Ref: LZ:TB

2 October 2002

Dr. Tom Parry
Chairman
Independent Pricing and Regulatory Tribunal
Level 2, 44 Market Street
PO Box Q290
QVB Post Office NSW 1320

Dear Dr. Parry

Consultation *on the* Terms *of Reference Elecetricity* Operating *and Capital Expenditure Review*

Country Energy welcomes the opportunity to comment on the Tribunal's draft terms of reference.

The attachment provides general comment on the approach and principles that may be appropriate for determining the prudency and efficiency of expenditure, and to ensure some degree of pragmatism in the review. Country Energy supports the view that given the commercial and regulatory incentives faced by the distributors, that actual expenditure incurred during the current regulatory period should be considered to be efficient.

Country Energy looks forward to further consultation in relation to the review of the capital and operating expenditure and we are happy to provide further information and comments if required. If you have any questions or wish to discuss this response, please do not hesitate to contact Mr Terry Miller, Group General Manager Networks on 6338 3578 or Mr Lawrence Zulli on 6883 4547.

Yours sincerely

Terri Benson
General Manager Regulatory Affairs

1. Introduction

In considering the total revenue needs of the NSW distributors for the forthcoming regulatory period, the Tribunal has indicated an intention to undertake extensive analysis and engage external assistance to form a view as to the prudency and efficiency of actual expenditure incurred during the current period and projections for operating and capital expenditure for the next period.

Investment in system and non-system assets is made by Country Energy to maintain the reliability, integrity, safety and capacity of distribution services. The current regulatory arrangements have provided some uncertainty and an element of risk for the distribution businesses in terms of their network investments. Additionally, the "regulatory benchmarks" for operating and capital expenditures as contained in the current determination do not represent amounts that would have allowed Country Energy to adequately fulfil its obligations particularly in the areas of network maintenance and the development of information systems.

The key regulatory decisions to be made in the 2004 electricity price review will be to provide greater certainty to Country Energy and the NSW distributors for ongoing new investment and sufficient revenues in order to meet our obligations in delivering regulated distribution services and do not compromise the long term integrity of the network. We believe the focus should be the long term, efficient and sustainable service delivery in a safe and reliable manner to customers rather than cost reduction.

Ultimately, the expenditure amounts allowed must reflect these requirements for each distributor. It is accepted that the Tribunal and customers need to have confidence that expenditure levels are prudent and efficient. However Country Energy submits that the search for efficient expenditures through the application of the detailed analytical means as proposed by the Tribunal in the draft terms of reference may fail in practice to deliver sufficient expenditure allowances given the information uncertainty facing the Tribunal. This is clearly evidenced by the "benchmark" expenditures in the current determination, which was the result of a similar analysis undertaken in the 1999 review.

In the Productivity Commission's 2000-01 Annual Report, these sentiments were summarised as follows:

"Given uncertainties and information difficulties, there are limits to what regulators can achieve. Rather than aiming for an ideal, but unattainable outcome, the public policy goal should be a set of regulatory arrangements that will improve efficiency through time and that will reduce some of the bigger risks of making regulatory errors. A framework is needed in which regulators are encouraged to intervene only when significant improvements in efficiency are in prospect and not be overly ambitious in finetuning the prices they regulate… The Commission's recent inquiries have revealed a need to re-balance the emphasis away from achieving immediate gains for users and consumers from existing infrastructure – much of it government owned or previously government owned – to a regulatory framework that will also facilitate efficient investment in augmented and new facilities."

2. Prudency and Efficiency of Expenditure in the Current Regulatory Period

There are at least two approaches that could be adopted by the Tribunal to form an opinion as to whether the requirements of prudency and efficiency have been satisfied.

One approach is for the Tribunal to obtain detailed information on the operating expenditures and capital expenditure projects that have been undertaken during the current regulatory period. The Tribunal could then form a view for example, as to whether the need for these operating and maintenance expenditures and capital expenditures are adequately justified, and that the asset management strategies employed and decisions made reflect efficient and least cost approaches of providing the relevant services.

