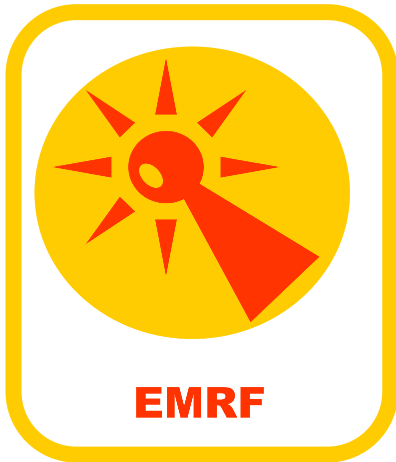

18th May 2004

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Dear Sebastian

Energy Markets Reform Forum Submission to the ACCC TransGrid's and EnergyAustralia's Responses to GHD Consultant's Reports

I enclose the Energy Markets Reform Forum's submission in relation to TransGrid's and EnergyAustralia's responses to the ACCC's GHD Consultants reports.

Yours sincerely

Mark Gell
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ENERGY MARKETS REFORM FORUM COMMENTS

ON THE RESPONSES TO

THE REPORTS BY THE ACCC CONSULTANT (GHD)

ON

TRANSGRID AND ENERGYAUSTRALIA

RELATING TO

Capital Expenditure and Asset Base, Operational Expenditure and Service Standards

SUBMISSION TO

AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

AND

REPORT TO NEM ADVOCACY PANEL

May 2004

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I General Observations

1. Insufficient time to provide adequate information

Both TransGrid (TG) and EnergyAustralia (EA) have expressed significant dissatisfaction with both the ACCC and its consultant, GHD, regarding the [lack of] planning for the review, the quality of the work undertaken and the lack of time provided for the review of past and planned capex, and the future opex claims.

The EMRF would not disagree that the time provided by the ACCC for its consultant's review was short. However, the EMRF would point out that the constraints placed on GHD by the lack of useful data provided initially by the applicants was the predominant and major cause for the shortcomings and the delay. The EMRF highlighted this deficiency in the provision of data, in its initial submission.

The EMRF is concerned that the ACCC's planning of its reviews is based on the assumption that applicants will provide clear, concise and relevant information at the time of the application, and that the applications will be provided in a timely manner in order that the ACCC can then undertake its review in an orderly and transparent manner. The assumption is that light handed regulation can be successfully implemented. In contrast, the approach taken by state regulators assumes that a significant amount of very specific information is required, it provide for a review timetable which ensures that information in a (specified) format is available and readily amenable to regulatory assessment. These (state) regulators define the information required, the time it is to be provided, the structure in which it is to be submitted, and then allow for a sufficiently long period for timely completion of the reviews.

This point is made by EA in its response to the consultant's report. Whilst both TG and EA attribute the failure of providing sufficient time for the review to the ACCC,

in reality both companies should accept responsibility for the delays, due to their inability to provide concise, useful data in adequate time. After all, the current review is the second review of both TG and EA by the ACCC and unfamiliarity with the process is arguably not an acceptable reason.

Both TG and EA have observed that the analysis by GHD of the historic capex has been superficial and does not provide a clear recommendation to the ACCC. This is true, but again surprisingly, neither TG nor EA accept any responsibility for this state of affairs. The GHD review of the processes used by both organizations to demonstrate that the capex incurred clearly shows that neither made any serious attempt to comply with the requirement for it to be "prudent" at the time of commitment of the capex, nor to continue to show that prudency still applied as each project developed.

What both TG and EA have failed to do as part of their applications, is to provide sufficient documentation to demonstrate that they had applied appropriate governance processes to ensure that the capex for each of the projects they had assessed as being prudent at the commencement of the project, was in fact being continuously monitored and assessed throughout the various stages in the evolution of each project. This approach is essential to ensure, notwithstanding all the changes the projects were required to accommodate as the various approvals were gained, that the selected option remained the most "prudent" and that the level of costs of the option meant that the project remained "prudent".

2. Demonstrating prudency

The EMRF points to provisions in the National Electricity Code which specify that it is the obligation of a regulated business to demonstrate that the investments made and to be incorporated into the regulated asset base, must be "prudent". This is because there is an obligation on electricity network users to reimburse the network business for the revenue determined by the regulator. The *quid pro quo* is that the network business must be able to demonstrate that the revenue related to capital expenditure is determined to be prudent.

