

28 October 2002

Mr Michael Seery
Consultation on Terms of Reference
Electricity Operating and Capital Expenditure Review
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

The logo for EnergyAustralia, featuring the company name in a bold, sans-serif font with a trademark symbol. To the right of the text is a stylized graphic of a power plug or a cluster of dots arranged in a grid pattern.

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Paul A Broad
Managing Director

Dear Mr Seery,

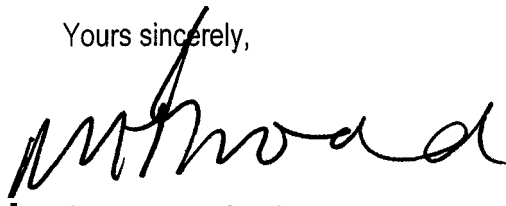
Electricity Operating and Capital Expenditure Review Terms of Reference

EnergyAustralia welcomes this opportunity to assist the Tribunal in developing the terms of reference for its operating and capital expenditure review of the NSW DNSPs for the 2004 network determination. Retrospective and prospective reviews of operating and capital expenditures have become a feature of Australian regulatory practice, and depending upon the quality of the reviews, they can materially alter the nature of the regulatory controls.

Please find attached EnergyAustralia's comments relating to the draft terms of reference. EnergyAustralia cannot stress highly enough the care and precision that needs to be taken in establishing the terms of reference for the review in order to ensure that appropriate and predictable results are delivered. As such, you will note that many of EnergyAustralia's comments relate to the clarity and use of specific terms.

EnergyAustralia appreciates being given the opportunity to provide comments on this important matter. If you have any queries regarding this submission please do not hesitate to contact either myself on 9269 2111 or Mr Mike Martinson, Group Manager Regulatory Strategy, on 9269 2234.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Paula Broad', written in a cursive style.

(PAULA. BROAD)
Managing Director

EnergyAustralia Submission on the terms of reference for the Electricity Operating and Capital Expenditure Review

Use of efficiency and prudence tests

EnergyAustralia considers it important that the use and definitions of the “efficiency and “prudence” tests should be clearly defined in the draft Terms of Reference (TOR). We note that the Tribunal has correctly recognised that the timing of decisions is critical when assessing the prudence of those decisions, as outlined on page 6 of the draft TOR¹. However, we believe that clearer definitions of “efficiency” and “prudence” would be of great assistance to the consultant.

We are concerned that the balance of the two tests as understood from the draft TOR may not be appropriate. “Prudence is generally seen as an ex-ante concept and is unlikely to be appropriate for assessing past investments. In assessing “prudence”, EnergyAustralia believes that the most appropriate demonstration is the existence of defined procedures for the assessment and approval of capital projects. These procedures would necessarily seek to ensure that required outcomes are delivered at least cost.

“Efficiency” in the Australian regulatory framework has generally been used as an ex-post constraint on capital expenditures. With an ex-post “efficiency” test, the costs of any project undertaken can be examined in detail and compared to the prevailing network and market conditions.

However, in an ex-ante framework the consultant would be required to make this same assessment by breaking the whole capital expenditure program into specific projects and make assumptions regarding its expectations of future network and market conditions. Any benefits arising from the level of information intensity and subjectivity introduced by this approach is unlikely to outweigh the resulting financial costs and reduced business incentives.

Reduced business incentives may arise because the “efficiency” test approach is unlikely to provide for circumstances where the priority and nature of projects may change over time, or where trend information is used to provide a statistical basis for levels of forecast expenditure². In these circumstances, the “efficiency” test would create a framework of explicit “approval” of projects, rather than providing for a “prudent” program of capital investment.

It would appear that combining the two tests may result in several undesirable features and outcomes:

- The process may confuse the issue of “prudence”, which should be forward looking, and “efficiency”, which should be backward looking;
- The process is information intensive and may prove to be inconclusive, particularly if efficiency is assessed on an ex-ante basis;

¹ “the consultant is to assess the ‘prudence’ on the basis that the investment decision was prudent at the time it was made – not with hindsight.”

² For example replacement capex projects can be budgeted based on statistical analysis of failures, condition, and age.

- The proposed approach may provide incentives on the businesses to spend only the approved amounts on only the specifically approved projects as opposed to a flexible program. This would ignore the actual - and often changing - needs of the network and its customers; and
- It may create an environment where the consultant's asset management and operational expertise dilutes the fundamental accountability of the DNSPs.

In summary, we believe that "prudence" should be the *ex-ante* test applied by the consultant when reviewing the forward capital expenditure programs of the DNSPs. Given that a prudent process would include delivering outcomes at the least cost, this should provide the Tribunal with the confidence that the level of capital expenditure is "prudent", while still providing the businesses with the appropriate incentives to adjust the actual projects in the capital program in order to cater for changing circumstances throughout the period.

Consultant's capital expenditure program

EnergyAustralia believes that this requirement should be modified to be conditional upon the consultant materially critiquing the proposals of the DNSPs, given the likely costs involved in undertaking the whole capital expenditure planning process.

