ENERGEX

Revised Regulatory Proposal

for the period July 2010 – June 2015

January 2010

energex

positive energy

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1 Executive summary

ENERGEX Limited is a Queensland Government Owned Corporation (GOC) that builds, owns, operates and maintains the electricity distribution network in the fast growing region of South East Queensland (SEQ). ENERGEX provides distribution services to almost 1.3 million connections, delivering electricity to 2.8 million residents and businesses across the region. ENERGEX's network covers around 25,000 square kilometres, stretching from Gympie in the north to Withcott in the west, Stradbroke Island in the east and Coolangatta in the south. ENERGEX's assets include more than 50,000 kilometres of underground cables and overhead lines, over half a million power poles, some 43,000 distribution transformers, 250 zone and bulk supply substations, and approximately 300,000 street lights.

ENERGEX's key focus is distributing safe, reliable and affordable electricity in a commercially balanced way that provides value for its customers, manages risk and builds a sustainable future.

On 30 June 2009 ENERGEX submitted its *Regulatory Proposal* (original proposal) to the Australian Energy Regulator (AER) for the *regulatory control period* from 1 July 2010 to 30 June 2015 (the *2010-15 regulatory control period*) in accordance with the requirements of clause 6.8 of the National Electricity Rules (the *Rules*) and with consideration of the transitional arrangements for Queensland under clause 11.6 of the *Rules*.

ENERGEX's *Regulatory Proposal* has been subject to public consultation and a detailed review by the AER and its consultants. On 30 November 2009 the AER published a draft distribution determination (draft determination) for the Queensland electricity distribution businesses. This *Revised Regulatory Proposal* is in response to the AER's draft determination and is submitted in accordance with clause 6.10.3 of the *Rules*.

ENERGEX has reviewed the matters raised by the AER in its draft determination, in particular where the AER has made adjustments to its *Regulatory Proposal*. Where applicable, ENERGEX has implemented the adjustments required by the draft determination, or provided additional information and arguments to support its original proposal for the AER's consideration.

ENERGEX does not necessarily accept the rationale behind all of the AER's adjustments included in this *Revised Regulatory Proposal,* such as the AER's interim escalation rates and the Weighted Average Cost of Capital (WACC) of 10.06 per cent, but has adopted them for the purpose of the building block calculation. ENERGEX will comment on these matters in its submission in response to the draft determination to be lodged with the AER by 16 February 2010. ENERGEX expects that the AER will take these matters into consideration in making the final determination.

The key matters addressed in this *Revised Regulatory Proposal* include:

- a revised maximum demand forecast based on a recent National Institute of Economic and Industry Research (NIEIR) report validating the maximum demand forecast included in ENERGEX's *Regulatory Proposal*;
- re-inclusion of the growth capital expenditure removed as a result of MMA's/AER's demand forecast;
- re-inclusion of updated business cases in support of non-system capital programs in relation to property and Information and Communication Technology (ICT);
- re-inclusion of costs for public liability self insurance in operating expenditure;
- inclusion of forecasts for feed-in tariff payments and administration costs;
- new information to support a departure from the *Statement of Regulatory Intent* on the value for gamma;
- updated capital and operating expenditure programs to reflect the AER's interim escalation rates;
- the proposal for significant storm events and retailer credit risk to be recognised as specific nominated pass through events; and
- exclusion of adjustments for overs and unders in the Post Tax Revenue Model (PTRM).

In accordance with the AER's draft decision to exclude the 2008-09 over-recovery from the PTRM, ENERGEX provides the following proposed revenue outcomes in Table 1.1 for its *Revised Regulatory Proposal*.

Table 1.1 Revised building block revenue requirements for 2010-15

Nominal $M	2010-11	2011-12	2012-13	2013-14	2014-15
Annual revenue requirement	1,213.9	1,357.9	1,513.4	1,674.0	1,809.6
Smoothing	0.2	-9.1	-14.9	-9.2	39.9
Smoothed building block revenue	**1,214.1**	**1,348.9**	**1,498.5**	**1,664.8**	**1,849.6**

ENERGEX continues to adopt a balanced approach to the establishment of X factors to transition the annual revenue variation over the *2010-15 regulatory control period.* In accordance with the requirements of the *Rules*, ENERGEX submits the following X factors in this *Revised Regulatory Proposal*.

Table 1.2 Revised Building Block Revenue Requirements for 2010-15

	2010-11	2011-12	2012-13	2013-14	2014-5
X factor	-26.5%	-8.4%	-8.4%	-8.4%	-8.4%

The control mechanism is required to be in the CPI minus X form, indicating a revenue increase.

Taking into account the forecast consumption growth, the anticipated impact on average network prices in real terms is initially 25.9 per cent, followed by an average of 4.6 per cent for the remaining years of the *2010-15 regulatory control period*.

The AER in its draft determination requires ENERGEX to exclude over recoveries from previous years from the calculation in the PTRM. For the purpose of providing a better indication of future price changes, ENERGEX has modelled the price impacts with the inclusion of the over recoveries, resulting in an increase in the average initial price in 2010-11 of 20.9 per cent.

Although the AER's final determination and resultant decision on prices can not be made until June 2010, ENERGEX has committed to consultation with customers to provide an early indication of future electricity prices. ENERGEX has commenced discussions with community and industry stakeholder groups on the 2010-15 distribution determination and will continue its consultation to provide timely notice of expected network charges.

2 Demand forecast

2.1 AER's draft decision

In accordance with the capital and operating expenditure objectives in the *Rules*[1] the AER accepted the customer number and energy consumption forecasts proposed by ENERGEX in its *Regulatory Proposal* submitted in June 2009.

However, the AER considered the system and spatial maximum demand forecasts proposed by ENERGEX did not provide a realistic expectation of the demand forecast required to achieve the capital and operating expenditure objectives in the *Rules*.

The AER's conclusions are summarised below:

	2010-11	2011-12	2012-13	2013-14	2014-15
Maximum demand (MW)	4,864	5,027	5,228	5,466	5,684
Customer Numbers	1,363,138	1,389,033	1,417,664	1,448,548	1,480,294
Energy Consumption (GW.h)	22,416	23,138	24,042	24,795	25,845

2.2 ENERGEX's response

ENERGEX's baseline maximum demand forecast (V31) for the next *regulatory control period* was based on summer 2007-08 and winter 2008 peak demand. The baseline maximum demand and energy consumption forecasts were then adjusted to align with forecasts produced by NIEIR in April 2009, which took into account the impact of the Global Financial Crisis (GFC). ENERGEX then included an adjustment for expected demand reductions from its demand management (DM) initiatives.

ENERGEX's system maximum demand and spatial forecasts were used to develop the forecast growth capital expenditure. Subsequent adjustments to the forecast growth capital expenditure program proposed by both ENERGEX and the AER were based on a scaling of the program using the system maximum demand forecast. On this basis, ENERGEX has provided an updated system maximum demand forecast to validate its proposed growth capital expenditure.

[1] Clauses 6.5.7(a)(1), 6.5.7(c)(3), 6.5.6(a)(1), 6.5.6(c)(3).

ENERGEX's forecasts of summer maximum demand at 50 per cent Probability of Exceedence (PoE) leading up to the submission of its *Regulatory Proposal* in June 2009 are presented below in Table 2.1.

Table 2.1 Forecasts for the *2010-15 regulatory control period*

50 PoE maximum demand (MW)	2010-11	2011-12	2012-13	2013-14	2014-15	Comments
ENERGEX's V31 Forecast	5,486	5,767	6,023	6,250	6,490	No GFC and no DM Initiatives
NIEIR April 2009	5,144	5,378	5,699	5,945	6,085	Includes GFC but not DM Initiatives
Regulatory Proposal	5,126	5,338	5,633	5,844	5,941	Includes impact of GFC and DM Initiatives

ENERGEX notes the AER's confirmation that the customer number and energy consumption forecasts proposed by ENERGEX provided a realistic expectation of the demand forecasts required to achieve the capital and operating expenditure objectives outlined in the *Rules*.

The AER was not satisfied that the system and spatial maximum demand forecasts proposed by ENERGEX provided a realistic expectation of the demand forecast required to achieve the capital and operating expenditure objectives. The AER adjusted ENERGEX's forecasts accordingly, on the basis of McLennan Magazanik Associates' (MMA) analysis.

ENERGEX notes the comments made by MMA in relation to ENERGEX's forecasts. ENERGEX also notes MMA's observation that its growth projection for the *2010-15 regulatory control period* is approximately the same as ENERGEX's (range from 1,034 MW to 1,088 MW).[2]

However, ENERGEX believes MMA's alternative demand forecasts are flawed on the basis that the starting point for analysis (2006-07) understates the initial value for the 2008-09 50 per cent PoE maximum demand.

ENERGEX believes the key limitations of MMA's analysis are that:

- there is no methodological justification for using 2006-07 summer values over another year;
- it ignores the changes in temperature sensitive load and the impact of those changes;

[2] Source: MMA *Review of ENERGEX's maximum demand forecasts for the 2010 to 2015 price review*, October 2009, page 4.

- there is no supporting information provided on the calculation of the lower range for maximum demand; and
- it misinterprets Powerlink's 2009 Annual Planning Report (APR) data.

Each of these issues is discussed further in the following sections.

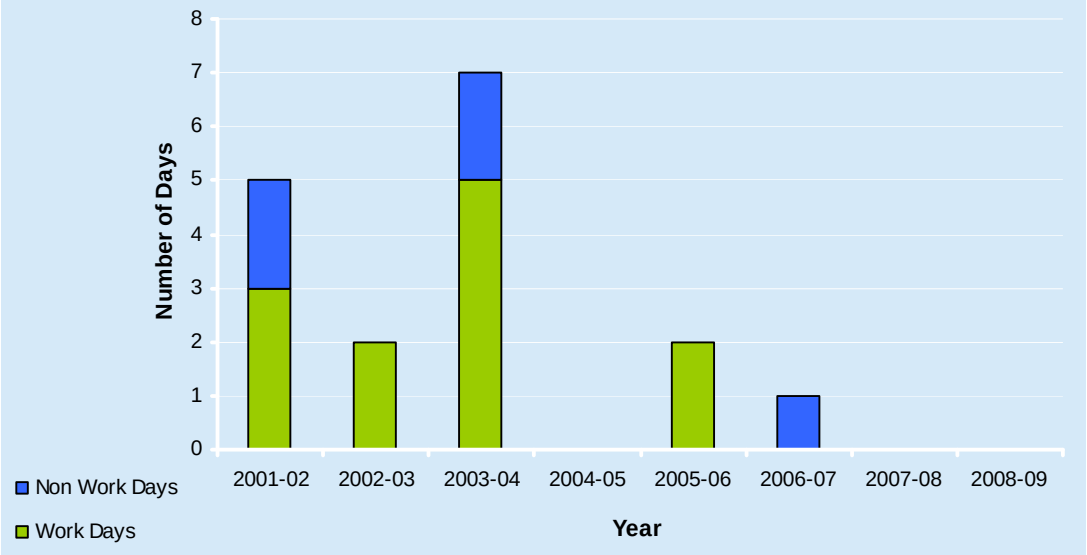
2.2.1 Methodology for Calculating Maximum Demand

It is generally acknowledged that weather variability makes forecasting maximum demand a difficult exercise. This was noted by MMA in its report that states:

> *The mild weather over the past two summers does, however, raise some potential difficulty with using 2007-08 and 2008-09 data, especially if trend analysis is used as a main forecast tool. In such a case the 2006-07 summer appears to be a more appropriate year to use as a starting point, although this may not pick up any genuine changes in trend in those two years*[3].

ENERGEX supports MMA's observation that the 2007-08 and 2008-09 summers were mild. This is clearly evident from Figure 2.1 below where there were no days in the summers of 2007-08 and 2008-09 with an average temperature above 30.2°C[4].

Figure 2.1 Days with Average Temperature > 30.2 Degrees at Amberley



[3] Source: MMA *Review of ENERGEX's maximum demand forecasts for the 2010 to 2015 price review*, October 2009, page 28.

[4] 30.2 C is the long term average temperature at Amberley weather station and is used by ENERGEX as the 50 PoE summer day.

On the basis that the 2007-08 and 2008-09 summers were considered mild, MMA adopted the 2006-07 summer as a starting point and utilised trend analysis to predict the 2007-08 and 2008-09 starting values. ENERGEX believes this approach is flawed, as by MMA's own admission, this approach "*may not pick up any genuine changes in trend in those two years*"[5].

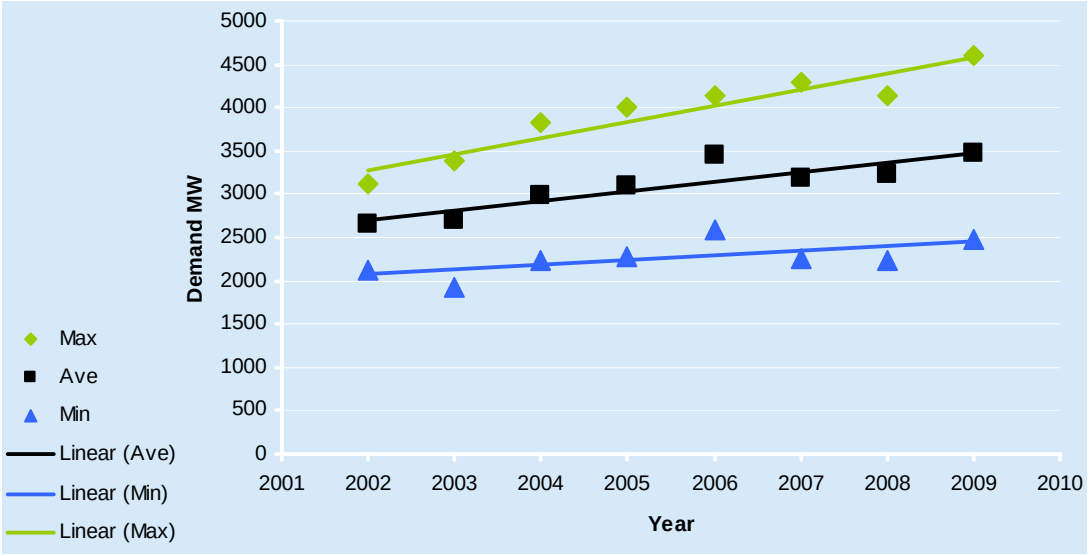
Over recent years, consumer electricity usage patterns have changed substantially, necessitating the use of a broader range of metrics/comparators to calculate forecast maximum demand. Due to this change in behaviour, ENERGEX believes in addition to average temperature observations, consideration should be given to changes in temperature sensitive load. Temperature sensitivity of load increased rapidly in the early 2000s. This trend has continued in the current *regulatory control period* but at a lower rate. Temperature sensitive load is a significant contributor to ENERGEX's maximum demand as illustrated in Figure 2.2 below.

