

Ergon Energy Corporation Limited

Submission on the *Better Regulation:
Expenditure Forecast Assessment
Guidelines for Electricity Distribution and
Transmission*

Issues Paper

Australian Energy Regulator

15 March 2013



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for Electricity Distribution and Transmission
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1. INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its *Better Regulation: Expenditure Forecast Assessment Guidelines for Electricity Distribution and Transmission Issues Paper* (Issues Paper). This submission is provided by Ergon Energy, in its capacity as a Distribution Network Service Provider (DNSP) in Queensland.

Ergon Energy supports any consultative approach aimed at improving the understanding of the AER's expenditure assessment methods. This is particularly important for Ergon Energy at this time. As Ergon Energy is required to submit a regulatory proposal next year, a clear understanding of the process and basis for assessing expenditure forecasts is vital to ensure due process.

Ergon Energy shares the concerns of the Energy Networks Association (ENA) that the approach to developing the guidelines isn't delivering the clarity and certainty industry expect it to, and on this basis, Ergon Energy has contributed to, and supports the ENA submission to the AER on the Issues Paper.

In response to the AER's invitation to provide comments on the Issues Paper, Ergon Energy has therefore focused on concerns relating to the benefits and costs of rushing through revolutionary change to expenditure assessment and a departure from established expenditure assessment frameworks. Ergon Energy has provided detailed responses to the AER's specific questions in the Issue Paper in the attached table and is available to discuss this submission or provide further detail regarding the issues raised, should the AER require.

2. GENERAL COMMENTS

The new National Electricity Rules (Rules) place a much greater onus on the AER to ensure its decision on an efficient and prudent expenditure forecast is in the long term interest of customers. The movement to a higher powered incentive for businesses not to spend more than the expenditure allowance, particularly for capital expenditure, therefore requires the AER to carefully consider its obligations in assessing expenditure allowances.

Ergon Energy believes there would be merit in establishing clearly what the outcomes of any guideline process should deliver and how they will be applied. In Ergon Energy's view this would go beyond seeking views of stakeholders. As the economic regulator, the AER is in the best position to develop the evidentiary basis for change in assessment frameworks. Only after the outcomes are understood can Ergon Energy gauge whether the benefits of any proposed changes in meeting that outcome exceed the costs.

To this end the effort and cost expended on a new requirement/intervention should be commensurate with the benefit realised from that intervention. Ergon Energy notes particularly the recent introduction of Regulatory Information Notices (RINs) has substantially increased reporting costs, as would any additional reporting requirement. There is little evidence to demonstrate net benefits from this quite intrusive and expensive information requirement. In fact, the AER pursued Rule changes on the basis that the current framework required it to undertake a detailed assessment of hundreds of rows of information, even though it was the one that required the business to provide it.¹

Ergon Energy's concern is that the AER is seeking revolutionary changes to the way it assesses and therefore mandates expenditure forecast information. If this revolutionary change to set expenditure allowances uses broader economic approaches, then DNSPs will be forced to make large investments to obtain audit quality data and systems to pursue the direction the AER is heading. Rather than proceeding on the basis that revolutionary change is needed for the next round of regulatory reviews, Ergon Energy believes the AER should make a clear distinction between benchmarking techniques that can be applied in the next round of regulatory reviews and aspirational techniques that can be applied in the future. This would allow the AER to focus on the latter as a separate piece of work with a timetable commensurate with the resourcing effort required to complete this work in a meaningful way. This would also allow for a more detailed discussion about the costs and benefits of the AER's aspirational approach.

¹ Rule Change Proposal, *Economic regulation of transmission and distribution network service providers: AER's proposed changes to the National Electricity Rules*, September 2011, p 13 & 29.



2.1. Role of the Guidelines

Ergon Energy regards many of the issues raised for consideration in this Issues Paper as material, urgent and necessary for establishing a robust expenditure assessment guideline. However, Ergon Energy is concerned that many issues are not directly relevant to establishing the guidelines. Therefore there is a risk that there will be an insufficient level of clarity as to how the AER will use expenditure assessment techniques for the next round of regulatory reviews.

Ergon Energy concurs with the ENA in its assertion that the primary purpose of the guideline is to ensure an efficient process and cost level for regulatory reviews for all participants by:

- Providing more certainty and understanding on the complete process the AER will use to assess expenditure over the various milestones of the price review—from Framework and Approach (F&A) to Final Determination.
- Allowing Network Service Providers (NSPs) to better target their proposals in light of the AER's approach, reducing the amount of querying and re-work of information in the regulatory proposals.

To this end, Ergon Energy would seek from the AER, an understanding of:

- How the AER interprets the relevant National Electricity Law (NEL) and Rules provisions;
- How the AER proposes to assess expenditures against those provisions; and
- How the AER's assessment approach promotes the NEL objective and delivers long term benefits to consumers.

In the absence of clarity on these matters, Ergon Energy is concerned that important matters will be overlooked or not given due consideration in their context, due to the sweeping changes being attempted, rather than incremental changes over a period of time.

The Guideline gives no indication of how the AER will apply the information it collects or derives from its models. The AER says it will rely on the F&A process for each DNSP to achieve this. However, the proximity of the F&A to the regulatory proposal date would make it very difficult for a DNSP to change course in the information and forecasting approaches it has already developed.

Ergon Energy would also be concerned with any approach in which forecasts of the DNSPs are devalued despite the requirement of 6.5.6(c) and 6.5.7(c), the forecast expenditure criteria, obliging the AER to accept the DNSP's reasonable expenditure forecasts. Ergon Energy reiterates that it was a fundamental tenet of the NEL and Rules that DNSPs are in the best position to forecast their expenditure requirements.

2.2 Scope of Current Consultation

Ergon Energy regards the Issues Paper as aiming to integrate consultation on two separate matters—the task of developing the guideline and the task of developing and publishing annual benchmarking reports. Whilst similar in nature and related, Ergon Energy regards these tasks as different and requiring separate processes. Ergon Energy's preference would be for the consultation on guidelines and establishing an appropriate means of assessing expenditure forecasts to be dealt with entirely separately from the consideration of annual benchmarking reports.

2.3 Objectives for Expenditure Assessment

The AER's objective, as set out in chapter 3 of the Issues Paper is to expand the assessment techniques available to the AER. Ergon Energy has noted concerns with this objective above. With this in mind, Ergon Energy would like the AER to focus its objectives on its intended approach to the assessment of forecasts against the NEL and Rules requirements in the upcoming round of reviews. Ergon Energy is seeking clarity and certainty in advance of its preparations for these reviews in relation to what techniques it will be subject to.



