



DRAFT DECISION

Evoenergy

Access Arrangement

2021 to 2026

Attachment 6

Operating expenditure

November 2020

© Commonwealth of Australia 2020

This work is copyright. In addition to any use permitted under the Copyright Act 1968, all material contained within this work is provided under a Creative Commons Attributions 3.0 Australia licence, with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos
- any illustration, diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright, but which may be part of or contained within this publication. The details of the relevant licence conditions are available on the Creative Commons website, as is the full legal code for the CC BY 3.0 AU licence.

Requests and inquiries concerning reproduction and rights should be addressed to the:

Director, Corporate Communications
Australian Competition and Consumer Commission
GPO Box 4141, Canberra ACT 2601

or publishing.unit@accc.gov.au.

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165

Email: AERInquiry@aer.gov.au

AER reference: 65197

Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Evoenergy for the 2021–26 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency carryover mechanism

Attachment 9 – Reference tariff setting

Attachment 10 – Reference tariff variation mechanism

Attachment 11 – Non-tariff components

Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

Contents

Note	2
Contents	3
6 Operating expenditure	4
6.1 Draft decision	4
6.2 Evoenergy's proposal	6
6.2.1 Stakeholder views	8
6.3 Assessment approach.....	11
6.3.1 Incentive regulation and the 'top-down' approach.....	12
6.3.2 Building an alternative estimate of total forecast opex	13
6.3.3 Interrelationships.....	19
6.4 Reasons for draft decision.....	19
6.4.1 Base opex	20
6.4.2 Rate of change.....	24
6.4.3 Step change	29
6.4.4 Category specific forecasts	30
6.4.5 Marketing costs	34
Shortened forms	36

6 Operating expenditure

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

This attachment outlines our assessment of Evoenergy's proposed opex forecast for the 2021–26 access arrangement period.

6.1 Draft decision

Our draft decision is to not accept Evoenergy's initial proposal but rather, to accept its amended proposal for a total opex forecast of \$171.0 million (\$2020–21) for the 2021–26 access arrangement period,¹ submitted on 1 October 2020.² Evoenergy initially proposed forecast total opex of \$176.1 million (\$2020–21) based on estimated opex in its base year (2019–20).³ It subsequently amended this proposal to update for actual audited 2019–20 opex which had become available since the proposal was submitted.

Our alternative estimate of forecast opex is \$0.2 million (\$2020–21), or 0.1 per cent, higher than Evoenergy's amended proposal. We are satisfied Evoenergy's amended proposal of forecast opex meets the opex criteria⁴ and the requirements for forecasts and estimates.⁵

Figure 6.1 compares the opex forecast we approve in this draft decision to Evoenergy's initial proposal, the forecasts we approved for 2010–21 and Evoenergy's actual opex in that period.

¹ Including debt raising costs.

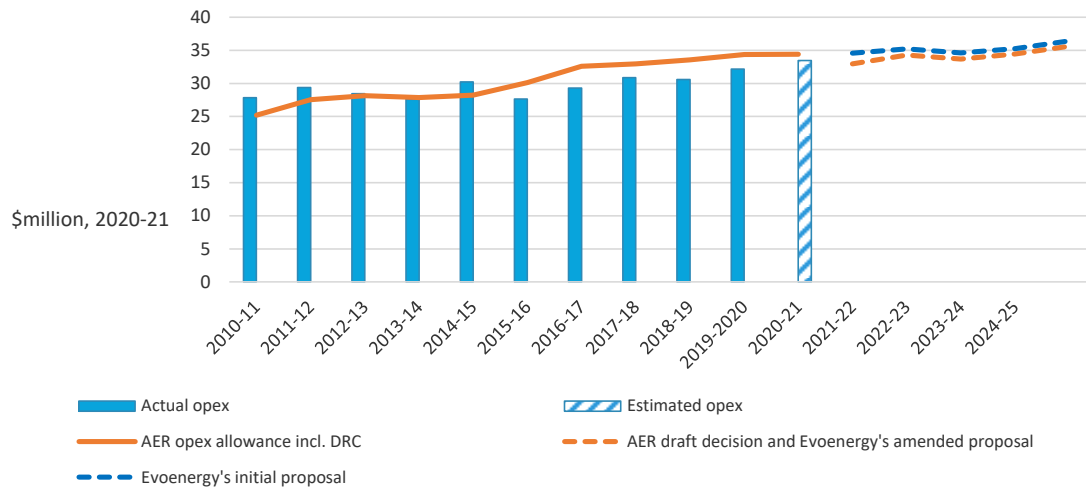
² Evoenergy, *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020.

³ Including debt raising costs; Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, p. 2-14 to 2-15.

⁴ National Gas Rules (NGR), r. 91.

⁵ NGR, r. 74.

Figure 6.1 AER's draft decision compared to Evoenergy's past and proposed opex (\$ million, 2020–21)



Source: Evoenergy, Annual RIN (various years); Evoenergy, *RIN 3 Workbook 1 Forecast Consolidated*, June 2020; AER, Final Decision – *ActewAGL Distribution access arrangement 2016–21 – Revenue forecast model – RFM PTRM*, May 2016; AER, Final Decision – *ActewAGL (ACT, Queanbeyan and Palerang) Access arrangement 2010–15, PTRM after appeal*, September 2010; Evoenergy, *Response to AER information request IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020; AER analysis.

Note: Includes debt raising costs, unaccounted for gas, utilities network facility tax, energy industry levy and IT access utilisation fee.

Table 6.1 sets out our draft decision (Evoenergy's amended forecast opex), our alternative opex estimate and Evoenergy's initial proposal.

Table 6.1 AER's draft decision on opex and Evoenergy's proposed opex for the 2021–26 access arrangement period (\$ million, 2020–21)

	Evoenergy's Initial Proposal (1)	AER's Draft Decision / Evoenergy's Amended Proposal (2)	AER's Alternative Opex Estimate (3)	Difference (3)–(2)
Based on reported opex in 2019–20	167.1	160.9	160.1	–0.8
Base year adjustments	–54.3	–53.7	–50.8	2.9
2019–20 to 2020–21 increment	0.1	0.1	0.1	–
Output growth	2.1	2.0	2.0	–
Price growth	1.6	1.5	0.3	–1.2
Productivity growth	–1.7	–1.6	–1.6	–
Step changes	2.3	2.3	2.1	–0.2
Category specific forecasts	57.9	58.5	57.9	–0.6
Total opex (excluding debt raising costs)	175.1	170.0	170.1	0.1
Debt raising costs	1.0	1.0	1.1	0.1
Total opex (including debt raising costs)	176.1	171.0	171.2	0.2

Source: Evoenergy, *2021–26 Access Arrangement Proposal – Appendix 2.1 – Opex Model*, June 2020; Evoenergy, *Response to AER Information request IR003 – Opex Model*, 1 October 2020; AER analysis.

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

We have not included some aspects of Evoenergy's proposal in our alternative estimate, such as the labour price index (WPI) forecast from BIS Oxford Economics, which we consider do not reflect a realistic expectation of labour prices as it was produced at the onset of the COVID-19 pandemic. However, this is offset by other factors, with the result that overall there is no difference between our alternative estimate and Evoenergy's amended proposal.

6.2 Evoenergy's proposal

Evoenergy used a 'base–step–trend' approach to forecast opex for the 2021–26 access arrangement period, consistent with our preferred approach. Evoenergy submitted its initial opex proposal of \$176.1 million (\$2020–21) to us on 26 June 2020, which was based on estimated opex for its proposed base year (2019–20).⁶

⁶ Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, pp. 2-14 to 2-15.

On 1 October 2020, Evoenergy amended its opex proposal to \$171.0 million (\$2020–21), using audited 2019–20 opex (see Table 6.1).⁷

In applying our base-step-trend approach to forecast opex, Evoenergy:

- Used reported opex in 2019–20 as the base for forecasting its opex over the 2021–26 period. If no other adjustments were made, this would lead to a base opex of \$160.9 million (\$2020–21).⁸
- Then adjusted its base opex by:
 - Removing category specific forecasts made up of unaccounted for gas (UAG), Utilities Network Facility tax (UNFT), Energy Industry Levy (EIL) and IT Asset Utilisation Fee (ITAU). This reduced its opex forecast by \$53.7 million (\$2020–21).
 - Applying the approach in the *Expenditure forecast assessment guideline* (the Guideline) to calculate the 2019–20 to 2020–21 opex increment (to arrive at the starting point for its forecast).⁹ This reduced its opex forecast by \$0.1 million (\$2020–21).
- Applied its overall rate of change forecast to its adjusted base opex, increasing it by \$1.9 million (\$2020–21). Evoenergy forecast output growth of \$2.0 million (\$2020–21), input price growth of \$1.5 million (\$2020–21) and productivity growth reduced its forecast opex by \$1.6 million (\$2020–21).
- Proposed one step change for expensing pigging and inspection costs, which are capitalised in the 2016–21 access arrangement period. This increased its opex forecast by \$2.3 million (\$2020–21).
- Proposed four opex category specific forecasts totalling \$58.5 million (\$2020–21) for UNFT (\$45.3 million), UAG costs (\$9.5 million), EIL (\$3.2 million) and ITAU (\$0.6 million)
- Proposed debt raising costs of \$1.0 million (\$2020–21).

