Submission to the AER on its Preliminary Determination

Operating expenditure

Summary

This document sets out further detail of Ergon Energy's response to the Australian Energy Regulator's (AER's) Preliminary Determination on our operating expenditure. We have provided a detailed response to the AER's approach to assessing and substituting base year costs in a separate submission.

Ergon Energy largely disagrees with the AER's Preliminary Determination in relation to operating expenditure forecasts. This document outlines some of the reasons why and provides evidence the AER should consider when revoking and substituting its distribution determination for Ergon Energy in October 2015.

The AER mostly ignored the evidence we provided for step changes, and bottom up and rate of change adjustments, giving primacy to the assumptions and inputs underpinning its alternative forecast, even when they were not materially different to what Ergon Energy proposed.

We explore the AER's reasoning behind its decision and where necessary provide further evidence as to why the AER's decision was incorrect.

Contents

1. Introduction

This document details our response to the AER's Preliminary Determination on operating expenditure. Ergon Energy has structured this document in the following manner:

- Chapter 2 summarises the AER's Preliminary Determination in relation to operating expenditure.
- Chapter 3 provides a general response to the AER's assessment approach.
- Chapter 4 provides an overview of our response on base year costs.
- Chapters 5 and 6 provide a detailed response on the AER's concerns in regard to rate of change factors and step changes, respectively.
- Chapters 7 and 8 outline our response to issues of debt raising costs and the transition path.

2. AER's Preliminary Determination

Attachment 7 of the AER's Preliminary Determination details its positions on operating expenditure forecasts. As noted in our *Submission to the AER's Preliminary Determination*, the AER did not accept our proposed total operating expenditure allowance of $1,821.1 million for the regulatory control period 2015-20. Instead, the AER determined a total operating expenditure allowance of $1,629.9 million.

Table 1: AER's preliminary determination on Ergon Energy's forecast operating expenditure, 2015-20

$m (real 2014-15)	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Ergon Energy's proposal	349.6	356.1	363.6	372.9	379.0	**1,821.1**
AER Preliminary Determination	314.4	320.3	325.4	332.0	337.8	**1,629.9**
Difference	(35.2)	(35.8)	(38.3)	(40.9)	(41.1)	**(191.3)**

Source: AER (2015), *Preliminary Decision, Ergon Energy determination 2015-16 to 2019-20, Attachment 7 – Operating expenditure*, April 2015, p9.

Attachment 7 of the AER's Preliminary Determination and supporting documentation provides an exhaustive explanation of the assessment and reasoning behind its decision. The vast majority of the material in the attachment relates to the AER's single point estimate of an "alternative base year" of the average operating expenditure between 2006 and 2013.

The AER has adopted a significant change in approach, based on what it considers was appropriate following the major changes made to the decision-making framework in November 2012. The AER believes these changes place significant new emphasis on the use of benchmarking in operating expenditure analysis.

The AER notes its assessment approach is not fully consistent with its own Expenditure Forecast Assessment Guideline (the Guideline). However, in all of the material presented by the AER, the AER do not clearly explain where the AER has departed and a justification as to why. Nevertheless, the AER summarises its considerations around its assessment process, which includes how it accounts for its own obligations under the National Electricity Rules (NER) as follows:

> "Our approach is to compare the service provider's total forecast opex with an alternative estimate that we develop ourselves. By doing this we form a view on whether we are satisfied that the service provider's proposed total forecast opex reasonably reflects the opex criteria. If we conclude the proposal does not reasonably reflect the opex criteria, we use our estimate as a substitute forecast."[1]

[1] AER (2015), *Preliminary Decision, Ergon Energy determination 2015-16 to 2019-20, Attachment 7 – Operating expenditure*, April 2015, p15.

