



# **DRAFT DECISION**

## **Directlink Transmission Determination 2020 to 2025**

### **Attachment 6 Operating expenditure**

October 2019

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## Note

This attachment forms part of the AER's draft decision on Directlink's 2020–25 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Pricing methodology

Attachment 12 – Pass through events

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## Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
EBSS	efficiency benefit sharing scheme
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
WACC	weighted average cost of capital

## 6 Operating expenditure

Operating expenditure (opex) refers to operating, maintenance and other non-capital expenses. Forecast opex for prescribed transmission services is one of the building blocks we use to determine a service provider's total revenue requirement. This attachment outlines our assessment of Directlink's proposed total opex forecast for the 2020–25 regulatory control period.

### 6.1 Draft decision

Our draft decision is to include total forecast opex of \$23.5 million (\$2019–20) in Directlink's revenue for the 2020–25 regulatory control period.

This amount is based on Directlink's updated opex forecast that it submitted to us on 21 August 2019 in response to our information request (Directlink's updated opex forecast).<sup>1</sup> Directlink's updated opex forecast rectifies several modelling errors in its original opex forecast submitted on 31 January 2019. We have not accepted Directlink's opex forecast of \$24.7 million (\$2019–20) that it had initially included in its proposal.

We have assessed Directlink's updated opex forecast by comparing it with our alternative estimate of total opex.<sup>2</sup> We used our standard 'base–step–trend' approach to develop our estimate.<sup>3</sup> Despite some differences in several elements of our opex forecasts, our alternative estimate is \$23.1 million (\$2019–20) and is about \$0.3 million lower than Directlink's updated opex forecast. This difference is immaterial and therefore we are satisfied that Directlink's updated opex forecast of \$23.5 million (\$2019–20) reasonably reflects the opex criteria.<sup>4</sup>

Figure 6-1 compares Directlink's updated opex forecast to its past actual opex, our previous regulatory decision and our alternative estimate.

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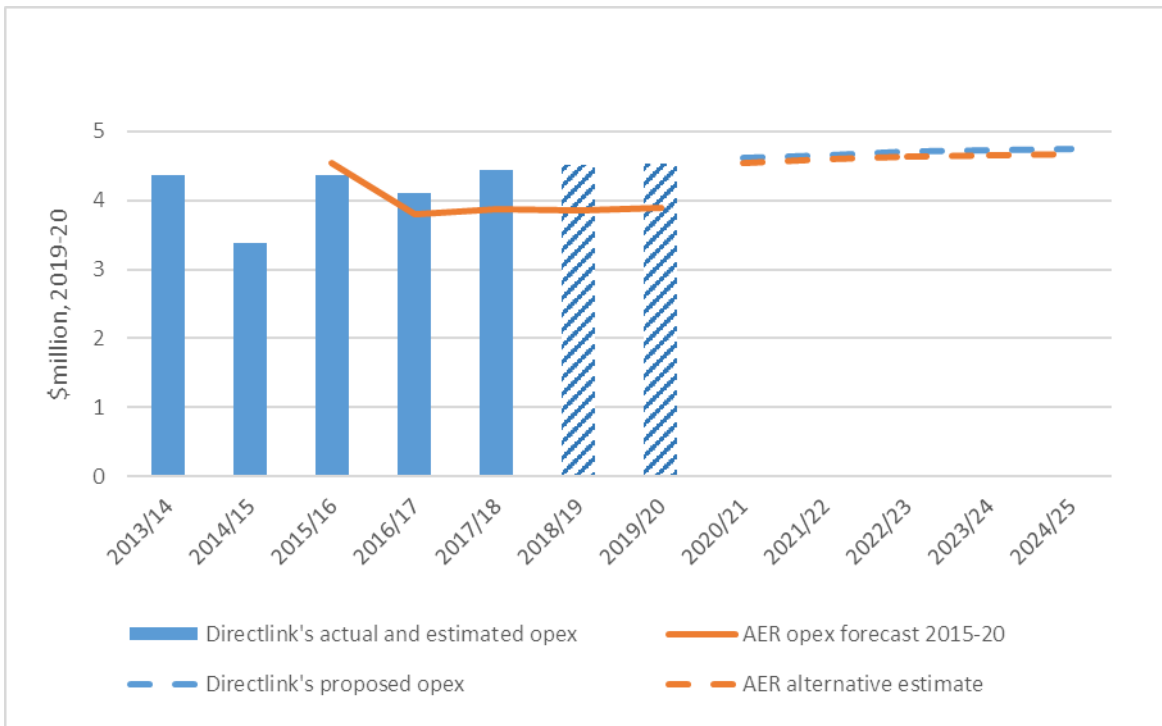
<sup>1</sup> Including debt raising costs; Directlink, *Response to AER Information Request #014 - Updated PTRM and bill impact*, 21 August 2019.

