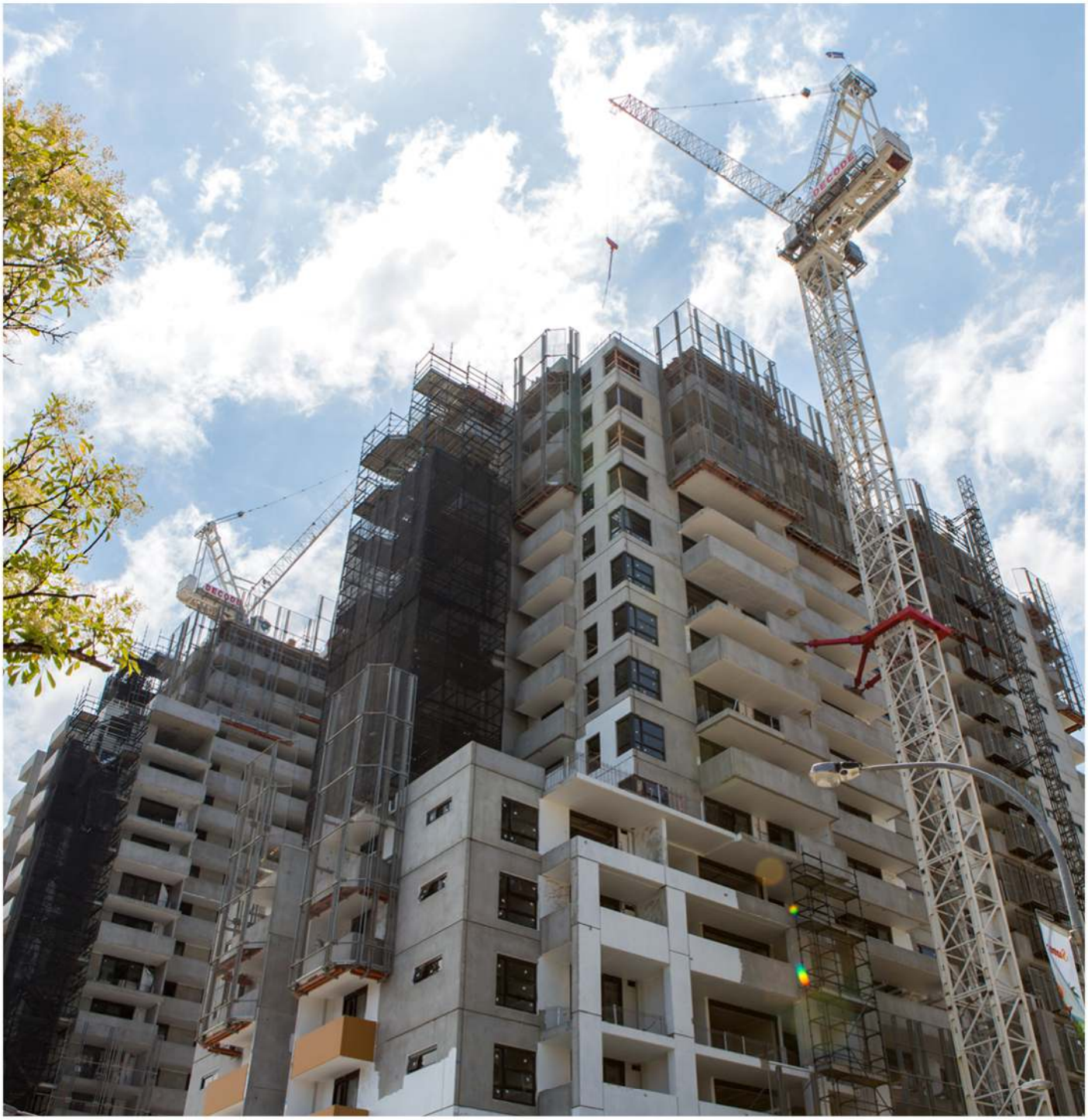

Jemena Gas Networks (NSW) Ltd

Revised 2020-25 Access Arrangement Proposal

Attachment 4.3

Response to the AER's draft decision - Property costs, overheads and inflation in the capex and roll-forward models

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Table of contents

Abbreviations ..... **iii**
Overview ..... **iv**
1. Property costs **1**
1.1 AER draft decision 1
1.2 JGN's response to the draft decision 2
2. Capitalised overheads **8**
2.1 AER draft decision 8
2.2 JGN's response to the draft decision 8
2.3 Our revised proposal capitalised overheads forecast 15
3. Inflation in the capex and roll forward models **16**

Abbreviations

AA	Access Arrangement
AER	Australian Energy Regulator
CAM	Cost Allocation Methodology
Capex	Capital Expenditure
EI	Economic Insights
ERP	Enterprise Resource Planning
JGN	Jemena Gas Networks (NSW) Ltd
MTFP	Multilateral Partial Factor Productivity
Opex	Operating Expenditure
RFM	Roll Forward Model

Overview

In its draft decision, the Australian Energy Regulator (**AER**) has accepted Jemena Gas Networks (NSW) Ltd's (**JGN**'s):[1]

- 2014-15 capital expenditure (**capex**) as conforming subject to JGN providing information regarding:
  - the overspend in capitalised overheads and property capex
  - the difference in inflation inputs between the capex model and the roll-forward model (**RFM**) for the 2014-15 year.
- JGN's capex for 2015-20 as conforming subject to:
  - JGN providing information regarding the overspend of capitalised overheads and property capex
  - JGN providing information regarding the difference in inflation inputs between the capex model and the RFM during the 2015-2020 period

In addition, it has noted that it will assess whether capex incurred in 2018-19 is conforming in its final decision, and 2019-20 capex in the 2025-30 Access Arrangement (**AA**) review.

This attachment provides the additional information that the AER seeks on these items:

- Section 1 addresses the AER's requirements in relation to the overspend against allowance in property.
- Section 2 includes an explanation of expenditure on capitalised overheads in the 2014-15 and 2015-20 periods.
- Section 3 discusses the inflation inputs in the capex model and RFM.

Presentation of financial information

Throughout this attachment all monetary values are reported in the value of a dollar in 2020 and exclude the impacts of inflations unless stated otherwise.

