Final Decision

Evoenergy Electricity Distribution Determination 2024 to 2029

(1 July 2024 to 30 June 2029)

Attachment 6
Operating expenditure

April 2024

AUSTRALIAN ENERGY REGULATOR

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Version	Date	Pages
1	30 April 2024	51

List of attachments

This attachment forms part of the AER's final decision on the distribution determination that will apply to Evoenergy for the 2024–29 period. It should be read with all other parts of the final decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The final decision attachments have been numbered consistently with the equivalent attachments to our draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The final decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 16 – Alternative control services

Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

Attachment 20 – Metering services

Contents

6 Operating expenditure

Operating expenditure (opex) refers to the operating, maintenance and other non-capital expenses incurred in the provision of standard control services. Forecast opex for standard control services (SCS) is one of the building blocks we use to determine a service provider's total revenue requirement.

This attachment outlines our assessment of Evoenergy's proposed total opex forecast for the 2024–29 regulatory control period (2024–29 period).

6.1 Final decision

We consider Evoenergy's revised proposal total opex forecast largely reflects prudent and efficient SCS costs required to achieve the opex objectives in the 2024–29 period. However, we consider $2.8 million ($2023–24) of Evoenergy's smart meter step change is not properly allocated to SCS,[1] and should be reallocated to alternative control services (ACS). Specifically, this cost relates to development and delivery of Evoenergy's legacy meter retirement plan.

Our final decision is therefore to not accept Evoenergy's revised proposed total opex forecast of $364.8 million ($2023–24), which included the proposed smart meter step change. Accounting for the reallocation of smart meter costs, however, our alternative estimate of total forecast opex of $360.6 million ($2023–24) is not materially different to Evoenergy's revised proposal opex forecast of $362.0 million ($2023–24), on a like for like basis (i.e. if Evoenergy's revised proposal had allocated the same proportion of its smart meter step change costs to ACS).

Our final decision is therefore to approve total forecast opex of $362.0 million ($2023–24), including debt raising costs, for the 2024–29 period as reasonably reflecting the opex criteria.[2] This is consistent with Evoenergy's revised proposed opex forecast of $364.8 million ($2023–24), less the portion of its smart meter step change costs ($2.8 million ($2023–24)) which we have allocated to ACS, as discussed in section 6.4.3.4.

The main reason our alternative estimate of total forecast opex is not materially different to Evoenergy's revised proposal forecast is due to our conclusion on its base year opex efficiency. Specifically, based on further evidence in Evoenergy's revised proposal and our updated analysis, we consider that Evoenergy's opex in its revised proposed base year of 2022–23 is not materially inefficient. We have therefore not made a negative efficiency adjustment as we did in our draft decision.

In relation to our base year efficiency analysis, there are several reasons for the change in our conclusion from the draft decision that opex in the base year was materially inefficient. In

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1 NER, cl. 6.5.6(b)(2).

2 The opex criteria are set out in cl. 6.5.6(c) of the NER and the opex factors are set out in cl. 6.5.6(e). We must not accept a distributor's proposed opex if we are not satisfied that it reasonably reflects those criteria: NER, cl. 6.5.5(d).

making this final decision the key drivers of our view that opex in the base year is not materially inefficient are:

- Evoenergy's updated (6.5% lower) actual base year opex moving from 2021–22 ($66.4 million ($2023–24)) to 2022–23 ($62.1 million ($2023–24)), which is then compared against our estimated efficient opex
- The mechanical updates impacting the estimated efficient opex, including the more recent *2023 Annual Benchmarking Report* results, updated data for Evoenergy, and the application of the benchmarking roll forward model using an additional year of actual data
- The inclusion of an allowance for differences in the treatment of network overhead capitalisation practices between distribution network service providers (DNSPs). This recognises that while Evoenergy has historically expensed 100% of network overheads, other DNSPs have expensed only 50-70%, and not accounting for this would likely disadvantage Evoenergy in terms of measured opex efficiency. We have applied sensitivity testing and exercised regulatory judgement to do this, rather than the direct application of an operating environment factor (OEF). This reflects there are some questions around whether network overhead capitalisation practice differences meets the OEF criteria, and how best to account for them. We did not make this allowance in our draft decision.

The main driver of our slightly lower alternative estimate of total forecast opex (on a like-for like basis) is our lower estimate of Evoenergy's SCS smart meter step change costs (by $0.8 million ($2023–24)).

Our final decision opex forecast for Evoenergy is:

- $25.5 million ($2023–24), or 7.6%, higher than the opex forecast in our draft decision for the 2024–29 period
- $32.7 million ($2023–24), or 9.9%, higher than Evoenergy's actual (and estimated) opex in the 2019–24 period
- $6.2 million ($2023–24), or 1.7%, higher than the opex forecast we approved in our final decision for the 2019–24 period.

Table 6.1 sets out Evoenergy's revised opex proposal, our alternative estimate for the final decision, and the difference between our alternative estimate and Evoenergy's revised proposal, the latter of which we are accepting for our final decision (excluding $2.8 million ($2023–24) reallocated to ACS). It also includes Evoenergy's initial proposal as well as our draft decision.

Table 6.1 Comparison of Evoenergy's revised proposal and our final decision ($million, 2023–24)

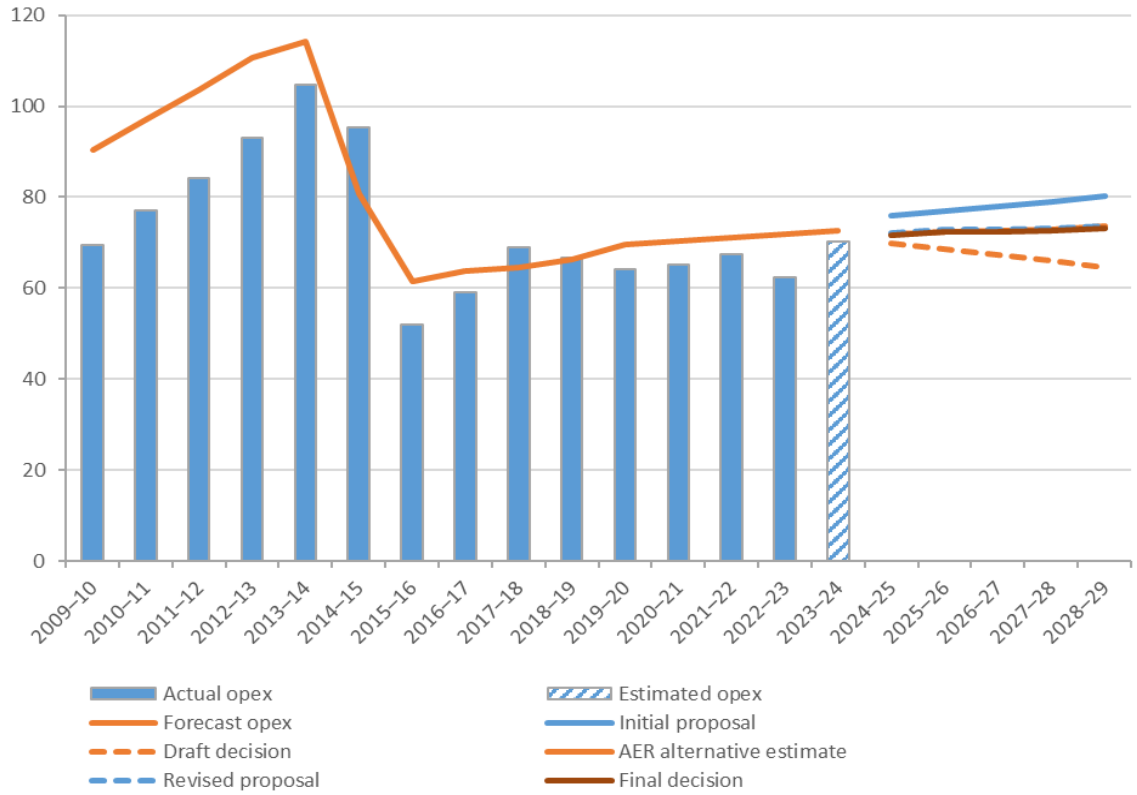
	Proposal	Draft Decision	Revised proposal	Revised proposal (ex. ACS costs) (a)	Alternative estimate (b)	Difference (b-a)
Based on reported opex in 2022–23	**337.2**	**332.1**	**311.4**	**311.4**	**310.5**	**–0.9**
Efficiency adjustment	–	–51.6	–	–	–	–
Transition costs	–	20.9	–	–	–	–
Total base year adjustments	–2.9	–2.9	–	–	–	–
2022–23 to 2023–24 increment	7.2	–2.1	3.4	3.4	3.4	–
Total trend	**14.3**	**7.9**	**8.2**	**8.2**	**8.4**	**0.3**
Step change – Insurance premiums	5.0	5.0	5.0	5.0	5.0	–
Step change – SOCI	14.6	14.6	15.0	15.0	15.0	–
Step change – DER Integration	11.6	9.9	9.9	9.9	9.9	–
Step change – Smart metering	–	–	9.0	6.2	5.4	–0.8
Total step changes	**31.2**	**29.4**	**38.8**	**36.0**	**35.3**	**–0.8**
Total opex, excluding debt raising costs	**386.8**	**333.6**	**361.7**	**358.9**	**357.5**	**–1.4**
Debt raising costs	3.2	2.9	3.1	3.1	3.1	–
Total opex, including debt raising costs	**390.1**	**336.5**	**364.8**	**362.0**	**360.6**	**–1.4**

Source: Evoenergy, *SCS opex model*, November 2023; AER analysis.

Note: We have only included SCS smart meter costs for columns (a) and (b) above. In other words, we have excluded $2.8 million from the smart metering step change in both columns (as belonging in ACS). Numbers may not add up to totals due to rounding. Differences of '0.0' and '–0.0' represent small variances and '–' represents no variance.

Figure 6.1 compares the total opex forecast for Evoenergy (brown line) we have included in the final decision for the 2024–29 period, our alternative estimate for the total opex forecast and Evoenergy's revised opex proposal (the blue dashed line), which we have used as the basis for the final decision for the 2024–29 period. We have also included the forecasts we approved in past decisions, as well as Evoenergy's 2024–29 proposal's initial forecast, and its actual and estimated expenditure over the 2019–24 period.

Figure 6.1 Historical and forecast opex ($million, 2023–24)



Source: Evoenergy, *Regulatory accounts 2014–15 to 2022–23*; AER, *Draft decision, Evoenergy distribution determination 2024–29 – Opex model*, September 2023; AER analysis.
Note: Includes debt raising costs and movements in provisions. Evoenergy revised its Cost Allocation Method in 2014–15 meaning opex prior to this revision is not on a like-for-like basis with opex in the years following.

6.2 Evoenergy's revised proposal

Evoenergy included total forecast opex of $364.8 million ($2023–24) in its revised proposal for the 2024–29 period, as set out in Table 6.2. This is $35.5 million ($2023–24) (10.8%) higher than Evoenergy's actual and estimated opex for the 2019–24 period, $35.5 million ($2023–24) (6.5%) lower than its initial proposal and $25.5 million ($2023–24) (7.6%) higher than our draft decision.[3]

Table 6.2 Evoenergy's proposed opex ($million, 2023–24)

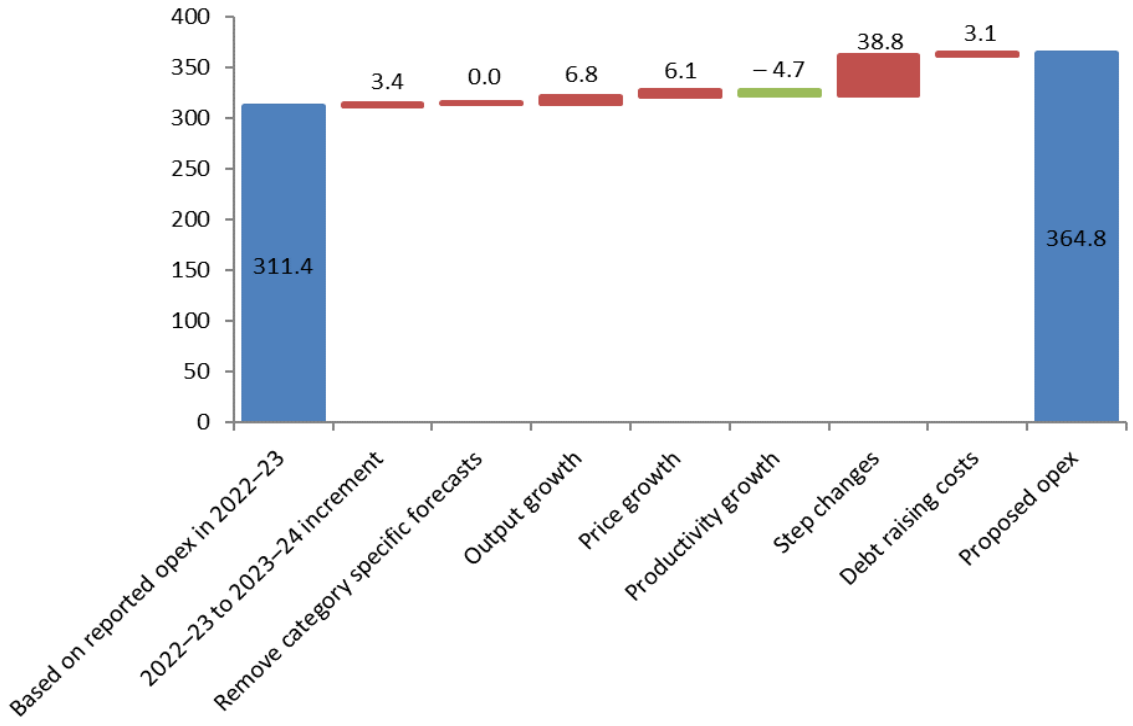
	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Total opex excluding debt raising costs	71.5	72.2	72.4	72.5	73.1	361.7
Debt raising costs	0.6	0.6	0.6	0.6	0.6	3.1
Total opex	**72.1**	**72.8**	**73.0**	**73.1**	**73.8**	**364.8**

Source: Evoenergy, *SCS opex model,* November 2023.
Note: Numbers may not add up due to rounding.

[3] Comparisons are inclusive of debt raising costs.

In Figure 6.2, we separate Evoenergy's revised forecast opex proposal into its different components.

Figure 6.2 Evoenergy's opex forecast ($million, 2023–24)



Source: Evoenergy, *SCS opex model*, November 2023; AER analysis.
Note: Numbers may not add up due to rounding.

Evoenergy continued to use our standard 'base-step-trend' approach to forecast opex for the 2024–29 period in its revised proposal.

In applying our base-step-trend approach to forecast opex for the 2024–29 period, Evoenergy:[4]

- used opex in 2022–23 as the base from which to forecast ($311.4 million ($2023–24))
- added $3.4 million ($2023–24) to reflect the change in opex between 2022–23 and 2023–24
- applied a rate of change comprising of:
  - output growth ($6.8 million ($2023–24))
  - real price growth ($6.1 million ($2023–24))
  - productivity growth (–$4.7 million ($2023–24)) of 0.5% per year.
- added 4 step changes totalling $38.8 million ($2023–24) for:
  - insurance premiums ($5.0 million ($2023–24))
  - security of critical infrastructure costs ($15.0 million ($2023–24))
  - consumer energy resources (CER) integration ($9.9 million ($2023–24))

[4] Evoenergy, *SCS opex model*, November 2023.

  - smart meter rollout ($9.0 million ($2023–24))
- added $3.1 million of debt raising costs to arrive at total forecast opex of $364.8 million ($2023–24) over the 2024–29 period.

6.2.1 Stakeholder views

We received only one relevant submission on Evoenergy's 2024–29 revised proposal that raised issues related to opex. This was from the Consumer Challenge Panel 26 (CCP26) which stated that the "AER's challenging of [Evoenergy's] opex base year efficiency is reasonable and is a technical matter that is best considered by them."[5]

Our assessment of Evoenergy's base year efficiency is detailed in section 6.4.1 below.

