



**Energex's FRC Pass-through
Application**

Draft Decision

April 2008

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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 Energex for expenditure related to the introduction of Full Retail Competition (FRC) to be included in its annual revenue requirement for 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 enquiries regarding this paper should be directed to:**

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Submissions are due by no later than 30 May 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.

PREAMBLE

As a result of the introduction Full Retail Competition (FRC) in Queensland, Energex has been required to improve its capacity to transfer customer data and other network data between electricity retailers in a reliable and timely manner. The costs of doing so fall into two main categories: capital expenditure required to implement new or enhanced IT systems; and ongoing operational costs associated with running and maintaining those systems.

Under the Queensland Competition Authority's (the Authority's) 2005 Electricity Determination, Energex can seek approval to pass through to customers any material cost increases that are incurred as a result of events beyond Energex's control. The introduction of FRC qualifies as such an event.

Accordingly, Energex applied to the Authority to pass through \$82.7 million in costs, comprising capital expenditure of \$53.9 million (\$38.9 million in "Stage 1" and a further \$15 million in "Stage 2") and operating costs of \$31.4 million. The Authority consulted stakeholders and sought expert technical advice from consultants, PB Associates.

On the basis of its analysis of Energex's submission, the comments of stakeholders and its consultant's report, the Authority has concluded that \$20.1 million of the Stage 1 capital costs and the majority of the operating costs (\$29.9 million) are justified. These costs convert to an additional revenue requirement over the balance of the current regulatory period of just over \$44 million.

As the Authority has already allowed Energex to raise \$15 million of additional revenue in 2007/08 and provided for a further \$15 million to be raised in 2008/09 in anticipation of approving some level of pass-through for FRC costs, this Draft Decision will allow Energex to raise the balance of the revenue, a further \$14.4 million, in 2009/10.

The Authority has also agreed with Energex that it will consider any further information provided by Energex regarding its "Stage 2" capital costs as part of the consultation process on this Draft Decision.

The Authority is seeking the views of stakeholders on this Draft Decision. Submissions should be received by the Authority by 30 May 2008.

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1. INTRODUCTION

1.1 Introduction of Full Retail Competition

Full Retail Competition (FRC) commenced in the Queensland retail electricity market from 1 July 2007. It was implemented through changes to the Electricity Act 1994, regulations, licences and the introduction of a new Electricity Industry Code.

Energex owns an electricity distribution network that is geographically located in the urban area of South East Queensland. The implications for Energex of FRC largely relate to the need to improve information technology systems and to facilitate the transfer of customers between competing retailers.

The Authority's 2005 Final Determination on the Regulation of Electricity Distribution set the regulatory framework to apply for the period 1 July 2005 to 30 June 2010. The regulatory arrangements applying to Energex were not affected by the introduction of competition to the retail segment of the electricity market.

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 FRC, the event relates to the requirement for Energex to modify its business systems to meet its new obligations directly associated with the introduction of FRC.

The Authority also noted in its 2005 Final Determination 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.

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. If it is relying on forecasts, these must be established “with absolute certainty”.

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 Application for Pass-through

On 28 February 2007, Energex submitted an application to the Authority for approval to pass-through costs totalling \$117.1 million relating to the introduction of FRC in Queensland to customers. The Authority released Energex’s application seeking comment from interested parties. Three submissions were received.

Given the timing of the application, it was clear that a Final Decision on Energex’s cost pass-through application could not be made before 2007-08 distribution prices had to be finalised. Consequently, the Authority allowed Energex to raise a provisional amount of \$15 million in its 2007-08 pricing in order to reflect potential FRC related costs. The Authority took this step so that distribution prices in the first year of full retail competition would not be held artificially low. [As this pass-through application is still to be finalised, the Authority has advised Energex that it will be permitted to raise a similar provisional amount in its 2008-09 pricing. Both these provisional amounts will be taken into account once the Authority determines the actual amount it will approve for pass-through to customers.]

With the issue of 2007-08 pricing resolved, it was agreed with Energex that the assessment of the application would be delayed to permit Energex to focus on ensuring its preparedness for FRC on 1 July 2007.