<sup>2</sup> Including debt raising costs.

<sup>3</sup> AER, *Expenditure Forecast Assessment Guideline for Electricity Transmission*, November 2013.

<sup>4</sup> NER, cl. 6A.6.6(c).

**Figure 6-1 Historical and forecast opex (\$million, 2019–20)**



Source: Directlink, *Regulatory accounts 2013–14 to 2017–18*; Directlink, *Response to AER Information Request #014 - Updated PTRM and bill impact*, 21 August 2019; AER analysis.

Note: Includes debt raising costs.

## 6.2 Directlink’s proposal

Directlink proposed a total forecast opex of \$23.5 million (\$2019–20, see table 6-1).<sup>5</sup> This is 7.0 per cent more than its reported and estimated opex in the 2015–20 regulatory control period.

**Table 6-1 Directlink's proposed opex (\$million, 2019–20)**

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Total forecast opex	4.6	4.7	4.7	4.7	4.8	23.5

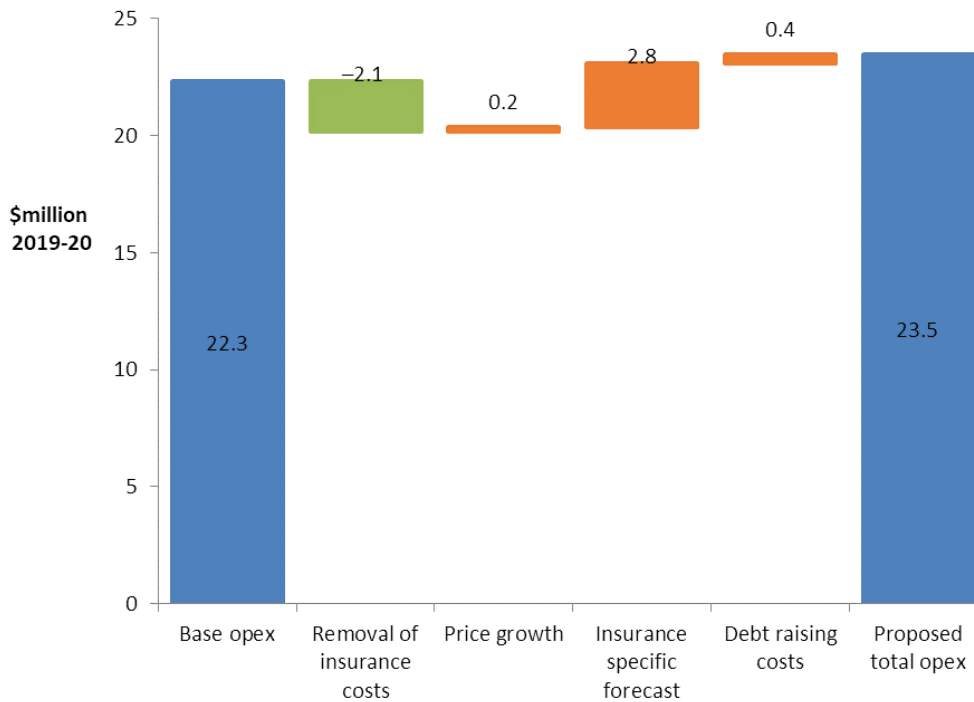
Source: Directlink, *Response to AER Information Request #014 - Updated PTRM and bill impact*, 21 August 2019.

Note: Includes debt raising costs.

In figure 6-2 we separate Directlink's proposed opex into the different elements that make up its forecast.

<sup>5</sup> Including debt raising costs; Directlink, *Response to AER Information Request #014 - Updated PTRM and bill impact*, 21 August 2019.

**Figure 6-2 Directlink's opex forecast (\$million, 2019–20)**



Source: Directlink, *Response to AER Information Request #014 - Updated PTRM and bill impact*, 21 August 2019; AER analysis.

Directlink stated that it adopted our 'base–step–trend' forecasting method to forecast opex for the 2020–2025 regulatory control period.<sup>6</sup> The key elements of Directlink's proposal are described below.

