FINAL DECISION
Evoenergy
Distribution Determination

2019 to 2024

Attachment 6
Operating expenditure

April 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Evoenergy for the 2019-2024 regulatory control period. It should be read with all other parts of the final decision.

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

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 15 – Alternative control services

Attachment A – Negotiated framework

Attachment B – Pricing methodology

Contents

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
capex	capital expenditure
CCP 10	Consumer Challenge Panel, sub-panel 10
CPI	consumer price index
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
EBSS	efficiency benefit sharing scheme
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	National Electricity Rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
RBA	Reserve Bank of Australia
RIN	regulatory information notice
RPP	revenue and pricing principles

6 Operating expenditure

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

This attachment outlines our assessment of Evoenergy's forecast opex for the 2019–24 regulatory control period.

6.1 Final decision

Our final decision is to include total forecast opex of $295.8 million ($2018–19) in Evoenergy's revenue for the 2019–24 regulatory control period. This is an increase of 2.6 per cent from Evoenergy's actual opex in the current regulatory control period, which allows for:

- additional efficient and prudent expenditure required to meet Evoenergy's expanded responsibilities for vegetation management under the *Utilities (Technical Regulation) Amendment Act 2017* (ACT), which took effect from 1 July 2018
- additional expenditure for demand management, which will support deferral of augmentation to Evoenergy's network
- expected increases in input costs (including the cost of labour), and in the costs of operating a larger network with more customers.

Evoenergy's revised opex proposal adopted the approach we used in our 2018 draft decision, with updates to account for the more recent available information.

We used our standard 'base-step-trend' approach to develop our estimate of total forecast opex, which we compare to Evoenergy's revised proposal.[1] The total opex forecast we have adopted in this final decision starts with Evoenergy's actual costs in 2017–18 as a base year. We have then forecast growth in prices, output and productivity and assessed Evoenergy's step changes in accordance with our *Expenditure forecast assessment guideline* (the Guideline).[2]

Our total forecast is 2.1 per cent lower than Evoenergy's revised proposal of $302.0 million ($2018–19), which we do not accept. The primary reason we have not accepted Evoenergy's revised opex proposal is our decision to include a productivity growth forecast of 0.5 per cent per year in our estimate of efficient forecast opex. This reflects the opex productivity that can be achieved by a prudent electricity distributor acting efficiently under business-as-usual conditions. Evoenergy did not included any

[1] AER, *Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013.

[2] AER, *Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013.

forecast opex productivity growth in its revised proposal, which was consistent with its April 2018 initial regulatory proposal.

In formulating our alternative total opex estimate, we have also:

- updated Evoenergy's base opex to reflect the Reserve Bank of Australia's (RBA) most recent inflation forecast from February 2019.
- updated our output growth forecast, using an average of the output weights estimated in the four benchmarking models presented in our 2017 annual benchmarking report and updated with 2016–17 data.
- updated our labour price growth forecasts to include Deloitte Access Economics' February 2019 wage price index forecasts which we averaged with Evoenergy's forecast prepared by BIS Oxford Economics.

We have substituted our alternative estimate as the forecast opex in Evoenergy's revenue determination for the 2019–24 regulatory control period. The reasons for our final decision are set out in further detail in section 6.4.

Evoenergy's proposed opex and our final decision are set out in Table 6.1.

Table 6.1 Evoenergy's proposed opex and our final decision ($ million, 2018–19)

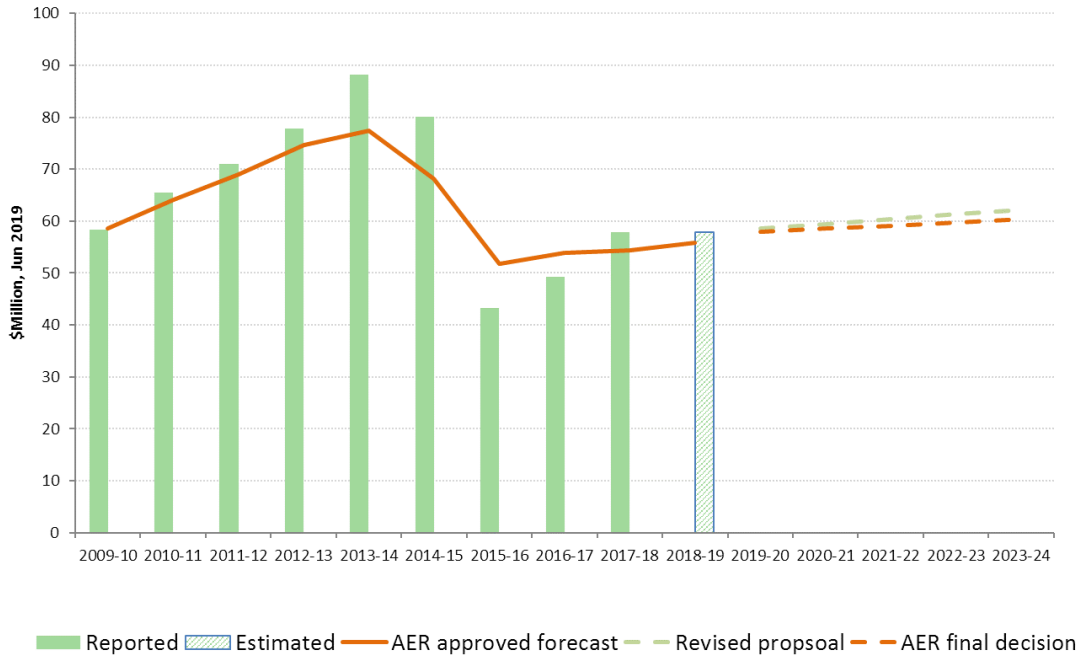
	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Evoenergy's proposed opex	58.7	59.5	60.4	61.3	62.2	302.0
AER final decision	57.9	58.6	59.2	59.8	60.3	295.8
Difference	–0.7	–0.9	–1.2	–1.5	–1.9	–6.2

Source: Evoenergy, *Revised revenue proposal*, *Post tax revenue models (PTRM)*, November 2018; AER analysis

Note: Includes debt raising costs. Numbers may not add up to total due to rounding.