2.4 Principles for the Selection of Assessment Techniques

Ergon Energy is concerned about the proposal to standardise cost allocations and capitalisation. Businesses have usually developed approaches to cost allocation and capitalisation within defined statutory and regulatory boundaries based on their own circumstances. There is obviously an important distinction to be made between how to ensure consistency of information and dictating to DNSPs how they should report their affairs to stakeholders.

Furthermore, Ergon Energy would recommend caution is taken in applying techniques that use Regulatory Asset Bases (RAB) as input measures.

2.5 Expenditure Assessment Techniques

Benchmarking is useful internally for DNSPs to explore areas of difference to other DNSPs, in terms of process and cost and, where necessary, implement changes to drive improvement and innovation. Small, quick wins from benchmarking usually have little effect on overall expenditures. Longer term changes to the inherited and inherent environment of the DNSP could take decades before the effects will be felt in lower prices for services.

Benchmarking also satisfies a basic desire for comparison with others. However, it is far from a precise science. Pursued in this way can result in significant costs to arrive at a fairly obvious result – that an apple can't be an orange. Benchmarking should not be the basis on which allowances are set and should be used cautiously in reward/penalty schemes. A DNSP's pursuit of improving its benchmark position relative to others can very easily lead to sub-optimal outcomes.

Ergon Energy's experience is that any attempt at benchmarking expenditure assessments across DNSPs using high level ratios will be misleading, unless the underlying drivers, inherent costs and cost allocation practices of the expenditures of the quite different DNSP businesses in Australia are taken into account. The single biggest issue in benchmarking is how to derive data sets that fairly and even-handedly allows comparison between DNSPs that are not operating in the same environment, and further, how to then use those comparisons to set expenditure allowances.

At its simplest Ergon Energy, compared to Energex, has half the number of customers and three times the length of lines, so should one expect Ergon Energy's prices to be 6 times Energex's? In reality, the difference in price is around two times. The information creates an impression that does not represent reality. In theory one could apply a multitude of additional measures and metrics to compare these businesses across a number of dimensions. However, the question needs to be raised – have the additional, broader overall measures of comparison improved the understanding of underlying reality of two very complex organisations operating in heterogeneous environments and circumstances?

The AER has also assumed that the same data set (expenditures) coupled with physical data can be used for econometric analysis. The analysis the AER is proposing would appear to be a more sophisticated style ratio analysis and using the ratios in economic models. This is also a flawed assumption. Most DNSP's economic decisions involve minimising the life cycle costs of the electricity network in the environment it is to operate in. This involves long term investments in designs, equipment and materials and is manifested in the design and construction standards of the DNSP not in the short term expenditure forecasts. These standards have led to an asset base that is largely inherent and inherited and reflects the DNSP's circumstances.

2.6 Proposals for Further Work

Ergon Energy is concerned that the AER's proposed work program prioritises examination of specific techniques, in advance of setting the scope of guidelines and the context in which these tools will function. Ergon Energy is particularly concerned that the AER has set up a series of workshops on tools and techniques on the basis that the approach undertaken is a "done deal". This has been done without reflecting on whether a broader, wider range of assessment will deliver anything more or better than what is currently the case.





Industry requires certainty in how the Rules are to be applied, in advance of the techniques that will be used. Ergon Energy believes this should be the focus of the work now, with the analysis of different types of techniques being the scope for further review and evolution over time.

2.7 Expenditure Assessment Process

Ergon Energy believes that the AER's focus should align firstly with promotion of the NEL objective, in order to achieve dynamic efficiency, and in turn achieving the greatest value for customers. Ergon Energy does not regard benchmarking as the primary means of achieving this objective, and asserts that maintenance of existing incentive regulation should not be departed from without considerable forethought.

2.8 Expenditure Incentive Schemes and their Application

Ergon Energy believes that incentive regulation continues to be the optimal and mandated approach to assessing a DNSP's costs, and it concerns Ergon Energy that there is an inferred intention to transition over time to benchmarking as the primary tool for setting efficient expenditure forecasts. Ergon Energy believes this represents a fundamental shift away from the current regime.

Aspects of the AER's approach to expenditure assessment cannot co-exist with the incentive arrangements and need to be considered further. This is particularly the case with operating expenditure forecasts. For example, a DNSP may respond to the incentive under the Rules in the first period by reducing its expenditure below what the AER was satisfied at the beginning of the period reasonably reflected the efficient and prudent costs of meeting the opex objectives. If the AER was, through some expenditure forecasting technique, to adopt a new efficient benchmark in the second period which is much lower than what it was satisfied was efficient in the previous period; the DNSP is forced into a loss making position. This is despite the fact that it "beat" the AER's previously determined efficient forecast in the first period. There obviously needs to be a reconciliation of incentive arrangements and assessment techniques, particularly when incentives have carry-over implications.

Furthermore, Ergon Energy would seek to reinforce the inherent interdependence of expenditure assessments and incentives. The current regime is based on incentive regulation, with actual revealed costs underpinning the setting of future expenditure allowances. This structure largely determines the method of assessment that can be used without interfering with the incentive nature of the regime.

2.9 Other Issues

Ergon Energy reiterates the ENA's view that the industry requires further clarity on how the AER intends to manage the relationship between the guidelines and RINs.

There is no indication of timing under this Issues Paper but the premise is that all changes are capable of finalisation before November 2013 for almost immediate implementation. Ergon Energy simply does not see these timeframes as realistic as each of these instruments will need to evolve over time. Rather than rushing through broad brush changes, Ergon Energy would prefer the AER to ensure that their evolution reflects the reality of the information requirements that support it, to ensure perverse outcomes do not occur.

Ergon Energy also notes that in an already uncertain environment, the Issues Paper has created further concerns and uncertainty for Ergon Energy leading up to lodgement of its regulatory proposal to the AER. As discussed above, a change in focus by the AER will help to address this uncertainty.