- Directlink selected the 2017–18 financial year as its base year to forecast base opex because it provides the most recent data and no non-recurring costs were incurred in that financial year.<sup>7</sup> If no other adjustments were made, this would lead to a base opex of \$22.3 million (\$2019–20) over the 2020–2025 regulatory control period
- to forecast input prices growth, Directlink divided its forecast opex into labour and non-labour costs based on its historical division of labour and non-labour costs. Directlink applied Deloitte Access Economics' forecast real wage price growth for the New South Wales' utilities industry to its labour costs and the consumer price index to its non-labour costs<sup>8</sup>
- Directlink proposed no output and productivity growth<sup>9</sup>

<sup>6</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, p. 82.

<sup>7</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, pp. 82–83.

<sup>8</sup> Deloitte Access Economics, *Labour Price Growth Forecasts prepared for the AER*, 19 July 2018, p. 40.

<sup>9</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, pp. 83–84.



- Directlink did not propose any step changes but it has proposed two category specific forecasts:
  - \$2.8 million (\$2019–20) for insurance premium costs<sup>10</sup>
  - \$0.4 million (\$2019–20) for debt raising costs.<sup>11</sup>

This resulted in total opex forecast of \$23.5 million (\$2019–20).

Directlink's original proposal included an opex forecast of \$24.7 million. In response to an information request, Directlink provided us with an updated opex forecast on 21 August 2019 which made the following corrections to its original proposal:

- correcting the adjustment of its base opex from nominal \$2017–18 to real \$2019–20
- incorporating real rather than nominal insurance premium forecast in its opex model
- correcting the weights that represent Directlink's historical price input mix in its rate of change forecast
- updating its debt raising cost forecast.

For the purposes of this draft decision, we have assessed Directlink's updated opex proposal and used it for comparisons against our alternative estimate. Directlink's updated opex forecast is available on our website.

### 6.2.1 Submissions on Directlink's proposal

We received one submission on Directlink's opex proposal from the Public Interest Advocacy Centre (PIAC).<sup>12</sup> PIAC is concerned that while Directlink's proposed opex forecast is relatively minor, it still represents a noticeable step increase from our opex forecast determined for the 2015–20 regulatory control period. PIAC questions whether Directlink could find any further opex efficiencies, noting that Directlink has not forecast productivity growth.

## 6.3 Assessment approach

Our role is to decide whether to accept a business' total opex forecast. We are to form a view about whether a business' forecast of total opex 'reasonably reflects the opex criteria'.<sup>13</sup> In doing so, we must have regard to the opex factors specified in the National Electricity Rules (NER).<sup>14</sup>

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<sup>10</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, p. 84–85. Directlink has made an adjustment to its base opex forecast to avoid double counting insurance premium costs.

<sup>11</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, p. 86.

<sup>12</sup> Public Interest Advocacy Centre, *Submission to Directlink 2020–25 revenue proposal*, 16 March 2019.

<sup>13</sup> NER, cl. 6A.6.6(c).

<sup>14</sup> NER, cl. 6A.6.6(e).

The *Expenditure forecast assessment guideline* (the Guideline), together with an explanatory statement, sets out our assessment approach in detail.<sup>15</sup> 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.<sup>16</sup>

Our approach is to assess the business' 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.<sup>17</sup> We compare our alternative estimate with the business' total opex forecast to form a view on the reasonableness of the business' proposal. If we are satisfied the business' forecast reasonably reflects the opex criteria, we accept the forecast.<sup>18</sup> If we are not satisfied, we substitute the business' forecast with our alternative estimate that we are satisfied reasonably reflects the opex criteria.<sup>19</sup>

In making this decision, we take into account the reasons for the difference between our alternative estimate and the business' proposal, and the materiality of the difference. Further, we take into consideration interrelationships between opex and the other building block components of our decision.<sup>20</sup>

Figure 6-3 summarises the base–step–trend forecasting approach.

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<sup>15</sup> AER, *Expenditure forecast assessment guideline for electricity transmission*, November 2013; AER, *Expenditure forecast assessment guideline, Explanatory statement*, November 2013.

<sup>16</sup> NER, cl. 6A.2.3(c).

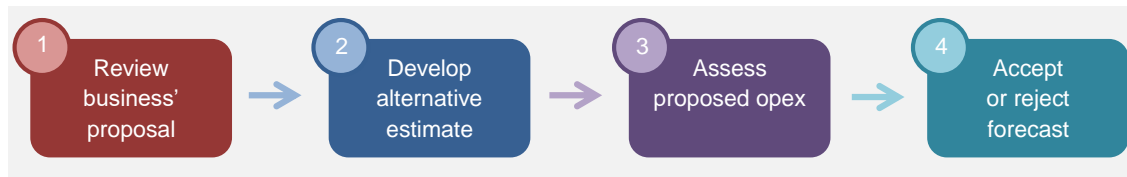
<sup>17</sup> A 'top-down' approach forecasts total opex at an aggregate level, rather than forecasting individual projects or categories to build a total opex forecast from the 'bottom up.'

