

Wilson Cook & Co

Engineering and Management Consultants
Advisers and Valuers

Reply to: Auckland Office
Our ref: 0709
Email: jeffrey.wilson@wilsoncook.co.nz

28 February, 2008

Mr Dennis Mahoney, Program Manager, Energy Networks
Independent Pricing and Regulatory Tribunal of New South Wales
Level 8, BT Building, 1 Market Street
Sydney NSW 2000

Dear Mr Mahoney,

REVIEW OF OPERATING EXPENDITURE IN INTEGRAL ENERGY'S REVISED PUBLIC LIGHTING PRICE PROPOSAL (FINAL)

In response to your instructions, we report on the impact of the proposed operating expenditure in Integral Energy's (Integral's) revised public lighting price proposal of 21 December 2007 on the opinions expressed in our final report of 30 October 2007.

General Considerations

Scope of Review

In accordance with our terms of reference, which are appended, we report only on the reasonableness and efficiency of the operating expenditures that are now proposed by Integral for FY 2008 and FY 2009, considering them only to the extent that they differ from those proposed by Integral originally, as reviewed in our final report. The assessment is necessarily brief because of the reporting deadline but we are satisfied that we have considered all material matters relevant to the task.

Integral's Comments on Draft Report Taken into Account

Integral's comments on our draft of this supplementary report have been taken into account and such changes as were considered appropriate have been incorporated.

Abbreviations and Terms

The abbreviations and terms used are those in our final report. All sums stated are in nominal dollars unless noted otherwise.

Letter to be Read in Conjunction with Final Report

This letter should be read in conjunction with and in modification of our final report (file "WCook IEPubLtgReviewReport FINAL.pdf" sent to IPART by email for the Tribunal's use on 8 November 2007).

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Proposed Additional Opex

Subsequent to its initial application and the presentation of our final report, Integral undertook further analysis of its public lighting costs and revised its forecast operating expenditure (opex) for its public lighting services for FY 2008 and FY 2009. Integral submitted its revised proposal to the Tribunal on 21 December 2007.

Integral has now proposed the inclusion of various costs in its opex projections for FY 2008 and FY 2009, specifically:

- Labour cost increase above CPI;
- A pro rata increase in maintenance costs based on the projected increase of the number of lighting installations;
- The cost of an additional 10 staff for ongoing inspections of steel lighting columns;
- Reporting and consultation costs arising from public lighting asset management plan;
- An increase in piece rate payments for bulk lamp change and emergency repair activities; and
- A share of outage management system (OMS) ongoing opex costs.

The costs are summarised in Table 1 for FY 2008. Integral have proposed that the costs be escalated at CPI for FY 2009.

Table 1: Integral's Additional Opex – FY 2008

Cost Driver	Additional Opex (\$000)	Integral's Comments
Above CPI labour cost increases	137.1	Based on actual labour cost changes in excess of CPI.
Pro rata maintenance cost increases for increase in number of lights	480.6	Based on population of lights increasing at 3.6% p.a.
Additional inspections and resulting minor repairs	866.0	Based on 10 additional full-time equivalent staff and associated equipment.
Reporting and consultation costs arising from public lighting asset management plan	251.5	Costs of providing additional level of detail and of consultation with councils, required by the NSW Public Lighting Code.
Increase in piece rate payments for bulk change and emergency repairs	449.7	Left out of cost projections made for 2004 Determination.
Share of outage management system (OMS) ongoing opex requirements	226.4	Capex was included in the 2004 determination but no additional opex was allowed.
Total	2,411.3	

Source: Integral's revised public lighting proposal.

Integral states that these costs are new costs or have not been recovered previously from either public lighting customers or other customers. It acknowledges that the existence of some of these additional costs was known at the time of its June 2007 submission (and

was mentioned to us – a preliminary estimate of all the additional costs was provided to us on 20 September 2007) but that the additional costs were not included in its original proposal and that supporting documentation was not provided in respect of them.