6.3 Assessment approach

Under the regulatory framework, a business must include a forecast of total opex that it considers is required to meet or manage expected demand, comply with all applicable regulatory obligations, and to maintain the safety, reliability, quality, and security of its network and contribute to achieving emissions reduction targets (the opex objectives).[6]

Our role is to decide whether to accept a business's total opex forecast. We are to form a view about whether a business's forecast of total opex 'reasonably reflects the opex criteria,' including whether it is a prudent and efficient way of meeting the opex objectives.[7] In doing so, we must have regard to each of the opex factors specified in the National Electricity Rules (NER).[8] We must make our decision in a manner that will, or is likely to, contribute to the achievement of the National Electricity Objective.[9]

The *Expenditure forecast assessment guideline* (the Guideline) sets out our assessment approach in detail.[10] While the Guideline provides for greater regulatory predictability, transparency and consistency, it is not mandatory. However, if we make a decision that is not in accordance with the Guideline, we must state the reasons for departing from the Guideline.[11] Where relevant we must also assess opex associated with emissions reduction proposals taking into account our *Guidance on amended National Electricity Objective*.[12]

Our approach is to assess the business's forecast opex over the regulatory control period at a total level, rather than to assess individual opex projects. To do so, we develop an alternative estimate of total opex using a 'top-down' forecasting method, known as the 'base-step-trend' approach.[13] We compare our alternative estimate with the business's total

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5 CCP26, *Evoenergy Final Submission*, January 2024, p. 18.

6 NER, cl. 6.5.6(a).

7 NER, cl. 6.5.6(c).

8 NER, cl. 6.5.6(e).

9 NEL, s. 16(1)(a). The National Electricity Objective is set out in s. 7 of the NEL.

10 AER, *Expenditure forecast assessment guideline – distribution*, August 2022; AER, *Explanatory statement – expenditure forecast guideline*, November 2013.

11 NER, cl. 6.2.8(c)(1).

12 AER, *Guidance on amended National Electricity Objective*, September 2023.

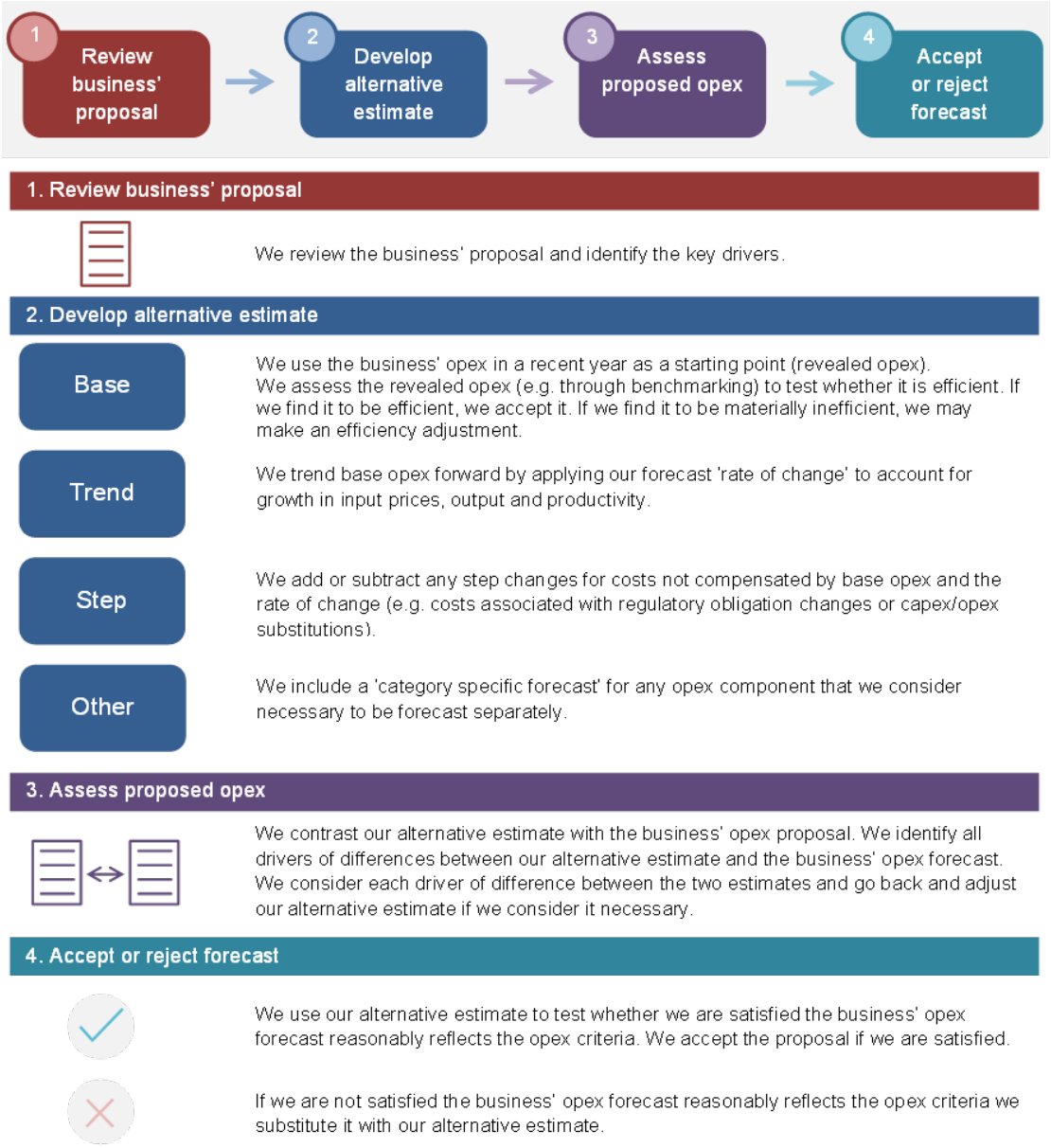
13 A 'top-down' approach forecasts total opex at an aggregate level, rather than forecasting individual projects or categories to build a total opex forecast from the 'bottom up.'

opex forecast to form a view on the reasonableness of the business's proposal. If we are satisfied the business's forecast reasonably reflects the opex criteria, we accept the forecast. If we are not satisfied, we substitute the business's forecast with our alternative estimate that we are satisfied reasonably reflects the opex criteria.

In making this decision, we take into account the reasons for the difference between our alternative estimate and the business's proposal, and the materiality of the difference. Further, we take into consideration interrelationships between opex and the other building block components of our decision.[14]

Figure 6.3 summarises the 'base-step-trend' forecasting approach.[15]

Figure 6.3 Our opex assessment approach



14 We are required to take into account these interrelationships under s. 16(1)(c) of the NEL.

15 Our base-step-trend approach is set out in our expenditure guideline. See AER, *Expenditure forecast assessment guideline – distribution*, August 2022, pp. 24–27.

6.3.1 Interrelationships

In assessing Evoenergy's total forecast opex, we took into account other components of its proposal and our determination, including:

- the efficiency benefit sharing scheme (EBSS) carryover—the estimate of opex for 2023–24 (the final year of the current regulatory control period (2019–24)) that we used to forecast opex, was the same as the level of opex we used to calculate EBSS carryover amounts. This consistency ensures that the business is rewarded (or penalised) for any efficiency gains (or losses) it makes in the final year the same as it would for gains or losses made in other years
- the operation of the EBSS in the 2019–24 period, which provided Evoenergy an incentive to reduce opex in the base year
- the impact of cost drivers that affect both forecast opex and forecast capital expenditure (capex). For instance, forecast labour price growth affects forecast capex and our forecast price growth used to estimate the rate of change in opex
- the approach to assessing the rate of return, to ensure there is consistency between our determination of debt raising costs and the rate of return building block
- concerns of electricity consumers identified during Evoenergy's engagement with consumers.

6.4 Reasons for final decision

We do not accept Evoenergy's revised proposed total forecast opex of $364.8 million ($2023–24), which included the proposed smart meter step change. However, accounting for the reallocation of smart meter costs we consider should be allocated to ACS, our alternative estimate of total forecast opex of $360.6 million ($2023–24) is not materially different ($1.4 million ($2023–24) or –0.4% lower) to Evoenergy's revised proposal opex forecast of $362.0 million ($2023–24), on a like for like basis.

Our final decision is therefore to approve total forecast opex of $362.0 million ($2023–24), including debt raising costs, for the 2024–29 period as reasonably reflecting the opex criteria.[16] This is consistent with Evoenergy's revised proposed opex forecast of $364.8 million ($2023–24), less the portion of its smart meter step change costs ($2.8 million ($2023–24)) which we have allocated to ACS, as discussed in section 6.4.3.4 and in our final decision Metering Services Attachment 20.

We discuss the components of our alternative estimate below. Full details of our alternative estimate are set out in our opex model, which is available on our website.

[16] The opex criteria are set out in cl. 6.5.6(c) of the NER and the opex factors are set out in cl. 6.5.6(e). We must not accept a distributor's proposed opex if we are not satisfied that it reasonably reflects those criteria: NER, cl. 6.5.5(d).

6.4.1 Base opex

This section provides our view on the prudent and efficient level of base opex that we consider Evoenergy would need for the safe and reliable provision of electricity services over the 2024–29 period.

For this final decision, on the basis of the revised base year and further benchmarking analysis, we consider there is not sufficient evidence to conclude that Evoenergy's revised base year opex of $62.1 million[17] ($2023–24) in 2022–23 is materially inefficient. We have therefore relied on revealed opex in the base year to forecast base opex in our alternative estimate of total opex.

Our draft decision found material inefficiency in Evoenergy's opex over the benchmarking period and in the 2021–22 base year. [18] In relation to base year opex we found an efficiency 'gap' of 15.7%. We applied this as an efficiency adjustment via a 5-year linear transition / glide path, which brought the effective 5-year average efficiency adjustment down to 9.4%.

In its revised proposal Evoenergy proposed base opex of $62.3 million ($2023–24) or $311.4 million ($2023–24) over the next regulatory control period. This was on the basis of revealed costs in 2022–23, which it updated as the base year from 2021–22 year in its initial proposal. Evoenergy submitted that its opex in 2022–23 represented the efficient level of sustainable costs to provide standard control services and to ensure that it can achieve the operating expenditure objectives, factors, and criteria specified in the NER.[19]

Evoenergy, supported with advice from Frontier Economics, also responded to the base year opex efficiency issues identified in our draft decision and provided the additional information we sought. It also proposed new and updated OEFs that it considered should be taken into account relating to tax and levy[20] and network overhead capitalisation practice[21] differences. In addition, it proposed that as a part of our benchmarking approach we should make an allowance for the statistical uncertainty associated with our benchmarking results.[22] It also further expanded on its arguments in relation to the limitations of benchmarking warranting caution in application.[23] Other aspects of its revised proposal on base opex efficiency include:

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17 The minor difference in our alternative estimate to reported opex in Evoenergy's revised proposal is due to updated inflation data.

18 AER, *Draft Decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 11.

19 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 14.

20 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 15–17; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 18–21.

21 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 17–20; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 22–26.

22 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 25–26; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 34–42.

23 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 26–27; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 48–86.

- updated benchmarking results reflecting the 2023 Annual Benchmarking Report results, 2023 actual data (available since draft decision) and revised circuit length data which it put forward as a correction[24]
- re-proposed non-application of a vegetation management OEF adjustment[25] which we included in the draft decision, and accepted the draft decision on OEF adjustments for sub-transmission, termite exposure, backyard reticulation, and workers' compensation[26]
- re-proposed application of a vegetation management step change adjustment to the benchmarking roll-forward model, which the draft decision rejected.[27]

Our assessment of these issues in terms of the proposed base year and the efficiency of Evoenergy's opex is summarised in section 6.1 and set out in sections 6.4.1.1 and 6.4.1.2.

A key reason for the change in our final decision on the efficiency of opex in the base year, relative to our draft decision, is the updated base year of 2022–23. This has opex ($62.3 million ($2023–24)) that is 6.5% lower than opex in the previous base year of 2021–22. Further updates to our estimated efficient opex, including the use of results from the *2023 Annual Benchmarking Report*, also contributed. We have also used sensitivity testing and regulatory judgement to make an allowance for differences in the treatment of network overhead capitalisation differences. This was not included in the draft decision, but we consider that given Evoenergy's historical practice of expensing 100% of network overheads, which is materially different to the practice of other networks, not accounting for this would likely disadvantage Evoenergy in terms of measured opex efficiency.

In terms of non-efficiency related adjustments to base opex, Evoenergy added the forecast change in opex between 2022–23 and 2023–24. This is in line with our standard approach. We discuss this in section 6.4.1.3.

6.4.1.1 Proposed base year

Our final decision is to accept 2022–23 as Evoenergy's base year, and we have used opex in that year in our alternative estimate of opex.

Our draft decision accepted 2021–22 as Evoenergy's base year.[28] However, we noted that if Evoenergy were to adopt 2022–23 as its base year in its revised proposal, given actual data would be available, we would consider this as part of our final decision.[29]

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24 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 14; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 43–47.

25 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 20–25; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 13–18.

26 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 12; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, p. 12.

27 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 25; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 27–33.

28 AER, *Draft Decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 12.

29 AER, *Draft Decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 12.

Evoenergy's revised proposal updated the base year from 2021–22 to 2022–23, reflecting the most recent available audited data on its operating costs. The updated, lower, base year opex proposed by Evoenergy is $62.3 million ($2023–24), or $311.4 million ($2023–24) over the next regulatory control period. This is in comparison to opex in 2021–22 of $66.8 million ($2023–24), or $334.2 million ($2023–24) over the period, which Evoenergy used in the initial proposal. Evoenergy's actual opex in 2022–23 is materially lower (6.8%) than opex in 2021–22.

Evoenergy considered 2022–23 is an appropriate base year as it:

- is the most recent regulatory year for which actual audited data is available for the regulatory submission
- captures expenditure required to sustainably maintain safety and service standards, and meet and manage network demand within the current operating environment, consistent with customer expectations
- reflects revealed efficient costs under an incentive based regulatory framework, incorporating the efficiency gains that Evoenergy has achieved to date, including incurring expenditure below the AER's approved efficient regulatory allowance
- accounts for the current and prudent costs to comply with all applicable regulatory obligations and requirements associated with the provision of SCS, as required under the NER
- reflects the expenditure that Evoenergy expects to incur on a recurrent basis.

For this final decision, we accept 2022–23 as Evoenergy's base year, including as it uses the most recent available actual opex data. We consider it is reasonably representative of base opex costs in the next regulatory control period.

6.4.1.2 Efficiency of Evoenergy's opex

As summarised in section 6.3, and in our *Expenditure Forecast Assessment Guideline*, our preferred approach for forecasting opex is to use a revealed cost approach. This is because opex is largely recurrent and stable at a total level. Where a distribution business is responsive to the financial incentives under the regulatory framework, the actual level of opex it incurs should provide a good estimate of the efficient costs required for it to operate a safe and reliable network and meet its relevant regulatory obligations. However, we do not assume that the business's revealed opex is efficient. We examine the historical trend in opex and use our top-down benchmarking tools, and other assessment techniques, to test whether the business is operating materially inefficiently over the benchmarking period and particularly whether its opex in the base year is higher than our estimate of efficient opex.

We assess the efficiency of opex in a base year using our benchmarking results and other tools, and make downward adjustments where we consider there is material inefficiency. The size of any efficiency adjustment is informed by any 'efficiency gap' found between actual or proposed base year opex and our estimated efficient base year opex. Estimated efficient base year opex is obtained using our benchmarking roll-forward model, which draws on our econometric opex cost function benchmarking results, the use of a benchmark comparison point of 0.75 (instead of 1.0) and incorporates OEF adjustments to the efficiency scores.

In line with this approach, our assessment of the efficiency of Evoenergy's base opex is set out in the following sections:

- Section 6.4.1.2.1 – analysis of Evoenergy's revealed costs
- Section 6.4.1.2.2 – benchmarking the efficiency of Evoenergy's opex over time
- Section 6.4.1.2.3 – benchmarking the efficiency of Evoenergy's base year opex
- Section 6.4.1.2.4 – statistical uncertainty and benchmarking limitations.

6.4.1.2.1 Analysis of Evoenergy's revealed costs

Figure 6.1 shows Evoenergy's opex forecast for the next regulatory control period, its actual opex in previous regulatory control periods, our previous regulatory decisions and our alternative estimate that is the basis for our final decision.

