



**FINAL DECISION**  
**Directlink transmission**  
**determination**  
**2015–16 to 2019–20**

**Attachment 7 – Operating**  
**expenditure (PUBLIC)**

April 2015

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AER reference: 53446

## Note

This attachment forms part of the AER's final decision on Directlink's revenue proposal 2015–20. It should be read with other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – maximum allowed revenue

Attachment 2 – regulatory asset base

Attachment 3 – rate of return

Attachment 4 – value of imputation credits

Attachment 5 – regulatory depreciation

Attachment 6 – capital expenditure

Attachment 7 – operating expenditure

Attachment 8 – corporate income tax

Attachment 9 – efficiency benefit sharing scheme

Attachment 10 – capital expenditure sharing scheme

Attachment 11 – service target performance incentive scheme

Attachment 12 – pricing methodology and negotiated services

Attachment 13 – 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
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider

Shortened form	Extended form
NTSC	negotiated transmission service criteria
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

## 7 Operating expenditure

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

The total opex presented in this attachment is exclusive of debt raising costs. We have included \$0.3 million for the 2015-20 regulatory control period for debt raising costs (see Attachment 3).

### 7.1 Final decision

We are not satisfied that Directlink's forecast total opex of \$18.5 million<sup>1</sup> for the 2015-20 regulatory control period reasonably reflects the opex criteria.<sup>2</sup> We therefore have not accepted the forecast opex Directlink has included in its building block proposal.<sup>3</sup> Our substitute estimate of \$17.7 million, which we consider reasonably reflects the opex criteria, is outlined in Table 7-1.<sup>4</sup>

**Table 7-1 AER final decision on Directlink's total opex<sup>(a)</sup> (\$million 2014–15)**

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Directlink's revised opex proposal	4.3	3.5	3.6	3.6	3.5	18.5
Directlink's revised opex and cable replacement program proposal	5.9	5.2	5.3	5.2	5.2	26.7
AER final decision <sup>(b)</sup>	4.1	3.4	3.5	3.4	3.4	17.7
Difference (\$million)	-1.8	-1.8	-1.8	-1.8	-1.8	-9.0
Difference (%)	-31.0%	-34.8%	-34.3%	-34.7%	-34.0%	-33.7%

Source: Directlink, proposal; AER analysis

Note: (a) This is exclusive of debt raising costs.

(b) This includes expenditure which was classified as capex in Directlink's revised proposal.

<sup>1</sup> Excludes Directlink's proposed debt raising costs of \$0.4 million (\$2014-15).

<sup>2</sup> NER, cl 6A.6.6(c)

<sup>3</sup> NER, cl 6A.6.6(d)

<sup>4</sup> NER, cl 6A.14.1(3)(ii)

## 7.2 Directlink’s revised proposal

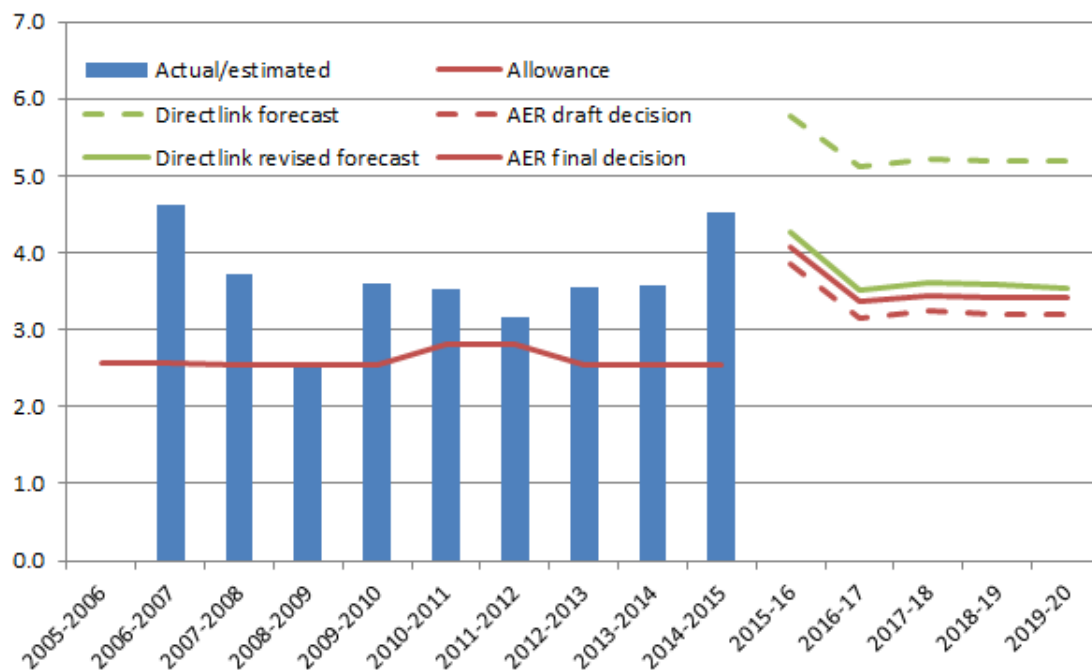
In its revised proposal Directlink forecast opex of \$18.5 million for the 2015–20 regulatory control period. The revised forecast of opex is \$7.6 million (or 29.0 per cent) lower than its initial forecast of opex over the 2015-20 period.<sup>5</sup>

The decrease in Directlink’s proposed opex mainly results from:

- a 42.4 per cent decrease in its forecast insurance
- a 16.1 per cent decrease in the commercial services fee
- a 3.6 per cent decrease in operating and maintenance expenditure (on a like-for-like basis)
- commensurate reductions in the amount of margin accruing to APA Operations, which charges 10 per cent on all opex elements.

Figure 7.1 shows Directlink’s annual actual and forecast opex from 2005-06 to 2019-20 compared to the AER forecast.

**Figure 7.1 Directlink’s actual/estimated and proposed opex, 2005-06 to 2019-20<sup>(a)</sup> (\$ million, 2014–15)**



Source: AER analysis.

<sup>5</sup> Directlink’s initial proposal included amounts for cable repairs and three labour positions. In Directlink’s revised proposal these amounts were shifted from opex to capex. The majority of the \$7.6 million difference is attributable to this classification change.



Note: (a) The AER final decision includes expenditure which was classified as capex in Directlink's revised proposal. Directlink's revised proposal excludes opex that was shifted to capex between its initial and draft proposal.

### 7.3 AER's assessment approach

We assess whether or not to accept the service provider's total forecast operating expenditure. We accept the service provider's forecast if we are satisfied that it reasonably reflects the opex criteria.<sup>6</sup> If we are not satisfied, we replace it with a total forecast opex that we are satisfied does reasonably reflect the opex criteria.<sup>7</sup>

The service provider's forecast is intended to cover the expenditure that will be needed to achieve the operating expenditure objectives. These objectives are to:<sup>8</sup>

1. meet or manage the expected demand for prescribed transmission services over the regulatory control period
2. comply with all applicable regulatory obligations or requirements associated with providing prescribed transmission services
3. where there is no regulatory obligation or requirement, to maintain the quality, reliability and security of supply of prescribed transmission services and maintain the reliability and security of the transmission system.
4. maintain the safety of the transmission system through the supply of prescribed transmission services.

We must assess the proposed total forecast opex against the opex criteria set out in the NER. The opex criteria provide that the total forecast must reasonably reflect:<sup>9</sup>

1. the efficient costs of achieving the operating expenditure objectives; and
2. the costs that a prudent operator would require to achieve the operating expenditure objectives; and
3. a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives.

The Australian Energy Market Commission (AEMC) noted that '[t]hese criteria broadly reflect the NEO [National Electricity Objective]'.<sup>10</sup>

In deciding whether or not we are satisfied the service provider's forecast reasonably reflects the opex criteria we must have regard to the opex factors.<sup>11</sup>

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<sup>6</sup> NER, cl. 6A.6.6(c), 6A.14.1(3)

<sup>7</sup> NER, cl. 6A.6.6(d), 6A.13.2(b)(3), 6A.14.1(3)(ii)

<sup>8</sup> NER, cl. 6A.6.6(e), 6A.14.1(3)(ii).

<sup>9</sup> NER, cl. 6A.6.6(c),

<sup>10</sup> AEMC, Final Rule Determination: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, 29 November 2012, p. 113.

<sup>11</sup> NER, cl. 6A.6.6(e), 6A.14.1(3)(ii).

The opex factors are also set out exhaustively in the NER. The opex factors we must have regard to are:

- the most recent annual benchmarking report that has been published under clause 6A.31 and the benchmark operating expenditure that would be incurred by an efficient Transmission Network Service Provider over the relevant regulatory control period;
- the actual and expected operating expenditure of the Transmission Network Service Provider during any preceding regulatory control periods;
- the extent to which the operating expenditure forecast includes expenditure to address the concerns of electricity consumers as identified by the Transmission Network Service Provider in the course of its engagement with electricity consumers;
- the relative prices of operating and capital inputs;
- the substitution possibilities between operating and capital expenditure;
- whether the operating expenditure forecast is consistent with any incentive scheme or schemes that apply to the Transmission Network Service Provider under clauses 6A.6.5, 6A.7.4 or 6A.7.5;
- the extent the operating expenditure forecast is referable to arrangements with a person other than the Transmission Network Service Provider that, in the opinion of the AER, do not reflect arm's length terms;
- whether the operating expenditure forecast includes an amount relating to a project that should more appropriately be included as a contingent project under clause 6A.8.1(b);
- the most recent NTNDP and any submissions made by AEMO, in accordance with the Rules, on the forecast of the Transmission Network Service Provider's required operating expenditure;
- the extent to which the Transmission Network Service Provider has considered and made provision for efficient and prudent non-network alternatives;
- any relevant project assessment conclusions report required under 5.16.4 ; and
- any other factor the AER considers relevant and which the AER has notified the Transmission Network Service Provider in writing, prior to the submission of its revised Revenue Proposal under clause 6A.12.3, is an operating expenditure factor.

For this determination, there are no additional operating expenditure factors that we will take into account under this last clause.

### **7.3.1 The Expenditure Forecast Assessment Guideline**

We issued an Expenditure Forecast Assessment Guideline (Guideline) in November 2013. Our Guideline sets out our intended approach to assessing operating expenditure in accordance with the NER.<sup>12</sup> After conducting an extensive consultation process with service providers, users, consumers and other interested stakeholders, we issued our guideline together with an explanatory statement.<sup>13</sup>

We may depart from the approach set out in the Guideline but if we do so we have to give reasons for doing so. In our Framework and Approach paper for each service provider, we set out our intention to apply our Guideline approach in making this determination.<sup>14</sup>

Our approach is to compare the service provider's total forecast opex with an alternative estimate that we develop ourselves.<sup>15</sup> By doing this we form a view on whether we are satisfied that the service provider's proposed total forecast reasonably reflects the criteria. If we conclude the proposal does not reasonably reflect the opex criteria, we use our estimate as a substitute forecast. This approach was expressly endorsed by the AEMC in its decision on the major rule changes that were introduced in November 2012. The AEMC stated:<sup>16</sup>

While the AER must form a view as to whether a NSP's proposal is reasonable, this is not a separate exercise from determining an appropriate substitute in the event the AER decides the proposal is not reasonable. For example, benchmarking the NSP against others will provide an indication of both whether the proposal is reasonable and what a substitute should be. Both the consideration of "reasonable" and the determination of the substitute must be in respect of the total for capex and opex.