3. TABLE OF DETAILED COMMENTS

Question(s)	Ergon Energy Response
Scope of current consultation	
Question 1 Should we anticipate the application of some assessment techniques to gas service providers as part of this consultation?	No comment.
Question 2 Do stakeholders have any preliminary comments on the development of guidelines that will be different for transmission and distribution businesses? Should consultation be separate for these businesses?	<p>Ergon Energy supports the development of guidelines for transmission businesses, but believes these should be developed separately from those developed for distribution businesses. The environment in which transmission businesses operate is significantly different to that of distribution businesses, in particular market operation, impacts associated with network design, equipment specifications and underlying technical, operating, economic and social impacts.</p> <p>Furthermore, with the exception of very large customers, electricity customers very rarely have any direct relationship with transmission businesses, whereas the majority of electricity customers will have numerous interactions with distribution businesses for a variety of reasons, though most likely in relation to maintenance of access to the electricity network.</p>
Question 3 How should linkages between expenditure assessment, information collection and storage, cost allocation and incentive arrangements be dealt with in the development of our overall assessment framework?	<p>These linkages should be treated with caution. Ergon Energy noted in its introductory comments concerns with the interaction between responding to current incentives and the AER's substitution of expenditure forecasts in the future. The current regulatory framework has been developed with incentive mechanisms as a core element, in recognition of the fact that no assessment framework can accurately determine future efficient costs with a suitable level of accuracy, or in the absence of detailed knowledge and information, such as engineering expertise and risk assessment studies.</p> <p>Ergon Energy notes that the annual and determination RIN processes generate a significant amount of information and require considerable effort to produce. In addition to current regulatory reporting requirements, Ergon Energy, like all DNSPs, collects, analyses and stores significant amounts of data for its own information to enable it to make decisions. In the last few years particularly, there has also been significant concentration on external reporting of DNSP information as well. Information that is relevant, needed and therefore already available should be the starting point for any data requests.</p> <p>The proposed collection of additional data should be the subject of a cost/benefit analysis, as collection of data does not automatically translate into useful information or represent a positive benefit to customers and electricity prices. To the extent that the AER believes additional information is required, this information ought to be collected incrementally and in consultation with DNSPs.</p>
Objectives for expenditure assessment	
Question 4 Have we appropriately characterised the role of benchmarking in expenditure assessments, and set an appropriate objective in expanding and formalising our approach in consultation with stakeholders?	<p>The purpose and the objective of the Guideline needs to be more clearly defined and reconsidered. The AER provides little indication of how it will apply its task, other than to state that its intended process will be set out in the F&A for each DNSP. For example, the Issues Paper is not clear on whether the AER's intention is to collect and assess information about expenditure incurred by DNSPs in delivering their services to customers or whether the intention is to assess the effectiveness of the incentive-based regulatory regime that is currently in place.</p> <p>The Issues Paper casts a wide net in terms of the data it is seeking to collect, without sufficient clarification on</p>



Question(s)	Ergon Energy Response
	<p>the intended use of this information. For example, the AER has stated that it intended to monitor DNSP's costs in order to benchmark efficiency, but also to benchmark 'revealed costs' (presumably the costs the DNSP would incur if operating efficiently). This infers that there is one efficient cost for all DNSPs which would enable comparison.</p> <p>Ergon Energy does not believe the AER has made clear whether its intention is to set future prices for a DNSP's services on the basis of revealed costs in conjunction with trend analysis, or a cost-delinked approach via a combination of econometric analysis and economic forecasting, or both. In addition, the AER also indicates it intends to track a DNSP's responses to incentive regulation. In Ergon Energy's view, therefore, the objective and purpose of benchmarking in assessment is far from clear and more needs to be done to explain the process for how benchmarking will apply in AER expenditure assessment and substitution of forecast.</p> <p>Ergon Energy does not believe that benchmarking of expenditures between DNSPs effectively answers the question of whether a company is appropriately responding to the incentive mechanism inherent in CPI-X price-setting. This is particularly the case because investments are generally spread over a long period of time, and the design and materials used in the construction of assets are based on long-term economic decisions, usually made in previous determination periods and are not able to be adjusted for short-term economic benefit.</p> <p>Whilst Ergon Energy acknowledges that high-level benchmarking and modelling techniques represent an important part in the expenditure assessment process, they are not appropriate for use as the primary means of determining expenditure allowances.</p>
<p>Question 5 Do stakeholders have views on the use of revealed costs and the reliance on incentive mechanisms, and how this should change with the increased reliance on benchmarking to assess expenditure allowances?</p>	<p>In previous determinations, the AER's Rule change, and in this Issues Paper, Ergon Energy has witnessed what can only be described as the regulators dilemma when assessing out-turn expenditure. It appears expenditure above forecast represents evidence of inefficiency and under-expenditure represents evidence of over-forecasting. In reality, out-turn expenditure is a consequence of a range of circumstances that will rarely track directly to forecasts.</p> <p>Therefore, although useful as an indicative tool, revealed costs can be misleading as benchmarks. For instance, in the exercise of seeking a 'like for like' comparison between DNSPs during a particular period, adjustments are required to ensure comparison is feasible. However, the challenge in undertaking this exercise is what are reasonable adjustments to make and are the same adjustments made for all DNSPs or are they unique depending on the DNSP.</p> <p>Additionally, much of a DNSP's revealed costs are dependent on uncontrollable circumstances. For this information to be useful, tracking of historical fluctuations is required to enable appropriate comparisons to be made. This process, by its nature, is backward looking, and use as a forecasting tool is again uncertain. Once the 'differences' are removed, unit costs remain and again the multitude of differences in decision-making will demonstrate differences in costs, though not necessarily inefficiency.</p>
<p>Question 6 Are there any other principles that you think that should be added to this list? Should we include principles that guide the selection of the assessment techniques to be applied in the framework and approach stage, from the list of appropriate techniques (that will be) outlined in the Guideline? If so, do you think that the principles outlined here provide appropriate guidance on technique selection?</p>	<p>Ergon Energy would support principles that focus on how the AER is likely to form a view of a satisfactory expenditure forecast, having regard to expenditure assessment. This would afford DNSPs with greater clarity and ensure appropriate controls are in place to ensure the correct technique is applied.</p> <p>In general, Ergon Energy reiterates the Productivity Commissions' view that processes should be:</p> <ul style="list-style-type: none"> • Transparent; • Capable of maximising learnings; • Involve international collaboration; and



