# Country Energy's submission to the Independent Pricing and Regulatory Tribunal

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Response to Total Cost Review – Draft Report

25 July 2003

# Table of Contents

## *1. Introduction*

Country Energy welcomes the opportunity to provide written comments in relation to the *Total Cost Review - Draft Report* ('Draft Report') released by the Tribunal and we look forward to further consultation leading up to the finalisation of the review.

A review of expenditures is being undertaken to enable the Tribunal to make an informed determination as part of the 2004 network price review. Following publication of the Issues Paper in November 2002, the Tribunal sought information from Country Energy (and the other NSW electricity distributors) in respect of their respective service-price proposals, including the roll forward of the regulatory asset valuation and efficient expenditure requirements for the forthcoming regulatory period. Meritec has been commissioned by the Tribunal to provide advice on the prudency of incurred expenditure and the efficiency of projected expenditure.

Due to the limited analysis contained in the Draft Report relating specifically to Country Energy's expenditure programs as detailed in our April 2003 submission, our response provides general comment in relation to the initial findings and conclusions in the Draft Report.

Our response will firstly cover a number of key issues relating to Country Energy that have arisen in relation to the total cost review. This is followed by general comments in relation to the Draft Report and the consultation process and then a discussion on key matters of concern in relation to the assessed extent of capital expenditure 'overspends' by Country Energy and prudency of capital expenditure incurred during the current regulatory period. We then provide comment on Meritec's initial findings and conclusions relating to future expenditure requirements, including the use of cost performance measures. Given the relative materiality of future metering requirements, our response also provides separate and more detailed comments on the assessment of future metering related capital expenditures. This is followed by a discussion in relation to the inspection and maintenance of private poles and the potential impact on future expenditure requirements.

## *2. Key Issues for Country Energy*

Based on our review of the Draft Report the key issues that we would like to further explore with the Tribunal and Meritec in direct consultation are:

- The extent of Country Energy's capital expenditure overspend during the current regulatory period;

- The proposed treatment of non-system expenditure incurred during the current regulatory period (and the opening regulatory asset base for July 2004);

- The weight and reliance, if any, to be placed on Meritec's distribution cost performance analysis in relation to conclusions to be drawn about Country Energy's incurred expenditure and future expenditure efficiency;

- Proposed changes to Country Energy's investment program for the forthcoming regulatory period, in particular the provision of sufficient allowances that provide our distribution business with the ability to improve service standards in rural areas and to introduce demand management related pricing policies; and

- Details relating to the design and implementation of price cap controls and associated pass-through mechanisms to ensure the distributors have the ability to recover material cost increases in the forthcoming regulatory period relating to the inspection and maintenance of private poles and other safety related requirements.

In our opinion some of the positions expressed in the Draft Report in relation to the above will lead to significant disincentives for ongoing investment in electricity distribution assets, all of which will lead to an outcome that is suboptimal for all stakeholders.

Country Energy acknowledges that Meritec has raised some other residual issues on which further information or clarification has been sort. We have provided this specific information directly to Meritec.

## 3. General Comments in Relation to the Draft Report and Consultation Process

The total cost review is a critical component of the current network pricing review. Country Energy is disappointed that a key report has been released into the public arena, in draft form, that relies heavily on work prepared by a consultant with a number of key issues misrepresented or conclusions reached based on apparent flaws and absence of the necessary detail to substantiate the views that have been drawn.

The commentary and analysis in the Draft Report is misleading in several ways. This is reflected in the apparent capital expenditure 'overspend' by Country Energy in the current regulatory period, the reductions foreshadowed in claimed capital expenditure for non-system assets incurred during the current regulatory period, and the potential decreases in proposed capital expenditure projections from July 2004.

By emphasising the misrepresented capital expenditure 'overspend' we believe the Draft Report has created an artificial pressure to reach a final decision that provides for a reduction of a similar order. This may have mistakenly led stakeholders to expect that they will see a reduction in legitimate asset value. This makes the ensuing consultation more contentious and the process more difficult as we attempt to work with the Meritec moving forward. It is imperative that the final decision is based on an agreed set of facts and not on a set of preliminary findings. Once the true facts are explored and Meritec undertakes more thorough analysis, it is our expectation that the final decision will certainly have a different outcome. However, Country Energy remains concerned that the Draft Report may have created a false expectation with stakeholders.

Meritec has adopted a number of highly contentious assumptions and approaches in relation to a number of key issues that must be discussed with Country Energy and reassessed. There has been limited direct consultation with Country Energy to date on these matters.

A common view expressed by a number of stakeholders at the recent public forum was that in some areas of the review the material and analysis presented did not enable meaningful conclusions to be drawn. The Draft Report expresses a general position on some matters without reaching a definitive conclusion, or a position has not been reached based on incomplete analysis of the data, or a position has been prepared in complete isolation from the distributors, or a concept appears for the first time (for example comparative analysis with the New Zealand distributors).

The Draft Report also fails to acknowledge the significant improvements that have been made by Country Energy during the current regulatory period in relation to the utilisation of assets, improvement in performance measures, and competency in our operations.

***Consultation Process Thus Far***

Country Energy is disappointed with the process to date and the current state of consultation on several very significant issues.

These concerns include failure by Meritec to engage in any meaningful direct dialogue with Country Energy on key issues in the two months leading up to the publication of the Draft Report and the public forum, the limited transparency particularly in relation to the requests from Country Energy to Meritec to provide the analytical work underlying the apparent 'overspend', and the failure to meet important deadlines in relation to materials and drafts to be provided to Country Energy (and the other distributors) for review and comment.

Country Energy has participated actively and constructively in the consultation process. We have worked diligently to meet the timetable and information requirements of the Tribunal and Meritec in all respects. Country Energy provided substantial details to support our total expenditure in our 10 April 2003 submission to the Tribunal. To further assist Meritec in its review, Country Energy during April provided numerous documents including our asset management plans, network development plans, planning criteria, asset maintenance and replacement strategies, corporate strategy statements, capital approval processes, maintenance policies and procedures, design and construction standards, and numerous other related documentation and details. We also provided further detail on the scope of our costs in response to Meritec's detailed cost template and information request questionnaire.

On 25 June, Meritec provided a preliminary draft report for review and comment. Country Energy's provided comments to clarify the anomalies and inconsistencies contained in preliminary draft report. This input was not reflected in the report despite concerns raised by Country Energy. We would have welcomed a fuller opportunity to work with Meritec prior to the release of the Draft Report. This would have enabled the determination of a more robust set of findings and conclusions, rather than those that are now on public record. Meritec has had our submission since April 2003 and therefore has been fully aware of the quantum of costs involved and the substantiation of individual costs.

Country Energy has been unable to obtain access to the underlying data used by Meritec, which has meant that we have been unable to fully understand Meritec workings and inhibited our ability to present a suitably detailed response.

***Further Consultation Prior to Finalisation of the Report***

The Tribunal has now initiated a public consultation process to finalise the review and has requested submissions in response to the Draft Report by 25 July.

The consultation process is now the crucial activity.

Given the importance of the total cost review, Country Energy wishes to express concern with the timetable for finalisation. The consultation process is scheduled for completion 'sometime' in August, although a firm date has not been set. We point out to the Tribunal the many delays in the consultation process so far, the outstanding issues that need to be resolved, the complexity of issues raised in the Draft Report, and the need for robust conclusions means that we need to make further submissions and representations on some of these topics.

There remains a good deal of work to be completed jointly to ensure that the final report represents a sound, balanced and workable outcome. Accordingly, Country Energy would welcome the opportunity of discussing our issues further and providing further information to substantiate costs, if required. We note Meritec's stated intention of consulting further with the distributors and other stakeholders. Country Energy also welcomes Meritec's commitment to revise its initial findings in the light of further discussion with the distributors. Country Energy has a strong desire to continue to engage in positive and constructive dialogue and data exchange with the Tribunal and its advisers throughout the total cost review and the 2004 price review process, to ensure a fair and reasonable outcome is delivered.