Our estimate is unlikely to exactly match the service provider's forecast because the service provider may not adopt the same forecasting method. However, if the service provider's inputs and assumptions are reasonable, its method should produce a forecast consistent with our estimate. Accordingly, part of our approach is to assess the service provider's forecasting method.

If a service provider's total forecast opex is materially different to our estimate and there is no satisfactory explanation for this difference, we may form the view that the service provider's forecast does not reasonably reflect the opex criteria. Conversely, if our estimate demonstrates that the service provider's forecast reasonably reflects the

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<sup>12</sup> NER cl. 6A.5.6

<sup>13</sup> AER, *Expenditure forecasting assessment guideline - explanatory statement*, November 2013

<sup>14</sup> AER, Framework and approach paper - Directlink, Regulatory control period commencing 1 July 2015, January 2014.

<sup>15</sup> AER, Expenditure forecast assessment guideline, November 2013, p. 7.

<sup>16</sup> AEMC, Final Rule Determination: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, 29 November 2012, p. 112.

expenditure criteria, we will accept the forecast.<sup>17</sup> Whether or not we accept a service provider's forecast, we will provide the reasons for our decision.<sup>18</sup>

### 7.3.2 Building an alternative estimate of total forecast opex

Our usual approach to forming an alternative estimate of opex involves five key steps:

1. We typically use the service provider's actual opex in a single year as the starting point for our assessment. While categories of opex can vary from year to year, total opex is relatively recurrent.
2. We assess whether expenditure in that base year reasonably reflects the opex criteria. We now have a number of different techniques including economic benchmarking, by which can test the efficiency of expenditure in the base year. If necessary, we make an adjustment to the base year expenditure to ensure that it reflects the opex criteria. We can utilise the same techniques available to assess the efficiency of base year opex as to make an adjustment of base year opex.
3. As opex tends to change over time due to input price changes, output and productivity we trend the adjusted base year expenditure forward over the regulatory control period to take account of those changes. We refer to this as the rate of change.
4. We then adjust the base year expenditure to account for any other forecast cost changes over the forthcoming regulatory control period that would meet the opex criteria. This may be due to new regulatory obligations and efficient capex/opex trade-offs. We call these step changes.
5. Finally we add any additional opex components which have not been forecast using this approach. For instance, we forecast debt raising costs based on the costs incurred by a benchmark efficient service provider. If we removed a category of opex from the selected base year, we will need to consider what additional opex is needed for this category in forecasting total opex.

Underlying our approach are two general assumptions:

- the efficiency criterion and the prudence criterion in the NER are complementary, and
- past actual expenditure was sufficient to achieve the expenditure objectives in the past.

We have used this general approach in our past decisions. It is a well-regarded top-down forecasting model for regulatory purposes that have been employed by a number of Australian regulators over the last fifteen years. We refer to it as a 'revealed cost

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<sup>17</sup> NER, cl. 6A.6.6(c)

<sup>18</sup> NER, cl. 6A.14.2

method' in our Guideline (and we have sometimes referred to it as the base-step-trend method in our past regulatory decisions).

### **7.3.3 Comparing the service provider's proposal with our estimate**

Having established our estimate of total forecast opex we can test the service provider's proposed total forecast opex. Obviously, this includes comparing our alternative total with the service provider's total forecast opex. However, it also includes assessing whether the service provider's forecasting method, assumptions, inputs and models are reasonable, and assessing the service provider's explanation of how that method results in a prudent and efficient forecast.

The service provider may be able to adequately explain any apparent differences between its forecast and our estimate. Necessarily, we can only determine this on a case by case basis using our regulatory judgment.

This approach is supported by the AEMC's decision when implementing the changes to the NER in November 2012. The Commission stated:<sup>19</sup>

'the AER could be expected to approach the assessment of a NSP's expenditure (capex or opex) forecast by determining its own forecast of expenditure based on the material before it. Presumably this will never match exactly the amount proposed by the NSP. However there will be a certain margin of difference between the AER's forecast and that of the NSP within which the AER could say that the NSP's forecast is reasonable. What the margin is in a particular case, and therefore what the AER will accept as reasonable, is a matter for the AER exercising its regulatory judgment.'

### **7.3.4 A summary of the opex factors and how we take them into account**

An important change to the NER, following the rule change in November 2012, relates to the opex factors we must have regard to when making our decisions. Not only have the opex factors been altered but they have been changed into an exhaustive list of the factors that we must take into account.

While we have regard to each factor, we attach different weight to different factors when making our decision to best achieve the National Electricity Objective. This approach has been neatly summarised by the AEMC as follows:<sup>20</sup>

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<sup>19</sup> AEMC, Final Rule Determination: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, 29 November 2012, p.112.

<sup>20</sup> AEMC, Final Rule Determination: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, 29 November 2012, p. 115.

‘As mandatory considerations, the AER has an obligation to take the capex and opex factors into account, but this does not mean that every factor will be relevant to every aspect of every regulatory determination the AER makes. The AER may decide that certain factors are not relevant in certain cases once it has considered them.’

We make reference to the factors throughout this chapter and the related appendixes where they are relevant. However, for transparency and ease of reference, we have included the below table, which summarises how we have had regard to each of the opex factors in our assessment.

Opex factor <sup>(a)</sup>	AER's consideration
Annual benchmarking report and the benchmark opex that would be incurred by an efficient TNSP over the relevant regulatory control period	The annual benchmarking report does not capture information relating to Directlink.
Actual and expected opex of the TNSP during any preceding regulatory control periods	<p>In assessing Directlink's bottom up forecast we had regard to actual opex in the preceding regulatory control period.</p> <p>In assessing the efficiency of the opex we also had regard to trends in total level opex.</p>
Extent to which the opex forecast includes expenditure to address concerns of electricity consumers as identified by the TNSP in the course of its engagement with electricity consumers	Directlink's proposed opex forecast does not identify any concerns raised by electricity consumers.
The relative prices of operating and capital inputs	We considered the relative prices of operating and capital inputs in assessing Directlink's proposed bottom up build of costs.
The substitution possibilities between operating and capital expenditure	We considered whether there are more efficient and prudent trade-offs in investing more or less in capital in place of ongoing operating and maintenance expenditure.
The opex forecast is consistent with any incentive scheme or schemes that apply to the TNSP	We considered what incentive schemes applied in the previous regulatory control period in assessing Directlink's opex forecast. We also considered what incentive schemes should apply in the forthcoming regulatory control period in setting our forecasts. For example, we considered how the allowed opex provides for higher reliability targets when applying the STPIS.
The extent the opex forecast is referable to arrangements with a person other than the TNSP that do not reflect arm's length terms	If we identify costs incurred to related party businesses, we examine whether this adversely affects the TNSP's opex forecast. We consider that APA Group is a related party to Directlink and have considered this in assessing any influence on Directlink's opex forecast.
Whether the opex forecast includes an amount relating to a project that should more appropriately be included as a contingent project	We did not identify any projects that would more appropriately be included as a contingent project.
The most recent NTNDP and any submissions made by AEMO on the forecast of the TNSPs required opex	We examined these factors and took them into account in considering whether the proposed total forecast opex reasonably reflects the opex criteria.
The extent to which the TNSP has considered and made provision for efficient and prudent non-network	We identified any non-network alternatives to ensure that

alternatives	they are properly reflected in the total forecast opex.
Any relevant project assessment conclusions report required under cl.5.16.4	We are unaware of any RIT-T project being submitted by Directlink.
Any other factor the AER considers relevant and which the AER has notified the TNSP in writing, prior to the submission of its revised Revenue Proposal under cl.6A.12.3, is an opex factor	No other factors are notified by the AER.

Source: AER analysis

Note: (a) The opex factors are set out in NER cl. 6A.6.6(e).

### 7.3.5 Interrelationships

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

- the trade-off between potential capex and opex solutions in our assessment of operating and maintenance costs (see section 7.4.2)
- the effect of forecast capex and operating and maintenance costs on reducing likely insurance costs (see section 7.4.3)

## 7.4 Reasons for final decision

We are not satisfied that Directlink's total forecast opex reasonably reflects the opex criteria. We reached this conclusion after undertaking our analysis using a bottom up calculation of expenditure. When we compare Directlink's total forecast opex with our estimate of the efficient opex a prudent operator would require to achieve the opex objectives based on a realistic expectation of the demand forecast and cost inputs, its proposal is materially higher such that it does not reasonably reflect the opex criteria.

The key areas of difference between our alternative estimate of total opex and Directlink's proposed forecast total opex are:

1. Operating and maintenance expenditure. We did not agree with Directlink's proposal to include cable repair expenditure as capex and have included it as opex. Consistent with our draft decision, we consider that an opex forecast for three cable repairs per year is prudent and efficient, rather than the 12 cable repairs proposed by Directlink. We assessed that Directlink's proposed proactive cable replacement was inefficient and did not include it in our alternative opex forecast.
2. Insurance expenditure. We consider that Directlink's forecasting method results in a higher insurance expenditure than would be incurred by a prudent operator achieving the opex objectives.
3. Commercial services expenditure. Consistent with our draft position, we consider that the method of allocating the EII commercial services fee should use the most contemporary audited revenue, which is calendar year 2013.

4. APA 10 per cent margin. As the APA 10 per cent margin is applied to all elements of opex, the lower O&M, insurance and commercial services expenditure results in a lower margin amount being included in our opex forecast.

Table 7-2 summarises the quantum of the difference between Directlink's proposed total forecast opex and our alternative estimate, excluding cable repair expenditure.

**Table 7-2 AER final decision on Directlink's total opex, excluding cable repair expenditure (\$million 2014–15)**

	2015–16	2016–17	2017–18	2018–19	2019-20	Total
Directlink's initial proposal <sup>(a)</sup>	5.0	4.3	4.4	4.4	4.4	22.5
AER draft decision <sup>(a)</sup>	3.7	3.0	3.1	3.0	3.0	15.8
Directlink's revised proposal	4.3	3.5	3.6	3.6	3.5	18.5
AER final decision	3.8	3.0	3.1	3.1	3.1	16.1
Difference between AER final decision and Directlink revised proposal (\$million)	-0.5	-0.5	-0.5	-0.5	-0.4	-2.4
Difference (%)	-12.2%	-13.6%	-13.6%	-13.9%	-12.7%	-13.2%

Source: Directlink, proposal; AER analysis

Note: (a) Excludes cable repair opex shifted from opex to capex in Directlink's revised proposal.

