

8 April 2004

Sebastian Roberts
General Manager
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ACCC
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Dear Mr Roberts

EnergyAustralia revenue reset - GHD final report

I refer to the GHD final report relating to EnergyAustralia's operating and capital programs as part of the current transmission regulatory review, released publicly by the ACCC on 26 March 2004.

EnergyAustralia is very disappointed by GHD's report and believes that the lack of conclusions drawn by GHD reflects constraints imposed on the process that GHD was obliged to manage. One clear contributing factor to these constraints was a change to GHD's terms of reference imposed by the ACCC at a late stage in the process and without EnergyAustralia being given the opportunity to comment. The absence of clear criteria to guide the review, together with a constrained timeframe in which to deliver a report appear to be the primary drivers behind the disappointing and inconclusive GHD report. EnergyAustralia believes that GHD has not delivered a report that makes an effective contribution to the revenue-reset process. Also, the fact that the ACCC has been undertaking a concurrent "principles" review which could affect the assessment of our future capital program proposals has served to undermine the integrity of the overall reset process.

You will, of course, appreciate that the ACCC's process relates to assets within our portfolio, which from both an operational and capital planning perspective are indistinguishable from assets regulated by IPART. It is instructive to note that IPART's process commenced a good six months earlier and only after some key methodological issues had been resolved with the businesses and after IPART's technical advisers had settled on a detailed specification of the information required for their review. (In this regard, I would refer you to Attachment 1)

EnergyAustralia's response to GHD's report is in two parts. The first section demonstrates that the inconclusive report was the inevitable outcome from such a constrained process. The second section discusses some of GHD's more general comments.

EnergyAustralia would prefer to work constructively with the ACCC to achieve a practical and proper outcome to the current review process. However, given what we consider to be serious flaws in the process followed to date, we will be prepared to pursue any rights of review or other available remedies should the outcome warrant such action.

I would be happy to discuss any aspects of our response at our meeting on 15 April 2004.

Yours sincerely

George Maltabarow
General Manager - Network

GHD Process

Constraints on GHD process

EnergyAustralia believes that GHD's process has been constrained by two things: the lack of a clear methodology and a lack of time in which to conduct the review. GHD was appointed by the ACCC in August 2003 but did not actively begin the review until December 2003. Despite this delay of four months, GHD failed to adequately plan its approach to the review. This resulted in GHD beginning the interview stage without a clear articulation of their approach. At no stage in those interviews or in the two months following was there a clear articulation of what test for "prudence" GHD would use. Similarly, there was no articulation of how "efficiency" was to be measured or proved, and there was no indication of how GHD would approach its opex review. To date, there is still no documented interpretation of either of these concepts or the method by which they are to be applied.

The ACCC reviewed the terms of reference for GHD after the review had commenced. The change to the terms of reference promulgated by the ACCC significantly changed the scope of the review, but ACCC did not provide for further resources or time in which to conduct the more detailed review. Neither the ACCC, nor GHD provided details of the revision of the terms of reference to EnergyAustralia. In fact, it was not until the release of a draft of GHD's report that EnergyAustralia was made aware that the terms of reference had been modified.

GHD did not adequately specify the type or level of detail required to satisfy itself that EnergyAustralia's programs, both past and future were prudent. Furthermore, in the information requests that EnergyAustralia did receive, EnergyAustralia was not told how information was to be used, or how the information provided would answer questions GHD had in relation to prudence. This has resulted in a misunderstanding of the expectations of documentary evidence that was expected to be provided throughout the review. EnergyAustralia believes that GHD's reliance on ad hoc questions has not been an effective way of delivering the information they have required for this review. Nor could it be said that this satisfied the most rudimentary requirements of due process.

IPART and Meritec – a stark contrast

GHD's process can be starkly contrasted with that conducted by Meritec, IPART's consultants appointed to conduct a similar review for EnergyAustralia's much larger portfolio of distribution assets. (Distribution assets make up approximately 90 per cent of EnergyAustralia's total asset base). Meritec provided a detailed questionnaire and series of templates on 31 January 2003 to be filled in by all DNSPs and submitted with initial submissions on 10 April 2003. In addition, Meritec clearly articulated its approach and the tests it would use to determine prudence. In fact, these issues had been detailed in an Issues Paper released by IPART on 26 November 2002, some eighteen months before its decision would apply in July 2004. The timetable used by IPART and Meritec is included as Attachment 1 to this letter. It highlights the distinctly longer timeframe and better planned process conducted by IPART and Meritec, which has clearly influenced the quality of the outcomes from their report. We do not accept that the relatively

lower value of our assets regulated by the ACCC justifies the application of a less rigorous approach.

GHD comments

GHD's report highlights a number of misunderstandings, particularly about Board approval, the level of information provided by EnergyAustralia and the role of EnergyAustralia's governance process. We can however accept that the superficial nature of the "desktop" review approach taken by GHD was a necessary product of that constrained timetable.

