Zincara

From strategy to action

Evoenergy Access Arrangement 2021

Capital Expenditure

Stage 2

Public

Prepared for

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TABLE of CONTENTS

TABLE of TABLES

1. EXECUTIVE SUMMARY

In January 2021, Evoenergy resubmitted its revised GN21 plan in response to the AER's Draft Decision published in November 2020. The revised GN21 plan contains major adjustments to account for the ACT Government's Parliamentary and Governing Agreement (P&G Agreement) which was published for the forthcoming fixed four-year of the ACT Legislative Assembly on 2 November 2020.

The AER engaged Zincara P/L (Zincara) to advise on the revised capex. The focus of the advice is to provide the AER with a view on whether the revised capex meets the requirements of the National Gas Rules (NGR) and in particular NGR 79.

The major reduction is in the market expansion category which Evoenergy said is consistent with the P&G Agreement to cease new gas connections by 2023. Evoenergy had not made any changes of scope in the stay in business and the augmentation categories except for the allocation of indirect costs and minor impacts due to the revised labour escalators.

A comparison of the direct costs and the construction management fees for both GN21 is shown in the table below.

Table 1-1: Comparison of the Initial and Revised GN21 Plans ($2021 million)

	Initial GN21 Plan			Revised GN21 Plan		
	Direct Cost	**CMF Allocation**	**Total**	**Direct Cost**	**CMF Allocation**	**Total**
Market Expansion	[redacted]	[redacted]	24.8	[redacted]	[redacted]	11.0
Augmentation	[redacted]	[redacted]	0.9	[redacted]	[redacted]	1.1
Network Renewal	[redacted]	[redacted]	12.1	[redacted]	[redacted]	12.7
Meter Replacement	[redacted]	[redacted]	22.2	[redacted]	[redacted]	26.4
Total	[redacted]	[redacted]	**60.1**	[redacted]	[redacted]	**51.2**

Source: 1 Evoenergy–Appendix 3.1 Capex model- June 2020_Confidential - Worksheet: Calc/Capex Flow (Real2021) (Step 2–Step3)
2 Evoenergy–Appendix 3.1 Capex model- Jan 2021_Confidential - Worksheet: Calc/Capex Flow (Real 2021) (Step2-Step3)
Exclude overheads and contribution
Minor differences are due to rounding errors.

The Market Expansion capex is derived from the unit rates multiplied by the connection volumes. A comparison of the unit rates between the Initial and Revised GN21 Plan showed that the unit rates are the same. The change in the direct cost is as a result of the forecast demand which is subject to a separate study.

The AER has accepted the capex for the other categories subject to satisfactory explanation of three minor capital costs categories. As there are no change between the plans, we have only reviewed the supporting information provided for the minor cost categories of:

- Minor capital works (Networks)
- Minor capital works (Pipes)
- Minor capital works (HP facilities).

We are satisfied with the explanations provided by Evoenergy and as such recommend acceptance of these minor costs. The annual cost for each of these categories is $0.1million.

In relation to the Contract Management Fee (CMF), Evoenergy has maintained the same capex ($[redacted] million over five years) for both of its GN21 plans. Evoenergy's explanation to maintaining this CMF include the cost is not proportional to the work and the small scale operation of the roles and overheads. Zincara is concerned about this approach and considers that a prudent service provider will be forecasting a reduction in the CMF given the declining market. The level of activities such as supervision and asset recording in a declining market should be less than that of a growth market.

In its revised GN21 plan, Evoenergy had reduced its CMF allocated to Market Expansion in line with the reduced direct capex and the remainder of the CMF allocated to the other categories ($[redacted] million reduced to $[redacted] million). With the total CMF staying the same for both plans, the reduction in CMF for Market Expansion has the effect of increasing the CMF for the other categories by $[redacted] million. We consider that without any change in direct capex for the other categories, there should not be any change in the allocation of CMF from the initial to the revised GN21 plans.

As Evoenergy has forecast its CMF on the revised Market Expansion capex is only $[redacted] million, we estimate that the potential savings of the CMF from the reduced Market Expansion is the remaining half of the CMF which was allocated in the initial GN21 plan. The initial GN21 Plan had allocated $[redacted] million to the Market Expansion. As such the potential savings is $ [redacted] million.

However, we acknowledge that there are fixed cost and transitional arrangement costs which may be difficult to save in the next Access Arrangement period as the changes in Market Expansion are due to the recent ACT Government direction. We therefore estimate that the savings for the next Access Arrangement period is in the order of $2.5 million ([redacted]% of $[redacted] million estimated above).

We therefore consider that a reasonable CMF for the next five years should be $[redacted] million.