We have seen a slight increasing trend in Evoenergy's opex since 2015–16 when it decreased to its lowest level ($51.8 million ($2023–24)). This substantial drop in opex (approximately 45%) occurred early in the last regulatory control period – coinciding with the AER's 2014–19 reset decision in which we found Evoenergy's base opex was materially inefficient. This was at the time in which Evoenergy made large workforce reductions as part of a restructure of its organisation.[30] Following this, there were increases in Evoenergy's actual opex of approximately 15% in 2016–17 and 2017–18 and opex rose to $69.0 million ($2023–24). Following some decreases, and offsetting increases in the subsequent years, actual opex in the 2022–23 base year was at $62.3 million ($2023-24), broadly in line with the level of opex in 2016–17. Evoenergy estimated opex in 2023–24 will be higher at $70.2 million ($2023–24).

Over the last and current regulatory control periods, Evoenergy's actual opex has generally been below the AER's forecast, other than in 2014–15 (17.9% higher) and in 2017–18 (7.0% higher). In the current regulatory control period, the actual and estimated opex is estimated to be 7.5% below the AER's forecast. In its initial proposal, Evoenergy noted this was achieved despite significant cost pressures in a challenging economic environment and additional regulatory obligations which it needed to comply with.[31]

Evoenergy has performed creditably against the AER's opex forecasts over the last two regulatory control periods, and in 2022–23 it has achieved opex reductions that return its opex to levels closer to those at the start of the 2014–19 regulatory control period.

6.4.1.2.2 Benchmarking the efficiency of Evoenergy's opex over time

Benchmarking broadly refers to the practice of comparing the economic performance of a group of service providers that provide the same services as a means of assessing their relative performance. Our *2023 Annual Benchmarking Report* includes information about the use and purpose of economic benchmarking, and details about the techniques we use to benchmark the efficiency of distribution businesses in the NEM.[32] The *2023 Annual*

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30 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy 2019–24 Distribution revenue proposal*, September 2018, pp. 19–23.

31 Evoenergy, *Attachment 2 – Operating expenditure*, January 2023, p. 11.

32 AER, *Annual Benchmarking Report – Electricity distribution network service providers*, November 2023.

Benchmarking Report is our latest report and the updated results from this report are used to inform this final decision.

While opex at the total level is generally recurrent, year-to-year fluctuations can be expected. To shed light on Evoenergy's general level of operating efficiency, in this section we look at the efficiency of Evoenergy's opex over time, using our top-down benchmarking tools, as well as other supporting techniques. This is followed (in section 6.4.1.2.3) by looking at the efficiency of opex in the base year (2022–23).

In relation to historical performance, Evoenergy's unadjusted benchmarking results indicate that it performs less well on opex efficiency measures compared to other networks, and that it is materially inefficient over the relevant benchmarking periods. However, this analysis does not take account of operating environment differences and other factors that may be impacting on Evoenergy's measured efficiency scores, including differences in capitalisation of network overhead practices. We discuss these factors below in section 6.4.1.2.3.

Period-average econometric opex cost function efficiency scores

This section presents the results of the econometric opex cost function models that compare the relative opex efficiency of DNSPs in the NEM. These model the relationship between opex (as the input) and outputs, and so measure opex efficiency. The results presented reflect an average efficiency score for each DNSP over a specified period. The periods we look at are the 2006-to-2022 (long) period and the 2012-to-2022 (short) period. The four econometric opex cost function models presented in this section represent the combination of two cost functions (Cobb-Douglas and Translog) and two methods of estimation (Least Squares Econometrics (LSE) and Stochastic Frontier Analysis (SFA)), namely:

- Cobb-Douglas Stochastic Frontier Analysis (SFACD)
- Cobb-Douglas Least Squares Econometrics (LSECD)
- Translog Stochastic Frontier Analysis (SFATLG)
- Translog Least Squares Econometrics (LSETLG).

We have examined the results from these models as presented in the *2023 Annual Benchmarking Report.*[33] This is an update from the results we used in the draft decision from the *2022 Annual Benchmarking Report*. We have also updated the *2023 Annual Benchmarking Report* results for the following items which, as discussed below, we consider are reasonable:

- revised 2006–2022 circuit length data for Evoenergy
- updated capitalised corporate overheads for Evoenergy relating to dual function assets.

Revised circuit length data

We have accepted Evoenergy's revised circuit length data and included these in updated *2023 Annual Benchmarking Report* results for this final decision.

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33 AER, *Annual Benchmarking Report - Electricity distribution network service providers*, November 2023, pp. 51–53. These results reflect our preferred approach to addressing corporate overhead capitalisation differences.

Evoenergy's revised proposal included corrections to its circuit length data for 2020–21 and 2021–22.[34] The corrections were proposed by Evoenergy after it found circuit lengths were incorrectly reported to the AER in these years. Evoenergy provided the AER with corrected 2020–21 and 2021–22 circuit length data and as a result proposed reinstating originally submitted, audited circuit length data dating back to 2005–06.[35] The proposed changes in circuit length are material, with circuit length reported in each year increasing between 12–19%. Circuit length is an output in our econometric benchmarking models.[36] Data revisions to this output therefore impact the results produced by these models.

We sought further explanation from Evoenergy regarding the origin of the incorrect circuit length data. Evoenergy explained that the reporting error occurred as a result of route (rather than circuit) length data being used as the basis of preparation in 2020–21 and 2021–22.

We are satisfied that the revision and reinstatement of historical circuit length data for Evoenergy is an appropriate correction after having assessed the data and Evoenergy's response to our questions relating to the origin of the reporting error.

Updated capitalised corporate overheads for Evoenergy

We have updated Evoenergy's capitalised corporate overheads series in the period 2015–22 to correct for the omission of its dual function asset related capitalised corporate overheads. We have included this series in updated *2023 Annual Benchmarking Report* results for this final decision.

We reviewed Evoenergy's capitalised corporate overheads, which for all DNSPs are treated as opex for benchmarking purposes under our preferred approach to addressing capitalisation differences between DNSPs.[37] As a result, we discovered that capitalised corporate overheads related to dual function assets were missing from the total capitalised corporate overhead series for Evoenergy in the period 2015–2022. Evoenergy agreed that these costs had been omitted and should be included.[38] The change in corporate overheads is material in these years, increasing capitalised corporate overheads by between 7–12%.

Updated period-average efficiency scores (for circuit length data and capitalised corporate overheads)

The updated econometric opex cost function benchmarking results from the *2023 Annual Benchmarking Report* are presented in Figure 6.4 over the long period (2006–22). These results do not include the lower actual opex Evoenergy achieved in 2022–23. These two updates made a net immaterial impact on Evoenergy's (EVO) efficiency score, with other DNSPs' scores not materially affected. The circuit length update slightly increased Evoenergy's efficiency, while the capitalised corporate overheads update decreased

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34 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, p. 14

35 As there was a break in the circuit length data series in 2020–21 and 2021–22 caused by a change in the measurement / reporting approach, the AER had previously worked with Evoenergy to ensure that it was on a like-for-like basis.

36 In the opex multilateral productivity models discussed below, circuit length is both an input and output.

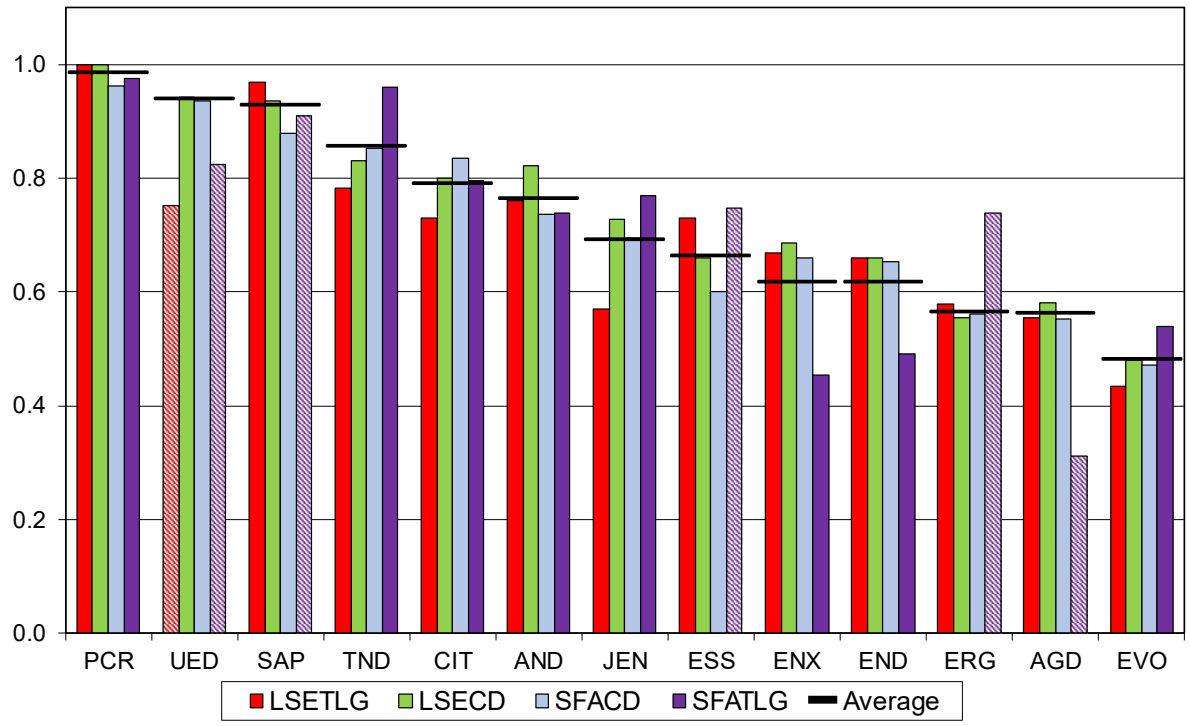
37 AER, *How the AER will assess the impact of capitalisation differences on our benchmarking – Final guidance note*, May 2023.

38 Evoenergy, *Information request EVO IR#057 – capitalised corporate overheads – 20240207*.

Evoenergy's efficiency score, causing a very minor net increase when considered together. Further, these updates had no impact on Evoenergy's ranking relative to other DNSPs over the long period, with Evoenergy ranking last out of 13 DNSPs with an unadjusted period average efficiency score of 0.48.

Our standard approach is to use a 0.75 benchmark comparison point, rather than 1.0, to recognise data and modelling imperfections when assessing the relative efficiency of distribution businesses to the benchmark comparators. This is discussed further in section 6.4.1.2.4. Where the econometric model-average score is below 0.75, we take this as prima facie evidence that a DNSP has been materially inefficient over the relevant period. With a model-average score of 0.48, there are concerns with Evoenergy's efficiency performance. Following our standard approach, where the model-average score is below 0.75 we directly test the efficiency of the DNSP's actual opex in the base year. This involves application of our economic benchmarking roll-forward-model and, importantly, adjusting for the presence of material OEFs not already captured in the modelling. This enables us to account for some factors beyond a distributor's control that can materially affect its benchmarking performance. This is discussed further in section 6.4.1.2.3.

Figure 6.4 Distribution businesses' average opex efficiency scores, 2006–2022



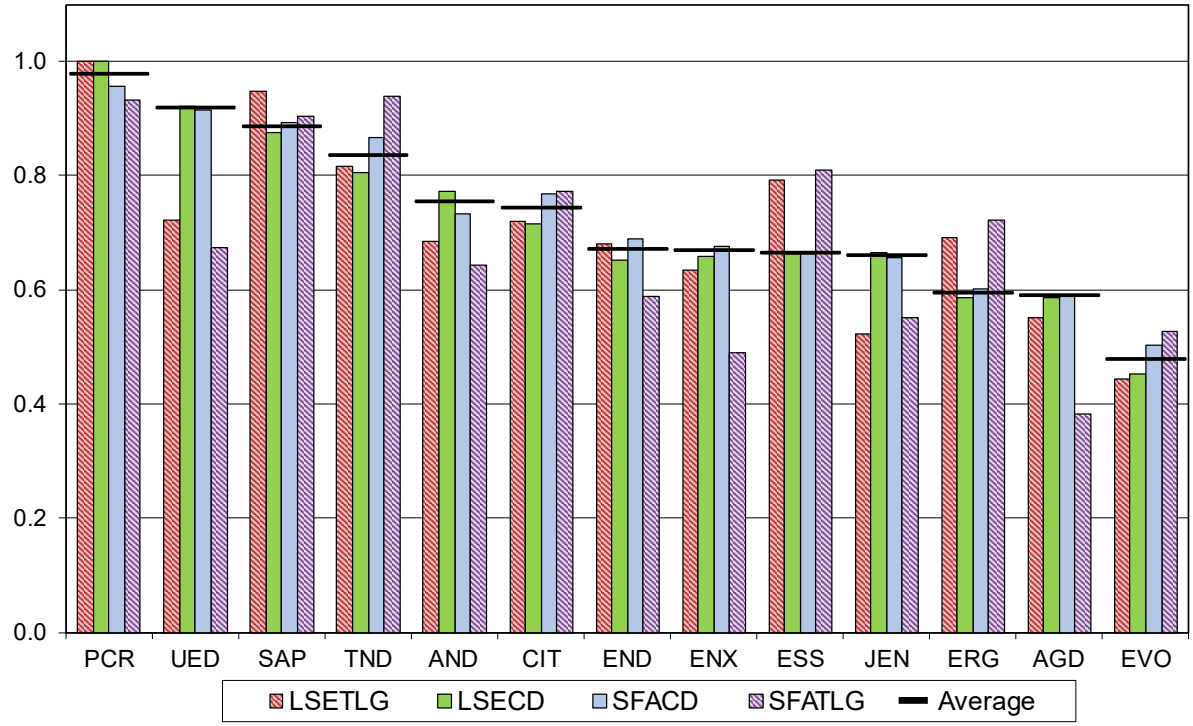
Source: AER, *2023 Annual Benchmarking Report – Electricity distribution network service providers*, November 2023; AER analysis.

Note: These results reflect our preferred approach to addressing corporate overhead capitalisation differences and incorporate updated circuit line length and corporate overhead data for Evoenergy. Columns with a hatched pattern represent results that do not satisfy the monotonicity requirement (that an increase in output is only achieved with an increase in opex) and are not included in the model-average efficiency score for each DNSP (which is represented by the black horizontal line).

It can take some time for more recent improvements in efficiency by previously poorer performing distribution businesses to be reflected in period-average efficiency scores. As a result, we also examined Evoenergy's average performance over the shorter and more recent 2012–22 time period as can be seen in Figure 6.5. With the updates noted above,

Evoenergy's model-average score over the 2012–22 period is 0.48 and it is again ranked last of the 13 distributors.[39] This indicates that Evoenergy has not materially improved its efficiency relative to its peers over the 2012–22 period, compared with its efficiency over the 2006–22 period. In part this is explained by other distributors improving their performance since 2012. Again this does not account for the presence of material OEFs.

Figure 6.5 Distribution businesses' average opex efficiency scores, 2012–2022



Source: AER, *2023 Annual Benchmarking Report – Electricity distribution network service providers*, November 2023; AER analysis.

Note: These results reflect our preferred approach to addressing corporate overhead capitalisation differences and incorporate updated circuit line length and corporate overhead data for Evoenergy. Columns with a hatched pattern represent results that do not satisfy monotonicity (that an increase in output is only achieved with an increase in opex) and are not included in the model-average efficiency score for each DNSP (which is represented by the black horizontal line). In the case of the SFATLG model, this does not satisfy monotonicity for the majority of Australian DNSPs and we exclude the model from calculating the model-average efficiency score for all Australian DNSPs.