Figure 6.1 shows Evoenergy's opex forecast (both initial and revised proposals), its historical reported opex, our previous regulatory decisions, our draft and final decision forecasts.

Figure 6.1 Historical and forecast opex ($ million, 2018–19)



Source: Evoenergy, Annual reporting regulatory information notices; Evoenergy, Revenue proposal 2019-24, Workbook 1 Regulatory determination; AER analysis.

Note: Includes debt raising costs.

6.2 Evoenergy's revised proposal

In its revised proposal, Evoenergy forecasts opex of $302.0 million ($2018–19, inclusive of debt raising costs), an increase of 4.8 per cent from its actual and estimated opex for the 2014–19 regulatory control period. Evoenergy's revised opex forecast is 1.7 per cent higher than that of our draft decision, and 2.2 per cent below its January 2018 regulatory proposal.

Table 6.2 Evoenergy's proposed opex ($ million, 2018–19)

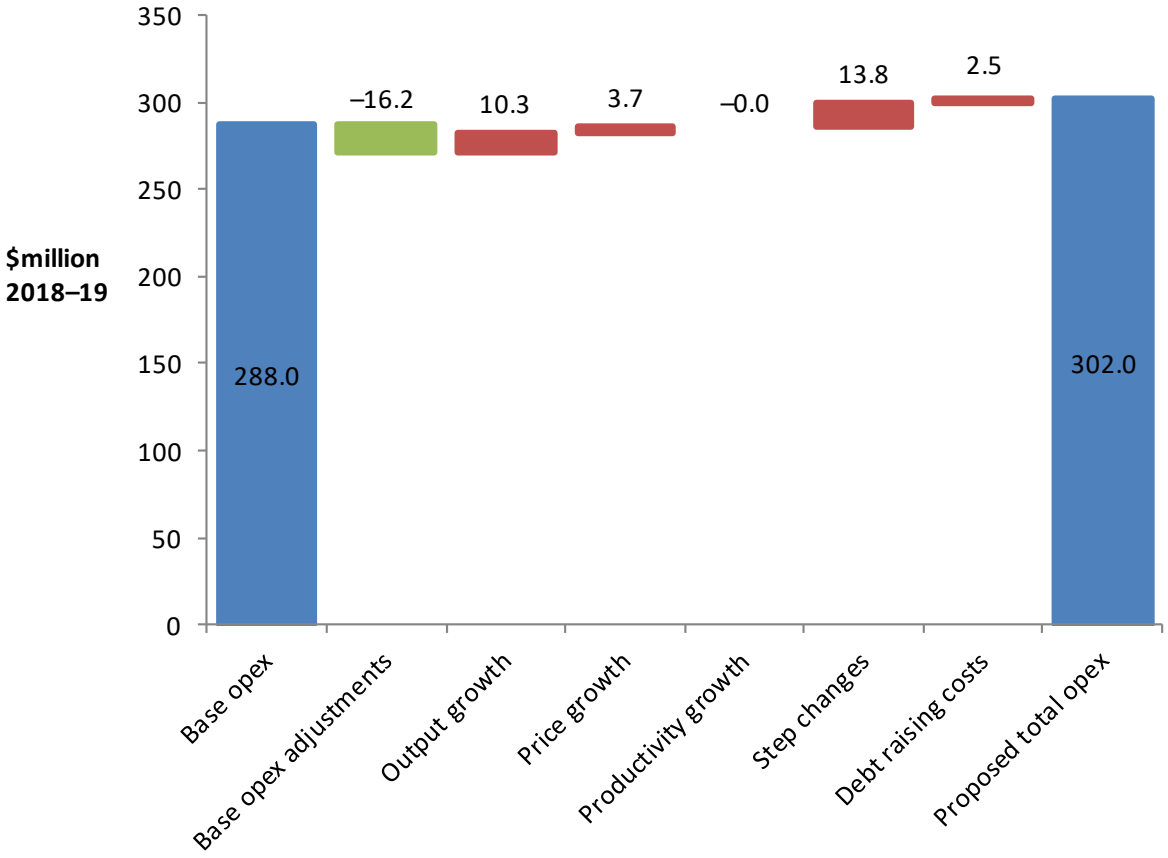
	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Opex excluding debt raising costs	58.2	59.0	59.9	60.8	61.7	299.5
Debt raising costs	0.5	0.5	0.5	0.5	0.5	2.6
Total opex	**58.7**	**59.5**	**60.4**	**61.3**	**62.2**	**302.0**

Source: Evoenergy, *Revised revenue proposal*, *Post tax revenue models (PTRM)*, November 2018; AER analysis

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

Figure 6.2 provides a breakdown of Evoenergy's opex forecast into key components.

Figure 6.2 Evoenergy's opex forecast breakdown



Source: AER analysis.

Evoenergy stated that it has adopted the changes from our draft decision, and revised its base year opex from an estimated to actual basis. The key elements of Evoenergy's proposal are set out below:

- Evoenergy used its reported opex in 2017–18 to derive a base opex of $288.0 million ($2018–19). This is 2.0 per cent higher than its January 2018 regulatory proposal which relied on an estimate of its opex in 2017–18.
- Consistent with our draft decision, Evoenergy adjusted its base year opex to account for the costs that it proposed to recover as cost pass throughs and the costs that Evoenergy had incorrectly reported as standard control service opex in 2017–18.[3] This equates to an adjustment to the base opex of $16.2 million ($2018–19).