Question(s)	Ergon Energy Response
	<ul style="list-style-type: none"> Involve peer review of processes and be subject to regular consultation with stakeholders.
Expenditure assessment techniques	
<p>Question 7 Are there any assessment techniques that should be considered as forming part of the guidelines? What are the relative benefits and shortcomings of each of the approaches and how could the latter be addressed?</p>	<p>Many of the decisions impacting economic efficiency are committed in the specification of materials and the design parameters of the network, and in determining the equipment and work force required to maintain/operate the network. Further, the operational aspect of how these materials and other resources are acquired and deployed, inclusive of the decision to invest, requires decision-making on whether it is acceptable to delay investment, or whether investment decisions should be made to ensure appropriate service delivery is maintained. These are fundamentally different questions, and analysis of each requires different techniques, the intricacies of which are often lost or subverted by benchmarking.</p> <p>In relation to the relative benefits and shortcomings of the suggested approaches, Ergon Energy provides the following comments:</p> <p>Engineering review:</p> <ul style="list-style-type: none"> Capable of providing detailed and accurate assessments, although effectiveness is limited to analysis of one firm at a time, as results are highly subjective; Process of information gathering is intrusive, time-consuming and therefore, expensive; and Useful for targeted reviews of large material projects, presumably on the basis of results of other techniques which indicate close scrutiny is required. <p>Trend Analysis:</p> <ul style="list-style-type: none"> Appropriate for use where expenditure categories remain relatively consistent; and Requires regulator to be cognisant of and prepared to acknowledge changes in expenditure profiles. <p>Governance & Policy reviews:</p> <ul style="list-style-type: none"> Although conducted in the past, the impacts of these reviews don't seem to be reflected in or have had an influence on final decisions with respect to expenditure. If such reviews are to be relied upon in the future, a requisite level of confidence would need to be engendered in such processes. <p>Expenditure benchmarks:</p> <ul style="list-style-type: none"> Useful as informative rather than deterministic tools, as a means of highlighting areas for further investigation; Useful as starting points for dialogue with DNSPs regarding justifications for levels of opex and capex incurred/proposed; Risk in applying simplistic models without due consideration of a business' cost drivers/cost structure and network characteristics – expenditure benchmarking tools are not a panacea for improvement of credibility of regulatory processes; Can produce perverse information where sample data is incorrectly assumed to be homogenous; and Will be ineffectual where not cognisant of economies of scale/scope, where data sets are not transparent and based on replicable methodology and where data is not consistently collected over a

Question(s)	Ergon Energy Response
	<p>significant period of time.</p> <p>Modelling:</p> <ul style="list-style-type: none"> • Augex and Repex models are useful to provide 'reasonableness' perspectives of expenditure, but are not appropriate for use as determinative tools. • Models have limitations (incomplete list of expenditure drivers/not cognisant of different planning standards/methodologies etc.)
Proposals for further work	
<p>Question 8 Do stakeholders agree with our general approach of attempting to derive quantitative relationships between expenditures and drivers? Are there better, more cost effective alternatives to assessing disaggregated expenditures?</p>	<p>Ergon Energy believes that the provision of network services is a complex balancing act, and the relationship between the drivers and the requirement for expenditure in different activities that support the provision of services and meet customer expectations are not always direct or immediately observable.</p> <p>Ergon Energy recommends a very long term view be taken, certainly beyond the duration of a single regulatory control period.</p>
<p>Question 9 Do stakeholders have any in-principle comments about the level of expenditure disaggregation given our expectation that lower levels of aggregation e.g. by asset type, are likely to be conducive to more robust benchmarking and other quantitative analysis?</p>	<p>Ergon Energy disputes the general assumption that lower levels of aggregation will be more conducive to robust benchmarking/quantitative analysis. Obtaining unit costs and volumes for each asset type will not necessarily provide robust data.</p> <p>Ergon Energy notes that network assets, as presented in the RAB are usually combinations of equipment types, and these can span several asset classes (with the asset class usually being the basis of the regulatory depreciation schedule). The replacement costs of the asset class should not be confused with the schedule of rates estimates that an engineer uses to produce an expenditure forecast.</p> <p>Ergon Energy also notes that comparability is a significant issue. For example, an estimate for a particular 10km line extension will not be the same for another 10km line extension in a different location. Estimates are likely to vary significantly within a network area, let alone estimates in different networks areas.</p> <p>Finally, Ergon Energy notes that any disaggregation should not be greater than businesses use to manage their own costs.</p>
<p>Question 10 Do stakeholders agree that economic benchmarking will be an important adjunct to more detailed expenditure assessments?</p>	<p>Ergon Energy agrees that benchmarking is an important adjunct, but reiterates its concerns that it is not an answer in itself. The risk of regulatory error is high if benchmarking is used as a deterministic tool. The AER should seek to avoid arrangements which will potentially drive sub-optimal behaviours, whereby DNSPs chase questionably set targets in attempts to "out-perform" their peers.</p> <p>Ergon Energy believes comparison is the primary purpose for which benchmarking should be used, as a means to guide where further investigation is required, not as an expenditure setting mechanism.</p>
Expenditure assessment process	
<p>Question 11 Do stakeholders agree that the first-pass process described above is a useful and appropriate application of expenditure assessment techniques?</p>	<p>A first-pass process allows DNSPs & others to query the conclusions from the benchmarking and other assessment processes. Furthermore, this process provides stakeholders with early notification of potential areas of concern with the accuracy of expenditure forecasts, and provides the opportunity for more evidence to be provided in relation to targeted areas. In turn, a targeted approach is better able to make the regulatory process more accessible to all stakeholders and represents a potential reduction in the cost incurred by</p>



Question(s)	Ergon Energy Response
	<p>participants.</p> <p>Ergon Energy notes that the most likely outcome is distraction with the detail of how the tools are being applied at the expense of analysis of the issues they expose, and suggests that limiting categories to a reasonably high level of aggregation may assist in reducing this potential.</p>
<p><i>Expenditure incentive schemes and their application</i></p>	
<p>Question 12 Do stakeholders have any views on the relationship between the assessment tools that we have identified, and our existing incentive schemes? Given the interrelationship between the two, and that our incentive schemes are to be revised over 2013, what processes should we follow to ensure there are appropriate incentives on NSPs to make efficiency gains, while at the same time implementing appropriate expenditure assessment techniques?</p>	<p>As revealed costs methodology for opex and benchmarking do not naturally align, Ergon Energy has concerns that where the AER makes efficiency adjustments to base costs, the result will be a dilution of the efficiency gains/losses, in turn undermining the EBSS scheme.</p> <p>Ergon Energy noted in its overview comments an example of where a DNSP responds to the incentive under the rules in the first period by reducing its expenditure below what the AER was satisfied at the beginning of the period reasonably reflected the efficient and prudent costs of meeting the opex objectives.</p> <p>If the AER was, through some expenditure forecasting technique, to adopt a new efficient benchmark in the second period which is much lower than what it was satisfied with in the previous period, the DNSP is forced into a loss making position. This is despite the fact that it “beat” the AER’s previously determined efficient forecast in the first period. There obviously needs to be a reconciliation of incentive arrangements and assessment techniques, particularly when incentives have carry-over implications.</p>
<p><i>The guideline, benchmarking reports and determinations</i></p>	
<p>Question 13 Do stakeholders have any comments on how best to manage the interrelationships between the guidelines, F&A processes, determinations and annual benchmarking reports?</p>	<p>In recognition of the volume of information generated by the development of annual revenue determinations, Ergon Energy believes the introduction of benchmarking techniques should be incrementally implemented over a reasonable timeframe, which will lower the risk of perverse outcomes in any single determination, and allow for a measured, monitored establishment. In fact, Ergon Energy would regard this as a priority for the AER to consider, not a decision left to the end of the process.</p> <p>Ergon Energy believes that changes of this magnitude, and the uncertainty and risk associated with the results that may be produced, the industry would be best supported by the provision of a reasoned approach and minimised risk afforded by an extended monitoring and transition period.</p> <p>As a starting point, Ergon Energy believes a simple streamlined approach, that can be incrementally expanded would be most beneficial and most easily allow for obligations under concurrent regulatory instruments to be satisfied. However, the timing of this approach should be established early in the process.</p>
<p>Question 14 How would it be best to maintain a degree of consistency in assessment techniques and associated data reporting, while at the same time allowing improvements in techniques?</p>	<p>In conjunction with suggestions detailed in Question 13, Ergon Energy suggests that an incremental approach would over time lead to improvements in techniques, allowing for models to be tested and correlated to actual results and providing opportunities for shortcomings identified to be addressed.</p> <p>In recognition of the current RIN requirements, and the extensive data collated as a result, Ergon Energy believes benchmarking ought to be introduced in a managed way, with an extended period of review and process improvement, enabling implementation in an evolutionary manner.</p>
<p>Question 15 Are there any ways the expenditure assessment process, including in preparing NSP forecasts, could be improved by linking the Guidelines, the F&A process and the NSP’s obligation to notify us of its forecasting methods?</p>	<p>Ergon Energy sees no issues with the sequencing of events as specified in the Rules. However, each of the individual processes should exist within a coherent, integrated framework that minimises duplication of effort and contributes to an enhanced understanding of an NSP’s cost drivers and efficient costs.</p>



