



Submission to the AER on its
Preliminary Determination
Capitalised overheads and ICT
expenditure



Summary

This document sets out Ergon Energy's response to the Australian Energy Regulator's (AER) Preliminary Determination on capitalised overheads and ICT expenditure.

In revoking and substituting its Preliminary Determination, the AER must:

- reverse its decision to reduce capitalised overheads and its consequential application to capitalised ICT costs. Ergon Energy has not amended our revised Regulatory Proposal, other than to reflect updated expenditure forecasts for ICT costs. Once allowing for differences in capitalisation practices there is not a material difference in operating expenditure between the Queensland service providers and comparison firms.
- review its approach to assessing base year operating expenditure. Ergon Energy does not agree with the AER's assessment that ICT base year operating expenditure includes inefficiencies.
- properly reconsider the ICT operating expenditure step changes. Ergon Energy has included \$4.493 million in ICT cost increases per annum above increases accommodated via the growth escalation. This represents estimated additional ICT costs to support Standard Control Services in a fully contestable retail market.

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1. Introduction

On 30 April 2015, the Australian Energy Regulator (AER) released its Preliminary Determination on Ergon Energy's Regulatory Proposal for the regulatory control period commencing on 1 July 2015 and ending on 30 June 2020.

This document details our response to the AER's Preliminary Determination on capitalised overheads and Information and Communication Technology (ICT) expenditure. We have made revisions to our Regulatory Proposal and its supporting documents to reflect these positions, where necessary. This includes updating our forecasts in light of more current information regarding:

- increased inter-period ICT capital investment resulting in higher Asset Service Fees (ASF) than originally forecast
- reduction of ASF following a downward revision of the rate of return to 7.41%
- reduction in the step change related to new systems. Increased operating costs related to investments in systems for market capability only have been included in the revised step change.

This document is structured in the following manner:

- Chapter 2 summarises the AER's Preliminary Determination in relation to ICT expenditure.
- Chapter 3 provides our response to the positions adopted by the AER on capitalised overheads.
- Chapter 4 details our response to the AER's Preliminary Determination on ICT overheads and expenditure.

In response to the AER's concerns the SPARQ Solutions Pty Ltd (SPARQ) Board on behalf of Ergon Energy and Energex have engaged KPMG to undertake an analysis of the ICT:

- operating model
- asset charging model
- cost benchmarking
- governance processes.

The full report is attached as a separate submission document.¹

¹ KPMG (2015), *Report to the Board of SPARQ Solutions on ICT Expenditure Forecasts for the Period: 2015 to 2020*, 25 June 2015. Hereafter referred to as *KPMG – SPARQ ICT expenditure forecast*.

2. The AER's Preliminary Determination

The AER accepted Ergon Energy's forecast of ICT capital expenditure of \$23.6 million (2012-13 \$ real) allocated for end user devices as proposed in the Non-Network ICT Capital Expenditure category. The AER provided an alternative expenditure allowance for capitalised overheads and implied a proportionate reduction to ICT capitalised overheads (Attachment 6 – Capital Expenditure).

Attachment 7 – Operating Expenditure rejected Ergon Energy's overall base year operating expenditure and provided an alternative estimate of efficient base year costs. By default, this revised estimate implied a reduction to ICT operating expenditure and disallowed all ICT operating expenditure step changes.

In summary, the AER:

- accepted our forecast for Non-Network ICT capital expenditure for end user devices
- rejected our capitalised overhead forecast which included ICT operating expenditure
- rejected our base year operating expenditure which included ICT operating expenditure
- rejected our step changes which included those related to ICT operating expenditure.
- did not accept that the SPARQ ICT financial arrangements do not lead to any material differences in revenue requirements relative to the ICT financial arrangements of other Distribution Network Service Providers (DNSPs).

The AER also highlighted Ergon Energy's total ICT expenditure and raised the following concerns:

- The use of 2012-13 as the base year for forecasting 'operational support' and 'telecommunications pass through' costs does not capture the efficiencies identified by the Independent Review Panel on Network Costs (IRP) and ITNewcom (SPARQ's consultant).
- There is an over-recovery of the financing costs which SPARQ charges to Ergon Energy via the ASF because Ergon Energy proposed a significantly higher return on capital than the AER's estimate in the preliminary decision.
- Ergon Energy is relying on SPARQ ICT costs, the majority of which have not been market tested and there is evidence to suggest that there is further scope for efficiencies through reforms to the arrangements between Ergon Energy and SPARQ.
- It is not transparently reported and rather should be reported within 'overheads' rather than in 'non-network IT'. Moreover, the off-balance sheet arrangement with SPARQ lacks transparency, which hinders the AER's ability to assess and track Ergon Energy's ICT expenditure across regulatory control periods.

These concerns have been responded to in Section 4.

3. Our response to the AER's approach to capitalised overheads

This ICT expenditure recovery model was discussed with the AER as part of the 2010-2015 regulatory submission. Our Expenditure Forecast Method, submitted to the AER in 2013 outlined our proposal to continue this approach for the regulatory control period 2015-20. We also note that Ergon Energy's Cost Allocation Method (CAM) included "various cost items relating to the ICT portfolio" as part of the share support cost allocated between regulated distribution services and unregulated costs.

In respect of our proposed CAM, the AER made the following determination on 15 August 2014:

"We consider the CAM proposed by Ergon Energy gives effect to and is consistent with our guidelines and the rules. We therefore approve, under clause 6.15.4(c) of the rules, Ergon Energy's proposed CAM."²

The AER has therefore been aware of our approach for some time.

3.1. Incorrect approach to assessing capitalised overheads

The AER's Preliminary Determination appears contradictory in terms of how it assessed and substituted capitalised overheads. The AER appears to acknowledge (correctly) that any forecast must adhere to the AER's approved CAM.