It is essential that the Tribunal recognise that the distributors must have a final opportunity to respond to the Meritec *draft* final report and any recommended adjustments to costs. Country Energy suggests that the Tribunal set a date of late August for further submissions to the draft final report prior to the publication of a final report by mid September.

Further consultation should be conducted in an open and transparent manner before reaching any final determination on total costs. Another public workshop should be scheduled to discuss the findings. We believe that the final report will be seriously undermined if an open and consultative process with all stakeholders is not achieved. We are optimistic that this will yield results that all parties can support.

***Considered Analysis of All Material and Information Provided***

Meritec must have considered analysis of all information provided. Country Energy believes that the Draft Report does not reflect a full and proper consideration of the substantive and detailed information provided by Country Energy in our April 2003 submission and our response to the Meritec information request. In this respect, Country Energy believes the Draft Report has a number of shortcomings:

- In some areas it is unclear as to what information Meritec has based its conclusions and, in particular, what information provided by Country Energy was incorporated into and what was excluded from the preparation of the Draft Report;

- To the extent that information provided by Country Energy has been excluded from consideration by Meritec, no adequate reason for that exclusion has been given;

- In some areas it is unclear what assumptions Meritec has made. There are inadequate and incomplete explanations of the consultants' methodologies and assumptions; and

- We are unable to reproduce the conclusions Meritec have reached particularly in respect of overspend during the current regulatory period.

We are concerned that the consultation process based on an incomplete Draft Report that has not considered all of the submitted information to date may lead to reliance on erroneous facts.

This is particularly the case in respect of Meritec's assessment of Country Energy's non-system capital expenditure during the current period. Country Energy does not accept that there is a reasonable justification for the simple treatment, particularly in the context of information submitted by Country Energy of the circumstances in which this expenditure was incurred and its relevance to our distribution business. In this respect we do not consider that the objectives of the National Electricity Code have been fully achieved or have the prudency factors that where notified by the Tribunal to the distributors been properly considered.

These issues may have been exacerbated by the short timeframes. Meritec had a challenging timetable to meet which means they may not had the opportunity to fully consider all of the submitted information and understand and deal with the very complex matters. However, Country Energy believes that appreciation of this information is critical to the proper consideration of past and future expenditure requirements.

## *4. The Preferred Conceptual Approach to the Total Cost Review*

At a more conceptual level, Country Energy's believes that many aspects of the overall approach underpinning the Draft Report would be largely addressed if, in the final report, the Tribunal and its consultant adopt an approach that clearly demonstrates:

- A commitment to giving practical effect to the guiding principles for sound regulation, as advocated by the Productivity Commission; and

- A commitment to the ongoing provision of the highest possible level of regulatory certainty.

The Commission has acknowledged the significant challenges facing regulators. As noted by the Commission:

- There is a significant risk that regulatory decision-making may severely diminish incentives for on-going investment in infrastructure;

- The information that is available to regulators in their decision-making is, unavoidably, characterised by a high degree of uncertainty; and

- In light of this uncertainty, and the potential costs to society of overly aggressive regulatory decisions, there is a strong case for regulators' decisions to err in favour of encouraging more, rather than less infrastructure investment.

The general substance of the Draft Report does not, in our opinion, reflect a practical application of these principles.

## *5. Capital Expenditure Incurred during the Current Regulatory Period*

The opening regulatory asset base for the forthcoming regulatory period is established by including capital expenditure that has been prudently incurred for the period from July 1999 to June 2004.

In table 6 of the Draft Report, Meritec provides a summarised comparison of expenditures projected at the time of the 1998 capital expenditure review against actual expenditure incurred during the period 1999 to 2003. Meritec has claimed that Country Energy has spent 62% more on capital expenditure than the levels 'projected' in 1998. This claim appears to be at odds with the Tribunal's analysis that showed moderate over expenditure by Country Energy over the course of the current regulatory period, estimated to be 14%[1].

Additionally, Country Energy's analysis presented in the April 2003 submission suggests that the cumulative capital expenditure overspend to be only 16% when compared with the capital expenditure 'allowances' in the 1999 Determination, the difference being attributed to non-system investments such as FRC systems, IT, and fleet and vehicles. The following table,

[1] IPART, Regulatory arrangements for the NSW Distribution Network Service Providers from 1 July 2004 Issues Paper, November 2002, p 13.

provided in Country Energy's April submission, shows comparison of capital expenditure regulatory 'allowances' and actual spends[2].

| $ million | 1999/00 | 2000/01 | 2001/02 | 2002/03 Forecast |
|---|---|---|---|---|
| *System Assets* | | | | |
| Allowances (Worley) | 134.3 | 139.8 | 131.8 | 131.5 |
| Actual (excl contributed) | 89.6 | 107.2 | 127.4 | 163.7 |
| Cumulative Overspend | (44.7) | (77.3) | (81.7) | (49.5) |
| | | | | |
| *Non-System Assets* | | | | |
| Allowances (Worley) | 15.0 | 9.4 | 14.7 | 9.0 |
| Actual | 45.3 | 30.4 | 53.6 | 62.8 |
| Cumulative Overspend | 30.3 | 51.2 | 90.1 | 143.9 |
| | | | | |
| *Total* | | | | |
| Actual | 134.9 | 137.6 | 181.0 | 226.5 |
| Allowances (Worleys) | 149.3 | 149.2 | 146.5 | 140.5 |
| Cumulative Overspend | (14.4) | (26.1) | 8.4 | 94.4 |
| Cumulative (%) | (9.7%) | (8.7%) | 1.9% | 16.1% |

**Forecast and actual capital expenditure 1999/00-2002/03 (in 2001/02 dollars)**

Country Energy believes that Meritec has presented an apparently flawed assessment of Country Energy's capital expenditure performance over the current regulatory period and, as a result, has erroneously overestimated the extent of the capital overspends. We believe the following adjustments to table 6 of the Draft Report would correct the position.

- ***Customer funded capital expenditure is wrongly included***.

  Country Energy believes that there is no basis for including capital contributions in the analysis. The assessments of overspend and the prudency of past expenditure should be limited to expenditure that is funded by the distributors only. Capital contributions are funded by customers and do not form part of a distributor's regulatory asset base. Additionally distributors have little control over the number of connection requests to the network that occur from year to year and the associated contributions provided. Capital contributions also include gifted assets where accredited service providers have carried out the works.

  On this basis Country Energy cannot agree with the inclusion of capital contributions in the analysis as it is misleading and unfairly overstates the extent of the over spend.

  Our analysis suggests that the inclusion of capital contributions accounts for almost $100 million of the 'overspend'.

  It should be noted that the 1998 projections for capital contributions were derived by Country Energy on the basis of the unknown effects in moving to new arrangements for determining capital contribution (Determination 5.4 and associated guidelines) that was introduced by the Tribunal at around the same time. For Country Energy the new principles were very dissimilar to the principles that had been previously applied. This

[2] Country Energy, Submission to the Independent Pricing and Regulatory Tribunal 2004 Electricity Network Determination, April 2003, p 4-11.

contributed to a reasonable degree of uncertainty as to the capital contribution projections. Meritec should acknowledge this uncertainty in their analysis.

Country Energy notes that the Tribunal in the Section 12A report, the 1999 IPART Determination, and in the recent Issues Paper for the 2004 price review, refer to allowed capital expenditure exclusive of capital contributions and recoverable works. It is surprising that Meritec have now proposed to include capital contributions in the analysis.

- ***The original 'projections' provided by Country Energy in 1998 were revised upwards but this has not been reflected in the Draft Report.***

Meritec appear to be comparing 'actual' capital expenditure against the original capital 'projections' provided by Country Energy in 1998. However the Tribunal's final decision on capital expenditure provided a higher allowance than the original projections in recognition of the revised forecasts provided by Country Energy during the 1998 capital expenditure review.

