



Final Decision

Cost Pass-through Application Ergon Energy - Tropical Cyclone Larry

**September 2008
as amended in April 2009**

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PREAMBLE

On 6 November 2007, Ergon Energy provided a pass-through application for costs incurred in responding to Tropical Cyclone Larry. This application sought approval to pass through operating costs of \$7.9 million, capital expenditure of \$12.1 million and \$8.0 million of accelerated depreciation for assets that were destroyed.

The Authority's Final Decision on the application is to approve the pass through of \$7.9 million of operating expenditure and \$6.7 million of capital expenditure. This will allow Ergon Energy to raise an additional \$5 million of revenue in 2008-09 (already included in current prices) and a further \$8.4 million in 2009-10. Given that the Authority has already allowed Ergon Energy to raise some additional revenue in its 2007-08 prices in anticipation of this Final Decision, there should be only a marginal impact on prices.

In arriving at its Final Decision, the Authority considered the application from Ergon Energy, a report prepared by Evans and Peck and submissions from stakeholders.

Ergon Energy's application did not provide the level of support for the claim that the Authority would normally require. In normal circumstances, the Authority would not approve claims that were insufficiently supported. However, Cyclone Larry was clearly an event worthy of cost pass-through consideration and Evans and Peck reported that the approach adopted by Ergon Energy was likely to understate its true costs.

The Authority has approved the pass through of all costs claimed for 2005-06 but not the costs claimed for 2006-07. The latter relate predominantly to accelerated depreciation in respect of assets destroyed by the cyclone. As these assets will not be removed from Ergon Energy's regulated asset base until the end of the current regulatory period, Ergon Energy suffers no financial loss from this aspect of the Authority's decision.

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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 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 reasonable 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. 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 the costs it was seeking to pass through to customers were incremental rather than gross costs. The Authority wrote to Ergon Energy on 29 June 2007 seeking further details of the costs included in the application. This letter provided a detailed description of the additional information that the Authority considered Ergon Energy should provide in any revised application. No submissions were received from stakeholders in response to the release of Ergon Energy's application.

On 6 November 2007, Ergon Energy provided a revised cost pass-through application. This application sought approval to pass through operating costs 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 from stakeholders in response.

The Authority engaged Evans and Peck to provide advice on Ergon Energy's revised application. Evans and Peck had to seek 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 and with only two years remaining in the current regulatory period, 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 final 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, Evans and Peck was required to:

- (a) identify the extent to which capital and operating costs identified by Ergon Energy were incremental, with incremental costs being those that:
 - (i) could be specifically attributed to responding to Cyclone Larry; and
 - (ii) were not previously allowed for in the capital and/or operating expenditure included in the Final Determination;
- (b) 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

- (c) provide a detailed explanation where Evans and Peck considered that 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.

1.5 Draft Decision

On 28 July 2008, the Authority released its Draft Decision on Ergon Energy's revised application.

In reaching its decision, the Authority was faced with the fact that Ergon Energy had provided insufficient information to verify its claims. In normal circumstances, the Authority would not approve claims that were insufficiently supported. However, Cyclone Larry was clearly an event worthy of cost pass-through consideration and, after thorough review, consultants Evans and Peck advised that Ergon Energy's claim was conservative.

The Authority's Draft Decision was to approve the pass through of capital costs of \$6.7 million and operating costs of \$7.9 million incurred in 2005-06, the revenue impact of which required an additional \$5 million to be raised in 2008-09 (already included in prices on a provisional basis) and a further \$5.8 million to be raised in 2009-10.

1.6 Submissions

Submissions were received in response to the Draft Decision from Ergon Energy (2008), Origin Energy (2008) and Queensland Council of Social Services (QCOSS) (2008).

Most of the comments made in submissions were general in nature or applied equally to both operating costs and capital costs. Comments made in these submissions are presented in section 5.

2. ERGON ENERGY'S APPLICATION

As indicated earlier, following a request for further information from the Authority, Ergon Energy submitted a supplementary application that substantially revised the total cost that it was seeking to pass through. However, Ergon Energy provided insufficient detail in its supplementary application. For example, no disaggregation of the new total amount of operating expenditure was provided.

To assess Ergon Energy's revised claims for operating expenditure, capital expenditure and disposals, Evans and Peck had to gather significant additional data. As a result, 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 as Ergon Energy did not provide details of actual capital expenditure by asset class.

Table 1 shows the total operating costs and total capital expenditure that constituted the claim made by Ergon Energy in its supplementary application. It also shows the disaggregation of those totals made by Evans and Peck. Finally, it shows a slight re-aggregation of some of the Evans and Peck categories that was made by the Authority to assist in the following discussion.