To better understand Energex’s application, the Authority and its consultant, PB Associates (PBA), held a workshop with Energex on 28 August 2007. At this workshop, it became apparent that Energex’s position had changed significantly from that presented in the application originally submitted to the Authority.

The Authority provided Energex with an opportunity to address these differences and a range of related issues of concern to the Authority and its consultant. Energex submitted a supplementary cost pass-through application on 28 September 2007.

The supplementary application indicated that Energex was seeking approval to pass through \$82.7 million of costs associated with the introduction of FRC, compared with \$117.1 million sought in its original application. The supplementary application was subsequently released for public comment. The Authority received 3 submissions in response.

PBA provided the Authority with its assessment of Energex’s cost pass-through application on 21 December 2007.

1.4 Submissions

Original application

Submissions on Energex's original FRC cost pass-through application were received from AGL, Origin Energy and TRUenergy in March 2007.

All submissions noted the lack of detail in Energex's application and suggested that significantly more detail was required in order to conduct a thorough assessment of Energex's application.

The submissions questioned whether all the proposed costs were FRC related rather than related to the recent separation of Energex's electricity distribution and retail businesses and the subsequent sale of the retail business.

TRUenergy suggested that Energex was seeking additional costs for activities which it should have been providing irrespective of FRC. AGL argued that Energex should not be permitted to recover costs required to bring Energex to a level of compliance it should have been achieving in the absence of FRC (but may not have been achieving due to vertical integration).

Origin Energy and TRUenergy claimed that Energex was overstating the legal and regulatory framework changes that would occur as a result of FRC. The submissions argued that the majority of instruments required to facilitate FRC were already in place in Energex and should only require enhancement of its capacity to comply.

TRUenergy and Origin Energy expressed concern at the quantum of Energex's proposed FRC related expenditure, particularly in light of the substantially lower expenditure identified in the Queensland Government's 2005 FRC cost benefit analysis report¹. That report estimated that the state-wide (Energex and Ergon Energy combined) cost to implement FRC would be approximately \$55 million in total over a five year period.

Supplementary application

In August 2007, the Authority's consultant, PBA, sent an extensive list of questions to Energex seeking clarification on a range of issues raised in the application and the public submissions.

Energex's response to the questions from PBA made it clear that the application could not be adequately assessed without substantial revision and that this task was not the responsibility of the Authority or its consultant.

Energex subsequently requested that it be permitted to submit a supplementary application. The Authority agreed to Energex's request and a supplementary application was received from Energex on 28 September 2007. The supplementary application was subsequently released for public comment. Submissions on the supplementary FRC cost pass-through application were received from TRUenergy, Origin Energy and Queensland Treasury.

Queensland Treasury provided support for Energex's application indicating that it supported the pass-through of incremental, prudent and efficient costs that were directly attributable to the introduction of FRC and were necessary for Energex to meet the obligations that arose as a consequence of the revised legal and regulatory framework for FRC.

TRUenergy suggested that the supplementary application did not adequately address the issues raised in retailer submissions to the original application. TRUenergy noted that, other than an

¹ GHD *Full Retail Competition – Cost Benefit Analysis*, Report to Queensland Treasury (May 2005).

adjustment to labour costs, no other items had been amended as a result of that initial consultation process.

Further, TRUenergy argued that Energex had still failed to demonstrate that a number of costs identified in its application were related to the introduction of FRC rather than resulting from the retail business sale.

TRUenergy also suggested that Energex's proposed costs remained substantially above those claimed by Victorian distributors. TRUenergy argued that the prior introduction of FRC in other Australian jurisdictions, together with the development of a national approach to transactions and protocols, should have delivered implementation cost efficiencies for Energex that were not available to the Victoria businesses.

Origin Energy noted that Energex's supplementary application provided more data and information than the original application and allowed a more informed assessment of the appropriateness of the costs claimed to be associated with FRC. However, Origin Energy had difficulty reconciling the costs claimed in Energex's supplementary application with those reported in the original application and suggested that a more detailed reconciliation should be provided.

Origin Energy again questioned the ability of Energex to accurately account for the costs incurred as a result of FRC and urged the Authority to undertake further analysis of the data submitted by Energex.