The AER's approach to forming an alternative estimate of operating expenditure (as outlined above) is set out in the Guideline. While the AER's assessment approach is not found in the NER, the AER claims the Australian Energy Market Commission's (AEMC) rule change decision in 2012 expressly endorses the AER's approach:

> "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."[2]

In its Preliminary Determination, the AER emphasises that it makes an assessment about the total forecast operating expenditure and not about particular categories or projects in the operating expenditure forecast. We agree that the AER's task is to assess the total forecast, but equally argue that the AER's assessment is not about:

- particular step changes which are of its own construction outside the NER
- modelling choice and techniques
- its own considerations around one off and bottom up adjustments
- deriving an alternative forecast based on extended history and without regard to future forecast expenditure

The reasoning behind this position is outlined in this submission.

[2] AEMC (2012), *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012,* 29 November 2012, p112.

3. Our response

Ergon Energy considers that the AER has largely put to one side the evidence we provided in favour of developing its own alternative forecast. We have outlined below why we disagree with this position. We also detail why the AER's approach to determining an alternative base year forecast was incorrect. Ergon Energy maintains there was no need for the AER to amend the rate of change factors in arriving at a total forecast. We also respond to the AER's decision to exclude step changes from the forecast trend.

3.1. The AER has disregarded important evidence

Our October Regulatory Proposal included a suite of documentation and evidence that supported what we believed satisfied NER requirements. This included (but was not limited to):

- Appendix A of the revised Regulatory Proposal
- *0A.01.02 – Ergon Energy's Journey to the Best Possible Price*
- *0A.02.01 – Huegin Ergon Benchmarking*
- *06.01.01 – Operating Forecast Expenditure Summary Document*
- *06.01.02 – System Related Operating Expenditure Forecasting Summary*
- *06.01.04 – Step Changes for Operating Costs*
- *06.01.05 – Meeting Rule Requirements for Expenditure Forecasts*
- *06.02.02 – Jacobs: Cost Escalation Factors 2015-20*
- relevant models supporting the forecasts.

In addition to the documentation in our proposal, we have provided material that was useful to the AER in assessing our forecast including:

- our Expenditure Forecast Method
- the AER-approved Cost Allocation Method (CAM).

We also made various submissions on benchmarking, including in response to the AER's issues paper and various cross submissions and in response to AER draft decisions for other network businesses. Some of these submissions appear below:

- *Detailed responses to numerous questions raised by the AER in our assessment*
- *Frontier Economics – Taking account of heterogeneity when benchmarking*
- *Huegin – Benchmarking operating expenditure*
- *Huegin – Heterogeneity in electricity networks*
- *PWC – Letter on OH&S differences*
- *Synergies – Comments on the use of benchmarking in regulation*
- *Synergies – Concerns over AER's use of benchmarking*
- *Ernst & Young – RIN Data Review.*

Within the AER's preliminary decision there is a noticeable absence of referencing to the source material we provided to explain our position. In fact, based on our interpretation of the Preliminary Determination, the AER places undue emphasis on satisfying itself of the alternative forecast than our own forecast:

> "Having considered the differences between the guideline forecasting method and Ergon Energy's method, we are satisfied that the guideline forecasting method produces an opex forecast that reasonably reflects the opex criteria."[3]

The AER's incorrect focus on its own alternative estimate has led to the inappropriate consideration of our forecast against the criteria and factors.

For example, the AER made the following comments in reaching its decision that its alternative forecast should be used:

> "Ergon Energy's opex forecasting method differs from the Guideline forecasting approach in that it disaggregated total opex into cost categories and applied different forecasting methods to different cost categories, which it called functional areas. Ergon Energy applied what it called a base step trend method to the majority of its cost categories. This method is broadly similar to the Guideline forecasting method. However, Ergon Energy used category specific forecasting methods for some cost categories."[4]

Such an approach appears to lift the AER's Guideline to a status not supported by the NER or National Electricity Law. The NER requires Ergon Energy to develop forecasts according to cost categories. If a total forecast would not meet the NER requirements if the same forecasting method was applied, then alternative methods should be used. This would appear to be the intention of the AEMC:

> "Both the consideration of "reasonable" and the determination of the substitute must be in respect of the total for capex and opex."[5]

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[3] AER (2015), Ibid, p24.
[4] AER (2015), Ibid, pp312-313.
[5] AEMC (2012), *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012,* 29 November 2012, p112.