Opex multilateral partial factor productivity (MPFP) over time

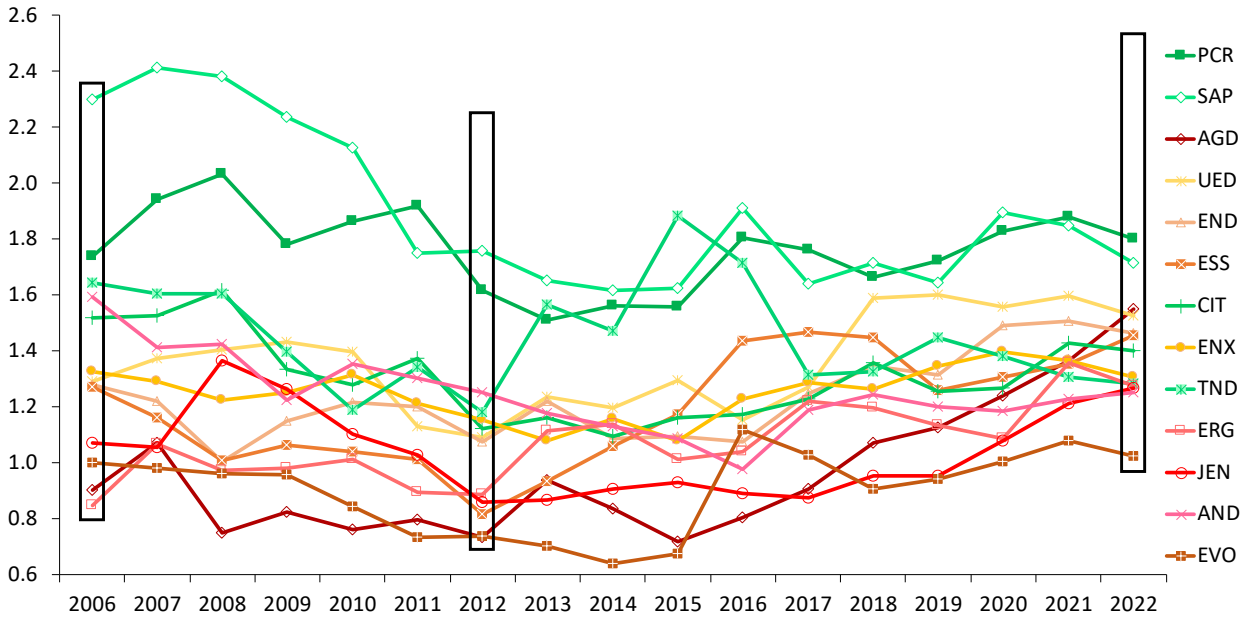
We also use productivity index number techniques to compare productivity levels over time and between businesses. The multilateral total factor productivity (MTFP) index measures the total factor productivity of each business, whereas the opex and capital multilateral partial factor productivity (MPFP) indexes measure the productivity of opex or capital inputs respectively. Our opex MPFP efficiency results are not adjusted for material OEFs.

The results from our opex MPFP analysis can be seen in Figure 6.6 where a higher score means that a DNSP is more productive relative to its peers. These reflect updated *2023 Annual Benchmarking Report* results, using the revised circuit line length and corporate overhead data. Evoenergy has typically ranked among the poorer performing DNSPs in terms of opex MPFP. Evoenergy's performance has remained consistent since 2006, other

[39] Noting the exclusions for monotonicity.

than an increase in measured opex MPFP in 2015–16, following large reductions in opex, as discussed above. However, Evoenergy's performance has since worsened. Evoenergy has ranked last over the last five years. The recently improved performance of other DNSPs, particularly Ausgrid and Jemena, is a factor here. Evoenergy's average ranking over the full 2006–22 period is last.

Figure 6.6 Opex MPFP for individual businesses, 2006–22



Source: AER, *2023 Annual Benchmarking Report – Electricity distribution network service providers*, November 2023; AER analysis.
Note: These results incorporate updated circuit line length and corporate overhead data for Evoenergy.

We note that the opex MPFP results are broadly consistent with the econometric opex cost function results. As noted above for the efficiency scores from econometric modelling, these do not account for any material OEFs.

Partial Performance Indicators and cost category analysis

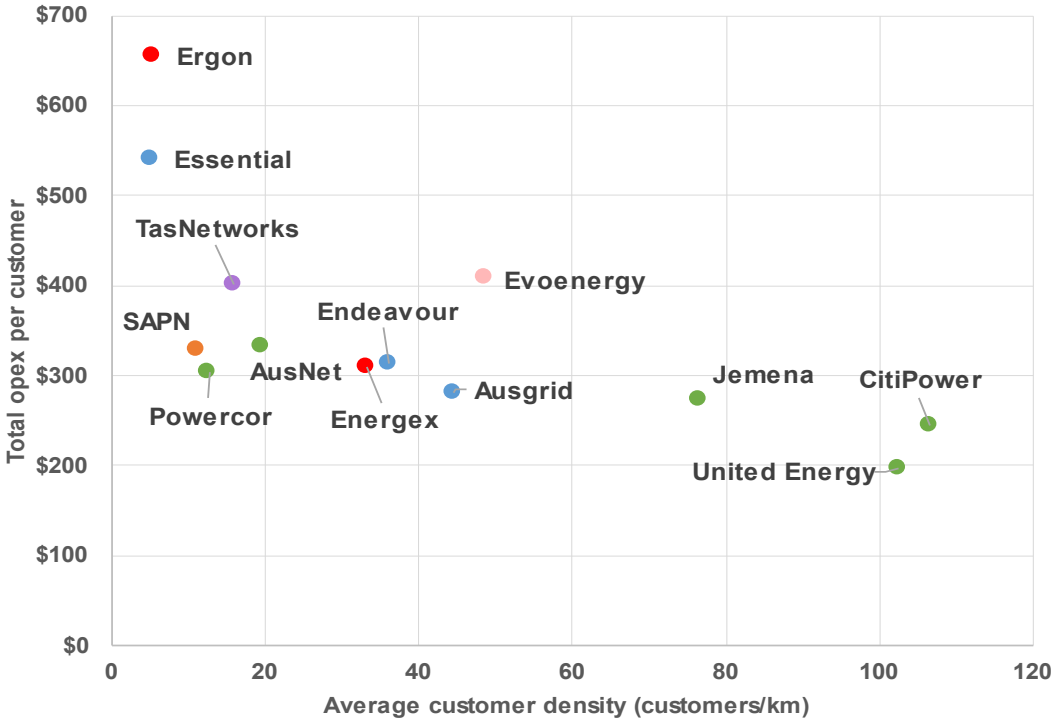
We have also examined the relative opex performance of Evoenergy over the 5-year period (2018 – 2022) using partial performance indicators (PPIs). This simple ratio method relates one input to one output. PPIs provide some information about the total and category specific opex performance of a business and may help as cross checks and in understanding potential drivers of relative efficiency or inefficiency. Rankings for PPIs may be affected by factors outside the control of the distribution businesses (as for our other benchmarking techniques) and must be analysed with caution, with comparisons also generally limited to businesses with similar characteristics, e.g. customer density.

The evidence on Evoenergy's performance on the range of opex PPIs is relatively consistent across the outputs considered. Evoenergy consistently underperforms on both opex 'per customer' metrics (Figure 6.7) and opex 'per circuit length' metrics (Figure 6.8). We would largely expect urban businesses such as Evoenergy which have denser distribution networks to perform better on 'per customer' metrics than their rural counterparts, whereas on 'per km' metrics, more rural DNSPs will perform better because their costs are spread over a longer network. In Figure 6.7, we see that Evoenergy has a higher total opex per customer than

many networks with much lower customer densities (Endeavour, Energex, AusNet Services). Similarly, in Figure 6.8, we see that Evoenergy's opex per circuit kilometre is higher or comparable to DNSPs with higher customer density (Jemena, United Energy). We acknowledge that these results may, to an extent, be driven by Evoenergy's practice of expensing a larger share of network overheads than its peers.

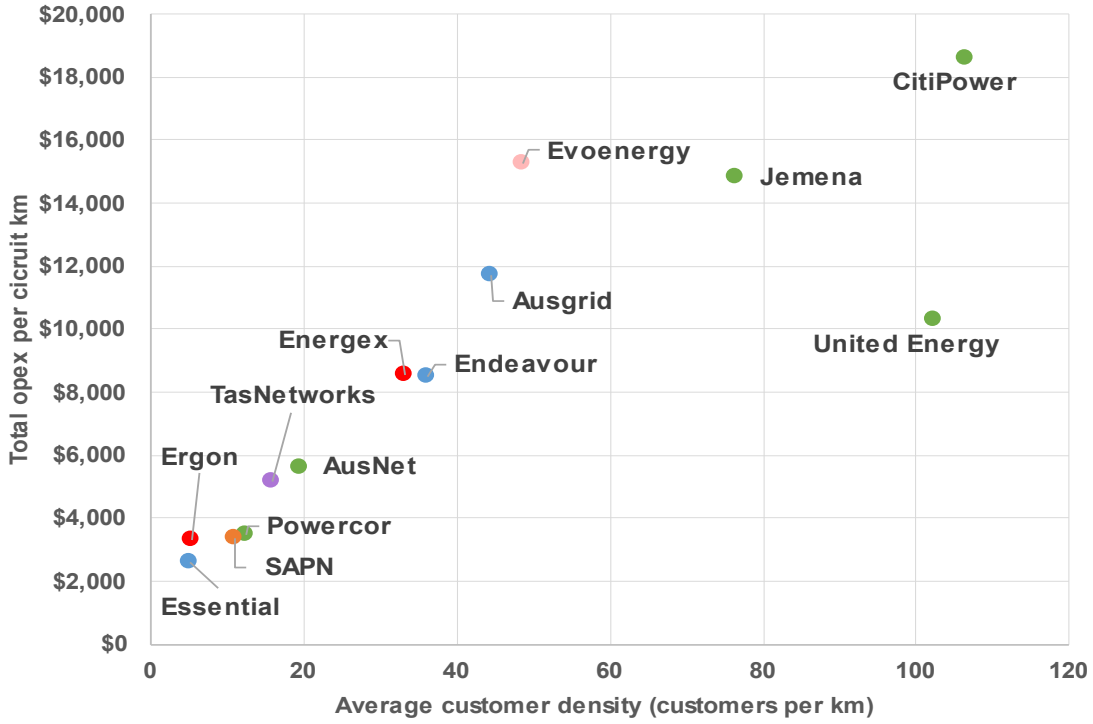
Since the draft decision, our PPIs in Figure 6.7 and Figure 6.8 have been updated for an additional year of data, our preferred approach to addressing capitalisation differences, as well as the revisions to Evoenergy's circuit length data and corrected capitalised corporate overheads.

Figure 6.7 Total opex per customer against customer density (2018–22 average) $2023–24



Source: AER analysis

Figure 6.8 Total opex per km of circuit line length against customer density (2018–22 average) $2023–24



Source: AER analysis

6.4.1.2.3 Benchmarking the efficiency of Evoenergy's base year opex

Given the evidence in section 6.4.1.2.2 indicating the relative inefficiency of Evoenergy's opex over time, we have undertaken further analysis.

In the draft decision, we concluded Evoenergy's opex in the proposed base year of 2021–22 was materially inefficient.[40] For this final decision, taking into account the 6.5% lower actual opex in the updated base year of 2022–23, and accounting for network overhead capitalisation practice differences (which we did not do in the draft decision) we do not find sufficient evidence to support a conclusion that opex in the base year is materially inefficient.

The following sub-sections set out how we have reached this conclusion, reflecting the following process:

- First, using results from our econometric opex cost function benchmarking and our benchmarking roll-forward model, deriving the estimated efficient rolled forward opex in the base year.[41] This takes into account the 0.75 benchmark comparison point and

40 AER, *Draft Decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 11.

41 In this application to Evoenergy, we have applied the results updated for the approach to capitalisation practices, which treats capitalised corporate overheads as opex for benchmarking purposes. This means that both the estimated efficient rolled-forward base year opex and actual base year opex include capitalised corporate overheads. The resulting efficiency gap is expressed in percentage terms, and applied as an efficiency adjustment to SCS opex (excluding capitalised corporate overheads) in the opex model.

material OEFs, and considers Evoenergy's argument in relation to accounting for step changes in the benchmarking roll-forward model.

- Second, determining the actual base year opex, including any appropriate adjustments to actual opex.
- Third, determining if there is an efficiency "gap" between the estimated efficient rolled-forward opex in the base year and actual base year opex. Where estimated efficient rolled-forward base year opex is below actual base year opex, we infer that the latter is materially inefficient.

Deriving the estimate of efficient rolled-forward base year opex incorporating OEF adjustments

The results for the estimated rolled-forward efficient opex in the base year for each benchmarking model are shown below under the heading *Calculation of efficiency gap between actual base year opex and estimated efficient base year opex*. We outline our benchmarking roll-forward approach used to derive these estimates in recent decisions.[42] This approach includes making post-modelling OEF adjustments to the benchmarking results to take into account material differences in operating environments, reflecting outcomes of our previous OEF review, undertaken with our consultant Sapere-Merz, and past reset decisions.

Table 6.6 shows each of the material OEFs that are relevant to Evoenergy, and our calculated OEF adjustments for the long and short benchmarking periods, as we have applied them in our final decision.[43] Evoenergy accepted our draft decision on the material OEF adjustments relating to sub-transmission, termite exposure, backyard reticulation and workers' compensation. These OEF adjustments are not discussed further and we have applied them with minor mechanical updates in this final decision, including for an additional year of data, consistent with the draft decision.[44]

In this final decision we have also taken the following positions as set out in more detail below:

- The OEF for jurisdictional taxes and levies: We excluded this OEF in our draft decision pending further information from Evoenergy in its revised proposal. After assessing the information Evoenergy provided, including a proposed adjustment to reflect the ACT's higher payroll taxes relative to other jurisdictions[45], we have decided on balance not to include an OEF for taxes and levies in this final decision. This reflects a middle ground between the advantage Evoenergy faces by its opex not including energy industry-specific taxes and levies, and the possible disadvantage Evoenergy faces through the higher payroll taxes levied in its jurisdiction.

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42 AER, *Final Decision – Jemena determination 2021–26 – Attachment 6 – Operating Expenditure*, April 2021, p. 25.

43 The spreadsheets used to calculate these adjustments are published along with this decision.

44 More information on these OEFs is contained in Section 7 of the 2023 Annual Benchmarking Report: AER, *Annual Benchmarking Report - Electricity distribution network service providers*, November 2023 and in our draft decision AER, *Evoenergy 2024–29 – Draft Decision Attachment 06 – Operating expenditure*, September 2023, pp. 24–28, 31–33.

45 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 15–17.

- The network overhead capitalisation practice OEF Evoenergy included in its revised proposal to reflect its unique practices:[46] While we have not included this OEF in our alternative estimate, we have taken these capitalisation practice differences into account through sensitivity testing and regulatory judgement. This reflects that we consider the treatment of network overheads is not entirely exogenous in a network's decision-making and that capex / opex trade-offs are reflected in network overheads are captured in our benchmarking results to some extent. However, we consider that making no allowance for Evoenergy's full expensing of network overheads, which is unique amongst DNSPs, may disadvantage it in terms of measured opex efficiency.
- The vegetation management OEFs: We have included these in this final decision, consistent with the draft decision. This reflects our view that these OEF calculations are fit for purpose. We have taken into account the arguments Evoenergy made in its revised proposal that these OEFs should not be included as they are based on incomplete information / evidence.[47]

Table 6.3 OEF adjustments for Evoenergy, %

OEF	2006–22 period	2012–22 period
Sub-transmission (Licence conditions)	–0.35	–0.03
Termite exposure	0.01	0.01
Backyard reticulation	3.48	3.31
Workers' compensation	0.74	0.74
Vegetation management (bushfire)*	–3.38	–4.60
Vegetation management (division of responsibility)*	0	0
Total	**0.51**	**–0.57**

Source: AER, *Annual Benchmarking Report, Electricity distribution network service providers*, November 2023; Sapere Research Group and Merz Consulting, Inde*pendent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, August 2018; AER analysis.
Note: While Sapere-Merz identified vegetation management as a material OEF, it did not quantify it given data issues. We have calculated the OEF for vegetation management, as explained below.

These results indicate that Evoenergy incurs net cost disadvantages and advantages over the two benchmarking periods (resulting in 0.51% and –0.57% OEF adjustments, respectively) relative to the benchmark comparator businesses.[48]

Below we also discuss Evoenergy's arguments around a proposed adjustment to estimated efficient opex in order to allow for its approved vegetation management step change in the current regulatory control period.

