



**Cost Pass-through Application
Ergon Energy - Tropical Cyclone Larry**

Draft Decision

July 2008

SUBMISSIONS

The Queensland Competition Authority considers public involvement to be an important element of its decision making processes. It therefore invites submissions from interested parties on its Draft Decision regarding the application by Ergon Energy for additional operating and capital expenditure related to its response to Tropical Cyclone Larry to be included in the 2005-06 to 2009-10 regulatory period.

To facilitate the publication of submissions on the Authority's website, it is preferred if submissions are provided electronically by disk or email. Where this is not possible, written submissions are acceptable and should be sent to the address below. **Submissions, comments or inquiries regarding this paper should be directed to:**

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Submissions are due by no later than 15 August 2008.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (i.e. the complete version and another, excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked "confidential", the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997* (the QCA Act), the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest. Notwithstanding this, there is a possibility that the Authority may be required to reveal confidential information as a result of an FOI request.

Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office of the Authority, or on its website at www.qca.org.au. If you experience any difficulty gaining access to documents, please contact the office (07) 3222 0555.

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority's website.

TABLE OF CONTENTS

	PAGE
1. INTRODUCTION	1
1.1 Tropical Cyclone Larry	1
1.2 Cost Pass-Through Mechanism	1
1.3 Ergon Energy's Application for Pass-through	2
1.4 Independent Technical Analysis	2
2. ERGON ENERGY'S APPLICATION	4
3. OPERATING COSTS	7
3.1 Total Operating Costs	7
3.2 Operating Expenditure by Sub-category	7
3.3 Summary	11
4. CAPITAL EXPENDITURE	12
4.1 Total Capital Expenditure	12
4.2 Accelerated Depreciation	13
5. REVENUE IMPACTS	15
6. DRAFT DECISION	16

1. INTRODUCTION

1.1 Tropical Cyclone Larry

Severe Tropical Cyclone Larry (Cyclone Larry) crossed the tropical north Queensland coast near Innisfail on the morning of 20 March 2006 and maintained cyclone strength for several hundred kilometres inland until the early hours of 21 March 2006. The Bureau of Meteorology classified Cyclone Larry as a Category 5 cyclone at the time it crossed the Queensland coast, making it the worst cyclone to hit the coast of Queensland since 1931.

Damage to infrastructure and crops was extensive between Babinda and Tully. Less severe damage occurred in areas north to Cairns, south to Cardwell and on the Atherton Tablelands.

Ergon Energy owns an electricity distribution network that is located in the region where Cyclone Larry crossed the coast. Significant damage to the network and severe disruptions to electricity supply occurred in the region during, and in the wake of, Cyclone Larry.

1.2 Cost Pass-Through Mechanism

In its 2005 Final Determination, the Authority provided for the pass through of costs where major exogenous and unforeseen events outside the control of a distribution network service provider (DNSP) impacted significantly, either up or down, on the returns of the regulated business.

The question to be answered in deciding whether a general cost pass-through is required is simply whether an event is of such an unusual and unexpected nature, and the associated costs likely to have such an impact on the returns of the business, that they should be passed through immediately to customers. The alternative is for the DNSP to accommodate these costs (along with any other variations) until the next regulatory reset.

The Authority placed a materiality threshold on a pass-through event of 1% of actual annual regulated revenue per event, based on the regulated revenue in the year of the event. With respect to Cyclone Larry, the event relates to the requirement for Ergon Energy to restore power to customers and re-establish the integrity of its network.

The Authority also noted in its 2005 Final Determination that:

...amounts of less than 1 per cent in any one year (whether associated with a cumulative event or not) are unlikely to be sufficiently large to warrant immediate pass-through to customers.

In addition, the Authority specified in its 2005 Final Determination that the actual or forecast costs associated with any pass-through event:

...must be agreed by the Authority, and the DNSP must demonstrate that the costs have not already been incorporated in the cost building blocks used to calculate the DNSPs' regulated revenue. Forecast costs will only be accepted where:

- *the costs are known with reasonable certainty; and*

- *it is known with absolute certainty that the costs will be incurred in the forecast year.*

The responsibility for establishing that a cost pass-through event has occurred, and the amounts to be considered, rests entirely with the regulated business. The business must establish beyond doubt that the event for which it is seeking to pass through the associated costs meets the definition established by the Authority, that the materiality threshold has been met and that the costs in question warrant passing through to customers immediately.