4. Base year expenditure (Steps 1 and 2)

Critical to the AER's approach to assessing an NSP's forecast is the AER's development of its own alternative single point estimate and the comparison of this estimate to the AER's derivation of Ergon Energy's base year. This is identified in the first two steps of the AER's assessment approach and consumes the largest proportion of the AER's reasoning and decision.

It is also the area of assessment where Ergon Energy has the greatest concern.

In summary, we consider:

- The AER placed undue confidence in its subjectively derived single point estimate from its benchmarking to reject Ergon Energy's revealed cost as a logical starting point.
- Most, if not all, factors considered by the AER were driven to the outcome of a single point estimate.
- Alternatives to adjust the revealed cost were not considered.
- A realistic application of its subjectively determined single point estimate to the circumstances of the business was not considered.

We have therefore concentrated our response to the AER's identification of base year costs in a separate submission, *Opex (Base Year) – Response*.

5. The rate of change (Step 3)

The AER's forecast of the overall rate of change used to derive our forecast operating expenditure was higher than what Ergon Energy proposed. The AER calculated a price growth rate which is lower than Ergon Energy's, primarily because the AER's labour forecasts were lower and because the AER used internal labour rates of Distribution Network Service Providers (DNSPs) in Victoria to set the growth rate, rather than use Ergon Energy's actual data.

The AER also considers that Ergon Energy's forecast labour using the average weekly ordinary time earnings (AWOTE) is not reasonable and has instead applied an average of:

- Energex's utilities sector forecast, and
- Deloitte Access Economics' forecast.

Further, the AER limits any allowance for rate of change productivity to the short to medium term productivity outlook for a benchmark DNSP. As a result, its productivity rate of change was different to ours.

After comparing its (lower) alternative estimate to our (higher) estimate of rate of change, the AER chose its own estimate.

Ergon Energy has reviewed the AER's preliminary decision in relation to its approach to the rate of change and its application to the operating expenditure forecast. Ergon Energy does not understand why the AER substituted Ergon Energy's rate of change forecast with its own, given the small differences in the overall outcome.[6] The AER's justification for the substitution appears to be based on its preferred forecast methodology despite the two forecasting approaches resulting in very similar total rate of change forecasts.

The AER recognises that the efficient level of expenditure over the period may differ from that required in the base year. When developing its alternative estimate, the AER applies a forecast annual rate of change to its determined base year.

> "Our starting point for assessing the service provider's proposed change in annual expenditure is to disaggregate the service provider's proposal into the three rate of change components. This enables us to identify where there are differences in our estimate and the service provider's estimate of the components of the rate of change. While individual components in the service provider's proposed annual change in expenditure may differ from our rate of change component forecasts, we will form a view on the overall rate of change in deciding what to apply to derive our alternative opex forecast."[7]

While the AER has discretion to substitute its preferred forecast, it should be recognised that its rate of change forecast is no better or worse than our own forecast and the AER has not set out in any clear way why its approach is to be preferred. Indeed, its forecast leads to an overall higher rate of change in operating expenditure over the regulatory control period 2015-20. This is because of an

[6] AER (2015), Ibid, pp282-283.
[7] AER (2015), Ibid, p279.

assumption that the base year is efficient and an assumption of a constant efficiency frontier for the forecast period.

As a result, we have not identified any evidence that supports a change in approach. We have therefore maintained our approach to forecasting the rate of change to operating expenditure in our revised Regulatory Proposal. Our forecast includes an explicit assumption that the efficient frontier will move over time and that we need to continually improve even if the base year operating costs are at an efficient level. We have updated our forecast based on the latest available information from Jacobs.[8]

5.1. Price growth

The AER's assumed price growth rate of change is made up of labour price growth and non-labour (which includes materials) price growth. The difference in the forecast price growth between the AER and Ergon Energy is driven primarily by the following reasons:

- the operating expenditure weighting between labour and non-labour – generally the more weight attributed to labour, the higher price growth. The AER used weightings based on Victorian DNSPs and not our own
- the AER used a lower labour price forecast based than what was recommended by our experts.