[1] AER, '*Attachment 5: Capital expenditure | Draft decision – Jemena Gas Networks (NSW) Ltd Access Arrangement 2020-25*, November 2019, page 5-17

1. Property costs

1.1 AER draft decision

In its draft decision, the AER has accepted JGN's 2014-15 and 2015-20 capex subject to us providing additional information on the overspend in capitalised overheads (see section 2) and property capex.

The AER's key concerns with property capex in the 2015-20 period are in relation to the costs associated with the Melbourne head office relocation.

In its draft decision, the AER states:

> *"It is not clear to us how the overall cost of the relocation has been allocated to the various regulated and non-regulated entities given that Jemena and its holding company owns and operates a numbers of businesses within and outside of Australia."*[2]

> ***Point of clarification***
>
> Jemena, nor its holding company, owns or operates businesses outside of Australia.
>
> Perhaps there is some confusion with the fact that Jemena's two shareholders own and operate businesses outside Australia but this is of no relevance in this case. Jemena is an Australian based business and operates regulated and non-regulated entities in Australia.
>
> Cost allocation is therefore only between these Australian owned and operated entities.

The AER has requested that we provide it with additional information so that it can finalise its assessment of our property capex:

> *"We seek assurance and a reconciliation that the cost allocation is reasonable and appropriate. In addition, we also expect JGN to demonstrate that the relocation provides an overall benefit to NSW gas customers. Further, to establish that the relocation is not primarily driven by Jemena's other business entities, or for branding purposes, in what costs are allocated to the JGN business based on a simple cost based methodology that is disproportional to the benefits NSW customers receive."*[3]

In the following sections we provide an explanation of the overspend in property capex together with the additional information the AER has requested. Specifically:

- Section 1.2.1 provides an overview of historical and estimated property capex for 2014-15 to 2019-20, highlighting the key drivers of the overspend against the AER's allowance.
- Section 1.2.2 explains in more detail the projects that contributed to the overspend of property capex in 2014-15.
- Section 1.2.3 provides more information on the Melbourne office relocation, including an explanation of the allocation of costs to JGN and the benefits to JGN customers.

The additional information we provide in this attachment supports the AER's draft decision which accepted this element of our 2020-25 AA Proposal.

For completeness, we note that the AER did not indicate in its draft decision any changes that it would make to historical property capex should it reject this element of our AA proposal. As a result, if the AER was to depart from its draft decision, to make a different final decision, JGN will not have been provided with an opportunity to

[2] AER, '*Attachment 5: Capital expenditure | Draft decision – Jemena Gas Networks (NSW) Ltd Access Arrangement 2020-25*, November 2019, page 5-60.

[3] Ibid., page 5-60.

make submissions in respect of the substance of that element of the AER's decision. We request that the AER provide JGN with a reasonable opportunity to make submissions if it considers departing from its draft decision.

1.2 JGN's response to the draft decision

1.2.1 Overview of historical property capex

Table 1-1 provides a summary of the property capex compared to the allowance for 2014-15 and 2015-20.

Table 1-1: Property capex ($2020, Millions)

	2014-15		2015-20	
	Allowance	Actuals	Allowance	Actuals/estimate
Melbourne head office relocation	-	0.2	3.3	16.1[1]
North Sydney fit-out and Greystanes property relocation	-	35.4	0.7	3.4
Other NSW property capex	0.3	4.0	2.1	2.1
Property	**0.3**	**39.5**	**6.1**	**21.6**

(1) Total 2014-15 to 2018-19 actual expenditure on Melbourne head office is $14.982M ($nominal), or $16.252M ($2020). Estimate for 2019-20 is nil.

The key drivers of the overspend in property capex over the 2014-15 and 2015-20 period were:

- The North Sydney office fit-out, and Greystanes relocation and office fit-out (these projects account for the overspend in 2014-15 and contributed to the overspend in the 2015-20 period).
- The Melbourne head office relocation and fit-out (this was the key driver of the overspend in the 2015-20 period).
- Other NSW property moves including a new depot in Cardiff and a new meter centre (this contributed to the overspend in 2014-15 and in the 2020-25 period).

1.2.2 2014-15 expenditure

As noted above, the key drivers of the overspend on property capex in 2014-15 were the North Sydney fit-out, the Greystanes property relocation and fit-out, and expenditure on a new depot in Cardiff and a new meter centre. These property moves were not foreseen at the time of the 2010-15 AA review, so were not included within the 2010-15 allowance.

North Sydney and Greystanes

In 2014-15 and over 2015-20 we incurred $38.8M of property capex on the North Sydney and Greystanes offices.

As noted in the Jemena NSW Property Business Case, dated 19 June 2014, which we provided to the AER as part of the 2015-20 AA review and in our response to IR009[4], Jemena's two principal leases in North Sydney and Sydney Olympic Park were due to terminate in 2015. Management approached the market in late 2013 with its property requirements. Following receipt of market tested outcomes, Management decided on the following strategy:

- Consolidation of NSW office based functions into one leased site in North Sydney.

[4] JGN, *2020-25 Access Arrangement Review: Response to AER Information request IR009, Capex: Various – 2015-20 Property*, 18 September 2019

- The purchase of a site and construction of a depot to accommodate JGN's operational requirements and for training and storage facilities.

The expenditure on these relocations was not foreseen at the time of the 2010-15 AA review—and therefore not included within the AER's allowance for 2014-15. At the time it was not known that the owner of the Sydney Olympic Park office intended to sell the site for redevelopment, meaning that an extension of the lease would not be granted.

This capex comprised of:

- Fit-out costs for a new leasehold in North Sydney.
- Purchase of new property at Greystanes (including stamp duty).
- Construction and fit-out of a new depot and training facilities at Greystanes.
- Professional services fees (including quantity surveyors, architects, engineering services, and legal).

In relation to the fit-outs, we conducted an open market tender to engage a suitable design and construction contractor with the key selection criteria being: proposed project team; experience on similar projects; commercial competitiveness; and project delivery methodology.