A primary reason for this was the revised capital expenditure forecasts provided by the former Great Southern Energy based on additional information that had become available. The revised forecasts were submitted to the Tribunal for review, were subsequently included in the section 12A report, and subject to public consultation. Meritec also accepted the readjusted projection at that time. The Tribunal in the 1999 Determination considered it relevant and appropriate that these forecasts be included in the building block analysis. This variation is also acknowledged in the Tribunal's Issues Paper released in November 2002[3].

The revised capital expenditure projections submitted by the former Great Southern Energy for the period 1999/2000 to 2003/04 were $38 million, $42 million, $36 million, $32 million and $32 million respectively (see the Section 12A report). However in their present analysis, Meritec do not appear to have fully adjusted the original projections for the revised forecasts.

We believe that this would add some $70 million to the 'projections' over the five-year period.

Additionally there were other revisions provided by the former Advance Energy's to the original projections for asset renewal requirements that were made in light of changes to asset lives that had become available at that time, which was also subjected to public consultation and accepted by the Tribunal. The revised projections add some $11.8 million per annum to the 'projections'.

We believe that this would add almost $60 million to the 'projections' over the five-year period.

It should also be noted that the former NorthPower's capital expenditure projection submission to the 1998 capital expenditure review included an amount of approximately $18 million per annum for fleet and motor vehicles. Worley later adjusted this estimate to approximately $2.5 million per annum to take account of the trade-in value of vehicles.

*"…Vehicles and Plant*

[3] IPART, Regulatory arrangements for the NSW Distribution Network Service Providers from 1 July 2004 Issues Paper, November 2002, p 13.

*There was not a consistent approach to the inclusion of vehicles in the capital expenditure projections provided by the distributors since some utilise their own vehicles, others lease, and others use the vehicles through a subsidary company. We have therefore shown vehicles and plant as a separate item for IPART's consideration. We have made adjustments to the projected expenditures for vehicles in one particular case to take account of the vehicle trade-in values…"* [4]

This is also acknowledged in the individual distributor section of the Worley report as a footnote to the capital expenditure table for NorthPower:

*"… NorthPower's projected expenditures were adjusted to take account of the trade-in value of the vehicles…"* [5]

Changes to sales tax laws has meant that the original projections provided by the former NorthPower have been proven to be correct but these allowances were denied by Worley in the 1998 capital expenditure review.

We believe that this would add almost $80 million to the 'projections' over the five-year period.

Our analysis suggests that all of the above factors accounts for about $210 million of the apparent 'overspend'. We seek to discuss this matter further with Meritec, as we were unable to replicate their calculation of the 1998 projections for Country Energy.

Country Energy strongly contends that it was not provided with a full opportunity to submit all of its requirements for non-system capital expenditure in the 1998 review process. This occurred as it was indicated to the former distributors at that time that the review of non-system investments did not form part of the Worley review. Senior officers of Country Energy involved in the 1998 capital expenditure review have confirmed this to be the case. This is clearly evidenced by the absence of any projections for fleet and motor vehicles in the individual tables and schedules for Advance Energy and Great Southern Energy in the Worley final report in 1998. This is also demonstrated by the absence of corporate IT systems for each of the former distributors. In fact the former Great Southern Energy did not include any projections for non-system assets. Consequently full regulatory allowances for non-system assets were not included in the final determination.

It is also noted that in the present review Meritec have included 'actual' expenditure on fleet and motor vehicles, corporate IT system allocation, and other non-system assets at full capital cost in their comparison to the 1998 'projections' in table 6 of their Draft Report. This is an unfair comparison, as the 'projections' do not include all the forecasts of non-system requirements.

- ***Some systems expenditure is double counted.***

  Capital spending of $22 million on IT systems relating to full retail competition (FRC) is counted twice in table 6. That is actual IT costs (including FRC systems) has been included once under ' actual renewal capex – end of life' and again as a separate line item under 'actual capex – Y2K and FRC'. This will need to be corrected by Meritec.

[4] Worley International, Report to the Independent Pricing and Regulatory Tribunal on Capital Expenditure Review in NSW Electricity Distribution, October 1998, p 3-5.
[5] Worley International, Report to the Independent Pricing and Regulatory Tribunal on Capital Expenditure Review in NSW Electricity Distribution, October 1998, p 7-12.

It should be noted that, in many cases, the above items are a function of factors and parameters that have already been determined by the Tribunal in the 1999 Determination.

The table presented below shows the effects of implementing the corrections and changes that Country Energy has identified above. Note that we have not corrected for inflation to replicate the Meritec analysis, although we continue to disagree with the Meritec approach. We have also made corrections to asset renewals (see the separate discussion below).

| Projected (1998 dollars) v. Actual (nominal dollars) | 2000-2003 | 1999-2003 |
|---|---|---|
| (excluding capital contributions & recoverable works) | $m | $m |
| Projected renewal capex - end of life | 270 | 321 |
| Actual renewal capex - end of life | 254 | 303 |
| Projected renewal capex - environmental etc | 0 | 0 |
| Actual renewal capex - environmental | 0 | 0 |
| Projected growth capex | 175 | 213 |
| Actual growth capex | 205 | 258 |
| Projected reliability improvement capex | 0 | 0 |
| Actual reliability improvement capex | 0 | 0 |
| Projected non-system capex | 104 | 134 |
| Actual non-system capex | 166 | 206 |
| Projected capex - Y2K and FRC | 0 | 0 |
| Actual capex - Y2K and FRC | 22 | 22 |
| Project capex - streetlighting and metering | 29 | 34 |
| Actual capex - streetlighting and metering | 21 | 26 |
| Projected - Total | 579 | 701 |
| Actual - Total | 667 | 814 |
| Actual as pct of projected | 115% | 116% |

**Amended table 6: Projected *(in 1998 dollars)* v. Actual Capital Expenditure *(in nominal dollars)***

On this basis the variation in 'actual' expenditure from 'projections' from 1999 to 2003 would be 16% (not including any adjustment for the effect of inflation).

The remaining 'overspend' is mainly attributable to the effect of inflation. The Draft Report compares capital expenditure 'projections' (referred to in 1998 dollars) against 'actual' capital expenditure (referred to in nominal dollars). Meritec acknowledges that this would account for up to 12% of the 'overspend'[6]. Country Energy believes that table 6 should be modified and a common cost reference adopted, such as current dollars, to ensure like with like comparisons. It should also be noted that the increase in labour costs over the last four years has moved at a rate well in excess of rate of inflation.

Once the effect of inflation or labour rates is included the apparent 'overspend' is negligible, if not negative.

[6] Meritec, Total Cost Review – Draft Report, June 2003, section 4.1

The following comments are also provided for Meritec's review:

- ***The 1999 financial year is wrongly included.***

  Meritec have reviewed capital expenditure over a five-year period from 1999 to 2003. It is noted that the 1999 financial year sits outside the current regulatory period. Our analysis suggests that this accounts for a further $25 million (not including capital contributions) of the 'overspend'.

- ***The former Great Southern Energy did not provide projections for capital contributions, recoverable works, metering and street lighting in the submission to the 1998 capital expenditure review.***

We are concerned that Meritec's work may not deliver appropriate conclusions about the level of 'overspends' and the prudency of these expenditures. There is a need for Meritec to adopt a consistent approach to the assessment of over expenditure taking into account the above factors.

We strongly question the relevance of table 6 in determining the prudency of incurred capital expenditure. There is a very high probability of significantly underestimating prudent costs.

Country Energy urges the Tribunal to take these issues into careful consideration. The final report should be underpinned by sound, reliable and verifiable analysis in this respect. Country Energy acknowledges the commitment of Meritec to work closely with the distributors to ensure that Meritec's final report the Tribunal is based on a thorough analysis of all relevant issues and data. During a recent site visit, Country Energy discussed the reasons for the apparent anomalies and inconsistencies and invited Meritec to engage in further detailed analysis and discussion of this issue, especially if any difficulty was encountered in the analysis of the data.