"...the starting point of our capitalised overheads assessment is Ergon Energy's proposal, which is based on their CAM. As such, Ergon Energy's forecast application of the CAM underlies our estimate."³

However, the AER appear to immediately depart from this compliance obligation in favour of a more philosophical view:

"As a logical proposition we consider that reductions in Ergon Energy's forecast expenditure should see some reduction in the size of Ergon Energy's total overheads."⁴

...

² AER (2014), *Final Decision, Ergon Energy Revised Cost Allocation Method*, 15 August 2014.

³ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p6-90.

⁴ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p6-89.

“We have only reduced the capitalised overheads to account for the reduced scale of Ergon Energy’s approved capex based on assessment techniques best suited to each of the capex drivers...”⁵

The AER also appear to be agnostic to compliance with the CAM in respect of operating expenditure:

“We have considered ...whether it is necessary to account for the way the CAM allocates overheads between capex and opex in making this decision. We considered that this was not necessary in order to satisfy the capex criteria. This is because:

- our opex assessment sets the efficient level of opex inclusive of overheads and so has accounted for the efficient level of overheads required to deliver the opex program...”⁶
-

Based on the evidence provided by the AER, apart from the recognition that Ergon Energy used the CAM in establishing a forecast and this was the starting point for the AER’s assessment (which was later rejected and substituted), it does not appear the AER has taken into account the need to comply with CAM arrangements at all.

3.2. Flaws in AER reasoning on CAM application

Ergon Energy cannot replicate the AER’s Preliminary Determination in a way that remains consistent with the AER-approved CAM for Ergon Energy. The AER makes different reductions to capital and operating expenditure which do not reconcile back to CAM compliance.

There is no basis to the reasoning provided by the AER that a one to one relationship must exist between the direct capital expenditure allowed by the AER and the overhead allocated to it. If the AER did want such an arrangement to exist, it would have required a very different CAM arrangement to the one approved.

The AER has failed to recognise that although overheads may in fact move in alignment with direct capital expenditure, the AER-approved CAM arrangements would not move the overhead rate at the same proportion as the direct capital expenditure reduction.

We attempt to illustrate this in a simple example. Suppose Ergon Energy incurred the following standard control service expenditure in year 1 of a regulatory control period:

- Direct capital expenditure of \$400 million
- Direct operating expenditure of \$300 million
- Overhead expenditure (applying to standard control services) of \$200 million.

⁵ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p 6-90.

⁶ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p 6-90.

This means total expenditure for the year is \$900 million. We also assume in year 2 both direct capital expenditure and overhead fall by 5%. However, direct operating expenditure falls by 15% as shown in the table below.

Table 1: Illustration - costs in years 1 and 2

\$m	Year 1	Year 2	% change
Direct capital expenditure	\$400.00	\$380.00	-5%
(plus) Direct operating expenditure	\$300.00	\$255.00	-15%
Total direct expenditure	\$700.00	\$635.00	-9%
(plus) Overhead	\$200.00	\$190.00	-5%
Total expenditure	\$900.00	\$825.00	-8%

Assuming the CAM allocates the overhead pool according to the percentage of direct costs; overheads will not be allocated in a linear fashion, but according to the proportion of direct costs to total cost in year 2. This is shown in Table 2 below.

Table 2: Illustration - CAM allocation

\$m	Year 1	Year 2	% change
Direct capital expenditure	\$400.00	\$380.00	-5%
(plus) Direct operating expenditure	\$300.00	\$255.00	-15%
Total direct expenditure	\$700.00	\$635.00	-9%
(plus) Overhead	\$200.00	\$190.00	-5%
Total expenditure	\$900.00	\$825.00	-8%
Overhead allocated to direct capital expenditure	\$114.29	\$113.70	-1%
Overhead allocated to direct operating expenditure	\$85.71	\$76.30	-11%
Total capital expenditure (incl. overhead)	\$514.29	\$493.70	-4%
Total operating expenditure (incl. overhead)	\$385.71	\$331.30	-14%

Even though overhead costs have reduced at the same rate as direct capital expenditure, the amount of overhead applied to direct capital expenditure increases, because direct operating expenditure has decreased at a greater proportion. In the above example, the AER would determine that overheads have not reduced in line with direct capital expenditure, because the overhead allocation has only reduced by 1% when direct capital expenditure has moved 5%. This is clearly incorrect and provides further reasoning why the AER should reconsider its approach to the determination of capitalised overheads.

3.3. The need to have regard to NER requirements, when revoking and substituting its Preliminary Determination

SPARQ ICT costs for the regulatory control period 2015-20 reflect:

- investment previously undertaken in prior regulatory control periods in relation to capital ICT, as well as proposed investment during the regulatory control period 2015-20 (reflected in the ASF)
- a combination of in-house, contracted and outsourced licencing, telecommunications and operational support services.

As such SPARQ ICT expenditure included in the overheads forecast for the regulatory control period 2015-20 is heavily influenced by decisions taken in previous regulatory control periods.

Ergon Energy has provided the AER with the process we have followed to calculate our forecasts, including overheads, on a revealed cost methodology (see *06.01.01 – Forecast Expenditure Summary – Operating costs*). Overhead expenditure forecasts have been calculated separately to direct operating expenditure and capital expenditure forecasts because overheads, such as SPARQ ICT, do not change in the same proportion to direct spend over time.

Expensed and capitalised overheads forecasts also have to reflect the approved CAM. The AER approved Ergon Energy's CAM in August 2014. The National Electricity Rules (NER) require Ergon Energy to propose an operating expenditure and capital expenditure forecast in line with the approved CAM. Ergon Energy believes the AER must consider clauses 6.5.6 (b)(2) and 6.5.7 (b)(2) of the NER when determining the operating and capital expenditure allowance:

"The forecast of required operating [capital] expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* must:

...

be for expenditure that is properly allocated to *standard control services* in accordance with the principles and policies set out in the *Cost Allocation Method for the Distribution Network Service Provider*."