It is not up to the Authority to detect that an eligible pass-through event may have occurred nor is it the Authority's responsibility to assemble the necessary information to enable a meaningful assessment of the relevant cost information. The Authority's role is to assess the application and information presented by the regulated business.

1.3 Ergon Energy's Application for Pass-through

On 21 May 2007, Ergon Energy submitted an application to the Authority for approval to pass through costs associated with Cyclone Larry totalling \$29.3 million. This included operating costs of \$15.9 million, capital costs associated with new assets valued at \$19.1 million and \$8.0 million of accelerated depreciation for assets that were destroyed.

While the Authority released Ergon Energy's application for comment, the information provided by Ergon Energy did not clearly establish that, inter alia, the costs it was seeking to pass through to customers were incremental costs rather than gross costs. The Authority wrote to Ergon Energy on 29 June 2007 seeking further details of the costs included in its application.

On 6 November 2007, Ergon Energy provided additional information in support of its cost pass-through application. This revised information indicated that Ergon Energy was now seeking approval to pass through costs associated with operating expenditure of \$7.9 million, capital expenditure of \$12.1 million and \$8.0 million of accelerated depreciation for assets that were destroyed.

On 22 November 2007, the Authority released Ergon Energy's revised cost pass-through application for comment. No submissions were received in response.

The Authority engaged Evans and Peck to provide advice on Ergon Energy's revised application. Evans and Peck had to seek yet further information from Ergon Energy in order to assess the application and provided the Authority with its final assessment on 1 May 2008.

Given the delays in collecting necessary information to make an informed assessment and with only two years remaining in the current regulatory period to spread any cost over, the Authority decided to allow Ergon Energy to raise an additional \$5 million of revenue in its 2008-09 distribution pricing based on a draft report from Evans and Peck. This represented around half the operating expenditure claimed by Ergon Energy in its application. This provisional amount will be taken into account once the Authority determines the actual amount it will approve for pass-through to customers.

1.4 Independent Technical Analysis

The terms of reference for the consultancy with Evans and Peck required it to provide an independent technical assessment of whether the expenditure proposed by Ergon Energy was consistent with the pass-through conditions set out in the Authority's 2005 Final Determination. Specifically, Evens and Peck was required to:

- identify the extent to which capital and operating costs identified by Ergon Energy were incremental, with incremental costs being those costs that;
 - could be specifically attributed to responding to Cyclone Larry; and
 - were not previously allowed for in the capital and/or operating expenditure included in the Final Determination;
- determine whether the capital and operating costs identified by Ergon Energy were prudent and efficient given the nature of Ergon Energy's network, the magnitude of Cyclone Larry and the urgency needed to complete the works; and
- provide a detailed explanation where Evans and Peck considered there was a material difference between Ergon Energy's proposal and the level of expenditure deemed prudent and efficient.

The report from Evans and Peck is available on the Authority's website.

2. ERGON ENERGY'S APPLICATION

As indicated earlier, following a request for further information from the Authority, Ergon Energy submitted a supplementary application which substantially revised the total cost pass-through amount sought. However, Ergon Energy provided less detail in its supplementary application than had been provided in its initial application. For example, no disaggregation of the total amount of operating expenditure was provided.

In order to assess the revised total amounts of operating expenditure, capital expenditure and disposals claimed by Ergon Energy, Evans and Peck undertook a significant amount of additional data gathering. As a result of this work, Evans and Peck was able to provide a more detailed breakdown of the operating expenditure incurred by Ergon Energy as well as more detail on capital expenditure, though this could only be based on asset disposals (rather than actual capital expenditure by asset class) as Ergon Energy had failed to keep any other detailed records.

Table 1 shows Ergon Energy's two-line supplementary costs, Evans and Peck's further disaggregation of those costs and a slight re-aggregation of some costs by the Authority to assist in the following discussion. In its review of the Ergon Energy application, Evans and Peck identified an error in the treatment of capital expenditure already included in the regulated revenue which meant that Ergon Energy's capital expenditure claim for 2005-06 should have been \$6.7 million and total capital expenditure claim should have been \$7.8 million rather than the \$12.1 million included in the application. Ergon Energy agreed with this correction.