Table 7-3 summarises the quantum of the difference between Directlink's proposed total forecast opex and our alternative estimate for cable repair expenditure.

**Table 7-3 AER final decision on Directlink's cable replacement program expenditure (\$million 2014-15, excluding APA Operations' 10 per cent margin)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Directlink's initial proposal	1.6	1.6	1.6	1.6	1.6	8.0
AER draft decision	0.3	0.3	0.3	0.3	0.3	1.5
Directlink's revised proposal	1.5	1.5	1.5	1.5	1.5	7.5
AER final decision	0.3	0.3	0.3	0.3	0.3	1.5
Difference between	-1.2	-1.2	-1.2	-1.2	-1.2	-6.0



AER final decision and Directlink revised proposal (\$million)

Difference (%)	-80.1%	-80.1%	-80.1%	-80.1%	-80.1%	-80.1%
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Source: Directlink, Revised revenue proposal, January 2015, Directlink 2015 - Revised proposal PTRM - Jan 2015.xlsx, tab 'Input'; Directlink, Revised revenue proposal, January 2015, Table 5.1, p.26; AER analysis to remove 10 per cent margin.

Our reasons are set out in more detail below.

### 7.4.1 Forecasting method

We note that our preferred forecasting approach is to apply our 'revealed cost method' as described above. In our draft decision we noted that, given the specific circumstances of Directlink's recent operational history, assessing the efficiency and prudence of Directlink's proposed expenditure by using a bottom up assessment approach was appropriate.<sup>21</sup> Given the significant period of outages<sup>22</sup> over the current regulatory control period we considered that we would have to make an adjustment to any chosen recent historical base year to account for them. We considered that this would have required an engineering assessment akin to that which would have been required for the assessment of the bottom-up build. In reaching our final decision, we have formed our alternative opex forecast using this method, having regard to all the available information.

### 7.4.2 Operating and maintenance costs

We have not included Directlink's proposed operating and maintenance expenditure in our alternative forecast of total opex. This is because we consider that it does not represent the efficient costs that a prudent operator would require to achieve the operating expenditure objectives.<sup>23</sup> Instead we have included \$12.4 million (real \$2014-15) for the 2015-20 regulatory control period (see Table 7-4).

**Table 7-4 AER operating and maintenance expenditure included in alternative opex estimate (\$000s, real 2014-15, excluding APA Operations' 10 per cent margin)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Direct operating and	2,529.9	1,885.1	1,955.1	1,907.3	1,933.7	10,211.2

<sup>21</sup> AER, Draft decision Directlink transmission determination - Attachment 7 - Operating expenditure - November 2014, pp. 15-17.

<sup>22</sup> Circuits 2 and 3 have been offline between August 2013 and x. Due to the fire in the Mullumbimby converter station x has been offline since August 2012 and is not expected to be back online until August 2015.

<sup>23</sup> NER. cl. 6A.6.6(c)(2).

maintenance costs  
(excluding cable repair  
program)

ABB Service Agreement	133.8	133.8	133.8	133.8	133.8	669.1
Cable repair program	295.9	295.9	295.9	295.9	295.9	1,479.5
Total operating and maintenance costs	2,959.7	2,314.8	2,384.8	2,337.1	2,363.5	12,359.8

Source: AER analysis.

In its revised proposal Directlink proposed total direct operating and maintenance expenditure of \$11.0 million (real \$2014-15) for the 2015-20 regulatory control period (see Table 7-5). This represents a 3.6 per cent decrease in operating and maintenance costs compared with Directlink's initial proposal and a 2.8 per cent increase compared with the AER's draft decision.<sup>24</sup>

**Table 7-5 Directlink proposed operating and maintenance expenditure (\$000s, real 2014-15, excluding APA Operations' 10 per cent margin)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Direct operating and maintenance costs <sup>(a)</sup>	2,563.0	1,910.3	1,981.2	1,932.8	1,959.6	10,346.9
ABB Service Agreement	137.0	137.0	137.0	137.0	137.0	685.2
Total operating and maintenance costs	2,700.0	2,047.4	2,118.2	2,069.9	2,096.6	11,032.1

Source: Directlink, Revised revenue proposal, January 2015, Directlink 2015 - Revised proposal PTRM - Jan 2015.xlsx, tab 'Input'; AER analysis to remove 10 per cent margin.

Note: (a) This excludes the cable repair expenditure which Directlink included in opex in its initial proposal and proposed to include in capex in its revised proposal.

## Cable replacement program

In its revised proposal, Directlink transferred the cable replacement planning and execution expenditure and expenditure for three additional staff worth \$3.3 million (real 2014-15) over the 2015-20 regulatory control period in its original proposal from opex to capex. Directlink submitted that this is consistent with its capitalisation policy.<sup>25</sup>

<sup>24</sup> Directlink, Directlink, Revised revenue proposal, January 2015, Directlink 2015 - Revised proposal PTRM - Jan 2015.xlsx, tab 'Input'; Directlink, Revenue proposal, May 2014, Directlink - Regulatory Information Notice Templates - May 2014.xlsx, tab '2.1 Opex'; AER analysis. In order to be able to make a like-for-like comparison the cable repair and three staff position expenditure that was included in Directlink's initial proposal and the AER's draft decision has been removed for the purposes of this calculation.

<sup>25</sup> Directlink, Directlink, Revised revenue proposal, January 2015, pp. 31-32.

Directlink proposed \$7.8 million (real 2014-15) capex for proactive and reactive cable repair over the 2015-20 regulatory control period (see Table 7-6).

**Table 7-6 Directlink proposed cable replacement program expenditure (\$000s, real 2014-15, excluding APA Operations' 10 per cent margin)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Cable sourcing program	516.9	516.9	516.9	516.9	516.9	2,584.3
Cable joint sourcing	353.1	353.1	353.1	353.1	353.1	1,765.7
Reliability planning and coordination	292.6	292.6	292.6	292.6	292.6	1,463.1
Cable replacement execution costs	327.9	327.9	327.9	327.9	327.9	1,639.4
<b>Total</b>	<b>1,490.5</b>	<b>1,490.5</b>	<b>1,490.5</b>	<b>1,490.5</b>	<b>1,490.5</b>	<b>7,452.4</b>

Source: Directlink, Revised revenue proposal, January 2015, Directlink 2015 - Revised proposal PTRM - Jan 2015.xlsx, tab 'Input'; Directlink, Revised revenue proposal, January 2015, Table 5.1, p.26; AER analysis to remove 10 per cent margin.

Note: Directlink did not distinguish the respective proactive and reactive cable repair expenditure.

We do not consider that the cable repair expenditure should be shifted from opex to capex. In making this assessment we have had regard to the Tribunal's decision in *Jemena Gas Networks (NSW) Ltd (No 3)*.<sup>26</sup> The Tribunal's view was that the usual matters to which regard will be had in deciding whether expenditure is capex or opex are: '(1) the character of the advantage sought and, in this respect, its lasting qualities and recurrence may play a part; (2) the manner in which the advantage is to be used, relied upon or enjoyed and, in this respect as well, recurrence may play a part; and (3) the means adopted to obtain the advantage, that is, whether a periodical reward or outlay is provided to cover its use or enjoyment for periods commensurate with the payment or whether a final provision or payment is made so as to secure future use or enjoyment'.<sup>27</sup> The Tribunal also noted that distinguishing between opex and capex depends on what the expenditure is calculated to effect from a practical and business point of view.<sup>28</sup> On this approach, we consider that:

- the cable repairs are required to maintain the operation of the asset. We refer to the Tribunal's view that 'it is an operating expense when it is to repair defects resulting from the operations of the person who incurs the expense'. In operating the asset water ingress has caused the cable to fault. Repair of the cable involves removing the water damaged part of the cable and replacing it with a small section of

<sup>26</sup> *Jemena Gas Networks (NSW) Ltd (No 3)* [2011] ACompT 6

<sup>27</sup> *Jemena Gas Networks (NSW) Ltd (No 3)* [2011] ACompT 6, para 33, citing from *Mount Isa Mines Ltd v Federal Commissioner of Taxation* [1992] HCA 62, para 147-8.

<sup>28</sup> *Jemena Gas Networks (NSW) Ltd (No 3)* [2011] ACompT 6, para 34.

undamaged cable.<sup>29</sup> The cost of maintaining an income-producing asset (e.g. the cost of “servicing” plant and equipment) is an operating expense.<sup>30</sup>

- no benefit of an enduring kind is acquired as a result of the expenditure<sup>31</sup>
- cable repair expenditure is recurring, not 'once and for all'<sup>32</sup>
- the cable repairs consist of a small part of the entire cable length. A cable repair is typically 250 metres long.<sup>33</sup> We forecast three repairs per year. The entire cable length for Directlink is 354 kilometres.<sup>34</sup> The Tribunal's view is that '[o]rdinarily work done in renewing a major or important part of plant or equipment can be treated as capital expenditure, depending upon the extent of the work'.<sup>35</sup> We do not consider that a cable repair constitutes a major part of plant or equipment.

We refer to the Tribunal's view that '[i]f accounting standards adopt the proper legal meaning then the accounting standards may be used as a proxy'.<sup>36</sup> In this instance we consider that AASB 116 is able to be used as a proxy.

The Australian Accounting Standard for Property, Plant and Equipment (AASB 116) requires that the cost of an item of property, plant and equipment is recognised as an asset if, and only if, it is probable that future economic benefits associated with the item will flow to the entity.<sup>37</sup> We asked Directlink to provide evidence of the expected future economic benefit of the cable repairs and employee positions which it proposed shifting from opex to capex.<sup>38</sup> Directlink did not identify any expected future economic benefit in its response to the AER. In relation to the labour positions it submitted that that these costs are related to condition monitoring activities, normal coordination or document preparation and management activities, 'which would be operating, rather than capital in nature'.<sup>39</sup> Directlink stated that 'it considers that it would not be unreasonable to classify these expenditures as operating costs, rather than capital expenditure'.<sup>40</sup> As Directlink has not identified any future economic benefits associated with the cable replacement program we are classifying the proposed cable repair program as opex. This is consistent with industry practice, where repairs are classified as opex. Consequently, we have assessed Directlink's proposed cable replacement program expenditure as opex.

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<sup>29</sup> Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6, para 36.

<sup>30</sup> Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6, para 36.

<sup>31</sup> Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6, para 33.

<sup>32</sup> Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6, para 33.

<sup>33</sup> Directlink, Revised revenue proposal, January 2015, p.22.

<sup>34</sup> Directlink, Revised revenue proposal, January 2015, p.22.

<sup>35</sup> Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6, para 38.

<sup>36</sup> Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT 6, para 31.

<sup>37</sup> AASB 116, cl. 7(a).

<sup>38</sup> AER, AER Information request - Directlink Opex R1, sent 16 February 2014, Question 7.