At the time of the 2015-20 AA Review, the AER noted that it was satisfied with the cost estimates we provided on the NSW and Melbourne head office property projects. In its draft decision the AER stated:

> *The main driver of JGN's forecast capex reduction* [from 2010-15 AA to the 2015-20 AA] *in other non-network capex is a 90 per cent reduction in forecast property capex. This is due to JGN incurring significant one-off property costs for office and depot relocations in the 2010-2015 access arrangement period related to the expiry of existing lease arrangements. Cost estimates for property capex projects are typically derived from competitive tender processes or historical costs for similar projects. We are satisfied that this is a reasonable basis for estimating property related costs.*[5]

In our response to AER information request IR009[6], we demonstrated that the actual capex incurred on the North Sydney office fit-out and Greystanes relocation was in line with the forecast that we provided to the AER as part of the 2015-20 AA Review, although the timing of the capex was later than originally forecast—at the time we expected to incur most of the property capex on the North Sydney and Greystanes relocations in 2014-15, whereas in reality, some expenditure slipped into the 2015-20 AA period.

Other NSW property

Expenditure on Other NSW property also contributed to the overspend in property capex in 2014-15. This included a new meter testing facility and a new depot in Cardiff.

- Metering testing centre: We incurred capex in the period 2013-14 to 2015-16 to construct and fit out a meter testing and refurbishment facility in Old Guildford, including the purchase and installation of meter testing rigs. The majority of the expenditure on this facility was incurred in the 2010-15 AA period, with $1.8M incurred in 2014-15 ($4.5M in total). [redacted] The design and construction of this facility was competitively tendered.

5 AER, *Draft Decision, Jemena Gas Networks 2015-20 | Attachment 6 Capital Expenditure,* November 2014, page 6-43

6 JGN, *2020-25 Access Arrangement Review: Response to AER Information request IR009, Capex: Various – 2015-20 Property*, 18 September 2019

- New depot at Cardiff: Due to continued growth in the network in the Hunter and Central Coast regions, the previous depot in Cardiff was no longer able to cater for the staff or materials required to be housed on site. The site was also congested with poor staff facilities and poor security (due to its location). As the lease on the previous site was due to expire in June 2015, the opportunity was taken to relocate to a larger depot better suited to meet the requirements in the region. JGN incurred capex in 2013-14 and 2014-15 to purchase land, and design and construct a new depot ($4.6M in total, of which $2.2M was incurred in 2014-15). The design, project management and construction of these facilities were competitively tendered.

1.2.3 Melbourne office relocation

Driver for the office relocation

In its draft decision, the AER noted that it seeks assurance: *"that the relocation is not primarily driven by Jemena's other business entities, or for branding purposes."*[7]

The drivers for the move were set out in the *Jemena Victoria Property Business Case*.[8] The business case was submitted to the AER as part of the 2015-20 AA review, and again as part of our response to IR009.

The relocation was required as the property leases at Jemena's Melbourne head office (in Mount Waverley) and other offices in Forrest Hill and Docklands were due to expire—it was not driven by Jemena's other business entities or for branding purposes. As explained below, many of the core business functions that JGN relies on are provided by staff located in Jemena's Melbourne head office. By adopting an enterprise support model, where staff work across a number of Jemena businesses thereby increasing the efficiency and utilisation of resources, JGN customers' receive benefits in the form of lower overall costs.

Cost allocation

In its draft decision, the AER states:

> *"It is not clear to us how the overall cost of the relocation has been allocated to the various regulated and non-regulated entities…"*

The cost allocation to JGN of a portion of the Melbourne head office relocation capex was undertaken in accordance with Jemena's Cost Allocation Methodology (**CAM**)[9]. The Jemena CAM allocates costs in accordance with the following key principles:

- **Simple** – can be easily communicated and understood, but within the bounds of achieving a causation based cost attribution or allocation to the relevant asset owners (i.e. entities) and eventually to the relevant activity;
- **Justifiable** – uses cost attribution mechanisms and causal allocators, where relevant, and can be reasonably demonstrated that the costs would necessarily be incurred for the support services to be provided (or the right to benefit from a support service);
- **Transparent** – identifies data sources and calculations with same costs not allocated more than once and is readily understood by cost centre managers that receive cost allocations;
- **Consistent** – will not produce volatile results between years and, also, across all the allocable asset owners without justifiable reasons for such volatility; and
- **Auditable** – uses verifiable data and sufficient documentation for an external observer to readily trace cost attribution and allocation and is auditable.

7 AER, *Draft Decision, Jemena Gas Networks 2015-20 | Attachment 6 Capital Expenditure,* November 2014, page 5-60.

8 Jemena, *Jemena Victoria Property Business Case*, 19 June 2014 [CONFIDENTIAL]

9 We submitted the Jemena CAM with our AA RIN response in June 2019 (*JGN-1-1.3-1 Jemena Cost Allocation Methodology-20190205-Public*)

Under the Jemena CAM costs that are not directly attributed to a specific Jemena entity, and that arise to provide services to multiple Jemena entities, are allocated using an appropriate causal driver that is the most significant trigger of consumption or utilisation of resources or services.

> Jemena's auditors undertake reviews of the CAM and its application on an annual basis, as part of their annual audit program of all the Jemena entities. The auditors test the allocation of costs to the entities within the Jemena group. Additionally, as part of the AA RIN process our auditors also test the allocation to JGN to confirm that the allocation of costs is appropriate and in accordance with the CAM.

The allocation of the Melbourne head office relocation capex to the various Jemena entities was based on the estimated number of seats required by staff working in the Melbourne head office, spit across entities in accordance with the effort spent by staff on each entity. The allocators used to estimate the number of seats are consistent with the Jemena CAM principles, as follows:

- Seats occupied by teams working only on one Jemena entity were allocated to that entity in total.
- For teams working across entities, timewriting data was used to calculate the proportion of time (effort) that Melbourne based staff spend working on JGN and the other Jemena entities (in % terms).[10]
- For each of the teams/functions the proportion of time (effort) spent working on each entity was then applied to the total seats occupied by that team/function in the Melbourne head office.
- The estimated number of seats required by all the teams located in the Melbourne head office was tallied.
- The total number of seats allocated to JGN as a proportion of total seats in the Melbourne head office was then used to allocate the capex associated with the new Melbourne head off office to JGN.