5.1.1. Incorrect reasoning for substituted price weightings

There is no basis for adopting weightings based on economic analysis undertaken in 2004 using regulatory accounts data for Victorian DNSPs.[9]

The AER adopts a forecast price growth which is weighted to account for the proportion of operating expenditure that is labour and non-labour. The AER adopted a 62 per cent weighting for labour and 38 per cent for non-labour. The AER based these weightings on Economic Insight's benchmarking analysis which applied weight of 62 per cent Electricity, Gas, Water and Waste Services (EGWWS) wage price index (WPI) for labour and 38 per cent for five producer price indexes (PPIs) for non-labour. The five PPIs cover business, computing, secretarial, legal and accounting, and public relations services.

These operating expenditure weightings are based on separate analysis from Pacific Economic Group's (PEG) using Victorian DNSPs' regulatory accounts data. The AER's justification for these weightings is below:

> "We consider the weightings from PEG's analysis represent reasonable benchmark weightings for efficient frontier."
>
> …

[8] *06.02.07 – Jacobs: Addendum Cost Escalation Factors 2015-20.*

[9] The AER based its weightings on PEG's analysis – PEG (2004), *TFP research for Victoria's Power Distribution Industry*, *Report prepared for Essential Services Commission*.

> “We have also adopted these output weights in our recent determinations for NSW and ACT distribution determinations. We consider these weightings represent the weightings for a prudent firm because it has been used in previous economic benchmarking analysis by Pacific Economic Group Research and Economic Insights.”[10]

This analysis is not current and does not take into account the following factors:

- The efficient split between labour and non-labour is likely to have changed over time, even for the Victorian DNSPs on which the splits are based.
- Differences in operating environments – it is reasonable to assume that labour content will be a higher percentage of operating costs where there is more distance and time between operating activities as found in Ergon Energy’s distribution area when compared to the relatively compact areas of Victoria. The AER has recognised this by including adjustments for other environmental factors when assessing the efficient base year operating costs for Ergon Energy and not relying entirely on the results of its Stochastic Frontier Analysis benchmarking.[11]
- There are likely to be differences in accounting treatments (e.g. capitalisation policies).
- There are different approaches to contracting of services for operating activities.

The above list is not exhaustive. Ergon Energy continually reviews and balances these and other factors to minimise operating expenditure costs.

5.1.2. AER’s choice of labour forecasts is no improvement on what we proposed

The AER characterised Ergon Energy’s forecast as being based on AWOTE and rejected the forecast because the AER has used WPI in previous decisions. It considers that regardless of the nature of the task, if labour is employed by a business that operates in the utilities industry, then it should be escalated by the EGWWS industry forecast. Further, it considered that AWOTE tends to be volatile and therefore more difficult to forecast.

The AER’s method of using a WPI based on only EGWSS forecasts is not an improvement on Ergon Energy’s method of using an index constructed from construction and utilities labour indices and incorporating labour productivity. Ergon Energy's experts apply separate labour price forecasts for utilities and professional services and then apply these forecasts to varying degrees depending on the type of labour. Jacobs has extensive experience of the electricity distribution industry across Australia and proposes that labour in the distribution industry in Queensland is better characterised as a mix of construction and utilities activities (refer to section 5 of Jacobs’ report).

Jacobs advises that our labour costs are more closely aligned to a mix of EGWWS, the non-residential construction industry and factors relevant to Queensland:

- WPI for the utilities sector
- WPI for Queensland
- Labour Productivity Index

[10] AER (2015), Ibid, p285.
[11] Refer to section A.6 of Attachment 7 of the Preliminary Determination.

- Brisbane CPI for Queensland
- Non-residential Building construction Cost Index for Queensland.[12]

Jacobs then performed an empirical analysis developing the respective weightings of each of these elements to meet the AWOTE forecasts based on AWOTE being effectively WPIs inclusive of productivity changes. That is:

AWOTE = Function (WPIs, BCI, CPI, LPI).