Assessment

Labour Cost Increases above CPI

Integral states that labour costs are increasing at a rate greater than CPI (assumed at 2.5%) and it is proposing \$0.137 m to be included in its public lighting expenditure on this account. The justification for the increase is based on the increase in the labour component of public lighting operating costs between FY 2006 and FY 2007, adjusted for CPI. In FY 2006 and FY 2007, the labour cost component is stated to be about \$2.3 m and \$2.5 m respectively, giving a nominal increase \$0.2 m. Deducting 2.5% for CPI from the FY 2007 labour cost gives an increase above CPI of \$0.137 m. These are Integral's calculations. Strictly speaking, they should be made differently with a slightly higher figure arrived at but the error is not material; and on the other hand, there is an element of doubt as the labour cost increase is calculated historically and wage movements may be different in the future. Therefore, we have not adjusted Integral's calculation.

The increase from FY 2008 to FY 2009 would be \$0.137 m plus CPI of 2.5%.

Although we have not verified the labour cost components in FY 2006 and FY 2007 or analysed the composition of the labour force or any changes in it, the amount is small and the calculation appears reasonable.

No question arises in respect of efficiency as total opex before the addition of this inflationary component was determined in the final report to be efficient.

Pro Rata Maintenance Cost Increases for Increase in Number of Lights

Integral argues that its maintenance expenditure ought to be increased pro rata with the number of lights. Whilst prima facie there is a case for increased opex as the size of the installation grows, we do not consider that it ought to be pro rata, as economies of scale would need to be taken into account as well as other parameters such as the age and condition of the asset base.

Based on growth in the number of lights of 3.6% p.a., Integral proposes an additional cost in FY 2008 of \$0.481 m. Taking this as an upper bound, we recommend that the Tribunal agree to half this amount for FY 2008 – the mid-point between the upper bound and a lower bound of zero is proposed in the absence of a detailed analysis of past costs vs. growth – and for the same sum escalated by 2.5% for FY 2009.

Additional Inspections and Resulting Minor Repairs

Integral has engaged ten additional staff for ongoing inspections of its public lighting assets and for accompanying minor repairs. This follows on from a major inspection programme in 2004 that identified an increasing quantity of street light column structural problems and a smaller number of electrical defects, both of which are potentially hazardous. Integral states that this work addressed only short-to-medium-term hazards that were rectified over the three years to FY 2007 and that in its opinion a continuing

inspection programme to visit each column every four years is required. The basis of the additional costs is given in Table 2. We noted that Integral had mentioned this plan to us during our review of its original proposal but that it did not present evidence of the costs or include the expenditure in its proposal.

Table 2: Details of Additional Inspection Costs (FY 2008)

Category	Quantity/Cost	Comments
Columns requiring inspection each year	14,163	
Man-hours per column	1.1	Includes travel and minor repairs.
Total man-hour requirement	15,579	
<i>Costs:</i>		
Staff costs	\$786,000	Based on actual 2007 rate for an inspector.
Vehicle costs	\$80,000	Based on \$16,000 p.a. for a utility vehicle.
Total	\$866,000	

Source: Integral.

We discussed the costs with Integral and noted that it is not alone in reporting defects in steel lighting columns. We are satisfied that there is adequate justification for the programme to reduce public hazard and that its cost is reasonable for the scope of work being undertaken. In that context – reasonableness of need and cost – the expenditure may be considered efficient for the purpose of this review, escalated at 2.5% for FY 2009.

Reporting and Consultation Costs

Integral has proposed an additional \$0.252 m associated with increased consultation and reporting requirements stemming from the *Public Lighting Code*. It says that it has responded to these requirements by increasing the level of its reporting to and consultation with councils. A breakdown of the additional costs is given in Table 3.

Integral say that the costs were not included in the estimates it made for the 2004 determination.

Integral says that one of the main issues raised by councils in public forums and feedback to IPART was a perceived lack of consultation and reporting by public lighting providers such as Integral. The *Public Lighting Code* addressed this issue, requiring specific actions in this area. Integral says it has responded to these requirements and increased the level of reporting to and consultation with councils with regard to public lighting and that this has imposed additional costs on it for the preparation of reports, meetings with councils, inventory review and data “cleansing”.