2. INTRODUCTION

2.1 BACKGROUND

In November 2020, the Australian Energy Regulator (AER) published its Draft Decision for Evoenergy's proposal for its Access Arrangement for the period 2022-2026. AER's Draft Decision accepted Evoenergy's capex forecast subject to Evoenergy clarifying some minor aspects of the capex forecast. In January 2021, Evoenergy resubmitted its revised GN21 plan. The revised GN21 plan contains major adjustments to account for the ACT Government's Parliamentary and Governing Agreement (P&G Agreement) which was published for the forthcoming fixed four-year of the ACT Legislative Assembly on 2 November 2020.

A comparison of Evoenergy's GN21 plan with its January revision of its GN21 plan is shown below.

Table 2-1: Revised capex forecasts 2021/22 to 202526 by category ($2021 million)

	GN 21 plan	Revised GN21 plan
Market expansion	26.3	11.7
Capacity Development	0.9	1.1
Stay in business – network renewal	12.9	13.6
Stay in business – meter renewal	23.6	28.0
Non-system	0.0	0.0
Gross capex	**63.8**	**54.4**
Capital contributions	0.5	0.3
Net capex	**63.3**	**54.0**

Source: Evoenergy-Revised GN21 Plan-January 2021_Public 14 Jan 2021, p 16

2.2 SCOPE OF THE CONSULTANCY

The AER engaged Zincara P/L (Zincara) to advise on the revised capex. The focus of the advice is to provide the AER with a view on whether the revised capex meets the requirements of the National Gas Rules (NGR) and in particular NGR 79.

For information on Zincara's recommendation to the AER prior to the Draft Decision, refer to Zincara's report to the AER in November 2020.

2.3 APPROACH

In carrying out this analysis, Zincara has adopted a similar approach that it had used in assessing Evoenergy's GN21 provided in July 2020:

- Analyse the information provided in Evonenergy's final plan;
- Confirm the conclusions reached by the AER in its Draft Decision;

- Consider third parties submissions received by the AER on Evoenergy's final plan; and
- Conclude on the prudence and efficiency of the revised capex submission.

This report details our findings in the specific areas where Evoenergy had changed from its initial GN21 Plan to the revised GN21 Plan.

2.4 COST REPORTING

All costs shown in this report are in real 2021 dollars unless otherwise stated. Any reference to direct cost means that the cost includes labour, material and contractors.

This report is presented in regulatory years (e.g. July 2021-June 2022). The sections of the report which is presented in calendar years will have a notation CY.

It should also be noted that some totals in the tables may differ slightly with the addition of the numbers on the tables. This is due to rounding errors.

3. EVOENERGY'S REVISED GN21 PLAN

3.1 INTRODUCTION

In January 2021, Evoenergy submitted its revised GN21 plan. The revised GN21 plan contains major adjustments to account for the ACT Government's Parliamentary and Governing Agreement (P&G Agreement) which was published for the forthcoming fixed four-year of the ACT Legislative Assembly on 2 November 2020.

The major reduction is in the market expansion category which Evoenergy said is consistent with the P&G Agreement to cease new gas connections by 2023. Evoenergy has not made any changes to the capex for the augmentation, network renewal and meter replacement categories except for the allocation of indirect costs and minor impacts due to the revised labour escalators.

A comparison of the direct costs and the construction management fees for both GN21 is shown in the table below.

Table 3-1: Comparison of the Initial and Revised GN21 Plans ($2021 million)

	Initial GN21 Plan			Revised GN21 Plan		
	Direct Cost	**CMF Allocation**	**Total**	**Direct Cost**	**CMF Allocation**	**Total**
Market Expansion	[redacted]	[redacted]	24.8	[redacted]	[redacted]	11.0
Augmentation	[redacted]	[redacted]	0.9	[redacted]	[redacted]	1.1
Network Renewal	[redacted]	[redacted]	12.1	[redacted]	[redacted]	12.7
Meter Replacement	[redacted]	[redacted]	22.2	[redacted]	[redacted]	26.4
Total	[redacted]	[redacted]	**60.1**	[redacted]	[redacted]	**51.2**

Source: 1 Evoenergy–Appendix 3.1 Capex model- June 2020_Confidential - Worksheet: Calc/Capex Flow (Real2021) (Step 2–Step3)
2 Evoenergy–Appendix 3.1 Capex model- Jan 2021_Confidential - Worksheet: Calc/Capex Flow (Real 2021) (Step2-Step3)
Exclude overheads and contribution
Minor differences are due to rounding errors.

From the table above, the revised GN21 plan has the market expansion direct costs reduced significantly but all other direct costs are the same as the initial GN21 plan. It is also noted whilst the total Construction Management Fee (CMF) remains the same for both plans, the allocation of CMF to the various activities has been revised.