The assessment of prudency is not a result of the regulated business claiming it to be the case – it requires the business to *prove* that it is prudent to an independent party. EA, in its submission, states on page 4:-

> "…EnergyAustralia submits that, in the absence of specific criteria laid down by the ACCC, our programs were delivered in line with appropriate industry practice during the past period."

With this statement, EA appears to maintain that the "traditional" approach of government corporations in selecting the preferred technical option and sticking with it regardless of the eventual cost, or that perhaps even if it fails to meet appropriate cost/benefit criteria, this remains acceptable practice under the current regulatory environment, now governed by the National Electricity Code.

Surprisingly, EA then admits (page 4):-

> "…we have recognised that our capital governance process can be improved to meet expectations of more exacting regulatory requirements in the next period."

This statement would appear to suggest quite clearly that EA does not currently have adequate corporate governance processes sufficient to demonstrate to a third party that their capital investment decisions are prudent, let alone economically efficient.

Further, EA (surprisingly) seems to imply that the Regulatory Test (RT) does not provide sufficient direction as to the requirement for assessing the prudency of new investments. While it is accepted that the RT is the focus of a review at this time, it still details the required criteria that regulated network businesses must analyse and use in carrying out the appropriate analysis of all new investments, to provide an auditable trail of decisions made, and that a continuous review of the cost/benefit of all investment projects is implemented to accommodate changes as core inputs vary the calculations underpinning the original investment decision.

There is nothing new in following such a process. It is normal commercial practice by all enterprises (public, listed and private) following sound corporate governance principles.

3. Use of Quality Assurance to aid the investment process

The EMRF points out that quality assurance programs were initially introduced into business as a primary tool to ensure that the quality of a manufactured item met the minimum standards established by the business. With the emergence of certification of internal quality assurance programs during the last two decades, businesses have been using the principles underpinning these "technical" quality assurance programs to apply to all internal processes, to ensure that the internal decision making not only was being followed, but more from a corporate viewpoint, was *seen* to be followed. Introduction of this ability to have formal verification that internal processes were being followed has allowed company directors to have confidence in the work being carried out under delegation within the businesses.

If regulated businesses followed the standard practices established as part of a certified quality assurance program for all capex to be rolled into the regulated asset base, then proving that capex was indeed prudent would be a relatively straight forward process.

It seems that both TG and EA do not have such verifiable programs in place, otherwise they would have been able to provide the ACCC consultant with readily available documentation certifying the changes that had been made to the original design of the projects, did not adversely affect the prudency and economic efficiency of the project.

4. Monitoring Changes during the process

The cost of the design function of a design construct project is usually accepted in industry to be less than 10% of the total project cost. Thus, experienced project managers (as TG and EA say they are) will attempt to ensure that fundamental changes are incorporated during the design phase, as to make such changes during the construction phase is a most expensive undertaking.

TG and EA noted that as they refine the project during the design phase, they also identified that usually costs will vary. This meant that in the very early stages of a project there is a high degree of volatility of the expected final cost of a project. What both then imply is that regardless of this volatility, because they had commenced the design of their preferred option, this committed them to completing the project as conceptualized, because the costs to change from the initial concept will be too high. This raises two fundamental issues:-

1. The costs incurred in changing the design of the project are likely to be relatively modest if the decision to change is made during the design phase. As final decisions on commitment for major plant items, key design features (such as above or below ground, rights of easement, etc) and routes can only

be made after the core planning and environmental approvals have been gained, a near-firm final estimated cost should be able to be set prior to significant expenditure being incurred. Thus, to imply that projects are locked in well ahead of planning and environmental approvals because of the incurred costs, is patently incorrect.

2. If the cost to the preferred option increases significantly (eg the cost of the Haymarket development increased from $143m to potentially $260m, including contractor claims) then a sound corporate governance program would require continuing Board and/or management approval of the increasing amounts, verification that the preferred option is still the most appropriate, and that it still remained "prudent". To gain such approval must require formal demonstration of the need for the cost increases, and justification in continuing with the project. A Board would normally expect to receive clear demonstration that the preferred option is still the most cost effective solution.