Figure 2.2 ENERGEX Summer Temperature Coefficients at Amberley

Further evidence of the impact of temperature sensitive load is shown by the divergence of recorded peak demand growth, compared with average demand growth for ENERGEX's network shown in Figure 2.3.

5 Source: MMA, *Review of ENERGEX's maximum demand forecasts for the 2010 to 2015 price review*, October 2009, page 28.

Figure 2.3 ENERGEX Summer Season Recorded Daily Peak Demand Trends



2.2.2 MMA's conclusion on starting value in 2008-09

MMA estimated that the most likely range for system maximum demand in 2008-09 was 4,600 MW to 4,750 MW and adopted the estimate of 4,624 MW. ENERGEX does not understand the factors MMA took into account in recommending a lower estimate as no justification was provided by MMA.

ENERGEX strongly believes that MMA's estimate of 4,624 MW is grossly understated and is therefore not a reasonable 50 PoE load for 2008-09.

Actual recorded peak demand for the summer of 2008-09 on the ENERGEX network was 4,593 MW and the average temperature for this day was 27.5°C. The temperature characteristic for that day of peak demand in 2008-09 was milder than the 90 PoE day of 28.8°C and was substantially lower than the long term average 50 PoE of 30.2°C.

Instead of using a linear interpolation of actual recorded demand to calculate the 50 PoE maximum demand for 2008-09, ENERGEX adopted the methodology developed by ACIL Tasman. The inputs to the ACIL Tasman model are the GSP (Gross State Product) and the 2007-08 and 2008-09 recorded demands and temperatures. A Monte Carlo simulation, based on the recorded temperatures for the last 50 years, was then carried out. To determine the 50 PoE temperature corrected maximum demand, the 50th percentile of recorded peak yearly demand was selected. For 2008-09 this was 4899 MW which is 275 MW above MMA's estimate.

Considering the fact that 2008-09 was a mild summer, ENERGEX submits that MMA's adjustment of just 31 MW above the recorded peak demand of 4,593 MW is unrealistic.

2.2.3 Powerlink's 2009 Annual Planning Report

MMA used the temperature corrected peak demand for South East Queensland from the Powerlink 2009 APR to assess the likely upper band for the 50 PoE demand for the summer of 2008-09. It is unclear to ENERGEX why this value was considered the upper limit. Nonetheless, ENERGEX considers that MMA has erred in its judgement due to the following:

- Powerlink's APR sets Queensland out into 10 geographic zones. The APR refers to the area of South East Queensland as Moreton plus Gold Coast zones. However, the area defined by Powerlink as South East Queensland does not align with the entire ENERGEX area of supply. The South East Queensland load in Powerlink's APR does not account for ENERGEX's western area which is supplied from Powerlink's South West zones while Powerlink's Gold Coast zone supplies the northern section of Country Energy's network.
- MMA misinterpreted the report by subtracting the total Queensland embedded generation of 157 MW at the time of system peak. The native demand quoted in the Powerlink's APR was 4,907 MW with 31.7 MW of embedded generation in the ENERGEX network at the time of system peak. The resulting 50 PoE demand is calculated at 4,875 MW which is 125 MW higher than the upper bound set by MMA.
- ENERGEX further submits that adjusting the native demand for embedded generation for Powerlink is reasonable from a transmission network perspective. However, this approach may not be appropriate for distribution networks as embedded generation at the transmission and sub-transmission level will still require capacity at a distribution network level. In addition, embedded generation cannot be relied on to be always available at the time of peak demand.

Table 2.2 sets out the 50PoE weather corrected demand for 2008-09 determined by MMA, ENERGEX and Powerlink.

Table 2.2 Comparison of weather corrected maximum demand for 2008-09

	MMA	ENERGEX	Powerlink*
Weather corrected maximum demand for 2008-09	4,624	4,899	4,875

While Powerlink's APR load does not completely align to ENERGEX's network, it is a reasonable approximation for the purposes of this comparison.

2.3 NIEIR October 2009 Forecast

As part of its annual forecasting process, ENERGEX recently commissioned NIEIR to independently prepare electricity consumption and maximum demand projections to 2019 for its distribution area. This report provided in **Appendix 2.1** updates previous reports prepared by NIEIR in October 2008 and April 2009 for ENERGEX.

This report also incorporates an updated economic outlook, forecasts growth in Queensland GSP and includes an assessment of the impact of the GFC and associated flow-on effects. NIEIR's forecasting methodology, based on a model that has been developed and refined over the last fifteen years, does not need to temperature correct for actual demand.

The 50 PoE demand forecast produced by NIEIR for the ENERGEX network does not include the expected reduction from DM initiatives. Consistent with its original proposal, ENERGEX adjusted NIEIR's forecast for DM initiatives. As shown in Table 2.3, this latest forecast aligns closely with the demand forecast as proposed in ENERGEX's *Regulatory Proposal*. The variation is immaterial when considered over the entire ENERGEX network and has no impact on the forecast growth capital expenditure as discussed in Chapter 3.

Table 2.3 NIEIR's October 2009 Demand Forecast

Maximum Demand (MW)	2010-11	2011-12	2012-13	2013-14	2014-15
NIEIR October 2009 forecast	5,136	5,416	5,722	5,914	6,083
NIEIR October 2009 adjusted for DM Initiatives[6]	5,118	5,376	5,655	5,814	5,940
Regulatory Proposal	5,126	5,338	5,633	5,844	5,941
Variation	-8	38	22	-30	-1

The growth projection for the 2010-15 period based on NIEIR's October 2009 forecasts is 1,075 MW[7] and is within the range calculated by MMA.

2.4 ENERGEX's revised demand forecast

As outlined in section 2.2, ENERGEX believes that MMA's approach to derive the starting value for 2008-09 is flawed and cannot be relied upon to prepare the demand forecast for the *2010-15 regulatory control period*.

In the public forum on its draft determination, the AER stated that it expected ENERGEX to provide an updated demand forecast. NIEIR's updated maximum demand forecast finalised in October 2009 is the latest forecast available at the time of preparing this *Revised Regulatory Proposal*.

ENERGEX believes that the NIEIR forecast is an independent and robust forecast that does not rely on adjusting the starting values for 50 PoE demand, is the most up to date forecast, and will provide a realistic expectation of the forecast demand required to achieve the capital expenditure and operating expenditure objectives of the *Rules*.

ENERGEX submits the demand forecast as shown in Table 2.4 for the *Revised Regulatory Proposal*.

6 Source: Based on NIEIR October 2009 adjusted for Demand Management Initiatives

7 Source: NIEIR's October 2009 forecast for 2009-10 is 5,008 MW.

Table 2.4 Revised Demand Forecasts for the *2010-15 regulatory control period*

System Maximum Demand (MD)	2010-11	2011-12	2012-13	2013-14	2014-15
ENERGEX's Revised MD (MW)[8]	5,118	5,376	5,655	5,814	5,940

[8] Source: Based on NIEIR's Oct 2009 adjusted for Demand Management Initiatives

3 Forecast capital expenditure

In this chapter of the *Revised Regulatory Proposal* ENERGEX has adopted the AER's approach from the draft decision. Revisions are adjusted against the original *Regulatory Proposal* forecast with all values reflected in real $2009-10 using escalation rates proposed in the *Regulatory Proposal* submitted on 30 June 2009. Finally, an overall adjustment using the AER's draft decision escalators is then applied to determine the revised capital expenditure requirement.

3.1 AER's draft decision

In accordance with clause 6.12.1(3) of the *Rules*, the AER in its draft decision did not accept ENERGEX's forecast capital expenditure for the next *regulatory control period*.

In its review of ENERGEX's forecast capital expenditure, the AER made the following adjustments:

- $289 million reduction to growth capital expenditure to reflect expected slower growth in economic activity;
- $159 million reduction to non-system capital expenditure to exclude unsupported proposed expenditure on major building projects;
- $7 million reduction in indirect costs associated with ICT services that do not reasonably reflect the capital expenditure criteria, including the capital expenditure objectives; and
- $372 million reduction to total capital expenditure, applied across all components of capital expenditure forecasts, to account for revisions in the escalation of real input costs.

Following the adjustments (including adjustments for indirect costs) summarised above, the AER determined that $5,718.3 million was a reasonable level of capital expenditure for ENERGEX for the next *regulatory control period*.

3.2 ENERGEX's response

ENERGEX's *Regulatory Proposal* determined a baseline forecast capital expenditure for the *2010-15 regulatory control period* of $6,689.6 million. This baseline level of expenditure was adjusted to account for impacts to forecast demand due to the GFC and DM initiatives. ENERGEX considered the resultant adjusted program expenditure of $6,466 million to be prudent, efficient and based on a realistic expectation of demand forecasts and input costs.

In its draft decision, the AER was satisfied that ENERGEX's capital expenditure planning and governance processes were consistent with the achievement of the capital expenditure objectives outlined in the *Rules*. The AER was also satisfied that the following capital expenditure programs would lead to prudent and efficient outcomes:

- asset replacement – $1,165.3 million;
- reliability and quality of service enhancement – $306.3 million; and
- security compliance – $1,817.4 million.

ENERGEX accepts the AER's draft decision in relation to these capital expenditure programs.

However, the AER was not satisfied that ENERGEX's growth capital expenditure adequately accounted for the GFC and forecast demand. It was also of the view that the proposed cost escalators did not adequately reflect current market volatility. These were the key factors that contributed to the AER's draft decision to reject ENERGEX's proposed capital expenditure allowance.

ENERGEX acknowledges the AER's confirmation that proposed capital expenditure for tools and equipment, motor vehicles and end-use computing assets are prudent and efficient.

The AER considered that the major non-system capital building projects had not been demonstrated to be prudent and efficient.

ENERGEX accepts the AER's draft decision in relation to the business-as-usual portion of the program. ENERGEX acknowledges the comments made by AER's consultant Parsons Brinckerhoff (PB) on the quality of the documentation provided on its six major projects proposed in the forecast for non-system property capital expenditure. Consequently ENERGEX submits updated business case proposals, prepared under its capital governance framework, that address concerns about the prudence, efficiency and justification of expenditure on the major projects.

This *Revised Regulatory Proposal* incorporates ENERGEX's response to matters raised in the draft decision, correction of errors and updated information on selected programs. Further discussion on the following matters is outlined below:

- growth capital expenditure forecasts;
- Traveston dam pump load project;
- major property project forecasts;
- motor vehicles, tools and equipment forecasts;
- ICT services expenditure; and
- overhead allocations.

3.2.1 Growth capital expenditure forecasts

ENERGEX's baseline demand and spatial forecasts were used to develop the forecast growth capital expenditure. Subsequent adjustments to the forecast growth capital expenditure program proposed by both ENERGEX and the AER are based on a scaling of the program using the system maximum demand forecast.

As discussed in Chapter 2, ENERGEX disagrees with MMA's analysis of maximum demand. In particular, ENERGEX believes that MMA's approach to derive the starting value for 2008-09 is flawed and cannot be relied upon to prepare the demand forecast for the 2010-15 *regulatory control period*.

ENERGEX's revised demand forecast was prepared by NIEIR in October 2009. As shown in Table 3.1 this forecast was based on the latest economic outlook and is in alignment with the forecast proposed in the *Regulatory Proposal*.

Table 3.1 Revised Demand Forecasts for the *2010-15 regulatory control period*

System Maximum Demand (MW)	2010-11	2011-12	2012-13	2013-14	2014-15
ENERGEX's Revised MD[9]	5,118	5,376	5,655	5,814	5,940
Regulatory Proposal	5,126	5,338	5,633	5,844	5,941
Variation	-8	38	22	-30	-1

The variation in the demand forecasts is considered immaterial when considered over the entire ENERGEX network and has no impact on the growth capital program as proposed in the *Regulatory Proposal*.

In light of the above, ENERGEX resubmits its original growth capital expenditure forecast, with the exception of Traveston Dam pump load, discussed below, for this *Revised Regulatory Proposal*.

3.2.2 Traveston dam pump load project

In this *Revised Regulatory Proposal*, ENERGEX has reduced its capital expenditure program by $20.2 million for the Traveston dam pump load project in response to the Commonwealth Environment Minister's decision to not allow the Traveston Crossing Dam to proceed. The construction of replacement projects, such as desalination plants, has been deferred beyond the *2010-2015 regulatory period* and therefore no substitution projects are required.

[9] Source: Based on NIEIR's October 2009 report, adjusted for the impact of Demand Management Initiatives

Table 3.2 *Revised Regulatory Proposal* for Traveston dam pump load project

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Regulatory Proposal	-	0.2	19.0	1.0	-	20.2
Revised Regulatory Proposal	-	-	-	-	-	-

Total may not add up due to rounding.