Board approval of future capex

GHD make several comments that they would have expected to see evidence of Board approval for projects that comprise the forecast capital expenditure plan for 2004-2009. EnergyAustralia does not accept that it is appropriate for Board approval to be required for each individual project in the future capex program. Board approval is sought for the indicative program when the submission is made. Board approval for each project is sought as a critical part of the governance process that occurs at an appropriate stage of the planning and development of individual projects.

EnergyAustralia's overall submission, which contains the forecast capex program was approved by the EnergyAustralia Board. This approval demonstrates that the Board agrees that the level of planning information available for these projects is sufficient to allow these projects to be included in the forecast program. This approval was given in the knowledge that the projects and project estimates were indicative (as provided for under ACCC's current ex-post review framework), and would be subject to the new governance procedures that EnergyAustralia is applying to projects in the next regulatory period. GHD itself agreed that the governance procedures, when fully implemented, will place EnergyAustralia at the forefront of best practice governance in the industry.

The expectation that all projects in the submission will be fully planned and analysed and that preliminary designs and estimates will be available is not reasonable, particularly for projects that fall toward the end of the Regulatory Period and that are presently in the initial stages of option development. Also, it must be understood that major projects are subject to NSW Planning laws which require public consultation processes and could result in projects being developed to Board approval stage in a radically different form to the technically efficient project initially contemplated. EnergyAustralia's capital program for transmission is an "indicative" program and contains projects at various stages of development.

EnergyAustralia believes that the level of documentation that GHD has presumed for these projects demonstrates a lack of understanding of the capital governance process and the role and timing of that process. Furthermore, it demonstrates GHD's lack of understanding of the complexity of transmission planning and uncertainty associated with estimating costs for projects in an uncertain environment that can be influenced by conditions of planning approvals, environmental assessments, public consultation and feasibility analysis.

Board approval of past capex

GHD commented that it would have expected to see Board papers and supporting documentation for past capital projects. These documents exist and summaries are available to GHD. However, due to the constraints of time placed on the process, and the fact that this request for information was not specifically highlighted until late in the process, EnergyAustralia was able to provide the information only recently.

We would have expected that a request for Board papers would have been formal and given with some notice and it is disappointing that this was not the case. Without time to seek Board approval (together with appropriate justification) for the release of Board papers we provided summaries of these documents. However, EnergyAustralia can confirm that past capital projects have all been the subject of Board approval subject to our policy that projects that have an expected expenditure above \$5m must be approved at Board level. For projects with total expenditure below \$5m, approval has been delegated to the Managing Director.

All projects have supporting documentation to a detailed level. GHD initially sought detailed information on planning criteria for specific projects. The information provided by EnergyAustralia at that stage appears to have been sufficient as GHD has reached conclusions that the projects built in the current period were the most appropriate to address the constraints that had been identified.

However, it appears that GHD was not able to satisfy itself as to whether the project cost was efficient. This is largely because such information was not sought by GHD until very late in the process and there has been a restricted time frame in which EnergyAustralia has been able to respond to the related information requests. In fact, EnergyAustralia provided information to GHD but was told there was insufficient time to assess it.

Both GHD and the ACCC appear to have underestimated the time it takes to collate information detailed to the level that has eventually been sought. With appropriate planning (such as that conducted by Meritec throughout the distribution pricing review process) the expectations of documentary evidence and the level of required detail should be set out prior to the commencement of a review and then augmented as necessary during its conduct. Furthermore, the Meritec process has demonstrated that with appropriate planning, the reliance on time consuming ad hoc information requests, as has been adopted by GHD and the ACCC staff to date, can be minimised. While we recognise that some ad hoc requests may be required, we do not believe that ad hoc requests should form the primary basis of the information collection process.

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. Furthermore, GHD's report misrepresents the state of EnergyAustralia's documentation and the rigour of the decision making used for capital projects. We would equally assert that had GHD taken the time to understand the way EnergyAustralia conducts its capital

investment process, it would not have been so superficial.

EnergyAustralia stresses that if appropriate specification of documentation had been set out at the commencement of the review, EnergyAustralia would have been in a much better position to provide information that was more streamlined and targeted to address GHD's particular concerns.

Given that GHD appear to have some (unspecified and opaque to us) standard for documentation, EnergyAustralia believes that it is not appropriate for GHD to apply such a standard ex-post when no ex-ante guidance as to the appropriate presentation of information or evidence that may be sought was provided by the ACCC.

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. Indeed this has been the conclusion of Meritec, who reviewed our capital investment methodologies and performance for IPART. Furthermore, IPART have accepted that it is inappropriate to impose, specific requirements ex poste.

For our part, 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.

We submit that these proposals will improve transparency and our ability to demonstrate efficiency and prudence in the next period. We invite the ACCC to comment on the adequacy of our proposed framework or to determine other requirements for the next period to provide improved certainty within the regulatory framework.