<sup>18</sup> NER, cl. 6A.6.6(c).

<sup>19</sup> NER, cll. 6A.6.6(d) and 6A.14.1(3)(ii).

<sup>20</sup> NEL, s. 16(1)(c).

**Figure 6-3 Our opex assessment approach**



**1. Review business' proposal**



We review the business' proposal and identify the key drivers.

**2. Develop alternative estimate**

**Base**

We use the business' opex in a recent year as a starting point (revealed opex). We assess the revealed opex (e.g. through benchmarking) to test whether it is efficient. If we find it to be efficient, we accept it. If we find it to be materially inefficient, we may make an efficiency adjustment.

**Trend**

We trend base opex forward by applying our forecast 'rate of change' to account for growth in input prices, output and productivity.

**Step**

We add or subtract any step changes for costs not compensated by base opex and the rate of change (e.g. costs associated with regulatory obligation changes or capex/opex substitutions).

**Other**

We include a 'category specific forecast' for any opex component that we consider necessary to be forecast separately.

**3. Assess proposed opex**



We contrast our alternative estimate with the business' opex proposal. We identify all drivers of differences between our alternative estimate and the business' opex forecast. We consider each driver of difference between the two estimates and go back and adjust our alternative estimate if we consider it necessary.

**4. Accept or reject forecast**



We use our alternative estimate to test whether we are satisfied the business' opex forecast reasonably reflects the opex criteria. We accept the proposal if we are satisfied.



If we are not satisfied the business' opex forecast reasonably reflects the opex criteria we substitute it with our alternative estimate.

## 6.4 Reasons for draft decision

Our draft decision is to accept Directlink's total updated opex forecast of \$23.5 million (\$2019–20).<sup>21</sup> We are satisfied this forecast reasonably reflects the opex criteria.<sup>22</sup>

<sup>21</sup> Including debt raising costs.

<sup>22</sup> NER, cl. 6A.6.6(c).

Our alternative estimate of total opex is \$23.1 million (\$2019–20). It is not materially different from Directlink's forecast.

Table 6-2 compares the differences between our alternative estimate and Directlink's proposal. Our forecast differs from Directlink's because:

- we used our Guideline approach to forecast the change in opex between the base year (2017–18) and the final year of the current regulatory control period (2019–20) to ensure consistency with our calculation of efficiency benefit sharing scheme carryover amounts
- we used the most recent consumer price index forecasts to adjust nominal numbers to real numbers<sup>23</sup>
- we used the most recent Deloitte Access Economics' New South Wales real wage increase forecasts to forecast real price growth, weighted by the transmission industry average of labour and non-labour mix.<sup>24</sup>

**Table 6-2 Our alternative estimate compared to Directlink's proposal (\$million, 2019–20)**

	Directlink	Our alternative estimate	Difference
Based on reported opex in 2017–18	22.3	22.2	-0.1
Efficiency adjustment	0.0	0.0	0.0
Remove insurance from final year estimate	-2.1	-2.1	0.0
2017–18 to 2019–20 increment	0.0	-0.2	-0.2
Output growth	0.0	0.0	0.0
Price growth	0.2	0.2	0.0
Productivity growth	0.0	0.0	0.0
Step changes	0.0	0.0	0.0
Insurance	2.8	2.7	0.0
Debt raising costs	0.4	0.3	-0.1
<b>Total opex</b>	<b>23.5</b>	<b>23.1</b>	<b>-0.3</b>

Source: Directlink, *Response to AER Information Request #014 - Updated PTRM and bill impact*, 21 August 2019; AER analysis.

Note: Numbers may not add up to total due to rounding.

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.

<sup>23</sup> Reserve Bank of Australia, *Statement on monetary policy - Appendix Forecasts*, August 2019.

<sup>24</sup> Deloitte Access Economics, *Labour Price Growth Forecasts prepared for the AER*, 24 June 2019, p. xiii.

## 6.4.1 Base opex

We have used the opex Directlink incurred in 2017–18 to forecast its total opex. This is consistent with Directlink's proposal. Using our Guideline approach to forecast the change in opex between the base year (2017–18) and the final year of the current regulatory control period (2019–20), we have estimated a base opex of \$22.2 million (\$2019–20).