In its review of the Ergon Energy supplementary 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 claimed should have been \$7.8 million rather than the \$12.1 million included in the application. Ergon Energy agreed with this correction.

Table 1: Ergon Energy's claimed aggregates and Evans and Peck's disaggregation of them

<i>Ergon Energy categories¹</i>	<i>Evans and Peck categories²</i>	<i>QCA categories³</i>	<i>2005-06</i>	<i>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	Overtime Labour		
	Materials	Materials	\$842,359	\$12,467
	Property, Plant & Equipment	Fleet	\$580,071	\$33,591
	Transport			
	Accommodation, Travel, Entertainment and Training	Other	\$495,852	\$17,415
	Health & Safety			
	Other Employee			
	Other			
	Computer & Communications			
	Marketing			
	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	Overtime Labour		
	Purchases (Materials)	Materials	\$2,519,591	\$546,687
	Transport	Fleet	\$833,689	\$241,818
	Travel and Accommodation	Other	\$1,283,112	\$20,665
	Other Costs			
	Minus capex already included in AARR		(\$8,517,841)	(\$0)
	Total		\$6,661,334	\$1,175,823

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

2. Evans and Peck constructed these categories after extracting 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 provided no detail on actual capital expenditure. The capital expenditure claimed was based on the assumption that assets requiring disposal were replaced with like assets.

One of the concerns that the Authority had raised with Ergon Energy's initial applications was the lack of detail on what constituted incremental costs and what costs had *implicitly* been financed as part of the Authority's 2005 Determination of Ergon Energy's revenue requirements. In this regard, while the Authority determined the revenue cap for Ergon Energy based on the costs and associated activities that Ergon Energy presented to the Authority at the time, actual costs and associated activities over the regulatory period will necessarily deviate from the levels forecast at the start of the regulatory period. The flexibility to do this is essential for a regulated business such as Ergon Energy to be able to respond to changing trends and priorities over the regulatory period. It is the difference between what Ergon had planned to spend just prior to Cyclone Larry occurring (which had implicitly been financed by the existing revenue cap) and the actual costs incurred that should be the subject of any cost pass-through application.

In preparing its supplementary application, Ergon Energy sought to remove any costs that had previously been included in the cost base for the 2005 Determination. It did so by removing all the overhead costs and all the normal-business-hours labour costs that had been included in its original application.

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

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 of 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 incurred in responding to this emergency. However, in its cost pass-through application, Ergon Energy did not supply the information needed to identify the extra costs it had incurred.

For example, as noted above, Ergon Energy has not differentiated 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 made it extremely difficult to identify the additional operating expenditure that was incurred in response to the cyclone.

Similarly, on capital expenditure, Ergon Energy did not identify what new and replacement assets were actually deployed to restore electricity supplies and to repair its network. Ergon Energy did identify the assets that it believed had been destroyed during the cyclone and disposed of following the cyclone, but it did not identify actual assets installed. 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 charged only a cost reflective price for the network services they receive. Ergon Energy did not identify the capital expenditure that had already been planned for the region separately from the capital expenditure actually incurred in the wake of the cyclone. However, it is the difference between these two that constitutes the capital costs that need to be recovered via the cost pass-through mechanism.

While the Authority accepts the comments by Evans and Peck that Ergon Energy has been conservative in excluding operating costs that may have included some level of overlap with the costs already allowed in the 2005 Determination and is therefore more likely to have under-estimated than over-estimated its costs, more than two years after the event there is still no clear picture of the incremental costs incurred by Ergon Energy in responding to the cyclone damage. As a result of this information deficiency, Evans and Peck had to rely more on its own assessment of what might be reasonable than on Ergon Energy's stated costs.

Finally, Ergon Energy's application 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 has been excluded from the cost pass-through amount. This decision by the Authority does not impose any burden on Ergon Energy as those assets remain in the regulatory asset base and continue to attract a rate of return and depreciation as if they were still in production. The next regulatory reset is the appropriate time to consider how these assets are to be written off, along with any other assets that have been removed from use ahead of the end of their useful lives.

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 was able to expand somewhat on the information provided initially by Ergon Energy, as discussed in section 2 and summarised in Table 2 which shows the amounts the Authority proposed to accept for pass-through purposes in its Draft Decision.

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>	<i>QCA 2006-07</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	0

The amounts claimed by Ergon Energy for 2006-07 for both operating and capital related expenses did 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 did not reach this level and, as a result, no further consideration of these costs, other than for the later discussion of accelerated depreciation, was included in the Draft Decision.