II Comments regarding the TG response to the GHD report

1. Light handed regulation

Much of the TG observations relate to the complaint that GHD (and the ACCC) seem to have not understood the concept of light handed regulation. It appears that TG is of the view that light handed regulation requires the regulator to accept whatever the regulated business considers is appropriate. Electricity network customers would have grave difficulties with such an interpretation of the role of the ACCC in regulatory reviews of network business.

The EMRF is of the view that the term "light handed regulation" is often a euphemism used by network businesses to deny regulators (and stakeholders) legitimate access to relevant data in order that they can independently establish that the cost claims are justifiable and are fair, reasonable and economically efficient.

In fact TG provided an immense amount of detail regarding many of their activities, but, disappointingly, failed to provide the relevant data to sustain their claims that the costs they have incurred represented prudent investment. This was the outcome of the analysis by GHD (and also of the EMRF in its response to the TG application).

TG now advises that to provide this additional data is not possible in the time frame permitted by the ACCC. They observe (page 3) that:-

> "… given the complexity and scope of the review, it is not surprising that some important issues detrimental to the integrity of the review remain within the GHD Final Report."

It should be noted that the timeframes set by the ACCC for the whole review reflects the TG (and EA) requirement to have a regulatory decision in sufficient time to set the 2004/05 tariffs. There was no reason why TG could not have submitted their

application earlier and indeed provided appropriate data in a format which would enable an easier (and perhaps more expeditious) review to support their claims.

2. Prudency of past capex

It is accepted that this is the first review of the (past) capex approved by the ACCC from an earlier review, and that therefore there may be some challenges facing both the business and the regulator. Notwithstanding this, it does not permit TG to provide insufficient data to sustain their claims for roll-in of past capex. Being aware that there was every possibility that an audit of selected projects might well be undertaken (a normal ACCC practice, as evidenced from other reviews), TG could have provided the necessary information in a manner akin to that undertaken in financial or quality assurance audits. Unfortunately, TG did neither of these and now complains that it has insufficient time to provide the requested data. The ACCC must reject this proposition, and the EMRF strongly considers that sufficient time must be set aside to enable proper review, with adequate transparency and disclosure.

Compounding its apparent lack of foresight, TG criticizes GHD (page 4):-

> "… this has been compounded by GHD's apparent difficulty in interpreting the relevant principles to apply in determining whether capital expenditure is prudent. GHD confuses the application of the Commission's Draft Regulatory Principles for assessing the prudency of capital expenditure with the Commission's 1999 Capital Expenditure allowance for TransGrid, and with the estimates used in carrying out the regulatory test."

If TG had any doubt whether the ACCC would use the RT to assess prudency, then TG has had ample opportunity to interrogate the ACCC about this issue. That TG has preferred to get an interpretation of this fundamental issue from its own legal advisers

and not from the ACCC is curious to say the least, considering its response to the GHD report.

The EMRF notes that TG's response to the GHD contains additional information sought by GHD and stakeholders. For TG to be supplying this additional information only days before the scheduled date for release of the ACCC Draft Decision is disappointing. It might well be assumed that TG did not carryout any continuous monitoring of incurred capex costs at the senior management level, thereby allowing staff a free rein, based on the assumption that all costs would be automatically recovered under the new revenue cap – the approach historically used, when there appeared to be little independent evaluation of the solutions to meet needs and of the costs incurred.

Even in its response to the GHD report, TG continues to show its disregard for the need for independent assessment, as required under the National Electricity Code and the ACCC's draft statement of regulatory principles for transmission network businesses. For example, TG states, regarding the OPGW project (pages 4 and 5):-

> "TransGrid does not understand why the potential commercial benefits of these assets is a relevant consideration. In TransGrid's view, the $2 million in question is an optional unregulated investment undertaken to provide a commercial opportunity. This capital is at risk, and returns on this investment depend entirely on TransGrid's ability to compete in a contestable communication market. The balance of the capital investment in OPGW is required to meet the need for regulated services, as recognised by GHD in their Final Report. Accordingly, apart from the $ 2 million in question, the balance of TransGrid's expenditure on OPGW projects should be included in the regulated asset base for revenue setting purposes."