Table 1: Revised categorisation of Ergon Energy cost components

<i>Ergon Energy categories¹</i>	<i>Evans and Peck categories²</i>	<i>QCA categories³</i>	<i>\$ million 2005-06</i>	<i>\$ million 2006-07</i>
Operating costs	Operating costs	Operating costs		
Total operating costs	Consultants/Contractors	Contractors & Overtime Labour	\$5,931,004	\$16,246
	Internal Overtime Labour			
	Materials	Materials	\$842,359	\$12,467
	Property, Plant & Equipment Transport	Fleet	\$580,071	\$33,591
	Accommodation, Travel, Entertainment and Training Health & Safety Other Employee Other Computer & Communications Marketing	Other	\$495,852	\$17,415
	Total		\$7,849,285	\$79,719
Capital expenditure⁴	Capital expenditure	Capital expenditure		
Total capital expenditure	Contract Labour	Contractors & Overtime Labour	\$10,542,782	\$366,652
	Internal Overtime Labour			
	Purchases (Materials)	Materials	\$2,519,591	\$546,687
	Transport	Fleet	\$833,689	\$241,818
	Travel and Accommodation Other Costs	Other	\$1,283,112	\$20,665
	Minus capex already included in AARR		(\$8,517,841)	(\$0)
	Total		\$6,661,334	\$1,175,823

1. Ergon Energy's supplementary application only included total costs.

2. Evans and Peck constructed these categories after extracting more information from Ergon Energy's financial systems.

3. The Authority aggregated some of the Evans and Peck categories to facilitate discussion in this document.

4. *Ergon Energy was unable to provide any detail on actual capital expenditure other. Capital expenditure was provided based on the assumption that assets requiring disposal were replaced with like assets.*

In preparing its supplementary application, Ergon Energy sought to remove any costs which had previously been included in the cost base for the 2005 Determination as this was a key weakness of its original application. To achieve this, Ergon Energy removed all overhead costs and all normal business hours labour costs that had been included in its original application. Ergon Energy adopted this approach because it had been unable to separately identify those tasks and investments that were already planned for the region affected by the cyclone (and hence already funded via the original 2005 Determination) from the activities and investment that actually occurred following the impact of the cyclone. It is this difference between previously funded costs and the actual costs incurred which is central to any cost pass-through application.

Evans and Peck were of the view that Ergon Energy had been extremely conservative in adopting this approach and had most likely removed substantial costs that were associated with its response to Cyclone Larry. For example, costs related to setting up and operating the Emergency Response Centre, additional management supervision and involvement, negotiation and organisation of the provision of extra staff from other Ergon Energy regions and from other organisations such as Energex. Given this view, Evans and Peck were inclined to give the benefit of the doubt to Ergon Energy when assessing other costs components in recognition of the costs Ergon Energy had most likely already excluded unnecessarily.

This situation only arises due to the extremely poor record keeping by Ergon Energy. There is no doubt that Ergon Energy would have incurred significant costs beyond its normal operating cost in responding to a disaster of the magnitude associated with Cyclone Larry. Indeed, this was very much the sort of unexpected and unprecedented event for which the cost pass-through mechanism was designed.

Ergon Energy should have been aware from the outset that it would need to seek special approval from the Authority in order to recover the additional costs it was likely to incur in responding to this emergency. However, when it came time to prepare its cost pass-through application, it appears that Ergon Energy has struggled to piece together the information needed to demonstrate the precise nature of the extra costs it incurred.

For example, as noted above, Ergon Energy has been unable to differentiate between what its "business-as-usual" operating costs would have been and the total operating costs it incurred in the region affected by the cyclone during the response period. This lack of fundamental information made it extremely difficult, or as Ergon Energy subsequently discovered, impossible, to identify what operating expenditure was incremental and due to the response to the cyclone and what expenditure would have been incurred in the region during this period had there been no cyclone.