Ergon Energy's proposal has allocated overhead expenditure in accordance with the AER-approved CAM, as required by the NER. Any change to overhead expenditure needs to be considered separately to changes in direct operating or capital expenditure and must consider the approved CAM.

SPARQ ICT expenditure supports Ergon Energy's operating and capital program but does not have a linear relationship to operating and capital expenditure. Ergon Energy's forecast SPARQ ICT costs reflect efficient and prudent ICT expenditure, as evidenced by market testing and independent benchmarking reports. The forecast has been determined on a revealed cost methodology and allocated in accordance with the approved CAM as required by the NER.

Ergon Energy believes it is inappropriate for the AER to make a determination that we are unable to reconcile with NER requirements.

4. Our response to the AER's concerns with ICT overheads

In the Preliminary Determination the AER stated in relation to SPARQ ICT costs included in the overhead pool:

“We accept this expenditure because we do not have any firm evidence that this expenditure is not prudent or efficient given a realistic expectation of demand and cost inputs. However, our assessment of Ergon Energy's proposed ICT expenditure has revealed some areas of concern.”⁷

Ergon Energy addresses the concerns raised by the AER in the Preliminary Determination in the following sections. In doing so, Ergon Energy also believes it is important to reiterate that:

- the relationship between overhead expenditure, in particular SPARQ ICT expenditure included within overheads, and direct expenditure contained within our proposed operating expenditure and capital expenditure forecasts is not linear
- the NER require the operating expenditure and capital expenditure forecasts to reflect the approved CAM.

We have stated some of our concerns with the AER's approach to the CAM above. It is important to note that the forecast capital program for the regulatory control period 2015-20 does not directly impact SPARQ ICT forecasts for the corresponding regulatory control period, and as such a reduction in the capital program will not result in a corresponding reduction in the SPARQ ICT costs.

We also note, from our reading of the Preliminary Determination, that the AER has not engaged in the detail of some of the characteristics of the unique SPARQ joint ICT arrangements. In addition, our approach has been misinterpreted / misunderstood by the AER's consultants.

In our October Regulatory Proposal documentation, we demonstrated that SPARQ's ICT expenditure is represented via four cost categories. The current ICT model passes through SPARQ's costs, without margin, to Ergon Energy – and these costs are recognised in Ergon Energy's books as overheads for accounting purposes. The four cost category line items are:

- Operational Support – internal and external costs related to ICT support (license maintenance and support, service contracts, internal and external labour);
- Telecommunication pass through – third party costs associated with the provision of telecommunication and data network services;
- Non-capital project costs – internal and external labour related to ICT project work that cannot be capitalised in accordance with the network business' capitalisation policies and Australian Accounting Standards
- ASF – amortisation/depreciation and financing charges related to past and forecast ICT capital investments.

We also demonstrated that SPARQ ICT costs for the regulatory control period 2015-20 reflect:

⁷ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p 6-90.

- investment previously undertaken in prior regulatory control periods in relation to capital ICT, as well as proposed investment during the regulatory control period 2015-20 (reflected in the ASF)
- a combination of in-house, contracted and outsourced licencing, telecommunications and operational support services.

4.1 Our ICT approach

In its Preliminary Determination, the AER indicated that some 65% of SPARQ's total ICT expenditure is capitalised,⁸ including ASF. The AER considered that this approach did not correctly capture SPARQ's costs and failed to provide sufficient transparency for trending of ICT capital expenditure. The AER considered that it be most accurately captured as 'Non-Network IT and Communications Expenditure', and incorporated into Ergon Energy's Regulatory Asset Base (RAB).⁹

While acknowledging that the model is unique within the National Electricity Market, Ergon Energy considers that the broader substitution of ICT capital expenditure with ICT operating expenditure through trends such as Software as a Service (SaaS) and other 'Cloud' sourced solutions will necessitate similar treatment in the future. Although the SPARQ ASF arrangement reflects capital expenditure in SPARQ on behalf of Ergon Energy, it is anticipated that future solutions such as Enterprise Resource Planning (ERP) could be provisioned through SaaS. This presents difficulties in consistent comparisons across the DNSPs, but reflects the changing landscape of ICT and the potential for increases in ICT operational expenditure over increases in the RAB associated with ICT investments.

KPMG were engaged to assess the ICT asset charging model employed by SPARQ, and the potential differences this model may have in the annual revenue requirements for Ergon Energy. KPMG concluded that there is no material difference to the Maximum Allowable Revenue (MAR) under the AER's Post Tax Revenue Model (PTRM). KPMG modelled the MAR calculated under SPARQ's current ICT asset charging model to the AER's PTRM. Their analysis found that after discounting the five year forecast differences by a post-tax vanilla Weighted Average Cost of Capital (WACC), there is no material difference to MAR for the forecast period. For Ergon Energy, the SPARQ methodology produces results that are approximately 2.6% less than the NPV of the PTRM regulatory equivalent, as shown in the Figure 1 below.

⁸ Ibid

⁹ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p6-96.