This resulted in Evoenergy proposing an amended total opex forecast of \$171.0 million (\$2020–21) for the 2021–26 access arrangement period.¹⁰ This is 9.3 per cent higher than Evoenergy's actual and estimated opex for the 2016–21 access arrangement period.

⁷ Evoenergy, *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020.

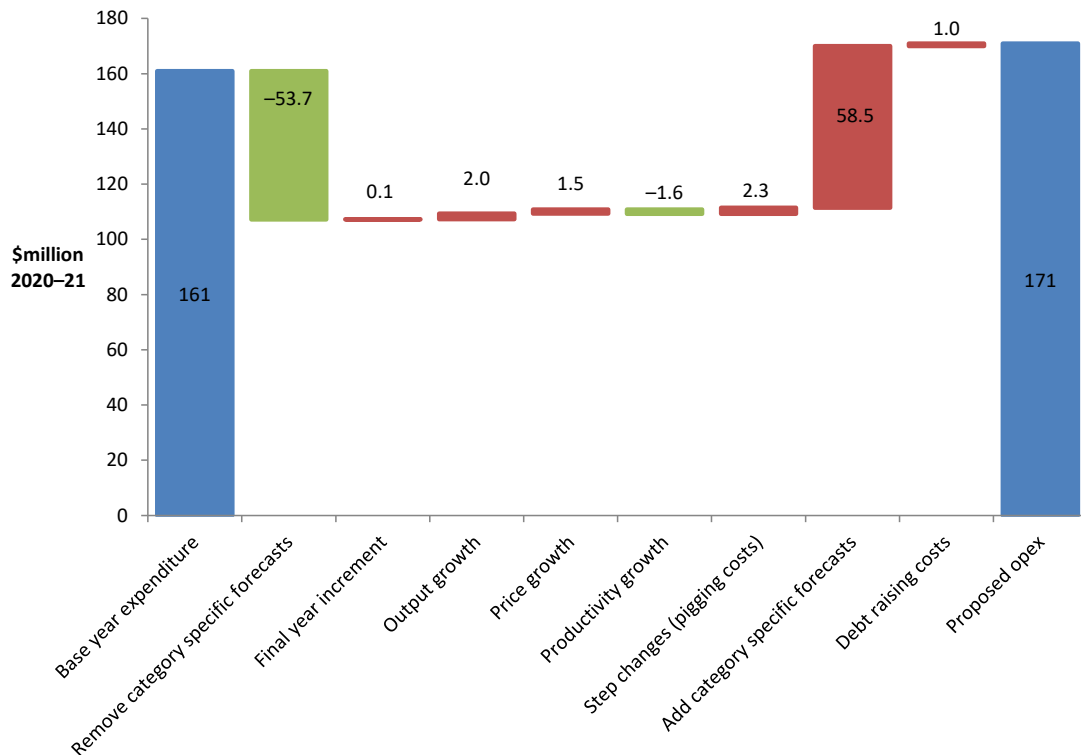
⁸ This is net of movements in provisions.

⁹ This increment is necessary to ensure we measure incremental efficiency gains accurately. This is discussed in: AER, *Better Regulation, Explanatory Statement, Expenditure forecast assessment guideline*, November 2013, pp. 62–65.

¹⁰ Evoenergy, *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020; includes debt raising costs.

Figure 6.2 shows the different elements that make up Evoenergy's amended opex forecast for the 2021–26 period.

Figure 6.2 Evoenergy's amended opex forecast for the 2021–26 access arrangement period (\$ million, 2020–21)



Source: Evoenergy, *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020.

6.2.1 Stakeholder views

We received submissions from seven stakeholders on Evoenergy's 2021–26 access arrangement proposal, a number of which raised issues on opex. While they were broadly supportive of the proposal, they raised concerns around the efficiency of base year opex including benchmarking results, the impact of the COVID-19 pandemic on the accuracy of the rate of change forecasts, UAG and marketing costs. We have taken these submissions into account in developing our positions set out in this draft decision. Table 6.2 summarises the opex issues raised in submissions.

Table 6.1 Submissions on Evoenergy's 2021–26 opex proposal

Stakeholder	Issue	Description
Consumer Challenge Panel (CCP24), Energy Consumers Australian (ECA)	Base opex	<p>CCP24 raised concerns about the findings of Economic Insights' which outline that "Evoenergy's normalised real opex per customer is similar to the sample average." benchmarking for Evoenergy. CCP24 considered that 'average' is not efficient.¹¹ CCP24 expects the AER to undertake an analysis of the appropriateness of the proposed base year and the robustness of Economic Insights analysis.¹²</p> <p>ECA considered that the AER should test whether it is appropriate to use 2019-20 as the base year because:¹³</p> <ul style="list-style-type: none"> • There has been a step increase in opex between 2018-19 to 2019-20, even after discounting the increase attributable to increases in the UNFT (\$0.46 million). • Some of the increases are in categories which appear to be within Evoenergy's control. • It is not clear the extent to which any of the benefits of Jemena's transformation program have flowed onto Evoenergy under its asset management arrangement.
CCP24, ACT Council of Social Service (ACTCOSS), ECA, Origin, EnergyAustralia	Rate of change	<p>CCP24, ACTCOSS, ECA and Origin broadly supported Evoenergy's proposed rate of change approach because it is consistent with regulatory precedent. However, they suggested that wages increase assumption be tested further in light of COVID-19.¹⁴</p> <p>CCP24 considered that due to the impact of COVID-19, there will be a need for ongoing consumer engagement; revision of forecasts (including demand, connections, inflation, labour costs); and the potential need to re-consider Access Arrangement provisions post the final AER Decision.¹⁵</p> <p>Origin noted that Evoenergy's labour costs are forecast to increase an average 0.83 per cent per year in real terms over the access arrangement period. It stated that in the current economic environment we would expect minimal (if any) growth in labour costs at least in the short-term.¹⁶</p> <p>CCP24 and EnergyAustralia questioned whether Evoenergy's proposed productivity grow forecast of 0.5 per cent is appropriate given it is lower than the lower band of Economic Insights' benchmarking results. Economic</p>

¹¹ CCP24, *Advice to Australian Energy Regulator on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 26.

¹² Ibid., p. 27.

¹³ Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slides 21–22.

¹⁴ CCP24, *Advice to Australian Energy Regulator on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 48; ACTCOSS, *Submission: Evoenergy's gas network 2021–26 access arrangement proposal to the Australian Energy Regulator*, August 2020, p. 23; Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22.

¹⁵ CCP24, *Advice to Australian Energy Regulator on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 5.

¹⁶ Origin Energy, *Evoenergy access arrangement proposal*, August 2020, p. 2.

Stakeholder	Issue	Description
		Insights' report shows 'frontier shift' is between 0.54 and 1.35 per cent per annum; with an intermediate estimate of 0.95. ¹⁷
ECA	Step change	ECA supported the proposed pigging costs step change. ¹⁸ However, EnergyAustralia questioned the extent to which this reflects incentives arising from stranding risk. ¹⁹
CCP24, ECA	Opex category specific forecasts	<p>CCP24 encouraged the AER to undertake a network wide analysis of UAG to assess how Evoenergy performs against other gas distribution networks. It also encouraged the AER to examine Evoenergy's gas procurement arrangements to give comfort to consumers that competitive processes and sourcing options were used.²⁰</p> <p>ECA considered that the AER should explore why UAG volumes are higher at a time when consumption has reduced. They expected the AER to require further information on how UAG is calculated. Particularly, the basis for which the unit cost estimate for replacement gas is derived, given that it is supplied by a related party (Jemena).²¹ ECA also noted that more information is required to substantiate an increase in insurance premiums while acknowledging this is a cost pass through.</p> <p>ECA queried why the ITAUF should be included in opex forecast. They also noted that it is not clear how its cost was calculated.²²</p>
CCP24, ACTCOSS, ECA, EnergyAustralia	Marketing opex	<p>CCP24, ACTCOSS, ECA, EnergyAustralia raised concerns about marketing cost included in forecast opex.²³</p> <p>CCP24 suggested that marketing should be a negative step change. It stated: <i>"The base year costs for 2019/20 include ~\$1.1m in marketing for the 'gas rewards' cash back programme. In our Advice on the Draft Plan we argued that the justification for a continuation of marketing costs seems inconsistent with ACT Government policy..."</i>²⁴</p> <p>ACTCOSS and ECA considered that further information is required to justify inclusion of marketing costs in opex forecast. While ACTCOSS supports programs that deliver measurable outcomes of improved efficiency in use of</p>

¹⁷ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 27; EnergyAustralia, *Evoenergy – Proposed Access arrangement 2021–26 – 1 July 2020*, August 2020, p. 2.

¹⁸ Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22.

¹⁹ EnergyAustralia, *Evoenergy – Proposed Access arrangement 2021–26 – 1 July 2020*, August 2020, p. 2.

²⁰ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 27.

²¹ Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22.

²² Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–2 submission*, August 2020, Slide 22.