The Authority would have expected Ergon Energy to be able to identify and cost its planned operating activity in the region prior to the cyclone and then to be able to identify and cost on a unit and rate basis its actual operating expenditure in the region following the cyclone, the difference between these two amounts then being the value of the incremental operating expenditure that needed to be recovered through the cost pass-through mechanism.

Similarly, on capital expenditure, Ergon Energy was unable to identify what new and replacement assets were actually deployed to restore electricity supplies and to repair its network. The best Ergon Energy could do was to identify the assets that it believed had been destroyed in the cyclone and needed to be disposed of following the cyclone. Whether these had been replaced with like assets, whether they were new assets or "second-hand" assets that might have been available has not been identified. The regulatory process relies heavily on the

accuracy of the asset base to ensure that the business receives an appropriate return on its investment and that consumers are only charged a cost reflective price for the network services they receive. The Authority would have expected that Ergon Energy would have had detailed records on the assets it had throughout the region, the assets it had on hand in stores and the assets it purchased in order to repair its network. It should have been a simple matter to identify what capital expenditure had already been planned for the region, what capital expenditure actually was incurred in the wake of the cyclone and again the difference would provide the basis for determining what capital related costs needed to be recovered via the cost pass-through mechanism. Unfortunately, little of this information is available.

While the Authority accepts the suggestion from Evans and Peck that Ergon Energy has attempted to adopt a conservative approach by excluding operating costs which may have included some level of overlap with the costs already allowed in the 2005 Determination and is therefore more likely to be under-estimating its costs than the reverse, it is disappointing that more than two years after the event there is no clear picture of the legitimate costs incurred by Ergon Energy in responding to the cyclone damage.

As a result of this information deficiency, Evans and Peck have had to rely more on their own assessment of what might be reasonable than on Ergon Energy's capacity to demonstrate the accuracy of its proposed costs. If it were not for the obvious merit of the event itself as being deserving of consideration for cost pass through and the apparent conservatism of Ergon Energy's supplementary application, much of this application would fail to meet the Authority's information requirements.

Due to the deficit of detailed information, the following sections considering operating and capital costs to be passed through to consumers is regrettably brief.

Finally, Ergon Energy included a significant claim for accelerated depreciation to write off the remaining value of numerous assets that were destroyed in the cyclone. For reasons discussed later, this entire amount has been excluded from the cost pass-through amount. This decision by the Authority does not impose any burden on Ergon Energy.

3. OPERATING COSTS

3.1 Total Operating Costs

In its supplementary application, Ergon Energy sought to pass through operating costs of \$7.85 million in 2005-06 and \$0.08 million in 2006-07.

While Ergon Energy did not provide a breakdown of this revised operating expenditure claim in its supplementary application, Evans and Peck were able to expand somewhat on the limited information provided initially by Ergon Energy, as discussed in section 2 and summarised in Table 2. Table 2 also includes the amounts the Authority proposes to accept for pass-through purposes.

Table 2: Cyclone Larry Operating Expenditure for 2005-06 and 2006-07 (\$nominal)

<i>Expense Category</i>	<i>Ergon Energy 2005-06</i>	<i>Ergon Energy 2006-07</i>	<i>QCA 2005-06</i>
Contractors & Overtime Labour	5,931,004	16,246	5,931,004
Materials	842,359	12,467	842,359
Fleet	580,071	33,591	580,071
Other	495,852	17,415	495,852
Total Opex	7,849,285	79,719	7,849,285

The amounts claimed by Ergon Energy for 2006-07 for both operating and capital related expenses do not meet the materiality threshold set out in the Authority's 2005 Determination. As noted in section 1, in discussing the materiality test at that time, the Authority noted that:

...amounts of less than 1% in any one year (whether associated with a cumulative event or not) are unlikely to be sufficiently large to warrant immediate pass-through to customers.

Ergon Energy's costs in 2006-07 do not reach this level and, as a result, no further consideration of these costs, other than for the later discussion of accelerated depreciation, is included in this Draft Decision.

3.2 Operating Expenditure by Sub-category

Contractors and Overtime Labour

As shown in Table 2, Ergon Energy claimed it incurred contractor and overtime labour costs of \$5.93 million in 2005-06.