This amendment to the system capital growth program has been reflected in the *Revised Regulatory Information Notice* (RIN) in Schedule 2.2.3 – Material projects and programs.

3.2.3 Major property projects

In previous *regulatory control periods*, ENERGEX focussed on investing in network infrastructure to meet the challenges of sustained peak demand growth. As a result, the non-system property portfolio requires continued investment to support the increasing system capital and operating programs.

In order to assess the current state and future requirements of the property portfolio resulting from the impacts of continued growth in capital and operating programs, ENERGEX commenced its first long term strategically focussed planning cycle in 2007. The resulting Corporate Property Strategy for 2010-15 indicates that a significant increase in funding is needed to address growing compliance, safety and efficiency issues in the existing property portfolio and to derive maximum value for ENERGEX into the future. The latest Corporate Property Strategic Plan for 2010-15 was endorsed by the Board in December 2009 and is provided in confidential **Appendix 3.1**.

In July 2009, ENERGEX expanded the role of the Information Management Steering Committee (IMSC) to include the assessment of all business investment decisions. The Investment Review Committee (IRC) replaces the IMSC[10]. The IRC's role is to review and approve all investment decisions and to support the Chief Executive Officer (CEO) and Board through the annual development of a balanced capital and operating project investment portfolio for inclusion in the Statement of Corporate Intent. The IRC prioritise proposed business change projects based on their value contribution to ENERGEX, its customers and shareholders. The Committee also undertakes an ongoing strategic oversight, scrutiny and challenge function for the investment portfolio and proposed new business change projects.

In its draft decision, the AER stated that its reduction to the property program expenditure was in relation to six major projects which were not supported by business case documentation and were not demonstrated to be prudent or efficient.

[10] The IMSC had oversight of ICT projects only. As a result of internal re-organisation, the IMSC was replaced by the IRC which has oversight of all capital and operating projects and programs, except regulated energy network system projects.

The projects excluded by the AER represent the foundation projects essential for implementation of the Corporate Property Strategy for 2010-15 to address ENERGEX's existing and long term property requirements. Furthermore, they are required to:

- meet mandatory building, safety and compliance requirements;
- address limitations on existing and future operational capacity;
- address distribution, logistics and warehousing inefficiencies;
- address existing community conflicts due to urban encroachment;
- reduce excessive maintenance costs on ageing property assets; and
- meet ENERGEX's long term growth, reliability and efficiency imperatives.

ENERGEX submits business case proposals in support of the increase in forecast expenditure for the six major projects in this *Revised Regulatory Proposal*. The business case proposals have been prepared under the IRC capital governance framework and address the AER's concerns about the prudence, efficiency and justification of expenditure on these six projects. The proposals were submitted to the IRC in December 2009 and were recommended for progression to business case development and inclusion in ENERGEX's Business Change Investment Portfolio for 2010-11. Business case proposal documentation in support of these projects is provided in **Appendices 3.2 to 3.7**.

In this *Revised Regulatory Proposal*, ENERGEX re-submits the full value of the six major projects excluded by the AER and PB during their review. The value of these projects is $171.5 million including the full cost of the logistics and warehousing facility project as shown in Table 3.3.

Table 3.3 *Revised Regulatory Proposal* for Property Capital Expenditure

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
ENERGEX's *Regulatory Proposal*						
BAU program	24.8	35.1	23.8	18.5	24.7	126.9
Major projects	118.3	32.6	20.6	-	-	171.5
Total	**143.1**	**67.7**	**44.4**	**18.5**	**24.7**	**298.4**
AER's Draft Decision						
BAU program	24.8	35.1	23.8	18.5	24.7	126.9
Major projects	2.7	2.7	2.6	2.6	2.5	13.1
Total	**27.5**	**37.8**	**26.4**	**21.1**	**27.2**	**140.0**
ENERGEX's *Revised Regulatory Proposal*						
BAU program	24.8	35.1	23.8	18.5	24.7	126.9
Major projects	118.3	32.6	20.6	-	-	171.5
Total	**143.1**	**67.7**	**44.4**	**18.5**	**24.7**	**298.4**

Total may not add up due to rounding.

3.2.4 Motor vehicles, tools and equipment

In reviewing the capital expenditure forecast for this *Revised Regulatory Proposal*, ENERGEX identified an error in the application of materials escalations which resulted in a minor understatement of forecast expenditure for these categories. The correction of the error resulted in an increase to *Regulatory Proposal* forecasts of $7.8 million for motor vehicles and $2.0 million for tools and equipment as shown in Table 3.4 and Table 3.5 below.

Table 3.4 *Revised Regulatory Proposal* increase for motor vehicles

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Regulatory Proposal	**32.8**	**41.8**	**42.0**	**32.3**	**47.4**	**196.3**
Escalation correction	0.6	1.2	1.6	1.6	2.8	7.8
Revised Regulatory Proposal	**33.4**	**43.0**	**43.6**	**33.9**	**50.2**	**204.1**

Total may not add up due to rounding.

Table 3.5 *Revised Regulatory Proposal* increase for tools and equipment

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Regulatory Proposal	**13.3**	**10.9**	**10.7**	**10.6**	**10.7**	**56.2**
Escalation correction	0.2	0.3	0.4	0.5	0.6	2.0
Revised Regulatory Proposal	**13.5**	**11.2**	**11.1**	**11.1**	**11.3**	**58.2**

Total may not add up due to rounding.

In this *Revised Regulatory Proposal*, ENERGEX submits the corrected values for these categories.

3.2.5 ICT services expenditure

ENERGEX's response in relation to ICT services expenditure is discussed in Chapter 4 Forecast operating expenditure.

3.2.6 Overhead allocations

As a consequence of the revisions in the capital and operating expenditure programs, indirect expenditure had been reallocated according to the AER's approved Cost Allocation Method (CAM).

3.3 Escalation rates

In its draft determination the AER concluded that ENERGEX's cost escalators used in its *Regulatory Proposal* do not reasonably reflect the capital expenditure criteria. The AER substituted these escalators in determining the capital expenditure allowance for ENERGEX. The AER stated that it considers that using the most recently available data to update cost escalation forecasts satisfies the capital expenditure objectives.

For the purpose of the building block calculation, ENERGEX acknowledges and has applied the AER's interim escalation rates. ENERGEX expects that the AER will update these escalation rates to reflect the most recent data in its final decision.

Taking into account the significance of escalation rates, ENERGEX is assessing the AER's methodology and indices. ENERGEX will provide further comment on this matter in its submission to the AER's draft determination.

3.4 ENERGEX's revised forecast capital expenditure program for 2010-15

In this *Revised Regulatory Proposal* ENERGEX submits the following:

- re-inclusion of the full capital expenditure forecast in relation to growth;
- $20.2 million reduction to growth capital expenditure due to cancellation of the Traveston dam pump load project;
- re-inclusion of the full value of the six major property projects;
- $7.8 million increase to motor vehicles forecast to account for corrections to application of ENERGEX's escalators;
- $2.0 million increase to tools and equipment forecast to account for corrections to application of ENERGEX's escalators;
- $4.4 million adjustment for ICT services indirect expenditure and re-allocation of overheads; and
- $390.5 million reduction to account for the application of the AER's interim escalation rates.

As a result of the incorporation of these revisions, ENERGEX submits the following revised capital expenditure program in Table 3.6.

Table 3.6 *Revised Regulatory Proposal* Capital Expenditure Program for 2010-15

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
***Regulatory Proposal* capital expenditure**	**1,239.5**	**1,269.7**	**1,301.9**	**1,292.4**	**1,362.5**	**6,466.0**
Adjustment to capex – Traveston dam project	-	-0.2	-19.0	-1.0	-	-20.2
Adjustment to motor vehicles and tools and equipment non-system capex	0.9	1.5	2.0	2.0	3.4	9.8
Adjustment to overheads and shared ICT costs	0.6	0.1	3.7	0.1	-0.2	4.4
Adjustment to cost escalators*	-56.4	-64.9	-78.8	-88.1	-102.2	-390.4
Revised Regulatory Proposal* capital expenditure	**1,184.6**	**1,206.2**	**1,209.8**	**1,205.5**	**1,263.4**	**6,069.5**

** Based on the application of the AER's interim escalation rates.*
Total may not add up due to rounding.

A breakdown of the revised capital expenditure program by category including the revisions discussed in previous sections and the application of the AER's interim escalation rates is provided in Table 3.7.

Table 3.7 *Revised Regulatory Proposal* Capital Expenditure Program for 2010-15 by category

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Growth	397.4	432.7	483.7	529.6	591.2	2,434.6
Asset replacement/renewal	152.6	241.6	199.0	259.1	233.6	1,085.9
Reliability and quality of service enhancement	81.6	47.7	68.0	47.7	41.8	286.7
Security compliance	368.1	364.1	364.6	306.9	313.1	1,716.7
Total System*	**999.8**	**1,086.0**	**1,115.3**	**1,143.3**	**1,179.7**	**5,524.0**
End-use computing assets	3.1	4.2	1.3	1.7	2.2	12.4
Land and buildings	136.8	63.4	40.0	16.8	22.0	279.0
Fleet	32.0	41.8	42.5	33.0	48.7	198.0
Tools and equipment	12.9	10.9	10.7	10.7	10.9	56.1
Total Capital Expenditure*	**1,184.6**	**1,206.2**	**1,209.8**	**1,205.5**	**1,263.4**	**6,069.5**

**Based on the application of the AER's interim escalation rates.*
Total may not add up due to rounding.

4 Forecast operating expenditure

In this chapter of the *Revised Regulatory Proposal* ENERGEX has adopted the AER's approach from the draft decision. Revisions are adjusted against the original Regulatory Proposal forecast with all values reflected in real $2009-10 using escalation rates proposed in the *Regulatory Proposal* submitted in June 2009. Finally, an overall adjustment using the AER's draft decision escalators is then applied to determine the revised capital expenditure requirement.

4.1 AER's draft decision

In accordance with clause 6.12.1(4) of the *Rules* the AER in its draft decision did not accept ENERGEX's forecast operating expenditure for the next *regulatory control period*.

In its review of ENERGEX's forecast operating expenditure proposal, the AER made the following adjustments:

- $2.2 million reduction to demand side management initiatives;
- $11 million reduction to other support costs that are not consistent with the *Rules*;
- $2.2 million reduction in indirect costs associated with ICT services;
- $15 million reduction in self insurance expenditure;
- $19 million reduction in debt raising costs;
- $87.4 million reduction in equity raising costs; and
- $140 million reduction to total operating expenditure, applied across all components of operating expenditure forecasts, to reflect the impact of revised input cost escalators.

Following the adjustments (including adjustments for indirect costs) summarised above, the AER determined that $1,586.3 million was a reasonable level of operating expenditure for ENERGEX for the next *regulatory control period*.

4.2 ENERGEX's response

In its *Regulatory Proposal,* ENERGEX proposed operating expenditure for the *2010-15 regulatory control period* of $1,843.1 million; comprising $1,696 million in controllable and $147.3 million in uncontrollable operating expenditure. This level of operating expenditure was considered by ENERGEX to be prudent and compared favourably with industry efficiency benchmarks.

The AER was satisfied that ENERGEX's methodology for establishing forecast operating expenditure is sound but was not satisfied that ENERGEX's proposed total forecast operating expenditure of $1,843.1 million reasonably reflects the operating expenditure criteria in the *Rules*.

ENERGEX accepts the AER's conclusion that ENERGEX's controllable operating expenditure in network operating costs, network maintenance costs, meter reading costs, customer services, and levies were prudent and efficient.

The AER considered that a reduction of $2.2 million to demand side management initiatives was required to exclude the demand and energy data capture and analysis program, which did not reasonably reflect the operating expenditure criteria, including the operating expenditure objectives. ENERGEX will review the scope of this project and may seek funding for this work through the Demand Management Innovation Allowance (DMIA).

The AER was not satisfied that the proposed ICT shared costs reflect the operating expenditure criteria, including the operating expenditure objectives. As a result, the AER considered that a reduction of $2.2 million in operating expenditure and $6.8 million in capital expenditure was necessary. ENERGEX has included in this *Revised Regulatory Proposal* updated information and revised business cases in support of these ICT initiatives.

Also, the AER considered that a reduction of $10.8 million to other support costs was required for ENERGEX's operating expenditure forecasts to comply with the *Rules*. Accordingly, ENERGEX has incorporated this revision.

The AER noted that due to the current volatility within financial markets, updated information regarding the financial obligations of ENERGEX in respect to defined benefit superannuation schemes is expected in the *Revised Regulatory Proposal*. ENERGEX does not accept the AER's observation as ENERGEX has not included any additional defined benefit superannuation costs to account for volatility in the financial market in its *Regulatory Proposal*. This issue is further discussed in Section 7.1.2.

The AER was not satisfied that ENERGEX's proposed uncontrollable expenditure for self insurance allowances, benchmark debt raising costs or benchmark equity raising costs reasonably reflected the operating expenditure criteria, including the operating expenditure objectives as outlined in the *Rules*. ENERGEX acknowledges the AER's position and has provided specific comments on these items in further sections.

ENERGEX has prepared this *Revised Regulatory Proposal* in consideration of the draft decision and provides further discussion on the following matters:

- self insurance;
- feed-in tariff payments;
- feed-in tariff administration costs;
- ICT services expenditure; and
- overhead allocations.

4.2.1 Self insurance

In its *Regulatory Proposal*, ENERGEX proposed a total of $15.1 million as a self insurance allowance for 2010-15. The AER's draft decision on uncontrollable operating expenditure provided a total allowance for self insurance of $38,000 for public liability risks.