***Asset Renewal Capital Expenditure in the Current Regulatory Period***

Table 6 also portrays an apparent significant disparity between 'projected' and 'actual' asset renewal (end of life) capital expenditure during the current regulatory period. We believe the relatively large 'overspend' on asset renewal partly reflects the definition of what is included in each cost category, namely:

- 'Actual' non-system expenditure has been included in the 'actual' renewal capital expenditure category whereas the relative small amount of 'projected' non-system capital expenditure has been included in 'projected' reliability improvement capital.

- 'Actual' reliability improvement capital expenditures has been included in the 'actual' asset renewal capital expenditure category, whereas 'projected' reliability improvement capital expenditure has been included as a separate line item. We would suggest that 'projected' reliability improvement capital expenditure be included in 'projected' renewal capital expenditure to ensure like with like comparison to the analysis of 'actual' asset renewal expenditure.

- The $85 million in 'projected' renewal allowance for Country Energy's is low when compared with the projections provided by Country Energy in 1998. This should be corrected particularly in light of the adjustments to projections that were made by the former distributors, Great Southern Energy and Advance Energy (see above discussion).

If table 6 is modified accordingly, the 'overspend' is not apparent.

There are a number of errors in the treatment by Meritec of certain costs. This should be corrected in addition to the other matters raised in relation to table 6 of the Draft Report. Country Energy has previously raised concerns in this respect. Country Energy will continue to work with the Tribunal's consultants to clarify and address the issues raised above and we are confident that the outcome of this work will reinforce the reasonableness of Country Energy's moderate overspends. It doing so we believe the incurred asset renewal capital expenditure to be prudent in meeting the requirements of an ageing asset base and to maintain the integrity of the network.

***Non-System Capital Expenditure in the Current Regulatory Period***

Country Energy believes that it has appropriately included in the asset roll forward an item of capital expenditure for non-system investments that has been incurred during the current regulatory period. The expenditure has been incurred in the development of information technology and computer systems, motor vehicles and plant, communication systems, small plant and tools, office equipment and furniture, and buildings and property, which facilitate the delivery of distribution services. Information relating to the systems involved, and relevant expenditures, have been provided to Meritec and was comprehensively described in our April submission. The annual expenditure is summarised in the table above.

Country Energy views with concern the suggestion made by Meritec in their Draft Report that claims for non-system capital expenditure may be amended downwards as a consequence of its review, pending further assessment and consultation of the reasonableness of the amounts provided.

Meritec provides the following comments in relation to the extent of the capital expenditure incurred on non-system assets [7].

*"…In CE's case non-system investments such as fleet, IT, etc was a significant driver…"*

*"…Expenditure on IT system improvements was material in some cases and all DNSPs report a need for further work in this area…"*

*"…Non-system capex was also material although not all DNSPs included projections for it in their 1998 submissions. Some did. CE cited this as a particular reason for its overrun…"*

*"…One DNSP claimed that expenditure on land and buildings was not able to be included in the 1998 review and cited it as a reason for its overrun. Further discussion with that DNSP are required to assess the nature of expenditure and the reason why it was not included in the 1998 projections…"*

Based on this reasoning, Meritec is proposing to reduce Country Energy's claim for capital investments in non-system assets over the current regulatory period [8].

*"…Overruns under these headings should therefore not necessarily be accepted…"*.

Meritec's primary reason to justify its disallowance of all non-system expenditures is on the basis that Country Energy should have submitted appropriate allowances in the 1998 capital

[7] Meritec, Total Cost Review – Draft Report, June 2003, section 4.1
[8] Meritec, Total Cost Review – Draft Report, June 2003, section 4.1

expenditure review and presumably on the basis of Meritec's observation that Country Energy actual spends exceed the 1998 capital expenditure projections. The following comment is made [9].

*"…DNSPs should presumably have ensured that appropriate allowances were made in their 1998 submissions for non-system capex…"*

The Draft Report rejects Country Energy's claimed capital expenditure on the basis of a 'broad brush' approach to the analysis, with little reference to the prudency of the expenditure incurred. While it is noted that these comments are preliminary, we believe the basis of this view is flawed. It is entirely unsatisfactory for Meritec to make such a statement without regard or analysis of the reasonableness of specific expenditures made by Country Energy. Without having reviewed the underlining information provided by Country Energy, it is hard to determine how Meritec have reached their conclusion.

It also provides a very narrow understanding of the non-system expenditure that Country Energy's network business is required to undertake particularly vehicles and fleet and IT systems. It is clear that our understanding of the extent of non-system expenditure requirements and the cost of meeting these requirements is radically different from that of Meritec. For the Tribunal to rely upon the conclusions reached by Meritec in this respect may be misleading as to true prudency.

There are some key points to note in this respect.

As stated earlier in our response to the apparent 'overspend', Country Energy strongly contends that it was not provided with the opportunity to submit all of its requirements for non-system capital expenditure in the 1998 review process and where projections were provided for required 'non-system' activities they were not included in developing the capital expenditure regulatory allowances as it was indicated to Country Energy at that time that the review of non-system investments did not form part of the Worley terms of reference. As referred to earlier, this is clearly demonstrated by the absence of detail in the Worley final report in 1998 relating to non-system investments such as corporate IT systems, fleet and motor vehicles particularly in the tables and schedules describing the expenditure requirements for each of Country Energy's predecessor distributors.

We therefore cannot agree with the conclusion reached by Meritec.

We mentioned earlier that the former NorthPower's original capital expenditure projections in the 1998 review included an amount of approximately $18 million per annum for fleet and motor vehicles. Worley later adjusted the original estimate to approximately $2.5m per annum. Country Energy has spent on average in excess of $20 million per annum over the course of the current regulatory period. We strongly believe that for a business of our size and the extent of operations, an allowance of $2.5 million per annum on fleet and motor vehicles capital items is extraordinarily low and not sustainable.

The following is an extract from the Worley final report relating specifically to IT systems [10].

*"…IT Systems*

[9] Meritec, Total Cost Review – Draft Report, June 2003, section 4.1
[10] Worley International, Report to the Independent Pricing and Regulatory Tribunal on Capital Expenditure Review in NSW Electricity Distribution, October 1998, p 3-5.

*Some distribution companies have included capital expenditure for IT systems relating to GIS, financial systems, customer information systems and IT hardware renewals/upgrades. However, there is not a high level of consistency in the presentations.*

*Where they are discernible, expenditures related to GIS and asset management systems have been shown as a separate item. We have also recorded separately (but not reviewed or commented on) IT expenditures related to financial systems and customer information systems* ***since these are outside our area of competence*** *and such expenditures may need to be apportioned between the regulated and non-regulated portions of the business…. [emphasis added]"*

Country Energy considers it a peculiar situation where Meritec can now claim that IT capital expenditure associated with our distribution businesses should now be adjusted downwards, and yet Meritec (formerly Worley International) clearly indicated to the Tribunal in their 1998 final report that they were not in a position to provide comment on the prudency and sufficiency of such investments.

Additionally, Country Energy view is that Meritec's initial conclusions contained in the Draft Report prematurely assumes that forecasts of information technology and systems could have be carried out in 1998 with reasonable certainty of the changes that have subsequently occurred, that have been completely out of the control of Country Energy as a result of the imposed responsibilities of full retail contestability and other industry related changes.

***An Assessment of the Prudency of Non-System Capital Expenditure***

Irrespective, the present assessment should be based on the prudency of the capital expenditure that has occurred, rather than a simple debate over whether non-system investments forecasts were provided or not.