It is unclear from the draft TOR whether the intent is to have the consultant develop its own capital expenditure program or rather to have the consultant provide a critique and costing of the program put forward by the DNSPs. EnergyAustralia considers that the latter approach is by far the more preferable option. The former requirement would appear to be very onerous upon both the consultant and the DNSPs, who will have to provide sufficient information in order for the consultant to make such an assessment.

EnergyAustralia is doubtful that the consultant will have sufficient time or resources to effectively undertake the full capital expenditure planning process required to make such an assessment. Moreover, the volume of information requests needed for such an assessment is unlikely to be useful in the short time frame of the consultancy without the detailed understanding of the network and network planning that the DNSPs possess internally.

Ultimately, EnergyAustralia believes that any views on the most appropriate capital expenditure program developed by the consultant should be used as a "sanity check" on the DNSPs' own proposals.

EnergyAustralia recognises that it is appropriate for IPART to challenge the Company's expenditure proposals with an independent review. We believe, however, that an approach should be pursued where the DNSP works closely with IPART and its consultant to address any specific concerns relating to the prudence of the process or the resultant investment program.

Such an approach is likely to yield a better result in terms of customer outcomes as well as recognising the business's ultimate accountability for the management of the network. This approach would also provide an opportunity for EnergyAustralia to improve its processes should IPART or its consultant identify any areas for improvement.

Service standards

EnergyAustralia believes that the TOR should require consultation with the DNSPs regarding service quality requirements of customers and identified areas of service quality improvement. EnergyAustralia has a strong record in this area, and would be able to assist the consultant in assessing relevant information as appropriate, including the results from the “Willingness to Pay” pilot study currently being undertaken by the DNSP’s.

It is unclear against what service standards the consultant would be required to make the assessments of service and price. Furthermore, it is unclear what assistance the consultants would receive in relation to measuring and or weighting the mix of service and price in their recommendations to the Tribunal.

If the consultant is to develop a comprehensive “shadow” capital expenditure program, it is essential that this be done on the basis of an agreed set of service standards.

Planning standards and best practice

EnergyAustralia is currently reviewing its planning standards to ensure that all relevant legal and regulatory obligations continue to be met in the most appropriate manner. EnergyAustralia believes that the outcomes of the review would be assisted greatly if the consultant were to work closely with the DNSPs to ensure that due regard is paid to the continuing development of the planning standard framework.

The draft TOR requires the consultant to form a view on “*best practice standards for efficient maintenance and utilisation of network assets*”. While the attainment of “best practice” is the aim of EnergyAustralia’s internal processes, we note that it is a matter of considerable subjectivity in defining precisely what “best practice” is.

EnergyAustralia would be more than happy to work with IPART and its consultant in determining an agreed view as to how “best practice” is best defined.

Review of the DNSPs’ systems for capital expenditure development

It is not clear from the draft TOR what the systems review would entail, or what criteria the consultant should apply when undertaking this section of the review. We submit that a clearer description of this aspect of the review would be of great assistance to the consultant.

Growth forecasts

The draft TOR is not clear as to the role of growth forecasts in the review and the relationship to the key specified outputs. EnergyAustralia has devoted considerable resources to refining its forecasting processes, and would be more than happy to assist IPART and its consultant in this area as appropriate.

Distributed generation and demand management options assessment

Whilst EnergyAustralia agrees that incorporating non-network solutions into the capital expenditure processes is important, the test proposed by the Tribunal raises some significant concerns.

In the draft TOR the Tribunal has opted for a “potential” test for the assessment of non-network options to reduce or defer capital expenditure. This is a vague test that creates significant financial and planning risks for DNSPs. EnergyAustralia would rather see the Tribunal replace the “potential” test with a “viability test.”

In making such a change the revised test would more effectively mitigate the risks to network security and reliability compared to the “potential” test. Moreover the revised test applies a level of critical assessment of the potential projects that would see the more probable and effective projects being included in the assessment of the DNSPs’ capital expenditure program.

Finally, EnergyAustralia believes that the most appropriate place for such projects to be considered and incorporated is via the “prudent” planning processes. EnergyAustralia’s processes take explicit account of viable non-network solutions as part of its commitment to efficient investment and support of environmentally responsible projects. Therefore] we would argue that the consultancy should address whether non-network solutions have been appropriately considered in the planning processes. This is also a more practical approach, as it is unlikely that the consultants will be aware of all proposed non-network projects.

Capital contributions assessment

It is unclear as to why the Tribunal has proposed a possibility test in relation to the calculation of the level of assets that will be contributed by customers and developers. The current test has no probability threshold and will therefore capture all possible capital contributions regardless of the probability that they will be forthcoming.

EnergyAustralia considers that a more reasonable test to be applied here is a “probable” test. This test inherently requires that the outcome being tested is more likely to occur than not (i.e. greater than 50 per cent probability). This is a more conservative approach, but it is more appropriate given the potential social losses associated with constraining infrastructure investment due to placing an inappropriate reliance on capital contributions that may not be forthcoming to fund network investment.