In responding to the immediate consequences of the cyclone at short notice, Ergon Energy had only two options. It either brought in contractors sourced from the general workforce and/or other similar organisations or it had its existing staff working longer hours. Given the size of the task, Ergon Energy did both these things.

Contractor costs included the cost of services provided by other network operators and external contractors who were engaged by Ergon Energy to assist with the clean up and repair work in response to Cyclone Larry. The majority of these costs were for Field Services and related to the clean up of damage from vegetation debris. Two principal contractors were appointed following a commercial tender process. Other contractor costs included helicopter charter for

the transfer of crews and equipment, backhoe hire, bus charter to transport crews, fencing hire and erection, delivery of power poles and generators, tree trimming equipment, and road traffic management services.

Overtime was required of existing staff in order to make Ergon Energy's network safe and to restore power as quickly as possible. The majority of overtime labour costs was incurred in the first few weeks after the cyclone.

Consultant's Assessment

Due to the lack of detailed information provided by Ergon Energy, Evans and Peck was not able to assess Ergon Energy's claim for contractor and overtime labour costs by applying unit rates to hours worked or tasks completed as would have been preferred.

Instead, Evans and Peck reviewed the arrangements Ergon Energy entered into with the two principal contractors and compared the rates under these contracts with those applying under other existing contracts held by Ergon Energy.

Evans and Peck considered that, while some of the work performed by these contractors (such as some vegetation management) would probably have occurred regardless of the cyclone, it would have been a fraction of the total costs incurred in response to Cyclone Larry and more than off-set by Ergon Energy's decision to remove all normal business hours labour costs from its application.

Similarly, while Evans and Peck considered that the overtime hours worked in the region affected by Cyclone Larry probably included some overtime that would have been worked regardless of the cyclone, they also recognised that other regions supplying staff for Cyclone Larry related work would have incurred overtime costs or extra contractor costs to maintain operations in their own regions or they may have deferred non-essential maintenance work.

For these reasons, Evans and Peck concluded that the contractor and overtime costs claimed by Ergon Energy were reasonable (probably conservative) and likely to have been directly related to responding to the impact of Cyclone Larry.

The Authority's Position

In light of the emergency conditions under which Ergon Energy had to respond to the effects of Cyclone Larry, it is to be expected that the amount of overtime worked by Ergon Energy staff and the use of contractors would have been considerably higher than normal, particularly in the period immediately after the cyclone went through the region but also in the ensuing months as order was progressively restored.

That Ergon Energy has been unable to clearly identify the extent of these additional costs is disappointing and clouds the assessment of the reasonableness of the costs claimed. Nevertheless, there can be no doubt that there was extensive damage that required a prompt response from Ergon Energy and the Authority accepts the advice of Evans and Peck that Ergon Energy has acted conservatively in compiling its final application. There is also no doubt that the total costs incurred by Ergon Energy in the region following Cyclone Larry were in excess of those claimed for pass-through. This information was obtained by Evans and Peck from Ergon Energy's financial records. What is missing is the detail on which of those costs related to the various activities undertaken in response to the cyclone and, of these, what were the incremental costs brought about by the cyclone. While it would be better for both the business and consumers that costs were more robustly identified, the Authority accepts the overtime and contractor costs proposed by Ergon Energy and supported by Evans and Peck.

As shown in Table 2 these represent the bulk of Ergon Energy's claimed operating costs.

Materials

As shown in Table 2, materials costs claimed by Ergon Energy totalled \$842,359 in 2005-06.

Materials were required to repair assets where the damage resulting from the cyclone was not deemed to be serious enough to warrant replacement. The majority of costs classified as materials were stores issued to repair poles and wires and included insulators, cross arms and stays.

The accounting treatment applied by Ergon Energy to poles and wires resulted in these costs being incorrectly treated as operating expenditure during the first few days of the clean up effort prior to them being correctly treated as capital expenditure thereafter.