In our opinion "after the event" identification of expenditure is a subjective issue, particularly where it would require the Tribunal to apply an undefined prudency test, and would be a very resource-consuming process. Given the incentives that Country Energy (and the NSW distributors) face to achieve an efficient level of expenditure, coupled with the generally mandatory nature of our capital, and operating and maintenance budgets, we question whether the level of detail involved in undertaking such an extensive exercise could be justified.

We would instead urge the Tribunal to adopt a more light-handed approach to assessing whether past expenditure is efficient. Country Energy advocates that the most appropriate approach is to rely on the observation that distributors have a commercial incentive to minimise their expenditure to efficient levels, subject to meeting service performance and compliance obligations, and to infer from this that they have spent prudently. The commercial incentives that would have influenced expenditure decision-making and conduct over the current regulatory period include:

- The distributors operate under an economic regulatory control framework that provides clear incentives to achieve efficient expenditure levels.

  For example, the Tribunal indicated in the 1999 determination that new capital expenditure during the course of the current regulatory period would be required to pass a "prudency test" for it be included in the distributors' regulatory asset base and therefore regulated network charges. Equally, existing in-service assets are subject to optimisation reflecting their utilisation and service level. If network investments are not prudently considered and implemented through the distributors' capital planning and approval process, then its opportunity value can be lost through this optimisation process.

- The distributors must ensure that rationed capital is prudently invested in order to meet shareholders' expectations for an appropriate return on assets, subject to service obligations and performance pressures from customers.

- Country Energy undertakes a significant number of relatively minor capital works, associated with the mandatory connection provisions of the Electricity Supply Act 1995, many of which may not achieve an acceptable hurdle rate and there are a number of major capital expenditure programs that are undertaken directly to comply with reliability, safety and environmental requirements with little or no discretion. This suggests that a distributor would be likely to adopt a least-cost approach to achieve the desired outcome.

- Country Energy's has generally adopted an approach of competitively tendering for contractor engagements for the vast majority of zone substation and sub-transmission related capital works to independent third parties, which ensures capital expenditure is undertaken on a cost-effective basis.

- Greater public disclosure of information and comparative reporting by the Tribunal and the Ministry which places pressure on the distributors performance level.

- The distributors publish an annual electricity supply development review report, as required under the demand management code of practice, which enable a market based approach to the consideration of non-network alternatives and the most efficient means for addressing emerging network constraints.

Country Energy believes that the above factors provide the commercial incentives to achieve prudent and efficient levels of expenditure, which means that the distributor is discouraged from "gold plating" the network or undertaking unnecessary expenditure. As a result, it could be inferred that the actual expenditure incurred during the period for operating, maintenance and capital activities represents the least-cost means of providing distribution services. In our opinion, there is no persuasive evidence to the contrary.

The "reliance on incentives" approach would be less intrusive and would also be consistent with the approach that has been adopted by the Essential Services Commission.

While the approach may inevitably reflect an estimate of prudency, we consider it to be far simpler and ultimately less resource intensive and, more importantly, less risky to the legitimate business requirements of the distributors compared with attempting to apply a yet to be developed prudency test to assess the distributors' capital investment activities from an ex-post perspective. In our opinion the prudency test should have been fully developed and finalised following the release of the 1999 determination to provide the degree of certainty that was desired by the distributors over the current regulatory period.

Nevertheless, if this option were not adopted, we would be concerned about the Tribunal adopting a detailed forensic approach to reviewing past expenditure decisions.

There are many factors that have impact expenditure in the current regulatory period, which must be considered by the Tribunal. A series of issues and cost imposts have emerged that were either unexpected at the time or expected but not well understood. This combined with some unrealistic assumptions and forecasts in the 1999 price review concerning non-system assets such as the replacement of information technology systems, FRC, and a host of other network investment and maintenance issues have had a material impact on the measured differences between actual spends and the regulatory expenditure "benchmarks".

Any assessment of Country Energy's actual expenditure during the current regulatory period must therefore take account of:

- Changes in scope of the distribution business;
- Events and circumstances beyond the control of distributors;

- Changes in operating and other conditions; and the
- Real costs of delivering distribution services, particularly to regional and rural NSW.