3.2 Operating Expenditure by Subcategory

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

Ergon Energy did not provide sufficient information for Evans and Peck to be 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 offset 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 Draft Decision

In light of the emergency conditions under which Ergon Energy had to respond to the effects of Cyclone Larry, it was 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.

As Ergon Energy did not clearly identify the extent of these additional costs, assessment of the reasonableness of the costs claimed is difficult. Nevertheless, there could be no doubt that there was extensive damage that required a prompt response from Ergon Energy and the Authority accepted the advice of Evans and Peck that Ergon Energy has acted conservatively in compiling its final application. There was 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. Evans and Peck obtained this information from Ergon Energy's financial records. What was missing was 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. The Authority accepted the overtime and contractor costs proposed by Ergon Energy and supported by Evans and Peck.

As shown in Table 2, these represented 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 Draft Decision

The information provided by Ergon Energy did not establish 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 did not identify what costs it might have incurred in the normal course of events and what additional costs it actually incurred in responding to the damage left by the cyclone. It was 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 was of concern to the Authority. Nevertheless, the Authority accepted the advice of Evans and Peck and proposed to include claimed material costs on the basis that Ergon Energy had 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 the fleet costs claimed by Ergon Energy were directly related to the impact of Cyclone Larry.

The Authority's Draft Decision

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

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

Other

These additional costs were primarily associated with:

- (a) accommodation, meals and travel;
- (b) health and safety;
- (c) marketing; and
- (d) 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 remainder 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 had demonstrated that its claimed marketing and other costs were directly related to the impact of Cyclone Larry and were efficient.

The Authority's Draft Decision

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

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

3.3 Summary of the Draft Decision

In its Draft Decision, based on the discussion above, the Authority proposed to accept all of the \$7.85 million 2005-06 operating costs sought by Ergon Energy as having been reasonably justified costs incurred in responding to the damage caused by Cyclone Larry.

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 did not meet the Authority's established materiality threshold and were not discussed further in the Draft Decision, other than for the discussion of accelerated depreciation.

As noted previously, in an effort to remove previously recognised costs, 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 that it estimated had already been included in the calculation of 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 this correction.

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>	<i>QCA 2006-07</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	0

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 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 significant overestimate. Evans and Peck estimated that the correct adjustment was more like \$5.6 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 Draft Decision

In its Draft Decision, the Authority acknowledged that the removal of business-hours labour and overhead cost components from its capital expenditure estimate would most likely lead to an under-estimate of actual capital expenditure incurred by Ergon Energy in responding to Cyclone Larry. The Authority also acknowledged 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.

Ergon Energy had not disaggregated its capital expenditure by asset category based on actual capital expenditure rather than on the basis of disposed assets. This raised serious concerns about the robustness of Ergon Energy's total capital expenditure claim.

However, the Authority accepted the advice of Evans and Peck regarding the likely conservative nature of these capital costs and proposed to approve the inclusion of all 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 Authority's Draft Decision

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

While Ergon Energy undoubtedly lost a range of assets damaged beyond repair as a result of Cyclone Larry, the asset base on which prices and revenue are calculated has not been reduced on account of these assets and, as such, Ergon Energy continues to receive a return on capital and have depreciation calculated as if the assets had not been destroyed. As a consequence, the Authority considered that Ergon Energy would not suffer any financial loss in relation to those assets during the current regulatory period.

The Authority noted that during this regulatory period, Ergon Energy would most likely dispose of other assets ahead of their useful lives ending for a variety of reasons and considered the treatment of disposed assets was best determined 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 had suffered no financial loss to date and would not suffer any loss over the remaining years of this regulatory period, there was no compelling reason for the treatment of disposed assets to be resolved as part of the current cost pass-through application.

For the above reasons, the Authority did not propose to approve the pass through of any accelerated depreciation costs.

In considering this issue, it is important to differentiate between assets included in Ergon Energy's statutory accounts and those on which prices and revenues are based. Ergon Energy has in all probability removed the destroyed assets from its statutory asset base. However, the assets remain in the asset base on which prices and revenues are based, until the next regulatory reset.

5. SUBMISSIONS AND THE AUTHORITY'S POSITION

5.1 Submissions

Three submissions, from Ergon Energy (2008), Origin Energy (2008) and Queensland Council of Social Service (QCOSS) (2008), were received in response to the Authority's Draft Decision.

Origin Energy generally agreed with the Authority's conclusions but did not make any comments in relation to specific aspects of the decision.

QCOSS suggested the Authority's Draft Decision would result in an unnecessary increase in the price of energy for regional and rural Queenslanders and that the particular circumstances of Ergon Energy's application were ones in which the costs should not be passed on to customers. In support of this view, QCOSS noted that, in a number of instances, the Authority's consultants had given Ergon Energy the benefit of the doubt when assessing cost components. QCOSS suggested that no cost components should be passed through to customers on this basis.