<sup>39</sup> Directlink, 20150223 Response to AER Information Request Opex R1, received 23 February 2014, pp.7-8.

<sup>40</sup> Directlink, 20150223 Response to AER Information Request Opex R1, received 23 February 2014, p.8.

In its initial proposal Directlink proposed expenditure for 11.5 reactive cable repairs per year.<sup>41</sup> In our draft decision we assessed that expenditure for three cable repairs was prudent and efficient.<sup>42</sup> In its revised proposal Directlink rescope its program to consist of:<sup>43</sup>

- reactive replacement of cable failures once they occur, and
- proactive replacement of cable sections in locations where previous faults have occurred that were reactively repaired under its previous strategy.

In relation to Directlink's reactive replacement of cables, we continue to hold our draft view that three repairs per annum is prudent and efficient. Directlink provided no new evidence to support relying on the historical average number of faults. Our draft decision noted that the new replacement strategy of replacing longer sections of faulted cable, which has been in place for three years, has yielded a significant reduction in cable faults per year. The use of an historical average is inconsistent with this finding. Directlink reiterated its submissions on the correlation of cable faults with rainfall.<sup>44</sup> Directlink focuses on the lower than average rainfall in 2014 coinciding with three to four cable faults in the 2013-14 period. However, we observe that following the introduction of the new replacement strategy<sup>45</sup>, the number of cable faults fell dramatically through 2011-12 to 2012-13 despite the average to higher than average rainfall during this period. As no additional information has been provided to justify a different failure forecast, we assess that an average cable failure rate of three per annum is a reasonable estimate of the expected cable faults as the full impact of Directlink's new cable repair strategy<sup>46</sup> is realised.

In relation to Directlink's proposed proactive cable repair, we undertook a technical engineering review and assessed that it is not standard industry practice to proactively replace cable in order to pre-emptively avoid its failure except in the case of known cable 'type' faults. In such circumstances, a business case would ordinarily be developed to demonstrate the need and efficiency of proactive cable replacement (e.g. CONSAC cable replacement programs). Directlink has not provided such information to demonstrate the business case for the proposed proactive cable replacement expenditure or such information to demonstrate the value of the proposed proactive cable replacement in remediating such failure events.

In response to AER enquiries, Directlink provided information on the analysis of the cable condition and on the strategies to address the cables historical failure rate. Of

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<sup>41</sup> Directlink, Revenue Proposal, May 2014, p.27; Directlink, Revenue Proposal, May 2014: Attachment 09 3 Phacelift O&M Model (final).xlsx, tab 'Cable Repairs'.

<sup>42</sup> AER, Draft decision: Directlink transmission determination 2015-20, Attachment 7, p.19.

<sup>43</sup> Directlink, Revised Revenue Proposal, January 2015, p.19.

<sup>44</sup> Directlink, Revised Revenue Proposal, January 2015, p.20.

<sup>45</sup> The new replacement strategy is to replace longer sections of faulted cable than in the past. It does not refer to the proactive replacement of cable.

<sup>46</sup> The new replacement strategy is to replace longer sections of faulted cable than in the past. It does not refer to the proactive replacement of cable.

the documents submitted, two reports addressed the condition of the cable and strategies to address this condition. We have reviewed these reports and make the following comments.

PSC provided a report which concluded that ‘... a strategy of careful analysis of past cable faults to identify areas that have and are likely to experience clusters of failures, and the replacement of these cables, is a prudent approach to improve the reliability of the DC cables’.<sup>47</sup> The report suggests the recommended proactive strategy is cost efficient but only refers to the potential improvement in the reliability of the cable. The value of the proactive strategy is not assessed other than in these engineering terms. We accept that the reliability of the cable may be of concern. However, we consider that a prudent service provider when assessing efficient costs would only propose to improve performance by replacing cable before it fails if it had first undertaken a cost benefit analysis. Moreover, the current strategy of reactively replacing larger section of cable either side of faults is significantly improving the cable’s reliability, and any proactive strategy would need to provide commensurate benefits over the brought forward costs of practice replacement. Such an approach is not evident in the PSC report.

The report from Orton makes observations regarding the cable’s condition and the ABB’s advice makes recommendations about repairing longer sections of cable.<sup>48</sup>

We generally concur with the ABB considerations regarding the replacement of failed cable with longer sections. As PSC points out, this is essentially the strategy that Directlink has successfully applied. We do not question the cable condition or the potential reliability concerns it raises.

However, while it may be prudent to proactively replace cable, there is no information to show that proactive replacement is more efficient than the current strategy of replacing long sections on failure. Hence, on the information available to us, we cannot conclude that the additional cable replacement volume (that is, over the failure estimate volume) is efficient. Consequently, we assess that the efficient estimate is for the reactive replacement of failed cable. As noted above, we remain of the view that an average cable failure rate of three per annum is a reasonable estimate of the expected cable faults as the full impact of Directlink’s new cable repair strategy is realised.

Consistent with our assessment that three cable repairs per annum is a reasonable estimate, we have included the pro-rated amounts, as per our draft decision for cable sourcing and cable joint sourcing in our alternative opex estimate (see Table 7-7).

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<sup>47</sup> Directlink, Directlink Revised Revenue Proposal, January 2015, Attachment 5.3, PSC - Directlink DC Cable Replacement Strategy, p. 10.

<sup>48</sup> Orton Consulting Engineers International Ltd, 5/30/2012, ‘Directlink HVDC Cable Failures Investigation, JECTEC Laboratory Test Program and Site Inspection’; Directlink, January 2015, ‘Directlink Revised Revenue Proposal, Attachment 5.3, PSC - Directlink DC Cable Replacement Strategy’, p. 9.

In its initial proposal Directlink proposed three new staff positions - a senior reliability engineer, works practices specialist and a works planner.<sup>49</sup> We did not include the expenditure for these positions in our draft decision. This was on the basis that the existing engineering position was sufficient when considered together with the expenditure included for various supporting consultancies to meet the condition monitoring, provision of asset reliability advice and asset failure investigation requirements for the Directlink asset.<sup>50</sup> We also stated that the work proposed for the Works Practices Specialist was mostly one-off work, a significant amount of which had already been outsourced to PSC. We also stated that we considered that the current O&M Supervisor position is sufficient to undertake the planning, scheduling and supervision of completion of maintenance work that is attributed to the Works Planner.<sup>51</sup>

In its revised proposal Directlink submitted that the AER's rejection of the expenditure for the three positions 'hinged on the draft decision's assessment that Directlink would only undertake three cable replacements per year going forward'. As explained above, this was not the basis of our position. In its revised proposal Directlink linked the proposed three new staff positions to the cable replacement program.<sup>52</sup>

We continue to hold our view as set out in our draft decision that the capex for these three positions for work across the Directlink asset does not reasonably reflect the efficient costs that prudent service provider would require. Directlink ties the three positions to the cable replacement program. Given we have forecast cable repairs to be three per year, and that we have not included expenditure for proactive cable replacement as there is no evidence to support its efficiency, the lack of need is even more evident.

**Table 7-7 AER included expenditure for the cable replacement program (\$000s, real 2014-15, excluding APA Operations' 10 per cent margin)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Cable sourcing program	127.7	127.7	127.7	127.7	127.7	638.4
Cable joint sourcing	87.2	87.2	87.2	87.2	87.2	436.2
Reliability planning and coordination	0	0	0	0	0	0
Cable replacement execution costs	81.0	81.0	81.0	81.0	81.0	405.0
Total	295.9	295.9	295.9	295.9	295.9	1,479.5

<sup>49</sup> Directlink, Revenue proposal, May 2014, Table 9.1, p.71.

<sup>50</sup> AER, Draft decision: Directlink transmission determination 2015-20, Attachment 7, pp.19-20.

<sup>51</sup> AER, Draft decision: Directlink transmission determination 2015-20, Attachment 7, p.20.

<sup>52</sup> Directlink, Revised revenue proposal, January 2015, pp.23-25.

## Phase reactor maintenance

Directlink did not accept the AER's draft decision to not include forecast expenditure for phase reactor maintenance. In its revised proposal, Directlink submits that the phase reactor will require maintenance 'which had not been specified at the time of the bottom-up cost study'.<sup>53</sup> It submits that this includes management of air filtration systems, thermostatic controls, cleaning and replacement of sail cloth.<sup>54</sup> It proposed forecast costs of \$553 per year for 2016-17 to 2019-20.<sup>55</sup>

We reviewed Directlink's reasons for inclusion of this forecast opex and accept this expenditure on the basis of the further information provided by Directlink in its revised proposal. We have included this amount in our alternative opex forecast.

## Pre-start inspection costs

As discussed above, Directlink did not accept the AER's draft decision regarding the annual number of cable repairs. In its revised proposal Directlink hard coded in 12 cable repairs per year.<sup>56</sup> It did not justify the increase from its initial proposal of 11.5 cable repairs per year. This had the effect of reinstating the pre-start inspection costs per cable repair as per Directlink's initial proposal.

As indicated above, we have applied our draft decision number of cable repairs, that is, three per year. Accordingly, the pre-start inspection costs we have included in our opex forecast are unchanged from our draft position of \$23,667 (real\$2014-15) over the 2015-20 regulatory control period.

### 7.4.3 Insurance costs

We have not included Directlink's proposed insurance expenditure of \$3.7 million (real \$2014-15) in our alternative estimate of forecast total opex. We are not satisfied that Directlink's proposed insurance expenditure reflects the efficient cost that a prudent operator would require to achieve the operating expenditure objectives. This is because we do not agree with some of the assumptions Directlink applied in estimating its proposed insurance costs. We consider that these assumptions result in a forecast that is above an efficient and prudent level.

We have included in our alternative opex estimate insurance expenditure of \$2.0 million (real \$2014-15) over the 2015-20 regulatory control period (see Table 7-8). The elements of our decision are set out below.

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<sup>53</sup> Directlink, Revised revenue proposal, January 2015, p. 32.

<sup>54</sup> Directlink, Revised revenue proposal, January 2015, p. 32.

<sup>55</sup> Directlink, Revised revenue proposal, January 2015: Phacelift Directlink Model final.xlm.

<sup>56</sup> Directlink, Revised revenue proposal, January 2015: Phacelift Directlink Model final.xlm.



**Table 7-8 AER insurance expenditure included in alternative opex estimate (\$000s, real 2014-15)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Industrial special risks premium	250.0	243.8	249.9	256.1	243.3	1,243.2
Public liability premium	21.5	20.9	20.4	20.9	21.4	105.2
Self insurance costs	123.3	123.3	123.3	123.3	123.3	616.3
Total insurance costs	394.8	388.0	393.6	400.3	388.0	1,964.7

Source: AER analysis.

Note: This expenditure does not include the 10 per cent APA Operations margin.

