EMRF

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Dear Mr Seery

<u>Energy Markets Reform Forum Submission</u>
<u>to IPART on The Meritec Report on Total Cost</u>

Please find attach Energy Markets Reform Forum's comments on the draft Meritec Report on Total Cost.

Yours sincerely

Mark Gell
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Energy Markets Reform Forum:

Comments On The Draft Meritec Report On Total Cost

The Energy Markets Reform Forum (EMRF) would like to provide its comments on the draft Meritec Report on Total Cost to the Tribunal. The EMRF welcomes the commissioning of an independent review of the very substantial opex and capex costs claimed by the DNSPs for the current and new regulatory periods. However, there are significant concerns with the review and we consider that IPART has erred, especially with respect to the terms of reference.

1. Terms of Reference

IPART's terms of reference to Meritec are not consistent with provisions in the National Electricity Code and this will mean that electricity consumers in this State will be required to pay for the excessive costs claimed by the DNSPs.

All the DNSPs have made capital expenditures over the period FY1999 to FY2003 substantially in excess of the projections they made at the time of the 1998 capex review. In the case of Energy Australia, the excess (i.e. actual as a percentage of projected capex) was 215%; 168% in the case of Intergal Energy; 162% for Country Energy; and 132% in the case of Australian Inland Energy.

The performance in terms of opex was just as disconcerting. In Energy Australia's case, the excess (i.e. actual as a percentage of projected opex, excluding transmission) was 159%; 156% for Intergal Energy; 108% for Country Energy; and 113% for Australian Inland Energy.

Yet, despite such substantial cost over-runs, the Tribunal's terms of reference (inter alia) only include an assessment of "the prudence of each DNSPs operating expenditure (opex) for the period from the financial year ending 30 June 1999 (FY1999) to the end of FY 2003; the prudence of each DNSP's capital expenditure (capex) for the same period…". (Our underlining). No-where does the Tribunal's terms of reference for assessment of the substantial cost over-runs for FY1999 to FY2003 include the "efficiency principle". Excess expenditures may be technically "prudent" but they need not necessarily be efficient and meet the "cost benefit" test, or the commercial test.

It is instructive to refer to (excerpts are attached) Clause 6.10.2 of the National Electricity Code (Objectives of the distribution service pricing regulatory regime to be administered by the Jurisdictional Regulators), Clause 6.10.3 (Principles for regulation of distribution service pricing) and Clause 6.10.5 (Form and Mechanism of economic regulation). In these three key Code provisions relating to the regulation of distribution networks, "efficiency", "cost effectiveness" and "incentive-based" are the key principles that must be applied by the Jurisdictional Regulator in economic regulation of distribution networks. The "prudence" principles does not appear in the text of the three Clauses cited above. However, the "efficiency" test for the DNSPs proposal expenditures for FY2003 to FY2009 is not applied in the terms of reference for the Meritiec Review on Total Cost. Curiously, the "efficiency principles" is attached to the terms of reference for assessing expenditure projections for FY2004 to FY 2014. Given that actual expenditure over-runs could be rolled-forward into the Regulatory Asset Base, we believe that the Tribunal has to be consistent in its regulatory decision-making, and most importantly abide by provisions of the Code.

<u>Accordingly, the EMRF strongly considers that IPART's terms of reference for the Meritec Review in respect of cost over-runs for Fy1999 to FY2003 must include the "efficiency test". We consider this to be consistent with the requirements of the National Electricity Code.</u>

2 Erring On The Side of DNSPs

The draft Meritec Report clearly acknowledges its limitations in that a detailed review is not being undertaken viz:-

> *"A detailed review of all projects for compliance with the network planning criteria and capital approval process was beyond the scope of this review. We thus limited ourselves to the question of how the stated criteria and process had affected the capital expenditures made or projected".*

But to give stakeholders some level of comfort the draft Meritec Report states:-

> *"We noted that DNSPs were required in this review to have their response signed by their directors and we considered that this added an additional level of assurance to the process".*

Notwithstanding the above, there are concerns that (as reported in the draft Meritec Report) DNSPs have apparently offered "qualitiative" responses to explain their (substantial) excess expenditures (albeit "in some cases quantitative responses" were provided). Further, "unclear" and inconsistent responses and incomplete details, and excessive claims for over-runs have been made. It should be clearly understood that electricity consumers have very strong objections to unjustifiable and ambit claims for cost over-runs, irregardless of whether information responses by DNSPs have been signed off by directors. This only underlines the need for Meritec to undertake a detailed review.