What TG misses entirely is that while the project might be needed for operating the network and therefore legitimately part of the RAB, there is no assessment other than

that by TG of the value of the work, which is related to commercial activity. If any element, including any marginal capacity, of regulated assets is used for commercial gain then the value of that commercial gain must be added into the revenue calculation. If the costs of the commercial element can be excised from the total cost of the work then this needs to be detailed. The need for the request for additional information above the bald assessment of $2m by TG is patently obvious.

TG must clearly advise how much of the marginal capacity of the OPGW project is being used for commercial gain.

3. Sydney CBD project

This project has suffered a major over-run of the anticipated cost since it was initially approved. There is every reason for the costs to be challenged and the ACCC has commissioned an independent study of how TG has approached the project.

While it may be that there is a need for some augmentation to the supply to the Sydney CBD, even after the specific and independent review dedicated to justify this project, it appears that there remains considerable doubt as to the prudency of the costs incurred. To impugn the review work by GHD which reached a similar conclusion after minimal time for review highlights that the GHD work may have considerably more merit than TG (and indeed EA) gives credence to.

4. Residual doubts on non-augmentation expenditure

The EMRF has been critical of the lack of benchmarking of the TG (and EA) claims for past and future capex and opex. Notwithstanding this, the EMRF notes that GHD appears to agree with TG about the required level of its non-augmentation capex.

The explanation from TG does highlight though, that TG does not maintain an appropriate set of cost codes which can be used for showing that it is recording the

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necessary data to demonstrate that its capex is necessary and prudent, especially with regard to cost. A normal business, knowing that it will require an assessment for audit purposes (such as a taxation or QA review), will ensure the information is readily stored in a format which allows easy access to the data.

GHD highlighted they had significant difficulty in interpreting the information provided by TG. Accordingly, TG should examine ways of storing and accessing data specifically for regulatory reviews. TG appears to be using the confusion surrounding their data retention method to prevent any reasonable review of their capex.

In its response on GHD comments on accounting for vehicles, TG advises that it provided the correct value for sale proceeds. What TG fails to recognize is that it should not be using sale proceeds for the vehicles but should be deleting the depreciated RAB value for these plant items from the RAB. To reduce the RAB by the sale value of the vehicles does not reflect the value at which the vehicles are held in regulatory accounts! The TG response is invalid.

5. Basic Errors

TG states that by adding $2bn of new assets there should be an (automatic) acceptance that there will be an increase in opex to manage the new investment. This raises some interesting points about the TG opex claim:-

1. The EMRF also drew the same conclusion as GHD about the phrase “50 staff surplus to core needs”. We certainly thought this meant that TG was proposing to reduce its total staff numbers.

2. Augmentation of the network probably will increase opex. Extension of the network outside the current boundaries will result in increased opex. But augmentation of the existing assets (eg replacing an existing transformer with a new larger one) will have little (or perhaps even lead to a small reduction[1]) impact on opex. Refurbishment/replacement should result in replacement of old equipment with new, clearly reducing opex needs.

   Therefore, to validate its increased opex claims, TG needs to identify what proportion of the new assets are the result of augmentation outside the existing network, what proportion is augmentation within the network and what is refurbishment or replacement, in order to demonstrate that its opex costs actually do increase as a result of capex. Intuitively an opex reduction should be the result of capex.

3. We can understand TG wanting to minimize the efficiency target deduction proposed by GHD. We accept that the proposed 2% is somewhat arbitrary, but when viewed in context with reductions that must

[1] The general view on opex, is that new equipment needs less opex. Augmenting the existing network is usually achieved by the replacement of the “old small unit” with a “new larger unit”. Thus there would be an expectation that an upgrade should result in a small increase in opex to reflect the increased cost of parts but a reduction in opex due to the newness of the equipment.

apply in internationally competitive businesses, a 2% reduction appears to be modest. To allay TG fears, the ACCC should seek input from competitive business to assess what efficiency reductions apply in the wider set of commercial enterprises and use this as a benchmark. The EMRF would be pleased to contribute to such a review.

TG quotes from the UK House of Commons TIC enquiry and uses this to support its argument about adequacy of returns and the deterrence of new investments. Whilst it is accepted that transmission performance is good in this country, it is yet to be demonstrated that the financial rewards granted by Australian regulators are at the same level as those in the UK. As provided in our earlier submission, there is little doubt that Australian regulators provide higher returns then their UK counterparts.