The market expansion capex is derived from the unit rates multiplied by the connection volumes. We carried out a comparison of the market expansion forecast unit rates[1] for the GN21 and the revised GN21 and confirmed that Evoenergy has not revised the unit rates. The change in market expansion capex is as a result of the forecast volumes which is the subject of a separate study. As we have recommended the acceptance of unit rates in our first report which is reflected in the AER's draft decision, we have not reviewed the unit rates further.

[1] Evoenergy-Appendix 3.2 Market expansion model-June2020_confidential
Evoenergy-Appendix 3.2 Market expansion model-Jan2021_confidential

In relation to the other categories of augmentation, network renewal and meter replacement, the direct capex for each category is the same for both plans. The AER has accepted the capex for each of the categories in its Draft Decision with a placeholder for three minor capex items subject to Evoenergy providing satisfactory explanations. The items are:

- Minor capital works (Networks)
- Minor capital works (Pipes)
- Minor capital works (HP facilities).

We have therefore only reviewed the items related to the minor capital works.

As can be seen from the table above, the CMF is the same for both the initial and revised GN21 plans. The AER in its Draft Decision has accepted the total CMF. However, given the significant decrease in the market expansion capital, the issue that has arisen is whether the CMF in the revised GN21 plan is reasonable and whether Evoenergy's revised allocation is appropriate.

The sections below are our review of the minor capital works items and the CMF.

3.2 MINOR CAPITAL WORKS

3.2.1 Networks (Augmentation)

The minor capital works for networks is essentially related to the augmentation of the network and is shown as augmentation in Table 3-1. The capex is required to replace minor equipment on the medium pressure network (210kpa). These works are generally triggered by field investigations or analysis of the performance of the networks.

Examples of the work over the last five years include:

- Modification of a district regulator due to vibration issues
- Replacement of obsolete pressure data loggers
- Minor reinforcement of the 110mm PE medium pressure main in Florey.

The annual capex for this category is shown in the table below.

Table 3-2: Annual Network Capex ($2021 million direct unescalated)

Program	Annual Forecast	Historical 5-year average capex (RY16-20)
Networks (Augmentation)	0.10	0.14

Source: Evoenergy-Attachment 3.3 Minor capital works explanatory note-Jan 2021_public, p 1

We recognized that this work is generally unplanned and the provision for the works would be from historical expenditure preferably over the last five years. Based on the information provided showing that Evoenergy has incurred an average expenditure of $0.14 million for the last five years, we recommend acceptance of the expenditure as reasonable.

3.2.2 Pipes (Network Renewal)

This capex is for reactive works to both above and underground pipeworks. The work is generally initiated through field investigations and to rectify issues related to safety and supply. Examples of these include installation of high pressure valves, cathodic protection equipment and high pressure piping equipment (sleeves and clamps).

The annual capex for this category is shown in the table below.

Table 3-3: Annual Pipes Capex ($2021 million direct unescalated)

Program	Annual Forecast	Historical 5-year average capex (RY16-20)
Pipes (Network Renewal)	0.10	0.17

Source: Evoenergy-Attachment 3.3 Minor capital works explanatory note-Jan 2021_public, p 1

We note the adhoc nature of the work and consider the provision based on a historical five year average to be reasonable.

3.2.3 HP facilities (Network Renewal)

This capex is for failed or at-risk equipment on the high pressure gas facilities. Similar to the above, the work is triggered by field investigations. The work includes:

- Upgrading of actuators/regulators;
- Improvement in water bath; and
- Replacement of doors and fencing for site security.

The annual capex for this category is shown in the table below.

Table 3-4: Annual Pipes Capex ($2021 million direct unescalated)

Program	Annual Forecast	Historical 5-year average capex (RY16-20)
Pipes (Network Renewal)	0.10	0.17

Source: Evoenergy-Attachment 3.3 Minor capital works explanatory note-Jan 2021_public, p 1

As above, we note the adhoc nature of the works and as such consider a provision based on a five year average is reasonable.

3.3 CONSTRUCTION MANAGEMENT FEE

Under the Distribution Services Agreements (DAMS), Jemena Asset Management Pty Ltd (JAM) provides distribution services to Evoenergy. JAM then outsources the asset services to Zinfra and other contractors. The services set out in DAMS include:

- Management services which relate to management and planning of the operations and maintenance of the gas network. The work is opex in nature.
- Assets services which relate to operations and maintenance services of the network. The delivery of these services is carried out by Zinfra under the service agreement with JAM.
- Capital Works which cover the management and delivery of all aspects of the capital program. With the exception of non-routine works (≥$500k), Zinfra is responsible for the delivery of the programme.

The Construction Management Fee (CMF) is for all costs related to the planning and managing of the capital works delivery. The delivery includes:

- Managing of resources required to deliver the capital plan;
- Project management of routine capital works, minor and medium non-routine capital projects;
- Construction field supervision;
- Quality assurance of capital works; and
- Capture and retention of asset data records.