Consultant's Assessment

Evans and Peck considered that the cost of materials claimed by Ergon Energy, as a proportion of total operating expenditure (around 10%), was consistent with what it would expect to find under normal operating conditions. Again, Evans and Peck noted that while there would have been a component of business-as-usual materials costs in the amount claimed by Ergon Energy for Cyclone Larry, this would have been more than offset by the costs Ergon Energy had excluded under its conservative costing approach. Evans and Peck was of the view that material costs of \$855,000 were a reasonable estimate of Ergon Energy's likely true costs in responding to Cyclone Larry.

The Authority's Position

The information provided by Ergon Energy has not established the basis for its claimed costs for materials. Clearly, responding to the cyclone and restoring its network would have required a range of materials for repairs and clean-up work. However, Ergon Energy has been unable to identify what costs it might have incurred in the normal course of events and what additional costs it incurred in responding to the damage left by the cyclone. It is also clear that some capital costs were incorrectly treated as operating cost in the records Ergon Energy did keep.

Despite the obvious need for expenditure of this type, the lack of supporting information from Ergon Energy is of concern to the Authority. Nevertheless, the Authority has accepted the advice of Evans and Peck and proposes to include claimed material costs on the basis that Ergon Energy has taken a conservative approach to estimating its overall costs.

Fleet

Data provided to Evans and Peck indicated that total fleet costs were accounted for almost equally by transport costs and property, plant and equipment costs.

The majority of transport costs were associated with the use of over 300 of Ergon Energy's line trucks and heavy vehicles in responding to Cyclone Larry. Over 100 kilometres of new powerline cable and 300 power poles were trucked in to the affected area.

Other transport costs included those associated with the movement of staff into the area from to other parts of the state, vehicle hire and fuel costs.

Almost all of the property, plant and equipment costs claimed by Ergon Energy were for equipment hire, the majority of which was for the supply of generators. Approximately 60 generators from Ergon Energy and Energex were trucked into areas worst hit by Cyclone Larry.

Consultant's Assessment

In assessing Ergon Energy's fleet cost claims, Evans and Peck was able to confirm that Ergon Energy had hired 100 generators in April 2006 and considered that supply of electricity from generators to key essential services was prompt and necessary. Evans and Peck also considered that the fuel costs identified appeared very low given the work required and the timeframe involved.

Evans and Peck concluded that fleet costs claimed by Ergon Energy had been demonstrated to be directly related to the impact of Cyclone Larry.

The Authority's Position

The Authority accepts Evans and Peck's advice that fleet costs appear to be reasonable. While Ergon Energy has not been able to separate its normal operating costs from the additional costs it incurred in responding to Cyclone Larry, the Authority considers that the additional costs following the cyclone are likely to dominate and this is supported by the slightly better information that appears to have been provided by Ergon Energy to demonstrate the nature of the task it undertook which required this expenditure.

The Authority therefore proposes to accept Ergon Energy's claimed fleet costs.

Other

These additional costs were primarily associated with:

- accommodation, meals and travel;
- health and safety;
- marketing; and
- freight.

Accommodation, meals and travel costs totalled almost \$178,000 and were associated with the transfer of approximately 250 staff to the cyclone affected area from other regions and from within the affected region. Most (85%) of these staff were deployed on capital expenditure work with the rest deployed on operating activities.

The main health and safety cost (\$115,000) was associated with the provision of personal protection equipment, including high visibility shirts and vests, safety glasses, wet weather gear and leech, tick and insect repellent. The remainder of health and safety costs was for the replenishment of first aid kits and the provision of safety equipment.

In support of these costs, Ergon Energy noted that, due to the volume of work required, many staff and contractors were diverted from their normal duties and required to undertake work they would not normally perform. As a result, many workers did not have the necessary safety and personal protection equipment required for the tasks they had to perform.

Marketing costs (\$107,000) were incurred for advertising, TV and radio media coverage necessary to keep the public informed about the ongoing status of the work being carried out by Ergon Energy.

The majority of other operating expenditure incurred in response to Cyclone Larry was for general freight and accounted for only a small proportion of Ergon Energy's total operating expenditure in response to Cyclone Larry.

Consultant's Assessment

Evans and Peck calculated that accommodation and travel costs claimed by Ergon Energy equated to less than \$200 per person per day. The daily allowance for accommodation and meals in the Cairns area allowed under the Queensland Public Service Act 1996 is \$176. As this allowance does not include the cost of travel, Evans and Peck concluded that Ergon Energy's expenses were reasonable.