Country Energy does not consider that Meritec's 'broad-brush' approach is consistent with the provisions of the National Electricity Code. There is an underlying requirement that the Tribunal should have proper regard to the prudency of actual expenditure and any resulting changes in scope and unforeseen drivers of costs, which may have resulted in actual expenditure being materially different to historic forecast expenditure. We strongly believe this expenditure to be efficient, as clearly exemplified by PB Associates in their recent review of FRC capital costs for Country Energy.

We remain firmly of the view that the detailed information presented in section 4.3.2 of our April 2003 submission provides a sound substantiation of the expenditures incurred. That information cannot be ignored or dismissed as part of this review. Country Energy sought the assessment of prudency primarily due to changes in scope. This is summarised below:

- There was a significant non-system capital expenditure program required supporting overall change initiatives such as FRC.

- There was a significant long-term investment in the IT needs of the core business of electricity distribution. In many areas the distribution business did not have the core systems or capabilities to adequately manage the electricity assets. In terms of specific asset management information and plans, Country Energy also undertook an upgrade of IT systems to ensure that a sound set of data and processes could provide a robust foundation for effective asset management plans. This expenditure is focused on the actual business systems (eg works and asset management etc) required to support the business.

- Legitimate requirements for motor vehicles and fleet.

- Non-system capital expenditure has also ensured that property purchases, communications equipment and other sundry items support the efficient management of the network.

Had this expenditure not been incurred it may have been reflected in an increase in operating expenditure.

Meritec's initial conclusions would reduce the claimed expenditure by over $190 million (or about 20%) of total expenditure claimed in the current regulatory period. This will lead to a significant under-recovery of capital costs to be funded entirely by the shareholder. This would be inconsistent with Country Energy's legitimate business interests and the operational and technical requirements of maintaining the electricity distribution network. Any potential write down in expenditure will significantly diminish the on-going incentives for efficient investment in electricity distribution and raises the prospect of heightened regulatory risk.

Country Energy requests that the Secretariat and Meritec explores this matter further and reviews the initial conclusion in light of the issues raised.

## *6. Capital Expenditure Projections*

Country Energy intends investing on average $245 million per annum in the electricity distribution network over the forthcoming regulatory period. Country Energy maintains that this capital expenditure will be required over the next regulatory period to meet:

- Customer requirements for network quality and reliability;
- Forecast growth in demand and system augmentation;
- Asset replacement and other regulatory compliance obligations;
- Customer expectations for improved customer services; and
- Maintenance of the performance, safety and integrity of the network.

Country Energy has provided a substantial amount of detailed and robust information to the Tribunal and Meritec to substantiate the nature and purpose of the capital expenditure forecasts. Country Energy considers that the provisions made in the April submission for capital expenditure (and operating costs) are sufficient to cover efficient costs for the forthcoming regulatory period, are soundly based, consistent with our recent actual capital expenditure, and realistically achievable.

Country Energy maintains that the best estimates of future capital expenditure are derived from a consideration of the age profile and condition of the asset population, and the existing and expected future available spare capacity within the network. Our forecasts have been generated accordingly. The required work has been costed at unit rates derived from prices contained in the NSW Treasury Guidelines. These rates have been benchmarked. It should be noted that the Guidelines are being used or proposed to be used by regulators in a number of other jurisdictions. Accordingly, Country Energy reiterates its firm views that it has demonstrated to the Tribunal that its forecasts for expenditure are best estimates and efficient.

Reductions in capital expenditure would be expected to have a consequential increase in operating expenditure. This is the dynamic of the trade-off for distribution networks. Thus any reduction in capital expenditure without a corresponding increase in operating expenditure, in turn, raises questions as to the safety and performance of the network over the medium to long term. Country Energy urges the Tribunal to make provisions in the final report for total costs that are sufficient to cover the Country Energy's forecasts of efficient requirements for the forthcoming regulatory period. Meritec should be encouraged to err on the side of caution to provide confidence to the Tribunal that its proposals do not compromise the capacity of Country Energy to meet its obligations.

In the sections that follow Country Energy provides further comments on the approach adopted by the Meritec for assessing Country Energy capital expenditure forecasts for the key categories of future capital expenditure, including metering.

***Projected Asset Renewal and Replacement Capital Expenditure***

Network asset renewal is required to maintain the integrity (safety and reliability) of the network. The age of Country Energy's electricity distribution networks varies considerably across the network, however 40% of the network is over 40 years old.

Country Energy's asset renewal strategies are based on the age and condition of existing assets and accepted technical asset lives. Our proposal is to maintain the average age of the network close to a constant level. The lives adopted are comparable with the rest of the Australian electricity distribution industry. There are no plans to accelerate replacement of assets beyond the assumed engineering asset lives. As a result of our analysis, Country Energy proposes to invest an average $105 million per annum on an asset renewal and replacement program. It is noted that this information is drawn from Country Energy asset renewal and replacement strategy documents. Our implementation plan will involve monitoring activity levels to ensure consistency with forecasted expenditure levels.

Country Energy has started to reach a point where unless system asset renewals and replacement allowances are increased in the forthcoming regulatory period the performance of the network could become an issue. In effect asset renewal expenditure is becoming more non-discretionary. Responsible asset risk management should not lead to future 'bow waves' in renewals expenditure. The consequences of any under-funding of Country Energy proposed replacement program over the forthcoming regulatory period might be an even higher level of replacement in subsequent periods with potential impact on network prices.

We firmly believe that Country Energy's replacement program represents the lowest total cost for our customers over the long term.

During the site visit on 23 April, Meritec reviewed Country Energy's detailed asset renewal capital expenditure strategies and forecasts. Meritec questioned Country Energy engineering management on several detailed aspects of the strategies, modelling and expenditure forecasts.

It is noted that the Draft report comments related to asset renewal related capital expenditure has been restricted to a high level comparisons between the NSW distributors. For example, in relation to Table 7 of the Draft Report Meritec states that [11]:

*"…. The table shows that*

- *AI has the youngest assets and the lowest projected renewal capex as a percentage of network replacement cost and as a percentage of total capex;*
- *EA has the oldest assets and the highest projected renewal capex as a percentage of network replacement cost but not as a percentage of its total capex;*

[11] Meritec, Total Cost Review – Draft Report, June 2003, section 4.2

- *CE's assets are younger than EA's but it has the highest renewal capex as a percentage of total capex and a high (but not as high as EA) level of renewal capex as a percentage of network replacement cost;*
- *IE's assets are younger than CE's but its renewal capex as a percentage of network replacement cost is higher than CE's and its replacement expenditure as a percentage of total capex is higher than EA's."*

We are unable to comment on the composition of the EnergyAustralia, Integral Energy and Australian Inland expenditure forecasts. However, it is clear that Meritec's has identified the appropriateness of Country Energy's projections, subject to further consultation. Country Energy believes that Meritec now has detailed information to substantiate our forecasts in this category. Accordingly, Country Energy does not expect Meritec to recommend any adjustments to projected asset renewal expenditure.

***Environmental, Safety, and Statutory Related Capital Expenditure***

Country Energy has made provision in the projections for asset renewals for regulatory (safety and environmental) requirements. This expenditure will ensure that the network will be maintained and operated in an environmental responsible manner that ensures the safety of all employees, customers and the general public. Country Energy's programs and strategies in this regard are linked closely with other capital and operating programs. The total capital expenditure is estimated at $5 million per annum.

***Supply Reliability Improvement Capital Expenditure***

We have submitted in our April submission details of the initiatives that form part of this program. Country Energy has included reliability related capital expenditure in its asset renewal forecasts. It is noted from the Draft Report that Meritec are comfortable with this approach.

During Meritec's site visit, Country Energy network management explained the basis and rationale of our reliability improvement program. Network performance reports were also made available to Meritec. It is Country Energy's view that Meritec has now been provided with sufficient explanatory and background information to be satisfied that our reliability improvement proposals are soundly based. Accordingly, it is our expectation that Meritec will not be recommending any modifications to the Country Energy's reliability improvement initiatives and therefore the asset renewal requirements.