The allocation of capex from the Melbourne head office relation to JGN and Jemena's others entities is shown in Table 1–2. The allocation is consistent with the allocation set out in the *Jemena Victoria Property Business Case*, which was provided to the AER as part of the 2015-20 AA review.

Table 1–2: Allocation of Melbourne head office relocation capex 2014-15 to 2018-19 ($nominal, Millions)

	Costs of Melbourne head office	% of costs[1]
JGN	15.0	38.54%
Other Jemena entities	23.9	61.46%
Total	**38.9**	**100.00%**

(1) Percentages may not tie due to rounding of costs.

Assurance on the cost allocation

In its draft decision the AER noted that:

"We seek assurance and a reconciliation that the cost allocation is reasonable and appropriate."

To provide the AER with assurance it seeks, we engaged our auditors KPMG to undertake an independent review of the Melbourne head office property move capex to confirm:

- The allocation of costs to JGN and to other Jemena entities.
- That the allocation to JGN is consistent with JGN's audited accounts.

[10] For a small number of teams/functions the allocation of seats was based on other drivers. For example, for the Risk Management & Insurance team, staff effort was allocated to the entities based on the insured values of the various Jemena entities—this determines premiums paid, which is a proxy for staff effort. For IT teams, timewriting was used to allocate effort for most teams, although for some teams the split of effort between entities was based on the software applications that the team supports for each entity.

- The allocation of costs to JGN is consistent with what has been reported in JGN's AA RIN response.

In its review, KPMG confirmed the cost allocation to JGN (in absolute and % terms), which is consistent with the allocation set out in the *Jemena Victoria Property Business Case*, which was provided to and reviewed by the AER in the 2015-20 AA review. KPMG's report is included as Attachment 4.9.

Benefits to JGN customers

One of the key ways that we drive efficiency is through the consolidation of functions across our entities. By adopting an enterprise support model, where staff work across a number of Jemena businesses, Jemena is able to optimise the utilisation of its staff and offices which benefits JGN customers in the form of lower overall costs. This is evidenced by benchmarking by Economic Insights[11] which shows that we have the second highest capital productivity of all Australian gas businesses measured in 2018, and that JGN is an efficient performer in its use of both operating expenditure (**opex**) and capital inputs.

Jemena's head office in Melbourne houses many of the corporate and support functions that are critical to the operations of JGN. JGN and its customers directly benefit from the functions provided by these teams as JGN could not operate without them. As the allocation to JGN is based on the effort that these teams dedicate to JGN, the benefits are directly in proportion to the costs.

Table 1–2 lists the key functions that are located in our Melbourne head office and the activities that they perform for Jemena's entities, including JGN.

Table 1–3: List of teams located in Melbourne and the benefits provided to JGN customers

Functions located in Melbourne	Benefit to NSW customers
Office of Managing Director	Provides executive oversight and board liaison on asset and financial management and stakeholder relations across all Jemena entities, including JGN.
Finance	Delivers and leads financial reporting and assurance activities such as accounting, group taxation, treasury, investment analysis, investor relations, risk, insurance internal audit and business services. All of these are critical functions for JGN to operate its business.
Legal and company secretary	Provides legal advice to the business in order to ensure any significant legal risks during the course of business are addressed and mitigated. Provide support to the group board and the JGN board and advises on issues ranging from the duties of Directors, transparent corporate governance and corporate regulatory compliance. Management and advice on economic regulation, environmental law, employment law, property law, and company law, including the role of company secretary. Provision of these services is essential to JGN's day to day operations.
IT	Provides and manages IT infrastructure and services. Defines, delivers and supports IT solutions and services that are critical to JGN's operations and to enable it to achieve strategic outcomes.
Works/service delivery management	Performs leadership activities directly attributable to the delivery of repair, maintenance, capital works, stakeholder relations and commercial activity. Commercial negotiations with subcontractors, and program and resource planning to deliver Asset Management Plans.
Business services	Manages finance systems, financial accounting, accounts payable, accounts receivable, payroll and fixed asset register relevant to JGN operations.
Operational risk	Responsible for the operational risk management including compliance assurance to relevant risk management frameworks and processes as per technical standards applicable to JGN. Perform activities such as network communications, SCADA, and technical and training.
Internal audit	Responsible for enterprise risk management, framework and policies, development and delivery of the internal audit program. Reports independently to Board Risk & Audit Committee.

[11] Economic Insights 2019, *Relative Efficiency and Forecast Productivity Growth of Jemena Gas Networks (NSW)*, p.63 (included as Attachment 6.4 of JGN's 2020 Plan.

Functions located in Melbourne	Benefit to NSW customers
Asset Investment & Major Projects	Provides engineering design as well as business case development and execution management for Jemena's major asset projects, including JGN's. Responsible for establishing, monitoring and managing the rolling works programs and other activity through the provision of effective planning, portfolio management and reporting.
Customer services	Responsible for daily liaison with customers with respect to connection enquiries, billing, meter and relevant meter data management.
Risk management & insurance	Responsible for procurement of insurance and management of risk, including for bushfire and other natural disasters, including for JGN.
Remuneration & benefits	Provides specialist advice for all aspects of employee rewards including market competitive remuneration, employee incentives and benefits.
Corporate communications	Manages corporate communications to all stakeholders, including customers, employees, neighbours, state and federal governments and regulators.
Learning & development	Responsible for partnering with the business to identify learning, skills and capabilities required by staff across the JGN business, and for recommending effective learning solutions to maintain competencies relevant to the JGN network.
Environment	Provide services to support and govern with HSE Delivery including adherence to jurisdictional obligations in partnership with JGN functions.
Regulation	Manages regulatory obligations, price reviews, consultations and relationships with regulators and market operators. As a regulated business, JGN must comply with the NGL and NGR and our pricing, compliance and regulatory modelling team is Melbourne based.
Human Resources	Responsible for all aspects of managing resources across the businesses, from recruitment/acquisition, talent management, ongoing HR services, industrial relations.
HSEQ	Manages employee health and services training, performance, quality and adverse impact on the environment. Provide strategic and effective solutions and services for people, change, communications, safety, environment, health and quality.
Policy & External Affairs	Manages Jemena's corporate brand and social license to operate. Owner of JGN's relationships with the State and Federal governments, and media relations.
Procurement	Lead strategic procurement and sourcing across Jemena, including JGN. Manages and monitors the effective commercial engagement of contractors.
GIS team	Supports the Dial Before You Dig function and manages mapping.
Property portfolio management	Manages property related assets in a consistent, professional and cost effective manner.