We note PIAC's concern that Directlink's proposed opex is noticeably higher than the forecast we set for the current regulatory control period. Directlink's proposed opex is \$3.5 million (\$2019–20) higher than our previous forecast, and \$1.5 million (\$2019–20) higher than the actual and estimated opex Directlink has incurred within the current regulatory control period.

Despite this increase in opex, we are satisfied that Directlink's opex in 2017–18 is representative of its efficient opex requirements for the 2020–25 regulatory control period. This is because Directlink faces incentives under our current regulatory regime in the current regulatory control period to maximise its profits by incurring only efficient costs and this gives us comfort to rely upon its revealed costs in forecasting opex for the 2020–25 regulatory control period.

Directlink is operated by APA Operations, one of the major shareholders of Energy Infrastructure Investments (EII). APA Operations is required to submit for EII's approval a detailed operating plan and budget each year.<sup>25</sup> As well as APA Operations, the non-operator investing entities (Osaka Gas and Marubeni) review and approve Directlink's operating budget and asset management plan.<sup>26</sup> The majority owners of EII have a strong incentive under the regulatory framework to only approve prudent and efficient expenditure that APA Operations would incur on behalf of Directlink because they have a financial interest in Directlink's opex performance.<sup>27</sup>

Directlink has been subject to the incentives of an ex ante regulatory framework including the application of an efficiency benefit sharing scheme (EBSS) in the 2015–20 regulatory control period. This is designed to give it a continuous incentive to reduce (or not overspend) its opex throughout the 2015–20 regulatory control period, including its proposed base year. Although Directlink seemingly receives a higher opex forecast under the revealed cost forecasting approach as a result of overspending against our previous opex forecast, it also receives a negative EBSS carry-over of \$2.0 million. The EBSS shares all opex overspend and underspend relative to our opex forecast between Directlink and consumers, providing a disincentive for Directlink to spend more than necessary to operate its network. Generally speaking, these incentives mean we can rely on the revealed cost forecasting approach to forecast Directlink's opex for the 2020–25 regulatory control period, unless there is clear evidence of material inefficiency.

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<sup>25</sup> Directlink, *Response to AER information request #005 - Insurance and Opex (Part A)*, 20 May 2019, p. 5.

<sup>26</sup> Directlink, *Response to AER information request #005 - Insurance and Opex (Part A)*, 20 May 2019, p. 5.

<sup>27</sup> Directlink, *Response to AER information request #005 - Insurance and Opex (Part A)*, 20 May 2019, p. 5.

In testing whether the chosen base year contains material inefficiency, we have examined some of the reasons why Directlink's reported opex in 2017–18 is higher than those in previous years.

Following the fire at Directlink's Mullumbimby converter station in August 2012, the capacity of Directlink was reduced. Directlink had to rebuild its system 1 Mullumbimby converter.<sup>28</sup> Some of Directlink's rebuilding costs in 2014–2016 were funded by insurance and were not reported as opex.<sup>29</sup> Therefore, Directlink's reported opex in 2014–15 and 2015–16 do not reflect Directlink's typical opex requirements.

There are other factors that contributed to Directlink's opex increases starting from 2016–17:<sup>30</sup>

- Directlink installed a fire suppression system in 2016–17 following the Mullumbimby converter station fire and started incurring additional and ongoing opex for monitoring and maintaining the system
- Directlink responded to a number of changes to Occupational Health and Safety (OH&S) legislation in New South Wales in between 2016 and 2018. Directlink incurred costs to upgrade its processes to reflect the higher OH&S standard and ensure compliance. In particular, these new processes apply to Directlink's contractors and Directlink has incurred additional expense for the hire of equipment to support tasks being undertaken in a safe manner by contractors
- Directlink changed its vegetation management practices in January 2017 which resulted in higher costs. Directlink explained that its previous ad hoc approach for vegetation management had resulted in rising costs, difficulties with visual inspection of assets and strained landholder relationships.

Directlink has quantified the increases in its operating and maintenance expenditure and demonstrated that its opex in 2017–18, after adjusting for the factors above, is largely consistent with its opex in previous years.<sup>31</sup> We are satisfied that Directlink's opex in 2017–18 is not materially inefficient and is representative of its opex requirements going forward. We have therefore relied on Directlink's 2017–18 opex to derive our alternative estimate.

We have forecast Directlink's insurance premium costs separately in our alternative estimate so we have removed Directlink's insurance costs of \$2.1 million (\$2019–20) from base opex to avoid double counting.