Origin Energy also noted the lack of detail provided by Energex in relation to its proposed "Stage 2" costs and suggested that approval of these costs should be withheld until more detailed data was provided to the QCA and relevant stakeholders.

More specific comments drawn from the submissions are noted in relevant sections later in this Draft Decision.

1.5 Independent Technical Analysis

The Authority engaged PBA to provide an independent technical assessment of the expenditure proposed by Energex for pass-through of costs associated with the introduction of FRC. The terms of reference for the consultancy required PBA to:

- identify the scope of Energex's additional responsibilities under FRC in Queensland;
- review Energex's existing IT and other systems and processes and identify the options available to either augment or replace existing systems and processes needed to meet its FRC obligations;
- determine whether the options proposed by Energex and their costs are prudent and efficient given the size of Energex's Queensland network and in comparison to the systems used, and costs incurred, in other states;
- identify the extent to which Energex's proposed capital and operating costs are incremental. Incremental costs are those costs that:
 - can be specifically attributed to the introduction of FRC; and
 - have not previously been allowed for in the capital and/or operating expenditure included in the 2005 Final Determination (including any expansion/replacement of related systems previously approved);

- review Energex’s proposed staff training strategy in terms of the scope and extent of training proposed and its relationship to current staff training provided by Energex;
- review the prudence and efficiency of costs associated with the provision of services by related parties of Energex, including the proposed financing arrangements with SPARQ Pty Ltd (Energex’s jointly owned IT service provider) for the provision of IT services;
- review Energex’s assumptions underpinning the proposed expenditure, including Energex’s proposed churn rates, and comment on their reasonableness;
- identify any efficiencies/synergies from the proposed new systems (for example Energex’s overall operating costs may be lower than previously allowed by the Authority due to the introduction of new systems) and replacement of old systems (for example, old systems may no longer need to be enhanced/maintained or old systems could be sold or redeployed in other areas of Energex’s operation);
- identify the level of prudent and efficient incremental FRC costs (for both capital and operating expenditure), having considered all the matters above; and
- where the consultant considers there is a material difference between Energex’s proposal and the level expenditure deemed efficient, provide a detailed explanation.

2. ENERGEX'S APPLICATION

Energex identified the key areas where the introduction of FRC would have an impact on internal processes and staff across the business. These were broadly categorised as follows:

- standing data management and customer transfers – this refers to the maintenance of standing data in accordance with various national regulatory instruments and the development of interfaces between Energex and NEMMCO;
- service order management – this refers to the capability that Energex requires to respond to requests for service orders from retailers such as for new connections and de-energisations;
- energy data management – this refers to the capability that Energex requires to read and transmit meter data to the market for market settlement purposes; and
- network billing – this refers to the capability that Energex requires to bill multiple retailers on a basis that meets regulatory requirements.

In its initial application provided to the Authority in February 2007, Energex sought approval to pass-through \$117.1 million of actual and anticipated costs associated with the introduction of FRC for the period 2005-06 to 2009-10. The costs associated with Energex's pass-through application, as originally submitted, are summarised in Table 1.

Table 1: Energex original cost pass-through application - February 2007
(\$million, nominal)*

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Implementation:						
Labour - Internal	0.2	2.0	0.2	0.0	0.0	2.5
Labour – External	0.3	0.8	0.2	0.0	0.0	1.3
Corporate Communications	0.0	0.5	0.1	0.0	0.0	0.6
SPARQ (ICT)	0.8	1.7	9.3	9.7	9.2	30.7
CVU-IVR	0.0	0.3	0.0	0.0	0.0	0.3
Sub Total	1.3	5.3	9.8	9.7	9.2	35.3
Operating costs:						
Labour - Internal	0.0	3.8	10.7	9.9	10.8	35.1
SPARQ (operating)	0.0	1.7	3.7	3.8	3.8	13.1
SEPL	0.0	0.2	1.2	1.3	1.3	4.0
Metering Dynamics	0.0	0.7	2.1	2.2	2.3	7.4
Sub Total	0.0	6.3	17.8	17.2	18.2	59.5
New FRC non-DUOS Service Costs	0.0	0.0	7.2	7.4	7.6	22.3
Total	1.3	11.6	34.8	34.3	35.1	117.1

Note: Totals may not add due to rounding

* In the Energex application, all values are in nominal dollars. Whilst it would be preferable to provide values in constant dollars, for comparative purposes, all values in this report have been similarly provided in nominal dollars.