Question(s)	Ergon Energy Response
Detailed timing and transitional issues	
<p>Question 16 Keeping in mind the preference to use up to date and nationally consistent data in all benchmarking analysis, what would be the best time to issue RIN templates? Would these need to be for all NSPs? How frequently should we do this?</p>	<p>In the first instance, Ergon Energy recommends that the AER keep in mind the implementation time required by DNSPs which do not currently have in place the systems to commence recording data in the format required to meet RIN requirements. The AER would also need to acknowledge the data gaps or averaging that may occur in the information supplied by DNSPs for a period of time whilst systems and processes are reviewed and upgraded.</p> <p>Once system changes have been implemented, Ergon Energy would suggest that the timing of the issuing of RIN templates should take into consideration each business' regulatory year and regulatory control period cycle, the publication of key underpinning data, such as the CPI, and the unavoidable internal constraints for DNSPs, such as auditing and governance timeframes.</p> <p>For instance, Ergon Energy would require approximately three months to complete auditing of data and allow for submission to the Board and Shareholders for approval, prior to release to the AER.</p>
<p>Question 17 Should we try and limit the collection and analysis of benchmarking data to annual benchmarking reports? Alternatively, should we focus our effort on benchmarking analysis at each draft and final decision stage, with less attention to annual benchmarking reports?</p>	<p>Ergon Energy believes the AER must take into account the most recent annual benchmarking report when assessing a regulatory proposal.</p>
<p>Question 18 Are there alternative, more flexible means to gather data for benchmarking purposes in annual reports and in determinations, such as requests outside the NEL provisions?</p>	<p>Ergon Energy does not believe data gathering mechanisms beyond those provided for in the NEL are necessary. The current RIN processes provide ample opportunity to gather any required information.</p> <p>Additionally, Ergon Energy believes the current RIN processes include very high certification standards, including statutory declarations, board approvals and audit reporting requirements. These represent significant constraints on the information businesses are able to provide.</p>
<p>Question 19 Should we be considering the alignment of regulatory years and of regulatory control periods for transmission and distribution NSPs to overcome some of these challenges? If so, should regulatory years reflect the Australian financial year? How would the alignment of regulatory control periods be best achieved?</p>	<p>Ergon Energy is not convinced that it would be necessary to align regulatory control years for distribution and transmission businesses or to align regulatory with financial years.</p> <p>Further, Ergon Energy believes staggered regulatory periods provide an opportunity for regular review of the effectiveness of assessment processes, and lessons learnt from one determination can assist in subsequent reviews.</p>
Attachment A: Holistic approach to selecting economic benchmarking techniques	
<p>Question 20 We are interested in your views on the holistic approach to the selection and establishing reporting requirements for economic benchmarking techniques</p>	<p>Ergon Energy is concerned that there has been insufficient analysis of options undertaken by the AER before proceeding with a holistic review process. In the most recent workshops, the AER seemed to have reached the holistic approach as the only available option open to them. As a result, workshops on a stream of different techniques and processes have already commenced, as if a pre-determined outcome on process and approach has already been reached. Ergon Energy would recommend additional consideration of this proposed approach.</p> <p>Each of the benchmarking techniques analysed is likely to provide different results. Ergon Energy is not clear whether the establishment of 10 techniques would provide any more indicative information to the AER than one. The selection of one economic model over another will therefore obviously result in subjective decision-making and again increase the risk of regulatory error.</p>



Question(s)	Ergon Energy Response
Economic Benchmarking techniques	
Economic efficiency	
Efficiency and productivity measurement	
Question 21 Have we identified all the relevant economic benchmarking techniques and, if not, are there other economic benchmarking techniques that should be considered?	Ergon Energy's experience is that any attempt at benchmarking expenditure assessments (regardless of the technique/s chosen) across DNSPs using high level ratios will be misleading, unless the underlying drivers, inherent costs and cost allocation practices of the expenditures of the quite different DNSP businesses in Australia are taken into account.
Relating productivity measurement to the AER's task	
Question 22 We are interested in your views on how economic benchmarking techniques should be applied in our decision making process regarding expenditure. Specifically, we are interested in your views on: § using these techniques to assist us to form a view on the efficiency of base expenditure and expenditure forecasts § measurement of the likely pace at which productivity improvements may be made over a regulatory control period.	Ergon Energy acknowledges merit in continuous measurement and comparison for the purposes of improvement and innovation. With that being said, Ergon Energy reiterates its position that economic benchmarking cannot be relied upon to provide consistent, reliable information. Whilst useful to provide comparative data, benchmarking cannot fully account for different cost drivers unique to each DNSP and would be inappropriate if used to infer relative efficiency between DNSPs. The comparison of base year expenditure through economic benchmarking techniques is further complicated by the cyclic nature of regulatory determinations, which requires reliance on data from other networks that is either out of date or not yet available. The long-term nature of network assets, lengthy investment cycles, frequent updates to accounting and reporting structures in the context of relatively short regulatory control periods and minimal historical data can distort benchmarking results, in addition to complicating the evaluation of what productivity improvements may be possible without undermining the security and reliability of the network. Ergon Energy advises extreme caution should be taken in the publication and use of information generated by benchmarking techniques, as there are and will continue to be significant errors in conclusions based on this data. Benchmarks must always be understood and acknowledged as mathematical models of complex and dynamic systems built from combinations of limited and often inaccurate assumptions or manufactured data which is extracted and manipulated.
Inputs, outputs and environmental variables	
Questions 23 - 44	Ergon Energy wishes to advise that in the context of concerns raised in its submission, and by the ENA regarding the scope and application of economic benchmarking techniques, It is only appropriate to directly respond to questions 20-22 of Attachment A. Ergon Energy believes it will be in a better position to provide responses to detailed questions raised in the AER's working groups once issues of scope and application have been clarified.
Attachment B: Category analysis	
Expenditure drivers	
Question 45 Do you agree with this list of expenditure drivers? Are there any others that should be added?	Ergon Energy does not disagree with the list of expenditure drivers, though it would note that the list is incomplete. Ergon Energy believes further industry consultation is required to develop suitable expenditure drivers, and to