In our draft decision we included in our alternative opex estimate insurance expenditure of \$1.8 million (real 2014-15) over the 2015-20 regulatory period. This consisted of \$1.3 million for property insurance, \$0.3 million for public liability and \$0.3 million for self-insurance.

Our key concerns with Directlink's initial forecast of insurance were:

- While APA Group charged EII an insurance amount for the total EII portfolio of assets, Directlink no longer allocated this total amount according to its cost allocation methodology. The cost allocation methodology provides for insurance, a shared cost, to be allocated on the basis of each EII asset's contribution to total EII revenue. Instead, Directlink obtained an estimate<sup>57</sup> from Marsh for the cost of insuring Directlink as a separate, stand alone asset. This amount was deducted from the total EII charged amount. We assessed that this resulted in an asymmetric and upwardly biased amount of insurance being attributed to Directlink.
- We considered that the Marsh estimate did not adequately take into account the capex and opex that Directlink had proposed to improve the design and management of the asset and which we accepted in our alternative estimate in our draft decision. This included addressing asset design and maintenance issues identified as likely causes of the Mullumbimby converter station fire, plus adding a fire suppression system to isolate fire from spreading throughout the converter station (which was not previously installed). We considered that this was likely to result in property and self-insurance being overstated.
- We also found that Marsh had applied higher maximum claim amounts for estimating the stand alone insurance estimate for Directlink than were actually being applied for insuring Directlink under the APA Group policies. We considered

<sup>57</sup> We note that the Marsh estimate and the "quote", which forms the basis of the amount invoiced by APA Operations to EII for insurance, does not reflect the outcome of a competitive market process.

that the higher maximum claim amounts would lead to higher public liability insurance estimates.

Our method of forecasting insurance for inclusion in our opex forecast consisted of:

- For property insurance, we used the 2011-12 EII insurance amount charged by APA Group. We chose 2011-12 to reflect pre-fire insurance levels. We indexed the 2011-12 EII to real 2014-15. We then applied the adjustments which Marsh recommended for the softening insurance market over the 2015-20 regulatory control period.
- For public liability insurance, we applied the 2013-14 public liability insurance amount charged by APA Group to EII, indexed to real 2014-15. We then applied the adjustments which Marsh recommended for the softening insurance market over the 2015-20 regulatory control period.
- For self insurance, we applied PSC's estimate of the pre-fire likelihood of 'a one in 42 year probability of a major failure to the Directlink facility' for the purposes of calculating an alternative estimate of working losses and major property loss.

Directlink did not accept the insurance amount in our draft decision. In its revised proposal Directlink forecast insurance costs of \$3.7 million (real \$2014-15, excluding APA Operations 10 per cent margin) over the 2015-20 regulatory control period (see Table 7-9). This is a 43 per cent decrease compared with its initial proposal, but remains an increase of \$1.6 million or 70.0 per cent over the 2009-14 period insurance costs.<sup>58</sup>

**Table 7-9 Directlink proposed insurance expenditure (\$000s, real 2014-15)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Industrial special risks premium	608.0	573.3	587.6	602.3	543.1	2,914.4
Public liability premium	22.0	21.4	20.9	21.4	21.9	107.6
Self insurance costs	126.4	126.4	126.4	126.4	126.4	632.0
<b>Total insurance costs</b>	<b>756.4</b>	<b>721.1</b>	<b>734.9</b>	<b>750.1</b>	<b>691.5</b>	<b>3,654.0</b>

Source: Directlink, Revenue Proposal, May 2014, Table 9.4, p.73; AER analysis.

Note: The AER has removed the 10 per cent APA Operations margin from the costs in Table 9.4.

<sup>58</sup> Directlink, Revenue proposal, May 2014, Directlink Regulatory Information Notice Templates.xlsx.

Directlink cited four main reasons for not accepting the AER's draft decision. These are set out below.

## Returning the Directlink asset to pre-fire risk levels

Directlink did not agree that insurance costs should return to pre-fire levels, consistent with the return of risk to at least pre-fire levels. In its revised proposal Directlink submitted that the insurance assessor found that the probable cause of the Mullumbimby fire was a short circuit fault in the Pole 1 converter but that the cause of the fire was not conclusively determined.<sup>59</sup> Directlink submitted that it has sought to identify and mitigate potential causes of the fire. It submitted that it cannot say with confidence that the proposed capital and operating program will return the fire risks associated with the asset to pre-fire levels. Directlink submitted that it is not able to provide comfort to insurers that the cause of the fire has been addressed.<sup>60</sup>

This is notwithstanding that PSC stated in the risk assessment report, commissioned by Directlink and submitted to support its proposed capex and opex:<sup>61</sup>

"In February 2014, PSC was engaged to determine the expected change in risk profile in the operation and maintenance of the Directlink facility before and after the August 2012 Fire Event and to review, at a high level, the costs and benefits of each recommendation, determine the mitigation of risk associated with that recommendation and determine whether the incremental cost of implementing that recommendation can be justified in terms of a change in risk profile. ...

PSC first selected a set of operational risks where the risk assumptions and/or risk levels are expected to change as a result of the August 2012 Fire Event. For each operational risk, PSC considered how the risk assumptions have changed between pre- and post-event.

The results showed that the post-event residual risk levels for the selected operational risks are considerably higher than the pre-event risk levels.

Each operational risk was then considered with a view to what GEIP recommendations could be used to mitigate the post-event residual risk levels, potentially to the same levels as the pre-event residual risk profile. ...

PSC considers that the implementation of the suite of recommendations will return the risk profile back to pre-event levels and in doing so will assist in maintaining the reliability and availability levels of the converter stations to those originally predicted by ABB in the Reliability and Availability Prediction technical report."

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<sup>59</sup> Directlink, Revised revenue proposal, January 2015, pp. 34-35.

<sup>60</sup> Directlink, Revised revenue proposal, January 2015, pp. 34-35.

<sup>61</sup> Directlink, Revenue proposal, May 2014: Att.9.2 PSC Risk assessment and cost benefit study, May 2014, pp. 4, 27.

However in its revised proposal Directlink submitted that it does not accept that the addition of these procedures reduces the risk of the asset to pre-fire levels.<sup>62</sup> Directlink submitted that while the proposed capex and opex improves the risk profile that prevailed before the event, the fact that an unexplained fire event resulting in a significant insurance claim has occurred, cannot be removed from consideration by insurers.

We continue to hold the view, based on our internal engineering expertise, that the changes in design and operation plus the addition of the fire suppression system will reduce the risk associated with the Directlink asset to lower than the pre-fire risk levels.

[CONFIDENTIAL MATERIAL OMITTED]<sup>63</sup>

On the basis of the opex and capex that we have included in our opex and capex forecasts, the phase reactor configuration has been substantially altered and Directlink's management standards will be consistent with GEIP standards. Additionally, the fire suppression system to be completed by May 2016, which did not exist pre-fire, is intended to limit the spread of any potential fire in the converter station building. The APA Group insurer for property, which provides the actual insurance coverage for Directlink, estimates that this will reduce the loss exposure to physical damage and business interruption by 97 per cent.<sup>64</sup> For these reasons, we consider that the most likely cause of the fire has been removed and that the Directlink asset will be returned to lower than pre-fire risk levels.

Directlink submitted that the adverse claims history 'significantly influences pricing of insurance going forward, and is further compounded by the absence of definitive cause'.<sup>65</sup> However, communication from APA Group's Manager of Corporate Development and Investments indicates that EII's actual property insurance premiums are reduced.<sup>66</sup> This is further supported by the EII Interim Results which show a 32.7 per cent decrease between 2013-14 and 2012-13, with the 2013-14 insurance expense for EII lower than any previous total EII insurance cost reported over the 2008-14 period.<sup>67</sup>

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<sup>62</sup> Directlink, Revised revenue proposal, January 2015, pp. 34-35.

<sup>63</sup> Directlink, 2012-13 pass through application – report on cause of 2007 failure, pp.2-3; CHC, Report to the Australian Energy Regulator, Directlink cost Pass-through proposal, 17th January 2013 : Report on application of good industry practice, p. 19.

<sup>64</sup> Directlink, Email 'Directlink - costings for fire suppression and Gotland solution projects', received 12 February 2015, Directlink papers: Item no.9 Board meeting: 26/11/14, p. 2.

<sup>65</sup> Directlink, Revised revenue proposal, January 2015, p. 35.

<sup>66</sup> Directlink, Response to AER information request capex R2, received 16 February 2015: APA Document Execution Form (signed).pdf, p. 15.

<sup>67</sup> Directlink, Response to AER information request - Directlink Opex R2, received 2 March 2015: Q4 EII - Interim Financial Statements CY14 (signed by Directors).pdf, p.1; AER - Draft decision Directlink transmission determination - opex model draft decision - November 2014 - (CONFIDENTIAL).xlsx.

We requested but did not receive from Directlink/APA Operations policy premiums and any supporting evidence (that is, "quotes"<sup>68</sup> and board approval of the "quotes"), including the assumptions made in arriving at the invoice amounts, charged by APA Operations to the EII Group<sup>69</sup>. We also sought information regarding the APA Group policies directly from APA Group but these were not provided on request.<sup>70</sup> Our assessment is therefore based only on the information before us.

## **APA Operations' methodology for calculating the insurance allocation from the EII "quote"**

In its initial proposal Directlink submitted that estimated Directlink's insurance premiums on the basis of an estimate provided by Marsh which assumed that Directlink was a ring-fenced or standalone asset.<sup>71</sup> Directlink's standalone insurance amount was deducted from the EII asset group total "quote", with the residual shared among the other EII assets. This forecast method denied Directlink the reduced premium benefits associated with risk diversification and purchasing economies provided by obtaining a "quote" for insurance for the EII asset group.<sup>72</sup> It is this group "quote" that EII has allocated on a revenue or asset value share in the past.

In our draft decision we expressed concern that Directlink's method of allocating the EII group insurance amongst the EII assets may contribute to a biased forecast of insurance costs for Directlink.<sup>73</sup>

In response to the draft decision Directlink altered its methodology for calculating insurance premiums. Directlink submitted that it obtains standalone "quotes" for all EII assets over a three year cycle and then applies an APA Group ex gratia discount<sup>74</sup> and the APA Operations 10 per cent margin.<sup>75</sup> The EII "quote" is 21 percent less than the total standalone EII premium estimates. While this revised method addresses some of the bias associated with the methodology applied in Directlink's initial proposal, it still imposes an assumption that the portfolio diversification and purchasing economies, worth a 21 per cent reduction in the total standalone premiums, are in proportion to the

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<sup>68</sup> As required under cl. 11.11(a) of the MOMSCA. We note that the Marsh estimate and the "quote", which forms the basis of the amount invoiced by APA Operations to EII for insurance, does not reflect the outcome of a competitive market process.

<sup>69</sup> AER, AER information request - Directlink Opex R2, Question 2, sent 25 February 2015.

<sup>70</sup> AER, AER information request - AER Directlink Opex R4, sent 18 March 2015; APA Group, Email from Mark Wright 'RE: AER information request - AER Directlink Opex R4', received 18 March 2015.