6. Service standards

We accept that the TG performance is of a high standard, especially when compared to EA performance. However, TG should not expect that a bonus for excelling should be automatic. There must be a need to strive for further improvement and this is what GHD recommends. Equally, as GHD noted that TG performance was already high, they recommended only a small movement from the standards suggested by TG itself. GHD is not recommending a stretched key performance indicator by any means.

7. Forecast capex

TG is selective in its criticism of the GHD report. GHD supports the proposed capex on the basis that it is required, but notes it has doubts about the amounts required. GHD observes that it had great difficulty in verifying the final amount to be included by the ACCC in its review as they had concerns with:-

- the application of the ROAM probabilities used;
- the project delivery processes;
- the rigour of analysis at the early stages of projects;
- the lack of information on refurbishment projects to justify the efficiency of the proposal;
- the lack of linkage between strategies and budgets; and
- whether improvements will result in sufficient savings to justify the capex.

The response from TG is a request for more time to resubmit its forecast capex program with the additional information to support its claims. This demonstrates that TG has not applied itself to disclosing a sufficiently detailed and transparent application, despite the fact that it concurrently required the ACCC to justify its Decision as to the future TG revenue cap.

8. Other matters

TG states that GHD has no basis on which to state that there is potential to reduce project costs. However, the criticisms that GHD made were a result of the demonstrated lack of controls that TG exhibited in its past projects, and which resulted in TG advising that they would improve their project governance. Thus, TG has even less reason to aver they are better positioned to control projects than GHD states is its view of TG processes.

TG points out that GHD was not retained to advise on *specific* efficiency opportunities for TransGrid. TG then states that this is what GHD has then done by its proposed efficiency target. This is not correct. GHD has included in its assessment for a *benchmarked* and conservative efficiency target.

Our interpretation of the words on page 58 of the GHD report:-

> "… retention of the additional functions and costs associated with informing the single shareholder of any significant issues that may arise with a positive or negative impact."

makes sense when read in context with the earlier part of the paragraph. Read in context, we interpret the words to imply that the governance applying to TG does not seem to suggest that the Board or management are informing its shareholder of the impacts of significant cost or time changes resulting from TG performance. This view of GHD encapsulates our concerns regarding TG performance (major cost and time over-runs) and lack of internal controls that exposes EMRF members and other electricity users in NSW to bear the resultant costs arising from (what appears to be) less than adequate internal control practices.

9. Attachments

General comment

The very fact that TG is at this very late stage (less than 8 weeks before the new transmission tariffs are to be in operation) supplying clarifications and additional information to the ACCC, supports the view of the EMRF that TG appears to have been extremely lax or obfuscating, or both, throughout this whole review process.

The ACCC must develop some reasonable approach which places the responsibility onto the applicant for the timely provision of useful information, and that failure to do

so carries some level of penalty, "*pour encourager les autres*" as succinctly propounded by Napoleon.

Attachment 4

TG uses this attachment to demonstrate that it has reconciled its 30 year plan with the refurbishment capex. TG adds "security initiatives" of $50m and "spare transformers" of $11m, to the 30 year plan to prove the amounts are reconcilable. However, no derivavation or explanation of the two additional items is provided, nor are amounts associated substantiated.

Reconciliation by including (ex post) additional unsupported and unproven items and amounts, is not reconciliation! This should not be accepted by the ACCC.

III Comments regarding the EA response to the GHD report

1. Time for the review

EA points out that the IPART review of its distribution assets started earlier than the ACCC review, and as a result the ACCC review is rushed and therefore subject to errors. The EMRF would agree that an earlier start would have been beneficial but would also point out that EA has been a significant contributor to delaying the process due to its poor responses to the review process. For EA to threaten potential action subsequent to the ACCC decision if the decision is not acceptable to EA, is not helpful. Stakeholders have legitimate claims that the regulatory review be adequately transparent and that there is adequate disclosure and justification of cost data. Anything less is unacceptable.

2. Constraints on the GHD process

EA is experienced in regulatory reviews, having been exposed to both IPART and the ACCC as regulators in earlier times and even more recently by the IPART review of the electricity distribution businesses. EA knows what is required by the regulator and that sound evidence is required to demonstrate prudency of capex, whether by using the regulatory test or by other means.