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<sup>28</sup> Directlink, *Updated Revenue Proposal 2015–2020, Attachment 5.1 - Directlink Asset Management Plan*, January 2015, p. 5.

<sup>29</sup> Directlink, *Response to AER Information Request #005 - Insurance and opex (Part C)*, 7 August 2019, pp. 6–7.

<sup>30</sup> Directlink, *Response to AER Information Request #005 - Insurance and opex (Part C)*, 7 August 2019, pp. 3–9.

<sup>31</sup> Directlink, *Response to AER Information Request #005 - Insurance and opex (Part C)*, 7 August 2019.

## 6.4.2 Rate of change

We have forecast an average annual rate of change of 0.32 per cent. It is attributable entirely to forecast price growth. We have forecast no output or productivity growth, consistent with Directlink's proposal.<sup>32</sup>

### *Forecast price growth*

We have forecast real average annual price growth of 0.32 per cent in our alternative opex forecast. This increased our alternative estimate of total opex by \$0.2 million (\$2019–20).

Our price growth forecast is a weighted average of forecast labour price growth and non-labour price growth:

- to forecast labour price growth, we have relied on the most recent real wage price forecast for the New South Wales utilities industry provided by Deloitte Access Economics<sup>33</sup>
- to forecast non-labour price growth, we have applied the forecast growth in CPI.

We have applied weights to account for the proportion of opex that is labour and non-labour, based on the transmission industry average (70.4:29.6).<sup>34</sup> This differs from Directlink's approach of using an average of its historical labour and non-labour costs to determine the weights.

We consider that we should adopt a benchmark input mix in our alternative estimate to forecast the price growth of a prudent and efficient network service provider. We have used the transmission industry to approximate a benchmark service provider for Directlink. We recognise that interconnectors such as Directlink may have different characteristics compared to transmission networks and Directlink's approach of using its revealed price weights rather than the transmission industry benchmark price weights may be reasonable in its specific circumstances.

However, we consider that using a network business' revealed input price weights would distort its incentive to use the most efficient mix of labour and non-labour inputs. The revenue and pricing principles require that we provide a regulated network business with effective incentives in order to promote economic efficiency.<sup>35</sup> It is important, in our revealed cost approach to forecast opex, that the past performance of a network business does not influence the rate of change used to trend forward the base opex. Forecasting the rate of change based on a network business' past

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<sup>32</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, pp. 83–84.

<sup>33</sup> Deloitte Access Economics, *Labour Price Growth Forecasts prepared for the AER*, 24 June 2019, p. xiii.

<sup>34</sup> Across all TNSPs, the proportion of labour (from in-house labour, field services contracts and non-field services contracts) was 70.4 per cent. For more detail on our approach to forecasting price changes refer to AER, *Draft decision, AusNet Services transmission determination 2017–18 to 2021–22, Attachment 7*, 20 July 2016, pp. 47–52.

<sup>35</sup> NEL, s. 7A(3).

performance, including its past input mix, would not provide a business an incentive to reveal its efficient costs. Using a business' revealed input mix to forecast rate of change would provide a disincentive on the business to use less of an input that is increasing more rapidly in price because this would reduce the forecast rate of change. We acknowledge that this risk is low given Directlink's revealed labour cost composition is materially lower than our benchmark weights. We note our use of the benchmark price weights does not create a material difference between our alternative estimate and Directlink's updated opex forecast.

### ***Forecast output growth***

We have not included any forecast output growth. This is consistent with Directlink's proposal. It is also consistent with Directlink's capital expenditure (capex) proposal, which does not include any expansion capex in the 2020–25 regulatory control period.<sup>36</sup>

### ***Forecast productivity growth***

We have not included any forecast productivity growth, consistent with Directlink's proposal.

Ideally we would forecast opex productivity growth based on past industry average productivity growth to the extent we think it represents business-as-usual conditions. However, we are not able to measure industry opex productivity growth for interconnectors. There is insufficient data to do so.

## **6.4.3 Step changes**

We have not included any step changes in our alternative total opex forecast, consistent with Directlink's opex proposal. However, we have considered a new cost that Directlink has proposed in its capex proposal and which we classify as opex.

### **6.4.3.1 Regulatory costs**

Directlink has proposed \$250,000 (\$2019–20) in its capex forecast for advisory costs associated with the establishment and implementation of a stakeholder engagement program over the 2020–25 transmission determination period and seeking external engineer expertise in preparing its proposal.<sup>37</sup>

These costs are incidental to Directlink's operating activity to prepare and submit a transmission regulatory proposal. Directlink has forecast these costs as being recurrent – \$50,000 (\$2019–20) per annum. As set out in our capex draft decision in Attachment 5, we have not included these forecast regulatory costs in our capex forecast. In our view, these costs are unlikely to attract any future economic benefits and are better

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<sup>36</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, p. 55.