<sup>71</sup> Directlink, Revenue proposal, May 2014, Attachment 09 5 Marsh Insurance Report, p.9.

<sup>72</sup> Directlink, Response to AER Information Request - Directlink opex 05 - Insurance, Commercial services fee, received 17 October 2014; Directlink, Revenue proposal, May 2014, p. 73. We note that APA Ops (EII) stated that it "interprets MOMSCA clause 11.11(a) as requiring it to provide a standalone insurance quotation for each asset as part of the EII portfolio, rather than a standalone insurance quotation for each individual EII asset". Directlink, Response to AER Information Request - Directlink opex 05 - Insurance, Commercial services fee, received 17 October 2014, footnote 3.

<sup>73</sup> AER, Draft decision: Directlink transmission determination 2015-20, Attachment 7, pp. 25-26.

<sup>74</sup> Directlink, Response to AER information request Opex R2, Question 3, received 2 March 2015.

<sup>75</sup> Directlink, Revised revenue proposal, January 2015, p. 36.

standalone premium weights. There is no reason to assume that this is the case, without understanding the risk covariance of the assets. Some assets may accrue more or less than their standalone premium share of the diversification benefits according to their risk covariance with the portfolio of assets.

In addition, we consider that this allocation method is not consistent with the Directlink cost allocation methodology approved by the AER.

We assess that the EII asset group insurance is a shared cost (see discussion below). The cost allocation methodology then requires that the shared cost is allocated on each EII asset's revenue share.<sup>76</sup>

## Application of Directlink Cost Allocation Methodology

In our draft decision we expressed concern that Directlink's original allocation methodology for insurance was not consistent with its CAM.<sup>77</sup> As indicated above, we continue to hold this view in relation to Directlink's revised allocation methodology.

In its revised proposal Directlink submitted that its CAM 'requires costs to be 1) directly attributable to assets where possible, then 2) allocated among assets using a causal allocator, and then 3) any remaining costs to be allocated on some reasonable basis'.<sup>78</sup> However, we are unable to identify the reference to such an allocation method in the version of the CAM currently approved (that is, the version dated April 2010).

We consider that insurance taken out by APA Operations is a shared cost as:

- Directlink, in response to AER information request Opex 01, included insurance under shared costs and not under direct costs.<sup>79</sup>
- Directlink has indicated that there is no directly charged cost to Directlink for insurance. Directlink submits that '[a]s EII insures its assets as a portfolio, there is no direct invoice for Directlink insurance written on a standalone basis'.<sup>80</sup>
- [CONFIDENTIAL MATERIAL OMITTED].<sup>81</sup>
- The insurance invoice is for the total EII Group insurance amount, is invoiced to Energy Fund Asset Pty Limited and described generically as 'Industrial Special Risk insurance for the period 1 Jun 14 - 1 Jun 15' and 'Combined General & Products Liability Insurance for the period 1 November 2014 - 31 October 2015'.

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<sup>76</sup> Directlink, Revenue proposal, May 2014: Att. 3.2 Attachment 3.2 Cost Allocation Methodology: Directlink Interconnector Cost Allocation Methodology EII Submission to the Australian Energy Regulator, April 2010, p.

<sup>77</sup> AER, Draft decision: Directlink transmission determination 2015-20, Attachment 7, pp. 25-26.

<sup>78</sup> Directlink, Revised revenue proposal, January 2015, p. 39.

<sup>79</sup> Directlink, Response to AER information request Opex 01, received 29 August 2014: 20140829 Response to 140806 Information request.xlsx, tab 'Info request opex 01', Table 4a: Actual and forecast EII cost allocation - shared costs (no margin) and Table 4b: Actual total EII cost type and actual applied allocation basis.

<sup>80</sup> Directlink, Revised revenue proposal, January 2015, p. 37.

<sup>81</sup> Directlink, Response to AER information request capex R2, received 16 February 2015: APA Document Execution Form (signed).pdf, p. 15.

This is in contrast to direct costs, which specify services to be provided to Directlink or are invoiced directly to the Directlink Joint Venture. For example, the Directlink fire suppression system costs were invoiced to the Directlink Joint Venture.<sup>82</sup> Directlink property taxes were invoiced to the Directlink Joint Venture.<sup>83</sup> Only those audit services that were specified as being for Directlink and Murraylink were allocated to Directlink and Murraylink.<sup>84</sup>

- Directlink's CAM states that '[a] monthly cost allocation is undertaken for all shared costs, the bulk of which are incurred under the MOMCSA'.<sup>85</sup> Directlink submits that 'insurance costs are accrued monthly in the EII financial accounts'.<sup>86</sup>
- APA Ops (EII) stated that it 'interprets MOMCSA clause 11.11(a) as requiring it to provide a standalone insurance quotation for each asset as part of the EII portfolio, rather than a standalone insurance quotation for each individual EII asset'.<sup>87</sup>

As a shared cost, the April 2010 version of the Directlink CAM requires that:<sup>88</sup>

[t]hese costs are allocated to an individual asset as a percentage (%) of the revenue the asset contributes to EII's total revenue.

In its revised proposal, Directlink submitted that insurance is not included in the list of costs in Appendix C. Directlink submitted that insurance is specifically identified in section 2.2 as a 'direct other cost'. It states that on this basis its methodology is consistent with the CAM. Directlink stated that historically insurance costs were allocated among various EII assets according to asset value and contribution to group revenue. It submitted that this is consistent with having no sound basis on which to directly attribute insurance costs to any particular asset. It submitted that 'the Mullumbimby converter station fire and ensuing increases in Directlink insurance premiums...' provided a foundation for direct attribution of costs.<sup>89</sup>

The CAM sets out:<sup>90</sup>

- costs directly associated with the operation and maintenance of Directlink which are directly attributed to the Directlink Joint Venture; and

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<sup>82</sup> Directlink, Response to AER information request capex R2, received 16 February 2015: APA Document Execution Form (signed).pdf, p. 1.

<sup>83</sup> Directlink, Response to AER Information Request Opex 02, received 20 August 2014, pp.14-22.

<sup>84</sup> Directlink, Response to AER Information Request Opex 02, received 20 August 2014, p. 5.

<sup>85</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, p. 10.

<sup>86</sup> Directlink, Revised Revenue Proposal, January 2015, fn. 29, p. 40.

<sup>87</sup> Directlink, Response to AER Information Request - Directlink opex 05 - Insurance, Commercial services fee, received 17 October 2014, footnote 3.

<sup>88</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, pp. 10-11.

<sup>89</sup> Directlink, Revised Revenue Proposal, January 2015, p. 39.

<sup>90</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, pp. 10-11.

- costs associated with the provision of other commercial services under MOMCSA which are allocated by EII to the Directlink Joint Venture using the allocation rules outlined in Appendix C.

The CAM states that the direct costs identified in section 2.2 are 'incurred by Directlink and attributed to the prescribed transmission service'.<sup>91</sup> However, insurance coverage for Directlink is neither:

- taken out directly for the Directlink asset (an option which is provided for under cl.11.4.1 of the MOMSCA) as opposed to under the APA Group policy (as per the option provided under cl.11.11(b) of the MOMSCA),
- directly invoiced to the Directlink Joint Venture, nor
- specified on the invoice as the insurance amount for Directlink.

Accordingly, we consider that insurance would fall under the section 2.2 category of 'an allocation of the costs incurred by EII for other commercial services under the MOMCSA'.<sup>92</sup> The MOMSCA sets out under 'Schedule 3: Commercial services' the key activities required to be performed. This includes to '... provide services to insure and maintain the Assets (actual insurances being a reimbursed cost to the Operator)'.<sup>93</sup>

Appendix C of the CAM includes commercial management and provides for the cost of commercial functions to be shared between EII assets in proportion to its contribution to group revenue.<sup>94</sup> We therefore consider that insurance costs are to be allocated according to the proportion of the EII asset's contribution to group revenue.

In its revised proposal, Directlink appeared to be interpreting 'direct attribution' as the existence of differential asset risk across the EII asset portfolio. However, the CAM provides guidance on the interpretation of 'direct attribution'. The CAM states that:<sup>95</sup>

'It should be noted that in instances where a service can be directly attributed to the asset, such as a legal cost relating solely to the asset, then this is attributed as a direct other cost as outlined in section 2.2.'

As set out above, insurance is not taken out solely for Directlink and it is not separately invoiced. We therefore do not consider that the EII group insurance costs are directly attributable to Directlink.

## **Basis to Directlink's insurance forecast**

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<sup>91</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, p.9.

<sup>92</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, p.8. Insurance is required to be obtained under the MOMSCA (cl.11.4.1).

<sup>93</sup> MOMSCA p.59.

<sup>94</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, p.8.

<sup>95</sup> Directlink, Revenue Proposal, May 2014: Attachment 3.2 Directlink Cost Allocation Methodology - May 2014.pdf, p.11.



In assessing the forecast of business as usual opex, such as insurance, our starting point is usually the revealed cost incurred by the business. We note that this is the basis for the majority of Directlink's bottom up build - the operating and maintenance build-up relies on current period expenditure information, the tax on property and capital and accounting/auditing costs are based on current invoice amounts.

In our draft decision we expressed concern about the magnitude of increase in forecast insurance premiums compared with the current period:<sup>96</sup>

- Directlink's property insurance premium was forecast to increase by 76 per cent in 2014-15 compared with 2013-14, notwithstanding that between 2010-11 and 2013-14 EII group property premiums had increased on average 4.6 per cent annually and Directlink's had increased by 5.7 per cent annually over the same period. We note that the Mullumbimby fire, which Directlink attribute as the cause of the premium increase, was in August 2012.
- Directlink's public liability insurance was forecast to increase by 1,685 per cent 2014-15 compared with 2013-14, notwithstanding that between 2010-11 and 2013-14 EII group property premiums had decreased on average 10 per cent annually and Directlink's had decreased by 19 per cent annually over the same period. We note that Directlink states that public liability premiums were not impacted by the Mullumbimby fire.

The premium increases are arrived at on the basis of estimates obtained from Marsh. Marsh attributes the increase in its estimate to calculating insurance on a standalone basis and, for property insurance, to the increase in the risk associated with the Directlink asset and the winding out of the claims history.

We do not consider that the Marsh estimates reasonably reflect the efficient costs of a prudent service provider. As set out in our discussions above, with respect to property insurance premiums, we consider that given the proposed capex and opex, the Directlink asset will have a lower risk level than pre-fire. We consider that the reduction in risk level would more than offset the cost associated with the claims history winding out. This appears to be borne out by FM Global's assessment of a 97 per cent decrease in loss exposure and the EII interim results which show a 32.7 decline in insurance costs (see section 'Returning the Directlink asset to pre-fire risk levels' above). If the claims history effect was greater than the reduction in risk level, we would expect to see an increase in EII insurance premiums until such time as the claims history effect was less than the impact of the reduction in risk level. However, as the insurance costs have decreased significantly, this indicates that the reduction in risk level more than offsets the premium increase attributable to the claims history.