ENERGEX does not agree with the AER's draft decision and resubmits an allowance for public liability insurance in this *Revised Regulatory Proposal.*

4.2.1.1 Storms

ENERGEX acknowledges the AER's position that events affecting key income generating assets are better dealt with through the cost pass through mechanism.

In accordance with the AER's preferred position, ENERGEX therefore proposes a specific nominated pass through arrangement for significant storm events, causing damage in excess in of $2 million per event, in this *Revised Regulatory Proposal*. This is discussed further in Chapter 7.

4.2.1.2 Retailer credit risk

In its *Regulatory Proposal*, ENERGEX proposed a self insurance allowance to cover retailer credit risk up to $5 million, and proposed that any costs over $5 million relating to a failure by a retailer to pass on DUOS (Distribution Use of System) charges recovered from customers to ENERGEX should be treated as a general nominated event.

In its draft determination, the AER rejected ENERGEX's self insurance allowance for retailer credit risk as AER is not satisfied that the events relating to retailer default are predictable and measurable and therefore fail to qualify as self insurance events.

In assessing ENERGEX's nomination for pass through of retailer credit risk, the AER considered that, should it occur, a retailer credit risk event may constitute a general nominated pass through event. The AER stated further that whether or not an event of this sort falls into the category of the general nominated pass through event would be assessed at the time of an application for cost pass through being made to the AER.

ENERGEX notes the recent failure of the retailer, Jackgreen (International) Pty Ltd, who was suspended from trading in the national electricity market on 18 December 2009. While the default payment amount is significant, it is unlikely to meet the 1% annual revenue threshold required under a general nominated pass through event. In the absence of self insurance, ENERGEX is unable to mitigate this risk.

In view of AER's rejection of self insurance for retailer credit risks and the setting of 1 per cent materiality threshold for general nominated pass through, ENERGEX is seeking a specific nominated pass through arrangement for retailer failure event. This is discussed further in Chapter 7.

4.2.1.3 Public liability

In its *Regulatory Proposal*, ENERGEX proposed a self insurance allowance of $6.3 million for public liability risks. The AER's draft decision allowed for $38,000 for self insurance costs for this purpose. ENERGEX does not accept the AER's draft decision in relation to public liability risk.

ENERGEX submits that the $38,000 allowance over the *regulatory control period* would be insufficient to cover the basic administration costs associated with establishment and operation of a self insurance program.

Moreover, the basis of the AER's calculation is fundamentally flawed because it fails to recognise that the distribution of public liability claims is highly skewed, with a very large number of small losses and a much smaller number of large losses. This means that the cost of each million dollars of coverage at the low end (from $0 to [redacted]) is much higher than at the high end (for example from [redacted]).

ENERGEX notes that between 2002 and 2007 it has had average annual losses of [redacted] for deductibles up to the [redacted]. This is significantly different to the $7,528 per annum proposed by the AER for the *2010-15 regulatory control period*. Finity has advised ENERGEX that the AER's approach to calculating this loss estimate is "not consistent with actuarial standards nor any known actuarial practice".

As suggested in the AER's draft determination, ENERGEX requested an indicative quote from its insurance broker. The broker confirmed that zero excess insurance products are not available, and further stated it was not possible to obtain a formal quote or even a theoretical non-binding indication of the likely premium of such a product.

The broker also confirmed that it was not possible to provide a formal quote for a scenario that had a lower excess, but did provide an informal non-binding premium estimate for a scenario that had an excess of [redacted] for public liability and [redacted] for bushfire. This informal non-binding premium estimate is approximately [redacted] per annum, which is considerably more than the AER's proportion based estimate of $7,528 per annum but is comparable to ENERGEX original proposal of around $1.2 to $1.4 million per annum for self insurance of public liability large claims. The non-binding premium estimate provided by the broker was for the primary layer cover only, and would not totally eliminate ENERGEX's excess.

ENERGEX holds the view that the premium estimate for a deductible cannot be derived by proportionate analysis of a higher order insurance policy. The appropriate method (in the absence of a formal insurance quote) should be to base the estimate on actual claims history and that information to be analysed in the manner that Finity Consulting Pty Ltd performed. ENERGEX's historical public liability large claims information was detailed in the confidential Appendix 12.2 of ENERGEX's *Regulatory Proposal*.

The AER stated in its draft decision that the claims Incurred But Not Reported (IBNR) benchmark used by Finity in deriving ENERGEX's public liability self insurance loss estimates were inappropriate. Finity has advised ENERGEX that it is standard actuarial practice to include an appropriate allowance for IBNR claims in the development of a liability projection.

Because ENERGEX only has a small number of large liability claims, Finity considered that it is not appropriate to use the development of ENERGEX's large claims costs to derive IBNR factors. Therefore the IBNR factors used by Finity to gross up the estimated cost of claims to derive a projection of ENERGEX's ultimate public liability were based on benchmarks complied from the public liability experience of over 30 insurers for which Finity undertakes work.

Moreover, Finity has advised ENERGEX that an IBNR is required under:

- Australian Accounting Standard AASB 13;
- APRA General Insurance Standards; and
- Institute of Actuaries Professional Standard 300.

ENERGEX therefore re-submits public liability costs of $6.3 million for consideration as a self insurance allowance on the basis that:

- it is reliably calculated based on actual historical claims using robust actuarial methods;
- it has been confirmed that there are no insurance products available to provide cover for the risk; and
- an informal non-binding premium estimate from our broker suggests that Finity's estimate is within a plausible range of the brokers estimate.

The brokers confidential advice is included in **Appendix 4.1**.

ENERGEX resubmits its original proposal for $6.3 million and has included this allowance in the forecast operating expenditure included in this *Revised Regulatory Proposal*.

4.2.2 Debt raising and interest rate hedging costs

ENERGEX acknowledges the AER's draft decision to reduce ENERGEX's proposed allowance for debt raising costs to $25.3 million for the *2010-15 regulatory control period* and has included this allowance in the forecast operating expenditure in this *Revised Regulatory Proposal*.

ENERGEX believes the AER's reasoning for rejecting the proposed methodology for hedging costs did not fully consider the merits of the issue. ENERGEX acknowledges the AER's draft decision to reject an allowance for interest rate hedging costs for Queensland DNSPs (Distribution Network Service Provider); noting the AER's position that approval of such an allowance may represent a fundamental change in the regulatory framework administered by the AER.

4.2.3 Equity raising costs

ENERGEX acknowledges the AER's draft decision to allow $36.8 million in equity raising costs for the *2010-15 regulatory control period*.

ENERGEX also acknowledges the AER's draft decision to transfer equity raising costs from forecast operating expenditure to the Regulatory Asset Base (RAB). Accordingly, this *Revised Regulatory Proposal* includes the allowance for equity raising costs in the RAB. The applicable asset life will be recalculated in accordance with the AER's methodology and adjustments made in ENERGEX's *Revised Regulatory Proposal*.

The AER's draft decision reviewed the treatment of equity raising costs by Queensland DNSPs and made an adjustment to the imputation payout ratio, increasing it from 71 per cent (as derived by financial expert Professor Bob Officer) to 100 per cent on the basis of consistency with the AER's gamma assumption[11].

ENERGEX considers that a 100 per cent dividend payout ratio is not appropriate and that Officer's[12] 71 per cent is the most appropriate assumption to apply. Notwithstanding this position, ENERGEX has applied the AER's draft decision in calculating the equity raising costs. ENERGEX will provide further comment on this matter in its submission to the AER's draft determination.

4.2.4 Feed-in tariff payments

In its *Regulatory Proposal* ENERGEX proposed feed-in tariff as a specific nominated pass through event. ENERGEX's proposal is that the event should apply to total payments made to retailers. The AER considers that the Queensland DNSPs should include forecasts of total payments associated with the feed-in tariff as part of their proposed operating expenditure allowance, with forecast errors, rather than total payments, being subject to cost pass through.

Based on the current year to date payment for the feed-in tariff, ENERGEX estimates $35.6 million over the next *regulatory control period* for payment of feed-in tariff at the current rate of 44 cents per kW.h.

The forecast feed-in tariff payments included in this *Revised Regulatory Proposal* is set out in Table 4.1 below.

Table 4.1 Forecast total payment for feed-in tariffs

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Feed-in tariffs payments	4.6	5.9	7.1	8.4	9.6	35.6

11 Source: AER's *Queensland Draft distribution determination 2010-11 to 2014-15*, page 175.

12 Source: N. Hathaway and R. Officer, *The Value of Imputation Credits*, manuscript, University of Melbourne, 1992.

4.2.5 Feed-in tariff administration costs

The Solar Bonus Scheme to encourage greater use of solar energy systems and boost the renewable energy market was announced by the Queensland government in March 2008. Under this scheme, a feed-in tariff was introduced where households and businesses will be paid 44 cents by the DNSP for every kilowatt-hour generated from solar power systems and fed into the grid. The feed-in tariff commenced on 1 July 2008 and is guaranteed for 20 years.

The forecast operating costs as set out in ENERGEX's *Regulatory Proposal* were based on 2007-08 operating expenditure and did not include any costs to administer the scheme. Since the commencement of the scheme, applications for connections of PV units to the grid have grown exponentially. ENERGEX has estimated that 8 full time equivalent employees (FTE) will be required to process and administer the scheme on an ongoing basis. This cost is incremental to the forecast operating costs included in the *Regulatory Proposal* submitted in June 2009.

The forecast feed-in tariff administrative costs included in this *Revised Regulatory Proposal* is set out in Table 4.2 below.

Table 4.2 Forecast of feed-in tariff administration costs

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Feed-in tariffs administration costs	0.8	0.8	0.8	0.8	0.8	3.9

Total may not add due to rounding.

4.2.6 ICT services expenditure

In its *Regulatory Proposal*, ENERGEX proposed a total of $457 million in ICT shared costs. As a result of the allocation process for indirect expenditure, $119 million in ICT shared costs were allocated to operating expenditure.

In its draft decision, the AER reduced the amount proposed by ENERGEX for ICT services expenditure by approximately $9.0 million relating to new capability projects that were not supported by analysis that demonstrated prudence or efficiency. Following the allocation of indirect expenditure, the capital program was reduced by $6.8 million and the operating program was reduced by $2.2 million.

ENERGEX acknowledges the comments made by PB on the documentation provided by ENERGEX for the planned new capability projects and resubmits business cases to support the prudence and efficiency of the proposed expenditure. Updated business case documentation for these projects is provided in **Appendix 4.2**.

ENERGEX notes the AER acceptance of the findings of PB that the expenditure proposed for ENERGEX's Distribution Management System (DMS) Stage 2 project is well justified.

In this *Revised Regulatory Proposal* ENERGEX submits the original ICT shared costs of $457 million.

4.2.7 Overhead allocations

As a consequence of the revisions in the operating and capital expenditure programs, indirect expenditure had been reallocated according to the AER approved CAM.

4.3 Escalation Rates

In its draft determination the AER concluded that ENERGEX's cost escalators used in its *Regulatory Proposal* do not reasonably reflect the operating expenditure criteria. The AER substituted these escalators in determining the operating expenditure allowance for ENERGEX. The AER stated that it considers that using the most recently available data to update cost escalation forecasts satisfies the operating expenditure objectives.

For the purpose of the building block calculation, ENERGEX acknowledges and has applied the AER's interim escalation rates. ENERGEX expects that the AER will update these escalation rates to reflect the most recent data in its final decision.

Taking into account the significance of escalation rates, ENERGEX is assessing the AER's methodology and indices. ENERGEX will provide further comment on this matter in its submission to the AER's draft determination.

4.4 ENERGEX's revised forecast operating expenditure program for 2010-15

In this *Revised Regulatory Proposal,* ENERGEX submits the following revised controllable operating expenditure program:

- $3.9 million increase for feed-in tariff administration costs;
- $2.1 million adjustment for ICT services indirect expenditure and re-allocation of overheads; and
- $139.5 million reduction to account for the application of the AER's interim escalation rates.

Table 4.3 Revised Controllable Operating Expenditure Program for 2010-15

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
***Regulatory Proposal* controllable opex**	**324.5**	**330.1**	**340.4**	**351.6**	**349.3**	**1,695.8**
Adjustment to demand management	-2.2	-	-	-	-	-2.2
Adjustment to other support cost	-2.2	-2.2	-2.2	-2.2	-2.1	-10.9
Adjustment to feed-in tariffs administration costs	0.8	0.8	0.8	0.8	0.8	3.9
Adjustment to overheads and shared ICT costs	0.9	0.9	2.0	1.1	1.1	6.0
Adjustment to cost escalators*	-16.1	-23.3	-28.9	-33.5	-37.7	-139.5
Total *Revised Regulatory Proposal* controllable opex*	**304.8**	**305.4**	**311.3**	**317.1**	**310.6**	**1,549.2**

** Based on the application of the AER's interim escalation rates.*
Total may not add due to rounding.

In relation to uncontrollable operating expenditure, ENERGEX has reviewed the AER's draft decisions and acknowledges the following for incorporation into its *Revised Regulatory Proposal* :

- $35.6 million increase for feed-in tariff payments;
- a self insurance allowance of $6.3 million for public liability;
- $19.5 million reduction to debt raising costs; and
- $87.4 million reduction to equity raising costs with remodelled equity costs to be incorporated in the RAB.