[3] On 6 February 2019, we have approved Evoenergy's cost pass through applications to recover costs associated with implementation of Power of Choice reforms and the changes required by the AER's new Ring-fencing Guideline. See, AER determination, *Power of Choice reforms cost pass through - Evoenergy*, February 2019; AER determination, *Ring-fencing guideline cost pass through - Evoenergy*, February 2019.

- Evoenergy then trended forward its base opex to account for:
    - expected increases in real input prices, including forecast increases in labour costs and an increase in line with CPI for non-labour costs ($3.7 million, $2018–19).
    - forecast output growth, driven primarily by increased customer numbers, circuit line length and maximum demand, all of which can increase the cost to Evoenergy of operating its network ($16.5 million, $2018–19).
    - forecast zero change in opex productivity over the regulatory period.
- Evoenergy included two step changes in its opex forecast, as revised in our draft decision:
    - $12.0 million ($2.4 million per annum) to meet the efficient costs of expanded vegetation management obligations following amendments to the *Utilities (Technical Regulation) Act 2014 (ACT)* passed in November 2017.
    - $1.8 million ($0.4 million per annum) in demand management costs to allow deferral of capex for the construction of a new substation at Strathnairn.
- Evoenergy forecast $2.5 million ($2018–19) of debt raising costs. Debt raising costs are transaction costs incurred each time debt is raised or refinanced.

6.2.1 Submissions on our draft decision and Evoenergy's revised proposal

We received six submissions on our draft decision and Evoenergy's revised proposal; three of which commented on Evoenergy's opex forecast. Where relevant, we discuss their submissions in our reasons for our decision in section 6.4.

6.3 Assessment approach

Our role is to form a view about whether a business's forecast of total opex is reasonable. Specifically, we must form a view about whether a business's forecast of total opex 'reasonably reflects the opex criteria'. In doing so, we must have regard to each of the opex factors specified in the NER.

If we are satisfied the business's forecast reasonably reflects the criteria, we accept the forecast.[4] If we are not satisfied, we substitute an alternative estimate that we are satisfied reasonably reflects the opex criteria for the business's forecast.[5] In making this decision, we take into account the reasons for the difference between our alternative estimate and the business's proposal, and the materiality of the difference. Further, we consider interrelationships with the other building block components of our decision.[6]

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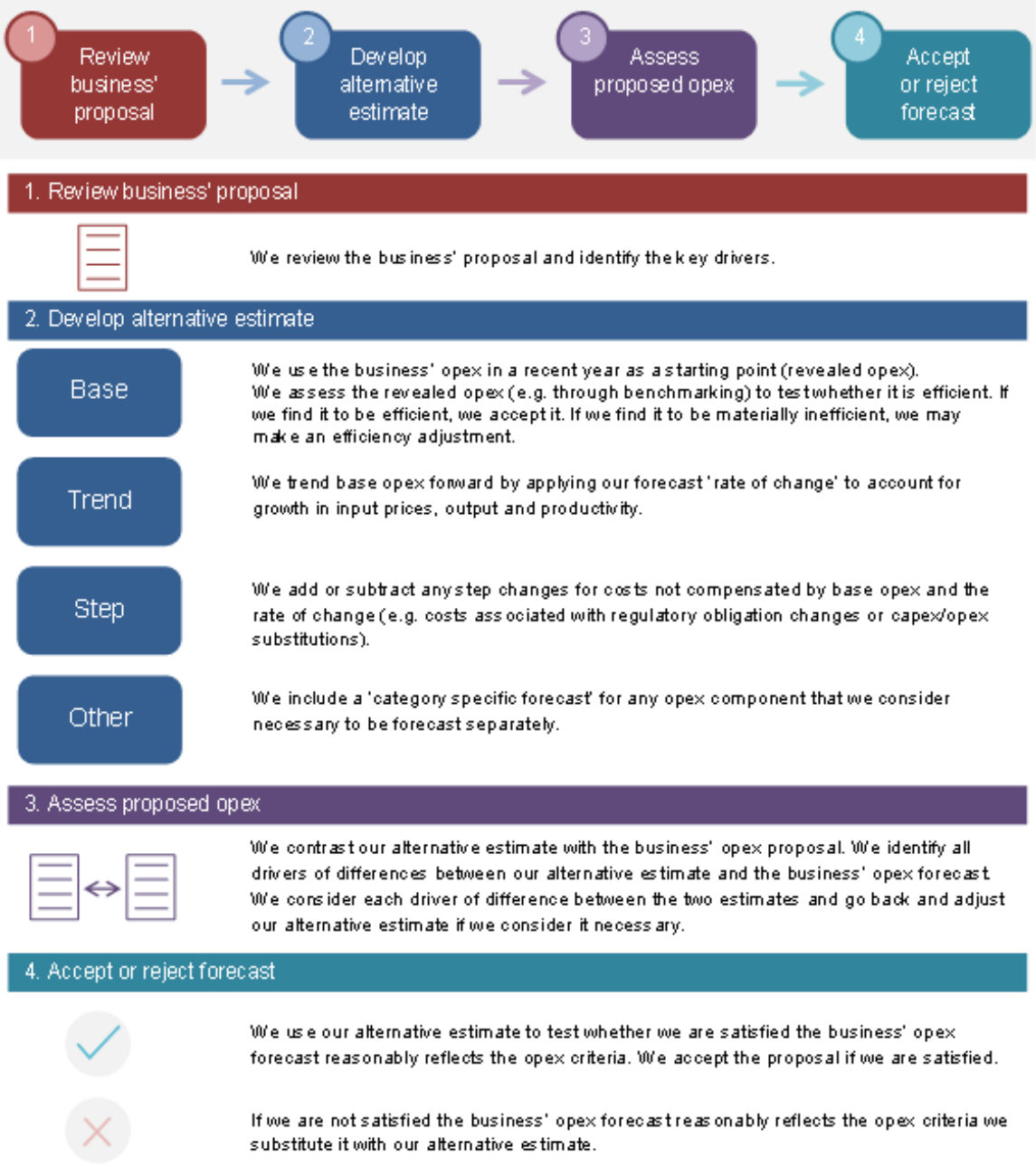
4 NER, cl. 6.5.6(c).