Evans and Peck suggested that any business-as-usual health and safety costs in Ergon Energy's claim would have been minimal during the period of the cyclone response because it would only have involved the replacement of existing personal protection equipment. Evans and Peck calculated that health and safety expenditure averaged around \$110 per person for approximately 1,000 employees and considered this a reasonable amount in the circumstances.

Evans and Peck considered that Ergon Energy's claims for marketing and other costs had been demonstrated to be directly related to the impact of Cyclone Larry and were efficient.

The Authority's Position

Based on the analysis provided by Evans and Peck, the Authority considers that "other costs" claimed by Ergon Energy in responding to Cyclone Larry are reasonable. The Authority accepts the advice of Evans and Peck that any overlap with existing costs is likely to be small relative to the total amount of operating expenditure being claimed by Ergon Energy.

The Authority therefore proposes to accept Ergon Energy's claimed "other costs".

3.3 Summary

Based on the discussion above, the operating costs the Authority accepts as having been reasonably justified by Ergon Energy in responding to the damage caused by Cyclone Larry is \$7.85 million in 2005-06.

4. CAPITAL EXPENDITURE

4.1 Total Capital Expenditure

In its supplementary application, Ergon Energy sought to pass through costs associated with capital expenditure of \$10.9 million in 2005-06 and \$1.2 million in 2006-07. As noted in section 3, Ergon Energy's claimed costs in 2006-07 do not meet the Authority's established materiality threshold and will not be discussed further, other than for the discussion of accelerated depreciation at the end of this section.

As noted previously, in an effort to remove previously recognised costs, and in the absence of any useful information to identify these, Ergon Energy removed all business hours labour and overheads from the total amounts of capital expenditure it had claimed in its initial application. In addition, Ergon Energy deducted \$8.5 million of capital expenditure which it estimated had already been included in its regulated revenue to arrive at its 2005-06 capital expenditure estimate of \$10.9 million.

Consultant's Assessment

The only breakdown of capital expenditure Ergon Energy provided in its original or supplementary applications was based on the share of assets disposed of as a result of Cyclone Larry. Ergon Energy was unable to provide Evans and Peck with a breakdown of capital expenditure by asset category, other than one based on asset disposals.

In the process of assembling additional data, Evans and Peck discovered errors in the calculation of Ergon Energy's capital expenditure claim. In particular, the adjustment Ergon Energy had made for capital expenditure already incorporated in Ergon Energy's regulated revenue was incorrect.

With this error corrected, Evans and Peck calculated Ergon Energy's revised capital expenditure for 2005-06 to be \$6.7 million, as shown in Table 3. Ergon Energy agreed with these corrected numbers.

Table 3: Cyclone Larry Capital Expenditure for 2005-06 and 2006-07 (\$nominal)

<i>Expense Category</i>	<i>Ergon Energy 2005-06¹</i>	<i>Ergon Energy 2006-07¹</i>	<i>QCA 2005-06</i>
Contractors & Overtime Labour	10,542,782	366,652	na
Materials	2,519,591	546,687	na
Fleet	833,689	241,818	na
Other	1,283,112	20,665	na
Total Capex	15,179,174	1,175,822	na
<i>Minus Capex already in AARR</i>	8,517,841	0	na
Total Capex Claim	6,661,334	1,175,822	6,661,334

1. As corrected by Evans and Peck and agreed by Ergon Energy.

As noted previously, Evans and Peck considered that the steps Ergon Energy had taken in an effort to demonstrate that it was only seeking to pass through incremental capital costs by removing all business hours labour and overheads from its capital expenditure in the region was a conservative approach that most likely understated the capital costs Ergon Energy had actually incurred in responding to Cyclone Larry.

Evans and Peck noted that Ergon Energy's estimate of previously recognised capital expenditure was based on the replacement of far more poles and cross arms than was estimated to have been replaced during Cyclone Larry. As a result, Evans and Peck considered that Ergon Energy's \$8.5 million adjustment for capital expenditure already included in its regulated revenue was a gross overestimate. Evans and Peck estimated that the correct adjustment was more like \$5.64 million. Even this was probably an over-estimate as it assumed that all poles, cross arms, substation structures, insulators and surge diverters replaced in response to Cyclone Larry were already funded in the 2005 Determination and would have been replaced at some time during the current regulatory period regardless of the intervention of Cyclone Larry.