Table 4.4 Revised Uncontrollable Operating Expenditure Program for 2010-15

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
***Regulatory Proposal* uncontrollable operating expenditure**						
Self Insurance	2.8	2.9	3.1	3.2	3.0	15.1
Debt-raising costs	7.2	8.1	9.0	9.9	10.7	44.8
Equity raising costs	20.6	19.8	18.8	15.7	12.6	87.4
Total	**30.6**	**30.8**	**30.9**	**28.8**	**26.3**	**147.3**
***Revised Regulatory Proposal* uncontrollable operating expenditure**						
Self Insurance	1.2	1.2	1.3	1.3	1.3	6.3
Debt-raising costs	4.1	4.6	5.1	5.6	6.1	25.6
Equity raising costs (transferred to RAB)	-	-	-	-	-	-
Feed in tariffs payments	4.6	5.9	7.1	8.4	9.6	35.6
Total	**9.9**	**11.8**	**13.6**	**15.2**	**17.0**	**67.5**

Total may not add due to rounding.

The breakdown of the revised operating expenditure program by category, including the revisions for controllable and uncontrollable expenditure discussed in previous sections, and the application of the AER's interim escalation rates is provided in Table 4.5.

Table 4.5 Revised Total Operating Expenditure Program for 2010-15*

2009-10 $M	2010-11	2011-12	2012-13	2013-14	2014-15	Total
***Revised Regulatory Proposal* controllable operating expenditure**						
Network operating costs	24.3	24.9	25.3	25.7	25.9	126.1
Inspection	18.2	19.2	20.4	20.8	22.0	100.5
Planned maintenance	62.6	60.2	61.1	61.6	61.8	307.3
Corrective repair	38.0	38.2	38.0	37.9	37.6	189.6
Vegetation	72.6	72.8	73.2	72.8	72.0	363.5
Emergency response/storms	8.1	8.3	8.3	8.4	8.4	41.5
Metering	13.8	14.1	14.5	14.9	15.4	72.7
Customer services	19.9	20.1	20.3	20.6	20.8	101.7
DSM initiatives	21.1	21.6	23.2	28.0	20.5	114.4
Levies	8.5	8.8	9.2	9.5	9.8	45.8
Feed-in tariffs administration costs	0.8	0.8	0.8	0.8	0.8	3.9
Other support costs	16.9	16.5	16.9	16.3	15.7	82.3
Total	**304.8**	**305.4**	**311.3**	**317.1**	**310.6**	**1,549.2**
***Revised Regulatory Proposal* uncontrollable operating expenditure**						
Feed-in tariffs payments	4.6	5.9	7.1	8.4	9.6	35.6
Self insurance	1.2	1.2	1.3	1.3	1.3	6.3
Debt raising costs	4.1	4.6	5.1	5.6	6.1	25.6
Total *	**314.8**	**317.2**	**324.8**	**332.3**	**327.6**	**1,616.7**

** Based on the application of the AER's interim escalation rates.*
Total may not add due to rounding.

5 Regulatory asset base and depreciation

Adjustments made to the capital and operating programs included in this *Revised Regulatory Proposal* have a consequential impact on the other elements in the proposal. This section discusses those elements, including updates to actual expenditure for 2008-09 and also provides information specifically requested by the AER.

5.1 Opening regulatory asset base

5.1.1 AER's draft decision

In accordance with clause 6.12.1(6) of the *Rules*, the AER in its draft determination decided that the total opening RAB as at 1 July 2010 for ENERGEX is $7,983.6 million, consisting of $7,887.4 million for *standard control services* and $96.1 million for *alternative control services*.

In accordance with clause 6.12.1(18) of the *Rules*, the AER decided to use actual depreciation for establishing the regulatory asset base for the commencement of the *2015-20 regulatory control period*.

5.1.2 ENERGEX's response

The AER considered the opening RAB as proposed by ENERGEX was appropriate and reasonable. ENERGEX accepts the AER's draft decision and as requested, updates the forecast information included in the Roll Forward Model (RFM) for 2008-09 with actual expenditure.

ENERGEX also accepts the AER's draft decision to use actual depreciation for establishing the RAB for the commencement of the *2015-20 regulatory control period*.

ENERGEX acknowledges the AER's draft decision to include equity raising costs in the RAB instead of attributed to operating expenditure as in the original proposal. ENERGEX has calculated equity raising costs of $33.6 million ($2009-10), based on the methodology used by the AER in its draft decision.

As a result of the revisions ENERGEX submits the revised Regulatory Asset Base for 1 July 2010 in Table 5.1.

Table 5.1 Revised Regulatory Asset Base for 1 July 2010

	Actual				Estimated
Nominal $M	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Opening RAB Value 1 July	4,345.2	4,996.7	5,596.7	6,248.6	6,955.9
Actual/estimated net capital expenditure	744.7	734.7	694.4	843.1	1,046.2
Actual/estimated regulatory depreciation	-93.2	-134.7	-42.5	-135.7	-144.7
Variance between forecast and actual 2004-05					53.1
Adjustment for return on variance					27.3
Closing balance 30 June	4,996.7	5,596.7	6,248.6	6,955.9	7,937.8
Actual/estimated contributed assets	38.8	47.2	49.3	45.7	70.6
Actual/estimated inflation rate	2.98%	2.44%	4.24%	2.47%	2.45%

The opening RAB value as at 1 July 2010 of $7,937.8 million will be divided as follows:

- $7,841.5 million for the *standard control services* RAB; and
- $96.4 million for the *alternative control services* asset base (street lighting assets).

ENERGEX has used the same methodology, reviewed and accepted by the AER in its draft decision, to divide the asset base between *standard control services* and *alternative control services*.

Based on the revised capital expenditures proposed in Chapter 3, ENERGEX submits the revised RAB for 2010-15 in Table 5.2.

Table 5.2 Revised RAB for the *2010-15 regulatory control period*

Nominal $M	2010-11	2011-12	2012-13	2013-14	2014-15
Opening RAB – 1 July	7,841.5	9,036.5	10,239.7	11,464.4	12,687.3
Forecast capital expenditure/additions	1,293.6	1,311.8	1,347.5	1,373.9	1,476.2
Forecast regulatory depreciation	-83.0	-92.0	-103.4	-116.1	-118.0
Forecast disposals	-15.5	-16.7	-19.4	-34.8	-17.7
Closing Balance	9,036.5	10,239.7	11,464.4	12,687.3	14,027.8
Forecast inflation rate	2.45%	2.45%	2.45%	2.45%	2.45%

5.2 Depreciation

5.2.1 AER's draft decision

In accordance with clause 6.12.1(8) of the *Rules* the AER did not approve the depreciation allowances submitted by ENERGEX. The depreciation allowances for ENERGEX are as set out in table 10.4 of the draft decision.

The AER reviewed the approach ENERGEX had taken to determining the remaining lives as at 1 July 2005 and accepted the remaining lives as proposed by ENERGEX in its *Regulatory Proposal*.

The AER also reviewed the remaining asset lives as at 1 July 2010 proposed by ENERGEX and accepted the rolling forward of these remaining lives.

The AER reviewed ENERGEX's proposed standard asset lives and accepted these standard asset lives.

5.2.2 ENERGEX response

ENERGEX acknowledges the AER's decision to accept ENERGEX's remaining and standard asset lives. ENERGEX has adopted the standard lives as contained in Table 10.2 of the draft determination.

5.2.2.1 Revised remaining lives

As noted above, ENERGEX's remaining standard lives at 1 July 2010 were established by rolling forward the lives at 1 July 2005 in accordance with clause 6.5.5(b)(2) of the *Rules*. The revision of the RAB at 1 July 2010 to account for actual capital expenditure in 2008-09 impacts on the calculation of remaining lives. The revised remaining asset lives based on the same methodology reviewed and accepted by the AER in its draft decision are provided in Table 5.3 below.

Table 5.3 Revised remaining lives for ENERGEX (years)

Assets Categories	Remaining Life (years)
System Assets	
OH sub-transmission lines	37
UG sub-transmission cables	34
OH distribution lines	28
UG distribution cables	47
Distribution equipment	27
Substation bays	32
Substation establishment	31
Distribution substation switchgear	28
Zone transformers	40
Distribution transformers	30
Low voltage services	30
Metering	11
Communications – Pilot Wires	19
Systems Buildings	59
Systems Easements	N/A
System Land	N/A
Non-system Assets	
Communications	0
Control Centre – SCADA	8
IT Systems	5
Office equipment & furniture	7
Motor vehicles	6
Plant & Equipment	4
Research & Development	0
Buildings	28
Easements	N/A
Land	N/A

5.2.2.2 Remaining life for equity raising costs

In its draft determination, the AER decided to include equity raising costs in the RAB. In order to amortise the costs, the AER attached a remaining life assumption to the equity raising costs that was based on a weighted average of the opening value of the RAB at 1 July 2010.

Following the update of the 2008-09 actual capital expenditure ENERGEX has recalculated the life of the equity raising costs as 46.1 years.

5.2.2.3 Revised forecast depreciation allowance

ENERGEX has calculated its depreciation allowance based on the following

- standard lives in Table 10.4 of the AER's draft determination;
- remaining lives included in Table 5.3 above;
- inclusion of equity raising costs in the RAB; and
- consequential adjustments to expenditures as described in Chapter 3 of this *Revised Regulatory Proposal*.

The total of the required regulatory depreciation allowance forecasts for the *2010-15 regulatory control period* is shown in Table 5.4 below.

Table 5.4 Revised forecast depreciation for the *2010-15 regulatory control period*

Nominal $M	2010-11	2011-12	2012-13	2013-14	2014-15
Straight Line Depreciation	275.1	313.4	354.3	397.0	428.8
Inflation on Opening RAB	192.1	221.4	250.9	280.9	310.8
Regulatory Depreciation	83.0	92.0	103.4	116.1	118.0

6 Cost of capital and taxation

6.1 Weighted average cost of capital

6.1.1 AER's draft decision

The AER calculated an indicative nominal vanilla WACC of 10.06 per cent in the draft determination.

The AER stated the nominated risk free rate, the debt risk premium and expected inflation rate will be updated closer to the date of the final decision.

6.1.2 ENERGEX's response

ENERGEX acknowledges the AER's draft decision to apply an indicative nominal vanilla Weighted Average Cost of Capital (WACC) of 10.06 per cent. While ENERGEX does not agree with a number of aspects of this decision, it does not have new evidence to present at this time to continue to support a departure from the AER's *Statement of Regulatory Intent*, with the exception of gamma.

ENERGEX also notes the AER's intention to update the nominal risk free rate, debt risk premium and inflation rate, closer to the date of the final decision.

ENERGEX agrees that an adjustment to the risk-free rate (via the convenience yield) is currently not required. However, if further economic shocks result in the return of abnormal market conditions prior to the proposed reset period, ENERGEX would seek to reinstate the convenience yield.

ENERGEX continues to hold the views submitted in its *Regulatory Proposal* that*:*

- given the issues that have been identified with both Bloomberg and CBA Spectrum data a mid point of both data sources is a good approach to measuring cost of debt. It is also noted if the AER is to reference Bloomberg, it has not yet addressed the method that it will use to estimate a ten year rate following the cessation of publication of the BBB and A bond yields previously relied upon. ENERGEX would welcome the opportunity to respond to any such proposal developed by the AER. ENERGEX intends to respond to these matters further in its response to the AER's draft decision;

- new evidence is presented in this revised proposal to support a value for franking credits of 0.2. ENERGEX notes that IPART has also recently reviewed the evidence relied upon by the AER to support a 0.65 value and it does not consider the value to be that high[13]; and
- a 100 per cent dividend payout ratio for gamma, which by AER preference is also extended to equity raising costs modelling, is not appropriate and that Officer's 71 per cent is the most appropriate assumption to apply[14].

6.1.3 Gamma

As stated above, in this *Revised Regulatory Proposal* ENERGEX intends to continue to depart in relation to the value of gamma. In its original proposal, ENERGEX proposed a value of 0.2, which relied on evidence that had been previously submitted to the AER by the Joint Industry Associations as well as a specific study prepared by Synergies Economic Consulting (Synergies). The Synergies study raised questions regarding the reliability of one of the key studies relied upon by the AER in its *Statement of Regulatory Intent*, being the study by Handley and Maheswaran (2008).

For this *Revised Regulatory Proposal*, ENERGEX and Ergon Energy also jointly commissioned a new study by Strategic Finance Group Consulting (SFG), which examines a number of aspects of the AER's gamma determination in the final *Statement of Regulatory Intent*. One of the most important aspects of this analysis is SFG's estimation of the value of franking credits (theta), which is based on the methodology applied by Beggs and Skeels (2006) using updated data. This analysis, which also responded to concerns previously raised by Skeels, produced a revised estimate for the value of franking credits of 0.23. One of the co-authors of the Beggs and Skeels' study (Skeels) has reviewed the analysis and concluded that SFG's estimate "represents the most accurate estimate currently available"[15].

Clause 6.5.3(e)(1) of the *Rules* requires that the rate of return is:

> *...a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing standard control service …;*

It is submitted that SFG's estimate of theta is an appropriate and reasonable estimate based on current market data and this has been acknowledged by a co-author of one of the key studies relied upon by the AER. This new study provides further support for ENERGEX's proposed value for gamma of 0.2 (and the position previously put by the Joint Industry Associations), even if a 100% distribution rate is assumed. At minimum, it raises serious questions as to how it can be considered reasonable to continue to exclude values below 0.5 from the bounds of a reasonable range.

ENERGEX submits an additional report by SFG in **Appendix 6.1**.

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13 Source: IPART's cost of capital after the AER's WACC review, *Other Industries Discussion Paper*, November 2009

14 Source: N. Hathaway and R. Officer, *The Value of Imputation Credits*, manuscript, University of Melbourne, 1992.

15 Source: Skeels in SFG Consulting (2009), Gamma: *Further Evidence to Support Departure from the AER's Statement of Regulatory Intent*: Report Prepared for ENERGEX and Ergon Energy, p.28.

In its draft determination, the AER also rejected the analysis undertaken on behalf of ENERGEX and Ergon Energy by Synergies, which raised questions regarding the tax statistics analysis by Handley and Maheswaran that was relied upon by the AER. The AER engaged Handley to review the Synergies study and during the course of this review, requested all of Synergies' data, which was provided.