46 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 17–20.

47 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 20–25.

48 Following our standard approach, these are those DNSPs with an econometric model-average efficiency score of over 0.75. In our updated 2023 Annual Benchmarking Report results under our preferred approach to addressing capitalisation, these are Powercor, CitiPower, SA Power Networks, TasNetworks, United Energy and AusNet Services, for the long period. All but CitiPower are the benchmark comparators for the short period.

OEF adjustment for taxes and levies differences

Our final decision is to not apply the taxes and levies OEF to Evoenergy. While we have applied a jurisdictional taxes and levies OEF across past reset decisions to recognise that taxes and levies are an exogenous cost that may vary materially between jurisdictions, we have not concluded this is appropriate for Evoenergy. Rather, we consider not applying an OEF reflects a middle ground between the advantage Evoenergy faces by its opex not including energy industry-specific taxes and levies, and the possible disadvantage Evoenergy faces through the higher payroll taxes levied in its jurisdiction.

Our draft decision excluded this OEF for Evoenergy, pending further information about the status of payment and recovery of its jurisdictional taxes and levies.[49]

Evoenergy provided information in its revised proposal that its energy industry-specific jurisdictional taxes and levies are generally recovered via a jurisdictional scheme 'unders and overs' account (and not via opex).[50] Evoenergy also indicated that it does not incur any other jurisdictional taxes or levies that are specific to the energy sector. However, Evoenergy submitted there are two types of more general taxes included within its opex that should be accounted for via an OEF due to jurisdictional differences, those being payroll and land tax. Evoenergy noted payroll and land taxes are both identified by Sapere-Merz as potentially relevant to an OEF calculation to recognise variations in taxes and levies between DNSPs and jurisdictions. Evoenergy's revised proposal applied our standard method to calculating a taxes and levies OEF, but included Evoenergy's payroll and land tax payments data over the period 2010–15. The resulting taxes and levies OEF adjustments were 5.4% in the 2006–22 period and 5.2% in the 2012–22 period.[51] Evoenergy noted the OEF adjustment is predominantly driven by payroll taxes, and that it pays the highest payroll tax rate (6.9% at the upper level) across the NEM.[52]

Evoenergy's proposed OEF adjustment indicates it considers it faces a material relative cost disadvantage in relation to its payroll and land tax payments. In our review of Evoenergy's modelling, we observe that it included its payroll and land tax payments but it did not include these taxes for other DNSPs. If payroll and land taxes are included as an OEF, to ensure any relative disadvantage faced by Evoenergy is accounted for appropriately, then the comparable costs faced by other networks would also need to be included. Some of the data necessary to carry out this analysis was collected as part of the 2018 Sapere-Merz review, but it is incomplete and does not cover all DNSPs. For sensitivity testing, we made some estimates of payroll and land taxes across comparator DNSPs where actuals were not available. On the basis of this sensitivity analysis, we find the OEF adjustment for Evoenergy may be approximately 2.5%.

We believe there may be merit to Evoenergy's argument that higher payroll tax rates in the ACT in particular have the potential to be a material driver of higher opex. This reflects the

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49 Evoenergy had not provided data on taxes and levies as part of the 2017–18 Sapere Merz review. See AER, *Draft decision, Attachment 6– Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 26.

50 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 15.

51 Frontier Economics, *Appendix 3.1 AER benchmarking of DNSP opex*, November 2023, p. 20.

52 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 14-17.

evidence presented around the magnitude of payroll tax payments and current differences in the payroll tax rate across different jurisdictions of the NEM. Generic taxes such as payroll and land taxes were considered by Sapere-Merz as potentially relevant for the calculation of a taxes and levies OEF.[53] However, these more general taxes have historically not been included as a part of this OEF adjustment as applied in past reset decisions. Rather, this has been limited to energy industry-specific taxes and levies. One factor in this approach was the wider availability of energy industry-specific tax data across all DNSPs. On the basis of including only energy industry-specific taxes for all DNSPs consistent with our past approach, we find the OEF adjustment for Evoenergy may be approximately -1.3%.

However, there are potential issues with whether, and how, we would incorporate payroll and land taxes into the OEF calculation, and whether other non-energy sector specific jurisdictional taxes and levies such as council rates (which Evoenergy does not incur) also warrant inclusion. We consider determining this for the final decision (and for broader application in resets) would require a more holistic review, and potentially industry-wide consultation. This is not feasible within the timeframe of a final decision. We therefore consider that any application of a taxes and levies OEF to Evoenergy may not accurately reflect Evoenergy's relative cost advantage/disadvantage.

While our final decision on this OEF has not changed since the draft decision, there are different reasons underpinning this conclusion. We consider that our final decision strikes a balance between recognising potential tax and levy related cost advantages and disadvantages Evoenergy faces, as well as the uncertainty resulting from the incomplete data available to us on non-energy industry-specific taxes and levies.

OEF adjustment for network overhead capitalisation practice differences

Our final decision is to not accept a proposed new OEF for network overhead capitalisation practices, but to instead, at this time, account for differences in these practices through sensitivity testing and regulatory judgement. This issue was not considered as a part of our draft decision. Making an allowance for differences in treatment of network overhead capitalisation practices in this final decision is one of the key factors contributing to our view that there is not sufficient evidence to conclude Evoenergy's opex in the base year is materially inefficient.

Evoenergy's revised proposal included an OEF adjustment that reflects differences in the practices between DNSPs in terms of capitalising network overheads.[54] This OEF adjustment was not directly raised in Evoenergy's initial proposal, nor in our draft decision, and has not been considered in a reset context for other distribution businesses. However, Evoenergy's initial proposal stated that it was monitoring the outcome of the AER's final guidance note on addressing capitalisation differences in benchmarking, which was published after Evoenergy's initial proposal was submitted.[55]

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53 Sapere Research Group and Merz Consulting, *Independent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, August 2018, p. 69.

54 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, p. 14.

55 Evoenergy, *Attachment 2 Operating expenditure*, January 2023, p. 20.

Evoenergy considered the basis for the inclusion of this OEF adjustment was that there are material variations between DNSPs in terms of the proportion of network overheads that are expensed or capitalised. In particular, Evoenergy highlighted its historical practice of fully expensing network overheads (reporting 100% of network overheads as opex), which is unique amongst its DNSP peers.[56] Evoenergy noted that failing to account for this difference between DNSPs places it at a significant disadvantage in benchmarking analysis and distorts estimates of period-average efficiency. It proposed network overhead capitalisation practice OEF adjustments of 13.7% and 15.3% in the long and short period respectively.[57]

We have made our final decision to not accept this proposed OEF after assessing Evoenergy's arguments and calculations relating to the proposed network overhead OEF as set out below. We discuss our sensitivity analysis further under the heading *Calculation of efficiency gap between actual base year opex and estimated efficient base year opex* below.

In relation to the broader issue raised by Evoenergy, we agree that differences in capitalisation practices have the potential to reduce like-for-like comparability and may obscure a business's relative efficiency in the benchmarking results. We assessed this broader issue in our final guidance note on how the AER will assess the impact of capitalisation differences on benchmarking.[58] Our position in the final guidance note was to allocate all **corporate** overheads, including capitalised corporate overheads, to opex for benchmarking purposes. We considered this treatment unsuitable for network overheads due to their lumpy nature compared to corporate overheads, their less consistent delineation from other cost categories compared to corporate overheads, and because safeguards in the regulatory framework prevent strategic cost reallocations between corporate and network overheads.

In the case of network overhead capitalisation, we have confirmed that Evoenergy expenses 100% of its network overheads and is an outlier among the DNSPs in this regard as they on average expense between 50–70% of network overheads. This is illustrated in Figure 6.8.

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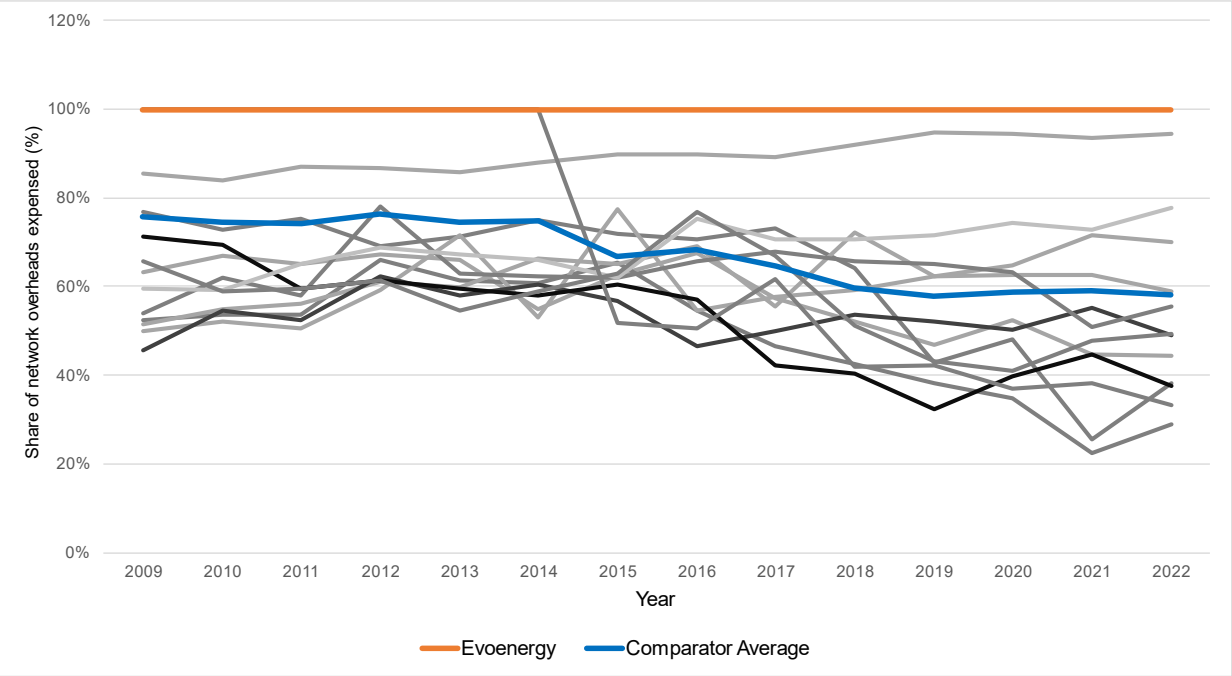
56 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, p. 18.

57 Frontier Economics, *Appendix 3.1: AER benchmarking of DNSP opex*, November 2023, p. 5.

58 AER, *How the AER will assess the impact of capitalisation differences on our benchmarking, Final Guidance note*, May 2023, p. 8.

Figure 6.8 Share of network overheads expensed by DNSP (2009–2022)



Source: Category Analysis Regulatory Information Notices (CA RINs) 2006–2022; AER Analysis.
Note: The grey lines in the figure above represent the other 12 DNSPs. The comparator average represents a customer-weighted average network overhead expensing rate for: SA Power Networks, CitiPower, Powercor, United Energy, TasNetworks and AusNet Services.

In addition, we observe that network overheads (both expensed-only and on a total expenditure (expensed and capitalised) basis) are a significant proportion (approximately 30–40%) of benchmarking opex for all DNSPs. Taken together, these ratios suggest that Evoenergy's 100% expensing of its network overheads potentially reduces the desired like-with-like comparability of the benchmarking data the desired like-with-like comparability of the benchmarking data.

However, we consider that the case of network overhead capitalisation differences is not as clear-cut as for corporate overheads. This is largely due to:

- The less consistent delineation from other cost categories (compared to corporate overheads), in particular between network overheads and direct costs. This can reduce like-with-like comparability between DNSPs, to the extent they have differing approaches to cost categorisation. We understand this may not be an insignificant issue from feedback we received from DNSPs during the capitalisation guidance note process.
- The lumpier nature of network overheads, and that its level is sensitive to the overall capex program, compared to the more recurrent, opex-like corporate overheads.

We use standard criteria to assess whether the inclusion of an OEF is appropriate. As we set out below, there are some questions about whether these standard OEF criteria (of

materiality[59], exogeneity[60] and non-duplication[61]) are fully met and application of the network overhead OEF is appropriate in this case.

We consider the proposed network overhead OEF satisfies the materiality criterion. Specifically, expensed network overheads are a significant proportion of DNSPs' opex, as set out above. This means that even minor differences in capitalisation rates between businesses can result in material differences in the opex we use for benchmarking.

In relation to exogeneity, the capitalisation of any particular business's network overheads may be driven, to an extent, by its business practices and decisions on whether to attribute costs to direct costs (e.g. to vegetation management, maintenance or capex categories) versus network overheads. This means that, on a forward-looking basis, the decision to expense or capitalise may not be fully exogenous. That said, we recognise historical business practices could be bearing on the measured efficiency results for reasons unrelated to efficiency.

The non-duplication criterion may not be met by a network overhead OEF to the extent that the level of capitalised network overheads is a proxy for, or tied to, the level of capex. This is because our econometric opex cost function benchmarking models may to some extent capture opex/capex tradeoffs made in the decision to expense or capitalise network overheads (given the correlation between the outputs in the models and a capital input variable). Therefore, the differences the network overhead capitalisation practice OEF would seek to capture may already be to some extent in the benchmarking results.

In addition to these conceptual points, quantitative analysis casts further doubt on how capitalisation differences between DNSPs would be measured. Our high-level analysis suggests that Evoenergy's network overheads are higher than otherwise when compared to the efficient comparator DNSP, because of both:

- its higher proportion of total expenditure which is treated as overheads, suggesting that Evoenergy may have a higher tendency to classify costs as overheads compared to other businesses, and
- its higher proportion of overheads allocated to network overheads rather than to corporate overheads, suggesting it may tend to classify overheads as network overheads rather than corporate overheads, relative to other businesses.

However, not providing any recognition of these differences would imply that capitalisation of network overheads is making no impact at all on the measured opex efficiency results. We do not consider this extreme case to be realistic.

We discuss our sensitivity analysis for how we have taken into account the impact of network overhead capitalisation practices further below under the heading *Calculation of efficiency gap between actual base year opex and estimated efficient base year opex.*

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59 In terms of the OEF creating material differences in a distribution network's opex.

60 Outside the control of a distribution network.

61 Not already taken into account within our benchmarking models.

OEF adjustment for vegetation management differences

Our final decision, consistent with our draft decision, is to recognise vegetation management as an OEF for Evoenergy consisting of two elements[62]:

- Bushfire risk obligation differences — the effects on opex of variations in mandated standards of bushfire mitigation activities, specifically reflecting the additional bushfire regulations in Victoria that were put in place in response to the 2009 bushfires.
- Division of responsibility differences — the effects on opex due to differences in responsibility for vegetation clearance between the networks and other parties, such as local councils, road authorities and land owners.

This reflects that vegetation management expenditure accounts for between 10–20% of total opex for most DNSPs and can differ due to factors outside of their control. Our previous analysis has also found that the overhead line variable does not fully explain variations in regulatory obligations and in vegetation density and growth rates across time and between different locations.[63] We discuss and respond to Evoenergy's specific arguments on these elements below.

Bushfire risk obligation differences

Our final decision is to apply the bushfire risk obligation OEF for Evoenergy, reflecting our view of the relative cost advantage Evoenergy has regarding these obligations. For the final decision, these OEF adjustments are –3.4% and –4.6% for the long and short periods (as in Table 6.6), reflecting mechanical updates since the draft decision, including for an additional year of data.

Our draft decision applied the approach we have applied in recent determinations.[64] At a high level this method uses the forecast cost impact of vegetation management regulations introduced in Victoria after the 2009 Black Saturday bushfires as a proxy for the differences in costs of managing bushfire risks in Victoria since 2011 compared to other states.

In its revised proposal, Evoenergy, with input from Frontier Economics, considered this OEF should not apply as:[65]

- The AER's approach is predicated on the assumption (without providing any supporting evidence) that Victorian networks have consistently faced a material cost disadvantage due to more stringent bushfire risk mitigation regulatory obligations than other networks.
- There are many conflating variables, making it difficult to reasonably proxy quantified impacts of bushfire risk mitigation expenditure. The bushfire risk OEF is calculated using forecast costs (approved by the AER as a step change) associated with bushfire

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62 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 29.