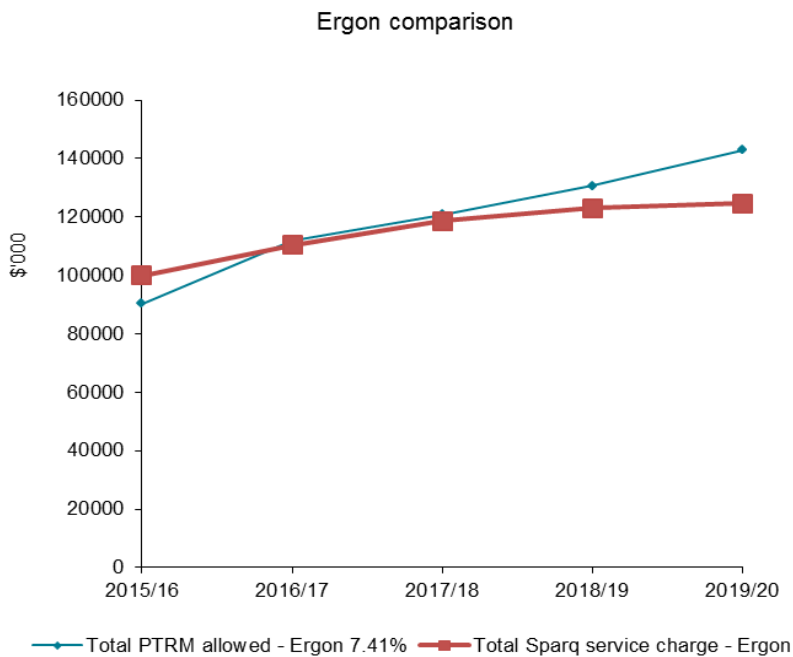


Figure 1: PTRM comparison

Source: KPMG – SPARQ ICT expenditure forecasts, p6.

Although the AER have indicated they would give consideration to the possible inclusion of the SPARQ assets in the RAB,¹⁰ the KPMG analysis concludes there is no material difference with the ASF approach. Ergon Energy will continue with the existing SPARQ ICT expenditure recovery model, and has tabled additional information on the ICT capital expenditure for the regulatory control period 2010-15 and the forecast ICT capital expenditure in Section 4.2.

Finally, Ergon Energy reports ICT costs in the Non Network IT and Communications section of the Category Analysis RIN. This section of the RIN is prepared in accordance with Ergon Energy’s Basis of Preparation document. It should be noted that expenditure reported for the regulatory control period 2010-15 against this category includes costs related to activities that other DNSPs may categorise as SCADA and Non-Network Control. For this reason it is argued that comparative benchmarking of ICT costs should only reference SPARQ costs.

4.2 ICT capital expenditure

Details of the actual capital expenditure for the regulatory control period 2010-15 and the proposed ICT capital expenditure in SPARQ for Ergon Energy are set out in *07.07.02 – AER 2015-2020 EE ICT Plan*. A summary is shown below in Figure 2.

¹⁰ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p6-92.

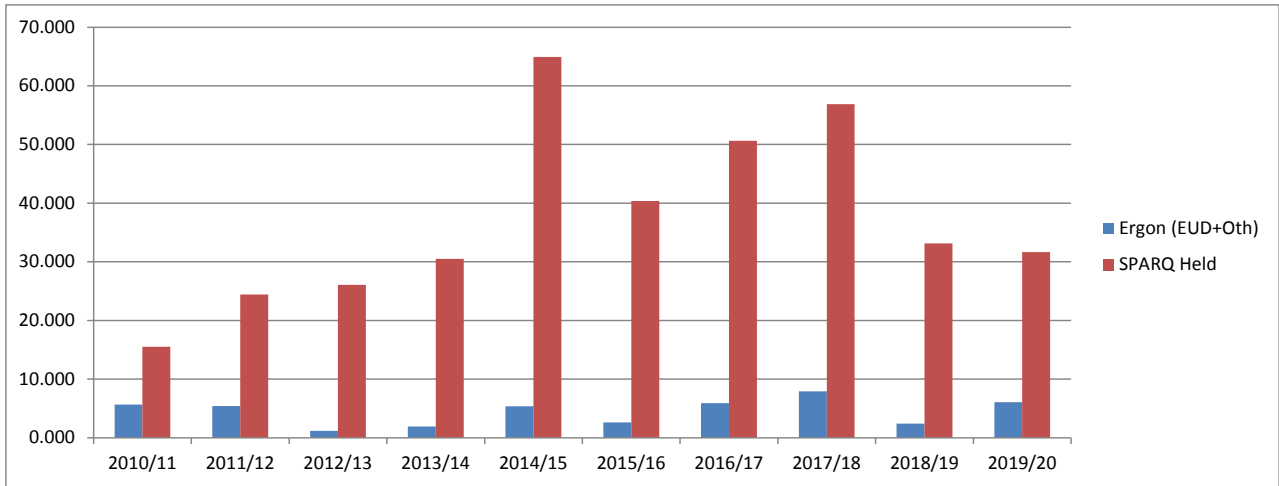


Figure 2: Estimated “Regulated” ICT capital expenditure 2010-11 to 2019-20

Based on KPMG’s analysis of DNSPs’ capital expenditure, Ergon Energy’s Non-Network capital expenditure as a percentage of total capital expenditure has trended below the industry mean for most of the regulatory control period 2010-15 and is expected to increase or be broadly in line with the industry mean over the regulatory control period 2015-20. This is shown in Figure 3.