<sup>37</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, p. 76.



recognised as opex rather than capex, consistent with the accounting standard AASB 116 Property, Plant and Equipment. However, we have not instead included Directlink's proposed regulatory costs in our opex forecast as a step change, consistent with our previous decisions.<sup>38</sup>

The Guideline states that we may add (or subtract) step changes for any costs that are not captured in base opex or the rate of change that are required for forecast opex to meet the opex criteria.<sup>39</sup> In the absence of a change to regulatory obligations or a legitimate capex/opex trade-off opportunity, we would accept a step change under limited circumstances.

While it is good industry practice to incorporate relevant stakeholders' inputs in regulatory revenue proposals, Directlink has not demonstrated that its proposed advisory costs are prudent and proportionate to the size and impact of its assets. As stated in Newgate's research report prepared for Directlink, "stakeholders do acknowledge that the size of the interconnector assets is an important consideration for a future engagement program. Almost no one expects APA to do extensive end-user research or engagement on these assets..."<sup>40</sup> Directlink has not justified its proposed costs with reference to the level and form of engagement its stakeholders are seeking.

Furthermore, we consider the stakeholder engagement is a type of business-as-usual activity that Directlink should consider within its base opex. Our estimate of base opex, which relies on Directlink's revealed opex in 2017–18, already provides a sufficient allowance for Directlink acting as a prudent service provider to meet all its existing regulatory obligations. We consider providing a step change for every new cost identified by the regulated entities will upwardly bias the total opex forecast if we cannot readily identify any declining or non-recurrent costs that they may have.

#### 6.4.4 Category specific forecasts

We have included two category specific forecasts for debt raising costs and insurance costs in our alternative estimate.

Our preferred forecasting approach is to forecast opex using base opex and the rate of change. However, in limited circumstances, we may forecast a particular category of opex independently of the base opex. For example, this may be to ensure consistency with other parts of the building block model. Alternatively, we may use a category specific forecast if a particular opex category is very volatile and causes total opex to

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<sup>38</sup> See, for example, AER, *Preliminary decision Ergon Energy determination 2015–20, Attachment 7 Operating expenditure*, April 2015, pp. 306–307; AER, *Final decision Jemena distribution determination 2016–20, Attachment 7 Operating expenditure*, May 2016, pp. 74–75; AER, *Draft decision APA gas access arrangement 2018–22, Attachment 7 Operating expenditure*, July 2017, p. 16.

<sup>39</sup> AER, *Expenditure forecast assessment guideline for electricity transmission*, November 2013, p. 24.

<sup>40</sup> Directlink, *Revenue Proposal 2020–25 - Attachment 4.1 Newgate Research - Interconnector engagement*, 27 November 2018, p. 5.

become so volatile that it no longer follows a predictable path over time. That is, if we isolate that opex category, our base opex forecast trended forward by the rate of change would be more reflective of the business' total opex.

### ***Debt raising costs***

We have included \$0.3 million (\$2019–20) debt raising costs in our alternative estimate, which is not materially different from Directlink's forecast debt raising costs.

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 for consistency with the forecast of the cost of debt in the rate of return building block. We discuss this in attachment 3.

### ***Insurance costs***

We have forecast Directlink's insurance costs of \$2.7 million (\$2019–20) as a category specific forecast, consistent with Directlink's updated opex forecast. Directlink's current insurance advisor, Marsh, has identified that insurance costs are expected to increase through 2025 due to a transition in the insurance market.<sup>41</sup>

Marsh notes that the global property and casualty insurance markets oscillate between hard and soft periods. According to Marsh, since 2017, the insurance market had moved out of the 'soft market', where insurance premium would be lower and policy conditions would be more favourable, and transitioned into a 'hard market', which demonstrates selective underwriting, shrinking capacity and higher premium levels.

Marsh's property premium projections are based on the exposure presented by Directlink, its claims history and the economies of scale that is provided by the greater EII portfolio.<sup>42</sup> Its liability premium projections are based on Directlink's proportion of an EII portfolio placement.<sup>43</sup> Marsh's insurance forecasting methodology appears reasonable and takes into account the benefits applicable to Directlink given its assets are insured as part of EII portfolio. The overall insurance premium projections are comparable with the insurance costs Directlink has incurred in the past.