5 NER, cll. 6.5.6(d) and 6.12.1(4)(ii).

6 NEL, s. 16(1)(c).

As set out in our draft decision in detail, we generally assess a business's forecast total opex using a 'base-step-trend' approach, as summarised in Figure 6.3.

Figure 6.3 Our opex assessment approach



6.3.1 Interrelationships

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

- the impact of cost drivers that affect both forecast opex and forecast capex. For instance, forecast labour price growth affects forecast capex and our forecast of forecast price growth used to estimate the rate of change in opex

- its proposed capex for the construction of zone substation at Strathnairn, which underpins Evoenergy's demand management opex/capex trade-off step change
- the approach to assessing the rate of return, to ensure there is consistency between our determination of debt raising costs and the rate of return building block
- concerns of electricity consumers identified in the course of Evoenergy's engagement with consumers.

6.4 Reasons for final decision

Our final decision is to include total forecast opex of $295.8 million ($2018–19, inclusive of debt raising costs) in Evoenergy's revenue for the 2019–24 regulatory control period. We consider that this forecast reasonably reflects the opex criteria. Our total forecast is 2.1 per cent lower than Evoenergy's revised proposal of $302.0 million ($2018–19, inclusive of debt raising costs).

The difference between our alternative estimate and Evoenergy's revised opex proposal is 2.1 per cent, which is not immaterial. Therefore, we are not satisfied that Evoenergy's proposed forecast reasonably reflects the opex criteria. We have adopted our alternative estimate as the forecast opex in Evoenergy's revenue determination for the 2019–24 regulatory control period.

Table 6.3 compares the differences between our alternative estimate and Evoenergy's revised opex proposal. The primary reason for the difference between our total forecast opex and Evoenergy's revised proposal is forecast opex productivity growth. We have forecast opex productivity growth of 0.5 per cent per annum reflecting the outcome of our recent opex productivity growth forecast review,[7] whereas Evoenergy forecast zero opex productivity growth.

[7] AER, *Final decision - Forecasting productivity growth for electricity distributors*, March 2019.

Table 6.3 Our alternative estimate compared to Evoenergy's proposal ($ million, 2018–19)

	Evoenergy	Our alternative estimate	Difference
Base opex	288.0	286.3	–1.7
Base opex adjustments	–16.2	–16.1	0.2
Output growth	10.3	10.3	0.0
Price growth	3.7	4.4	0.7
Productivity growth	0.0	–5.4	–5.4
Step changes	13.8	13.8	0.0
Debt raising costs	2.5	2.4	–0.1
Total opex	302.0	295.7	–6.3

Source: Evoenergy, *Revised revenue proposal - forecast SCS opex model*, November 2018; AER analysis.

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

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

6.4.1 Base opex

Evoenergy proposed in its revised proposal to use its reported opex for 2017–18 as the base to forecast opex over the 2019–24 regulatory control period. After appropriate adjustments, its base year opex is $54.35 million ($2018-19), which is 2.6 per cent higher than the estimated base year opex it relied on in its initial proposal.

In our draft decision, we examined the efficiency of Evoenergy's estimated base year opex of $52.98 million (net of base year opex adjustments) using multiple techniques and information sources, including its revealed opex over the 2014–19 regulatory control period, recent economic benchmarking analysis, and a review of its expenditure cost categories. We were satisfied that Evoenergy's opex in 2017–18 is not materially inefficient compared to its NEM peers.

For our final decision, we have accounted for Evoenergy's reported opex and movement in provisions in 2017–18, updated inflation forecasts from the RBA, and the base year opex adjustments we had made in our draft decision to arrive at an adjusted base year opex of $54.04 million ($2018–19).[8] This provides us with a total base opex of $286.3 million ($2018–19) across the 2019–24 regulatory control period.

Evoenergy's actual opex in 2017–18 is marginally outside the range of average efficient opex estimated by our econometric opex cost functions over the 2012–17 period. However, we have had regard to the other information sources that we relied on when evaluating Evoenergy's estimated base opex in our draft decision. We observed that Evoenergy has made significant opex reductions over the 2014–19 regulatory control period. Our opex multilateral partial factor productivity (MPFP) analysis also indicated that Evoenergy was amongst the middle group of networks in terms of opex efficiency.

All things considered, we accept Evoenergy's reported opex for 2017–18 as being not materially inefficient compared to its NEM peers and does not necessitate an efficiency adjustment in the given circumstances.

The Electrical Trades Union New South Wales branch (ETU) and the McKell Institute submitted that our benchmarking methodology does not adequately account for investments or expenditure allocated towards the safety or training of the workforce, or the maintenance of an adequate workforce.[9] It is their view that our benchmarking methodology risks incentivising Evoenergy and other distributors to seek opex reductions primarily through workforce reductions.[10] We have noted the ETU and the McKell Institute's comments on benchmarking. In this decision, we have relied on Evoenergy's actual revealed opex to set our opex forecast, rather than economic benchmarking. We have only used economic benchmarking to test whether Evoenergy revealed opex is efficient and can be used as a reasonable basis for forecast.

6.4.2 Rate of change

We trend the base opex forward to account for the forecast growth in prices, output and productivity. We refer to this as the rate of change.

