Appendix E: The need for a ‘transition path’ for operating and capital expenditure

Introduction

We believe a 'transition path' is appropriate if the AER is to make a distribution determination that provides for significant cuts to existing levels of expenditure. The AER has the power (if not a duty) to incorporate a transition path that takes into account:

- **the external cost inputs faced by Ergon Energy**
- **the prudent and efficient costs of reducing expenditure to the levels required by the AER.**

Customer benefits

In circumstances where the AER substitutes expenditure forecasts well below what is forecast, there should be allowance for the expenditure reductions needed to meet the forecast expenditure allowances, a realistic assessment of the input costs faced by Ergon Energy and prudent and efficient costs incurred in reducing expenditure.

Appendix E: The need for a 'transition path' for operating and capital expenditure

1 Introduction

In response to various requests from the AER to stakeholders to seek submissions from and to engage with stakeholders over the question of a 'transition path', in our submissions to the AER leading up to the Preliminary Determination, as well as our cross-submissions on the determinations made for DNSPs in NSW and the ACT, Ergon Energy argued that the relevant provisions of the NER require the AER to consider a 'transition path' if the AER was to make a distribution determination that provided for significant cuts to existing levels of expenditure.

These submissions were put to the AER in response to the draft determinations for NSW and the ACT which used a methodology that implied very large cuts in future operating and capital expenditure for Ergon Energy. The Preliminary Determination for Ergon Energy involved reductions in future operating and capital expenditure which, while not as large as those implied by the draft determinations for NSW and the ACT, are still substantial. In light of this, the issue of a transition path remains relevant and Ergon Energy notes that we sought to engage directly with the AER on a number of occasions on this issue ahead of receiving our Preliminary Determination.

We note the AER's view, in its Preliminary Determination, that it has no power to provide a transition path. As the AER is aware, this question is the subject of applications for merits and judicial review in NSW, the ACT and Queensland. Accordingly, Ergon Energy has addressed, in this revised Regulatory Proposal:

(a) the AER's power to consider a transition path

(b) the reasons why a transition path is appropriate

(c) the transition path that should be provided.

2 The AER has the power to include a transition path

The AER is required to approve expenditure allowances that satisfy the criteria in clauses 6.5.6(c) and 6.5.7(c) of the NER. These criteria require the expenditure allowances to reasonably reflect:

(a) efficient costs

(b) costs that would be incurred by a prudent service provider

(c) a realistic expectation of the DNSP's demand forecasts and cost inputs.

In its Preliminary Determination, the AER stated:

- A transition path is unnecessary when the AER's allowance is sufficient to achieve the relevant objectives.
- If a transition is a 'premium' above the efficient costs that a prudent operator would require, the AER cannot include that premium in the estimate of total forecast expenditure that the AER is satisfied reasonably reflects the relevant criteria.
- Conversely, if a transition is included as part of an allowance that reasonably reflects the relevant criteria, no further premium is required or possible.

The AER, in determining its forecast expenditure allowances, has relied heavily upon its findings as to the efficiency of revealed costs in the previous period, particularly in relation to operating expenditure and recurrent capital expenditure. However, it is important that the AER does not equate (or confuse) the methodology it has seen fit to adopt with the requirements of the NER itself. The fact that a category of costs may exceed the expenditure that the AER considers efficient as a result of its benchmarking analysis does not mean that such costs are excluded by the expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the NER. Each of the expenditure criteria must be given its full force and applied in approving expenditure forecasts. This necessarily permits consideration of costs that might not be captured under the AER's revealed costs approach.

In this context, Ergon Energy has two principal concerns about the AER's application of the expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the NER.

First, the AER has interpreted the third criterion (realistic expectation of required cost inputs) so as to give it virtually no relevance in the assessment of expenditure allowances. In effect, the AER equates this criterion to 'efficient costs' (i.e. the AER views the costs that are relevant in satisfying the third criterion are those costs which the AER deems 'efficient'). The AER has, by this approach, conflated the first and third criteria in a manner not permitted by the NER.

Through the third expenditure criterion, the NER recognise the fact that different DNSPs can face different cost inputs, not because one is less efficient than the other, but because cost inputs are not uniform across the country. No matter how efficient Ergon Energy is (or will be on 1 July 2015), certain cost inputs (including labour rates, property costs, materials, and fuel etc.) will not change overnight, if it all.