Question(s)	Ergon Energy Response
	further understand how each driver should interact with others.
<p>Question 46 To what extent do you think the expenditure drivers are correlated with each other? Given this level of correlation, should we examine the impact on expenditure of each one, or can this list be consolidated?</p>	<p>Ergon Energy notes that some correlations between expenditure drivers exist. However, these are already captured in the examination of historical expenditure.</p> <p>Beyond those already identified, Ergon Energy would advise the exercise of caution, as the extent of any further identified correlation would be subjective and therefore likely to result in errors due to inconsistency.</p> <p>Ergon Energy suggests there may be further opportunity to consolidate, and further examination should be on an individual basis and based on character/impact levels.</p>
<p>Customer driven capex Fee-based and quoted services</p>	
<p>Question 47 Do you think that the network segments outlined above provide a useful demarcation of the costs of customer-initiated network extension and/or augmentation? Do you think that there are significant cost differences in installing connection point assets and in network extensions between overhead and underground assets? What alternative asset type demarcations would be more appropriate?</p>	<p>Typically, DNSPs categorise connections by purpose, size and location, and the combination of these factors can represent significant differences in cost. Ergon Energy is concerned the proposed demarcation assumes a level of detail that is inconsistent with existing business processes, operationally difficult to achieve and would represent a significant burden for all DNSPs.</p> <p>Ergon Energy wishes to reiterate that connection work is ordinarily categorised by connection type (business, residential, rural, urban etc.), not by basic connection, extension and capacity upgrades. In many cases a connection may involve all 3 making separation of individual components impossible without arbitrary assumptions being made, and without being able to account for significant variations in cost.</p> <p>Furthermore, Ergon Energy wishes to advise that, accounting systems and non-financial data systems are not always directly linked, meaning financial reconciliations may not match electrical schematics, further interfering with the usability of some types of data.</p> <p>Ergon Energy requests that the AER consider the potential effects of introducing categories that are largely inconsistent with those currently used by DNSPs. Such an approach would render DNSPs' information subject to a number of arbitrary assumptions in order to meet guideline requirements, and ultimately compromising the value of any benchmarking analysis.</p> <p>With these issues in mind, Ergon Energy would recommend the AER consider delivering a degree of flexibility in the guideline in how connections are classified within DNSPs, as these categorisations have in many instances been in place for extended periods of time and reflect how individual DNSPs reconcile costs incurred.</p>
<p>Question 48 Do you agree with separating customer-requested expenditure by connection point assets, extensions, and augmentations? Do you think total expenditure for each service (excluding new connections services) is a sufficient degree of disaggregation? Should further sub-categories be identified?</p>	<p>Ergon Energy reiterates the potential difficulties in applying such categories, when connection work is often classified by type (i.e. residential, business, rural, urban) and these categories are often applied differently by each DNSP, as such, careful consideration and consultation would be required.</p>
<p>Question 49 Do you agree with separating new customer connections expenditure by the connection point, extension, and augmentation components? Do you think that the number of new connections, length of network extensions added, and size of capacity added are useful measures of the volume of work and expenditure required for new connection services? Should these categories be disaggregated into more detailed categories reflecting the type of work undertaken by the NSP to account for</p>	<p>See answers to questions 47 and 48 above.</p>



Question(s)	Ergon Energy Response
factors that drive changes in new connections expenditure over time?	
System growth capex	
<p>Question 50 Do you think the system growth expenditure driver category should be distinguished by expenditure directed at addressing different service standard issues, such as harmonics, voltage variance, ferro-resonance, and system fault levels? Would the benefits of distinguishing expenditure into these sub-categories for forecasting the timing and scope of changes in expenditure trends over time outweigh the added complexities from doing so?</p>	<p>Ergon Energy believes it is important to distinguish sub-categories of system growth for operational purposes. This is reflective of a normal power engineering approach, as system growth expenditure is driven by numerous factors. However, further analysis is required to determine if the effort of collecting data required by the AER from a financial perspective is matched by the benefits.</p> <p>Ergon Energy seeks to draw attention to some limitations in the current augex model, which does not adequately capture expenditure required for compliance with service standards or changes in Codes. This expenditure would therefore need to be treated separately from the augex model, or risk inappropriate treatment of costs and largely ignoring a proportion of a business' augmentation expenditure.</p>
<p>Question 51 Do you think that the network segments outlined above provide a useful demarcation of the costs of general load driven network extension and/or augmentation? What alternative asset type demarcations would be more appropriate?</p>	<p>For Ergon Energy to be comfortable with the suggested network segments, it would suggest that the Augex model requires detailed re-engineering to assess the cost of added capacities and ratio of added capacity to demand growth.</p> <p>More specifically, Ergon Energy believes that the guideline should provide generally defined network segments, and allow DNSPs the discretion to further disaggregate if their business has significantly different network segments.</p>
Deterioration in asset condition (replacement capex and maintenance opex)	
<p>Question 52 Do you think the above asset types are sufficient in capturing the cost differences associated with activities to address deterioration in asset condition? What other asset types may be suitable?</p>	<p>Ergon Energy regards the suggested list as an adequate start, but would request recognition of the difference between an asset class (as in RAB and Depreciation Tables) and asset equipment/type which is usually the target of maintenance activities. Capital replacement will naturally update the existing asset values as per the asset class.</p> <p>For example the asset class Distribution Lines includes equipment such as Air Break Switches (ABS). An ABS is a type of equipment and will have a specific maintenance program no matter what asset classes the equipment is associated with. Also an ABS may be part of a rural zone substation switchyard which is another asset class or distribution substation asset class. It is analogous to say tyres on a car where the asset is the car but maintenance of the tyres is a separate program and may include small trucks which are a different asset class to cars.</p>
<p>Question 53 Do you think cost differences between emergency rectification activities and other activities to address deteriorating asset condition are sufficient to require separate categorisation?</p>	<p>As Ergon Energy does not forecast emergency rectification by asset class or equipment, it would be appropriate for them to require separate categories. Ergon Energy does make arbitrary allocations back to asset class and equipment categories for budget reporting purposes, due to the nature of its accounting systems rather than as a reflection of management of emergency budgets. More specifically, emergency maintenance is trended at the headline level, because emergency situations are not predictable.</p>
<p>Question 54 Do you think cost differences between non-emergency prevention activities and non-emergency rectification activities to address deteriorating asset condition are sufficient to require separate categorisation?</p>	<p>Ergon Energy regards this as an area that requires caution, and is related strongly to a DNSP's capitalisation and work management policies.</p> <p>Ergon Energy would seek further clarification regarding the AER's proposed categorisation of these activities.</p>
<p>Question 55</p>	<p>Ergon Energy refers the AER to its previous comments regarding the differences between asset class and</p>