***Growth Related Capital Expenditure***

Country Energy's geographic area contains some of NSW fastest growing areas. Growth in demand may require capital expenditure to increase network capacity. The under-funding of growth related capital may result in the deterioration of voltage and the loss of supply during peak winter loading conditions as network capacity is outstripped by the load growth in some parts of the network over the coming years. This would be an undesirable outcome.

Country Energy is supportive of arrangements that increase the level of transparency of regulatory decision-making and network planning. In this regard, Country Energy prepares and publishes an annual electricity system development report to provide information to interested parties about forthcoming constraints and the underlying drivers.

Country Energy has undertaken an extensive review of capital expenditure requirements for growth related purposes including a review of planning criteria, analysis of subtransmission constraints, extensive modelling, and project identification, scope and costing. The total expenditure for growth related expenditure (excluding capital contributions) assuming a medium growth scenario is estimated to average over $70 million per annum for the forthcoming regulatory period.

Country Energy believes that the modelling and analysis that it has undertaken to produce its growth related expenditure forecasts is detailed and rigorous and that there is no reason to doubt the validity of the outcomes. We further believe that expenditure forecast requested are consistent with recent trends and that the underlying reasons are known and quantifiable.

It should be noted that our actual modelling shows that growth related capital expenditure requirements increase steeply in the first half of the forthcoming regulatory period and then gradually reduce over the next decade. The primary reason for this is the emerging capacity exhaustion of some parts of the Country Energy's subtransmission network that are approaching the limits of capacity. However, Country Energy has adopted a risk-managed approach to this lumpy expenditure requirement and has accordingly smoothed out capital expenditure requirements over a ten year period. The deferral of growth related expenditure in this manner is primarily due to an expected resource constraint.

At our meeting with Meritec on 23 April, Country Energy outlined its growth related capital expenditure program. Prior to the site visit, Country Energy provided a detailed line item breakdown of the growth related projects that comprise Country Energy's ten year network development plan. Country Energy's network management also provided information in relation to the key projects, the planning criteria and the application thereof.

The analysis performed by Meritec for the Tribunal has concluded in relation to the growth related capital expenditure projections for Country Energy that they *"… appear reasonable, subject to confirmation"*[12].

Country Energy believes that Meritec now has sufficient explanatory and background information along with detailed data to be satisfied that Country Energy forecasts of growth related capital expenditure are fully substantiated and reasonable. Accordingly, Meritec's acceptance of the capital expenditure forecasts in this category is appropriate.

***Metering (and Possibly Excluded Services) Related Capital Expenditure***

Country Energy continues to support the position that meter provision and maintenance for small end-use customers is more efficiently provided as an integrated distribution function, charged through DUOS, rather than being open to a competitive process. This should not be construed as Country Energy maintaining a monopoly position, as many metering activities are already contestable. Rather, Country Energy believes that leaving the responsibility of meter provision and maintenance to the distributors will deliver the optimal benefit to small customers.

For the purposes of the April submission Country Energy included the cost of basic metering services in the forecast expenditure requirement. These forecasts included meter replacements as well as the meters required for the connection of new customers.

The metering related capital expenditure estimates provided by Country Energy to Meritec are higher than the forecast provided in the April submission. Country Energy in the April submission did not make provision for the incremental cost of time of use (TOU) metering program, pending the Ministry of Energy and Utilities review of metering provision in NSW.

[12] Meritec, Total Cost Review – Draft Report, June 2003, section 4.2

Our estimate of the incremental capital expenditure requirement for TOU metering over and above basic metering is $7 million per annum.

During the 23 April site meeting, the requirement for an incremental capital expenditure requirement for the gradual installation of TOU metering was specifically highlighted in our discussions with Meritec in advance of Country Energy's proposal to investigate the mandatory introduction of TOU network prices for all new connecting small customers. TOU pricing enable customers to better manage their electricity consumption and will assist Country Energy to more efficiently operate and manage its distribution assets, particularly aimed to control peak demand on the network.

The Draft Report states in relation to Country Energy's proposal for metering capital expenditure [13]:

*"…. Sixty percent of CE's budget for possibly excluded services is accounted for by works funded by customer capital contributions and a further 22% by the proposed installation of time-of-use meters for small customers. The economy of installing such meters for small customers is unclear to us but CE advised us that they consider there is a good case for the investment. This requires discussion with CE…."*

The comment appears to foreshadow potential cuts to Country Energy's proposed program, subject to further consultation and substantiation.

*Relationship to Network Planning and Demand Management Program*

The Tribunal's inquiry into the role of demand management included recommendations in relation to network pricing and for distributors to actively pursue the integration of network planning and pricing processes. A key recommendation from the final report reads [14]:

*"… Recommendation 6*

*That DNSPs undertake trials of localised congestion pricing in regions of emerging constraint of the distribution network. Such trials should:*

- *be integrated with network planning processes and standard offer programs*
- *have regard to retail market design and the provision of time of use meters*
- *be carefully designed to manage the impacts on customers through: the use of rebates as well as positive price signals; optional tariff structures; and market segmentation to focus on customers most able to respond to price signals…"*

Effective demand side management delivers benefits to electricity customers, the community and distributors. As noted above, Country Energy has responded to this recommendation by developing a proposal to introduce mandatory TOU pricing from July 2004 that we believe would contribute to an effective demand management program and support efficient long-term network management.

This initiative together with the annual electricity system development review will optimise the amount of investment in network augmentation by working in consultation with customers and all stakeholders to identify the most cost-effective solutions to supply needs.

[13] Meritec, Total Cost Review – Draft Report, June 2003, section 4.2
[14] IPART, Inquiry into the Role of Demand Management and Other Options in the Provision of Energy Services – Final Report, October 2002, p 68.

TOU meters are therefore a fundamental tool for Country Energy in this regard.

*The 'Parer' Review*

The rejection of the gradual rollout of TOU metering in Country Energy's service territory would be fundamentally at odds with the formal endorsement of the Council of Australian Government 'Parer' review of national energy market reform and the recent findings and proposed policy guidance of the Victorian Essential Services Commission. These investigations viewed interval metering as a fundamental tool that was in the best interests of customers, the community and the long-term efficiency of the market. The findings and conclusions from these reviews should be recognised.

There is considerable risk that the Tribunal may not provide a separate allowance for the proposed mandatory 'market' rollout of more sophisticated metering.

Country Energy continues to work with Meritec to provide any additional information they may need to assure themselves that the Country Energy submission is reasonable and can be delivered. We have met with representatives from Meritec on 22 July and provided further additional background information to confirm the reasonableness and the benefits of this expenditure. To the extent that any issue remains when Meritec presents their final report, we will address them at that time.

If our proposal for the rollout of TOU meters is reject, Country Energy will still require funding for new and replacement meter programs, based on current standard technologies.

## *7. Operating Expenditure Incurred during the Current Regulatory Period*

Meritec has embarked upon a "bottom-up" assessment of distribution operating and maintenance costs. The cost categories relate to the major functions undertaken by a distribution business and to the allocated corporate and administration costs.

In relation to Country Energy's incurred operating expenditure during the current regulatory period, it is noted from table 8 that the overspend for Country Energy is relatively immaterial. We also note the comment by Meritec in relation to operating expenditure as a percentage of network investment that Country Energy *"…has the lowest and is within our normal range."* [15] Country Energy is firmly of the view that this provides a sound substantiation and prudency of incurred operating and maintenance expenditure during the current regulatory period. That performance data cannot be ignored or dismissed.

In relation to the increase of operating expenditure over the period 1999 to 2003, we note the comment by Meritec that [16]:

*"… On the other hand an increase in costs of around 30-40% over the period as cited by the DNSPs is equivalent to a compound annual rate of around 9% and is high in the prevailing low inflation environment worldwide…"*

Changes in the levels of operating expenditure by Country Energy reflects key differences in the distributors' operating environment in the current period. While Meritec have sought to compare the expenditure increases with the general rate of inflation, they have ignored the changes in cost structure, resulting from scope changes, that has occurred during the current regulatory period to compensation for the additional costs.