Our revised proposal used revised forecasts from Jacobs based on more updated information.

5.2. No basis for substituting output growth factors

To measure output growth, the AER used the same forecast customer growth as Ergon Energy. However, the AER used ratcheted maximum demand rather than Ergon Energy's proposed combination of zone substation capacity and distribution transformers. Ratcheted maximum demand represents the actual capacity a service provider must have to meet its customers' needs whereas zone substation capacity and transformers represent the amount of infrastructure a service provider must build to meet the capacity.

The AER acknowledges that both measures produce a similar result, but a service provider may build to meet future increases in maximum demand, which may result in a higher growth rate for capacity in the short term than the required amount of assets being built.

We do not agree with the AER's approach. Ergon Energy proposed methodology is based on the volume of equipment that needs to be maintained, rather than an energy (ratcheted demand) based methodology used by the AER. Installed power transformer capacity is a proxy for the number of power transformers (zone substations) to be maintained and the number of distribution transformers (as a proxy for distribution substations) as a measure of the amount of maintenance required on these assets.

Put another way, it does not matter if any energy flows through our network, the fact that equipment is an outdoor environment energised at high voltage, exposed to the elements and in many cases in public areas, requires that they be inspected and maintained for safe operation and the safety of the public.

Similarly, the length of lines is a better estimate for the amount of maintenance that will be required on the lines than the energy flowing through the lines. Particularly as the majority of the operating forecasts for powerlines are related to vegetation management rather than maintenance of the asset.

To the extent that both measures produce similar outcomes, one would have expected the AER would not substitute a reasonable approach.

The AER has also applied benchmark weights for output growth rather than applying Ergon Energy's methodology of attributing specific growth drivers to each operating expenditure Functional Area. The AER's only justification for this is that the benchmark firm has different weights to Ergon Energy (although it could not be certain). We see no reason why the AER should put our approach to forecasting to one side, in favour of its own approach, without more substantiated justification. Adopting different weights only adds to the risk that the AER has provided an unreasonable forecast that does not take into account individual circumstances or a realistic expectation of cost inputs.

[12] *06.02.02 – Jacobs: Cost Escalation Factors 2015-20*, section 5.4.

6. Step changes (Step 4)

Because operating expenditure is largely recurrent, it is generally accepted that expenditure required in the next year will be largely be a function of expenditure in the incumbent year, allowing for some trend in output, price, or other factor. There are likely to be changes outside of trend between years which will need to be taken into account if an operating expenditure forecast is realistic and reasonable.

Deviations from trend will often occur because of changes in regulatory arrangements or trade-offs between capital expenditure and operating expenditure. But there is no evidence that these are the only two factors that will cause deviations in operating expenditure beyond a trend within a period.

The AER applies a much narrower, prescriptive approach to cost increases outside trend. It identifies "step changes" for cost drivers such as new, changed or removed regulatory obligations, or efficient capital/operating expenditure trade-offs:

> "In developing our alternative opex forecast, we recognise that there may be changed circumstances in the forecast period that may impact on the expenditure requirements of a service provider. We consider those changed circumstances as potential 'step changes'."[13]

When assessing a service provider's proposed step changes, the AER makes the following assumptions:

- Step changes should not double count costs included in other elements of the operating expenditure forecast.
- A step change in our operating expenditure forecast is only included if the AER is satisfied a prudent and efficient service provider would need an increase in its base level of operating expenditure.

The AER's Preliminary Determination noted that, because it substituted Ergon Energy's actual revealed cost with its own alternative (lower) amount, and because it applied an alternative (lower) rate of change, the next step was to determine whether proposed step changes are already incorporated in these lower amounts. Following its assessment, the AER did not include any additional costs above its alternative base year cost and alternative rate of change because it was not satisfied that adding any of the incremental cost drivers would reasonably reflect the operating expenditure criteria.