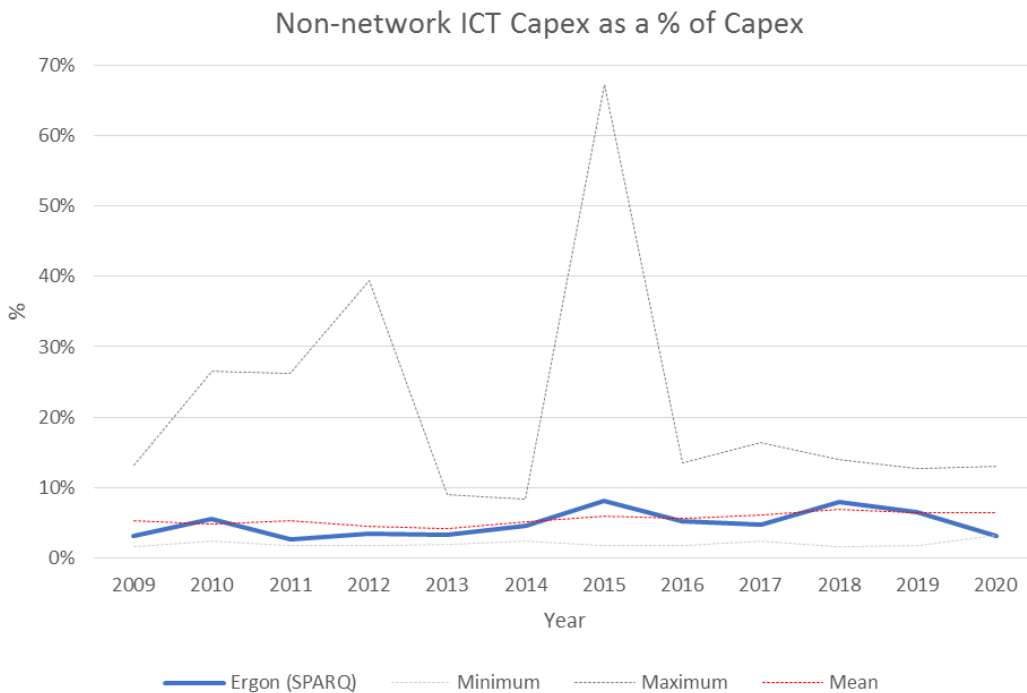


Figure 3: ICT capital expenditure as a percentage of capital expenditure

Source: KPMG analysis.

The AER’s Preliminary Determination for Ergon Energy refers to KPMG’s 2013 corporate benchmark of 4.48% for Corporate ICT capital expenditure as a percentage of total Corporate capital expenditure. This is a corporate benchmark that includes capital expenditure for unregulated activities. The KPMG equivalent benchmark for regulated ICT capital expenditure in 2013 was 7%.

The AER's analysis of Ergon Energy's substitute capital expenditure forecast to derive a benchmark mean ICT capital expenditure value,¹¹ and compare this with the total of the Non-Network ICT for end user devices and the SPARQ capitalised overheads is incorrect on two accounts:

- SPARQ's capitalised overheads are comprised of all cost components (operational support, telecommunication pass through, non-project operating expenditure and ASF).
- The KPMG 2013 regulated ICT capital expenditure as a percentage of total regulated capital expenditure was 7%, not 4.48%.

Given the cyclic nature of ICT investments, this metric should be considered over an extended period of time, in conjunction with a range of metrics to achieve a more holistic approach.

4.3 AER's claims of over-recovery of financing costs via ASF

The AER's preliminary decision determined a rate of return of 5.85%, as opposed to Ergon Energy's proposed WACC of 8.02% that was utilised in forecasting SPARQ's ASF to Ergon Energy.

Financing the acquisition of ICT assets held by SPARQ for the benefit of Ergon Energy is provided by Ergon Energy. This carries a finance charge set at the AER's approved rate of return, and has been applied to SPARQ's ASF. Changes to the rate of return are reflected in both existing and future ASF for SPARQ's ICT assets.

Under the AER's trailing average approach to estimate the return on debt, Ergon Energy's rate of return will be updated annually. In line with this approach, SPARQ will apply Ergon Energy's updated rate of return annually to all ICT capital financing costs. This will eliminate any potential for over- or under-recovery of financing costs charged to Ergon Energy during the regulatory control period 2015-20.

4.4 Market testing of SPARQ ICT costs

Since SPARQ's formation, the number of services outsourced has increased as a result of targeted market testing in order to achieve cost efficiencies and capability uplift. Approximately 45% of ICT costs relate to outsourced service agreements as at June 2015. SPARQ's outsourcing journey is illustrated in Figure 4 below and is supported by policy and strategic direction exemplified by artefacts such as "ICT As-a-Service Decision Framework". Documents such as these provide structure to prudently assess the risks and economic benefits of outsourcing additional ICT services in the future as new capability requirements are identified, or existing ICT services come up for renewal.

¹¹ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p6-93.

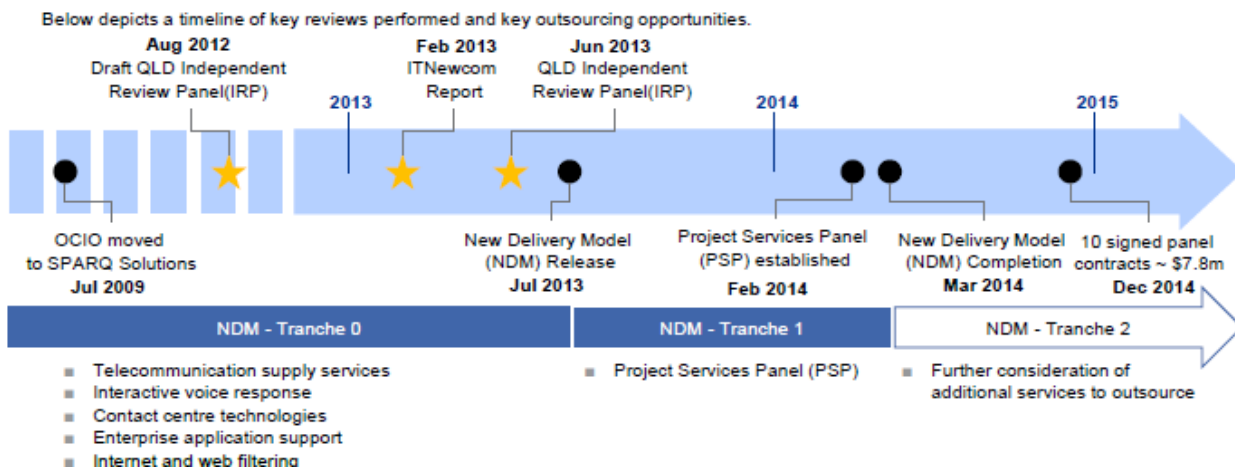


Figure 4: SPARQ outsourcing journey

Source: KPMG – SPARQ ICT expenditure forecasts, p27.