As a competent business EA should have ensured that it had adequate documentation generated at the time of the various decisions to proceed with each stage of the investment process, proving that its processes were sound and auditable. If EA had any doubts that there might be confusion or a lack of appreciation of the regulatory needs, they could have contacted the ACCC at the start of the current period to ensure it knew what documentation would be needed to prove prudency. EA failed to do this and what is even more concerning is the GHD observation and comments that indicate these essential business controls are still not in place.

EA highlights that GHD did not specify the type or level of detail required to prove prudency. In this EA completely misses the point. It is up to EA to demonstrate the prudency – both for internal uses and for regulatory needs. If EA does not have sufficient detail to demonstrate prudency for regulatory needs, it may be that it never provided sufficient detail for any internal needs. The Managing Director of PowerLink (Mr Gordon Jardine) made this point succinctly at the recent regulatory forum looking at the very issue of capex inclusion into the RAB.

3. The contrast between Meritec and GHD

EA notes that Meritec, in relation to the distribution review of EA assets, required submission of all necessary data and stipulated the format this data was to be submitted in. This requirement arose from the Issues Paper from IPART in November 2002. The EMRF agrees that the ACCC timeframe was too short, but EA could have provided the necessary data to the ACCC using the format required by IPART, rather than waiting for GHD to specify what was required.

4. Board approval of future capex

EA avers that its new governance processes will provide adequate substantiation of the prudency of its future capex. However, the experience to date where there is an expectation that EA would follow the requirements of normal business procedures, does not engender a high degree of confidence that the new procedures will be followed. For EA to state that its Board will approve a capex program based on preliminary data and then imply the Board will take no further interest in how its capital will be invested, is indeed very surprising and needs to be verified.

It is accepted that the planning and implementation of capex augmentation in a transmission network is a challenging exercise. In this, EA faces the same disciplines that businesses face in the competitive arena. This accepts that EA does have to

continually refine its designs and costings as circumstances change. What EA seems to fail to understand is that as these changes occur they are also expected *and required* to re-asses the cost/benefit of each project and to weigh up the benefits and detriments in light of the changed circumstances. If this is not accepted as being the case, then it is surprising and unacceptable given the responsibility EA management has to its Board and to its customers.

As each change occurs there must be documentation proving the continued viability of the project. This documentation must be made available to the regulator. If this documentation cannot be produced then there is a real concern that reviews of viability may not have been undertaken as changes occurred, thereby casting doubts on the governance processes within EA.

EA's criticism of GHD is surprising, as it overlooks the fact that GHD has been involved for many years as a consultant in the design and execution of large projects, including power transmission projects.

5. Board approval of past capex

EA states that it has internal documentation supporting the past capex, but that due to time constraints has only just been able to provide them. EA states that projects for less than $5m do not require Board approval, as this power is delegated to the Managing Director. What EA apparently fails to recognize is that sound governance procedures would require all approvals, regardless as to whether authority has been delegated, to be substantiated before the exercise of the delegation. Thus, it is immaterial whether the Board approval was granted to sustain the prudency of the expenditure – the issue is that there is the normal expectation that the delegate should have required documentation to sustain the request for funds in light of the changed circumstance.

EA was apparently able to demonstrate to GHD the need for specific projects based on technical need. What GHD was not able to secure from EA was the justification for the costs involved – that they were indeed efficient and prudent. EA states that they provided this additional data but were then advised there was no time to assess this due to time constraints. If appropriate governance procedures are in place, this data would have had to be immediately available, and EA could have provided it immediately information was requested – after all, the prudency element of capex requires a study of the amount of funds required and the return the expenditure will generate! This is a normal requirement, and one in which EA apparently did not face any problem during the parallel IPART review.

That EA blames GHD for EA not providing essential data as part of its supporting documentation (as on page 3 of the attachment), is surprising at best:-

> "EnergyAustralia strongly believes that GHD's remarks about the lack of documentation provided reflects the deficiencies in their own process and should not be used to question the existence of good capital practices."

If EA had in place "good capital practices", then it would have identified that the essential data proving prudency is part of the necessary information required for a regulatory review and if EA had the information as it implies it had, then it should have supplied the appropriate data immediately. That it did not do so raises severe concerns.

