that DNSPs are maintaining cost-effective operational structures and practices and that their overheads are reasonable."

Clarification Sought
"Is this recommendation referring to post FY 2009?"

Meritec Response 10
The recommendation refers to all periods, including that up to FY 2009, and including retrospective assessments of the period ending FY 2009: it was the latter in particular that we had in mind when we referred to 'future assessments'.

The same general point applies to opex as to capex: our view is that neither CPI nor any other inflationary index should be applied automatically to future projections expressed in today's dollars (real terms) to derive projections for future years in nominal terms. The only difference in respect of opex is that, in the absence of an appropriate index, CPI may be a suitable surrogate for this limited purpose whereas in the case of capex it is not. The reason it may be relevant as a surrogate in the case of opex stems from opex's constituent elements – mainly labour and overheads as summarised in Section 5.5 of the report. Having said that the use of a suitable labour index, applied to labour costs, together with a suitable index applied to overheads (after checking their reasonableness) would be preferable to the use of CPI.