Adjustments would need to be made to regulatory expenditure "benchmarks" to account for these factors and this should form part of the terms of reference.

Country Energy would be very concerned with any assumption that the forecast expenditure in the 1999 determination reflected the investment and operating and maintenance expenditure needs of the distributors. An approach that over-relies on "benchmarks" of this kind would result in a long-term under-investment in electricity distribution networks to the detriment of services. In our opinion, customers are no worse off for any increase in capital and operating expenditure. This was confirmed by the Productivity Commission in their recent review of access regimes.

3. Establishing an Efficient Level of Future Capital Expenditure

New investments to occur within the forthcoming regulatory period will be necessary to meet:

- customer requirements for network quality and reliability;
- maintain the safety and integrity of the network;
- customer expectations for improved customer services;
- forecast growth in demand and system augmentation; and
- asset replacement and other regulatory compliance obligations.

Country Energy agrees that forecast new investment should not exceed the amount that would be invested by prudent distributor acting in accordance with accepted good industry practice, in the efficient delivery of services.

A key issue for the Tribunal will be how to establish the expenditure levels to ensure that Country Energy has sufficient revenues to meet its particular obligations in delivering network services to regional and rural NSW, without resorting to a detailed "line-by-line" examination of all proposed cost items.

The draft terms of reference for the consultancy proposes that the consultant should develop its own program of capital expenditure. Country Energy is very concerned with an external party attempting to develop a capital works program within a relatively short period of time and without the detailed information, understanding and experience required of a range of factors associated with Country Energy's distribution business, including:

- Services to be delivered and outcomes to be achieved in accordance with the Country Energy corporate strategic plan and asset management plan;
- Specific needs of our customers with respect to the provision of timely and reliable service and supply which have been developed over many years of community consultation;
- Targeted investment planning that delivers the greatest benefit to our customers, particularly the prioritisation of feeder specific investments;
- Customer's willingness to pay;
- Knowledge of load growth trends across the total network, at each of the transmission connection points, in each area of our service area, zone substations and individual major distribution feeders;

- Detailed understanding of the network configuration through all voltage levels and historical design;
- The current condition and risk of our distribution network assets across all asset classes;
- Specific network age related and defect issues;
- Specific asset management strategies and planning criteria for rural distribution systems;
- Legacy issues arising from decisions made by predecessor distributors;
- Specific regional issues and activities;
- Operating environment in which capital expenditure activities are undertaken such as the diverse nature and geographical disabilities of our distribution network;
- Lumpiness of capital projects in rural areas due to changing circumstances and the anticipation of unexpected "spot load" demand growth;
- Increase (or reduction) in expenditure associated with the addition (or removal) of service obligations or functions;
- Fleet and mobile fleet strategies;
- Detailed information technology and systems integration strategies and issues specific to our business.

In our opinion the Tribunal should require the distributors to provide their investment proposals on the basis that they represent their best estimates of expected outcomes for the forthcoming regulatory period arrived at on a reasonable basis. This would then be used as a point of reference for a high level review by the Tribunal of the following:

- Reasonableness of the assumptions and commentary as provided by the distributors in their submissions that underlie the expected expenditures;
- Reasonableness of individual asset management and planning policies and linkage to the capital investment program and associated expenditures, including compliance with the NSW demand management code of practice;
- Reasonableness of forecasts of demand growth and related capital expenditure as provided by the distributors;
- The general age distribution, state, and risk of existing in-service assets and the reasonableness of the corresponding asset replacement and renewal programs;
- Current and projected levels of efficient maintenance expenditure and a general assessment of the trade-off;
- Reasonableness of projected levels of service quality and a general assessment of the integration of customer willingness to pay customer evidence in terms of additional resource requirements; and
- General assessment of the impact of differences in operating environment faced by the individual distributors.

Any other more detailed method of assessing the appropriateness of individual capital expenditures would be highly intrusive.

The Country Energy network has a number of significant and unique characteristics, which make comparison with other networks difficult. Those characteristics are important drivers in the development of the forecast capital expenditure and must be recognised in the expenditure review. Country Energy would have some concerns with the Tribunal using "best practice industry benchmarks" without due consideration of these drivers of costs.