63 Sapere Research Group and Merz Consulting, *Independent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, August 2018, p. 62.

64 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 30.

65 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 14, 20–21; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 13–18.

obligations (rather than actual costs). However, there are many variables affecting the vegetation management expenditure associated with bushfire regulations. Therefore, adopting forecast costs is not appropriate.

As noted in the draft decision, we recognise the approach used to determine the OEF adjustment does not directly quantify vegetation management cost differences. However, we maintain it is a reasonable approximation in the absence of sufficient quality data on the number and length of overhead spans and vegetation density.[66] As noted in the *2023 Annual Benchmarking Report*, improving the data and quantification of the vegetation management OEF is a future focus of benchmarking development.[67]

We note Evoenergy also questioned whether Victorian networks face more stringent bushfire risk mitigation regulatory obligations than networks in other states, or whether the obligations imposed on Victoria were a form of catch-up. In past decisions, we cited evidence that audits undertaken prior to Black Saturday found that the Victorian distributors were generally compliant with their bushfire mitigation and vegetation management requirements.[68] Therefore, we maintain that the introduction of the Victorian Bushfire regulations were introduced not as a catch-up to other states, but rather as additional obligations that resulted in all Victorian DNSPs having a cost disadvantage to non-Victorian DNSPs.

Division of responsibility

Our final decision, consistent with the draft decision, is to apply the division of responsibility OEF.[69] This results in OEF adjustments of 0% for the long and short period for Evoenergy.

At a high level this approach assumes that the benchmark comparator DNSPs in Victoria and South Australia undertake 82% of vegetation management within their network footprint, with other entities undertaking the remaining 18%. The 18% is derived as the midpoint between two sources of information we had available when this was first calculated for the 2015–20 Ergon Energy decision:

- the estimated total share of vegetation management costs borne by councils (24%), drawn from the Victorian 2014 Electric Line Clearance regulatory impact statement, and
- the percentage of an electricity network that is the responsibility of councils (12%), based on data specific to the operating area of AusNet Services, given the data we were able to collect.

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66 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 30.

67 AER, *Annual Benchmarking Report – Electricity distribution network service providers*, November 2023, p. 71.

68 See AER, *Final Decision: Ergon Energy determination 2015–16 to 2019–20 Attachment 7 – Operating expenditure*, October 2015, p. 63. These obligations include providing to ESV an Electricity Safety Management Scheme pursuant to Part 10 of the *Electricity Safety Act 1998* (Vic), a Bushfire Mitigation Plan and an Electric Line Clearance Management Plan. See AER, *Preliminary Decision: Ergon Energy determination 2015–16 to 2019–20 Attachment 7 – Operating expenditure*, April 2015, pp. 7-195–7-197; ESV, *Safety performance report on Victorian Electricity Networks 2013*, June 2014, p. 5.

69 AER, *Draft Decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 30–31.

In calculating the OEF adjustment of 0% for Evoenergy, we maintain the draft decision that Evoenergy faces a broadly similar division of responsibility in the ACT as the benchmark comparator DNSPs in Victoria and South Australia.[70]

In its revised proposal, Evoenergy maintained its argument that the division of responsibility OEF should not apply, as[71]:

- Industry information and consultation is needed to understand the cost impacts of differing levels for the division of responsibility. A sample size of one (AusNet Services) dating back to 2014 is not a reliable basis for quantifying an OEF, and the AER should seek more relevant information and evidence to build its assumptions, accounting for how regulations change over time.
- The methodology for adjusting for differences of division of responsibility should not confound incompatible variables and should reflect realistic assumptions, which differ between networks. The methodology adopted by the AER to quantify the division of responsibility OEF conflates variables that are not comparable, based on assumptions specific to AusNet Services in 2014, and which are uniformly applied to all DNSPs with no evidence that such an application is appropriate.
- Vegetation management responsibilities are evolving within the context of stronger environmental safeguards.

We continue to consider Evoenergy faces a similar division of responsibility in the ACT to that faced by the comparator DNSPs in their states. In addition, we have incorporated:

- The costs to Evoenergy arising from backyard reticulation, through the separate backyard reticulation OEF
- Evoenergy's newly widened vegetation management responsibilities, through the specific OEF allowance we have made to reflect these.

In calculating the division of responsibility for vegetation management in the ACT, backyard reticulation remains a key area of responsibility for vegetation management allocated to parties other than Evoenergy, i.e. private landholders. Under this arrangement, historically land holders have had primary responsibility for managing vegetation for approximately 15% of Evoenergy's route line length.[72] In its revised proposal, Evoenergy stated that it has not been able to validate the 15% figure we used in the draft decision.[73] This is similar to the 18%[74] of vegetation management undertaken by councils in the comparator DNSP states of Victoria and South Australia as noted above. This is used in our division of responsibility OEF model to represent the comparator division of responsibility against which other DNSPs' divisions of responsibility are compared. Given this similarity, we have retained an OEF for Evoenergy of 0%, reflecting no cost advantage or disadvantage for Evoenergy relative to the

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70 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 30–31.

71 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 23–24.

72 AER, *Draft decision – ActewAGL distribution determination – 2014–2019,* November 2014, p. 86.

73 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, p. 22; AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 31.

74 The customer-weighted percentage would change slightly given the comparators include TasNetworks, depending on the division of responsibility assumed for Tasmania.

comparators (the benchmark comparator DNSPs in Victoria and South Australia). In addition, to the extent Evoenergy incurs costs in relation to backyard reticulation, these are captured in that OEF adjustment (as set out in Table 6.6). This is in line with our previous Evoenergy revenue determinations.[75]

As in the draft decision, we have allowed for the expansion from 2018–19 of Evoenergy's vegetation management responsibilities arising through additional vegetation management obligations that it faces.[76] The associated increase in opex was recognised in the step change we approved in the last regulatory control period.[77] We have recognised this is a change (decrease) in division of responsibility (an increase in Evoenergy's responsibility) since the 2015 decision by incorporating the additional costs faced by Evoenergy since 2018–19 in our OEF analysis.[78] This is different to the approach Evoenergy proposed in terms of making adjustments to allow for these additional obligations in the benchmarking roll-forward model used to estimated efficient opex in the base year. The approach proposed by Evoenergy is discussed below under *Costs of a vegetation management step change in the base year*.

We acknowledge that the quantification of this OEF is not perfect, including for the reasons in Evoenergy's revised proposal noted above, although the 18% figure is based on 2 sources of information, not one, as submitted by Evoenergy. An exact measure of the split of responsibility between DNSPs and non-DNSPs is difficult to determine, both in the benchmark comparator states of Victoria and SA and in the ACT. As noted above, we intend to improve the data and quantification of the vegetation management OEF as part of our benchmarking development, which would include industry consultation. However, we consider our current approach to the division of responsibility OEF to be fit for purpose, given the available data.

Given our decision to apply a 0% OEF for Evoenergy, we also note that it is, practically, the same outcome as proposed by Evoenergy.

Costs of a vegetation management step change in the base year

Our final decision, consistent with our draft decision, is to not accept Evoenergy's argument and proposed adjustment to estimated efficient opex in order to allow for its approved vegetation management step change in the current regulatory control period. [79]

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75 AER, *Final decision – ActewAGL distribution determination 2014–2019*, April 2015, p. 169; See model published with the NSW/ACT 2014–19 reset decisions: AER, *Final decision – Ausgrid distribution determination – Ausgrid 2015 – Operating Environment Factors summary*, April 2015.

76 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 31.

77 AER, *Final decision – Evoenergy distribution determination 2019-24 – Attachment 6 – Operating expenditure*, pp. 18–23.

78 We have implemented this additional adjustment via the bushfire regulations OEF sheet in our vegetation management OEF model. This is applied by offsetting the costs of the step change for the relevant number of years against the costs of the bushfire regulations facing the comparator DNSPs. We have also made a correction to the starting year, from 2019–20 to 2018–19.

79 AER, *Draft decision – Evoenergy distribution determination 2019-24 – Attachment 6 – Operating expenditure*, pp. 33–34.

Evoenergy maintained its argument that the opex benchmarking roll-forward model does not adequately account for material changes in regulatory obligations. As a result, it considered an adjustment was required to estimated efficient opex, specifically to reflect the vegetation management step change that the AER approved in the 2019–2024 final decision.[80] Evoenergy did not agree with the draft decision reasoning for the following reasons:[81]

- The AER's approach fails to account for any additional increase in costs Evoenergy faced to comply with new obligations between the middle of the benchmarking sample period and the base year.
- The AER's reasoning that the time trend coefficient adequately compensates for these step changes is flawed. Specifically, the estimated time trend is capable of reflecting only the average impact on opex of increased regulatory obligations faced by DNSPs (across New Zealand, Ontario and Australia).
- Accounting for vegetation management as a step change adjustment to the benchmarking roll forward model allows for the cost impact to be recognised at a particular time, rather than adjusted for using an OEF, which is applied to the average rolled-forward opex over the relevant benchmarking period.

Frontier Economics put forward stylised analysis that it considered further illustrated these points.[82]

We do not agree with Evoenergy/Frontier Economics' arguments. We do not agree that our overall approach does not sufficiently compensate a DNSP when there are step changes that happen during/after the roll-forward period. In particular, we consider the time trend used in rolling forward from the middle of the benchmarking sample period to the base year provides compensation for step changes. The time trend derived from our econometric opex cost function modelling is positive. This means that a percentage increase in time (years) leads to a percentage increase in opex. Looked at in isolation, this would indicate negative opex productivity growth over the relevant benchmarking period. This is at odds with economic expectation for positive opex productivity growth over time due to technological progress and other factors. The measured positive time trend coefficient can be explained by it also reflecting increases in regulatory obligations over time, the costs for which we allow via forecast step changes. That is, productivity growth is more than offset by the growth in regulatory obligations, which is realised in a positive time trend coefficient.

In addition, we consider Frontier Economics' stylised example looks at Evoenergy's step change in isolation, and this construct highlights how Evoenergy is penalised under our approach. However, as stated in the draft decision, we do not consider a step change can be viewed in isolation. Other DNSPs have also incurred increases in costs for step changes (including for other regulatory obligations) during the benchmarking period, negatively impacting their opex efficiency scores. As discussed in the OEF adjustment for vegetation management differences section, we have accounted within the vegetation management

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80 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 14, 25.

81 Evoenergy, *Attachment 3 Operating expenditure*, November 2023, pp. 14, 25.

82 Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex,* November 2023, pp. 27–33.

OEF for Evoenergy's increasing step changes with newly widened vegetation management responsibility relative to that of the benchmark comparators during the benchmarking period.

Base year opex to which estimated efficient opex is compared

This section considers Evoenergy's actual base year opex to which estimated efficient opex in the base year is compared in the derivation of the efficiency gap. In particular we have considered which adjustments to make to actual base year opex for the purpose of this benchmarking comparison.

For the final decision, the only adjustment we have made is to remove movements in provisions. For 2022–23 this is an amount of $0.2 million ($2023–24) which due to its small size does not materially impact the benchmarking analysis. Consistent with the draft decision, we consider movements in provisions should be removed as these amounts, both positive and negative, would generally net out to zero over the benchmarking periods. In this regard, movements in provisions are effectively zero in the estimated efficient base year opex.

After making the adjustment for movements in provisions, the adjusted actual base year opex, plus capitalised corporate overheads, used to calculate the efficiency gap is $75.4 million ($2023–24) under our preferred approach to addressing capitalisation differences. Importantly, this incorporates actual opex in 2022–23 of $62.1 million ($2023–24), which is 6.5% lower than the actual opex in 2021–22 that was used in the draft decision.[83] This is calculated in our benchmarking roll-forward model, and reflects the application of the opex price deflator to nominal opex (with the adjustment for movement in provisions) plus capitalised corporate overheads.

Removing movements in provisions is the only base opex adjustment made by Evoenergy in its updated base year of 2022–23 in the context of its opex forecast. This adjustment was not made in Frontier Economics' benchmarking roll-forward modelling it carried out for Evoenergy's revised proposal.[84]

Calculation of efficiency gap between actual base year opex and estimated efficient base year opex

The results of the above discussion of estimated efficient base year opex, and actual base year opex for Evoenergy in 2022–23, are set out in Figure 6.9 using the 2006–22 (long) period results and in Figure 6.10 using the 2012–22 (short) period results. As noted in section 6.4.1.2.2, the benchmarking results are from the *2023 Annual Benchmarking Report,* updated to take into account Evoenergy's revised circuit length and capitalised corporate overheads for dual function assets. We have also applied the OEF adjustments we consider appropriate as set out in Table 6.6.

We estimate an efficiency gap between actual opex in 2022–23 and estimated efficient opex of 6.0%. Importantly, however, this does not include any allowance for the impact on the efficiency scores of differences between the DNSPs in network overhead capitalisation

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83 These number are slightly different to those in sections 6.4.1.1 due the use of adjusted inflation.

84 Frontier Economics, *Modelling files – '2024-01-23 Evoenergy Roll forward – STC'*, 23 January 2024.

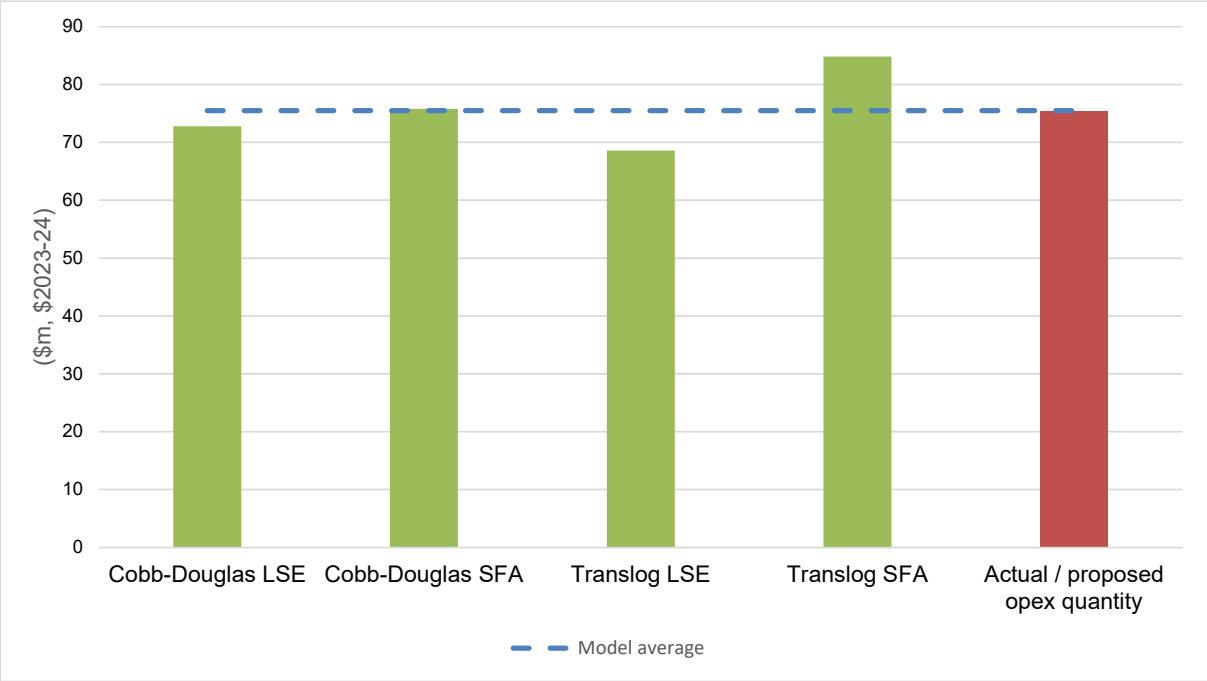
practices. As explained below, under our approach to making an allowance for this impact, the efficiency gap considerably closes.

This estimated efficiency gap takes into account the:

- model-average rolled forward efficient opex incorporating capitalised corporate overheads from the long period benchmarking results – $75.5 million ($2023–24) as illustrated by the blue dashed line, which is an average of the green columns, in Figure 6.9
- model-average rolled forward efficient opex incorporating capitalised corporate overheads from the short period benchmarking results – $66.3 million ($2023–24) as illustrated by the blue dashed line in Figure 6.10.