The Authority has some sympathy with this latter view. Indeed, in reaching its draft decision, the Authority was acutely aware that Ergon Energy had provided insufficient information to verify its claims. In normal circumstances, the Authority would not accept claims that were insufficiently supported. However, the Authority took the view that Cyclone Larry, and Ergon Energy's required response, was clearly an event worthy of cost pass-through consideration and, while the Authority would have preferred to have more detailed information upon which to base its assessment, it was satisfied, on the basis of the review by Evans and Peck, that Ergon Energy's claim was conservative. While approving pass through of any cost during a regulatory period will, by definition, raise the costs of electricity for some customers, the alternative of building in a contingency for such unusual events at the beginning of the regulatory period would also add to customer costs, even in regulatory periods in which no such unusual event occurs.

As the Authority's Draft Decision was to approve all of the 2005-06 costs claimed by Ergon Energy, the concerns raised by Ergon Energy regarding the magnitude of its cost pass through related only to 2006-07 costs which had been excluded by the Authority.

Ergon Energy suggested the Authority's Draft Decision not to pass through operating costs and capital expenditure incurred in 2006-07 was incorrect. In particular, Ergon Energy suggested the timing of costs was not relevant to assessing the materiality of costs and quoted similar suggestions from previous Energex submissions to the Authority on this matter which claimed the costs of responding to an event accumulated over a number of years should be assessed for materiality against the distributor's revenue for a shorter period (for example, one year's revenue). Ergon Energy also suggested the Authority incorrectly applied the materiality test to individual components within the pass-through claim, rather than the total claim.

In relation to accelerated depreciation, Ergon Energy made a number of comments, including:

- (a) the Authority provided no reasons for rejecting Ergon Energy's claim for accelerated depreciation;
- (b) the Authority's pass-through criteria do not include any assessment of whether the distributor is disadvantaged by the event for which the pass-through of costs is being sought; and

- (c) the assets destroyed by Cyclone Larry do not continue to earn a return and to be depreciated as if they were still in use, as claimed by the Authority.

5.2 The Authority's Response to Issues Raised by Ergon Energy

2006-07 operating costs and capital expenditure

The Authority disagrees with Ergon Energy's interpretation of the time period over which the materiality test for pass throughs is to apply. As noted previously, in its 2005 Final Determination the Authority clearly stated 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.

The Authority made this comment in response to Ergon Energy's (2005) proposal that the cumulative impact of an event be used to assess materiality against the cumulative revenue for the same period. Ergon Energy's latest proposal is for an even less stringent materiality test than it proposed previously because it involves comparing costs incurred over a number of years to revenue for a shorter period rather than the same period.

With respect to the application of the materiality test, the Authority did not apply the materiality test to individual components within the cost pass-through application as claimed by Ergon Energy. Having considered the broad merits of each component of the 2006-07 costs and determined that the accelerated depreciation claimed by Ergon Energy was not eligible for pass through to customers, the balance of the costs claimed for 2006-07 failed to meet the materiality test. The materiality test was applied to the total costs remaining for 2006-07 that might have been eligible for pass through. As noted in the following section, the Authority has maintained its view regarding the eligibility of the accelerated depreciation claimed and therefore the 2006-07 costs remain insufficient to meet the materiality test for that year.

Accelerated depreciation

As discussed in section 4.2 (the substance of which was also included in the Draft Decision), the Authority did provide its reasons for not approving Ergon Energy's request to pass through immediately costs relating to the write-off of disposed assets. Contrary to the claims of Ergon Energy, this decision places no financial penalty on Ergon Energy, and hence there is no disadvantage to Ergon Energy. The asset base on which prices and revenue are calculated has not been reduced on account of the assets destroyed and, as such, Ergon Energy continues to receive a return on capital and have depreciation calculated as if the assets had not been destroyed. Ergon Energy may have removed these disposed assets from its statutory asset base but this has no impact on its regulated return or its distribution pricing.

The Authority notes that the examples of regulators accepting accelerated depreciation claims cited by Ergon Energy do not include any cost pass-through claims.

As the Authority noted in its Draft Decision, as Ergon Energy has suffered no financial loss to date due to the loss of these assets 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 rather than in the context of the next regulatory reset.

Other matters raised by Ergon Energy and the Authority's responses

In its submission on the Authority's Draft Decision, Ergon Energy also raised a number of general issues of concern.

A key issue raised by Ergon Energy was that (allegedly) the Authority did not provide sufficient guidance on what information Ergon Energy was required to submit in order to have its cost pass-through application approved.