²³ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 28; ACTCOSS, *Submission: Evoenergy's gas network 2021–26 access arrangement proposal to the Australian Energy Regulator*, August 2020, p. 21; Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22; EnergyAustralia, *Evoenergy – Proposed Access arrangement 2021–26 – 1 July 2020*, August 2020, p. 2.

²⁴ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 28.

Stakeholder	Issue	Description
		appliances, it is not clear how this fits into the transformation roadmap that Evoenergy is promoting. ²⁵

6.3 Assessment approach

Our role is to decide whether or not to accept a business' forecast opex. We approve the business' forecast opex if we are satisfied that it meets with the opex criteria. The opex criteria require that:

"Operating expenditure must be as such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services."²⁶

In deciding whether forecast opex meets the opex criteria, we also apply the forecasting and estimate requirements under the National Gas Rules (NGR):

"A forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances."²⁷

We use a form of incentive based regulation to assess the business' forecast opex over the access arrangement period at a total level. To do so, we develop an alternative estimate of total opex using a 'top-down' forecasting method, known as the 'base-step-trend' approach.²⁸

Once we have developed our alternative estimate of total opex, we compare it with the business' total opex forecast to form a view on the reasonableness of the business' proposal. If we are satisfied the business' total forecast meets the NGR requirements, we accept the forecast. If we are not satisfied, we substitute the business' forecast with our alternative estimate.

In making this decision, we take into account the reasons for the difference between our alternative estimate and the business' forecast, and the materiality of that difference. We also take into consideration the interrelationships between the opex forecast and other constituent components of our decision, such that our decision is likely to contribute to the achievement of the National Gas Objective (NGO).²⁹

²⁵ ACTCOSS, *Submission: Evoenergy's gas network 2021–26 access arrangement proposal to the Australian Energy Regulator*, August 2020, p. 21; Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22.

²⁶ NGR, r. 91.

²⁷ NGR, r. 74(2).

²⁸ A 'top-down' approach forecasts total opex at an aggregate level, rather than forecasting individual projects or categories to build a total opex forecast from the 'bottom up'.

²⁹ NGL, s. 28(1).

6.3.1 Incentive regulation and the 'top-down' approach

Incentive regulation is designed to prevent network businesses from exploiting their natural monopoly position by setting prices in excess of efficient costs.³⁰ A key feature of the regulatory framework is that it is based on incentivising networks to be as efficient as possible. We apply incentive-based regulation across the energy networks we regulate, including gas networks. More specifically for opex, we rely on the efficiency incentives created by both ex ante revenue regulation (where an opex allowance is granted over a multi-year regulatory period) and the efficiency carryover mechanism (ECM).³¹

The incentive-based regulatory framework partially overcomes the information asymmetries between the regulated businesses and us.³² It is intended to align the commercial goals of the network businesses to the objectives of the regulatory regime—especially the long term interests of consumers (the NGO).

Incentive regulation aligns these goals by encouraging regulated businesses to reduce costs below our forecast, in order for them to make higher profits, and 'reveal' their costs in doing so. The information revealed by the businesses allows us to develop better expenditure forecasts over time. Revealed opex reflects the efficiency gains made by a business over time. As a network business becomes more efficient, this translates to lower forecasts of opex in future regulatory periods, which means consumers also receive the benefits of the efficiency gains made by the business. Incentive regulation therefore aligns the business' commercial interests with consumer interests.

The Productivity Commission explains:

"Under incentive regulation, the regulator forecasts efficient aggregate costs over the upcoming regulatory period (of usually five years), which it uses to set a revenue allowance for that period. The business makes higher profits if it reduces costs below those forecast by the regulator. In doing so, the business reveals the efficient costs of delivering the service, which would then influence the regulator's determination in the next period. Accordingly, incentive regulation encourages efficiency while reducing the risks that networks use their monopoly positions to set unreasonably high prices."³³

Incentive regulation is designed to leave the day-to-day decisions to the network businesses.³⁴ It allows the network businesses the flexibility to manage their assets and labour as they see fit to comply with the opex criteria³⁵ and achieve the NGO.³⁶

³⁰ Productivity Commission, *Electricity Network Regulatory Frameworks, volume 1, No. 62*, April 2013, p. 188.

³¹ The approach we apply to assessing a business' opex (and which we have applied in this decision) is more fully described in the Expenditure Assessment Guideline and its accompanying explanatory materials, which are published on the [AER's website](#).

³² Productivity Commission, *Electricity Network Regulatory Frameworks, volume 1, No. 62*, April 2013, p. 189.

³³ Productivity Commission, *Electricity Network Regulatory Frameworks, volume 1, No. 62*, April 2013, p. 27.

³⁴ Productivity Commission, *Electricity Network Regulatory Frameworks, volume 1, No. 62*, April 2013, pp. 27–28.

³⁵ NGR, r. 91.

³⁶ NGL, s. 28(1).

Our general approach is to assess whether opex, in aggregate, is sufficient to satisfy the opex criteria over the access arrangement period, rather than to assess individual opex projects or programs. To do so, we develop an alternative estimate of total opex using the 'base-step-trend' forecasting approach (section 6.3.2). This is generally a 'top-down' approach, but there may be circumstances where we need to use 'bottom-up' analysis, particularly in relation to our base opex assessment and for step changes.³⁷

6.3.2 Building an alternative estimate of total forecast opex

As a comparison tool to assess a business' opex forecast, we develop an alternative estimate of the business' total opex requirements in the forecast period, using the base-step-trend forecasting approach. We apply the forecasting and estimate requirements under the NGR.³⁸

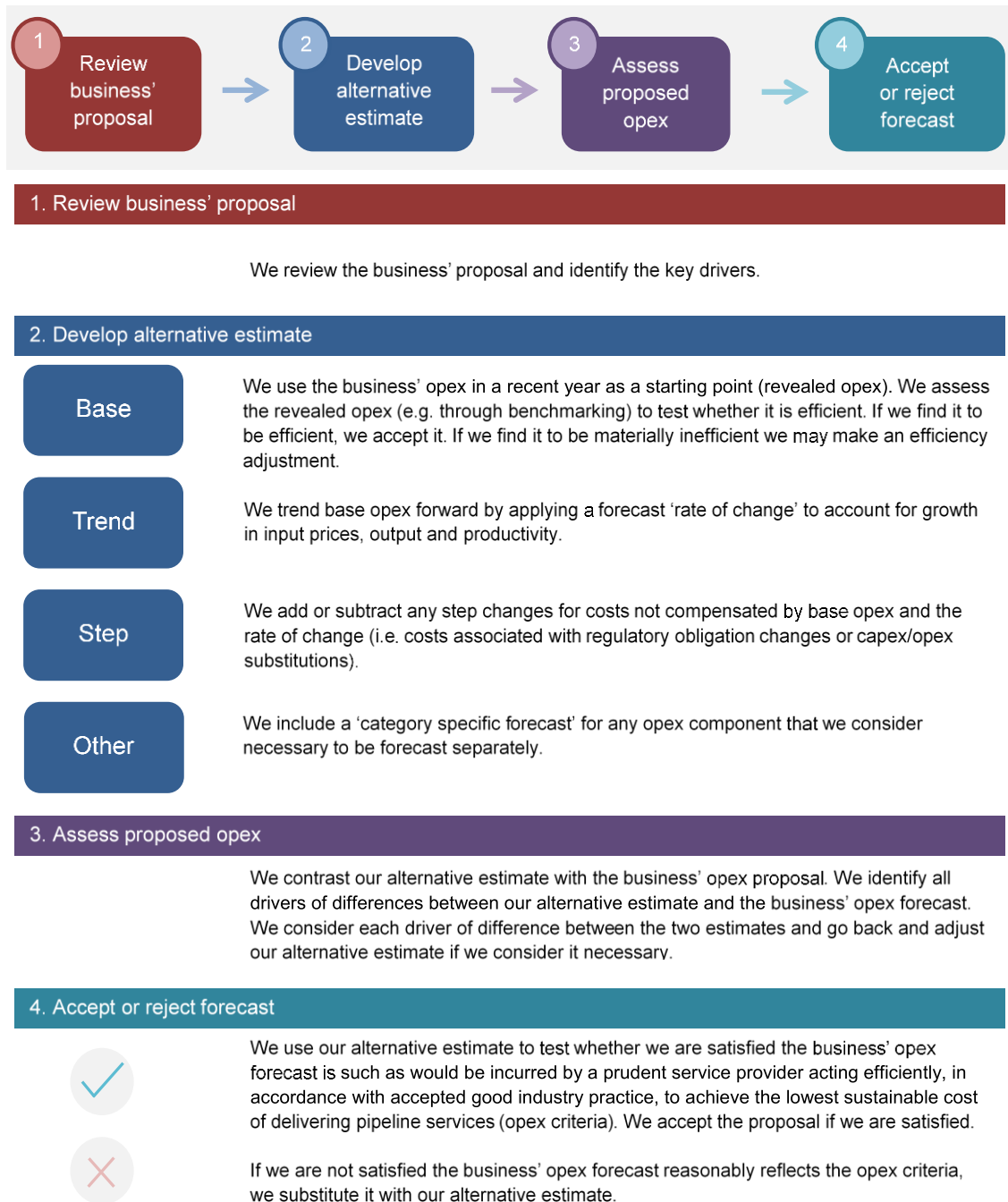
If a business adopts a different forecasting approach to derive its opex forecast, we develop an alternative estimate and assess any differences with the business' forecast opex.