With respect to Marsh quoting on a standalone basis, we note that the operating agreement (the MOMCSA) between APA Operations and EII provides for APA Operations to insure the EII assets under its APA Group insurance policies, which it does. It also provides for APA Operations to obtain an independent quote for

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<sup>96</sup> AER, Draft decision: Directlink transmission determination 2015-20, Attachment 7, pp. 23-24.

standalone insurance for the EII assets. Notwithstanding the costs which APA Group incurs in covering the EII assets under its APA Group policies, the MOMCSA provides for APA Operations to charge up to the amount of the independent quotation. The MOMCSA also provides for APA Operations to earn a 10 per cent margin on the quoted insurance amount.

Directlink submitted that:<sup>97</sup>

"At the time EII was established, APA was the largest provider of asset management and operating and maintenance services in the Australian energy networks industry. Entry into the MOMCSA was therefore viewed as a means by which EII could access economies of scale, scope and other efficiencies, along with asset management and corporate services expertise, that it would not otherwise be able to obtain on a stand-alone basis."

Directlink also stated that:<sup>98</sup>

"[n]otable features of [the MOMCSA] pricing mechanism include:

- o the cost pass-through component, which ensures that any economies of scale, scope and other efficiencies achieved by APA (or its contractors) are immediately passed through to Directlink and, in turn, are passed through to end-users;

- o the requirement that costs and expenses are only passed through if they have been approved in an Approved Operating Plan and Budget or an Authority for Expenditure, which imposes some discipline on the APA; and

- o the margin, which is paid to access the economies of scale and scope and other available to APA as well as APA's asset management and corporate service expertise, IT systems and business processes."

Consistent with this, we consider that a prudent and efficient operator would not pay a stand-alone insurance cost when it is paying APA Operations a 10 per cent margin to access economies of scale and market access via the APA Group insurance program. We consider that a prudent and efficient operator would come to the arrangement described by Directlink above, that is, Directlink's revenue share of EII's share of the APA Group insurance premiums.

We sought to verify the quotes and assumptions relied upon in forming the quote for the EII asset group insurance.<sup>99</sup> Directlink did not provide this information.

As expressed in our draft decision, we are concerned that the invoice amounts are not the result of a commercial transaction and do not reflect the actual costs incurred by

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<sup>97</sup> Directlink, Revenue Proposal, May 2014, Attachment 9.4 Outsourcing arrangements and margins, p.3

<sup>98</sup> Directlink, Revenue Proposal, May 2014, Attachment 9.4 Outsourcing arrangements and margins, p.3

<sup>99</sup> AER, AER information request - Directlink Opex R2, Question 2, sent 25 February 2015.

APA Operations in providing insurance coverage to Directlink under the APA Group insurance policies.<sup>100</sup>

Directlink stated that 'APA Group insurance costs are not relevant to the Directlink revenue proposal'.<sup>101</sup> It also stated that '[n]either Directlink nor EII have visibility of the total APA Group insurance costs'.<sup>102</sup>

This is despite the MOMCSA requiring that:

- '... the Operator [APA Operations] must make available ... on request, certified copies of any insurance policies or certificates of currency of any insurance policies which are taken out pursuant to this Agreement'.<sup>103</sup>
- '... the Operator... must deliver annually to the [owner] a schedule of insurance policies listing the major policies in effect relating to the Owner, the Asset Owners and Lessees, the Assets and the Operator's activities under this Agreement. This schedule shall include the necessary certificates to certify that the insurance is in place and shall include names of the insuring companies, the amounts of insurance, limits on liability, the term of the policies, the policy premiums and a brief description of the risks covered by the policies'.<sup>104</sup>

## **AER property (ISR) insurance forecast**

On the information available to us and in view of our assessment that the Directlink asset will be returned to lower than pre-fire risk levels, we have included in our opex forecast \$1.2 million (real \$2014-15) for the 2015-20 regulatory control period for ISR insurance.

We have calculated the ISR insurance using the EII ISR insurance amount for 2011-12, indexed to 2014-15. This is the most contemporary pre-fire ISR insurance expenditure. We applied Marsh' forecast market impacts for the 2014-20 period and used the latest audited EII results, calendar year 2013, to calculate Directlink's revenue share of total EII revenue. We applied this revenue share to calculate the forecast Directlink public liability premium. This yields a total ISR forecast of \$1.2 million (real \$2014-15). We consider that this is the best estimate based on the information and evidence available to us.

## **AER public liability insurance forecast**

On the information available to us, we have included \$0.1 million (real \$2014-15) for the 2015-20 regulatory control period as it reasonably reflects the opex criteria.

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<sup>100</sup> AER, Draft decision, Directlink transmission determination 2015-16 to 2019-20, Attachment 7: Operating expenditure, November 2014, p. 23.

<sup>101</sup> Directlink Response to information request OPEX 05, received 17 October 2014, p. 5.

<sup>102</sup> Directlink Response to information request OPEX 05, received 17 October 2014, p. 5.

<sup>103</sup> MOMCSA, cl.11.5(a), p.31.

<sup>104</sup> MOMCSA, cl.11.5(b), p.32.

Directlink did not accept our draft decision for public liability insurance. In its revised proposal, Directlink stated that in the draft decision we 'considered the forecast limit of \$650 million to be excessive relative to the current \$300 million limit'.<sup>105</sup>

In our draft decision we stated that:<sup>106</sup>

The maximum claim amounts are lower in the APA Group policies for industrial special risks and public liability and the Marsh certificate of currency than the amounts specified in the Marsh report.

The Marsh report specifies maximum claim amounts for public liability as \$650 million. Marsh indicated that it based its public liability premium on \$650 million instead of the current \$300 million limit as a result of a Maximum Foreseeable Loss study and the potential for liability connected with bushfire exposures. We requested that Directlink justify the proposed increase. In particular we asked Directlink to explain what has changed that has impacted on the expected probability of a fire event and the consequence of a fire event and provide an estimate of the impact of the change(s) on the probability and the consequence. Directlink did not respond to this question.

Directlink provided extracts of policy wording from the APA Group insurance policy for public liability. The policy wording specifies a significantly lower maximum claim amount. The Certificate of Currency provided by Marsh indicates a \$300 million maximum claim amount.

In the draft decision we estimated public liability insurance by applying the Directlink's revenue share of the 2013-14 actual public liability insurance amount charged by APA Operations to EII.

Directlink applied the same method described above to arrive at its estimate of public liability insurance. Namely, it calculated standalone insurance shares for each EII asset. It then applied these shares to allocate the EII public liability insurance invoiced by APA Operations to EII for 2014-15, after adjusting for market impacts over the 2014-20 period.<sup>107</sup>

As discussed above, we consider that Directlink's method of allocating the EII invoice insurance amounts is inconsistent with its CAM. We consider that the most efficient estimate of public liability insurance for Directlink would be Directlink's revenue share of the APA Group policy amount allocated to EII. However, in the absence of this information, we have calculated our forecast of Directlink's public liability insurance by using the 2014-15 EII public liability insurance amount invoiced by APA Operations to EII. We applied Marsh' forecast market impacts for the 2014-20 period and used the latest audited EII results, calendar year 2013, to calculate Directlink's revenue share

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<sup>105</sup> Directlink, Revised Revenue Proposal, January 2015, p. 41.

<sup>106</sup> AER, Draft decision: Directlink transmission determination 2015-20, November 2014: Attachment 7, p.29.

<sup>107</sup> Directlink, Revised revenue proposal, January 2015, Att. 5.6 Directlink Insurance Premium Allocation - Confidential.xls

of total EII revenue. We applied this revenue share to calculate the forecast Directlink public liability premium. This yields a total public liability insurance forecast of \$0.1 million (real \$2014-15) for the 2015-20 period.

### AER self insurance forecast

We have accepted Directlink's revised proposal of \$0.6 million (real \$2014-15) over the 2015-20 regulatory control period for self insurance in our alternative opex forecast as we consider this reasonably reflects the efficient costs of a prudent service provider on the basis of the information before us.

Directlink did not accept our draft decision of \$0.3 million for self insurance. It proposed \$0.6 million in self insurance. Directlink proposed self-insurance for working losses, major property loss, decontamination event, catastrophic property loss, and liability event.<sup>108</sup>

### Inflation

Notwithstanding that the invoiced insurance amounts relate to 2014-15 expenditure, Directlink applied 2.55 per cent inflation to the invoiced amounts in its opex build-up. The AER has not applied this inflation as it is not required as the amounts are already in real 2014-15 dollars.

### 7.4.4 Commercial services fee (also referred to as management fees and expenses)

We have included \$1.8 million (real \$2014-15) for the 2015-20 regulatory control period for the commercial services fee in our alternative opex estimate as this reasonably reflects the capex criteria. This is lower than Directlink's proposed amount of \$2.1 million (2014-15) per year. This is because we are not satisfied that the assumptions made in allocating a proportion of the total EII commercial services fee to Directlink are robust.

**Table 7-10 AER forecast of commercial services fee (management fees and expenses) (\$000s, real 2014-15)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
AER forecast of commercial services fee	353.6	353.6	353.6	353.6	353.6	1,768.0

Source: AER analysis.

<sup>108</sup> Directlink, Revised revenue proposal, January 2015, p. 41.

Directlink proposed \$2.1 million for the commercial services fee for the 2015-20 regulatory control period. This is a 16.0 per cent decrease on the costs initially proposed by Directlink.<sup>109</sup>

**Table 7-11 Directlink proposed commercial services fee (management fees and expenses) (\$000s, real 2014-15)**

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Proposed commercial services fee	428.2	428.2	428.2	428.2	428.2	2,141.2

Source: Directlink, Revised revenue proposal, January 2015, Directlink 2015 - Revised proposal PTRM - Jan 2015.xlsx, tab 'Input'; AER analysis to remove 10 per cent margin.

In its revised proposal Directlink submitted that it agreed with the AER that the Directlink methodology has a circularity flaw which requires 'a rough estimate of the forecast Directlink revenue'.<sup>110</sup> Directlink submitted that the 'degree of imprecision is expedient'.<sup>111</sup>

In its confidential version, Directlink described the nature of the unregulated EII assets. On the basis of this description Directlink submitted that the unregulated EII assets have a stable revenue stream.<sup>112</sup>

Directlink applies the following assumptions in calculating the commercial services fee.<sup>113</sup>

- Revenue shares for allocating the commercial services fee are calculated using:
  - Directlink forecast 2015-16 revenue of \$15.0 million
  - AER approved 2015-16 revenue forecast for Murraylink of \$13.5 million
  - Other EII asset 2012-13 revenue of \$66.0 million.
- A total commercial services fee of \$2.5 million<sup>114</sup> with two years escalation applied plus a further 2.55 per cent escalation applied within the PTRM model, yielding a proposed escalated commercial services fee of \$2.7 million before allocation.