Evoenergy has largely adopted our approach in our draft decision to forecasting the rate of change, including price growth, output growth and productivity growth. We have forecast an average annual rate of change of 0.93 per cent, compared to Evoenergy's forecast of 1.07 per cent. We have set out the reasons for our forecast, and the difference compared to Evoenergy's forecast below.

Price growth forecast

We have included forecast real average annual price growth of 0.49 per cent in our alternative opex estimate. This increases our opex forecast by $4.4 million ($2018–19). In contrast, Evoenergy forecasts average price growth of 0.43 per cent.

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9 The McKell Institute and ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, p.7.

10 The McKell Institute and ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, p.9.

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

- To forecast labour price growth, we have used the average growth in the wage price index (WPI) for the Australian Capital Territory utilities industry forecast by Deloitte Access Economics and Evoenergy's consultant, BIS Oxford Economics. Evoenergy has adopted this approach in its revised proposal.
- We forecast non-labour price growth in line with CPI.

Since our draft decision, we have received updated wage price index forecasts from Deloitte Access Economics. We have incorporated these into our alternative estimate.

Output growth forecast

For the purpose of our final decision, we have updated the weights we use to forecast output growth. We have derived these from the same benchmarking models presented in our 2017 annual benchmarking report but updated with 2016–17 data.[11]

In our draft decision, we changed our approach in estimating output growth weights by using four benchmarking models, rather than simply the Cobb Douglas Stochastic Frontier Analysis (CD SFA) model we used in our previous decisions.[12]

Since our draft decision, we have published our 2018 annual benchmarking report, presenting the four benchmarking models we used in our draft decision for the 2012–17 period.[13] We have also presented the results of an additional benchmarking model for the first time, the Translog Stochastic Frontier Analysis (Translog SFA) for the 2012–17 period.[14] This represents an alternative approach to forecasting average output growth weights by using all five benchmarking models for the 2012–17 period.

In its revised opex model, Evoenergy adopted our draft decision approach of using the four benchmarking models to estimate output growth weights but updated the weights derived from the models presented in our 2018 annual benchmarking report for the 2012–17 period.

For consistency, we have relied on the same benchmarking models as in our draft decision, but updated with 2016–17 data. While we have had regard to the results of the most recent annual benchmarking report, we have not relied on the additional Translog SFA model or the 2012–17 data set to estimate output growth weights.[15]

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11 AER, *2017 Annual benchmarking report - Electricity distribution network service providers*, November 2017.

12 The four benchmarking models are the Cobb Douglas Stochastic Frontier Analysis, the Cobb Douglas Least Squares Econometrics, the Translog Least Squares Econometrics and the Opex Multilateral Partial Factor Productivity analysis.

13 Whilst not explicitly presented in the 2018 annual benchmarking report, the benchmarking results of the four models we used in our draft decision for the 2006–17 period were contained in the supporting data files of the benchmarking report.

14 AER, *2018 Annual benchmarking report - Electricity distribution network service providers*, November 2018.

15 We must have regard to the most recent annual benchmarking report that has been published under the NER. It is an opex factor.

Table 6.4 shows the output specification and weights from each model as reflected in the 2017 annual benchmarking report.

Table 6-1 Outputs specification and weights derived from economic benchmarking models for 2006–2017 (per cent)

Output	MPFP	SFA CD	LSE CD	LSE TLG
Customer numbers	31.00	70.94	68.53	57.32
Circuit length	29.00	12.62	10.74	11.33
Ratcheted maximum demand	28.00	16.43	20.72	31.36
Energy throughput	12.00			

Source: AER analysis; Economic Insights, *Economic Benchmarking Results for the Australian Energy Regulator's 2018 DNSP Benchmarking Report,* November 2018

The differences in the output growth weights adopted in Evoenergy's revised opex proposal and our alternative estimate are negligible and do not contribute to a material difference in our opex forecasts.

Productivity growth forecast

We have included a productivity growth forecast of 0.5 per cent per year in our alternative estimate. As foreshadowed in our draft decision, we have undertaken an industry wide review of our opex productivity growth forecast. We have taken the outcome of this review into consideration when deriving our alternative estimate.

In our final decision of the opex productivity growth forecast review, we set out the analysis and evidence we have relied on to forecasting productivity growth.[16] We considered a productivity growth forecast of 0.5 per cent per year was a reasonable forecast of the productivity growth that could be achieved by a prudent electricity distributor acting efficiently under business-as-usual conditions and should be adopted in our electricity distribution determinations going forward.

Evoenergy made a submission to our opex productivity growth forecast review, providing its views on the AER's initial forecasting approach.[17] Evoenergy agreed with Cambridge Economic Policy Associates' (CEPA) submission that a reasonable range for productivity growth is 0.0 to 0.7 per cent.[18] Evoenergy submitted that in applying the productivity growth to Evoenergy's final determination for 2019–24, the AER should consider Evoenergy's specific circumstances, as outlined in its submission.[19]

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16 AER, *Final decision - Forecasting productivity growth for electricity distributors*, March 2019.

17 Evoenergy, *Submission to the AER Opex Productivity Growth Forecast Review Draft Decision Paper*, 21 December 2018.

18 Evoenergy, *Submission to the AER Opex Productivity Growth Forecast Review Draft Decision Paper*, 21 December 2018, p. 8.

19 Evoenergy, *Submission to the AER Opex Productivity Growth Forecast Review Draft Decision Paper*, 21 December 2018, pp. 8-10.

Evoenergy proposed zero opex productivity growth in its revised proposal. It also made a further submission following the conclusion of our opex productivity growth forecast review. In this submission it stated that, in its view, a zero productivity growth forecast would reflect the opex criteria. However, it also stated that, if we decide to apply our productivity growth forecast of 0.5 per cent per year, we should do so via a transition path.[20] Specifically, Evoenergy proposed a transition involving the application of a zero productivity growth factor up to 2020–21 and a 0.5 per cent per year productivity growth factor applied from 2021–22 to 2023–24.