Figure 6.3 summarises the base-step-trend forecasting approach.

³⁷ A 'top-down' approach forecasts total opex at an aggregate level, rather than forecasting individual projects or categories to build a total opex forecast from the 'bottom up'.

³⁸ NGR, r. 74(2).

Figure 6.1 AER's opex assessment approach



6.3.2.1 Base opex

If we find the business is operating efficiently, our preferred methodology is to use the business' historical or 'revealed' costs in a recent year as a starting point for our opex forecast.

We do not simply assume the business' revealed opex is efficient. It may include an ongoing level of inefficient expenditure. We use the business' actual opex in a single year as the starting point for our alternative estimate. This is the base opex.

We rely on the incentives under revenue regulation and any applicable efficiency incentive scheme to determine whether a business' 'revealed' opex is efficient.³⁹ We also assess the evidence the business submits to demonstrate the efficiency of its base opex.

To the extent that it is available, we may use benchmarking to test the efficiency of the base opex. Benchmarking is a way of determining how well a network business is performing against its peers and over time, and provides valuable information on what is 'best practice'.

If there are indications the business' revealed opex is inefficient, we may apply an efficiency adjustment to derive a base opex that complies with the opex criteria.

We consider revealed opex in the base year is generally a good indicator of opex requirements over the next access arrangement period because the level of *total opex* is relatively stable from year to year. This reflects the broadly predictable and recurrent nature of opex.

A business may experience fluctuations in particular categories of opex, and the composition of total opex can change, from year-to-year. While many operations and maintenance activities are recurrent and non-volatile, some opex projects follow periodic cycles that may or may not occur in any given year, and some opex projects are non-recurrent.

Even if disaggregated opex categories have high volatility, the total opex varies to a lesser extent because new or increasing components of opex are generally offset by decreasing costs or discontinued opex projects. Further, we expect the regulated business to manage the inevitable 'ups and downs' in the components of opex from year-to-year—to the extent they do not offset each other— by continually re-prioritising its work program, as would be expected in a workably competitive market. Our incentive-based, revealed cost, framework incentivises them to do so.

We also note that any volatility of total opex from year-to-year does not typically affect our choice of the appropriate base year when an ECM applies. A consequence of the operation of the ECM is that the forecast opex allowance (including ECM rewards and

³⁹ NGR, r. 71(1). We may infer opex is efficient without embarking on a detailed investigation, from the operation of an incentive mechanism.

penalties) is largely uninfluenced by the choice of base year. For example, although using a base year with unusually high opex would typically result in an increased opex forecast, this would be offset by a lower ECM reward (or a greater penalty).

If the business has demonstrated its ability to satisfy its obligations and service demand using its revealed costs, any further adjustments to base opex risk introducing a bias into the forecast—including through bottom-up type assessments. We therefore carefully scrutinise any such proposed adjustments.

6.3.2.2 Rate of change

We trend base opex forward by applying our forecast 'rate of change'. We estimate the rate of change by forecasting the expected growth in input prices, outputs and productivity. We consider that the rate of change takes into account almost all relevant sources of opex growth.

We forecast input price growth using a composition of labour and non-labour price change forecasts. To determine the input price weights for labour and non-labour prices, we have regard to the input price weights of a prudent and efficient benchmark business. Consistent with incentive regulation, this provides the business an incentive to adopt the most efficient mix of inputs throughout the access arrangement period but does not prevent the business from adopting its own mix of inputs.

We forecast output growth to account for the annual increase in output of services provided. The output measures used should, ideally, be the same measures used to forecast productivity growth. Productivity measures the change in output for a given amount of input. If the output measures differ from the productivity measures, they would be internally inconsistent and we cannot compare them like for like.

The output measures we typically use for gas distribution businesses are customer numbers, mains length, and energy throughput. We do not typically adjust forecast output growth for economies of scale because we account for these in our forecast of productivity growth.

Our forecast of opex productivity growth captures the sector-wide, forward-looking, improvements in good industry practice that should be implemented by efficient distributors as part of business-as-usual operations. For gas distribution, we generally base our estimate of productivity growth on recent productivity trends.

6.3.2.3 Step changes and category-specific forecasts

Lastly, we add or subtract any components of opex that are not adequately compensated for in base opex or the rate of change, but which should be included in the forecast total opex to meet the opex criteria. These adjustments are in the form of 'step changes' or 'category-specific forecasts'.

Step changes

Step changes should not double count costs included in other elements of the total opex forecast. For example, the costs of increased volume or scale should be

compensated for through the output growth component of the rate of change and, as such, should not be accommodated through a step change. In addition, forecast productivity growth may account for the cost of increased regulatory obligations over time—that is, 'incremental changes in obligations are likely to be compensated through a lower productivity estimate that accounts for higher costs resulting from changed obligations.'⁴⁰ Therefore, we consider only new costs that do not reflect the historic 'average' change as accounted for in the productivity growth forecast require step changes.

To increase its opex forecast, a regulated business has an incentive to identify new costs not reflected in base opex or costs increasing at a greater rate than the rate of change. It has no corresponding incentive to identify those costs that are decreasing or will not continue. Information asymmetries make it difficult for us to identify those future diminishing costs. Therefore, simply demonstrating that a new cost will be incurred—that is, a cost that was not incurred in the base year—is not a sufficient justification for introducing a step change. There is a risk that including such costs would upwardly bias the total opex forecast.

The test we apply is whether the step change is needed for the opex forecast to comply with the opex criteria.⁴¹ Our starting position is that only exceptional circumstances would warrant the inclusion of a step change in the opex forecast because they may change a business' fundamental opex requirements. Two typical examples are:

- a material change in the business' regulatory obligations
- an efficient and prudent capex/opex substitution opportunity.

We may accept a step change if a material 'step up' or 'step down' in expenditure is required by a network business to prudently and efficiently comply with a new, binding regulatory obligation that is not reflected in the productivity growth forecast. This does not include instances where a business has identified a different approach to comply with its existing regulatory obligations that may be more onerous, or where there is increasing compliance risks or costs, the business must incur to comply with its regulatory obligations. Often when a new regulatory obligation is imposed on a business, it will incur additional expenditure to comply. The business may be expected to continue incurring such costs associated with the new regulatory obligation into future access arrangement periods; hence, an increase in its opex forecast may be warranted.

We expect the business to provide evidence demonstrating the material impact the change of regulatory obligation has on its opex requirements, and robust cost–benefit analysis to demonstrate the proposed step change expenditure is prudent and efficient to meet the change in regulatory obligations.

⁴⁰ AER, *Expenditure forecast assessment guideline, Explanatory statement*, November 2013, p. 52.

⁴¹ NGR, r. 91.

By contrast, proposed opex projects designed to improve the operation of the business, which we consider as discretionary in the absence of any legal requirement, should be funded by base opex and trend components, together with any savings or increased revenue that they generate—rather than through a step change. Otherwise, the business would benefit from a higher opex forecast *and* the efficiency gains.

We may also accept a step change in circumstances where it is prudent and efficient for a network business to increase opex in order to reduce capital costs. We would typically expect such capex/opex trade-off step changes to be associated with replacement expenditure (or repex). The business should provide robust cost–benefit analysis to demonstrate clearly how increased opex would be more than offset by capex savings.

In the absence of a change to regulatory obligations or a legitimate capex/opex trade-off opportunity, we would accept a step change under limited circumstances. We would consider whether the costs associated with the step change are unavoidable and material—such that base opex, trended forward by the forecast rate of change, would be insufficient for the business to recover its efficient and prudent costs. We would also consider whether the business would continue to incur the costs of a proposed step change in future access arrangement periods.

Category specific forecasts

A category specific forecast is a forecast of an opex item or activity that is assessed and forecast independently from base opex, and is not subject to the ECM.

A category specific forecast may be justified if, as a result of including a specific opex category in the base opex, total opex becomes so volatile that it undermines our assumption that total opex is relatively stable and follows a predictable path over time.

We may also use category specific forecasts to avoid inconsistency or double counting within our regulatory decision. For example, we forecast debt raising costs separately to provide consistency with the forecast of the cost of debt in the rate of return building block of total revenue.

Absent such exceptions, we expect that base opex, trended forward by the rate of change, will allow the business to recover its prudent and efficient costs. This is a reasonable assumption given that the business has operated in the past with that level of opex, demonstrating that it is able to operate prudently and efficiently in meeting all its existing regulatory obligations, including its safety and reliability standards.

We consider it is also reasonable to expect the same outcome looking forward with the increase provided through the trend growth in the base opex. Some costs may go up, and some costs may go down—so despite potential volatility in the cost of certain individual opex activities, total opex is generally relatively stable over time.

For similar reasons as noted above in relation to step changes, we consider providing a category specific forecast for opex items identified by the business that may upwardly bias the total opex forecast. By applying our revealed cost approach

consistently and carefully scrutinising any further adjustments, we avoid this potential bias.