One of the concerns raised by Synergies was that it was not able to replicate the results produced by Handley and Maheswaran. A request was made to the AER for access to Handley's data so that these differences could be understood and reconciled. The AER has indicated that Handley is not willing to supply the data as it was an independent study and the data is proprietary.

Without access to Handley and Maheswaran's data, it is not possible to replicate their results or understand where and why there are differences between the results of the two studies. ENERGEX submits that if the AER is to rely on a study in making a determination, the affected businesses should be provided with the underlying data to enable it to understand and replicate the outcomes of that study. ENERGEX considers that this represents a significant imbalance in transparency.

As ENERGEX is unable to review the Handley data, ENERGEX cannot accept the AER's rationale of a gamma of 0.65. The AER has dismissed a number of reputable studies in the course of its reviews and has focused on two studies, being Beggs and Skeels (2006) and Handley and Maheswaran (2008). The concerns that have been raised with both studies seriously questions how they could be seen to represent sufficiently persuasive evidence to depart from the prior precedent of 0.5, noting that this departure has material consequences for all regulated businesses. In particular:

- the study by SFG, which applied the same methodology to Beggs and Skeels to extend their analysis based on more recent data, arrived at a significantly lower value for franking credits. Of critical importance here is that Skeels has effectively validated SFG's recent study; and
- it is not possible to replicate Handley and Maheswaran's results or understand how this has been derived. The Synergies study did not purport to establish a more reliable estimate for the value of franking credits (particularly given the concerns that have been expressed regarding the use of tax statistics analysis to value gamma). The study raised questions about Handley and Maheswaran's results. It is not possible to answer these questions without access to the data.

Regulated businesses are not the only ones who continue to question the AER's decision. For example, IPART has also recently reviewed the evidence relied upon by the AER to support a 0.65 value and it does not consider the value to be that high[16].

[16] Source: IPART's cost of capital after the AER's WACC review, *Other Industries Discussion Paper*, November 2009

ENERGEX contends there are a number of reputable and persuasive studies that have shown that the value of gamma may now be well below 0.5, or that values below 0.5 should at least be considered to be within the bounds of a reasonable range. This includes evidence previously presented to the AER by the Joint Industry Associations, which the AER subsequently rejected. It also includes the new evidence contained in the SFG study, which has been subject to review by Skeels.

ENERGEX therefore cannot accept the AER's value for gamma of 0.65. On this basis, ENERGEX proposes to continue to depart from the *Statement of Regulatory Intent* and apply a value for gamma of 0.2.

6.1.4 Inflation

ENERGEX acknowledges the AER's decision to apply geometric averaging to determine an inflation forecast and confirms that the departure from the AER's averaging method of Reserve Bank of Australia information was unintended[17].

However, ENERGEX has concerns with the AER's intention to reconsider the use of indexed Commonwealth bonds to derive the inflation forecast following the issue of a new indexed bond in October 2009. A key concern is how the AER will assess whether sufficient liquidity has returned to this market, which is necessary for market data to inform a reliable estimate. The AER has also not indicated if there are any other criteria that it might apply in determining whether it will change its methodology. ENERGEX is concerned that a change in methodology may be implemented prior to the final determination without having had an opportunity to fully consider and respond to it. In the absence of this information, ENERGEX is unable to fully consider the AER's likely approach to assessing ENERGEX's inflation forecast proposal prior to the AER's final determination.

ENERGEX would respond to these matters further in its response to the AER's draft decision.

6.2 Taxation

6.2.1 AER's draft decision

In its draft decision, the AER has assessed each of the inputs to the PTRM that are used to calculate the expected cost of corporate income tax in accordance with clause 6.5.3 of the *Rules*. The AER considered ENERGEX's standard and remaining tax lives methodology for establishing the opening tax RAB to be reasonable.

The AER has estimated the cost of corporate tax to ENERGEX for each regulatory year of the next *regulatory control period* totalling $195.7 million.

[17] Source: AER, *Draft decision, Queensland Draft distribution determination 2010-11 to 2014-15*, November 2009, page 280.

6.2.2 ENERGEX response

6.2.2.1 Opening tax asset base

ENERGEX acknowledges the AER's decision to accept ENERGEX's proposed methodology in calculating its tax asset base. Following the revision of the RFM to account for actual 2008-09 capital expenditure, ENERGEX proposes an opening tax asset base at 1 July 2010 of $3,716.5 million. The revision of the 2008-09 capital expenditure also impacts on the calculation of tax remaining lives at 1 July 2010. The updated remaining lives are set out in Table 3.4. ENERGEX has adopted the same approach to establishing the opening tax value of the RAB as at 1 July 2010 and the standard and remaining tax lives. This approach and the standard and remaining tax lives were considered by the AER in its draft decision as appropriate and reasonable.

For the purposes of this *Revised Regulatory Proposal*, ENERGEX has departed from the AER's value for the parameter gamma. ENERGEX has provided evidence in support of the departure and used 0.2 as the value for gamma.

Table 6.1 Tax remaining lives

Assets Categories	Tax Remaining lives
System Assets	
OH sub-transmission lines	29
UG sub-transmission cables	37
OH distribution lines	28
UG distribution cables	27
Distribution equipment	35
Substation bays	31
Substation establishment	30
Distribution substation switchgear	22
Zone transformers	29
Distribution transformers	27
Low voltage services	33
Metering	15
Communications – Pilot Wires	34
Systems Buildings	40
Systems Easements	N/A
System Land	N/A
Non-system Assets	
Communications	2
Control Centre – SCADA	8
IT Systems	3
Office equipment & furniture	11
Motor vehicles	7
Plant & Equipment	4
Research & Development	N/A
Buildings	24
Easements	N/A
Land	N/A

6.2.2.2 Taxation allowance

Revision of the opening tax asset base at 1 July 2010 and other consequential adjustments as described in the capital expenditure and operating expenditure chapter of this *Revised Regulatory Proposal* have resulted in a revision to the estimated corporate tax allowance for the next *regulatory control period*. Table 6.2 below shows ENERGEX's forecast tax allowance for the *2010-15 regulatory control period* as calculated using the AER's PTRM.

Table 6.2 ENERGEX's forecast tax allowance for the *2010-15 regulatory control period*.

Nominal $M	2010-11	2011-12	2012-13	2013-14	2014-15
Forecast tax depreciation	140.6	171.4	203.7	233.5	260.3
Tax payable	108.0	119.3	131.1	144.7	155.6
Less value of imputation credits	21.6	23.9	26.2	28.9	31.1
Net tax allowance	86.4	95.5	104.9	115.8	124.5

7 Schemes, pass through and other matters

7.1 Efficiency Benefits Sharing Scheme

7.1.1 AER's draft decision

The AER's draft decision considered that the following operating expenditure cost categories will be excluded from the operation of EBSS for the *2010-15 regulatory control period*:

- debt raising costs;
- insurance and self insurance costs;
- superannuation costs relating to defined benefit and retirement schemes; and
- non-network alternatives, including the demand management innovation allowance (DMIA).

Further, in assessing ENERGEX's operating expenditure, the AER noted that changes in financial obligations in relation to defined superannuation benefit schemes could be a Negative Change Event for the purposes of the *Rules*.

7.1.2 Superannuation

The AER has misunderstood the treatment of superannuation in ENERGEX's *Regulatory Proposal*. Forecasts for defined benefits superannuation included in ENERGEX's *Regulatory Proposal* did not account for ENERGEX's obligation to contribute at higher rates as a result of volatile market conditions.

Consistent with its original submission, ENERGEX does not propose to increase the additional superannuation contributions in the *Revised Regulatory Proposal*. ENERGEX has significant concerns about the appropriateness of superannuation financial obligations being handled through the cost pass through mechanism. ENERGEX's strong preference is to meet its obligations within its current operating expenditure forecasts, without the uncertainty of a change event in the future. For this reason superannuation costs should be removed from the operation of Efficiency Benefit Sharing Scheme (EBSS).

ENERGEX notes the AER's request for additional information in relation to defined benefit superannuation obligations. ENERGEX believes that its defined benefit superannuation obligations represent a long term liability that must be carefully managed.

Further information in relation to the defined benefits superannuation schemes as requested by the AER is available in **Appendix 7.1**.

7.1.3 Uncontrollable cost that satisfy pass through criteria

The intention of the EBSS is to achieve efficiency over the costs that a DNSP can control. For this reason the scheme has a provision that requires a DNSP to nominate exclusion of uncontrollable costs.

ENERGEX's proposal for a cap of $5 million as the materiality threshold for general nominated pass through events was rejected by the AER. The AER decided to adopt a threshold of 1 per cent of smoothed revenue allowance. In the case of ENERGEX, this translates to a minimum of $12 million hurdle for events to be approved under general nominated pass through arrangements.

ENERGEX submits that expenditure that meets the relevant criteria under clause 6.6.1(j) but fails the materiality threshold is uncontrollable. ENERGEX submits that costs associated with these events be treated as uncontrollable and therefore excluded from the operation of the EBSS.

ENERGEX notes that the AER's draft determination for ETSA Utilities provides for such exclusion.

7.1.4 Smart Grid Smart City (Confidential)

[redacted]

7.1.5 Revised exclusion for EBSS

On this basis of discussions in the previous sections, ENERGEX proposes that:

- superannuation be removed from the list of excluded operating expenditure cost categories from the operation of the EBSS;
- uncontrollable costs that satisfy pass through criteria under clause 6.6.1(j), but fail to meet the materiality threshold, be excluded from the operation of EBSS for the next *regulatory control period*; and
- operating costs associated with externally driven initiative be excluded from the operation of EBSS for the next *regulatory control period*.

7.2 Pass Through Arrangements

7.2.1 AER's draft decision

In the draft determination, the AER decided that the additional pass through events that apply to the Queensland DNSPs for the next *regulatory control period* are the:

- smart meter event;
- Carbon Pollution Reduction Scheme (CPRS) event;
- feed-in tariff event; and
- general nominated pass through event.

7.2.2 Significant storm event

7.2.2.1 AER's draft decision on self insurance for storm events

In its *Regulatory Proposal*, ENERGEX proposed a total of $8.5 million over 5 years to self insure expected storm events between $2 million and $10 million.

In its draft decision, the AER rejected self insurance for storm events on the grounds that if a commercial insurance company is unwilling to take on the risk associated with damage to the network, it is not prudent for a network service provider to self insure that risk.

The AER 's concerns are also in relation to the methodology used by Finity to generate self insured storm loss estimates proposed by ENERGEX such as:

- ENERGEX has not stipulated a measurable threshold, such as a dollar amount, for each event where attritional damage events become a self insurance event. As such the AER is unsure of how an event will be treated when it occurs, and is concerned about inconsistencies surrounding the application of the one in four year thresholds;
- the risk does not appear to be predictable and measurable and thus the AER cannot be certain that the proposed premium accurately reflects the costs incurred by a prudent operator;
- the Queensland DNSP's have the ability to cover non-material losses through their operating and capital expenditure programs; and
- Finity's assumptions regarding the 2004 storms that affected ENERGEX's network and the inclusion of these storms in the data set is unsatisfactory and does not produce a realistic expectation of the cost inputs required to achieve the operating expenditure objectives.

The AER indicated that if a material loss were to be incurred due to a storm event, ENERGEX may be able to seek a cost pass through when the timing and cost estimates of the event are known with certainty.

7.2.2.2 ENERGEX's response

ENERGEX disagrees with the AER's analysis regarding the methodology used to generate self insured storm loss estimates as the Finity report identified that the self insurance was to cover storm events in excess of $2 million per event. The actuarial study also calculated that such events have a probability of 1 occurrence every 4 years. This probability was based on an analysis of ENERGEX's loss history from storm events. In addition, ENERGEX's forecasts for emergency response/storm included in its operating expenditure program are based on an average storm season and do not include costs arising from atypical storm events.

The main implication of the AER's rejection of ENERGEX self insuring for catastrophic storms losses is that ENERGEX now has an unmitigated risk exposure for any storm events which cause losses between $2 million and the 1 per cent Annual Revenue Requirement (ARR) threshold (estimated at in excess of $12 million).

ENERGEX submits that such storm events meet each of the AER's eight criteria for a nominated event as outlined in the AER's draft determination [18]

Further, the AER has identified the following two forms of nominated pass through event:

(1) **Specific nominated pass through events** – these are events that are highly likely to occur and can be clearly defined. An event is only a specific nominated pass through event if the AER nominates the event in this distribution determination. The AER has considered the criteria, with emphasis on likelihood and controllability, in deciding which events should be specific nominated pass through events.

(2) **General nominated pass through event** – this will apply to unexpected events. This event is a set of broadly defined circumstances, the occurrence of which will constitute a general nominated pass through event. The AER will determine during the next *regulatory control period* whether an event constitutes a general nominated pass through event, should the event occur.

Given the AER considers that in the event of a material loss, ENERGEX may be able to seek a cost pass through should such an event occur, ENERGEX proposes that storm events causing significant losses that are not included in the emergency response/storm forecast costs be classified as a specific nominated event.

In its *Regulatory Proposal*, ENERGEX proposed a specific nominated pass through for storm events in excess of $10 million per event on the premise that storm events between $2 million and $10 million would be covered under its self insurance allowance. The AER has rejected this proposal and considered that a specific nominated event is not appropriate because such an event is not highly likely and may be eligible under the general nominated pass through event.

However, ENERGEX believes that the forseeability and frequency of storm events on its network mean that this type of event is appropriately defined as a specific rather than general nominated pass-through event. Consequently, ENERGEX's *Revised Regulatory Proposal* incorporates a specific nominated pass through event for a significant storm event. Based on the Finity report, such an event is highly likely to occur (expected 1 in 4 years) and ENERGEX does not consider that a general nominated pass through event is appropriate as significant storm events below the 1% Annual Revenue Requirement threshold will be unfunded.