Evoenergy suggested that its proposed transition path would enable it to secure efficiencies consistent with our opex productivity growth forecast while also maintaining the quality, reliability and security of supply and ensuring the safety of the distribution system.[21] Evoenergy also submitted that significant new obligations relating to safety and reliability are only now beginning to affect it and disrupt the potential for immediate productivity growth. The most significant new obligations it identified were:

- its new obligation to inspect privately owned electrical infrastructure in rural areas of the ACT
- a new requirement under the ACT's Electricity Service and Installation Rules that makes Evoenergy responsible for the process to test the protection of inverters accompanying embedded generation every five years
- the ACT Government's 100 per cent renewable energy by 2020 policy, driving more solar generation and storage installations in new developments, necessitating active network management by Evoenergy
- an expected expansion of the ACT Government's energy efficiency improvement scheme (EEIS) which provides incentives to transition from natural gas to efficient electric appliances.

We are not satisfied that Evoenergy has justified a departure from our proposed approach of applying a productivity growth factor of 0.5 per cent per year from its base year in our alternative estimate.

As noted previously, our forecast reflects the productivity growth that could be achieved by a prudent electricity distributor acting efficiently under business-as-usual conditions. This reflects our view that improvements in good industry practice should be implemented by all efficient distributors as part of business-as-usual operations, including from things such as new technology, changes to management practices and other factors that contribute to improved productivity within the industry over time.

Where there is a material change in a distributor's operating conditions that is not otherwise captured in the base year opex or the rate of change (such as a regulatory obligation), then our opex framework provides step changes to account for the

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[20] Evoenergy, *Submission on implementation of final decision forecast productivity growth*, 21 March 2019, p.1.

[21] Evoenergy, *Submission on implementation of final decision forecast productivity growth*, 21 March 2019, p.1.

increased or decreased costs of this change in conditions. Evoenergy has not proposed step changes for the obligations it identifies (as outlined above) or provided information to demonstrate the cost impact of these obligations on its business, or whether it has already incurred some of these costs in its base year (2017–18).

At this point in time, Evoenergy has not demonstrated the obligations it raised in its submission materially increase its opex or prevent it from finding productivity improvements in its network operation. We have considered the individual obligations identified by Evoenergy and make a number of observations about whether they are likely to materially change Evoenergy's opex requirements:

- The forecast costs associated with Evoenergy's new regulatory obligation to inspect privately owned electrical infrastructures are already included in our opex forecast. We discuss this below, and in our draft decision, in the context of our vegetation management step change.
- Under Evoenergy's electricity service and installation rules, it appears that customers with embedded generation are responsible for hiring a qualified electrician to test in-service inverters every five years.[22] It is unclear what costs Evoenergy will incur under this new operating requirement as alleged by Evoenergy.
- The ACT Government's 100 per cent renewable energy by 2020 policy was introduced in 2016 and is largely effected by the wind and solar farms the ACT Government has contracted under its nation-leading reverse auction process.[23] While the ACT has one of the highest proportions of renewable electricity in the NEM, it has one of the lowest proportions of households with rooftop solar (14.2 per cent).[24] There is insufficient information for us to properly evaluate how this policy may affect Evoenergy's costs associated with new connections at new developments, and the potential benefits brought about by the reduction in peak demand.
- The EEIS began on 1 January 2013. Any cost impact of the EEIS should have been reflected in Evoenergy's revealed opex and productivity growth within the current regulatory control period. The objectives of the EEIS are to encourage efficient and reduced use of energy by network users, and require electricity retailers to achieve emission savings targets.[25] At this point in time, it is not clear how an expansion of the EEIS would affect Evoenergy's network operation, and its productivity growth, in any material way.

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22 See, *Utilities (Electricity Service and Installation Rules Code) Determination 2013;* Evoenergy, *Service and Installation Rules*, Version 9, November 2018, clauses 7.6 and 7.11; https://www.evoenergy.com.au/developers/service-and-installation-rules, accessed on 22 March 2019.

23 Climate Council, *Powering Progress: States Renewable Energy Race*, October 2018, p.20. Accessed at https://www.climatecouncil.org.au/wp-content/uploads/2018/10/States-Renewable-Energy-Report.pdf.

24 Climate Council, *Powering Progress: States Renewable Energy Race*, October 2018, p.13.

25 See https://www.environment.act.gov.au/energy/smarter-use-of-energy/energy-efficiency-improvement-scheme.

The Consumer Challenge Panel (CCP10) submitted that it is reasonable for customers to expect improving efficiency over time. While recognising Evoenergy's improved productivity over the past couple of years, CCP10 stated that the opex productivity measures it has proposed are dynamic, meaning that productivity cannot be considered as a one-off action, no matter how significant the one-off improvement.[26]

In its submission, the ETU acknowledged the need for continuous efficiencies, but strongly argued that these should be weighed against the priorities of:[27]

- maintaining the utmost safety for workers and the public
- ensuring best practice in work procedures are in place
- maintaining the highest level of reliability in electricity supply
- delivering genuine cost saving to the end user
- ensuring the long-term efficiency and capacity of the workforce.

Genuine productivity gain should not compromise any of the priorities above. There is no evidence that our productivity growth forecast is so unreasonable that it poses a real risk of compromising the safety and reliability of electricity supply. Our productivity growth forecast is a conservative estimate based on the range of productivity growth demonstrated by electricity distributors in recent years. There is no evidence to suggest that this productivity growth was achieved at the expense of the safety of workers or the public.