[15] Meritec, Total Cost Review – Draft Report, June 2003, section 5.1
[16] Meritec, Total Cost Review – Draft Report, June 2003, section 5.1

It is necessary for Meritec to undertake careful and reasoned analysis of the causes of, and context giving rise to, those scope changes. Country Energy provided details of a range of factors that have occurred in section 3.3.3 of our April submission that have contributed to an increase in recurrent level of operating and maintenance expenditure.

Table 9 of the Draft report provides a comparison between actual and projected expenditure for 'possibly excluded services'. Meritec indicate that Country Energy has the highest increase of actual 2003 expenditure as a percentage of 1999 actual. However as Meritec has correctly pointed out the increase is a reflection of a data problem as Country Energy was only able to report a complete breakdown of the cost categories for the 2002 and 2003 financial years[17]. Prior to that, data was not fully available in the form required by Meritec and therefore costs incurred in some 'possibly excluded service' categories were not included in the total. Country Energy will provide further information to Meritec in this respect.

The treatment of 'possibly excluded services' as a separate cost item creates complexity and can only lead to errors in the analysis. Given the present uncertainty in respect of services that may become contestable, Country Energy urges the Tribunal to review the need to separately identify these costs. If this is to be a requirement, we urge the Tribunal to make available a final decision on prescribed and excluded services prior to, or forming part of, the draft determination in November.

We note Meritec's intention to seek further details and substantiation from the distributors that the amounts expended were soundly based. Country Energy will continue to work closely with Meritec in this respect.

## *8. Operating and Maintenance Expenditure Projections*

Future operating expenditure requirements will play a critical role in allowing Country Energy to:

- Maintain the safe operation of the distribution network;
- Optimise the operating life of assets;
- Meet customer expectations of continuing high reliability of assets and availability of supply;
- Promoting the more efficient utilisation of distribution networks; and
- Providing for a high level of customer service.

Country Energy reiterates that the operating and maintenance costs it has previously submitted represent is an efficient level of costs developed on a robust basis. A reduction in operating costs will lead to reduced asset lives, reduce our ability to address the increasing level of maintenance backlog, all of which will ultimately impact on customers.

To enable the Tribunal to assess operating cost forecasts, Country Energy provided information about operating costs, transparently forecast as:

- Base 2002 operating expenditure; plus
- Inflation and growth allowances; and
- Specifically identified expenditures to address maintenance backlog.

[17] Meritec, Total Cost Review – Draft Report, June 2003, section 5.1

Country Energy believes that reported operating costs during the current regulatory period are efficient for the specific conditions faced by the business at the time. These actual costs adjusted to include the incremental costs associated with any material changes and other relevant factors could be used as a basis for setting operating expenditure requirements in the forthcoming regulatory period. Country Energy notes that Meritec's approach to assessing future expenditure places significant emphasis on the previous levels of expenditure incurred. Country Energy is generally supportive of this approach, particularly for those costs that have a relatively consistent underlying trend. However due allowance must be made for specific programs or any other expected changes that may result in a material step increase in expenditure.

Our April submission demonstrated the strategies on which its operating and maintenance expenditure forecast is based. Country Energy described that it reviewed in detail its asset management and maintenance strategies following its formation. The outcome has been the deployment of disciplined and programmed preventive maintenance activities consistent with safety and performance requirements.

At our meeting with Meritec on 23 April, Country Energy network management described the intended program of maintenance backlog rectification, the extent of the backlog, and the cost model underlying the expenditure requirements. A copy of costing model was provided to Meritec. There is limited capacity to continue to make significant efficiency improvements given the high level of efficiency currently being achieved and the extent of the backlog. Additionally the electricity safety regulation 2002 has significantly increased the operational requirements and compliance obligations in a number of areas. The regulation requires that assets in bush fire prone areas must be inspected every year, including private poles.

We note the comment by Meritec that current operating expenditure is reasonable in comparison to industry standards. This should provide comfort to the Tribunal that Country Energy's forecasts of expenditure to be incurred are efficient. The exclusion of key operating costs will leave the electricity distribution businesses in the position of being unclear about the extent to which future regulated network prices might move to recover essential operating costs.

It is Country Energy's understanding that Meritec now has sufficient information to verify Country Energy's forecasts as being efficient and appropriate. Country Energy believes it has demonstrated the soundness of its forecasts. Accordingly, it is Country Energy's expectation that Meritec will not recommend any adjustments to Country Energy forecast operating expenditure.

***Cost-Based Performance Measures***

Meritec has used performance benchmarks as a means of comparing the 2003 operating expenditures for Country Energy and the other NSW distribution businesses. It has relied heavily upon the 'benchmark' cost range of New Zealand distributors for a range of indicators. Meritec claims to be able to identify efficient operating costs through the application of benchmarks. Principally as a result of the cost performance benchmarking in tables 10 and 11 of the Draft Report, it has been concluded that Country Energy's operating costs are reasonably efficient as it is acknowledged by Meritec that our relative cost performance lies within the cost ranges across the indicators analysed [18].

Benchmarks can be a useful regulatory tool as a means of industry-wide assessment of costs. However, while the use of benchmarking is less intrusive and costly than 'bottom up'

[18] Meritec, Total Cost Review – Draft Report, June 2003, section 5.2

assessments of the efficient level of expenditure, they must be applied with caution in recognition of the inherent difficulty in making comparisons between distributors. Whilst data and approaches from other jurisdictions can provide some limited guidance for regulators seeking to determine a broad range of efficient costs, we are concerned with the selective use of New Zealand benchmarks and note that the Draft Report provides little or no analysis of potentially significant differences between the electricity distribution businesses in New South Wales and New Zealand.

It is imperative that benchmarks are judged to be sound before regulators employ them to justify any reductions in operating cost forecasts. Care must be taken to ensure 'like-for-like' comparisons are made. The benchmarks determined must be seen in the context of the real differences that exist. A distributor's costs can be legitimately different from the 'benchmark' costs because of the specific circumstances in which that distributor operates. As emphasised in our April 2003 submission it is essential that difference in cost drivers are well understood so that cost differences are not mistaken for differences in efficiency.

The reasons for any differences between actual and benchmark costs should be carefully examined. For example, it is essential that the costs being benchmarked relate to the same defined activity, and that participating distributors use similar accounting policies, especially in relation to capitalisation. Additionally differences may exist in respect of scope of activities undertaken, legislative requirements, business conditions (customer density), network maturity, average demand, and a number of other factors that can make simple comparisons misleading. Differences in scope and business conditions of the distribution businesses should be normalised.

Country Energy has been working closely with the Secretariat for some time to highlight the uniqueness of our network. In our April 2003 submission, we expressed some concerns in relation to constructing benchmarks for the 2004 price review as benchmarking can demonstrate an apparent bias against those distribution businesses that serve rural areas.

The Draft Report appears to ignore the fundamental physical difference between the rural and urban businesses. Country Energy is not convinced that the New Zealand electricity distributors are reasonably comparable with a distribution business of the size and complexity of our rural network that serves 726,000 customers over a rural network covering three quarters of the area of New South Wales. The size of Country Energy's service area, the length of the electrical network, and the relatively unique business conditions faced makes it unlike most other distributors in the world. Little or no information is provided on the underpinning rationale or analysis employed in determining this position and therefore it is unclear as to why the New Zealand distributors are directly applicable to Country Energy. Meritec do not take into account any analysis of, nor benchmarks to, the other distribution businesses in Australia that are comparable to the rural network serviced by Country Energy. In fact what the Meritec analysis does show is that there are no high performing distributors that have similar scope and business conditions statistics to Country Energy.