The AER’s consultants cite a lack of market testing for services as further evidence that ICT costs are not efficient.

“...is relying on SPARQ ICT costs, the majority of which have not been market tested and there is evidence to suggest that there is further scope for efficiencies through reforms to the arrangements between Ergon Energy and SPARQ.”¹²

The AER’s consultants incorrectly used the volume of project work issued through the Project Service Panel (PSP) as a proxy for the level of ICT services actually subject to market testing:

“... ICT costs are a material source of inefficiency within Energex’s and Ergon’s opex ... and we estimate that so far only 4 per cent of SPARQ’s costs which were passed through to Energex and Ergon in 2013-14 have been market-tested. There appear to be material savings to be made from further reforms to the relationship between the DNSPs and SPARQ, and improvements to the DNSPs’ ICT systems, processes and use of the market.”¹³

The estimate of 4% outsourcing and hence the basis of the AER consultant’s conclusion of inefficiency is based on an incorrect interpretation of information provided to the AER on the level of work issued to the relatively newly created PSP which was primarily established to seek competitive pricing for ICT capital works.

¹² AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 6 – Capital expenditure*, April 2015, p 6-91.

¹³ Deloitte Access Economics (2015), *Queensland Distribution Network Service Providers - Opex Performance Analysis*, March 2015, p.xii.

The AER's consultants have relied heavily on the IRP and ITNewcom reports, but have drawn a number of incorrect conclusions from these reports.

First, a significant portion of SPARQ operational costs are outsourced and market tested. 100% of telecommunication services and 37-40% of operational support services are externally sourced from the market; these arrangements were in place in the base year.

This information was provided to the AER in Response 45¹⁴ and it is evident that from 2015-16 to 2019-20 approximately 46% of ICT operational services provided by SPARQ to Ergon Energy will be provisioned through external service providers.¹⁵ Further, SPARQ's utilisation of the PSP will continue to grow throughout the regulatory control period 2015-20, particularly with the two significant asset replacement programs for the Administrative ERP and the Enterprise Asset Management systems.

Second, the AER's consultants imply that the issuing of market contracts via SPARQ and not directly by the DNSPs may not produce the most cost effective outcome for the DNSPs. The consultants provide no evidence to support their claims that provisioning of these external services by SPARQ rather than directly by the DNSPs is less efficient or would result in adverse price outcomes for the DNSPs. The specialist nature of the tendered work and the volume of work that SPARQ will issue to the market place puts it in a stronger position than the individual DNSPs to extract value. In addition, outsourcing services separate to the core ICT function leads to integration and architecture fragmentation.

Finally, while there may be opportunity to outsource further operational support it is dependent on the ICT investment program which will allow for a rationalisation and replacement of bespoke and in some cases home grown systems with contemporary off the shelf applications better able to be supported via outsourced arrangements.

The AER has also incorrectly linked the IRP's commentary on competitive pressure with operational support services noting:

"The most important IRP recommendations were associated with the need to place competitive pressure on SPARQ, through market testing the services it provides to Energex and Ergon, as well as the need to change the relationships between the service providers and SPARQ."¹⁶

Presumably the AER and its consultants have drawn this conclusion from the following IRP extract:

"The Panel considers that the services currently provided by SPARQ may be delivered more efficiently by external service providers. To this end, it has recommended that the DNSPs (or, subject to Recommendation 30, the Holding Company) test the provision of these services by competitive tender. Through this market testing, the most cost effective use of in-house and third

¹⁴ AER Response 45

¹⁵ This includes Telecommunications, Operational Support Costs and Non-Capital Project Costs.

¹⁶ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 7 – Operating expenditure*, April 2015, p7-152.

party ICT service provision should be employed, while maintaining appropriate service levels. This would assist the DNSPs in their regulatory submissions to the AER.”¹⁷ (IRP p.54)

This statement was made in the context of ICT capital project delivery and to determine the best mix of internal and external operational services. It was not intended to subject SPARQ to competitive tendering of core work. It also ignores the IRP’s explicit statement with respect to SPARQ’s operational services:

“The Panel undertook its own assessment of SPARQ’s operations and found that:

- SPARQ is delivering ICT operational services such as the helpdesk function, desktop support, and network support efficiently compared with organisations against which it was benchmarked”¹⁸
-

4.5 AER findings with respect to capitalisation practices

In making substantial reductions to Ergon Energy’s forecast expenditure requirements for ICT, the AER “considers” that differences in capitalisation practices do not lead to material differences in operating expenditure between the Queensland service providers and comparison firms. Based on the reasoning provided by the AER in its Preliminary Determination, there is evidence that the AER has discriminated between different treatments.

KPMG have independently assessed the SPARQ arrangements, concluding that there is no material difference to the MAR under the AER’s PTRM. This would suggest in NPV terms, that there is no material difference between adopting traditional in-house capitalisation of ICT projects and the operating expenditure arrangement through SPARQ unless the AER rejects the step change in operating expenditure for capital expenditure already incurred. In the circumstance where the AER does reject the step change, there is a material difference between the two arrangements suggesting the AER has not properly considered substitution possibilities between capital and operating expenditure.

The existence of similar macro percentages (operating expenditure as a percentage of total expenditure) across DNSPs does not change the fact that Ergon Energy’s ICT costs are different to other DNSPs due to our capitalisation treatment. Any analysis at the micro level must take this into account, otherwise it will lead to erroneous conclusions.

This is supported by the following:

- Industry benchmarking which shows Ergon Energy and Energex ICT costs being line with other DNSPs when ASF are excluded.
- The IRP concluded that SPARQ is delivering ICT operational services efficiently compared with other organisations. The IRP excluded ASF to allow a more meaningful comparison.

¹⁷ IRP (2012), *Electricity Network Costs Review Final Report*, p54.