ENERGEX proposed that a significant storm event for the purpose of pass through arrangement be defined as follows:

> *The incurring of costs by ENERGEX as a result of a storm during the course of the 2010-2015 regulatory control period to the extent those costs exceed $2 million.*

[18] The AER's Draft Determination page 332

7.2.3 Retailer failure event

In its draft determination, the AER rejected ENERGEX's self insurance allowance for retailer credit risk as AER is not satisfied that the events relating to retailer default are predictable and measurable and therefore fail to qualify as self insurance events. In relation to pass through, the AER considered that should it occur a retailer credit risk event may constitute a general nominated pass through event.

As discussed in section 4.2.1.2, ENERGEX seeks to include retailer failure as a specific nominated pass through event in this *Revised Regulatory Proposal*. ENERGEX submits that a retailer failure meets the AER's criteria for nominated event and a specific nominated event is appropriate for the following reasons:

- the AER's rejection of self insurance for retailer credit risks ;
- the AER's rejection of the $5 million capped for general nominated event; and
- the recent failure of retailer Jackgreen (International) Pty Ltd which demonstrated the likelihood of the occurrence of such an event

ENERGEX proposes that a retailer failure event for the purpose of pass through arrangement be defined as follows:

> *The incurring of costs (default payment) by ENERGEX during the course of the 2010-15 regulatory control period due to a retailer failure. A retailer failure event is an event when the Australian Energy Market Operator Limited (AEMO) has issued a suspension notice to a retailer under clause 3.15.21(f) Rules.*

7.2.4 Revised pass through arrangements

In addition to the nominated events as set out in the AER's draft determination, ENERGEX proposes that the following events be included as pass through events for ENERGEX:

- significant storm event; and
- retailer failure event.

8 Revenue requirements

8.1 AER's draft decision

The AER's draft decision resulted in a total revenue requirement over the next *regulatory control period* of $7,158 million ($2009-10), compared to $7,515 million proposed by ENERGEX. The main reasons for this difference reflect the net effect of:

- removal of the $748 million from ENERGEX's forecast capital expenditure;
- removal of the $257 million from ENERGEX's forecast operating expenditure;
- a reduced allowance for tax;
- a reduced allowance for equity raising costs; and
- a higher WACC than proposed by ENERGEX.

8.2 ENERGEX's response

ENERGEX's *Revised Regulatory Proposal* has incorporated the majority of the revisions contained in the draft determination, including the AER's interim escalation rates.

The major differences between the draft determination and this *Revised Regulatory Proposal* flow from:

- ENERGEX's rejection of MMA's alternative maximum demand forecast and the resultant reduction in forecast growth capital expenditure;
- resubmission of the original non-system land and buildings capital expenditure;
- inclusion of feed-in tariff payments and administration costs;
- re-inclusion of self insurance for public liability; and
- inclusion of a value of 0.2 for the gamma parameter.

As a consequence of the revisions discussed in this *Revised Regulatory Proposal*, ENERGEX submits the following revised revenue requirement and associated X factors in Table 8.1.

Table 8.1 Revised building block revenue requirements for 2010-15

Nominal $M	2010-11	2011-12	2012-13	2013-14	2014-15
Regulatory depreciation	83.0	92.0	103.4	116.1	118.0
Return on capital	789.2	909.4	1,030.5	1,153.8	1,276.9
Operating expenditure	323.5	333.9	350.3	367.1	370.7
Tax allowance	86.7	95.8	105.3	116.3	124.9
Capital contributions	-64.4	-68.5	-70.6	-73.1	-75.1
Revenue from shared assets	-4.0	-4.7	-5.5	-6.1	-5.7
Annual revenue requirement	**1,213.9**	**1,357.9**	**1,513.4**	**1,674.0**	**1,809.6**
Smoothed building block revenue	**1,214.1**	**1,348.9**	**1,498.5**	**1,664.8**	**1,849.6**
Forecast CPI (%)	2.45%	2.45%	2.45%	2.45%	2.45%
X factors*	-26.5%	-8.4%	-8.4%	-8.4%	-8.4%

** A negative X factor indicates an increase in the annual revenue requirements.*

8.2.1 Capital contributions

In the draft determination the AER accepted ENERGEX's proposal to include forecast capital contributions in the RAB as provided under clause 11.16.3 of the *Rules*. This approach necessitates an offsetting revenue adjustment for these forecast contributions when calculating the X factors in the PTRM.

ENERGEX has applied the AER's interim escalation rates to its capital contributions forecasts. This revised capital contribution is provided in Table 8.1.

8.2.2 Revenue adjustment for shared assets

The AER's draft decision to accept the proposal to include shared assets used for the provision of *alternative control services* in the RAB as provided for under clause 11.16.3 of the *Rules*. This approach necessitates an offsetting revenue adjustment as a building block in the calculation of X factors for *standard control services*.

Adjustments to the WACC and escalation rates impacts on the forecast revenue derived from the shared assets. ENERGEX provides updated revenue adjustments in Table 8.1 above.

8.2.3 X factors

Following the revisions described elsewhere in this *Revised Regulatory Proposal,* ENERGEX proposes an X factor of 26.5 per cent for 2010-11 and 8.4 per cent for the remaining years of the *2010-15 regulatory control period*.

8.2.4 Pricing outcomes

Based on the updated annual revenue requirement included in this *Revised Regulatory Proposal*, the average residential customer's annual electricity bill in 2010-11 is likely to increase by approximately nine per cent. Beyond 2010-11, further price rises for residential customers will be approximately 1.5 per cent. ENERGEX's indicative prices for *standard control services* are outlined Table 8.2.

Table 8.2 Indicative DUOS Prices (c.kW.h nominal)

Customer Class	2010-11	2011-12	2012-13	2013-14	2014-15
ICC – Average	1.63	1.77	1.91	2.08	2.22
CAC – 33kV	2.03	2.19	2.35	2.52	2.70
CAC – 11kV Bus	1.92	2.06	2.21	2.37	2.52
CAC – 11kV Line	2.32	2.50	2.66	2.85	3.05
CAC – Average	2.23	2.40	2.56	2.75	2.94
SAC – demand	3.69	3.98	4.26	4.60	4.88
SAC – non-demand	7.74	8.33	8.89	9.59	10.20
SAC – Average	6.62	7.13	7.61	8.21	8.73

Individually Calculated Customers (ICC); Connection Asset Customers (CAC); Standard Asset Customers (SAC).

Indicative prices have been shown in nominal cents per kW.h for energy consumed but it should be noted that actual prices depend on the specific tariffs which are made up of a number of components of fixed, energy, demand and capacity charges. For this reason, these prices are indicative, are not binding and only provide a high level overview of the expected price impact for the next *regulatory control period*.

9 Alternative control services

9.1 Fee based and quoted services

9.1.1 AER's Decision

The AER approved the formula proposed by ENERGEX to derive the prices for fee based and quoted services, with the exception of a profit margin component. The approved formula is as follows:

Price = Labour + Contractors + Materials + Capital Allowance + GST.

The AER accepted ENERGEX's 2008-09 base labour rates and base contractor rates and escalated them to establish capped labour rates for the first year of the next *regulatory control period*. The AER's proposed labour cost escalators will be applied to these labour rates over the next *regulatory control period*.

The AER determined that ENERGEX's capital governance framework provides a level of assurance that materials are sourced and managed efficiently. The AER was satisfied that the cost of materials used to derive the price of quoted services in the first year of the *regulatory control period* is reasonable. The AER's proposed materials cost escalators will be applied to these materials rates over the next *regulatory control period*.

The AER accepted ENERGEX's methodology for calculating a general capital allowance for non-system assets used in the provision of fee based and quoted services (to be updated as part of the AER's final determination). However, the AER did not accept ENERGEX's proposed capital allowance for large customer connections.

The AER applied on costs and overheads to ENERGEX's direct costs (labour, materials and vehicles). These rates (except the labour on-cost rate derived by the AER) will be updated as part of the AER's final determination and will be fixed for the duration of the next *regulatory control period*.

9.1.2 ENERGEX's response

ENERGEX acknowledges the AER's decision regarding fee based and quoted services. ENERGEX's key concerns are:

- the application of pre-determined escalation rates to materials and contractors for quoted services;
- the removal of the profit margin component of the formula;
- the setting of fixed overhead and on-cost rates for quoted services in the next *regulatory control period*; and
- the administrative burden on ENERGEX to implement systems and processes in the provision of these *alternative control services*. .

ENERGEX will provide its response to the AER's interim escalation rates in its submission to the draft determination. ENERGEX expects that the AER will update the escalation rates to reflect the most recent data in its final decision.

The remaining issues are discussed further in this chapter.

9.2 Fee based services

ENERGEX accepts the AER's decision on fee based services, with the exception of escalation rates to be applied and the removal of the profit margin component of the formula. ENERGEX has provided additional information requested by the AER in its *Revised Regulatory Proposal*.

The AER accepted ENERGEX's proposal to use customer connections employee classification as the internal labour costs for fee based services. Actual 2008-09 values were not available at the time ENERGEX prepared its *Regulatory Proposal*. In accordance with the AER's draft decision, the 2008-09 actual total costs and hours incurred for this employee classification is provided in confidential **Appendix 9.1**.

ENERGEX does not accept the AER's draft decisions on the profit margin component or the AER's escalation rates. However, for the purpose of indicative prices for fee based services, the AER draft decisions in relation to these matters have been applied.

ENERGEX's concerns regarding the AER's decision on the profit margin component of the formula for fee based and quoted services is outlined in section 9.3.5.

Indicative prices for fee based services for 2010-15 are provided in Table 9.1.

Table 9.1 Indicative prices for fee based services for 2010-15

$/service (Nominal)	2010-11	2011-12	2012-13	2013-14	2014-15
Alterations and additions to current metering equipment	88.52	93.20	97.27	101.97	103.60
Attending loss of supply – LV customer installation at fault (BH)	98.95	104.18	108.73	113.98	115.81
Overhead Service Replacement – Single Phase	269.70	283.97	296.36	310.67	315.65
Overhead Service Replacement – Multiple Phase	317.78	334.59	349.20	366.06	371.92
De-energisation	44.26	46.60	48.64	50.98	51.80
Meter Test	103.30	108.76	113.51	118.99	120.90
Meter Inspection	79.22	83.41	87.05	91.26	92.72
Reconfigure meter	65.57	69.04	72.05	75.53	76.74
Off-cycle meter read	7.32	7.71	8.04	8.43	8.57
Site Visit	56.61	59.60	62.21	65.21	66.25
Locating ENERGEX underground cables	121.82	128.26	133.86	140.33	142.57
Temporary Connection	784.40	825.90	861.95	903.57	918.04
Re-energisation (BH)	38.58	40.62	42.39	44.44	45.15
Re-energisation (AH)	109.86	115.67	120.72	126.55	128.58
Re-energisation – visual (BH)	65.48	68.94	71.95	75.43	76.64
Re-energisation – visual (AH)	143.51	151.10	157.70	165.31	167.96
Re-energisation non-payment – visual (BH)	65.48	68.94	71.95	75.43	76.64
Re-energisation non-payment – visual (AH)	143.51	151.10	157.70	165.31	167.96
Supply Abolishment	304.72	320.84	334.85	351.02	356.63
Unmetered Supply	136.44	143.66	149.93	157.17	159.69
Streetlight Glare Screening	128.77	135.58	141.50	148.33	150.71
Replacement of standard luminaries with aero screen units (per streetlight)	294.34	309.91	323.44	339.06	344.49
Price Path					
Percentage	n/a	5.29	4.37	4.83	1.60

All indicative prices are exclusive of GST.
Business Hours (BH; After Hours (AH).

9.3 Quoted Services

In its *Regulatory Proposal*, ENERGEX proposed that prices for quoted services should reflect the actual cost of service provision based on the specific requirements of the customer and the current average cost of materials. The AER's draft determination decided on the application of pre-determined material and contractor escalation rates, and fixed overhead and on-cost rates.

In reviewing the systems and processes to provide the quoted services as outlined in the draft determination, ENERGEX established that the application of escalation rates for materials and contractor rates as set out in the AER's draft determination would pose an unreasonable administrative burden.

To minimise the burden on ENERGEX and at the same time address the AER's concerns, ENERGEX submits that an alternative approach to quoted services is required. These are outlined in the following sections.

9.3.1 Materials

ENERGEX is concerned about the application of a fixed escalator provided by the AER to the materials component of the quoted service prices. ENERGEX is unable to cost quoted services according to the AER methodology (i.e. applying a pre-determined materials escalator) without considerable alteration to its corporate systems and on this basis would be unable to provide these services.

In its *Regulatory Proposal,* ENERGEX did not provide a complete list of its materials in its illustrative quoted services prices because it has over 100 key materials used in the provision of these services. These materials are procured through competitive tendering processes and managed through ENERGEX's corporate store system. This results in materials costs being updated in real time. ENERGEX utilises an average cost approach to minimise the effects of price variations and mitigate the administrative complexity of managing multiple stock items.

ENERGEX is concerned that the application of a fixed escalator, determined at a point in time, would result in quoted services prices which do not reflect current market costs.

The AER determined that ENERGEX's capital governance framework provides a level of assurance that materials are sourced and managed efficiently. ENERGEX submits that provided it continues to use competitive tendering processes for the purchase of materials then this component of its quoted prices will be efficient and the AER should accept the material costs for quoted services to be sourced from ENERGEX's corporate procurement system.