Evans and Peck also suggested that the removal of business hours labour and overheads most likely compounded this understatement of costs as, to some extent, these costs were also embodied in the \$8.5 million of capital expenditure that Ergon Energy had deducted.

Given the highly conservative nature of the capital expenditure actually being claimed by Ergon Energy, Evans and Peck concluded that the remaining capital expenditure could be considered to be directly related to the impact of Cyclone Larry.

The Authority's Position

The Authority acknowledges that the removal of business hours labour and overhead cost components from its capital expenditure estimate will most likely lead to an under-estimate of actual capital expenditure incurred by Ergon Energy in responding to Cyclone Larry. The Authority also acknowledges the assessment of Evans and Peck that this conservative approach may have been even lower than Ergon Energy intended due to some double counting of costs already included in the \$8.5 million of capital cost deducted by Ergon Energy.

The Authority is surprised that Ergon Energy has been unable to disaggregate Cyclone Larry capital expenditure by asset category based on actual capital expenditure rather than on the basis of disposed assets. This raises serious concerns about the robustness of Ergon Energy's total capital expenditure claim.

However, the Authority accepts the advice of Evans and Peck regarding the likely conservative nature of these capital costs and proposes to approve the inclusion of Ergon Energy's 2005-06 capital costs, as corrected by Evans and Peck.

4.2 Accelerated Depreciation

In its supplementary application, Ergon Energy sought approval to pass through to customers \$8.0 million in accelerated depreciation due to the write-off of the remaining value of assets destroyed by Cyclone Larry. This amount was included by Ergon Energy as a cost incurred in 2006-07.

The purpose of the cost pass-through mechanism under which this application is being considered is to ensure that an unforeseen event does not impact significantly on the returns of the regulated business.

While Ergon Energy has undoubtedly lost a range of assets damaged beyond repair as a result of Cyclone Larry, at this point in time those assets remain in Ergon Energy's asset base and continue to earn a return and to be depreciated as if they were still in use. As a consequence, Ergon Energy is currently suffering no financial loss in relation to those assets.

During this regulatory period, Ergon Energy will dispose of other assets ahead of their useful lives for a variety of reasons. The treatment of disposed assets is best considered in the overall

context of the next regulatory review rather than in an ad hoc manner in responding to a cost pass-through application.

As Ergon Energy has suffered no financial loss to date and will not suffer any loss over the remaining years of this regulatory period, there is no compelling reason for the treatment of these assets to be resolved now. In fact, if treated in isolation, this matter would not give rise to a cost pass-through event.

The Authority does not propose to approve the pass-through of any accelerated depreciation costs.

5. REVENUE IMPACTS

Based on the above, the Authority considers only operating expenditure of \$7,849,285 and capital expenditure of \$6,661,334 in 2005-06 as being eligible for pass through to customers.

As Ergon Energy was unable to provide any detailed information on assets, the Authority has calculated the revenue impact of the above capital expenditure based on a weighted average of Ergon Energy's standard asset lives for assets disposed of following Cyclone Larry.

Based on this estimate of revenue associated with capital expenditure and using the same parameters used in the 2005 Final Determination to escalate 2005-06 costs to present values, the Authority has calculated the corresponding revenue requirement to be \$5 million in 2008-09 and a further \$5.8 million in 2009-10 (the final year of the current regulatory period).

As previously noted, the Authority allowed a provisional amount of \$5 million to be raised by Ergon Energy in its 2008-09 prices.

6. DRAFT DECISION

The Authority's Draft Decision is to approve the pass through of costs by Ergon Energy associated with an additional \$7.9 million of operating expenditure and \$6.7 million of capital expenditure incurred in 2005-06 responding to the impact of Cyclone Larry.

Based on the same parameters used in the 2005 Final Determination, the Authority has determined the total revenue impact of the cost pass through to be \$5 million in 2008-09 and \$5.8 million in 2009-10.