The Authority considers that the 2005 Final Determination clearly established the criteria that distribution businesses would be required to address in seeking approval to pass through extra costs to customers during the current regulatory period. In response to Ergon Energy's initial application, the Authority also provided Ergon Energy with detailed, but non-exhaustive, comments on the information it believed was missing from Ergon Energy's application and would be required in order to meet those criteria. The Authority also reinforced that it was up to the business seeking approval to pass through additional costs to make its case demonstrating that the criteria had been met. It was not the Authority's role to assemble this information. Despite this, the Authority believes that it has been exceedingly lenient in enforcing those requirements in this particular case. This stems more from the obvious worthiness of the event than the power of the arguments and information presented by Ergon Energy.

Ergon Energy suggested the Authority sought to assess the incremental costs associated with Cyclone Larry against the notional plans and programs associated with the costs that were included in the Authority's 2005 Final Determination.

This is not the case as Ergon Energy operates under the fixed revenue cap form of regulation. Actual costs (and associated activities) over the regulatory period will deviate from the levels of costs (and associated activities) forecast at the start of the regulatory period when the distributor's fixed revenue caps are determined. There are many reasons why actual costs and activities can be expected to vary from those forecast, including, but not limited to, changes in input costs, changes in demand for services and efficiency improvements by the distribution business.

In theory, the revenue cap should provide the business with sufficient funds to manage its operations and make necessary investments across the regulatory period. In practice, once set, the basis on which the revenue cap was determined is largely irrelevant. However, it remains implicit in this form of regulation that the regulated business will plan and manage its business and that the funds provided by the revenue cap will finance that business-as-usual activity, albeit that the works undertaken may be entirely different from those assessed in determining the revenue caps in the first place.

Reflecting this feature of the fixed revenue cap form of regulation, the Authority sought to compare Ergon Energy's Cyclone Larry costs against its business-as-usual expenditure, as indicated throughout the Draft Decision. In their report, Evans and Peck also refer to comparisons between Ergon Energy's gross costs and business-as-usual costs in trying to establish incremental costs. Similarly, in the letter the Authority sent to Ergon Energy in response to Ergon Energy's initial application, the Authority noted that incremental costs should be demonstrated with reference to existing plans for operating and maintenance expenditure.

The Authority agrees with Ergon Energy that it would be a nonsense to attempt to compare actual expenditure to forecast plans made up to five years previous, but this was not what the Authority required nor sought to do.

6. REVENUE IMPACTS

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

The Authority has calculated the corresponding revenue requirement consistent with the approach used in its 2005 Final Determination. In doing so, depreciation has been calculated based on a straight line basis. However, as Ergon Energy was unable to provide any detailed information on assets, the Authority has calculated depreciation on using a weighted average of Ergon Energy's standard asset lives for assets disposed of following Cyclone Larry (37.6 years).

A return on new assets has been calculated using the weighted average cost of capital (WACC) of 8.50% included the 2005 Final Determination, applied to new Cyclone Larry related capital costs.

For the purpose of calculating the revenue requirement, all figures have been converted to nominal amounts using the same inflation rate of 2.76% used in the 2005 Final Determination.

Table 3 presents the breakdown of these component parts of the total revenue requirement resulting from Ergon Energy's Cyclone Larry cost-pass-through application as determined by the Authority.

Table 3: Cyclone Larry pass-through revenue (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total	NPV
Return on Capital	277	567	566	566	565	277	
Depreciation	90	185	190	195	200	90	
Operating Costs	7,849	0	0	0	0	7,849	
Inflationary Gain ^a	92	184	184	184	183	92	
Total	8,125	567	572	577	582	10,423	9,221

Note: Totals may not add due to rounding

^a Represents the returns received from the inflation on Ergon Energy's asset base.

As previously noted, the Authority allowed Ergon Energy to raise a provisional amount of \$5.0 million in its 2008-09 prices. Raising the remaining revenue requirement over the remaining year of the current regulatory period, while maintaining the overall net present value, requires an annual revenue increase of \$8.4 million in 2009-10 as detailed in **Table 4**.

Table 4: Ergon Energy revenue pass-through accepted by the Authority (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total	NPV
Cyclone Larry Revenue	0	0	0	5,000	8,441	13,441	9,221

7. FINAL DECISION

The Authority's Final Decision, which maintains its 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 in 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 \$5.0 million in 2008-09 and \$8.4 million in 2009-10.

8. REFERENCES

Ergon Energy (2005), *Submission to the Queensland Competition Authority: Draft Determination – Regulation of Electricity Distribution*, February, 2005.

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