We consider that regardless of the existing efficiency level of an electricity distributor, or the efficiency savings a distributor has derived in the past, the distributor will still have an incentive to pursue productivity growth. As our opex forecast is intended to reflect the total opex a prudent distributor acting efficiently would require, we must take into account the likely opex productivity growth it can achieve. Otherwise, the customers would be paying more than needed, which would be inconsistent with the opex criteria under the NER.

6.4.3 Step changes

Evoenergy proposed two step changes in its initial regulatory proposal:

- $18.8 million ($2018–19) to meet the efficient costs of expanded vegetation management obligations and the new responsibility to inspect privately owned electrical infrastructures, following amendments to the *Utilities (Technical Regulation) Act 2014 (ACT)* (Vegetation management step change).
- $1.8 million ($2018–19) in demand management costs to allow deferral of capex for the construction of a new substation at Strathnairn.

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[26] CCP10, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, pp. 42-43.

[27] ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019.

For our draft decision, we substituted our alternative estimate of $12.0 million ($2018–19) for Evoenergy's vegetation management step change. We also included Evoenergy's proposed demand management costs in our opex forecast. Evoenergy adopted these estimates in its revised opex forecast.

CCP10 was supportive of our draft decision position.[28] The ACT Technical Regulator and the ETU (in conjunction with the McKell Institute) made submissions about our estimate of Evoenergy's vegetation management step change.

The ACT Technical Regulator submitted that:

> "…AER has determined that Evoenergy has overestimated its proposed vegetation management expenditure and has provided an alternative forecast opex $6.8 million lower than Evoenergy's proposed $18.8 million. Further commentary is required with respect to the assessment of public safety issues that could arise from insufficient funding for vegetation management, particularly where that work relates to mitigating the risk of bushfire."[29]

We are satisfied that the prudent and efficient level of expenditure required to meet Evoenergy's new vegetation management responsibilities is $2.4 million per annum ($2018–19). In constructing our step change forecast, we engaged extensively with Evoenergy to test the reasonableness of our assumptions and provided Evoenergy opportunities to challenge our cost estimates. We also relied upon information that likely reflects the best estimate of the efficient costs Evoenergy requires to meet its new regulatory obligation:

- We adopted the unit costs of the vegetation management expenditure Evoenergy had incurred when it was contracted by the ACT Government to undertake vegetation management near high voltage lines within specific urban areas in previous years.
- We relied on Evoenergy's most recent LIDAR survey that identified the number of vegetation defects in the designated ACT urban areas to forecast work volume. Based on its LIDAR survey, Evoenergy can better identify the areas with higher vegetation risks, prioritise its vegetation management and allocate its resources most efficiently.

We are therefore satisfied that Evoenergy, if acting prudently and efficiently, should be able to meet its new regulatory obligation with $2.4 million per annum ($2018–19), notwithstanding that it may allocate a different amount to its vegetation management activities due to changing circumstances.

We also note that Evoenergy remains responsible for vegetation management in its existing bushfire abatement zones or rural areas and our total opex forecast for the 2019–24 regulatory control period reflects Evoenergy's revealed historical costs of

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[28] CCP10, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, p.41.

[29] ACT Technical Regulator, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019.

managing vegetation and meeting its regulatory safety obligations in these areas. This is discussed further below.

Evoenergy has adopted our draft decision estimate in its revised proposal and did not raise any concerns that its base opex, coupled with the approved step change, would be insufficient for it to comply with its vegetation management responsibilities and provide safe and reliable electricity supply. Our opex forecast is not a cap on the expenditure Evoenergy may incur to deliver safe and reliable electricity supply. To the extent that it is prudent to spend more on vegetation management activities to address public safety issues, Evoenergy has a legal obligation to do so even if it means lower profits for its shareholders. We consider it unlikely that Evoenergy would prioritise the interests of its shareholders over its paramount duty to ensure public safety when operating its network.

Our role is not to supervise how an electricity distributor operates its network or whether it has allocated sufficient funding to comply with its regulatory obligations. To estimate the total opex required by a prudent network service provider acting efficiently, we have forecast the incremental costs it needs to meet the new vegetation management responsibilities. Evoenergy may allocate different funding to its vegetation management activities, depending on its operating efficiency or the level of vegetation risks it identifies. Evoenergy will decide how to fund its operational activities based on its needs and what it deems to be prudent and efficient. Therefore, if Evoenergy does not allocated sufficient funding to a particular operational activity, this does not mean our opex forecast is insufficient for a prudent network service provider acting efficiently to manage its network safely.

The ETU (in conjunction with the McKell Institute) submitted that $2.4 million per annum allocated towards vegetation management is inadequate for Evoenergy to meet the demands of best practice vegetation management.[30] The ETU submitted that:

- based on the estimated number of trees in Evoenergy's network, a $2.4 million per annum funding would be an unrealistic allowance
- Evoenergy had spent $2.55 million (nominal) in 2017–18 on vegetation management, and yet the AER determined that Evoenergy would be expected to spend $2.4 million per annum on vegetation management
- the entirety of the ACT is at high-risk of bushfire and the AER's vegetation management forecast of $2.4 million per annum appears insufficient to meet the scale of the challenge in ensuring all bushfire risks have been considered and actioned by Evoenergy staff
- the AER had previously found Evoenergy (formerly ActewAGL Distribution) to be insufficient in meeting its vegetation management responsibilities

[30] The McKell Institute and ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, pp. 18-25.

- any reduction in the capacity of Evoenergy to fully execute their responsibilities in vegetation management risks greater incidents of outages and potentially fires
- low vegetation management opex allocation is likely to result in cost pass throughs to consumers.

ETU's submission appears to have misunderstood our draft decision and considered that our step change forecast represents the total funding Evoenergy may allocate to its vegetation management across all high-risk bushfire areas in the ACT.