We accept that Integral has improved its reporting and attendance activities, although we were not able to obtain from Integral an annual report to councils of the type that the Code appears to require. We also accept that reporting to and consultation with customers generally is an activity that can be carried out only at a cost. However, whilst noting that Integral may disagree, we are not satisfied that the Code alone conveys the

requirement for this activity. Instead, we consider that all DNSPs either were, or ought to have been, engaged in conferring with and reporting to their customers in an appropriate manner, before the Code came into existence. We thus consider that the need for the requested additional \$0.252 m p.a. – an amount that *prima facie* appears excessive, to add further consideration to the point being made – is not established to our satisfaction and we thus do not consider it an efficient additional cost for the purpose of this report.

Table 3: Additional Reporting and Consultation Costs (FY 2008)

Cost Driver	Additional Cost (\$000)	Comments
Bi-annual meetings with major councils	67.5	Visits to the 12 major councils twice a year by Integral staff to discuss any issues that the councils may have with project completion or service quality.
Quarterly reports to councils	48.8	Quarterly written reports to 18 councils regarding current progress with jobs and key statistics.
Monthly forum meetings	43.2	Monthly internal meetings including representatives from billing, standards, construction and maintenance areas to discuss and rectify any outstanding public lighting issues
Inventory review and data adjustments	92.0	Complete review of public lighting inventory used as basis for charging and correction of any data discrepancies.
Total	251.5	

Source: Integral.

Piece Rate Payments for Bulk Lamp Change and Emergency Repairs

Integral has proposed an additional \$0.450 m to match the costs of an existing incentive pay scheme for public lighting bulk lamp change and emergency repair work. Integral claims that the cost of the scheme was omitted from the cost projections prepared for the 2004 determination due to an “accounting oversight”.

The scheme is designed to keep backlogs to a minimum and on that basis, appears to us to be a reasonable and efficient expenditure. We thus consider that it may be accepted in FY 2008, escalated at 2.5% for FY 2009.

Outage Management System Costs

Integral has proposed \$0.226 m to account for an allocation of part of the operating expenditure associated with its outage management system. It says that it implemented a new system in or around 2006 to replace a previous system that was developed in-house and thus did not have associated support or license costs. Integral states that its 2004 projections included only the capex required for introduction of the new system, not ongoing opex, and that this was an oversight. It says that the increased expenditure is associated with licence fees, vendor support contracts and internal support staff and is about \$0.88 m p.a. of which the apportionment to public lighting is 25.6%.

This item appears to us to be a reasonable and efficient expenditure. We thus consider that it may be accepted in FY 2008, escalated at 2.5% for FY 2009.

Opinion – Revised Recommended Efficient Opex Levels

In summary, in our opinion, the revised recommended levels of efficient opex for Integral Energy’s public lighting services are as shown in Table 4.

Table 4: Revised Recommended Efficient Opex Levels (\$000)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Final Report					
Recommendation in our Final Report a/	8,924	9,281	9,366	9,600	9,840
Corrections to Table 3.8 in Final Report b/	307	66	252	259	265
Our corrected recommendation	9,231	9,347	9,618	9,859	10,105
Integral’s Revised Proposal					
Additional expenditure proposed by Integral c/				2,411	2,471
Integral’s revised price proposal d/	9,231	9,347	9,619	12,270	12,577
Opex to be recovered from public lighting charges e/				8,904	9,127
Our Revised Recommendation					
Recommendation in Final Report				9,859	
Labour cost increases above CPI				137	
Pro rata maintenance cost increases				240	
Additional inspections and resulting minor repairs				866	
Reporting and consultation costs				0	
Increase in piece rate payments				450	
Share of outage management system costs				226	
Recommended efficient levels of opex f/				11,778	12,072

a/ Refer to Table 3.8 of the Final Report.

b/ Adjustments to correct a calculation error in Table 3.8 in the Final Report. (The error arose in the adjustment for night watch and customer-funded work.)

c/ Proposed by Integral in its revised price proposal. FY 2009 expenditure is FY 2008 expenditure escalated by CPI of 2.5%.

d/ FY 2005 to FY 2007 opex was taken from the corresponding regulatory accounts, adjusted to remove the night watch and customer-funded components. Forecast opex for FY 2008 is based on FY 2007 expenditure escalated by CPI of 2.5% plus Integral’s proposed additional expenditures; FY 2009 is an escalation of FY 2008 based on 2.5% CPI. Note that the base expenditure (less the proposed additional expense) reconciles with our adjusted recommendations.

e/ To ensure that there is no double counting, Integral has proposed to specifically exclude corporate overheads from the operating expenditure used as the basis of this price change.

f/ Before deduction of overheads that Integral now proposes not be recovered from public lighting charges, even though in our opinion they constitute a legitimate public lighting expense. The level in FY 2009 is the FY 2008 level plus CPI of 2.5%.