6.3.3 Interrelationships

In assessing Evoenergy's total forecast opex, we also took into account other components of its access arrangement proposal that could interrelate with our opex decision. The matters we considered in this regard included:

- the operation of the ECM in the 2016–21 access arrangement period, which provides Evoenergy an incentive to reduce opex in the base year
- our assessment of forecast demand growth, including Evoenergy's forecast growth in customer numbers and mains length, which we used to forecast output growth
- the impact of cost drivers that affect both forecast opex and forecast capex, including forecast labour price growth
- our assessment of the rate of return, to ensure there is consistency between our determination of debt raising costs and the rate of return building block
- interactions and trade-offs between the opex and capex proposals, including Evoenergy's proposal to expense its pigging costs
- the outcomes of Evoenergy's consumer engagement in developing its regulatory proposal.

6.4 Reasons for draft decision

Our draft decision is to not accept Evoenergy's initial proposal but rather, to accept its amended proposal for a total opex forecast of \$171.0 million (\$2020–21) for the 2021–26 access arrangement period,⁴² submitted on 1 October 2020.⁴³ Evoenergy initially proposed forecast opex of \$176.1 million (\$2020–21) based on estimated opex in its base year (2019–20).⁴⁴ It subsequently amended this proposal by updating for audited 2019–20 opex.

Our alternative estimate of forecast opex is \$0.2 million (\$2020–21), or 0.1 per cent, higher than Evoenergy's amended proposal.⁴⁵ We are satisfied Evoenergy's amended proposal of forecast opex meets the opex criteria⁴⁶ and the requirements for forecasts and estimates.⁴⁷

⁴² Including debt raising costs.

⁴³ Evoenergy, *Response to AER IR003 Attachment 1 Evoenergy gas network 2021-26 revised opex model*, 1 October 2020.

⁴⁴ Evoenergy, *2021–26 Access Arrangement Proposal – Attachment 2.1 – Opex Model*, June 2020

⁴⁵ Including debt raising costs.

⁴⁶ NGR, r. 91.

⁴⁷ NGR, r. 74.

Table 6.3 sets out our draft decision (Evoenergy's amended forecast opex), our alternative opex estimate and Evoenergy's initial proposal.

Table 6.3 AER's draft decision on opex and Evoenergy's proposed opex for the 2021–26 access arrangement period (\$ million, 2020–21)

	Evoenergy's Initial Proposal (1)	AER's Draft Decision / Evoenergy's Amended Proposal (2)	AER's Alternative Opex Estimate (3)	Difference (3)–(2)
Based on reported opex in 2019–20	167.1	160.9	160.1	–0.8
Base year adjustments	–54.3	–53.7	–50.8	2.9
2019–20 to 2020–21 increment	0.1	0.1	0.1	–
Output growth	2.1	2.0	2.0	–
Price growth	1.6	1.5	0.3	–1.2
Productivity growth	–1.7	–1.6	–1.6	–
Step changes	2.3	2.3	2.1	–0.2
Category specific forecasts	57.9	58.5	57.9	–0.6
Total opex (excluding debt raising costs)	175.1	170.0	170.1	0.1
Debt raising costs	1.0	1.0	1.1	0.1
Total opex (including debt raising costs)	176.1	171.0	171.2	0.2

Source: Evoenergy, *2021–26 Access Arrangement Proposal – Attachment 2.1 – Opex Model*, June 2019; *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020; AER analysis.

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

We have not included some aspects of Evoenergy's proposal in our alternative estimate, such as the labour price index (WPI) forecast from BIS Oxford Economics, which we consider do not reflect a realistic expectation of labour prices as it was produced at the onset of the COVID-19 pandemic. However, this is offset by other factors, with the result that overall there is not a material difference between our estimate and Evoenergy's amended proposal.

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

6.4.1 Base opex

We have used base opex of \$21.9 million (\$2020–21) for each year of the 2021–26 access arrangement period or \$109.4 million over five years to form our alternative estimate of forecast opex. This is slightly higher than Evoenergy's amended proposal of \$21.5 million (\$2020–21) each year or \$107.3 million over five years because while we have updated inflation forecasts published by the Reserve Bank of Australia

(RBA)⁴⁸ and we have not removed the ITAUF from base year opex for the reasons set out below. We consider our inflation forecasts are the best forecast possible in the circumstances because they are the most up-to-date information available at the time of our assessment.⁴⁹

Table 6.4 sets out our estimate of Evoenergy's base opex, which we explain further in the sections below.

Table 6.4 AER's forecast of base opex (\$ million, 2020–21)

	Our base opex
Reported 2019–20 opex (unadjusted for movements in provisions)	32.1
Remove reported movement in provisions	0.1
Reported 2019–20 opex	32.0
Add estimated change in opex between the base year and the final year	0.1
Estimated final year opex	32.1
Remove category specific forecasts	10.2
Base opex	21.9

Source: AER analysis

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

6.4.1.1 Choice of base year

We have used 2019–20 as the base year consistent with Evoenergy's amended proposal. In its initial proposal submitted on 26 June 2020, Evoenergy used estimated opex in 2019–20 as the starting point to forecast total opex over the 2021–26 access arrangement period. Evoenergy estimated 2019–20 opex, which included actual opex to the end of January 2020 and estimates for the remainder of the year, to be 10 per cent higher than historical annual average opex over the first four years of the 2016–21 access arrangement period.⁵⁰ We questioned the estimated increase as it was significantly higher than actual annual spend.⁵¹ Stakeholder submissions also raised concerns around increase in opex between 2018–19 and 2019–20, and suggested we test whether it is appropriate to use 2019–20 as the base year.⁵²

⁴⁸ RBA, *Statement on Monetary Policy—Appendix: Forecast*, August 2020.

⁴⁹ NGR, r. 74(2).

⁵⁰ Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, pp. 2–6.

⁵¹ AER, *Information request 003 to Evoenergy*, 21 August 2020.

⁵² Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slides 21–22.

In response to our request for clarification, Evoenergy submitted audited actual 2019–20 opex. This showed 2019–20 opex to be lower than previously estimated but still 8.7 per cent higher than the historical annual average opex in the 2016–21 period. It also provided an amended opex forecast to \$171.0 million, based on the audited 2019–20 opex.⁵³ Further, Evoenergy explained:

“Opex is 2019–20 is materially different to previous years due to an uplift in project costs associated with the 2021–26 access arrangement review. Given the relatively small size of Evoenergy’s gas network business, our opex is sensitive to these ‘lumpy’ project costs. This issue, and its interdependency with the efficiency carryover mechanism (ECM) adjustments, was examined in detail in the 2016–21 access arrangement review, as discussed in Attachment 7 – Operating expenditure | Final Decision: ActewAGL Distribution Access Arrangement 2016–21, pages 13–15. There is also discussion in our response to the AER’s draft decision - 2016–21 access arrangement.”⁵⁴

We acknowledge that the sensitivity to Evoenergy’s total opex to the lumpy nature of access arrangement costs was considered in our 2016–21 determination.⁵⁵ We recognise some cost categories are higher in some years and lower in others but a key consideration when selecting an appropriate base year is not whether an individual cost category is lumpy but whether the total opex is lumpy.⁵⁶ We consider opex typically to be relatively predictable over time. As shown in Figure 6.1, Evoenergy’s opex has been relatively stable over 2010–20.

Evoenergy is subject to the incentives of an ex ante regulatory framework, including the application of the ECM for opex. Typically, where a service provider is subject to these incentives, we are satisfied there is a continuous incentive for a service provider to make efficiency gains and it does not have an incentive to increase its opex in the proposed base year.⁵⁷ The choice of a base year has interdependency with the ECM adjustments. Due to the application of ECM to Evoenergy, the base year choice does not make any material difference to its revenue. Any change to forecast opex from using a different base year is almost perfectly offset by a change in the carryovers it receives under the ECM.

We have also considered benchmarking undertaken by Economic Insights, which Evoenergy commissioned to assess the efficiency of its base year expenditure.⁵⁸ While the analysis in this report excludes Evoenergy’s proposed base year (2019–20), it provide useful insights over the period 1999–2019.

⁵³ Evoenergy, *Response to AER information request IR003*, 28 August 2020, Question 6.

⁵⁴ Evoenergy, *Response to AER information request IR003*, 28 August 2020, Question 6.

⁵⁵ AER, *Final Decision: ActewAGL Distribution Access Arrangement 2016–21 Attachment 7 – Operating expenditure* May 2016, pp. 13–15

⁵⁶ AER, *Explanatory Statement Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 29.

⁵⁷ NGR, r. 71(1).

⁵⁸ Economic Insights, *Relative efficiency & forecast productivity of Evoenergy*, April 2020.

Benchmarking is a way of determining how well a network business is performing against its peers and over time, and provides valuable information on what is 'best practice'. We do not do annual benchmarking analysis of gas distribution networks, like we do for electricity distributors. Nonetheless, numerous benchmarking studies have been done of gas distributors that provide useful insights.