Given the accepted inherent uncertainties with the benchmarking approach, we do not believe that the Meritec approach is reasonable for setting efficiency targets and would lead to inappropriate conclusions about efficiency targets and underestimate operating costs for Country Energy, unless the differences discussed above are properly accounted for. The use of the Meritec analysis for this purpose would be disappointing given the experience with similar benchmarking analyses during the 1999 price review.

While there will inevitably be debate about the validity of comparisons, Country Energy believes that the findings in the Meritec report, while providing some broad high level conclusions on efficient costs, is unsound in respect of setting efficiency targets.

It is also noted that Meritec separately analyses direct and indirect costs and that capital expenditure is not included in a 'total' cost analysis. The only reasonable use of 'benchmarks' is to compare them with the distributor's total costs. This will largely overcome the problems that occur due to different cost structures, organisational arrangements, accounting practices and the allocation of costs to activities.

***Inspection and Maintenance of Private Poles***

We note that Meritec have still to review whether operating expenditure in the current regulatory period or projected operating expenditure in the forthcoming regulatory period includes the inspection and maintenance of private poles.

The issue of maintenance of private poles has been an ongoing issue particularly in relation to the responsibility for maintenance and associated costs.

Historically there have been varied approaches applied by the distributors that formed Country Energy. This has led to some inconsistency in terms of the assets to be maintained by Country Energy and the assets to be maintained by the customer. This has led in some circumstances Country Energy taking responsibility for the maintenance of all poles in some regions, in some cases even when they would otherwise have been considered 'private poles'. However in some other regions, historically the landowner has been deemed to be responsible and in cases has been charged for the full cost of maintenance for any pole on their property that required maintenance or replacement. In addition, as this is an issue with much history it could be that many landowners are not aware of or have knowledge that poles on their property are private. Also it is likely that few if any landowners would want to take maintenance responsibility for their poles.

In an attempt to find a consistent approach to the private poles issue, Country Energy has recently commenced discussions with the Ministry of Energy and Utilities. In our most recent discussions, it is our understanding that the Ministry will establish a "Private Poles" working group to work through the issues and attempt to develop a common approach across NSW. It is anticipated that this would be in the form of an industry policy and guidelines. It is anticipated that these guidelines will allow the financial impact of any new requirement to be determined in some circumstances.

The inspection and maintenance of private poles has the potential to impact significantly on Country Energy's future cost structure, over and above current projections for the forthcoming regulatory period. Any material change to present arrangements that is recognised by the Ministry must be recognised and provisions made available in the final determination to enable the distributors to recover additional material expenditures.

It may take some time before an agreement is reached on a consistent approach. A final resolution may not be available before the final 2004 determination is made in early 2004. At this stage it is difficult to accurately quantify the scale of the cost increase associated with inspecting and maintaining private poles until there is recognition of the common approach to be adopted across NSW and the activities to be performed by distributors. However we estimate that there may be up to 100,000 private poles in Country Energy's service area. Many have aged and are in poor condition, and in some areas maintenance has been limited. Country Energy preliminary estimates suggests that the total financial impact will be in excess of $10 million per annum.

Country Energy will need to further consult with the Ministry and the Tribunal on the likely impact and costs that it might incur arising from the implementation of any new industry policy in this regard. We therefore reserve the right to amend this estimate in light of further clarification of operation requirements and compliance obligations.

For this reason, Country Energy indicated in section 9.2.6 of our April submission that the best approach to the issue of private poles and other unforeseen material maintenance costs, for example the costs that may arise from new safety related requirements, should be the basis of a pass-through trigger in the form of a "U" factor in the weighted average price cap.

It should be recognised that Country Energy will continue with the existing policy of inspecting private poles at no charge to the property owner and as an interim measure, Country Energy will carry out emergency pole replacement at our cost. This interim measure will see our operating expenditure increase in 2003 and beyond.

Country Energy would welcome the opportunity to continue to discuss these issues with the Tribunal, Ministry and Meritec to communicate the importance of the issue and other material operating expenditure increases potentially facing Country Energy in the forthcoming regulatory period.

## *9. Concluding Comments*

Overall, Country Energy is seeking outcomes in the final determination of total costs that are consistent with and supports the major asset management initiatives proposed in our April submission, that are consistent with our business capabilities, and delivers service improvement initiatives to customers in regional and rural NSW. In April this year, when Country Energy lodged its detailed price-service proposal for the second regulatory period, it pledged to deliver service improvements to customers experiencing the lowest performance levels. It is not clear to Country Energy how the information from the April submission was analysed, what the relevance was of this information in the decision making process, and where it was used in the Draft Report.

In the foregoing sections, Country Energy has identified a number of factors, which require recognition, correction and/or adjustment in order to make a proper assessment of the prudency of expenditure during the current regulatory period, and the efficiency of projected expenditure in the forthcoming regulatory period. There are a number of areas where we believe the methodology used by Meritec to determine the prudency and efficiency is inappropriate.

There remains a number of issues that must be resolved in the lead-up to, and immediately after the final report. These issues include:

- The extent of Country Energy's capital expenditure overspend during the current regulatory period;

- The proposed treatment of non-system expenditure incurred during the current regulatory period (and the opening regulatory asset base for July 2004);

- The weight and reliance, if any, to be placed on Meritec's distribution cost performance analysis in relation to conclusions to be drawn about Country Energy's incurred expenditure and future expenditure efficiency;

- Proposed changes to Country Energy's investment program for the forthcoming regulatory period, in particular the provision of sufficient allowances that provide our distribution business with the ability to improve service standards in rural areas and to introduce demand management related pricing policies; and

- Details relating to the design and implementation of price cap controls and associated pass-through mechanisms to ensure the distributors have the ability to recover material cost increases in the forthcoming regulatory period relating to the inspection and maintenance of private poles and other safety related requirements.

Meritec appears to be recommending the rejection of incurred expenditures on non-system activities. It has done so without questioning the underlying basis of the expenditures. The draft decision to not allow recovery of non-system capital expenditure above that previously allowed in 1998 is arbitrary and fails to recognise the requirement of distribution businesses to invest in non-system assets. Meritec does not present any justification to support its case. This represents significant risk and uncertainty for Country Energy regarding its overall financial position at the beginning of the forthcoming regulatory period. Creating additional 'mechanisms' to disallow prudent capital expenditure only increases risk for regulated businesses.

Country Energy firmly believes that the incurred expenditure that has presented for consideration meets all the requirements of prudency and that we have provided detailed supporting information to establish that our projected capital expenditure is efficient and represents best estimates arrived at on a reasonable basis.

In light of the discussion presented in this response, Country Energy is concerned that Meritec's work may not deliver appropriate conclusions in the time available. The tight timetable for completion raises concerns regarding the likely effectiveness of the consultation and the detailed verification processes required to ensure that Meritec's advice to the Tribunal is rigorous and soundly based. Country Energy believes that thorough consultation with the distributors should be a key ingredient to Meritec's deliberations.

Country Energy's experience to date in relation to the prudency assessment of capital expenditure incurred during the current regulatory period does not provide us with much confidence. The focus of this assessment needs to be the prudency of expenditure and not discussion about whether or not it was included in historical forecasts. Moreover, any efficiency targets set on the basis of Meritec analysis is very likely to underestimate future operating expenditure requirements. Country Energy urges the Tribunal to take these issues into careful consideration.

Notwithstanding these concerns, Country Energy acknowledges and welcomes the commitment of Meritec to work closely with the distributors to ensure that the final report to the Tribunal is based on a rigorous understanding of all issues and data. There remains a good deal of work to be completed jointly by the Secretariat, Meritec and Country Energy to ensure that the final report represents a rigorously sound and balanced outcome. Country Energy has a strong desire to continue to engage in positive and constructive dialogue and data exchange with the Secretariat and Meritec for the remainder of the total cost review process, to ensure a fair and reasonable outcome is delivered.