¹⁸ IRP (2012), *Electricity Network Costs Review Final Report*, p54.

- SPARQ has participated in industry benchmarking studies undertaken by KPMG over a number of years and this data indicates SPARQ is operating competitively with other DNSPs.

4.6 AER findings and estimates for operating expenditure

Ergon Energy does not agree with the AER's assessment of 2012-13 base year operating expenditure being inefficient, and by default ICT base year operating expenditure also being inefficient.

The conclusion drawn by Deloitte does not reflect the actual findings of the IRP with respect to these specific ICT cost components (operational support & telecommunications). As noted above, the IRP concluded that SPARQ is delivering ICT operational services efficiently compared to other benchmarked organisations.

4.7 ICT expenditure benchmarking

The AER has relied on a single benchmark (ICT Total expenditure per customer) to support its argument of inefficient ICT expenditure. Ergon Energy disagrees with the use of a single metric to assess efficiency, in particular a metric that is naturally biased against a DNSP with low customer density like Ergon Energy.

KPMG were engaged to undertake benchmarking of Ergon Energy's ICT expenditure and forecasts against the other DNSPs. These benchmarks have been undertaken using historical and forecast data submitted by the 13 other DNSPs as part of the Regulatory Information Notice (RIN) responses covering two regulatory control periods.

The benchmark data for this analysis has been compiled from the Category Analysis RIN, the Economic Benchmarking RIN and the Reset RIN. For the purpose of this analysis the benchmark for Ergon Energy has been calculated using SPARQ's ICT expenditure data in order to compare the ICT capital expenditure and operating expenditure.

Nine DNSPs have proposed increasing ICT expenditure in their ICT strategic plans and regulatory submissions from the current period into the next period, while two DNSPs have proposed maintaining expenditure levels and one DNSP has planned a decrease in expenditure levels. Key drivers cited for increasing ICT expenditure include:

- increasing reliance on ICT to deliver electricity network services and business efficiencies
- impact on ICT from rapid technology changes
- impact on ICT to deliver planned regulatory changes and customer expectations
- regulatory requirements to consider non-network expenditure as an alternative to network expenditure.

It was also noted that in comparison to network assets, ICT investment cycles are typically shorter and the investment profile often "lumpier". In line with the industry trend, Ergon Energy has planned to increase our ICT expenditure from the regulatory control period 2010-15 into the regulatory control period 2015-20. This will see Ergon Energy trending in line with the industry mean into the regulatory control period 2015-20, driven significantly by the replacement of the ERP/EAM systems, as depicted in Figure 5 below.

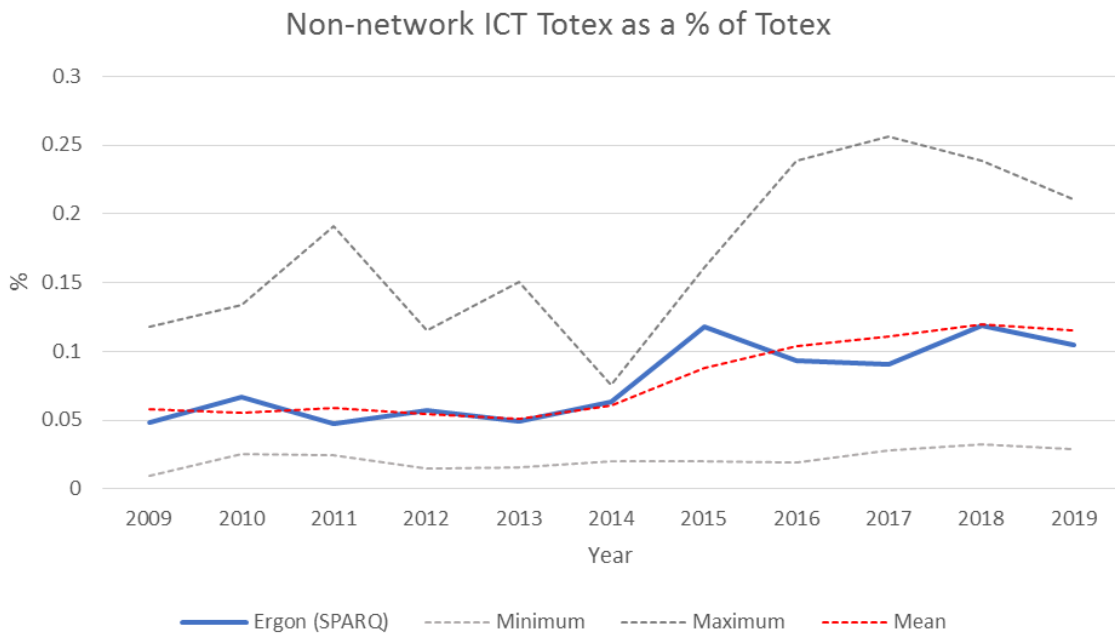


Figure 5: ICT total expenditure as a percentage of total expenditure

Source: KPMG analysis.

The IRP did make a number of specific recommendations with respect to ICT where further efficiencies may be possible. The majority of these recommendations relate to the delivery of ICT capital projects which will not materially impact on “operational support” or “telecommunications” operating costs in the timeframe of the regulatory control period 2015-20.

4.8 AER findings with respect to ICT operating expenditure step change

Ergon Energy does not agree with the AER’s rejection of all ICT operating expenditure step changes. Ergon Energy has included a step change of \$5.003 million in ICT cost increases. This represents additional ICT costs to support Standard Control Services in a fully contestable retail market.

The AER relied on the following macro assessment of operating expenditure efficiency to exclude all step change increases in ICT operational expenditure.

“We consider that ICT opex is a business as usual cost that a prudent service provider acting efficiently to deliver standard control distribution services would incur. We do not consider a step change is necessary as our estimate of base opex already provides a sufficient funding for Ergon Energy acting as a prudent service provider to efficiently deliver standard control distribution services, given its operating environment.”¹⁹

¹⁹ AER (2015), *Preliminary Decision, Ergon Energy Decision 2015-2020, Attachment 7 – Operating expenditure*, April 2015, p7-305.