2. Capitalised overheads

2.1 AER draft decision

In its draft decision, the AER has accepted JGN's 2014-15 capex subject to us providing additional information on the overspend in property capex (see section 1) and capitalised overheads.

The AER's key concerns were:[12]

- The variance between actuals and allowance – JGN has overspent its allowance in the current AA period.
- The 'step changes' in opex and capex on corporate overheads – the AER has noted that the shift between opex and capex categories raises the potential for double counting (ie. recovering the expenditure more than once).

The AER has requested that JGN include in its revised proposal:[13]

- An overall explanation for the overspend in the corporate overheads category and the overall capitalisation overspend in the current period.
- Assurance that the movement of overheads between capex and opex does not contain any double counting of costs under the regulatory regime.

In relation to our forecast capitalised overheads, the AER's draft decision:

- Accepts our proposal to remove all corporate overheads from capex starting 1 January 2021.
- Accepts JGN's proposed 75% fixed and 25% variable split for forecasting purposes.
- Requires JGN to adjust capitalised overheads to account for the same productivity factors used in the opex forecast.

In the following sections we provide our response to the AER's draft decision:

In section 2.2.1 we provide an explanation of the overspend on capitalised overheads.

In section 2.2.2 we demonstrate that there has been no double counting of corporate overhead costs.

In section 2.2.3 we respond to the AER's instruction that we adjust capitalised overheads to account for the same productivity factors used in the opex forecast.

2.2 JGN's response to the draft decision

2.2.1 Explanation of overspend in corporate overheads and overall capitalisation

The AER has requested that we provide an *overall explanation for the overspend in the corporate overheads category and the overall capitalisation overspend in the current period.*

Table 2–1 includes a comparison of JGN's overheads against the AER's allowance.

[12] AER, *Draft Decision, Jemena Gas Networks 2020-25 | Attachment 5 Capital Expenditure,* November 2019, Section 5.4.9 Capitalised overheads

[13] Ibid, page 5-67

Table 2–1: Capitalised overheads – actual vs allowance ($2020, Millions)

Category		Actuals				Estimate	Total	(Over)/ Underspent
		2015-16	2016-17	2017-18	2018-19	2019-20		
Network overheads(1)	Allowance	26.1	25.6	26.0	25.4	24.8	127.9	49.8
	Actual	16.2	15.3	16.0	14.9	15.7	78.2	
Corporate overheads	Allowance	1.2	1.2	1.2	1.3	1.3	6.2	(76.5)
	Actual	16.5	16.0	17.3	16.3	16.7	82.7	
Total Overheads	Allowance	27.3	26.8	27.3	26.7	26.1	134.2	(26.7)
	Actual	32.7	31.3	33.2	31.2	32.4	160.9	

(1) Network overheads includes direct capitalised overheads.

We expect that our actual capitalised overheads will be $26.7M higher than the AER's allowance. This is driven by an overspend of $76.5M in corporate overheads, which is partially offset by an underspend of $49.8M in network overheads.

Based on our review of the AER's final decision for the 2015-20 AA period, we understand that:

- The capitalised corporate overheads allowance was based on an historical average of JGN's corporate overheads over the 2010-11 to 2013-14 years.
- During 2010-14 period the capitalised IT overheads were classified as network overheads instead of corporate overheads. This meant that the allowances for 2016-20 capitalised corporate overheads did not include an allowance for capitalised IT overheads. These allowances were provided under capitalised network overheads.

  Based on AER's electricity category analysis RIN definitions[14] and RIN notice[15] published in 2014 to treat IT overheads as corporate overheads, Jemena started treating IT capitalised overheads consistently as corporate overheads across JEN and JGN from year 2014-15 onwards to better align the regulatory treatment across JEN and JGN. This change in classification was one of the key drivers of JGN overspending its corporate overheads allowance, as the allowance did not have these costs.

- The allowance for capitalised network overheads was based on an average of actual capitalised network overhead costs from 2011-12 to 2013-14 which included capitalised IT overheads. However, because we started treated capitalised overheads as corporate overheads this would create an artificial underspend compared to network overheads allowance.

Reclassification of IT costs

As noted above, in 2014-15, IT capitalised overheads were reclassified from network to corporate overheads. As IT capitalised overheads were categorised as network overheads in the AER's allowance for the 2015-20 period, any comparison of JGN's overheads against the allowance must account for this reclassification. Table 2–2 seeks to do this by re-categorising actual IT capitalised overheads from corporate back to network overheads.

14 AER, *Explanatory Statement - Final regulatory information notices to collect information for category analysis*, March 2014

15 AER, *Regulatory Information Notice issued under section Division 4 of Part 3 of the National Electricity (Victoria) Law*, March 2014, section 14.3 (c) Corporate overheads

Table 2–2: Capitalised overheads (with adjustment for actual IT costs) – actual vs allowance ($2020, Millions)

Category		Actuals				Estimate	Total	(Over)/ Underspent
		2015-16	2016-17	2017-18	2018-19	2019-20		
Network overheads	Allowance	26.1	25.6	26.0	25.4	24.8	127.9	(12.4)
	Actual	27.4	27.8	29.3	27.6	28.3	140.3	
Corporate overheads	Allowance	1.2	1.2	1.2	1.3	1.3	6.2	(14.3)
	Actual	5.3	3.6	4.0	3.6	4.1	20.5	
Total Overheads	Allowance	27.3	26.8	27.3	26.7	26.1	134.2	(26.7)
	Actual	32.7	31.3	33.2	31.2	32.4	160.9	

Once the reclassification of IT capitalised overheads is accounted for, the overspend in capitalised corporate overheads drops to $14.3M, and the underspend in network overheads becomes an overspend of $12.4M.