Question(s)	Ergon Energy Response
Do you think cost differences between non-emergency replacement activities and non-emergency maintenance activities are sufficient to require separate categorisation?	asset equipment, noting that maintenance is categorised by equipment and activity (inspection, vegetation scoping/cutting) whereas capital replacement is categorised by class. Ergon Energy is unsure there will be benefit in disaggregating operating expenditure to this level of granularity, particularly given the EBSS already provides incentives for a business to develop the least cost solution.
Routine maintenance (Opex)/ Non-routine maintenance (Opex)	
Question 56 Do you think the approach to using benchmarking and trend assessment for routine and non-routine maintenance is reasonable? Are there any alternatives which might be more effective?	Ergon Energy does not believe a routine maintenance model would be appropriate for deterministic purposes, given the differences in DNSP structures, operating environments and assets. Ergon Energy would also suggest that, a routine maintenance model may be inconsistent with the EBSS, which incentivise a business to develop the least cost solution; benchmarking which prompts efficiency adjustments to base costs may dilute the sharing ratio and disincentives further efficiencies. Ergon Energy believes the drivers will be unique to each DNSP's geography and climate (among other environmental aspects) and is not related to what are considered economic drivers. Trends in demand, energy, customer numbers, economic activity etc. have no impact; instead it is more closely correlated to categories such as environment, geography, vegetation, equipment populations/age, failure rates, and intensity/depth of inspection.
Question 57 Given the relative predictability of maintenance cycles and activities, do you consider it feasible to construct a deterministic maintenance model, such as that described above?	Ergon Energy asserts that a generalised deterministic model developed for application across the industry is unlikely to be successful, as non-routine maintenance will be prompted by different uncontrollable and unpredictable factors for each DNSP.
Changes to regulatory obligations	
Question 58 Do you think that expenditure directed at altering network infrastructure or management systems to ensure compliance with a changed regulatory obligation can be disaggregated in a way that improves accuracy in forecasting and efficiency assessments?	Ergon Energy notes that the degree of expenditure resulting from change in regulatory obligations will differ between DNSPs. Further, there are challenges in capturing incremental expenditure due to a change in regulatory obligation for an existing activity.
Actions of third parties and natural causes (vegetation management, emergency response Opex)	
Question 59 Do you think cost differences between emergency rectification activities and other activities to address third-party actions are sufficient to require separate categorisation?	Ergon Energy supports the proposal to separate third party actions and emergency rectification.
Question 60 Do you think expenditure on managing vegetation growth should be distinguished from expenditure on third-party stochastic events? Should expenditure on third-party stochastic events be distinguished into sub-categories?	For management purposes, Ergon Energy already separates expenditure related to vegetation management as it has a significant impact on reliability, and represents a significant proportion of the corrective maintenance budgets. Ergon Energy has over 3000 vegetation areas that determine scoping and cutting expenditures. Each of these vegetation areas is characterised by different regrowth, weed control, access and distribution/sub-transmission drivers. As Ergon Energy already maintains a register of vegetation information that is disaggregated for its own purposes, it can attest to the inaccuracy of the AER's assertion that 'vegetation growth tends to occur at reasonably predictable rates'. In addition to the EBSS incentives to develop the least cost solutions, and the current operating expenditure category for vegetation management contained in the RIN, Ergon Energy is not



Question(s)	Ergon Energy Response
	convinced that additional reporting streams on this issue represent additional value.
Question 61 Do you think general measures of network size and type are sufficient measures for investigating differences in third party expenditure across service providers? What other measures may be useful?	As explained in response to Question 59, Ergon Energy already separates third party expenditure, and is not convinced that analysis of third party expenditure on the basis of measurements related to network size and type will be appropriate to produce meaningful information for benchmarking.
Indirect activities and overheads	
Question 62 Do you think overheads should be separately reported, or included on a fully-distributed basis in the expenditure driver-activity-asset categories, or both?	<p>Ergon Energy provides a number of unregulated activities, meaning that should overheads be reported as a group, its results would be distorted as against other DNSPs without similar levels of unregulated service activity. Ergon Energy has some reservations about this suggested use of benchmarking overheads given that most DNSPs use a range of allocation principles depending on their CAMs, which would result in further distortion.</p> <p>Ergon Energy acknowledges that inclusion of overheads may create significant problems for some DNSPs and in turn will unreasonably impact the ability to benchmark and the method of allocation may add an unnecessary variable to be considered between entities.</p>
Question 63 How do you think overhead expenditure should be distinguished and assessed? How would you define any overhead expenditure sub-categories?	<p>For the purposes of context, Ergon Energy notes, industry experience to date indicates that overheads are one of the most difficult areas from which to glean meaningful comparisons. While Ergon Energy supports separate reporting of overheads, we refer you to our concerns in question 62.</p> <p>For the purposes of benchmarking, Ergon Energy suggests the least complex approach may be to use direct costs only when seeking to identify the variables that make each DNSP different. Total distributed cost comparisons, where they differ from the direct cost comparisons, can then be examined in light of the allocations process, and conclusions may then be drawn on overheads after making those adjustments.</p>
Real price escalation	
Question 64 How material do you think are changes in input prices on overall expenditure levels? What forecasting and modelling approaches do you think can reliably account for the impact of input price changes on expenditure without introducing overly burdensome reporting requirements?	<p>Ergon Energy regards changes in input prices on overall expenditure levels as significant. Materials are often purchased on the basis of large, long-term contracts, and due to the specialised nature of the equipment, are exposed to currency and other fluctuations that will not necessarily align with local economic drivers.</p> <p>Ergon Energy agrees with the suggestion of incorporating appropriate risk sharing mechanisms such as pass through adjustments to allow for circumstances “where factors are particularly uncertain and unmanageable”.</p>
Question 65 What categorisation of different inputs do you think provides a sufficient understanding of both how input prices may change over time, as well as how input prices may vary across geographical locations?	<p>Ergon Energy requests that the AER consider the difficulty in changing the input mix, particular on a short term basis, and note that it would not be prudent for a DNSP to seek to change their mix unless there was a high degree of confidence that the change in relative prices would be sustained. Either way, the potential for forecasting error exists.</p>
Cost estimation risk factors	
Question 66 Do you consider optimism bias and/or strategic misrepresentation to be a material issue in the cost estimation for non-routine projects? Do you consider downward biases in cost estimation to materially outweigh regulatory incentives to over-estimate expenditure? To what extent do you consider there to be a consistent downwards bias in initial project cost estimates?	<p>Generally, Ergon Energy does not consider strategic misrepresentation to be an issue under the current NER regime. Each DNSP applies varying techniques to build up specific project budgets. It needs to be recognised that when the estimates are being prepared for regulatory proposals there will be unidentifiable costs due to the high level nature of the scopes. Therefore when considering the cost build-up of projects, estimates need to be biased depending on the degree of detail available at that time.</p>