We do not consider that Directlink's assumptions result in the efficient allocation, and so cost, of the commercial services fee to Directlink.<sup>115</sup>

<sup>109</sup> Directlink, Revenue proposal, May 2014, Directlink - Regulatory Information Notice Templates - May 2014.xlsx, tab '2.1 Opex'. AER analysis to remove the APA 10 per cent margin.

<sup>110</sup> Directlink, Revised revenue proposal, January 2015, p. 44.

<sup>111</sup> Directlink, Revised revenue proposal, January 2015, p. 44.

<sup>112</sup> Directlink, Revised revenue proposal confidential, January 2015, pp. 44-45.

<sup>113</sup> Directlink, Revised revenue proposal, January 2015, p.45.

<sup>114</sup> For transparency reasons, we have presented the commercial services fee without the APA 10 per cent margin.

<sup>115</sup> NER cl.6A.6.6(c)(1).

As raised in the draft decision, we consider that Directlink's proposed method of using forecast revenue for the regulated assets but using historical revenue<sup>116</sup> for the non-regulated assets in order to arrive at the revenue shares for allocating the commercial services fee is likely to result in a biased allocation.<sup>117</sup> This is because Directlink has forecast negative real revenue growth in the unregulated EII assets while it has captured the upwards growth in the proposed revenue requirement for Directlink and the AER approved regulatory forecast for Murraylink. It is inconsistent to account for changes in Directlink's revenue without also accounting for the expected changes in revenue of the other assets.

We do not consider that the unregulated EII assets have a more stable revenue stream than the regulated EII assets. The EII asset portfolio consists of Gas pipelines: Telfer Gas Pipeline and lateral, Bonaparte Gas Pipeline and Wickham Point Pipeline; Electricity transmission cables: Murraylink and Directlink; Gas-fired power stations: Daandine power station and X41 power station; and Gas processing facilities: Kogan North and Tipton West.<sup>118</sup> We consider that assets which are part of a supply chain are likely to be impacted by changing economic circumstances. These include changing commodity prices, supply conditions and changing electricity demand. Furthermore, separate from changes driven by altering macroeconomic or industry-level conditions, we consider that there is specific company intelligence, which is not generally available to us, which would indicate likely changes in revenue growth. An example of such company intelligence was that Directlink revealed that the X41 power station is being expanded from 11 generator sets to 14 in 2014 and so it expects that the X41 power station revenue will increase in direct proportion in 2014.<sup>119</sup>

Prior to the draft decision we requested the revenue stream data for the individual EII assets to be able to test the Directlink claim. Directlink responded that it does not have forecasts of the revenue for the other, unregulated EII assets.<sup>120</sup>

Based on the available evidence we assess that the amount of the total commercial services fee to be allocated across EII assets is \$2.5 million. This is because in response to information request Opex 03, question 8, Directlink stated that:<sup>121</sup>

“APA Operations manages all EII assets under the fixed commercial services agreement for a fixed fee of \$2.5 million per year (plus margin)...”.

In a follow-up information request, Opex 05 Directlink stated that:<sup>122</sup>

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<sup>116</sup> In its initial proposal Directlink proposed using CPI to index the unregulated business total revenue. In its revised proposal Directlink is not inflating the unregulated business total revenue to equivalent real terms as the regulated businesses.

<sup>117</sup> AER, Draft decision: Directlink transmission determination 2015-20, November 2014, Attachment 7, p.32.

<sup>118</sup> For example, see APA Group, Energy Investments, <<http://www.apa.com.au/our-business/energy-investments.aspx>> accessed 12 February 2015.

<sup>119</sup> Directlink, Response to AER information request Opex 01, received 29 August 2014, p.3.

<sup>120</sup> Directlink, Response to information request OPEX 01, question 2(d), received 29 August 2014, p.2.

<sup>121</sup> Directlink, Response to AER information request Opex 03, received 18 September 2014, p. 8.

<sup>122</sup> Directlink, Response to AER information request Opex 05, received 17 October 2014, p. 6.

"The commercial services fee is reviewed annually through the EII budget process. It is not subject to automatic inflation escalation."

In the absence of EII asset forecast information, we consider that the most reliable indication of future revenue shares is revealed actual revenue shares.

We have used the latest audited financial results, calendar year 2013, as the basis for determining the EII asset's share of revenue.

**Table 7-12 AER's allocation of commercial services fees (\$2014-15)**

	2013 revenue (\$000s)	Proportion (%)	Allocation of commercial services fee (\$000s)
Fixed commercial services fee			2,500.0
Directlink	12,993	14.1	353.6
Murraylink	13,773	15.0	374.8
Other EII assets	65,094	70.9	1,771.6
Total	91,859	100.0	2,500.0

Source: AER, Directlink 2006-15 - PTRM - Final decision.xls; AER, Murraylink - PTRM - amended - final decision.xls; Directlink, Response to information request OPEX 01, 20140829 Response to 140806 Information request.xlsx; AER analysis.

### 7.4.5 Margin on expenditure

We have included a margin amount of \$1.56 million in our alternative opex estimate. This reflects our acceptance of Directlink's reasoning for inclusion of a margin, in particular that it allows Directlink to access economies of scale and scope. We consider this reasonably reflects the efficient costs of a prudent service provider.

Directlink proposed \$1.63 million in margin expenditure over the 2015-20 regulatory control period.

Our forecast of the margin reflects the lower amounts of operating and maintenance, insurance and commercial services fee included in our opex estimate.

### 7.4.6 Other expenditure

As per our draft decision, in relation to the other expenditure elements we have included the following in our alternative opex estimate as it reasonably reflects the opex criteria:

- For tax on property and capital we have included \$8,427 (real \$2014-15).



- For accounting/audit fees we have included \$8,887 (real \$2014-15).
- For 'other' we have not included any amount.

Directlink indicated in its revised PTRM that it accepted the draft decision amounts for 'tax on property and capital' and 'accounting/audit fees' but applied 2.55 per cent escalation to the amounts we included in the draft decision.<sup>123</sup> The amounts included in the draft decision were in real \$2014-15. Directlink did not justify the additional escalation amount.

We have not added escalation as the amounts we have included in our alternative opex forecast are based on:<sup>124</sup>

- the accounting/audit fees for the calendar year ended 2014 and relate to work to be carried out over both 2014 and 2015. Furthermore the regulatory account amounts provided for accounting/audit fees do not indicate an increasing trend in costs. In nominal terms the following amounts were reported:<sup>125</sup>
  - in 2011 - \$8,000
  - in 2012 - \$9,000
  - in the 6 months to 31 December 2013 - \$0.
- the tax on property and capital for 2013-14. The regulatory account amounts provided for tax on property and capital do not indicate an increasing trend in costs. In nominal terms the following amounts were reported:<sup>126</sup>
  - in 2011 - \$8,000
  - in 2012 - \$5,000
  - in the 6 months to 31 December 2013 - \$7,000.

Directlink did not respond to our draft decision to not include any amount for 'other'. It did not explain why it continued to include the amount. As set out in our draft decision, Directlink's basis for including the amount was as a provision for charges that TransGrid may charge for administration charges associated with discharging its functions as Coordinating NSP.<sup>127</sup> However, TransGrid confirmed in writing that it does not currently charge and will continue not to charge any costs for carrying out this function. In this final decision, we therefore maintain our draft decision position of not including any amount for 'other'.<sup>128</sup>

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<sup>123</sup> Directlink, Revised revenue proposal, January 2014: Att.81 Directlink 2015 - Revised proposal PTRM - Jan 2015.

<sup>124</sup> Directlink, Response to AER information request - Opex 02 - Accounting and auditing fees; tax on property and capital, received 20 August 2014.

<sup>125</sup> Directlink, Regulatory accounts for transitional 6 month period ended 31 December 2013, 2012 and 2011.

<sup>126</sup> Directlink, Regulatory accounts for transitional 6 month period ended 31 December 2013, 2012 and 2011.

<sup>127</sup> AER, Draft decision, Directlink transmission determination 2015-16 to 2019-20, Attachment 7: Operating expenditure, November 2014, p.34.

<sup>128</sup> AER, Draft decision, Directlink transmission determination 2015-16 to 2019-20, Attachment 7: Operating expenditure, November 2014, p.34.

## 7.4.7 Rate of change

For our final decision we have applied zero real material and labour escalation. This reflects that Directlink accepted our draft decision in relation to labour and material escalation. In our draft decision, to forecast Directlink's annual change in opex, we applied forecast CPI to account for changes to efficient opex for each year of the regulatory control period.<sup>129</sup> That is, we applied zero real material and labour escalation.

In its initial proposal, the only driver category to which Directlink applied real labour and material escalation was operating and maintenance, where it was applied in the Phacelift bottom-up build.<sup>130</sup> This bottom-up build consisted of opex and capex. The real labour and material escalation it applied is set out in Table 7-13.

**Table 7-13 Directlink's initial proposal for real labour and material escalation (\$000s, real 2014-15)**

	2015-16	2016-17	2017-18	2018-19	2019-20
Adjustment factor Labour	1.03	1.05	1.08	1.10	1.13
Adjustment factor materials	1.03	1.06	1.09	1.13	1.16

Source: Directlink, Revenue proposal, May 2014: Attachment 09 3 Phacelift O&M Model (final).xlsx, tab 'Modelling Assumptions'.

In its revised proposal, Directlink removed the real labour and material escalation applied in its bottom-up build of forecast operating and maintenance expenditure. Directlink stated that one of the updates of the Phacelift bottom-up build was the '[r]emoval of the forecast inflation adjustment'.<sup>131</sup> More specifically the PSC report regarding the updated bottom-up build noted that for APA and contractor labour and material costs:

- in relation to capex that it:

"has set the rates of escalation for labour and material to 0% (the original modelling assumed an annual rate of 2.5% and 3% respectively), and the MOMSCA percentage to 10% in accordance with instructions from the Company."<sup>132</sup>

- In relation to opex that:

<sup>129</sup> AER, Draft decision, Directlink transmission determination 2015-16 to 2019-20, Attachment 7: Operating expenditure, November 2014, p.34.

<sup>130</sup> Directlink, Revenue proposal, May 2014: Attachment 09 3 Phacelift O&M Model (final).xlsx, tab 'Modelling Assumptions'.

<sup>131</sup> Directlink, Revised revenue proposal, January 2014, p.32.

<sup>132</sup> Directlink, Revenue proposal, May 2014: Att 5.4 PSC, Phacelift update to bottom up cost study, January 2015, p. 2.

"... In addition to the rates of escalation being set to 0% and the MOMSCA set to 10%..."<sup>133</sup>

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<sup>133</sup> Directlink, Revenue proposal, May 2014: Att 5.4 PSC, Phacelift update to bottom up cost study, January 2015, p. 2