EA effectively confirms that it needs to do more in being able to prepare and track its continual review process when it states (on page 4 of its attachment):-

> "… we have recognised that our capital governance process can be improved to meet expectations of more exacting regulatory requirements in the next period. Accordingly, we have proposed an investment

> framework, including detailed governance requirements, that will apply in the next period."

The ACCC must assess the proposals for these changes and advise EA as to their adequacy.

EA comments that the ACCC has not set out specific criteria for assessing prudency and efficiency (see page 4 of the attachment):-

> "Turning to the substantive issue of whether past capital was prudent and efficient, EnergyAustralia submits that, in the absence of specific criteria laid down by the ACCC, our programs were delivered in line with appropriate industry practice during the past period."

This observation raises two very concerning points. Firstly, EA would appear to be assuming that the Regulatory Test (RT) does not apply to them. Secondly, that "appropriate industry practice" is an acceptable surrogate. If EA is of the view that the RT does not apply then they have the responsibility to advise the ACCC of this and to agree with the ACCC an alternative method for demonstrating prudency and efficiency. If "appropriate industry practice" is an acceptable alternative, then why have the RT?

6. Review of Opex

A "bottom up" analysis of opex is only one tool available to assess the opex requirement. As many practitioners are aware, such an approach can result in an overstated assessment. As practitioners also are aware opex is assessed on a number of other bases as well, such as past needs, benchmarking, and what the market itself will permit. GHD used a "driver" analysis.

EA has assumed that because Meritec accepted their case for opex, then GHD should do likewise. The assumption behind this is that as Meritec agreed with EA, then Meritec is correct and GHD wrong. It is just as legitimate to assume that Meritec *may* have been wrong – after all, Meritec did not appear to have carried out any form of assessment regarding the reasonableness of the opex claimed, such as benchmarking or "driver" analysis to support the "bottom up" approach used.

EA alludes again to the limited time provided for the analysis of opex (see page 5 of the attachment):-

> "… that GHD's inconsistent approach has again demonstrated the lack of time it had to undertake the review. The desktop review has used information that was not fit for purpose."

EA clearly does not understand that "light-handed regulation" relies on benchmarking and comparative approaches needed to assess the legitimacy of the business's claims. For EA to denigrate high level analyses, completely over looks the importance of these in ensuring "competition by comparison" remains a fundamental tool of the regulator.

The EMRF requires the ACCC to ensure that EA is not automatically granted all of the opex it requests unless it can be justified, and that the opex granted is in keeping

with the levels needed by a well run electricity transmission business. The approach taken by GHD does permit some benchmarking of performance, through using EA historical costs as a starting point.

7. Lack of conclusions

EA is critical that GHD reaches few conclusions in its report, particularly with regard to past and future capex. The EMRF review of the EA application and the GHD report brings similar conclusions to those of GHD regarding EA capex. It is our view that GHD had little option but to refuse to recommend inclusion of much of the EA capex. If GHD had (correctly in our view based on the lack of demonstrable prudency) recommended that elements of the EA capex be excluded from the RAB, then EA would have been even more critical of the GHD report.

The EMRF agrees with EA in that it concurs that investment must be made into the electricity transmission system and that to under-resource and limit the time for review can lead to perverse incentives to the regulated transmission businesses. At the same time, the EMRF requires that all investment be assessed for efficiency and prudency. EA must accept that it has a responsibility to properly manage the investment decisions at all stages of a project to ensure that as the project develops it remains efficient and prudent. Corporate governance processes used extensively in competitive businesses have a fully documented and auditable paper trail supporting the project or, if the project moves into being marginal with regard to costs/benefits, demonstrating why the project should continue as proposed or be varied to ensure the outcome remains prudent and efficient.

IV Concluding remarks

Both the TG and EA responses to the GHD reviews are rather weak and self-serving. The EMRF can find little of substance to justify the lack of information disclosures by both network businesses, particularly in areas which would enable independent assessment of past and future capex and opex claims to ensure they are prudent and economically efficient.

The ACCC must not entertain truncating its regulatory process because of time deadlines. Timelines should be extended and a robust review undertaken with the network businesses required to demonstrate and justify all relevant cost claims.