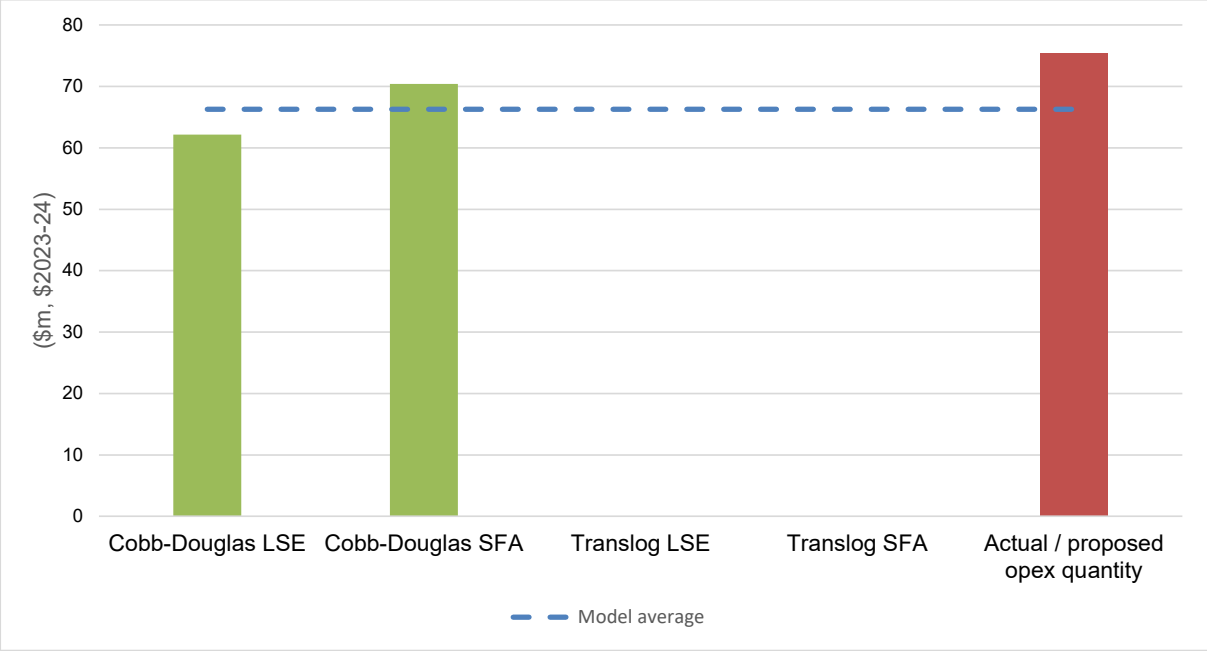
The average of these two estimates of efficient opex is $70.9 million ($2023–24). This average is $4.5 million ($2023–24), or 6.0%, less than actual base year opex plus capitalised corporate overheads of $75.4 million ($2023–24).

Figure 6.9 Estimates of efficient network services opex using data over the 2006–22 period ($million, 2023–24)



Source: Quantonomics, *Benchmarking results for the AER – Distribution*, November 2023; AER analysis.

Figure 6.10 Estimates of efficient network services opex using data over the 2012–22 period ($million, 2023–24)



Source: Quantonomics, *Benchmarking results for the AER – Distribution*, November 2023; AER analysis.
Note: We exclude the efficiency score for the LSETLG and SFATLG model for Evoenergy as it does not satisfy the monotonicity requirement (as noted above in section 6.4.1.2.2).

As noted above, the efficiency gap of 6.0% does not make any allowance for the impact of network overhead capitalisation practice differences. Evoenergy proposed that the impact of these differences on its measured opex efficiency score should be recognised via an OEF adjustment. We discussed above why we do not think the case has been fully made for reflecting the impact in this manner. However, we also noted given Evoenergy's atypical practice of expensing 100% of network overheads, network overhead capitalisation differences are likely to be having some bearing on its measured opex efficiency results.

As a result, we have carried out some sensitivity testing of our estimated efficient opex to make an allowance for differences in the treatment of network overhead capitalisation practices between DNSPs. This is to recognise that while Evoenergy has historically expensed 100% of network overheads, other networks have expensed only 50–70%, and not accounting for this in any way would likely disadvantage Evoenergy in terms of measured opex efficiency.

In this light, we consider that the most appropriate adjustment is likely to lie somewhere between fully accounting for these differences, as proposed by Evoenergy, and not making any allowance at all. As discussed in the network overhead OEF subsection above, this includes because the treatment of network overhead capitalisation practice differences is not completely exogenous in a network's decision making and to some extent any capex / opex trade-offs that are reflected in network overheads are captured in our benchmarking results. On the other hand, making no allowance at all for Evoenergy's full expensing of network overheads, may disadvantage it to some extent in relation to measured opex efficiency.

Sensitivity analysis that we have undertaken as part of this final decision suggests that when approximately 40-45% of the network overhead OEF proposed by Evoenergy is applied[85], the efficiency gap closes.

We consider that given this occurs when accounting for around half of the network overhead capitalisation practice differences as proposed by Evoenergy, this may represent a conservative treatment of their impact on the opex efficiency scores. We are using the OEF as a proxy for the purposes of this sensitivity analysis. As discussed in the network overhead OEF section, we do not conclude that the case has been made for characterising network capitalisation practices as an OEF.

As a part of this sensitivity testing we also considered an alternative method to account for Evoenergy's relatively high network overheads as a proportion of total expenditure which involves:

- adjusting Evoenergy's capitalisation rate of network overheads so that its capitalised network overheads as a proportion of total expenditure is the same as the comparators, and calculating the resultant higher opex for Evoenergy if it adopted a benchmark capitalisation of network overheads
- calculating the impact on Evoenergy's efficiency scores as a result of this higher opex.

Under this alternative method, the network overhead OEF adjustment for Evoenergy is smaller and thus it requires a higher percentage of the OEF adjustment than under Evoenergy's proposed method to close the efficiency gap. We consider this alternative method may be more appropriate because it provides a high-level adjustment for Evoenergy's relatively high network overhead expenditure as a percentage of totex. Evoenergy's approach does not make this adjustment, as it focuses only on the differences in network overhead capitalisation between Evoenergy and the comparators in terms of opex. In any event, this sensitivity testing shows that when making some allowance for capitalisation practice differences, the efficiency gap closes such that we conclude there is not sufficient evidence to determine Evoenergy's opex in the base year is materially inefficient.

6.4.1.2.4 Statistical uncertainty and benchmarking limitations

In its revised proposal, Evoenergy argued that taking into account the following further issues strengthened its overall contention that its base year opex should not be found inefficient:

- the statistical uncertainty associated with the benchmarking results, and a proposed approach to take this into account[86], and

[85] We have replicated Evoenergy's method for calculating a network overhead OEF adjustment in the long and short periods using our most updated data on DNSP overheads and opex as inputs into the calculation.

[86] Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 25–26; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 34–42.

- benchmarking limitations which mean it should only be used cautiously, if at all, in terms of its application to base opex efficiency assessments[87] – this built on similar issues it raised in its initial proposal.[88]

This section outlines the arguments put by Evoenergy in its revised proposal, and our response to these arguments.

Statistical uncertainty

We do not agree with Evoenergy and Frontier Economics' key analysis and conclusions in relation to incorporating statistical uncertainty into the application of the benchmarking results. Our preferred approach for this final decision is to maintain the 0.75 benchmark comparison point, reflecting our conservativeness in benchmarking application.

In its revised proposal, Evoenergy argued that estimated efficient opex obtained from the benchmarking roll-forward analysis has a degree of statistical uncertainty, and that this is not adequately taken into account in the AER's approach. Evoenergy considered it important to transparently and quantitatively capture statistical uncertainty through the use of confidence intervals around our estimate of efficient base year opex. Evoenergy considered:

- The estimate of efficient base year opex is a point estimate, derived by estimating econometric cost functions.
- This estimate is characterised by some statistical uncertainty as captured in the standard errors associated with the estimate.
- The AER should allow for a range of uncertainty to capture these statistical errors. Rather than the AER doing this by adopting a conservative approach to benchmarking (applying a 0.75 comparison point to account for model limitations and data imperfections) statistical uncertainty should be more formally quantified, drawing on the statistical results to derive a probabilistic assessment of opex efficiency.
- The AER should use confidence intervals around a point estimate in place of regulatory judgment via the 0.75 comparison point. This would improve the transparency of the range of statistical uncertainty of the point estimate of efficient opex.
- If actual base year opex falls within statistically derived confidence intervals, then the AER cannot be confident that the revealed opex is materially inefficient. The AER should conclude that actual base year opex is inefficient only if the AER can be 95% certain that actual base year opex is above estimated efficient base year opex.

Evoenergy engaged Frontier Economics who prepared this proposed approach and analysed the range of the AER's benchmarking efficiency scores for Evoenergy via confidence intervals determined using the standard errors computed in the benchmarking results. Frontier Economics considered that:

- In some models, Evoenergy's actual opex lies within the 95% confidence interval around efficient base year opex.

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87 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 26–27; Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 48–86.

88 Evoenergy, *Appendix 2.1 Base year efficiency*, January 2023, pp. 5–6, 35–37.

- The AER could not be sufficiently confident under these circumstances that actual base year opex is above estimated efficient base year opex.
- In these circumstances, one could not conclude that a DNSP's revealed base year opex is efficient; but one could conclude that there is no evidence of material inefficiency.[89]

In relation to the AER's benchmark comparison point of 0.75, Frontier Economics also presented analysis to show how much of the margin between 0.75 and 1.0 accounted for statistical uncertainty and the other uncertainties associated with the benchmarking models, including model uncertainty, uncertainty over the true outputs of the DNSPs, data limitations and imperfections, OEFs that have not been accounted for properly, shortcomings in the roll-forward process and other modelling limitations. Frontier Economics calculated that "only" 11.9 percentage points of the 25% margin would be left to account for all of these other uncertainties, which it considered inadequate.

We consider the 0.75 benchmark comparison point recognises the modelling and data limitations in benchmarking. In addition, we consider statistical and other uncertainties have both upside and downside risk, and these are addressed by the use of unbiased point estimates.

We agree there is statistical uncertainty in the econometric opex cost function modelling results. However, we consider statistical uncertainty is largely symmetrically distributed around the point estimate, and hence the upper side and lower side uncertainties are likely to offset each other. In contrast, examining whether Evoenergy's actual opex lies within the 95% confidence interval around efficient base year opex implicitly focuses on the upper bound of the confidence interval as the estimated efficiency score. This is because its proposed test looks at the position of actual opex relative to the upper bound of the confidence interval. To properly account for statistical uncertainty, we consider both upward and downward uncertainty needs to be considered and may offset each other in deriving the best estimate. In this regard, our view is that the point estimate, as the unbiased estimate (of the true value), is the best estimate while the upper or lower bound estimate is an upwardly or downwardly biased estimate.

In this regard, in 2006, the Australian Competition Tribunal considered the issue of point estimate versus the upper/lower bounds.[90] The Tribunal rejected the proposed method to add one standard deviation (i.e. a narrower confidence interval than Frontier Economics' proposed usage of two standard deviations) to the point estimate of WACC due to lack of convincing demonstration that the method was reasonable. In the context of developing the weighted average cost of capital (WACC) instrument since 2018, we have also stated that the best possible estimate of the expected rate of return is an unbiased estimate that is neither upwardly nor downwardly biased.[91]

Further, while the choice of 95% as the specific level of confidence is drawn from econometric practices, we consider Frontier Economics' usage of it in this context has not

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89 Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex,* November 2023, p. 7.

90 *Re Telstra Corporation Ltd (No 3)* [2007] AcompT 3 (17 May 2007) at 433–457.

91 AER. *Rate of return instrument Explanatory Statement*, February 2023, pp. 6–7.

been well established. In particular, we note that 95% confidence intervals are drawn at 2 standard deviations from the mean, and so are relatively wide.

We also consider that Evoenergy's approach, where actual opex is only concluded to be inefficient if actual base year opex is above estimated efficient base opex based on the upper bound of the 95% confidence interval, also seems to imply that the loss function is asymmetric. That is, that the loss from setting the opex allowance too low is greater than the loss of setting it too high. In some previous Australian regulatory decisions on WACC, regulated businesses argued for a value above the best point estimate because of asymmetric risks. In the case referenced above, the Australian Competition Tribunal, while accepting it is possible for asymmetric consequences to follow from too high or too low a rate of return, did not accept any presumption that this was the case.[92] It suggested that any claim of asymmetric effects should be supported by evidence, such as a social cost-benefit analysis that supports the specific adjustment proposed.

In relation to the other uncertainties noted by Frontier Economics, we consider those in relation to data and modelling limitations (e.g. cost function, output specification, measuring OEFs) are adequately addressed by our use of a 0.75 (rather than 1.0) benchmark comparison point. In relation to uncertainties around OEFs, our approach to incorporating material OEFs, both within the model and in post-modelling adjustments, is to derive the best estimate using available data, which are neither upwardly nor downwardly biased. This means that after adjusting for material OEFs, the uncertainty around the net efficiency score is expected to remain symmetrically distributed around the point estimate.

Benchmarking limitations

We consider that while our benchmarking tools are not perfect, this does not limit us from using them in revenue determination processes to inform our assessment of the efficiency of opex in a proposed base year.

Consistent with its initial proposal, Evoenergy, with input from Frontier Economics, submitted in its revised proposal that the econometric opex cost function models are fundamentally mis-specified.[93] Key arguments it raised in concluding that the opex benchmarking results should not be relied on included:

- The Translog models continue to exhibit excessive monotonicity violations[94] and these are likely to be a symptom of a more fundamental model misspecification problem. A key source of mis-specification relates to the models not accounting for increasing efficiency over time of the Australian DNSPs. This will result in biased estimates of efficiency for individual DNSPs (and other model parameters).
- The AER's approaches to addressing monotonicity issues to date are inappropriate, and that Quantonomics' approach of restricting the flexibility of the Translog functional form simply treats the symptom of the problem rather than the root cause.

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92 *Re Telstra Corporation Ltd (No 3)* [2007] AcompT 3 (17 May 2007) at 433–457.

93 Evoenergy, *Attachment 3: Operating expenditure*, November 2023, pp. 12, 26-27.

94 Monotonicity is a key economic property required for our econometric opex cost function models, which is that an increase in output can only be achieved with an increase in inputs (opex), holding other things constant.

- Statistical test results presented by Quantonomics indicate that the Translog model is to be preferred over the Cobb-Douglas model as it fits the data significantly better. We responded to this argument in the draft decision.[95]

Frontier Economics considered that as a result of these issues a fundamental review, including industry consultation, of the AER's econometric opex cost function benchmarking models is needed to ensure that they are capable of fitting the salient features of data well.[96] In this context, Evoenergy submitted that this would take time and involve consultation, which could not occur in time for final decision. Given this, and the seriousness of the benchmarking limitations raised, Evoenergy considered the AER should interpret the benchmarking results with a high degree of caution and not use them mechanistically in the reset.[97]

We recognise that our benchmarking has limitations. However, we do not consider these are as serious as argued by Evoenergy. Particularly important in this regard is that we only apply results where we consider they reliably inform our overall base year opex efficiency assessment. For example, we remove the results of econometric opex cost function models that do not meet the monotonicity requirements from calculating the model-average efficiency score. Further, using a 0.75 comparison point, adjusted for material OEFs, instead of 1.0, builds in a degree of conservativeness in part reflecting that we acknowledge our benchmarking tools are not exactly precise or perfect tools.

We also acknowledge that there are issues of judgement involved in developing and applying a benchmarking approach. Further, we acknowledge that there is scope for future benchmarking development work to ensure it continually improves.

While our (and any) benchmarking has limitations, we do not consider this limits us from continuing to use these tools in revenue determination processes, including this final decision. This position and our arguments outlined below are consistent with those in the draft decision.[98] In addition, with the assistance of our benchmarking consultant Quantonomics, we have examined Frontier Economics' analysis and new arguments, and do not agree with some of the key criticisms put forward, as explained further below.