Our step change forecast consists of the incremental costs Evoenergy requires to undertake vegetation management in defined urban areas of the ACT, a new regulatory obligation introduced under the amended *Utilities (Technical Regulation) Act 2014*. It does not represent the total costs Evoenergy requires to undertake vegetation management activities across its entire network. In 2017–18, the base year for our opex forecast, Evoenergy had spent about $2.6 million ($2018–19) for its existing vegetation management responsibilities. Assuming that Evoenergy maintains the same expenditure for its existing vegetation management responsibilities, together with the forecast step change, Evoenergy now has a forecast vegetation management expenditure of around $5.0 million per annum ($2018–19) and it can adjust its spending based on the risks posed by outstanding vegetation defects.

As stated in Evoenergy's initial proposal, Evoenergy was responsible for vegetation management in the bushfire abatement zone and rural areas prior to the introduction of its new vegetation management responsibilities in urban ACT. [31] These areas are the ones the ETU has identified in its submission as being high-risk bushfire areas.[32] Evoenergy's vegetation management expenditure for these areas are reflected in its revealed opex in 2017–18 and is included in our base opex forecast. The new areas of vegetation management responsibilities imposed by the amended *Utilities (Technical Regulation) Act 2014* are designated urban areas. When compared to the map of high-risk bushfire areas in the ACT depicted in ETU's submission, the majority of Evoenergy's new vegetation management responsibilities are in fact not in high-risk bushfire areas.

Notwithstanding this, we consider our step change forecast provides a sufficient allowance for tree-cutting costs that is comparable to what Evoenergy currently incurs with respect to high-risk bushfire areas and is sufficient to allow Evoenergy to meet its additional vegetation management responsibilities. As outlined above, we have relied on Evoenergy's revealed unit costs and LIDAR survey results, which we consider to be the best information available, to construct our alternative estimate. Also, Evoenergy has confirmed that it was responsible for the annual inspection and identification of vegetation defects on unleased territory within the defined urban areas prior to the

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[31] Evoenergy, *Revenue proposal 2019–24, Appendix 6.1 Vegetation management step change*, 27 April 2018, pp. 12-13.

[32] The McKell Institute and ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, pp. 21-22.

introduction of its new regulatory obligation.[33] Therefore, our step change forecast does not need to include an allowance for inspection costs within the designated urban areas because Evoenergy already incurs these costs.[34] As stated in the explanatory statement accompanying the *Utilities (Technical Regulation) Amendment Bill 2017*, having a legislative basis for tree cutting responsibilities across non-urban, rural and urban sectors will afford Evoenergy economies of scale and reduce costs.[35] We do not agree with the ETU's view that our step change forecast reduces Evoenergy's capacity to execute its vegetation management responsibilities.

In its submission, the ETU mischaracterised the findings we made in our final decision for Evoenergy for the 2014–19 regulatory control period, stating that we had found Evoenergy to be insufficient in meeting its vegetation management responsibilities.[36] In that decision, we found that Evoenergy did not act prudently and efficiently to manage costs associated with increased vegetation growth. We questioned the efficiency of Evoenergy's labour costs given its high level of internal resources used and the extent to which work was outsourced on an hourly rate basis for the urgent clearance of vegetation. These findings led to our conclusion that Evoenergy's vegetation management practices were inefficient, not *insufficient* as the ETU has suggested.

Evoenergy advised that it made significant improvement to its vegetation contract procurement procedures since 2014 when it moved from a *per hour basis* to a fixed price contract, which reduced overall trimming costs by 50 per cent.[37] Evoenergy further added that it would offer a combined tender in mid-2018 for its combined urban and rural trimming operations on the same basis. It expected that this process would attract competitive tenders and drive down average costs. We are satisfied that such vegetation contract procurement procedures are reflective of what a prudent service provider acting efficiently would do.

The ETU also argued that a low opex allowance for vegetation management is likely to result in cost pass throughs to consumers. It referred to the cost pass through application Evoenergy made to recover its expected vegetation management costs in 2018–19 pursuant to the amended *Utilities (Technical Regulation) Act 2014,* effective from 1 July 2018 (cost pass through application of December 2018).[38]

Under the cost pass through mechanism in the NER, Evoenergy will not be able to pass through cost to consumers that is already accounted for in our opex forecast

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33 *Evoenergy's response to the AER's information request #014*, 18 April 2018, p. 3.

34 This is distinct from the allowance we have provided within the step change forecast for the inspection costs associated with Evoenergy's new obligation to inspect electrical infrastructure on rural leased lands pursuant to clause 41I of the amended *Utilities (Technical Regulation) Act 2014.*

35 Explanatory statement for the *Utilities (Technical Regulation) Amendment Bill 2017*, presented by Mr Shane Rattenbury, Minister for Climate Change and Sustainability, p.11.

36 The McKell Institute and ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, pp. 22-23.

37 *Evoenergy's response to the AER's information request #021*, 7 May 2018, p. 7.

38 The McKell Institute and ETU NSW, *Submission on AER draft decision and Evoenergy revised proposal*, January 2019, pp. 24-25.

simply because its actual expenditure differs from our forecast. Evoenergy was entitled to make the cost pass through application of December 2018 because the costs relating to the new regulatory obligation were not included in our opex forecast for the 2014–19 revenue determination. Neither are the costs accounted for in our opex forecast for this final decision.

In relation to Evoenergy's cost pass through application of December 2018, Evoenergy had proposed, and we approved, a pass through amount of $2.4 million ($2018–19) for its vegetation management expenditure associated with its new regulatory obligation in 2018–19, consistent with our vegetation management step change forecast in our draft decision for this determination.

Having considered all stakeholders' submissions and the available information, we are satisfied that it is appropriate to maintain our draft decision estimate of Evoenergy's vegetation management step change.