Question(s)	Ergon Energy Response
<p>Question 67 What should be our approach to cost estimation risk factors and addressing potential asymmetric estimation risk? Would techniques such as reference class forecasting be beneficial? How would any techniques to address asymmetric cost estimation risk interact with potential incentive schemes (for either Opex or capex)?</p>	<p>Ergon Energy emphasises that forecast capital expenditures are made on the basis of estimates for projects, many of which are only in concept phase. Understandably, there are risks associated with achieving accurate forecasts where so many of the elements are either subject to change or yet to be identified. Ergon Energy does not support prescription of a particular methodology to take account of these risks.</p>
<p>Debt and equity raising costs</p>	
<p>Question 68 Do you think our established approach to assessing debt and equity raising costs remains appropriate? What modifications or alternative techniques would you suggest?</p>	<p>It is an open question whether pre-issuance debt costs should be treated as Opex or a part of the benchmark return on debt allowance. Ergon Energy considers pre-issuance debt costs are a valid cost which should be recovered.</p>
<p>Demand forecasts</p>	
<p>Question 69 Do stakeholders have any in-principle views on how demand forecasts should be derived and assessed?</p>	<p>In-principle, Ergon Energy is comfortable with the AER's recommended approach. For demand to be meaningful for capex, it needs to be analysed at a localised level. Demand drives less than 25% of capex for Ergon Energy and demand growth can be quite different at the localised or spatial level, and represent different economic drivers that are not captured in higher aggregate economic forecasts.</p> <p>Additionally, Ergon Energy reiterates that DNSPs are in the best position to determine bottom-up demand forecasts at the zone substation level, as distinct from the Australian Energy Market Operator, whose demand forecasts are at a terminal station level.</p>
<p>General uncontrollable cost factors</p>	
<p>Question 70 Do you think that the network segments outlined above provide a useful demarcation of the expenditure incurred to address various expenditure drivers? Do you think that there are significant cost differences in building, repairing, or replacing network assets based on region in which the work is being done? What alternative asset type demarcations would be more appropriate?</p>	<p>Ergon Energy suggests that further detailed empirical analysis is undertaken before this question can be definitively answered. Ergon Energy would also like to draw to the AER's attention the fact that the proposed network segments have not been universally applied by DNSPs in the differentiation of their costs, particularly in relation to rural network definitions.</p>
<p>Cost allocation and capitalisation policies</p>	
<p>Question 71 For the purposes of comparative analysis of various expenditure categories, do have any views on how to best control for difference in approaches to cost allocation, capitalisation and outsourcing?</p>	<p>The Cost Allocation Method (CAM) should not be developed in isolation from the fact that most businesses allocate costs through the same finance systems that are used to produce statutory accounts and therefore the cost/administrative burden of amending the CAM would need to be considered.</p> <p>Beyond that, Ergon Energy believes the EBSS should be left to incentivise businesses to develop the least cost solution.</p>
<p>Related party contracts</p>	
<p>Question 72 Do you think our conceptual framework for the assessment of related party contracts is reasonable? What other techniques may be appropriate? Should we apply the same conceptual framework when assessing the efficiency of related party margins on an ex post basis?</p>	<p>Ergon Energy's view in relation to related party contracts and margins is the same as its general view with respect to the overall framework: it needs to be transparent and well understood, allowing business to have a full understanding of how each transaction with be assessed.</p>



Question(s)	Ergon Energy Response
Self-insurance	
<p>Question 73 Do you think our conceptual framework for assessing self-insurance is appropriate? What other techniques may be appropriate?</p>	<p>Ergon Energy believes that self-insurance is an appropriate mechanism for the management of risks particularly with respect to:</p> <ul style="list-style-type: none"> • uninsurable risks (either as no insurance is available or insurance is not available on economic terms); • the amount of the deductibles under insurance policies; • any amount above insurance policy limits; and • other uninsured risks businesses consider it appropriate to retain. <p>As these costs are all 'business retained costs', it is important for self-insurance not to be too narrowly defined, as catastrophic events occur rarely.</p> <p>Ergon Energy also requests that the AER consider that:</p> <ul style="list-style-type: none"> • self-insurance costs are real costs involving actual outgoings of cash; • Regulatory reporting should be sufficient to ensure that there is not 'double counting' of costs when considering historical cost data; • regulatory determination processes should clearly define cost recovery measures via operating expenditure allowance or pass-through mechanism (where appropriate); • catastrophic events, such as bushfire, resulting in amounts above the insurance policy limit should be recovered through an appropriately drafted pass-through mechanism; and • For costs recovered by way of operating expenditure allowances further consideration is necessary as to whether such costs should be classified as controllable or non-controllable costs.
Development and use of benchmarks	
<p>Question 74 Do stakeholders have any in principle views on how benchmarks should be derived and applied?</p>	<p>Ergon Energy reiterates its position that benchmarks are a tool for guidance, which cannot and should not be used as a 'black-box' for determining expenditure allowances. When benchmarks are used, inevitably there is intense debate which often overshadows any benefits that could be taken by DNSPs to modify aspects of their service delivery.</p> <p>The use of benchmarks risks driving sub-optimal behaviours, and hence requires careful monitoring. Ergon Energy believes the Guideline should clearly address how the AER will identify and manage sub-optimal outcomes arising from a DNSP's response to benchmarks.</p> <p>Ergon Energy also stresses that any benchmarking approach adopted should be objective, unbiased, transparent and replicable.</p>