There have been a number of criticisms directed at the use of expenditure benchmarks. Country Energy's predecessors expressed some concern with the Tribunal's previous attempts at expenditure benchmarking studies. However high level "sanity test" examination of proposed expenditure levels to ensure that they are within an acceptable range could support the above process. These sanity tests would need to be developed in close consultation with the distributors. In this case comparisons should only be made with similar distributors in Australia with similar operating environments and with appropriate account made of uncontrollable distributor-specific factors. This was a particular failing of the 1999 price review where quality data from the US was unavailable and the operating environments of the benchmarked firms differed markedly.

Although past trends for capital expenditure cannot be completely determinative, an analysis of overall expenditure trends, or the trends in the different capital expenditure components, is still a useful source of information that may cast light on the reasonableness of future capital expenditure forecasts for Country Energy. However, whilst historical data may have some value, it is essential that each regulatory period be considered separately.

4. Establishing an Efficient Level of Future Operating and Maintenance Expenditure

As with capital expenditure, whilst historical data may have some value, it is essential that each regulatory period be considered separately in light of changes to the services to be delivered, changes in scope, outcomes to be achieved, and the operating environment in which those activities are to be undertaken and changes thereof. In the case of Country Energy, we propose that the Tribunal accept that the actual cost performance and the 2002/03 budget, provides a sound platform for the efficient level of operating and maintenance costs over the forthcoming regulatory period, subject to any additional resource requirements and expenditure to meet ongoing maintenance backlog and bush fire mitigation obligations.

Country Energy proposes that the approach that could be adopted for determining operating and maintenance expenditure forecasts over the forthcoming regulatory period be as follows:

- The budget operating expenditure for 2002/03 forms the starting point for the base level forecast of operating expenditure for 2003/04 onwards.

Having established a base, then this would be adjusted to reflect:

- Changes in expenditure requirement over the forthcoming regulatory period to take account of the expected "step" increases in cost associated with the additional obligations or functions or the employment of additional resources to comply with industry standards for maintenance, etc;

- Reasonable assumptions regarding "incremental" changes such as the annual rate of change in costs of inputs and the impact of annual demand growth over the forthcoming regulatory period.

Country Energy believes that a review of these two elements should form part of the expenditure review.

While this will inevitably reflect an estimate, it is considered far simpler to estimate just the "incremental" rates of change and "step" expenditure change in obligations and functions, and ultimately less resource intensive, as compared to an external consultant within a relatively short space of time with a considerable degree of information uncertainty attempting to develop an understanding of efficiency for all of the distributor's activities and functions.

The application of this approach would be less resource intensive, would permit a more light-handed approach to assessing the efficiency of actual operating expenditure, and will also reduce any risk to the distributor of underestimating the operating and maintenance expenditure moving forward.

5. Other General Comments

The following general comments are provided in relation to the draft terms of reference.

- The level of capital expenditure should be represented in five categories, namely:

  - Growth Related
  - Capital Contributions (Customer Related)
  - Asset Renewals and Replacement (including safety and environmental)
  - Reliability Related
  - Non-System Related

  Non system related capital expenditure such as information systems, communication systems, vehicles etc does not appear to be addressed in the draft terms of reference. It should be noted that some projects undertaken by Country Energy might have multiple drivers.

- There is a timing issue and difficulty in providing audited actual expenditures for 2002/03 within the timeframe proposed. The final report is due to be completed September 2003, thereby requiring the audited accounts to be prepared in August 2003. The Tribunal may need to consider the inclusion of unaudited data for the 2002/03 financial year.

- In all cases, references to "operating" expenditure should be a reference to "operating and maintenance" expenditure.

- Country Energy will be in the process of preparing their April 2003 submissions in February 2003. It is recommended that the operating and maintenance expenditure and capital expenditure forecasts be provided in late March 2003 to order to align with the distributors April 2003 submission, provide sufficient time for internal due process and consistency between the April 2003 submission and the forecasts provided to the Tribunal's consultants.