Economic Insights considered that Evoenergy's average opex per customer was below the average opex per customer for the other (six) gas distribution networks with lowest customer density.⁵⁹ It suggested Evoenergy appears to have performed better than the average for gas distribution businesses with relatively low customer density. However, Economic Insights cautioned against drawing inference from this outcome, stating that partial performance indicators (PPIs) do not enable influences such as scale economies or different mixes of inputs to be controlled for in a rigorous fashion.

We consider conclusions from the benchmarking undertaken by Economic Insights should be treated with caution. This analysis is limited by the small sample size of gas distribution businesses and it is difficult to test some of the underlying data sources—among other things.

Our review of Evoenergy's opex over time has not identified any significant inefficiencies. In the absence of any evidence suggesting to the contrary, we are satisfied that the 2019–20 base year opex is not materially inefficient.

6.4.1.2 Exclusions from base year

In choosing a base year, we need to decide whether any categories of opex incurred in the base year should be removed. We have removed movements in provisions⁶⁰ from the base year, consistent with our standard approach. We consider that changes in provisions should not be treated as actual reported opex for forecasting purposes. This is because changes in provisions reflect estimates of costs rather than the actual cost incurred in delivering network services.

In some circumstances a particular category of opex may be removed from the base year expenditure if it is more appropriate to forecast that category separately. We refer to these as 'category specific forecasts' (see section 6.4.4). We have removed government charges (UNFT and EIL), UAG and debt raising from base opex, consistent with our approach and Evoenergy's amended proposal that these costs are

⁵⁹ Economic Insights, *Relative efficiency & forecast productivity of Evoenergy*, April 2020, p. 30.

⁶⁰ A provision is a type of accrual accounting practice. A business records a provision for an anticipated cost when it expects it will incur a cost in the future but the amount and timing of the cost has not yet crystallised. For accounting purposes, increases in provisions are typically allocated to expenditure, and, in particular, to opex. If a business considers it is likely it will incur a future cost, or it expects the amount of the cost will be higher to that it has previously recorded, reported actual expenditure will increase. This means a business may sometimes report increases in expenditure when it estimates there is a change in a liability it faces. It may not actually expect to incur the cost for some time and the cost will not necessarily eventuate in the amount predicted. Similarly, if a business no longer considers it will incur a future cost, or it expects the amount of the cost will be lower than that it has previously recorded, reported expenditure will decrease.

forecast separately. However, we have not removed the ITAUF, which relates to services provided by Jemena to Evoenergy. The ITAUF is charged by Jemena to recover IT asset capital value for the migration of the nomination and operational balancing of Evoenergy gas system to a new platform.⁶¹ While we approved this cost item as opex category specific forecast in our 2016–21 determination and determined to exclude it from opex for the purpose of calculating the efficiency carryover amounts on the basis of non-recurrence, Evoenergy's submitted that ITAUF will not only apply over the 2021–26 period but also over the 2026–31 access arrangement. We consider that it is now appropriate for ITAUF costs to be included in base opex and subject to the efficiency carryover mechanism. As such, we have not excluded them in our alternative base year opex.

ECA queried why the ITAUF costs should be included in opex forecast. They also noted that it is not clear how its cost was calculated.⁶² We took these submissions into consideration in forming our view on forecast ITAUF.

6.4.2 Rate of change

Once we have estimated opex in the final year of the 2016–21 period, we apply a forecast annual rate of change to forecast opex for the 2021–26 period.⁶³

We have applied a forecast average annual rate of change of 0.3 per cent. This is lower than Evoenergy's forecast of 0.6 per cent. We compare both forecasts in Table 6.5.

⁶¹ Evoenergy, *Appendix 2.4 – IT asset utilisation fee – Nomination and operational balancing gas IT business case, Prepared by Jemena for Evoenergy, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, p. 1.

⁶² Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22.

⁶³ AER, *Expenditure forecast assessment guideline for electricity distribution*, November 2013, pp. 22–24.

Table 6.5 Our alternative rate of change compared with Evoenergy's amended proposal for the 2021–26 access arrangement period (per cent)

	2021–22	2022–23	2023–24	2024–25	2025–26
Evoenergy's proposal					
Input price growth	0.4	0.4	0.6	0.6	0.5
Output growth	0.8	0.6	0.5	0.5	0.5
Productivity growth	0.5	0.5	0.5	0.5	0.5
Opex rate of change	0.7	0.5	0.6	0.6	0.5
AER's alternative rate of change					
Input prices	0.0	–0.0	0.1	0.3	0.6
Output growth	0.6	0.6	0.6	0.6	0.6
Productivity growth	0.5	0.5	0.5	0.5	0.5
Opex rate of change	0.1	0.1	0.2	0.4	0.8

Source: AER analysis; *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020.

Note: The rate of change = (1+ price growth) × (1+ output growth) × (1+ productivity growth) – 1.

The difference between our forecast rate of change and Evoenergy's is driven by:

- a different approach to forecasting labour price growth
- our incorporation of the legislated superannuation guarantee increases.

We discuss this issue below.

6.4.2.1 Forecast input price growth

We have applied a real average annual price growth of 0.2 per cent to develop our alternative estimate of total opex. This increased our total opex alternative estimate by \$0.3 million (\$2020–21). It compares to Evoenergy's proposed average annual price growth of 0.5 per cent, which increased its total opex forecast by \$1.51 million (\$2020–21).⁶⁴

⁶⁴ *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020.

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

- To forecast labour price growth, we have used the most up-to-date forecast of growth in the utilities WPI for ACT as forecast by our consultant, Deloitte Access Economics (Deloitte).⁶⁵ This is a change to our standard approach of averaging the WPI growth forecasts provided by Deloitte and the consultant engaged by the business. This change reflects that the WPI forecasts submitted by Evoenergy have not factored in the full economic impacts of COVID-19. In contrast, Evoenergy adopted our standard approach, taking the average of the utilities WPI forecasts from Deloitte and that of their consultant, BIS Oxford Economics.⁶⁶
- Both we and Evoenergy applied a forecast non-labour real price growth rate of zero.⁶⁷
- Both we and Evoenergy have applied the same weights to account for the proportions of opex that is labour and non-labour, 59.7 per cent and 40.3 per cent, respectively.⁶⁸
- The difference between our real price growth forecasts and Evoenergy's mainly reflects a change in our approach to forecasting labour price growth.

Accounting for the impact of the COVID-19 pandemic

We have used a Deloitte-only forecast of WPI because it is the only available forecast which accounts for the impact of COVID-19 pandemic at this stage and would provide the best possible forecast of labour price growth in the circumstances⁶⁹. Deloitte's WPI forecast was undertaken in August 2020.⁷⁰ In contrast, the BIS Oxford Economics' forecasts used by Evoenergy were prepared at the onset of the COVID-19 pandemic, which has materially changed the economic outlook.⁷¹ As such, we do not consider our standard approach of averaging the Deloitte and BIS Oxford Economics' forecasts of WPI would produce the best possible forecast in the circumstances. In doing this, we considered the submissions from CCP24, ACTCOSS, ECA, Origin and EnergyAustralia, which considered that we should take into account the impact of COVID-19 pandemic.⁷²

⁶⁵ Deloitte Access Economics, *Labour price growth forecasts prepared for the Australian Energy Regulator*, August 2020.

⁶⁶ Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, p. 2-8.

⁶⁷ *Ibid.*, p. 9.

⁶⁸ *Ibid.*, p. 9.

⁶⁹ NGR, r. 74(2)(b)).

⁷⁰ Deloitte Access Economics, *Labour price growth forecasts prepared for the Australian Energy Regulator*, August 2020.

⁷¹ BIS Oxford Economics, *Labour cost escalation forecasts to 2025–26*, March 2020.

⁷² CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 48; ACTCOSS, *Submission: Evoenergy's gas network 2021–26 access arrangement proposal to the Australian Energy Regulator*, August 2020, p. 7; Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access*

We have accounted for the legislated increases in the superannuation guarantee in our labour price growth forecasts

Under the *Minerals Resource Rent Tax Repeal and Other Measures Bill 2014 (Cth)*, Schedule 6—Superannuation Guarantee Charge percentage, the superannuation guarantee is scheduled to increase incrementally from 9.5 per cent on 1 July 2020 to 12 per cent on 1 July 2025.

Evoenergy did not include an additional allowance for the legislated superannuation guarantee increases to its labour price growth forecasts. Further, Evoenergy, submitted that its consultant, BIS Oxford Economics considers that there is too much uncertainty surrounding the likely timing and quantum of superannuation guarantee charge increases for it to be factored into wage deliberations.⁷³ We note the concerns which have been raised in relation to the superannuation guarantee increase proceeding, particularly in light of the economic impacts of the COVID-19 pandemic. However, as the superannuation guarantee increases are currently legislated in place we consider it is appropriate to consider how they should be factored into forecasts of labour price growth.