Even if we adjust for the allowance and actual costs classification between network and corporate overheads it is important to understand why, at a total capitalised overheads level, JGN overspent its allowance. As the AER's allowances are based on historical costs, in explaining why JGN has overspent its allowance it is necessary to understand the changes in JGN's actual corporate and network overheads since 2013-14.

Reason for overspend

Only those IT costs that support capital works are capitalised. These include costs that arise from the provision and management of IT infrastructure and services. Costs include salaries, employee related expenses, procurement of software and hardware, maintenance and system support, telecommunication costs and procurement of external advice costs. Given the nature of these costs, capitalised IT overheads increase in line with the capital program and scale of business.

Table 2–3 below shows the relationship between IT capitalised overheads and distribution direct capex and that even though the IT overheads have increased these are in line with historical spend levels. It shows that IT capitalised overheads have increased in line with the increase in distribution related direct capex. Notably, the proportion of IT capitalised overheads to direct capex has remained relatively stable since 2011-12.

Table 2–3: IT capitalised overheads ($2020, M)

	2010-15 AA period							2015-20 AA period					
	2010–11	2011–12	2012–13	2013–14	2014–15	10-15 Total	12-14 Total	2015–16	2016–17	2017–18	2018–19	2019-20	Total
IT cap. O/Hs	7.2	13.0	8.2	9.8	10.8	49.0	31.0	11.2	12.4	13.3	12.8	12.5	62.2
Direct capex attracting O/Hs(1)	131.6	147.1	109.7	128.0	125.1	641.5	384.8	146.4	141.5	139.9	150.9	148.8	727.5
IT cap. O/Hs as % of dist. direct capex	5.5%	8.8%	7.5%	7.6%	8.7%	**7.6%**	**8.0%**	7.6%	8.8%	9.5%	8.5%	8.4%	**8.5%**

(1) Direct capex attracting overheads = Total direct capex excluding *ICT*, *telemetry* and part of *other capex* that does not attract overheads

The proportion of IT capitalised overheads to distribution direct capex over 2011-12 to 2013-14—the years over which the AER relied on when setting the network overheads allowance for the 2015-20 period—is 8.0%, which

is in line with the average of 8.5% over the current period. We note that the AER approved JGN's capitalised overheads from the 2010-11 to 2013-14 in full as part of the 2015-20 AA review.

Similar to IT, other non-IT capitalised overheads have also increased and contributed to $14M higher capitalised overheads compared to allowance. These include network type activities such as capital program management, stores, non-corporate property, procurement and health & safety activities. Allocations are usually driven by time-writing to an activity or by a causal allocator.[16] As with IT capitalised overheads, the key driver of these costs is distribution related direct capex.

Table 2–4 shows that our non-IT capitalised overheads have remained relatively stable over the 2015-20 AA period, ranging from $18.5M to $21.6M.

Table 2–4: Non-IT capitalised overheads ($2020, Millions)

	2011-15 AA period							2015-20 AA period					
	2010–11	2011–12	2012–13	2013–14	2014–15	10-15 Total	12-14 Total	2015–16	2016–17	2017–18	2018–19	2019-20	Total
Non-IT cap. O/Hs	12.1	12.5	18.2	18.1	20.2	81.2	48.9	21.6	18.9	19.9	18.5	19.9	98.7
Direct capex attracting O/Hs	131.6	147.1	109.7	128.0	125.1	641.5	384.8	146.4	141.5	139.9	150.9	148.8	727.5
Non-IT cap. O/Hs as % of dist. direct capex	9.2%	8.5%	16.6%	14.2%	16.2%	**12.7%**	**12.7%**	14.7%	13.4%	14.2%	12.2%	13.4%	**13.6%**

Table 2–4 shows the five-year average proportion of capitalised overheads to distribution direct capex between the previous period (12.7%) and current period (13.6%) is not materially different.

Noting that the AER's allowance for network overheads was based on actual overheads from 2011-12 to 2013-14—and noting that most of the non-IT capitalised overheads are network overheads—if we take the average proportion of capitalised non-IT overheads to distribution direct capex over these years, it remains at 12.7% (shown in Table 2–4), which is in line with the average of 13.6% over the current period.

We have underspent our capex allowance and benchmark well against our peers

While we have overspent the AER's capitalised overheads allowance, over the 2015-20 period, it is worth noting that we are forecasting that we will underspend the AER's capex allowance by $85M. This is despite significant growth in our network, beyond what was forecast by the AER in its final decision for JGN's 2015-20 AA. As we noted previously in our response to the Information Request IR033, JGN consistently benchmarks in the top three businesses on capex when compared to its peers, and analysis by Economic Insights (**EI**) has found that JGN's capital multilateral partial factor productivity (**MTFP**) index is the second highest for the latest available years among the gas distribution businesses. This should provide comfort that our historical capex, including out capitalised overheads, is efficient.

[16] For example, it is not practical for program managers and senior management to record time against a multitude of specific cost collectors (projects). They time write to catch-all cost collectors, which are then distributed based on the underlying direct costs of the respective cost collectors (projects).

2.2.2 Our costs have not been double counted

The AER states:

> *The critical observation is that opex and capex expenditure on corporate overheads shows a number of step changes. The shift between opex and capex categories raises the potential for double counting.*

While the AER appears to imply that JGN is able to shift costs between opex and capex at will, we must state categorically at the outset that this is simply not the case.

The capitalisation of costs must comply with relevant accounting standards, including AASB116 – property, plant and equipment. Our actual capitalised costs are audited annually—as part of the group and JGN statutory audits—for compliance with these standards and with our parent company capitalisation policy. This capitalisation policy has not changed over the period since 2010-11, nor has the Cost Allocation Methodology nor any of our booking practices. These polices, processes and independent compliance audits mean that costs cannot be shifted between opex and capex at will.

Additionally, we note that the allocation of JGN's costs was also audited as part of our AA RIN response, and our auditors did not find any misallocation or inappropriate classification of costs between opex and capex.

Since these costs—and the activities that they arise from—are capex in nature, they would not have formed part of JGN's opex allowance over 2015-20. On this basis, it is clear that there has been no double counting of costs.