<u>Against that background, the EMRF considers that the Meritec Review accepts only cost over-runs when and where they could be established and only when evidence and quantifications are provided (i.e. where expenditures are efficient). Electricity consumers object to the DNSPs business risks being transferred to them.</u>

3 Are Large Actual And Projected Expenditures Justifiable?

It is clear that the draft Meritec Report has cautiously pointed to many areas in which cost over-runs and projected expenditures are excessive and unjustified. This is supported by reference to actual growth in energy sales for FY1999 to FY2003 and (decreasing) projected growth for FY2004 to FY2014, which confirm that the DNSPs in NSW are operating in a low-growth environment. This is not to deny that certain actual and projected expenditures are driven by growth in certain areas, but the main issue is that **<u>the Meritec Review must be undertaken against an overall low growth environment in electricity sales, with the annual load factor for the decade ahead projected to decrease.</u>**

The Meritec Review, however, does not provide any material on the impact of demand management and more particularly, the impact of non-network solutions on the actual and projected expenditure claims by the DNSPs. The EMRF notes with concern the following:-

> *"All DNSPs recongise the need for investigation of non-network solutions but few reported material prospects for its implementation. DNSPs should demonstrate that they are giving non-network solutions full consideration. This should entail analysis in sufficient depth to test the possibilities closely. At this stage the majority if not all DNSPs give the appearance of complying with the requirements without confidence that material possibilities for demand management will be found. There may not be material possibilities for a number of reasons but we would pre-judge the situation if we accepted a negative view without receiving evidence to support it".*

Against that background, the EMRF considers that the DNSPs be required to provide the requisite non-network augmentation information to enable the Meritec Review to undertake an efficiency test for all expenditures associated with network claims. At the very least, all network proposals in excess of $10 million must be subject to this efficiency test.

3.1 Information Disclosures Inadequate

The DNSPs have made very substantial expenditure claims (both actual and projected) yet it is stated by Mertiec that:-

> *"The detailed submissions made to us by the DNSPs, comprising completed questionnaires and templates, detailed capital expenditure projections and other material are considered confidential to IPART and the DNSPs concerned".*

The EMRF is concerned with the extensive claims of "confidentiality" in this current regulatory review and formally requests that IPART should make available the above-mentioned information in order that stakeholders are able to assess the efficiency and reasonableness of the very substantial expenditure claims by the DNSPs. Transparency in this area may elicit non-network augmentation options. In addition, the benchmarking work used in the Meritec Review should be made available for stakeholder review.

4 Other Comments

4.1 Installed Cost of New Assets

In view of the draft Meritec Report's finding of excessive expenditure claims, we consider that Meritec should investigate more thoroughly the DNSPs installed costs of new assets, rather than simply accepting DNSPs proposals. We make this comment, against the background that most of the DNSPs cost estimates did not use unit rates similar to or the same as those in the current Treasury Guidelines on valuation, but are based on their own cost estimates. **The EMRF concerns will not be allayed unless all projects in excess of $10 million are properly assessed to check for reasonableness.**

4.2 Asset Renewal Expenditure

The EMRF notes the draft Meritec Report's discussion on the evidence elsewhere that actual asset lives many exceed the Treasury's draft Policy Guidelines on valuation. Yet the Meritiec

Report states *"We did not ask for or receive comprehensive information on the results of (condition assessment) programmes but were assured by the DNSPs that the programmes supported their requested replacement capex projections and their representations to us".* In light of this, the **EMRF would expect that the Tribunal would ensure that this issue be closely scrutinised against the need to ensure that there is no double-dipping for depreciation of assets that have already been fully-depreciated. Moreover, the EMRF is concerned that some DNSPs have made claims for increased expenditure on refurbishment even though asset ages did not suggest any urgency.**

4.3 Additions To The Capital Base

We note from the draft Meritec Report that a DNSP had claimed that a reason for its cost over-run was because expenditure on land and buildings was not able to be included in the 1998 review and that Meritec was investigating this. There may be other similar 'oversights'.