To apply the AER's approach of a fixed materials escalator, ENERGEX's inventory system would need to be duplicated in order for materials costs for quoted services to be different from current market rates. This is an unfeasible system solution that is not currently scoped or funded under the AER's draft determination. ENERGEX considers that without considerable alteration to its corporate systems, it would be unable to provide these services.

To address the AER's concerns ENERGEX proposes that quoted services prices would be subject to scrutiny by the AER as part of the Annual Pricing Proposal.

9.3.2 External labour (Contractor)

In its draft determination the AER proposes that capped contractor labour prices will apply in the formula for quoted services. ENERGEX does not understand the need for this as the AER in its draft decision noted that ENERGEX's contractor rates are based on competitive tendering processes[19].

In making its draft decision, the AER is proposing to override ENERGEX's purchasing governance arrangements and the market-driven outcomes of those arrangements. Given that the existing contracts are due to be renegotiated in the near future, application of the labour cost escalators to contractor costs would mean that quoted services prices would be de-linked from the underlying costs and market rates. Similar to materials, application of the labour cost escalators to contractor costs would require duplication of ENERGEX's current estimation and billing system, which poses an unreasonable administrative burden. Therefore ENERGEX would be unable to provide these services.

ENERGEX considers that provided it continues to use competitive tendering prices for the engagement of contractors then this component of its prices will be efficient.

To address the AER's concerns ENERGEX proposes that quoted services prices would be subject to scrutiny by the AER as part of the Annual Pricing Proposal.

9.3.3 Capital allowance

The capital allowance represents a return on and return of capital for non-system assets used in the delivery of the service. In its *Regulatory Proposal* ENERGEX proposed a separate capital allowance for large customer connections and a general capital allowance to apply to all remaining quoted services. The AER did not accept ENERGEX's proposed methodology of capital allowance allocation for large customer connections.

In accordance with the AER's draft determination ENERGEX has re-calculated its general capital allowance for inclusion in this *Revised Regulatory Proposal*. These recalculations are provided in **Appendix 9.2.** This adjustment has a negligible effect on the general capital allowance.

[19] Source: AER Draft Determination, page 408

9.3.4 On-costs and overheads

ENERGEX's proposed price formulas for quoted services include labour, fleet and materials on-costs. In addition, overhead rates are applied to all direct costs (labour, contractors and materials). The application of these proposed on-costs and overheads are in accordance with ENERGEX's approved cost CAM and will be updated annually according to the actual expenditure incurred on specific services.

In its draft decision, the AER accepted ENERGEX's proposed fleet and materials on-costs, as well as overheads, which are to be updated as part of the AER's final determination. The AER proposes to fix all on-costs (labour, fleet and materials) and overheads for the duration of the next *regulatory control period*.

The basis of the AER's draft decision on labour on-cost is unclear to ENERGEX. The proposed labour on-cost for quoted services is consistent with *standard control services*, which were determined to be prudent and efficient by the AER's consultants. ENERGEX's on-cost rate is an average rate, set to recover total forecast on-cost expenses for the financial year. ENERGEX manages the variable nature of on-costs through an annual adjustment process that reconciles actual and estimated expenditure and reallocates any under/over recoveries.

ENERGEX considers that fixing the on-cost and overheads rate will create additional administrative costs for ENERGEX and is not practical. ENERGEX's actual costs are based on the CAM which will be applied annually, including adjustments made for under/over recoveries. To apply fixed on-costs and overheads on quoted services, estimates and invoices will need to be manually adjusted which is administratively inefficient. ENERGEX considers that provided these costs are allocated in accordance with the CAM, which can be demonstrated as part of the annual price approval process, then customers will be protected from unreasonable price increases.

9.3.5 Profit margin

In its draft decision, the AER rejected ENERGEX's application of a profit margin to its direct costs on the basis that the general capital allowance is derived using WACC and therefore incorporates a profit margin.

ENERGEX's rationale for incorporating a profit margin in its price formulas for quoted and fee based services was to ensure competitive neutrality with external parties potentially or actually competing in any of these markets. In other words, the proposed price was intended to leave some 'headroom' to encourage the development of competition.

The AER's argument that ENERGEX's capital allowance in the price formula incorporates a profit margin assumes that the regulated WACC is appropriate for ENERGEX in providing its *alternative control services*. However, in principle, if a market is effectively competitive, ENERGEX should not be constrained from competing in that market by the application of a regulated WACC. Further, the costs of providing quoted services typically comprise a significant labour component and minimum use of regulated assets. Consequently,

ENERGEX believes that by not allowing for profit margin, these services will be provided below market rates.

The AER's draft decision highlights the problem of attempting to facilitate competition in the markets for *alternative control services* while regulating the prices of the incumbent service provider. If the price caps are set too low, then no competition will emerge in these markets because ENERGEX's regulated price will undercut all potential market players. This is inconsistent with the intent of clause 6.2.2(c)(1) of the *Rules* as the rationale for classifying distribution services as *alternative control services* is to develop competition in the relevant market.

In conclusion, the level of the price caps for fee based and quoted services will fundamentally determine whether competition develops in the provision of these services. As a result, ENERGEX submits that the AER should have greater regard to the relevant market circumstances in establishing the price caps and that inclusion of a profit margin in the formulas for fee based and quoted services is appropriate.

9.3.6 Labour

In its *Regulatory Proposal* ENERGEX applied escalation to a base labour rate to calculate the labour component of the formula for quoted services. ENERGEX notes that this was in line with the existing QCA process, however it does result in a level of administrative complexity.

To simplify the process by utilising existing systems and maintaining consistency with other formula components, ENERGEX proposes that the labour costs should reflect the labour rates at the time of service provision.

Labour rates are calculated annually as part of ENERGEX's capital and operating budget process. ENERGEX's processes for forecasting its capital and operating programs were reviewed and determined to be prudent and efficient by the AER's consultants.

To address the AER's concerns ENERGEX proposes that quoted services prices would be subject to scrutiny by the AER as part of the Annual Pricing Proposal.

9.3.7 Revised Quoted Services

In order to provide illustrative quoted services prices, ENERGEX's *Revised Regulatory Proposal* applies the following:

- **Labour component** – AER's labour costs escalators are used in the labour component of its illustrative quoted services. ENERGEX proposes that prices for quoted services would reflect the system labour rates at the time of service provision.
- **Materials component** – AER's materials cost escalators are used in the materials component of its illustrative quoted services. However, ENERGEX proposes that prices for quoted services should reflect the actual cost of service provision based on the specific requirements of the customer and the current average cost of materials.

- **Contractor component** – based on ENERGEX's existing contract agreements. ENERGEX proposes that prices for quoted services would reflect the actual cost of service provision based on the specific requirements of the customer and contract arrangements.
- **Overhead and on-cost rates** – based on updated ENERGEX forecast costs included in the *Revised Regulatory Proposal*. ENERGEX proposes that prices for quoted services would reflect the actual cost of service provision based on the specific requirements of the customer.

In this *Revised Regulatory Proposal*, where applicable, ENERGEX acknowledges and applies the AER's interim escalation rates as set out in its draft determination. ENERGEX expects that the AER will update these escalation rates to reflect the most recent data in its final decision.

Indicative prices for quoted services for 2010-15 are provided in **Appendix 9.3**

9.4 Street lighting Services

9.4.1 AER's decision

In relation to street lighting, in its draft decision the AER decided to:

- accept the opening value of ENERGEX's street lighting services asset base as at 1 July 2010 to be $96 million;
- accept ENERGEX's proposed depreciation allowance;
- apply a 10.06 per cent WACC to calculate ENERGEX's return on capital for street lighting services;
- approve forecast operating expenditure allowance for ENERGEX of $60 million ($2009-10) for the next *regulatory control period*;
- accept the allowance for corporate income tax for its street lighting services;
- accept the inclusion of a $10 million adjustment to ENERGEX's street lighting revenue representing the non-system assets used in the provision of street lighting services;
- approve revenue requirements for ENERGEX's street lighting services based on information provided by ENERGEX as part of the regulatory review process;
- endorse ENERGEX's pricing methodology for street lighting services as reasonable and appropriate; and
- accept modelling undertaken by ENERGEX for street lighting services, which accounted for the changes made by the AER, and determined prices for the *2010-15 regulatory control period*.

9.4.2 ENERGEX's Response

ENERGEX acknowledges the AER's draft decision on street lighting services.

To provide indicative prices for street lighting services, ENERGEX has applied the AER's interim escalation rates and updated modelling to reflect forecast costs included in this *Revised Regulatory Proposal*.

As a consequence of these revisions ENERGEX submits the following revised revenue requirement, associated X factors and indicative prices in Table 9.2 and Table 9.3.

Table 9.2 Revised revenue requirements for street lighting

Nominal $M	2010-11	2011-12	2012-13	2013-14	2014-15
Regulatory depreciation	6.7	7.6	8.6	9.6	10.7
Return on capital	9.7	10.9	12.0	13.2	14.3
Operating expenditure	11.9	12.4	12.9	13.5	13.9
Tax allowance	5.8	5.9	5.9	5.9	5.9
Revenue from shared assets	1.6	2.0	2.3	2.6	2.4
Annual revenue requirement	35.7	38.8	41.7	44.8	47.2
Smoothed building block revenue	36.7	39.0	41.4	44.0	46.7
Forecast CPI (%)	2.45%	2.45%	2.45%	2.45%	2.45%
X factors	17.09%	-3.65%	-3.65%	-3.6%	-3.65%

ENERGEX notes that in the AER's draft determination, Table 17.17 did not align with Table 17.14, as it incorrectly reflected the revenue requirement included in ENERGEX's *Regulatory Proposal*.

Although updated prices are included below, the inconsistency will result in a variance in the price path for street lighting services, when comparing the *Revised Regulatory Proposal* to the draft decision.

Table 9.3 Indicative prices for street lighting services for 2010-15

$/day	2010-11	2011-12	2012-13	2013-14	2014-15
Major street lights					
Non-contributed	0.94	0.98	1.03	1.07	1.12
Contributed	0.25	0.26	0.27	0.28	0.30
Minor street lights					
Non-contributed	0.38	0.39	0.41	0.43	0.45
Contributed	0.10	0.11	0.11	0.12	0.12
Price Path					
Percentage	n/a	4.47	4.47	4.47	4.47

All indicative prices are exclusive of GST.

Glossary

Term	Definition
AER	Australian Energy Regulator
APR	Annual Planning Report
ARR	Annual Revenue Requirement
BAU	Business As Usual
CAM	Cost Allocation Method
CEO	Chief Executive Officer
CPI	Consumer Price Index
CPRS	Carbon Pollution Reduction Scheme
DEWHA	Department of Environment, Water, Heritage and Arts
DINIS	Distribution Network Information System
DM	Demand Management
DMIA	Demand Management Innovation Allowance
DMS	Distribution Management System
DNSP	Distribution Network Service Provider
DUOS	Distribution Use of System
EBSS	Efficiency Benefit Sharing Scheme
Ergon Energy	Ergon Energy Corporation Limited
GFC	Global Financial Crisis
GOC	Government Owned Corporation
GSP	Gross State Product
GST	Goods and Services Tax
GW.h	Gigawatt hour
IBNR	Incurred But Not Reported
ICT	Information and Communication Technology
IMSC	Information Management Steering Committee

Term	Definition
IRC	Investment Review Committee
LV	Low Voltage
MMA	McLennan Magazanik Associates
MV.A	Mega Volt Ampere
MW	Mega Watt
NIEIR	National Institute of Economic and Industry Research
PB	Parsons Brinckerhoff
PoE	Probability of Exceedence
PTRM	Post Tax Revenue Model
RAB	Regulatory Asset Base
RFM	Roll Forward Model
RIN	Regulatory Information Notice
Rules	National Electricity Rules
SCG	Strategic Finance Group Consulting
SCI	Statement of Corporate Intent
SEQ	South East Queensland
SFG	SFG Consulting
SGSC	Smart Grid Smart City
SPARQ	SPARQ Solutions Pty Ltd
Synergies	Synergies Economic Consulting
WACC	Weighted Average Cost of Capital

Confidential information

Claim for confidentiality

Clause 6.8.2(c)(6) of the Rules requires ENERGEX to provide an indication of the parts of this *Revised Regulatory Proposal* ENERGEX claims to be confidential and wants suppressed from publication. **Attachment 3** of the RIN outlines the general provisions relating to the provision of information.

ENERGEX claims confidentiality over the Smart Grid Smart City section 7.1.3, and parts of the public liability section 4.2.1.3, all attachments and all appendices in this document on the grounds that the information is either Commercial-in-confidence or contains intellectual property. ENERGEX requests that the AER does not disclose the information contained in these attachments and appendices to any person outside the AER.

Appendices

No.	Title
2.1	NIEIR: electricity consumption and maximum demand projections to 2019
3.1	Non-System Property Strategic Plan
3.2	Business Case – Project 1
3.3	Business Case – Project 2
3.4	Business Case – Project 3
3.5	Business Case – Project 4
3.6	Business Case – Project 5
3.7	Business Case – Project 6
4.1	Brokers informal non-binding public liability premium estimate
4.2	Updated business cases to support ICT capital expenditure for planned new capability projects
6.1	Strategic Finance Group, Gamma: Further evidence to support departure from the AER's *Statement of Regulatory Intent*
7.1	Information in relation to the defined benefits superannuation schemes as requested by the AER
9.1	Fee based services – labour component
9.2	Fee based and quoted services – capital allowance
9.3	Indicative prices for quoted services for 2010-15

Attachments

Attachment No.	Title
1.	*Regulatory information notice*
2.	Roll forward model
3.	Roll forward model – tax asset base
4.	Post tax revenue model – equity raising costs
5.	Post tax revenue model – *standard control services*
6.	Post tax revenue model – street lights services
7	Post tax revenue model – revenue adjustments