Alongside the above statement, the AER also plotted a chart on the opex and capex overheads noting the potential cost shifting. In this chart, the AER used the capitalised overheads from our RIN data which includes the reclassification of IT costs from network to corporate overheads from 2014-15 onwards. This means that between the periods 2010-2014 and 2014-2020, costs are not directly comparable due to reclassification of costs. The step up in corporate overheads from 2014-15 is mostly caused by the re-categorisation of IT costs rather than an actual cost increase as described in section 2.2.1. In order to provide a like-for-like comparison, we have recreated the two overhead charts in the AER's draft decision with IT costs classified consistently as network overheads throughout the period 2010-20.

Figure 2–1 and Figure 2–2 show the trend in network and corporate overheads over the 2010-20 period as reported in the RIN and used in charts prepared by the AER in its draft decision (presented as a dotted line) and an alternative view, which ensures the consistent categorisation of IT costs (presented as a solid line).

Figure 2–1: Network overheads trend ($2020, Millions)

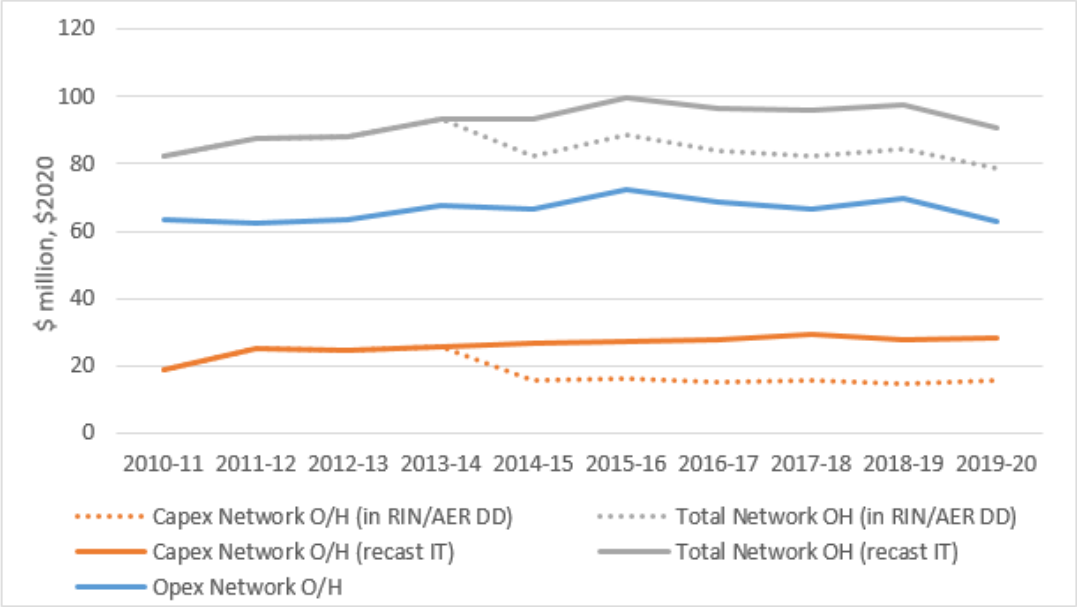
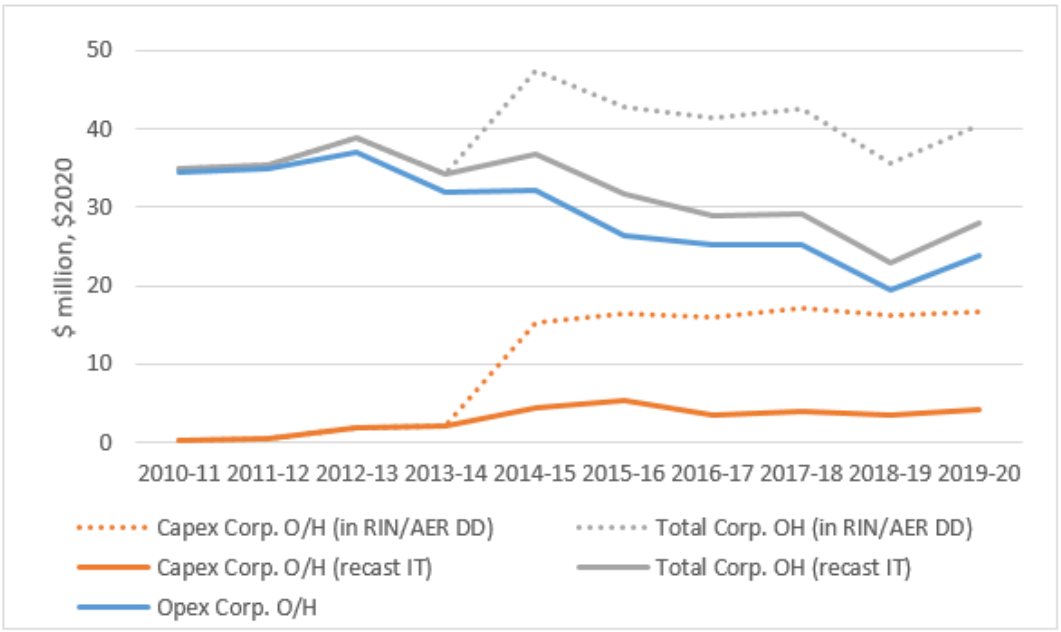


Figure 2–2: Corporate overheads trend ($2020, Millions)



It is clear from the charts that if IT costs were to be classified consistently as network overheads from 2010-11 to 2019-20, the trend on total network overheads is stable over time and gradually increasing in line with the increase in direct capex. The trend on total corporate overheads is gradually reducing over time. These two charts also shows that there is no evidence of cost shifting between opex and capex.

Substitute estimate

We note that in its draft decision, the AER has included our historical capitalised overheads capex as a 'placeholder', rather than specifying whether or not it has approved this capex. We consider that the information

provided within this attachment provides the AER with sufficient information to approve in full our historical capitalised overheads as prudent and efficient.

Should the AER not be satisfied with the additional information we have provided, and should it seek to make a substitute estimate, we expect that, in accordance with the rules, we will be provided with at least 30 business days to respond to its decision.