The CMF is charged as a single annual amount that relates to Zinfra's provision of routine and non-routine works <$500k.

As shown in Table 3-1 and replicated below, the CMF for both the initial and revised GN21 plans remain the same in spite of a significant reduction in the market expansion capital.

Table 3-5: Comparison of the Initial and Revised GN21 Plans ($2021 million)

	Initial GN21 Plan				Revised GN21 Plan			
	Direct Cost	**CMF Allocation**	**Total**	**CMF as % of total**	**Direct Cost**	**CMF Allocation**	**Total**	**CMF as % of total**
Market Expansion	[redacted]	[redacted]	24.8	[redacted]	[redacted]	[redacted]	11.0	[redacted]
Augmentation	[redacted]	[redacted]	0.9	[redacted]	[redacted]	[redacted]	1.1	[redacted]
Network Renewal	[redacted]	[redacted]	12.1	[redacted]	[redacted]	[redacted]	12.7	[redacted]
Meter Replacement	[redacted]	[redacted]	22.2	[redacted]	[redacted]	[redacted]	26.4	[redacted]
Total excl Market Exp	[redacted]	[redacted]	*35.2*	[redacted]	[redacted]	[redacted]	*40.2*	[redacted]
Total	[redacted]	[redacted]	**60.1**	[redacted]	[redacted]	[redacted]	**51.2**	[redacted]

Source: 1 Evoenergy–Appendix 3.1 Capex model- June 2020_Confidential - Worksheet: Calc/Capex Flow (Real2021) (Step 2–Step3)
2 Evoenergy–Appendix 3.1 Capex model- Jan 2021_Confidential - Worksheet: Calc/Capex Flow (Real 2021) (Step2-Step3)
Exclude overheads and contribution
Minor differences are due to rounding errors.

In its revised GN21 Plan, Evoenergy has forecast a change in its direct capex from $[redacted] million in its initial GN21 Plan to $[redacted] million. The reduction is due to the Market Expansion capital which has gone from $[redacted] million to $[redacted] million (less than 50% of the initial GN21 Plan).

However, in its revised GN21 Plan, Evoenergy has maintained its total CMF at the same level of $[redacted] million. Evoenergy has only allocated $[redacted] million to Market Expansion in line with the reduced direct cost. The remainder of its CMF ($[redacted] million) has been reallocated to all the other categories as shown in the table above. This has increased the CMF to the other categories from the initial GM1 Plan. However, these categories have not changed their scope or their direct costs.

We sought, through the AER, further information on how Evoenergy allocates its CMF and whether there are moves to reduce the CMF in light of the reduced capex. Evoenergy's response[2] is summarized as follows:

- The costs incurred by JAM will not vary proportionally with the volume of works performed.
- There is limited opportunity to reduce the CMF in line with reductions in direct costs (e.g. Market Expansion capex).
- Labour costs cannot be reduced over the short to medium term due to the small scale of Evoenergy's operations and the essential (i.e. fixed) nature of the roles and overheads funded through the CMF.
- Staff already perform multiple functions, and it is difficult to further reduce numbers when only one (or a fraction of one) FTE covers each function, with each requiring a specialist skillset.

[2] Evoenergy-Response to AER IR021-20210316_Confidential

3.3.1 Conclusion

Zincara considers that a prudent service provider will have to be planning to reduce its CMF given the reduction in the forecast capex. The DAMS agreement as was set out in 2013 needs to be revised due to the reduction in the Market Expansion capex. We believe that activities such as field supervision, quality assurance and recording of assets will be reduced with the reduced activities in Market Expansion.

Given that the scope of work and capex for the other categories (not including Market Expansion) has not changed, we consider that the allocation of CMF to these activities should also not change from the initial GN21 Plan to the revised GN21 Plan (i.e. CMF to these categories should be $[redacted] million). However, the CMF for the other categories in the revised GN21 plan is $[redacted] million.

This would also mean that the CMF for Market Expansion in both GN21 Plans should be $[redacted] million. However, Evoenergy in its revised GN21 Plan has allocated only $[redacted] million to Market Expansion. This implies that Evoenergy considers that only $[redacted] million of resources (fixed and variable) is required to manage a direct capex of $[redacted] million. We therefore consider that there is potential CMF savings of $[redacted] million.

From our experience, we estimate that the fixed cost component is in the range of 30%-40% which may be difficult to divest in the short to medium term. We also acknowledge that there will need to be some transitional arrangement in place given that the changes proposed in the Market Expansion capex are due to the recent ACT Government P&G Agreement. As such, we estimate the fixed cost including costs for the transitional arrangements which may be difficult to realize in the next Access Arrangement period is in the order [redacted]%. We therefore estimate that the potential savings is in the order of $2.5 million ([redacted]% of $[redacted] million estimated above).

We therefore consider that a reasonable CMF for the next five years should be $[redacted] million.