To this end, Ergon Energy notes that the term "step changes" and the criteria in which they are calculated is a construct of the AER's Guidelines, not the NER. It is not open, therefore, for the AER to dismiss costs on the basis that they do not meet its definition of a step change. What is required is an appropriate assessment of total operating expenditure requirements over the period.

Ergon Energy has reviewed the step changes proposed against the AER's preliminary decision. It appears that the AER incorrectly removed all of Ergon Energy's required adjustments to trended

[13] AER (2015), Ibid, p299.

operating expenditure forecasts on the basis that they "assessed them as step changes in formulating our alternative operating expenditure forecast."[14]

Nevertheless, based on the AER's Preliminary Determination, we no longer seek a step change or adjustment to the 2013-14 base year for the following:

- non-network alternatives
- remediation of contaminated land
- regulatory reset costs.

However, we maintain that a step change is required for parametric insurance. Our supporting submission, *Parametric Insurance – Response*, provides additional information to satisfy the AER that this step change in expenditure from the base year is necessary.

Ergon Energy has also retained step changes to overhead costs relating to ICT. Specifically:

- ICT Asset Service Fee and related costs
- Operational and licence fee costs.

Finally, we have identified a new step change in operating expenditure requirements for additional workload associated with the cessation of the Minimalist Transitioning Approach (MTA). Currently, Ergon Energy is allowed to operate a less onerous information management regime when providing National Metering Identifier information to retailers and AEMO. We will incur additional costs to meet the new regulatory obligations through our Market Transaction Centre once the MTA reaches an end. We will begin to incur these costs in 2015-16.

Our supporting document, *06.01.04 – (Revised) Step Changes for Operating Costs*, provides further detail on the above step changes.

6.1. Incorrect decision in respect of ICT expenditure

The AER decided that ICT operating expenditure is a business-as-usual cost and the AER's estimate of base operating expenditure already provides sufficient funding for Ergon Energy. Because of this, the AER has determined a step change is not necessary.

The AER also noted that any change in overheads as a result of a change in outputs, for example more ICT expenditure being required because of a growth in Ergon Energy's customer base, is already compensated through the AER's operating expenditure rate of change.

This contradicts the AER's own consideration of step changes in its Preliminary Determination. The AER stated:

> "One situation where a step change to total opex may be required is when a service provider chooses an operating solution to replace a capital one. For example, it may choose to lease vehicles when it previously purchased them. For these capex/opex trade-off step changes, we will assess whether it is prudent and efficient to substitute capex for opex or vice versa. In doing so

[14] AER (2015), *Preliminary Decision, Ergon Energy determination 2015-16 to 2019-20, Attachment 7 – Operating expenditure*, April 2015, p300.

> we will assess whether the forecast opex over the life of the alternative capital solution is less than capex in NPV [Net Present Value] terms."[15]

In supporting documentation to our October Regulatory Proposal, we noted Ergon Energy's operating expenditure forecast for 2015-20 includes expenditure for the SPARQ Solutions Pty Ltd (SPARQ) support functions for ICT capital works:

> "Ergon Energy uses operating expenditure (including Asset Service Fees) to fund SPARQ capital investment in ICT assets."[16]

These arrangements represent a substitution between capital and operating expenditure (consistent with the NER factors) and the AER's Guideline:

> "If it is efficient to substitute capex with opex, a step change may be included for these costs (capex/opex trade-offs."[17]

The AER should be indifferent to the accounting treatment of costs if, in NPV terms, there is no material difference between adopting traditional in-house capitalisation of ICT projects and the operating expenditure arrangement through SPARQ.

SPARQ engaged KPMG to analyse if there are material differences in outcomes between the approach adopted with Ergon Energy and Energex and traditional in-house capitalisation approaches. KPMG stated:

> "The differences in the NPV of revenues over the five years [using the SPARQ/Ergon Energy funding arrangements] are approximately 2.6% less than the PTRM regulatory equivalent for Ergon Energy."[18]

This analysis ignores the additional step change cost of Ergon Energy adopting in-house capitalisation and capability as an alternative to current arrangements with SPARQ.