Comment on the Presentation of these Additional Costs

In approving these additional costs, it may be appropriate to note for the record the chain of events that led to their presentation by Integral in its revised proposal, at least as we understand the situation.

The existence of these additional costs was identified by Integral during the course of analysis of Integral’s original proposal but Integral did not pursue a case in respect of them at that time. The case was pursued only after we pointed out in our final report that the overheads that Integral had transferred from its prescribed services to public lighting were being recovered under the other part of the determination and after the Tribunal,

taking note of that fact, formed the view that the overhead costs ought not to be recovered a second time from Integral's public lighting customers, even though in our opinion they (the overhead costs) constituted a legitimate public lighting expense. Having thus had its proposal reduced, Integral then submitted a revised proposal, the essence of which was a claim for the additional expenses that we have reviewed in this supplementary report.

Conditions Accompanying our Recommendation

The opinion expressed in this letter is subject to the same conditions as those applying to our Final Report, *viz.* the conditions set out in section 4.4 of that report.

Yours faithfully

Wilson Cook & Co Limited

A handwritten signature in blue ink that reads "Wilson Cook & Co." The signature is written in a cursive, flowing style.

Attachment: Terms of Reference.

Appendix A: Terms of Reference

Background

The Electricity Distribution Pricing 2004/05 to 2008/09, Final Determination (June 2004) designates public lighting as an excluded distribution service to be regulated under Rule 2004/01 (the Rule). The Rule requires that if a Distribution Network Service Provider (DNSP) seeks to increase its public lighting charges, it must make an application to the Tribunal and comply with the requirements of the Rule. Specifically, the Rule requires that DNSPs must set prices to signal economic costs of provision with reasonable endeavour (Clause 2.2)

IE's initial application dated 1 June 2007

In June 2007, IE applied for a public lighting price change of CPI (3.5%) plus 2% from 1 August 2007. To assist with its assessment of IE's application, the Tribunal engaged Wilson Cook & Co in August 2007 to review the public lighting costs as submitted by IE. Wilson Cook & Co submitted its report to the Tribunal in November 2007, revising the levels of capex and opex proposed by IE and recommending these as efficient costs for determining the public lighting charges for 2007/08.

IE's revised application dated 21 December 2007

Subsequent to its initial application and Wilson Cook & Co's final report, IE undertook further analysis of the public lighting costs and revised the forecast operating expenditure (opex) for its public lighting services for 2007/08 and 2008/09. IE submitted a revised application to the Tribunal on 21 December 2007. There is no change to the forecast capital expenditure (capex).

To assist with its assessment of the change in opex in the revised proposal, the Tribunal wishes to obtain assurance that the revised forecast opex represents efficient cost for determining prices for the public lighting services. The Tribunal is therefore seeking to extend the initial contract with Wilson Cook & Co to assess whether the revised opex that underpins the revised application is efficient.

Scope

Wilson Cook & Co should examine Integral Energy's revised forecast public lighting opex (2007/08 and 2008/09) that supports its revised application and recommend efficient level of opex that is consistent with maintaining the service standards as required by the NSW Public Lighting Code (the Code) and industry best practice.

If the level of efficient opex is different from that as recommended by Wilson Cook & Co in its November 2007 report, the consultant should justify why the change in costs is efficient.

If the consultant finds that the forecast opex is not efficient, it should indicate how the expenditures should be adjusted to reflect efficient levels. The Tribunal may rely on this review in determining whether to accept IE's revised public lighting price increase.

Outputs

The required outputs from the consultancy are:

1. a final written report which addresses the objectives of the consultancy;
2. discussions and meetings with the DNSP, the Tribunal and/or Tribunal Secretariat; and
3. presentation of findings to the Tribunal.

The consultant should note that the Tribunal may release the supplementary report as a public document. As such, the report should be written in plain English with findings clearly and logically presented.

The final report should be delivered no later than 31 January 2008.