In summary, EnergyAustralia believes that it is inappropriate for GHD to remark about the level of information that has been provided in the context of GHD having provided no information requirements, no criteria, and no clear strategy for the review. Again we stand ready to provide whatever information is required to satisfy any reasonable requirements.

GHD's review of opex

GHD decided not to undertake a bottom-up analysis of opex on the basis that GHD believed it did not have sufficient traceable information to base a review. EnergyAustralia believes that GHD has effectively ignored our carefully prepared and detailed normative case for opex and has relied on a superficial and inaccurate desk top review to cut EnergyAustralia's proposed opex by 15 per cent.

During the current regulatory period, EnergyAustralia has changed the allocation of shared costs between our transmission and distribution businesses. EnergyAustralia took great pains to explain how the various changes have impacted opex. While GHD accepted the new

methodologies as better representing costs to each business, it failed to use this information to form a view of corporate and other opex costs. Instead, GHD relied on a “driver” analysis resulting in recommendations for expected savings in this area that have little or no basis.

By contrast, in the maintenance area, GHD undertook a bottom-up review and accepted all maintenance costs proposed by EnergyAustralia.

Using the same information, Meritec and IPART accepted EnergyAustralia’s normative case for operating costs. Meritec undertook a bottom up review and agreed that corporate overhead costs allocated to distribution were appropriate. EnergyAustralia has therefore had support for approximately 90% of its overhead costs but GHD, via a superficial “driver” analysis, has recommended that a portion of the remaining allocation be cut significantly. Not only is this result inconsistent between EnergyAustralia’s distribution and transmission businesses (which are operated on an integrated basis), but GHD’s approach has been internally inconsistent with different methodologies applied to different parts of our proposed opex programs.

EnergyAustralia believes 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. GHD did not articulate why information was being required and how it was to be used. In the case of procurement, GHD used information that was high level and indicative to calculate predicted dollar savings that could be achieved in the period. EnergyAustralia believes that the use of this information was inappropriate and, disappointingly, not developed in good faith.

Lack of conclusions

GHD has reached few conclusions in its report. While we are concerned over the superficial “desktop” approach undertaken by GHD, we note that at least GHD’s approach provides some insight into their views of required opex levels. We note that no such insight has been provided relating to EnergyAustralia’s past or future capital expenditure programs.

It is not surprising that the GHD report provides no useful conclusions on our expenditure programs – even though this was the key criterion of the Terms of Reference for the review – given the constraints applied to the review. EnergyAustralia believes the lack of conclusions has materially impacted the value of the independent report to the ACCC’s revenue reset process. In addition, EnergyAustralia believes that the concurrent review that ACCC staff have conducted has effectively undermined the value of the independent report, and the lack of conclusions allows the ACCC to effectively make its own findings on engineering issues.

EnergyAustralia believes that this process sets a dangerous precedent for the industry where industry consultants are under-resourced and regulatory economists make judgments on multi-million dollar investments in critical infrastructure without an appropriate understanding of the investments themselves or of the complexity and context of the investment decisions is being made. We submit that NSW electricity consumers and taxpayers deserve better than this.

Attachment 1

	IPART capital review timetable	IPART distribution review	ACCC review
Sep-02	Consultation notice and draft terms of reference published for DNSP review	Processes for the 2004 electricity networks determination - open letter	
Oct-02	Submissions on draft terms of reference due		
Nov-02	Invitation to tender advertisement and project brief published.	Regulatory arrangements for the NSW DNSP from 1 July 2004 - Issues Paper A users guide to the Financial Model for the 2004 Electricity Network Pricing Review Weighted Average Price Cap model for Distributors Building Block Revenue model for Distributors Release of IPART's information requests	
Dec-02			
Jan-03	Draft templates of info requests to DNSPs		
Feb-03	Final templates of info requests to DNSPs		
Mar-03			
Apr-03	Templates submitted by DNSPs	DNSPs submissions due	
May-03			
Jun-03			
Jul-03	Consultant's Draft Report Submissions on draft report due	Public submissions due Public Forum - Non-DNSP submissions	
Aug-03			
Sep-03		2004 Electricity Distribution Review – Preliminary Analysis – Secretariat Discussion Paper	Initial submission
Oct-03	Consultants Final Report published Submissions due on Consultant's Final Report	Final date for submissions to be considered for Draft Report	EA responds to ACCC information requests
Nov-03			
Dec-03			Interviews with GHD engineering consultants
Jan-04		Release of Draft Report and Draft Determination	EA responds to GHD and ACCC information requests
Feb-04			Interviews with ACCC staff on capex
Mar-04		Submissions due on Draft Report Public forum	GHD draft report released for EA comment
Apr-04			GHD's report released to public for consultation Public consultation closes
May-04		Release of Final Report	ACCC Draft Determination
Jun-04			
Jul-04		New price path implemented	?
Aug-04			ACCC Final Determination