If the AER does reject the step change, there is a material difference between the two arrangements suggesting the AER has not properly considered substitution possibilities between capital and

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[15] AER (2015), *Preliminary Decision, Ergon Energy determination 2015-16 to 2019-20, Attachment 7 – Operating expenditure*, April 2015, p302.
[16] Ergon Energy (2014), *Ergon Energy ICT Expenditure Forecast Summary*, p4.
[17] AER (2013), *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p24.
[18] KPMG (2015), *Report to the Board of SPARQ Solutions on ICT Expenditure Forecasts for the Period: 2015 to 2020,* 25 June 2015, p13. Referred to as *KPMG – SPARQ ICT expenditure forecasts*.

operating expenditure and has not given Ergon Energy the opportunity to recover what otherwise would be efficient costs.

In response to the AER's specific concerns about ICT costs, Ergon Energy has provided substantial evidence supporting this expenditure and we consider this information has not been adequately taken into account by the AER. As such, we request that the AER both reconsider its position and provide a clear explanation as to why our evidence is not accepted (if the same position is arrived at).

In relation to rejecting the step change for additional operating expenditure, the AER notes:

> "Step changes should generally relate to a new obligation or some change in the service provider's operating environment beyond its control."[19]

Information in our supporting documentation demonstrates that additional ICT functionality is required to meet new obligations and requirements. Ergon Energy notes we have been operating under limited market arrangements which have not justified investment in the contemporary market systems that most DNSPs would have in place. As a prudent DNSP, Ergon Energy has deferred investment in such systems pending clear direction that contestable market capability would be required. This was provided in 2014 and reaffirmed in 2015 and consequentially prudent ICT investments were initiated to provide such capability.

On this basis, Ergon Energy has included increased operating expenditure for a range of systems required to operate in a fully contestable market (changing from vertically integrated systems to independent systems operating via market interfaces). These systems provide enhanced customer information and network billing capability, field force automation, and contact centre capability.

These systems allow Ergon Energy to operate in a fully contestable market place to bring customer benefits in terms of choice, expanded service and National Energy Customer Framework compliance and thus are a necessary cost that should be approved by the AER.

We have provided responses to the AER's specific questions in regard to ICT expenditure. In addition, we have provided further evidence in our supporting documentation and submissions, including:

- *07.00.07 – (Revised) ICT Expenditure forecast summary*
- *06.01.04 – (Revised) Step Changes for Operating Costs*
- *Capitalised Overheads and ICT Expenditure – Response*
- *KPMG – SPARQ ICT expenditure forecasts*.

6.2 Arguments rejecting parametric insurance not substantiated

The AER did not include a step change in its alternative forecast for Ergon Energy's parametric insurance costs. In deciding that no step change in costs was appropriate, the AER considered advice from AM Actuaries and determined the full cost of the step change was not reasonable to include in an alternative forecast, on the following basis:

[19] AER (2015), *Preliminary Decision, Ergon Energy determination 2015-16 to 2019-20, Attachment 7 – Operating expenditure*, April 2015, p302.

- Even if a payment is triggered and losses are sustained, there is limited connection between the actual loss sustained and the insurance payment.
- While the expected return to Ergon Energy is only half of the contract premium, AM Actuaries considered the cost is not reasonable in view of the limited protection it provides.
- While the cost is consistent with traditional insurance and provides cover in excess of that available from the traditional market, the cover is still capped and may not respond to significant loss. This is due to the relatively narrow event triggers and disconnect to actual losses occurred.
- The proposal does not appear to respond to other “storm” related natural disasters (for example, tornado and storm surge).
- Ergon Energy did not sufficiently assess the parametric insurance option against the alternative option of self-insurance.

We believe that most of the arguments put forward by the AER are as a result of not fully engaging in the detail supporting our proposal or a lack of understanding by the AER, or AM actuaries, of what we proposed. This may be due to the fact that parametric insurance is not a widely utilised product by NSPs in the NEM. We have included a comprehensive response to the AER’s concerns in our revised supporting document on parametric insurance as we continue to maintain it is an appropriate change in expenditure from trend, and more appropriate mechanisms to address the impact of cyclones than pass through mechanisms or self insurance.