2.2.3 Application of productivity forecasts

In its draft decision, the AER has applied a productivity factor to capitalised overheads. In states:[17]

> *Given the nature of overheads and JGN's ability to move overheads between capex and opex, as well as across and within regulatory periods, we find that productivity factors associated with opex should also be applied to capitalised overheads to better reflect reality given that JGN cannot identify the specific capex and opex projects that drives productivity.*

We do not agree with the AER's draft decision to apply a productivity factor to capitalised overheads. Specifically, we consider that:

- It is not appropriate to apply an *opex* productivity factor to *capex*—the model used to estimate an appropriate productivity factor for JGN excludes capitalised overheads, and there is no reasonable basis upon which this factor should be applied to capex. Any productivity factor that the AER applies should be based on appropriate benchmarking of relevant costs, derived from empirical data.
- Such a significant departure in the AER's approach should be the subject of a formal consultation process—yet the AER has undertaken no such engagement.

We also asked CEPA to review this aspect of the AER's draft decision.

CEPA states:[18]

> *Economic Insights' models use opex data that is post-capitalisation. In other words, all the GDNs' overheads that are capitalised are excluded from Economic Insights' modelling. This means that the opex productivity target does not represent changes in overheads that the GDNs associate with capex.*
>
> *As the capitalised overheads have not been included in the modelling, there is no direct link between the opex productivity estimate and any productivity that might be achievable for capitalised overheads. As the AER noted in its draft determination for SA Power Networks:*
>
> > *"We also note that SA Power Networks' capitalisation policy may impact the comparability of the benchmarking results and that this is an area we will consider as a part of our ongoing benchmarking development program"*
>
> *The impact on modelling of capitalisation policy is not limited to the relative efficiency assessment but will also affect the coefficient on the time trend (the productivity estimate). Therefore, the productivity trend may not represent the historical productivity achieved by gas networks across all opex type activities (i.e., pre-capitalisation). This will be much more pronounced for the gas network modelling undertaken by Economic Insights as it uses a much smaller sample than its modelling in the electricity sector, and the gas sample is largely made up of Australian firms.*
>
> *We do not consider the AER has evidence to support its draft decision for JGN that the historical opex productivity estimate should be applied to capitalised overheads.*

[17] AER, *Draft Decision, Jemena Gas Networks 2020-25 | Attachment 5 Capital Expenditure,* November 2019, page 5-67

[18] CEPA, *Review of the Australian Energy Regulator's approach to Jemena Gas Network's cost escalators*, December 2019, page

The AER has not previously engaged on this change in its approach and its decision is inconsistent with other recent decisions

Whereas the AER undertook a formal consultation process on appropriate productivity factors to apply to electricity distribution businesses opex,[19] it has not undertaken any consultation on its draft decision to apply an opex productivity factor on our forecast capex. As this change in methodology represents a significant departure from its previous approach—we are not aware of any previous AER decisions where it has applied a productivity factor to capex—we would expect it to undertake a formal consultation process on this topic. For example, in developing its opex productivity target for electricity businesses, the AER:[20]

- Published a draft decision paper.
- Held an industry wide workshop.
- Had bilateral meetings with stakeholders in the consolation period to facilitate more in-depth discussion of the issues that concerned stakeholders.
- Invited and received written submissions from stakeholders.
- Published a final decision paper.

In contrast to the above, at no time did the AER indicate its intent to apply a productivity target to part of our forecast capex prior to publishing its draft decision.

We also note that the AER's draft decision to apply an opex productivity factor to capitalised overheads is inconsistent with its recent SAPN draft decision, where it has no applied a productivity adjustment to SAPN's capitalised overheads. Additionally, in its most recent decisions on the Victorian gas networks, the AER did not seek to apply productivity to forecast capex.

2.3 Our revised proposal capitalised overheads forecast

Our forecast of capitalised overheads:

- Retains our proposal to remove all corporate overheads from capex starting 1 January 2021, which the AER has accepted.
- Retains the proposed 75% fixed and 25% variable split for forecasting purposes, which the AER has accepted.
- Includes no adjustment for productivity, for the reasons outlined in section 2.2.3.
- Has been updated to be based on the four-year historical average of 2015-16 to 2018-19 instead of a three-year average in our 2020 Plan and to account for our revised capex forecast (as detailed in Attachment 4.1).

Our forecast capitalised overheads for the 2020-25 AA period are shown in Table 2–5.

Table 2–5: Capitalised overheads ($2020, Millions)

Capitalised overheads	2020-21	2021-22	2022-23	2023-24	2024-25
Network	15.8	15.8	15.2	15.4	15.4
Corporate	8.3	-	-	-	-
Total	24.1	15.8	15.2	15.4	15.4

[19] AER, *Final decision paper, Forecasting productivity growth for electricity distributors*, March 2019

[20] AER, *Final decision paper, Forecasting productivity growth for electricity distributors*, March 2019, page 11

3. Inflation in the capex and roll forward models

In its draft decision, the AER seeks more information regarding the difference in inflation inputs between the capex model and the RFM for the 2014-15 year and during the 2015-2020 period:[21]

In our initial proposal, we applied different inflation series to the RFM and our expenditure forecast because of the different purposes of these models.

The RFM applies a six-month lagged December to December quarter CPI which is consistent with the series we applied to the RFM during the 2010-2015 period and that used for setting tariffs. Applying a consistent series in RFM ensures that we are not systematically over or under-compensated due to inflation differences. For expenditure forecast including both capex and opex, we have applied an unlagged June to June quarter CPI. This is because JGN operates on financial year basis from July and June and the application of June series ensures that the applied CPI is consistent with the actual cashflow timing of JGN's expenditure.

However, in AER's draft decision on capex, it has expressed preference to align the inflation inputs in capex to the RFM and has replaced the June quarter inflation series with December series only for 2018-19 and 2019-20. We are open to AER's amendments on this issue and have applied the December quarter CPI in our Revised 2020-25 AA Proposal capex model (Attachment 4.1) consistent with the RFM (Attachment 6.1) for the entire 2014-20 period.

[21] AER, '*Attachment 5: Capital expenditure | Draft decision – Jemena Gas Networks (NSW) Ltd Access Arrangement 2020-25*, November 2019, page 5-17