The AER rejected all of Ergon Energy's step changes on this basis, going on to argue that to include individual increases in operating costs would introduce a positive forecasting bias. The AER's preliminary decision has ignored the unique situation Ergon Energy occupies among Australian DNSPs with respect to market contestability within our network.

Ergon Energy has been operating under limited market arrangements which has not justified investment in the contemporary market systems that most DNSPs would have in place. As a prudent DNSP, Ergon Energy has deferred investment in such systems pending clear direction that contestable market capability would be required. This was provided in 2014 and prudent ICT investments were initiated to provide such capability.

On this basis, Ergon Energy has included increased operating expenditure for a range of systems required to operate in a fully contestable market (changing from vertically integrated systems to independent systems operating via market interfaces). These systems provide enhanced customer information and network billing capability, field force automation, and contact centre capability.

These systems allow Ergon Energy to operate in a fully contestable market place to bring customer benefits in terms of choice, expanded service and National Energy Customer Framework compliance.

Our supporting document, *06.01.04 – (Revised) Step Changes for Operating Costs*, provides further information on this step change.

Supporting documents

The following document supports our submission on capitalised overheads and ICT expenditure:

Document
KPMG – SPARQ ICT expenditure forecasts

Definitions, acronyms, and abbreviations

AER	Australian Energy Regulator
CAM	Cost Allocation Method
CIO	Chief Information Officer
DNSP	Distribution Network Service Provider
ICT	Information and Communication Technology
IRP	Independent Review Panel on Network Costs
MAR	Maximum Allowable Revenue
NSP	Network Service Provider
NER	National Electricity Rules
PSP	Project Services Panel
PTRM	Post Tax Revenue Model
RAB	Regulatory Asset Base
RIN	Regulatory Information Notice
SaaS	Software as a Service
SPARQ	SPARQ Solutions Pty Ltd
WACC	Weighted Average Cost of Capital

Appendix A. IRP recommendations and responses

IRP recommendation	Response
<p><i>Recommendation 12</i> - Return the role of the Office of the Chief Information Officer to each of the DNSPs and SPARQ focus on its role as a service provider to the DNSPs.</p> <p><i>(This recommendation was subject to the Queensland Government accepting Recommendation 30 to form a holding company.)</i></p>	<p>The Government did not proceed to implement recommendation 30, but the SPARQ Board considered the recommendation anyway. Without a holding company arrangement the cost of implementing individual Chief Information Officer (CIO) functions within each DNSP was found to be greater than the current arrangements. Consequently, Recommendation 12 was not pursued.</p> <p>Deloitte put forward that greater alignment of systems would ensue under this arrangement. No evidence or rationale was provided to substantiate this counter intuitive claim and historically this was not the case when the CIO functions were in the DNSPs prior to 2009.</p> <p>A number of common foundational systems have been introduced into Ergon Energy (Hansen PEACE, Ventyx Service Suite), and a joint Contact Centre System has been implemented, increasing the number of core joint systems, all under the current CIO arrangement.</p>
<p><i>Recommendation 13</i> - Each of the DNSPs reassess its Information Communication and Technology capital expenditure priorities and focus on the prudent capital expenditure required to maintain its core distribution business activities (including regulatory compliance and safety obligations).</p>	<p>This recommendation deals specifically with capital expenditure and has little relevance to “base year” ICT cost components referred to by Deloitte.</p> <p>In preparing its 2015-20 ICT program of works, the Office of the CIO undertook a series of ranking and prioritisation reviews to reduce the candidate list of ICT investments (approx. \$300M) to a final investment program of approx. \$225M which has been factored into the Ergon Energy’s submission via operating charges predominately ASF.</p>
<p><i>Recommendation 14</i> - In addition to the cost savings already identified by SPARQ Solutions, further efficiencies should be achieved through actions such as:</p> <ul style="list-style-type: none"> • Streamlining the testing process through the adoption of an automated testing tool; • Developing a common set of automated financial and management reports for the DNSPs; and • Reviewing existing system contracts to reduce user licence costs in line with future staffing levels within SPARQ Solutions and the DNSPs. 	<p>The IRP recommendation confirms SPARQ has delivered costs savings. The additional specific efficiencies do not impact on “base year” costs. Dealing with each:</p> <ul style="list-style-type: none"> • The automated testing capability has been implemented but this is predominately used in the delivery of new ICT capability (ICT capital expenditure). • This recommendation relates to the needs of a proposed holding company, which was not proceeded with. • SPARQ reviews licence usage and capacity requirements as a matter of course. This has been standard procedure prior to the IRP review and is reflected in ICT operating costs in the base year.
<p><i>Recommendation 15</i> - Alternative service delivery models for Information and Communication Technology services currently delivered by SPARQ Solutions should be tested as follows:</p> <ul style="list-style-type: none"> • issue market tenders for the delivery of capital projects; and • issue market tenders for the delivery of the relevant operational Information Communication and Technology services. 	<p>SPARQ implemented this recommendation by engaging a leading ICT outsourcing consultant to compare SPARQ’s costs versus offers available in the market.</p> <p>This led to:</p> <ul style="list-style-type: none"> • the establishment of a PSP to access turn-key and off-shore delivery at lower cost. • A strategy of systematically assessing all sourcing models whenever ICT Investments are required.

IRP recommendation	Response
<p><i>Recommendation 16</i> - Implement an integrated operating model that consolidates the Planning and Partnering positions within DNSPs to minimise the number of touch points between SPARQ and the DNSPs.</p>	<p>This recommendation has been implemented but creation of the roles in SPARQ or in the respective DNSPs does not change the costs.</p>