In relation to model mis-specification, on the basis of Quantonomics' analysis, we do not consider that Frontier Economics' claim that monotonicity violations are being driven by the model not accounting for changing efficiency over time of Australian DNSPs is supported by the evidence. In research published alongside the 2023 benchmarking report last November, Quantonomics augmented the models with an additional time trend specifically for Australian DNSPs, to account for any trend of improved efficiency of Australian DNSPs.[99] Quantonomics found that the statistical significance of the additional time trend suggests that

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95 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal,* September, p. 41.

96 Frontier Economics, *Appendix 3.1, AER benchmarking of DNSP opex*, November 2023, pp. 48–86.

97 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 14, 26–27.

98 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal,* , September 2023, pp. 38–40.

99 Quantonomics, *Opex Cost Function-Options to Address Performance Issues with Translog models*, October 2023.

a model with an additional Australia-specific time trend may potentially be an improvement on the standard specification. In this regard, this result is consistent with Frontier Economics' argument that there is a time-related factor that is not fully accounted for in the AER models. However, the Australian-specific time trend model does not result in a reduction in the number of Australian DNSPs affected by excessive monotonicity violations. This finding is inconsistent with Frontier Economics' claim that the absence of an Australia-specific time trend is a key reason why the Translog models are prone to monotonicity violations.

Further, in relation to bias, the efficiency scores for Evoenergy in the models with Australian-specific time trends are very similar to those obtained with the standard model. Although the differences are small, the average efficiency scores for Evoenergy are slightly lower. Hence, Frontier Economics' claim that the standard model produces downwardly biased estimates of efficiency scores is not supported by the evidence.

In terms of our response to monotonicity violations, as noted in the draft decision[100], we consider that our current approach of excluding model results where there are excessive[101] monotonicity violations remains fit for purpose while we continue to examine alternative solutions. Quantonomics has investigated two alternative model specifications as potential responses to the monotonicity violation problem:

- the model with the Australian-specific time trend (discussed above), and
- restricted Translog models, where the higher order term on customer numbers is excluded, as discussed in the draft decision.[102]

However, Evoenergy has broadly the same efficiency scores under these alternative models as under the standard models. This suggests that our conclusions in relation to Evoenergy's opex efficiency would be unlikely to be different under these alternative specifications.

6.4.1.3 Adjustments to base opex

Our base adjustments for Evoenergy, reflecting the most up-to-date information, is a reduction to base opex of $0.9 million ($2023–24) for the forecast change in opex between 2022–23 and 2023–24.

6.4.2 Rate of change

We have included a rate of change that increases opex, on average, by 0.84% each year in our alternative estimate. This contributed $8.4 million ($2023–24) to overall opex in our alternative estimate. This compares to Evoenergy's average annual rate of change of 0.81%, or $8.2 million ($2023–24) to its opex forecast.

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100 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September, pp. 11–12, 39.

101 We require this property to hold for at least half the data points of a business in order to include the efficiency score from a Translog model in our efficiency assessment. In addition, if a model does not satisfy monotonicity for the majority of Australian DNSPs, then we exclude the model from calculating the model-average efficiency score for all Australian DNSPs (even though the property may be satisfied for some DNSPs).

102 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposa*l, September, p. 39.

Evoenergy's revised proposal made some minor updates to its trend inputs and adopted our standard approaches for forecasting input price growth, output growth, and productivity growth. These changes, which we have included in our alternative estimate, and our additional updates for this final decision, include:

- **price growth** – Evoenergy updated its wage price index (WPI) forecast using our standard approach of averaging updated WPI forecasts provided by its consultant, Oxford Economics Australia, and our consultant KPMG's August 2023 WPI forecasts.[103] We have further updated our WPI forecast with the latest KPMG forecasts.[104]
- **output growth** – Evoenergy updated its forecasts for customer numbers and circuit length, consistent with actual and audited 2022–23 RIN data.[105] For ratcheted maximum demand, Evoenergy used actual demand based on forecast demand measured at the bulk supply point, including a forecast of no increase in ratcheted maximum demand over the forthcoming period.[106] For the output weights, Evoenergy stated that it used values based on our *Draft 2023 Annual Benchmarking Report*.[107] We have used Evoenergy's updated input values, but have updated the output weights consistent with our *2023 Annual Benchmarking Report*.

Table 6.4 shows Evoenergy's revised proposal, our final decision for each component of the rate of change and the differences in the values.

Table 6.4 Forecast annual rate of change in opex (%)

	2024–25	2025–26	2026–27	2027–28	2028–29
Evoenergy's proposal					
Price growth	0.7	0.8	0.5	0.5	0.6
Output growth	0.7	0.7	0.7	0.7	0.7
Productivity growth	0.5	0.5	0.5	0.5	0.5
Rate of change	**0.9**	**1.0**	**0.7**	**0.7**	**0.7**
AER alternative estimate					
Price growth	0.7	0.8	0.5	0.5	0.6
Output growth	0.7	0.7	0.7	0.7	0.7
Productivity growth	0.5	0.5	0.5	0.5	0.5
Rate of change	**1.0**	**1.0**	**0.7**	**0.7**	**0.8**
Difference	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Source: Evoenergy, *SCS opex model*, 30 November 2023; AER analysis.
Note: Numbers may not add up to totals due to rounding. Amounts of '0.0' and '–0.0' represent small non-zero values and '–' represents zero.

103 Evoenergy, *SCS opex model*, November 2023.
104 KPMG, *Wage Price Index Forecasts – Australian Energy Regulator*, 8 April 2024.
105 Evoenergy, *Attachment 3 Operating expenditure,* November 2023, pp. 34–35.
106 Evoenergy, *Attachment 3 Operating expenditure,* November 2023, p. 36.
107 Evoenergy, *Attachment 3 Operating expenditure,* November 2023, p. 34.

6.4.3 Step changes

We have included $35.3 million ($2023–24) of step changes in our alternative estimate of total opex for the final decision. This is $0.8 million ($2023–24) lower than Evoenergy's revised proposal, including the reallocation of $2.8 million ($2023–24) to ACS, and $5.8 million ($2023–24) higher than our draft decision (see Table 6.1). Our lower alternative estimate is due to us considering that not all of Evoenergy's smart meter step change is prudent. We provide further detail on each step change below.

Evoenergy's revised proposal included step changes totalling $38.8 million ($2023–24), or $36.0 million ($2023–24) when $2.8 million ($2023–24) is reallocated to ACS. Evoenergy:[108]

- added a new smart meter step change, related to the August 2023 Australian Energy Market Commission (AEMC) final report on the review of metering services ($9.0 million ($2023–24)
- accepted our draft decision on insurance premiums ($5.0 million ($2023–24))
- updated its security of critical infrastructure costs, reflecting new information obtained from market providers ($15.0 million ($2023–24))
- accepted our draft decision on its CER integration step change ($9.9 million ($2023–24)).

Table 6.5 shows Evoenergy's revised proposal, including Evoenergy's revised proposal exclusive of $2.8 million ($2023–24) reallocated to ACS, and our alternative estimate. We discuss each of these step changes below.

Table 6.5 Step changes ($million, 2023–24)

	Revised proposal	Revised proposal (ex. ACS costs) (a)	Alternative estimate (b)	Difference (b - a)
Smart meters	9.0	6.2	5.4	–0.8
SoCI	15.0	15.0	15.0	–
CER integration	9.9	9.9	9.9	–
Insurance premiums	5.0	5.0	5.0	–
Total step changes	**38.8**	**36.0**	**35.3**	**–0.8**

Source: Evoenergy, *SCS opex model*, November 2023; AER analysis.
Note: We have only excluded SCS smart meter costs for columns (a) and (b) above. In other words, $2.8m have been subtracted from both columns (as belonging in ACS).
Numbers may not add up to totals due to rounding. Differences of '0.0' and '–0.0' represent small variances and '–' represents no variance.

[108] Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 28.

6.4.3.1 Insurance premium

We have included $5.0 million ($2023–24) for the insurance premium step change in our alternative estimate of total forecast opex. We are satisfied that this amount reasonably reflects prudent and efficient expenditure for this step change.

Evoenergy's revised proposal included a $5.0 million ($2023–24) insurance premium step change for the 2024–29 period, consistent with both our draft decision and Evoenergy's initial proposal.[109]

Table 6.6 Insurance premium step change ($million, 2023–24)

	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Evoenergy's revised proposal	0.7	0.9	1.0	1.2	1.3	5.0
AER alternative estimate	0.7	0.9	1.0	1.2	1.3	5.0
Difference	–	–	–	–	–	–

Source: Evoenergy, *SCS opex model*, November 2023; AER analysis
Note: Numbers may not add due to rounding.

Evoenergy's initial proposal included $5.0 million ($2023–24) to account for increased insurance premiums.[110] In its revised proposal, Evoenergy stated that it accepts our draft decision and included $5.0 million ($2023–24) in its revised proposal for this step change.[111]

We discuss this step change, our assessment, and the basis for our draft decision in greater detail in our draft decision.[112]

6.4.3.2 Security of Critical Infrastructure (SoCI)

We have included $15.0 million ($2023–24) for the SoCI step change in our alternative estimate of total forecast opex. This is consistent with the amount proposed in Evoenergy's revised proposal, and $0.4 million ($2023–24) higher than our draft decision.

Table 6.7 Security of Critical Infrastructure step change ($million, 2023–24)

	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Evoenergy's revised proposal	3.2	3.0	2.9	2.9	3.0	15.0
AER alternative estimate	3.2	3.0	2.9	2.9	3.0	15.0
Difference	–	–	–	–	–	–

Source: Evoenergy, *SCS opex model*, November 2023; AER analysis.
Note: Numbers may not add up to totals due to rounding.

109 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 29.

110 Evoenergy, *Attachment 2 Operating expenditure,* January 2023, p. 28.

111 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 28–29.

112 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, pp. 47–49.

Evoenergy's initial proposal included $14.6 million ($2023–24) to uplift its critical asset risk management practices and controls, including an uplift to its cyber security capabilities, consistent with the requirements of the *Security Legislation Amendment (Critical Infrastructure Protection) Act 2022*.[113] Due to limitations on accessing relevant confidential information at that time, we provisionally included Evoenergy's proposed amount in our draft decision. We stated that we would continue working with Evoenergy in preparing its revised proposal, and undertake further assessment before making our final decision on the efficient amount for this step change.[114]

Following our draft decision, we received specialist advice on Evoenergy's proposal from our consultant, EMCa, who reviewed available information (including confidential information) provided through information requests and an onsite workshop.

For its revised proposal, Evoenergy included $15.0 million ($2023–24) for the SoCI step change, and explained that the slightly higher amount reflects additional information obtained from market providers. Evoenergy further provided an updated business case and modelling, and information through an additional information request, to support its revised proposal.

Having reviewed the information now available, for the final decision we have included $15.0 million ($2023–24) for the SoCI step change, as we are satisfied that the costs proposed by Evoenergy likely reflect prudent and efficient expenditure required by Evoenergy to uplift its security maturity in the 2024–29 period.

6.4.3.3 Consumer Energy Resource (CER) integration

We have included $9.9 million ($2023–24) for the CER integration step change in our alternative estimate of total forecast opex. This amount is consistent with both our draft decision and Evoenergy's revised proposal.[115]

Table 6.8 Evoenergy's CER integration step change ($million, 2023–24)

	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Evoenergy's revised proposal	2.0	2.0	2.0	2.0	2.0	9.9
AER alternative estimate	2.0	2.0	2.0	2.0	2.0	9.9
Difference	–	–	–	–	–	–

Source: Evoenergy, *SCS opex model*, November 2023; AER analysis.
Note: Numbers may not add up to totals due to rounding.

Evoenergy's initial proposal included $11.6 million ($2023–24) to support the energy transition and integrate an increased volume of consumer energy resources into its network.[116] We discuss this step change, our assessment, and the basis for our draft

113 Evoenergy, *Attachment 2 Operating expenditure,* January 2023, p. 29.

114 AER, *Draft decision, Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, p. 49.

115 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 29.

116 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 28.

decision to include a lower amount of $9.9 million ($2023–24), in greater detail in our draft decision.[117]

For its revised proposal, Evoenergy included our draft decision amount of $9.9 million ($2023–24) and stated that it accepted our draft decision in relation to this step change.[118]

For the final decision, we have included $9.9 million ($2023–24) for the CER integration change, consistent with our draft decision. We are satisfied that this amount reasonably reflects prudent and efficient expenditure for this step change.

6.4.3.4 Smart meter

We have included $5.4 million ($2023–24) for the smart meter step change in our alternative estimate of total forecast opex for the final decision. This reflects that we are not satisfied that all costs proposed are prudent and efficient.

Table 6.9 Smart meter step change ($million, 2023–24)

	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Evoenergy's revised proposal	2.2	2.2	1.8	1.4	1.4	9.0
Evoenergy's revised proposal (excl. ACS costs) (a)	1.7	1.6	1.2	0.8	0.8	6.2
AER alternative estimate (b)	1.4	1.4	0.9	0.8	0.8	5.4
Difference (b – a)	–0.2	–0.3	–0.3	–	–	–0.8

Source: Evoenergy, *SCS opex model,* November 2023; AER analysis.
Note: We have only included SCS smart meter costs for rows (a) and (b) above. That is, $2.8 million has been subtracted from both columns (as belonging in ACS).
Differences of '0.0' and '–0.0' represent small variances and '–' represents no variance.

Evoenergy included a new step change in its revised proposal associated with the August 2023 AEMC review of the regulatory framework for metering services final report. Evoenergy stated that these costs are required to facilitate an accelerated roll-out of smart meters, including for the development and implementation of a legacy meter retirement plan (LMRP) and an uplift to its IT capabilities.[119]

Consistent with proposals received from other distribution network service providers related to the AEMC's final report, we have assessed and discuss this step change in our Metering Services attachment to this final decision (Attachment 20).

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117 AER, *Draft decision*, *Attachment 6 – Operating expenditure – Evoenergy – 2024–29 Distribution revenue proposal*, September 2023, pp. 49–51.

118 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, pp. 28–29.

119 Evoenergy, *Attachment 3 Operating Expenditure*, November 2023, p. 32.

In summary, we have reallocated costs associated with development and implementation of the LMRP ($2.8 million ($2023–24)) to ACS, and further, not included $0.8 million ($2023–24) of Evoenergy's proposed step change costs in our alternative estimate of total opex as we did not consider this amount to be prudent.

For the final decision, we are satisfied that the remaining costs of $5.4 million ($2023–24) likely reflect prudent and efficient expenditure, and have included these in our alternative estimate of total forecast opex for the final decision.

6.4.4 Category specific forecasts

Evoenergy's proposal included one category specific forecast, which was not forecast using the base-step-trend approach, for debt raising costs. We have included a category specific forecast for debt raising costs in our alternative estimate of total opex.

6.4.4.1 Debt raising costs

We have included debt raising costs of $3.1 million ($2023–24) in our alternative estimate, consistent with the amounts proposed by Evoenergy.

Table 6.10 Debt raising costs ($million, 2023–24)

	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Evoenergy's revised proposal	0.6	0.6	0.6	0.6	0.6	3.1
AER draft decision	0.6	0.6	0.6	0.6	0.6	3.1
Difference	–	–	–	–	–	–

Source: Evoenergy, *SCS opex model,* 30 November 2023; AER analysis.
Note: Number may not add due to rounding; Values of '0.0' and '–0.0' represent small non-zero amounts and '–' represents zero.

Debt raising costs are transaction costs incurred each time a business raises or refinances debt. Our preferred approach is to forecast debt raising costs using a benchmarking approach rather than a service provider's actual costs in a single year. This provides consistency with the forecast of the cost of debt in the rate of return building block. We used our standard approach to forecast debt raising costs, which is discussed further in Attachment 3 to the draft decision.

Shortened forms

Term	Definition
ACS	Alternative control services
AER	Australian Energy Regulator
Capex	Capital expenditure
CCP26	Consumer Challenge Panel 26
CER	Consumer energy resources
EBSS	Efficiency benefit sharing scheme
LMRP	Legacy meter retirement plan
NEL	National Electricity Law
NER	National Electricity Rules
Opex	Operating expenditure
SoCI	Security of critical infrastructure
SCS	Standard control services
WPI	Wage price index