We generally do not forecast insurance costs on a category specific basis for other network service providers because we are concerned that this would create an upwardly biased opex forecast. Network service providers have strong incentives to use a bottom-up forecasting approach for new or rising costs and opt for the revealed cost approach when costs are declining. If we separately forecast insurance costs because it increases in price more rapidly than the total opex basket, then we must

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<sup>41</sup> Directlink, *Revenue Proposal 2020–25*, 31 January 2019, pp. 84–85.

<sup>42</sup> Directlink, *Revenue Proposal 2020–25 - Attachment 10-2 Marsh Insurance Forecast*, 31 January 2019, p. 10.

<sup>43</sup> Directlink, *Revenue Proposal 2020–25 - Attachment 10-2 Marsh Insurance Forecast*, 31 January 2019, p. 11.

also separately forecast opex items that increase in price less rapidly to avoid forecasting bias.

This draft decision differs from our previous decisions in which we did not approved insurance costs as category specific forecasts.<sup>44</sup> Table 6-3 shows the insurance costs as a percentage of total opex for Directlink and the network service providers for whom we had not forecast insurance cost on a category specific basis in our previous decisions.

**Table 6-3 Insurance costs as a percentage of total opex for selected network service providers (NSPs)**

NSPs	2014–15	2015–16	2016–17	2017–18
Directlink	19.4%	20.6%	12.3%	9.6%
ElectraNet	3.2%	3.1%	3.0%	2.7%
SA Power Networks	1.1%	0.8%	0.7%	0.7%
Powerlink	3.2%	3.1%	2.8%	3.4%
AusNet Services (Transmission)	2.9%	2.4%	2.2%	2.2%

Source: Regulatory Accounts, Category Analysis RINs; AER analysis.

We have forecast insurance costs as a category specific forecast in this draft decision due to Directlink's specific circumstances:

- as shown in table 6-3, Directlink's insurance costs represent a significant portion of its opex, which is far higher than other network service providers we have assessed previously. Directlink's forecast insurance costs are on average 12 per cent of its total opex forecast. This means that Directlink's opex is very sensitive to changes in its insurance costs and the insurance market
- compared to other network businesses, the scope of Directlink's operational activities and discretionary expenditure is much more limited as an interconnector. Directlink has very few cost categories and its opex is minor compared to other network service providers. We would expect less variance across Directlink's cost categories to offset expenditure increases or decreases. A strict application of our 'base-step-trend' forecasting approach may not be appropriate in this case due to Directlink's small size and limited flexibility to reprioritise its opex activities or to absorb significant cost increases.

Given Directlink's insurance costs represent a significant portion of its opex and the forecast increase in its insurance costs materially exceeds our rate of change for base

<sup>44</sup> See AER, *Powerlink transmission draft determination 2017–22, Attachment 7 Operating expenditure*, September 2016, p. 21; AER, *ElectraNet transmission draft determination 2018–23, Attachment 7 Operating expenditure*, October 2017, p. 17; AER, *Preliminary decision SA Power Networks determination 2015–20, Attachment 7 Operating expenditure*, April 2015, pp. 103–104; AER, *Draft decision: AusNet Services transmission determination 2017–22, Attachment 7 Operating expenditure*, July 2016, pp. 34–35.

opex, we consider that including this category of cost in our base opex forecast may not provide Directlink with a reasonable opportunity to recover its efficient costs. Therefore, we consider forecasting Directlink's insurance costs as a category specific forecast is more likely to produce a total opex forecast that reasonably reflects the opex criteria in Directlink's circumstances.

#### 6.4.5 Interrelationships

In assessing Directlink's total forecast opex we took into account other components of its proposal, including:

- the EBSS carryover
  - the level of opex used as the starting point to forecast opex (the final year of the current period) should be the same as the level of opex used to forecast the EBSS carryover. 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
  - in calculating Directlink's carryover amounts from the 2015–20 regulatory control period, we have excluded categories of opex not forecast using a single year revealed cost approach for the regulatory control period beginning in 2020, which are debt raising costs and insurance costs
- the operation of the EBSS in the 2015–20 regulatory control period, which provided Directlink an incentive to reduce opex in the base year
- the impact of cost drivers that affect both forecast opex and forecast capex. For instance, forecast labour price growth affects forecast capex and our price growth forecast used to estimate the rate of change in opex
- the classification of particular expenditure and how to account for them in our expenditure forecasts, such as Directlink's proposed regulatory costs
- 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.