We sought advice from Deloitte on how to best account for the superannuation guarantee increases. It noted that there is extensive research suggesting that increases in payroll taxes or compulsory contributions levied on employers are passed onto employees. This research suggests that the increases to the superannuation guarantee will likely result in slower WPI growth than would otherwise have been the case. Deloitte advised that the superannuation guarantee increases should be added to the forecast WPI growth rates, but only if those WPI growth rates take into account the superannuation guarantee changes.⁷⁴ Consequently we have added the legislated superannuation guarantee increases to Deloitte's WPI growth forecasts to forecast labour price growth.⁷⁵

6.4.2.2 Forecast output growth

We have adopted Evoenergy's approach to forecast output growth, but we have revised the output growth input of customer numbers upwards as set out in Table 6.6, reflecting our draft decision on demand forecast, particularly the post model adjustment to triple the rate of abolishment for tariff V (see Attachment 12). This results in an average annual output growth of 0.6 per cent. It increases our alternative estimate of

arrangement proposals 2021–26 submission, August 2020, Slide 22; Origin, *Evoenergy access arrangement proposal*, August, p. 2; EnergyAustralia, *Evoenergy – Proposed Access arrangement 2021–26 – 1 July 2020*, August 2020, p.2.

⁷³ Evoenergy, *Response to AER information request IR003*, 2 September 2020, p. 2.

⁷⁴ Deloitte Access Economics, *Impact of changes to the superannuation guarantee on forecast labour price growth*, 24 July 2020, p. 4.

⁷⁵ Deloitte Access Economics, *Impact of changes to the superannuation guarantee on forecast labour price growth*, 24 July 2020, pp. 4–5.

total opex by \$2.0 million (\$2020–21). This compares with 0.6 per cent proposed by Evoenergy, which increases its proposed opex by \$2.0 million (\$2020–21).

Table 6.6 Revised Customer Numbers

	2021–22	2022–23	2023–24	2024–25	2025–26
Customer Number Adjustments					
Evoenergy's proposal	158,810	160,165	161,389	162,490	163,541
AER alternative numbers	161,532	163,177	164,470	166,366	168,062
Difference	2,722	3,012	3,351	3,876	4,521

Source *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020; AER analysis.

For electricity distribution determinations, we typically forecast output growth based on the forecast growth in a defined output measure, using econometric modelling. However, for gas distribution decisions, we do not have the necessary data to undertake the modelling needed to determine a standard industry output specification.

To assess Evoenergy's output and productivity growth forecasts, we tested whether output growth, net of productivity growth, falls with an acceptable range based on the results of previous econometric studies. The acceptable range is based on the cost functions estimated by Economic Insights⁷⁶ and ACIL Allen.⁷⁷ We consider this approach uses the best information available to establish an acceptable range.

When we tested Evoenergy's forecast average annual output growth net of productivity growth against the acceptable range of forecast output growth, it fell within the acceptable range. The results are set out in Table 6.7.

Table 6.7 Comparison of Evoenergy's forecast output growth with the acceptable range of output growth net of productivity

	Proposed average annual growth rate, per cent	Acceptable range, average annual growth rate, per cent	Assessment
Evoenergy	0.07	–2.26 to 0.61	Within acceptable range

Source: AER analysis.

⁷⁶ Economic Insights, *Gas Distribution Businesses Opex Cost Function*, Report prepared for Multinet Gas, 22 August 2016; Economic Insights, *Productivity performance*, Report for Evoenergy, June 2020.

⁷⁷ ACIL Allen Consulting, *Opex Partial Productivity Analysis*, Report for AGN, 20 December 2016.

6.4.2.3 Productivity growth

We have adopted Evoenergy's proposed annual productivity growth rate of 0.5 per cent.⁷⁸ This decreases our alternative opex estimate by \$1.6 million (\$2020–21) for the 2021–26 period.

We consider network growth should deliver productivity gains such as economies of scale, particularly for operating costs.

Achieving productivity gains would be consistent with Evoenergy's past performance as well as that of other gas distribution businesses. According to the productivity performance study Economic Insights prepared for Evoenergy, opex partial factor productivity index performance improved from 1999 to 2019.⁷⁹

We have also considered Economic Insights' econometric analysis. Economic Insights found significant economies of scale, as well as positive technological change. Both economies of scale and technological change are components of productivity change and they indicate the gas distribution businesses should achieve positive productivity growth, to the extent that output is forecast to grow.

6.4.3 Step change

We have included one step change of \$2.1 million (\$2020–21) in our alternative estimate for the expensing of pigging and inspection costs, which were previously capitalised (see Table 6.8). This is slightly lower than Evoenergy's proposal of \$2.3 million (\$2020–21) because we used the forecast pigging inspection costs reflected in Evoenergy's capex model for consistency with the proposal to expense these costs over the 2021–26 access arrangement period. We identified a small discrepancy between pigging inspection costs reported in Evoenergy's amended opex model and the numbers reflected in its capex model.

⁷⁸ Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, pp. 2-10.

⁷⁹ Economic Insights, *Relative efficiency & forecast productivity of Evoenergy*, April 2020, p. 6.

Table 6.8 AER’s draft decision on Evoenergy’s proposed step change for the 2021–26 access arrangement period (\$ million, 2020–21)

	2021–22	2022–23	2023–24	2024–25	2025–26	Total
AER’s draft decision and Evoenergy’s amended proposal	0.45	0.94	–	0.05	0.82	2.3
AER’s alternative estimate	0.42	0.87	–	0.05	0.74	2.1
Difference						–0.2

Source: *Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model*, 1 October 2020; Evoenergy, capex model, June 2020.

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

6.4.4 Category specific forecasts

We have included category specific forecasts for four expenditure items in our alternative estimate of total opex for the 2021–26 access arrangement period. We have not forecast these costs using the base-step-trend approach. They include UNFT, EIL, UAG and debt raising costs.

Table 6.9 compares our draft decision (to accept Evoenergy’s amended proposal) with our estimate. The small difference between these two sets of numbers is driven by difference in inflation forecast and the fact that, as discussed in section 6.4.1.2, we have included ITAUF costs in base opex rather than considering them as a category specific forecast opex. We have used the most-up-to date inflation forecasts available at the time of our assessment.⁸⁰

We note that UNFT, EIL and UAG cost categories are subject to annual ‘true-up’ under the annual tariff variation mechanism and were subject to these arrangements in the 2016–21 access arrangement period.⁸¹ For the true-up adjustment to operate, an annual forecast for each of these cost categories is required. The true-up adjustment allows Evoenergy to pass through the changes to these cost categories where actual opex is different (higher or lower) than the approved forecast.

⁸⁰ RBA, *Statement on Monetary Policy—Appendix: Forecast*, August 2020.

⁸¹ Attachment 10 of this draft decision contains details on the tariff variation mechanism.

Table 6.9 AER's draft decision and Evoenergy's proposed category specific opex forecasts for the 2021–26 access arrangement period (\$million, 2020–21)

Category	Evoenergy's amended proposal	AER's alternative estimate	Difference
UNFT	45.3	43.9	–1.4
EIL	3.2	3.3	0.1
UAG	9.5	10.7	1.2
ITAUF	0.6	0	–0.6
Debt raising costs	1.0	1.1	0.1
Total	58.5	57.9	–0.6

Source: Response to AER IR003 Attachment 1 Evoenergy gas network 2021–26 revised opex model, 1 October 2020; AER analysis.

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

6.4.4.1 UNFT

We have included \$43.9 million (\$2020–21) for UNFT costs in our alternative estimate. This is lower than Evoenergy proposal of \$45.3 million (\$2020–21) because we have used the most-up-to date forecast inflation available at the time of our assessment and reflected our draft decision on forecast customer numbers in our UNFT calculations (see Attachment 12 of this draft decision).

The UNFT is payable to the ACT Government by owners of any network facility on land in the ACT. It is governed by the *Utilities (Network Facilities Tax) Act 2006*, with the tax rate set by the responsible Minister. The total UNFT for any year is calculated by multiplying the determined tax rate by the total network route length. The UNFT rate is set to increase by 5 per cent each year.⁸² However, in response to COVID-19, the ACT Government stated that it will freeze the UNFT at the current level to enable utility providers to pass on savings to customers and support improved hardship measures for ACT customers.⁸³ Evoenergy reflected this freeze in its opex forecast but assumed the ACT Government will increase the rate again from 2020–21, including the recovery of the amount not recovered during 2019–20.⁸⁴

⁸² ACT Government, *Australian Capital Territory Budget 2015-16 - Budget Review*, December 2015, p. 37; https://apps.treasury.act.gov.au/_data/assets/pdf_file/0007/805732/2015-16-Budget-Review.pdf

⁸³ Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, pp. 2-12; <https://www.covid19.act.gov.au/business-and-work/economic-survival-package/families-and-households#Utilities-Network-Facilities-Tax>.

⁸⁴ Evoenergy, *Attachment 2 – Operating expenditure, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, pp. 2-12.

We consider that Evoenergy's assumption around the annual increase of the UNFT rate following the freeze is reasonable because there is at least one instance in the past where the ACT Government doubled its annual rate increase in a single year, leading to a total increase of 10 per cent.⁸⁵

6.4.4.2 EIL

We have included \$3.3 million (\$2020–21) for EIL costs in our alternative estimate. This is slightly higher than Evoenergy proposal of \$3.2 million (\$2020–21) because we have used the most-up-to date forecast inflation available at the time of our assessment and reflected our draft decision on forecast demand (throughput) in our EIL calculations (see Attachment 12 of this draft decision).