Further information can be found in our supporting documentation:

- *06.01.04 – (Revised) Step Changes for Operating Costs*
- *Parametric Insurance – Response.*

6.3 Inappropriately assessing increased overheads allocated to operating expenditure as a step change

The AER assessed Ergon Energy's forecast increase in operating expenditure overheads based on the allocation under the AER-approved CAM as a step change. It excluded this step change from its alternative operating expenditure forecast.

The AER incorrectly assumes the estimate of base operating expenditure already provides a sufficient allowance for Ergon Energy to efficiently deliver Standard Control Services, given our operating environment. There is no basis for this, nor is there any basis for putting aside NER requirements in regards to compliance with the AER-approved CAM.

The AER recognised a service provider's operating expenditure may be affected by how much of its expenditure is expensed and how much of it is capitalised. The AER had regard to Ergon Energy's capitalisation policy when it assessed our operating environment factors in estimating its forecast of base operating expenditure consistent with the operating expenditure criteria (see appendix A). Therefore, the AER’s estimate of base operating expenditure already incorporates the effect of capitalisation policy differences.

In respect of our proposed CAM, the AER made the following determination on 15 August 2014:

> “We consider the CAM proposed by Ergon Energy gives effect to and is consistent with our guidelines and the rules. We therefore approve, under clause 6.15.4(c) of the rules, Ergon Energy's proposed CAM”.[20]

Any operating expenditure forecast must demonstrate that it relates to expenditure “properly allocated to *standard control services”* in accordance with the principles and policies set out in the CAM.[21]

Because of the operation of the CAM the AER approved for Ergon Energy, the forecast for Standard Control Service operating expenditure cannot be developed in isolation. Rather, Ergon Energy’s operating expenditure forecast must been developed through:

- the application of a BST methodology to direct operating Standard Control Service costs
- the allocation of forecast overhead costs for direct operating Standard Control Service costs on a basis consistent with the CAM (noting that relevant overhead costs have been subject to BST).

The AER’s Guideline for assessing operating expenditure cannot excuse it from determining a regulatory proposal consistent with NER requirements. We ask that the AER, when revoking and substituting its determination, reconsider its obligations in relation to its own approved CAM.

[20] AER (2014), *Final Decision, Ergon Energy Revised Cost Allocation Method*, 15 August 2014.

[21] NER, clause 6.5.7(b)(2).

7. Other costs that are not included in the base year (Step 5)

7.1. Debt raising costs

In the AER's fifth step, further adjustments are made to the operating expenditure forecast to achieve the operating expenditure objectives.

For instance, the AER's approach is to forecast debt raising costs based on a benchmarking approach rather than a service provider's actual costs. This is done to be consistent with the forecast of the cost of debt in the rate of return building block.

The AER's decision on debt raising costs and our response are provided in our supporting submission, *Rate of Return (Cost of debt) – Response*.

7.2. Costs not included in forecasts – impact of opex if capex reduced

Our forecasts are based on a normalised recurrent maintenance programs based on planned repex planning. However, the AER made substantial reductions to Ergon Energy's planned capital expenditure program. Should the AER continue with reduction to repex funding in the order of magnitude as advised in its preliminary decision, Ergon Energy will be unable to replace the volume of assets as detailed in its proposal. Ergon Energy's general approach will be to prioritise funding to achieve those programs with safety as prime driver.

A reduction in overall repex funding will result in less assets being replaced under planned circumstances. In effect, a higher risk level will prevail. To manage this risk, additional opex will be required to facilitate higher levels of asset inspection and maintenance, with additional operational and safety precautions introduced to ensure safe working and management of the power network. In other words, the AER's decision to reduce forecast capital expenditure will require necessary substitution of operating expenditure to address the reduction in planned replacement.

Ergon Energy estimates this consequence will be of the order of $10 million (direct, $2014-15) for the 2015-20 regulatory period with cash flow impacting the latter years of the period as the assets that would have been replaced continue degrade over time.