Cost inputs faced by Ergon Energy can be realistic (and even efficient) even though they exceed the level which the AER believes to be efficient having regard to its benchmarking and other enquiries. The AER's refusal to countenance this possibility has been found once before to be an error. Ergon Energy is concerned that the AER is once again taking a similar, but incorrect, approach.

Second, the AER has failed to recognise that a prudent and efficient DNSP will enter into arrangements to procure goods and services which may involve costs if those arrangements are to be terminated or substantially varied. For example, the costs of employing a person will include costs to be incurred if that employee is to be made redundant. Additional costs may be incurred in the sale of a property, the early termination of a lease, or the termination or variation of other contractual obligations (including as a result of the loss of volume-related discounts on purchases). Every prudent and efficient firm enters into supply arrangements which will obligate it to pay such costs. They are not, by themselves, necessarily imprudent or inefficient.

The AER's response to this fact is two-fold:

(a) these costs were inefficiently incurred

(b) customers should not pay for NSPs to become more efficient.

Again, the AER appears to have equated its revealed costs approach to assessing forecast expenditure with the requirements of the NER themselves. The AER has found, applying its benchmarking, that certain costs should not have been incurred in the relevant base year (it has not said which costs, it is has simply found that overall levels of expenditure were too high). However, this is a finding made by the AER entirely with the benefit of hindsight. Ergon Energy has incurred obligations under a regulatory regime where we operate under expenditure allowances and incentive schemes that reward efficient expenditure and penalise inefficient expenditure. For many years, the AER took the same view.

In this environment, Ergon Energy entered into arrangements in good faith to acquire labour, as well as certain goods and services, which included terms that would impose reasonable costs on Ergon Energy in the event of termination or variation. It is impossible for Ergon Energy to have known that the AER would, with the benefit of hindsight, find those costs to be inefficient or imprudent when compared to other DNSPs. It may be appropriate for the AER to find that those levels of expenditure should not be maintained (although we take issue with this elsewhere) but that does not justify a finding that these commitments were entered into imprudently or inefficiently, or that the cost of terminating them are themselves imprudent or inefficient. It is not a question of whether customers should pay for Ergon Energy to become more efficient, but rather whether a category of costs satisfies the expenditure criteria and should therefore be included in forecast expenditure allowances.

3 A transition path is appropriate

For the reasons outlined above, Ergon Energy believes that the AER has the power (if not a duty) to incorporate a transition path that takes into account:

(a) the external cost inputs faced by Ergon Energy

(b) the prudent and efficient costs of reducing expenditure to the levels required by the AER.

The report by PwC (*PwC – Transitional allowance*) explains why it is appropriate that the AER should include such a transition path for Ergon Energy.

The AER claims that it does not prevent a DNSP from inefficient spending (including costs incurred under existing agreements), just that the DNSP may need to fund that expenditure elsewhere (e.g. through other efficiencies or lower dividends). This argument ignores the fact that DNSPs operate under incentive schemes that punish them for overspending against the AER's forecasts, even if they can fund that overspend elsewhere. For example, if a DNSP overspends against the AER's capital expenditure forecast, it faces the threat of the ex post exclusion of that overspend from the RAB, even if it has found that money by reducing dividends. The proposition that a DNSP is free to determine its own transition path is incorrect.

4 The transition path proposed by Ergon Energy

In its earlier submissions to the AER, Ergon Energy focused our arguments on the AER's power, under the NER, to consider a transition path. Ergon Energy did not specify the type of path that would be appropriate, as we did not know what level of future operating and capital expenditure the AER would approve.

Ergon Energy sets out our calculations in *10.01.01 – Transitional path allowance* (confidential) of the transition path that we consider appropriate, based on:

(a) the expenditure reductions needed to meet the forecast expenditure allowances approved by the AER in its Preliminary Determination (corrected, in the case of forecast capital expenditure, for the errors in the Preliminary Determination)

(b) a realistic assessment of the cost inputs faced by Ergon Energy

(c) the prudent and efficient costs that will be incurred by Ergon Energy in reducing expenditure to the extent required.

Obviously, if the expenditure allowances approved by the AER differ materially from the Preliminary Determination, the appropriate transition path may also vary. If it is the AER's intention to materially depart from the forecast allowances approved in its Preliminary Determination, we urge the AER to consult fully and properly with Ergon Energy to determine whether a modified transition path would be appropriate.

5 Supporting documentation

The following documents referenced in this appendix accompany our Regulatory Proposal:

Name	Ref	File name
Transitional path allowance	10.01.01	Transitional path allowance
PwC – Transitional allowance	N/A	PwC – Transitional allowance