The EIL is an ACT Government levy used to recover the costs of regulating utilities and is applied to four energy sectors: electricity distribution, electricity supply, gas distribution and gas supply. The ACT Government determines regulatory costs each year and apportions these between the four energy sectors.

The EIL has two components, a component that is fixed (by the ACT Government) and a component calculated by multiplying consumption (throughput) by a separate EIL rate, which is also determined by the ACT Government.

6.4.4.3 UAG

We have included \$10.6 million (\$2020–21) for UAG costs in our alternative estimate. This is higher than Evoenergy proposal of \$9.5 million (\$2020–21) because we have reflected our draft decision on forecast demand (throughput) and forecast customer numbers.⁸⁶

UAG is the difference between the measured quantity of gas entering the network system (gas receipts) and metered gas deliveries (gas withdrawals). It may be attributable to gas leakage, inaccuracies in gas measurement or gas theft. Evoenergy is required to replace any UAG.⁸⁷ UAG is generally expressed as a percentage of gas receipts into the network. Jemena manages the UAG as part of services provided to Evoenergy under the Distribution Asset Management (DAMS) agreement.⁸⁸

Evoenergy forecast UAG rate of 2.49 per cent over the 2021–26 access arrangement period, which is based on a four year historical average. This compares to

⁸⁵ For example, the 2015–16 Budget Review determined to increase the UNFT rate by an additional 5 per cent for 2016–17, leading to a total increase of 10 per cent in that year; the rate was to revert to the usual annual 5 per cent indexation from 2017–18. See: ACT Government, *Australian Capital Territory Budget 2015–16 - Budget Review*, December 2015, p. 37; https://apps.treasury.act.gov.au/__data/assets/pdf_file/0007/805732/2015-16-Budget-Review.pdf.

⁸⁶ Attachment 12 of this draft decision contains details on our assessment of forecast demand.

⁸⁷ Evoenergy, *Appendix 2.5 – Unaccounted for gas forecast, Prepared by Jemena for Evoenergy, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, p. iv.

⁸⁸ *Ibid.*, June 2020, p. iv.

1.96 per cent in the 2016–21 period. Evoenergy submitted that increase in UAG rate is largely attributable to measurement related issues, rather than leakages on the network.⁸⁹ It stated that these measurement issues are related to the impacts of Jemena changing its enterprise reporting system and a calculation configuration within that system, which caused volatility in the rate of UAG over the 2016–21 access arrangement period such that corrections were necessary.⁹⁰

Three stakeholder submissions raised concerns around the proposed increase in UAG.⁹¹ ECA stated that we should explore why UAG volumes are higher at a time when consumption has reduced. CCP24 encouraged us to undertake a network wide analysis of UAG to assess how Evoenergy performs against other gas distribution networks and examine Evoenergy's gas procurement arrangements.⁹²

In our 2020–25 draft decision for Jemena Gas Networks (NSW) Ltd (JGN), we reviewed the impacts of measurement issues referred to by Evoenergy and considered the approach undertaken by JGN to address these issues was reasonable.⁹³ JGN replaced its enterprise reporting system, transitioning from GASS+ to SAP between July 2015 and May 2016. After this transition, JGN identified inaccuracies in UAG reporting within SAP in mid-2016. JGN carried out investigations to identify and correct UAG reporting errors in a process that was finalised in late 2018.⁹⁴ Evoenergy submitted that JGN's system change also affected the reporting of its UAG volume.⁹⁵

We have examined Evoenergy's UAG procurement arrangements and found that they are based on competitive tender.⁹⁶ We also reviewed Evoenergy's assumptions around UAG price and consider them reasonable.⁹⁷ However, in estimating UAG costs for the 2021–26 access arrangement period, we have adjusted gas throughput to reflect our draft decision on forecast demand (see Attachment 12).

⁸⁹ Ibid., June 2020, p. iv.

⁹⁰ Ibid., June 2020, pp. 8–9.

⁹¹ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 27; Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 22.

⁹² CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 27.

⁹³ AER, *Draft Decision AER - JGN access arrangement 2020-25 Attachment 6 - Operating expenditure*, November 2019, pp.37–40.

⁹⁴ We discuss the impact of JGN's UAG measurement issues in: AER, *Draft Determination AER - JGN access arrangement 2020–25 Attachment 6 - Operating expenditure*, November 2019, pp. 39–40.

⁹⁵ Evoenergy, *Appendix 2.5 – Unaccounted for gas forecast, Prepared by Jemena for Evoenergy, Access arrangement information, ACT and Queanbeyan-Palerang gas network 2021–26*, June 2020, pp. 8–9.

⁹⁶ AER, *Information request IR009 - UAG*, 10 September 2020; Evoenergy, *Response to AER information request IR009 - UAG*, 16 September 2020, pp. 1–2.

⁹⁷ AER, *Information request IR009 - UAG*, 10 September 2020; Evoenergy, *Response to AER information request 009 - UAG*, 16 September 2020, pp. 1–2.

6.4.4.4 Debt raising costs

We have included debt raising cost of \$1.1 million (\$2021–21) in our alternative opex forecast for the 2021–26 access arrangement period. This compares with Evoenergy’s proposal of \$1.0 million (\$2021–21).

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

6.4.5 Marketing costs

A number of stakeholder submissions have raised concerns about the marketing costs included in Evoenergy’s base opex.⁹⁸ ECA considered that it is not clear how gas rewards marketing expenditure fits into the transformation roadmap that Evoenergy is promoting.⁹⁹ CCP24 suggested that this cost category should be subject a negative step change.¹⁰⁰

We sought clarification about the marketing costs included in Evoenergy, base opex.¹⁰¹ Evoenergy stated:¹⁰²

“Evoenergy considers that continuing to forecast marketing expenditure is consistent with other elements of our proposal, such as accelerated depreciation, since we have not sought in our proposal to fully align with the ACT Government’s vision for the future of the gas network.

Full alignment with Evoenergy’s current understanding of the ACT Government’s vision, as set out in the government’s Climate Change Strategy 2019-25, would have resulted in a proposal to fully depreciate our existing asset base by 2045 rather than the proposed initial minor step of shorten lives for new, long lived assets. The proposal would also have included a steep decline in our forecast of customer numbers and usage, no market expansion capital expenditure, and funding for a large-scale disconnection program.”

⁹⁸ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 28; Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slides 21-22.

⁹⁹ Energy Consumers Australia, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021–26 submission*, August 2020, Slide 21.

¹⁰⁰ CCP24, *Advice to the Australian Energy Regulatory on Evoenergy gas network 21 plan for Evoenergy (ActewAGL) ACT, Queanbeyan and Palerang access arrangement July 2021–June 2026*, August 2020, p. 28.

¹⁰¹ AER, *Information request IR017*, 16 October 2020.

¹⁰² Evoenergy, *Response to AER Information request IR017*, 22 October 2020, p. 1.

In response to CCP24's suggestion of a negative step change, Evoenergy stated:¹⁰³

“Regarding the CCP’s comment suggesting that marketing expenditure should be treated as a negative step change, we consider this to be inconsistent with incentive regulation and that it would undermine the AER’s opex forecasting approach. Evoenergy would have serious concerns if the AER departed from this well-established and accepted approach, particularly when an opex efficiency carryover mechanism (ECM) is in operation, such as for Evoenergy.

Under the AER’s established opex forecasting approach (as adopted in our proposal) and the operation of the ECM, if Evoenergy considered it inefficient to continue the marketing program, either because of external policy decisions or an internal commercial assessment, we would have a strong incentive to discontinue this expenditure and be rewarded through ECM gains, with customers benefiting over the long term through lower costs.”

In reviewing Evoenergy’s proposal, we have assessed forecast opex over the 2021–26 access arrangement period at a total level (‘top-down’ forecasting method), rather than to assess individual opex projects or programs (see). This is consistent with our approach to incentive regulation as discussed earlier in section 6.3. As set out in section 6.4.1, our assessment has found Evoenergy’s base year opex is not materially inefficient. Given this, and Evoenergy’s response set out above, detailed consideration of the marketing costs in the Evoenergy’s base year opex is not required for the purposes of assessing the proposed total opex forecast against the opex criteria.

¹⁰³ Evoenergy, *Response to AER Information request IR017*, 22 October 2020, p. 2.

Shortened forms

Shortened form	Extended form
ACT	Australian Capital Territory
ACTCOSS	ACT Council of Social Service
AER	Australian Energy Regulator
CCP / CCP24	Consumer Challenge Panel, sub-panel 24
DAMS	Distribution Asset Management
ECM	Efficiency carryover mechanism
ECA	Energy Consumers Australia
EIL	Energy industry levy
Guideline	<i>Expenditure forecast assessment guideline</i>
ITAUF	IT asset utilisation fee
JGN	Jemena Gas Networks (NSW) Ltd
NGL	National Gas Law
NGR	National Gas Rules
NGO	National Gas Objective
Opex	Operating expenditure
PPI	Partial performance indicators
RBA	Reserve Bank of Australia
UAG	Unaccounted for gas
UNFT	Utilities network facility tax
WPI	Labour price index