Against this background, the EMRF reiterates its reminder to the Tribunal of its earlier undertakings to do an ODV assessment of each DNSP's assets on an asset by asset basis, with a view to retiring redundant and under-utilised assets, from the Regulatory Asset Base.

4.4 Summer Peaks And Capex

We note with concerns Meritec's assessment that:-

> *"The trend from winter to summer peaking in certain locations has been evident for some time and, whilst it justifies certain works, should not be over-played as a capex driver affecting the networks as a whole".*

Meritec further concludes that:-

> *"We may recommend deferral of a portion of EA and IE's growth capex to IPART unless the aggregate expenditures are considered reasonable and there is an expectation that there should not be over-runs later".*
>
> *"Overall, capex in the region of 4% of network replacement cost, as proposed by EA and IE in particular, appears high in the projected low-growth environment and should be reassessed".*

The EMRF have a concerm that the draft Meritec Report seems to provide material indicating that non-network costs are being claimed by DNSP's e.g. IT costs and costs associated with FRC.

These assessments clearly reinforce the EMRF's concerns with excessive claims in actual and projected expenditures by the DNSPs. They further underline the need to clearly identify and isolate those locations where summer peaking is resulting from the use of air-conditioners, in order to allocate costs appropriately and ensure that they are not smeared across all customers classes.

4.5 Opex Expenditures: Prudence And Efficiency

It is noted that Meritec has had difficulty in obtaining reliable information to assist with assessing actual and projected opex. Thus, Meritec states:-

> *"As in the capex case, DNSPs offered qualitative responses to the questions and generally did not mention possible off-setting savings where new factors were adding to costs. This made if difficult for us to judge prudence".*

Meritec concludes that (notwithstanding some justification for cost increases for FY1999-FY2003) that:-

> *"…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 world wide".*

Of concern to the EMRF is the absence of any information to indicate that DNSPs had sought to obtain efficiency savings in their operations. Clearly, a cost-plus culture is unsustainable in any regulatory environment that seeks to reduce monopoly rents by replicating a competitive market environment. The Tribunal must not perpetuate a cost-plus culture and must not allow for transfer of the inefficient costs incurred by DNSPs to consumers.

5 Concluding Remarks

It is the EMRF's assessment, even on the basis of the draft Meritec Report and the constrained terms of reference, that DNSPs have made ambit claims for expenditure over-runs, as well as for projected expenditure. There is a concern too that the summer peaking phenomenon in certain location is being used as a primary reason for substantial expenditure claims (especially capex across DNPS networks).

Yet, despite DNSPs large expenditure claims, there are apparently (on the basis of the draft Meritec Report) significant doubts about their justification as well as their willingness to provide quantitative material following interrogation by Meritic.

The Tribunal has the responsibility in this review to ensure that DNSPs business risks are not automatically transferred to consumers. Even where the Tribunal is convinced of justifiable expenditure over-runs, there is still an over-riding issue of the extent to which the DNSPs shareholder should be making the capital contributions. The EMRF is undertaking further analysis in this area and will comment further.

Excerpts From The National Electricity Code

6.10.2 Objectives of the distribution service pricing regulatory regime to be administered by the Jurisdictional Regulator

"The *distribution service* pricing regulatory regime to be administered under Part D of the *Code* must seek to achieve the following out comers:-

(a) an efficient and cost-effective regulatory environment;
(b) an incentive-based regulatory regime…"

6.10.3 Principles for regulation of distribution service pricing

"The regime which the revenues of *Distribution Network Owners* and *Distribution Network Service Providers* (as appropriate) are to be regulated is to be administered by the *Jurisdictional Regulators* in accordance with the following principles:

(a) Concerns over monopoly pricing in respect of the *distribution network* will, wherever economically efficient and practicable, be addressed through the network introduction of competition in the provision of *distribution services*".

6.10.5 Form and mechanism of economic regulation

"(d) In setting a separate regulatory cap to be applied to each *Network Owner* in accordance with clause 6.10.5(b), the *Jurisdictional Regulatory* must take into account each *Distribution Network Owner's* revenue requirements during regulatory control period, having regard for:-

(5) the provision of a fair and reasonable risk-adjusted cash flow rate of return on efficient investment including sunk assets subject to provisions of clause 6.10.3(e)(5)".

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