As noted earlier, Energex submitted a supplementary application on 28 September 2007. The supplementary application revised the total cost pass-through amount from the original

\$117.1 million to \$82.7 million. Energex advised that the reduction to the proposed cost pass-through was principally due to:

- removal of costs associated with excluded services (reduction of \$32.7 million);
- rebasing of costs using actual (as opposed to forecast) labour rates (reduction of \$10.6 million);
- the inclusion of \$15 million additional FRC costs anticipated to arise during the current regulatory period (referred to as “Project Implementation - Stage 2” in its supplementary application); and
- removal of some forecast costs for IT equipment that had already been allowed for in the Authority’s 2005 Final Determination.

In addition, Energex also revised its approach to the categorisation of some cost components. As a result, it is not possible to fully reconcile the original and supplementary cost pass-through applications submitted by Energex. However, the major differences are those noted above.

The details of Energex’s revised supplementary cost pass-through application are shown in Table 2.

Table 2: Energex supplementary cost pass-through application - August 2007
(\$'000, nominal)

	2005-06 <i>Actual</i>	2006-07 <i>Actual</i>	2007-08 <i>Forecast</i>	2008-09 <i>Forecast</i>	2009-10 <i>Forecast</i>	TOTAL
FRC Project Implementation Costs - Stage 1						
Labour - Internal	143	1,699	98	0	0	1,940
Labour - Contract	231	844	1,258	0	0	2,332
Other Project Administrative Costs	18	159	600	0	0	777
Corporate Communications	0	227	0	0	0	227
CVU-IVR	0	82	182	0	0	264
SPARQ (ICT) – Asset Service Charge	770	0	11,599	10,861	10,123	33,353
Total Project Costs – Stage 1	1,161	3,011	13,738	10,861	10,123	38,894
FRC Operational Costs						
Labour – Internal	0	55	3,723	4,975	5,199	13,952
SPARQ (ICT)- Maintenance and Support	0	0	3,676	3,777	3,881	11,334
SEPL – Labour	0	32	547	0	0	579
Metering Dynamics - Labour	0	55	1,466	1,613	1,685	4,819
Metering Dynamics – Sample Meters	0	0	240	247	253	740
Total FRC Operational Costs	0	143	9,651	10,611	11,019	31,424
New FRC non-DUOS Service (Re-en and de-en Costs)	No longer included in the application					
Total FRC Costs – Stage 1	1,161	3,153	23,388	21,473	21,142	70,318
FRC Project Implementation Costs – Stage 2						
Labour – Internal	0	0	1,038	0	0	1,038
Labour – External	0	0	438	0	0	438
SPARQ (ICT) – Asset Service Charge	0	0	1,110	6,424	6,024	13,558
FRC Costs – Stage 2	0	0	2,586	6,424	6,024	15,035
Less removal of IT costs in 2005 Determination						
Return on Assets & Depreciation for FACOM	0	0	0	107	99	206
Maintenance & Support FACOM	0	0	0	366	376	742
Return on Assets & Depreciation on Network Billing	45	290	319	560	524	1,737
Total FRC Costs	1,117	2,864	25,655	26,864	26,168	82,667

In its supplementary application, Energex presented its proposed FRC cost data in a format that reflected the FRC project stages and Energex’s internal categorisation of costs. However, the titles used to describe the various cost categories do not generally provide an easily understandable description of the items and activities that could be interpreted by a reader external to the organisation and not familiar with the specific systems and processes employed by Energex.

In order to make the presentation of costs more understandable to readers and also to better align the analysis and treatment of the proposed FRC costs with those in other jurisdictions, PBA revised the cost categories provided by Energex as shown in Table 3.

Table 3: Revised categorisation of Energex FRC cost components

PBA categories	Energex categories
Project implementation costs	FRC Project Implementation Costs – Stage 1
Project Management and Implementation	Labour –Internal Labour- Contract Other Project Administrative Costs
Corporate Communications	Corporate Communications
IT and Business Systems	CVU-IVR SPARQ (ICT) Asset Services Charge
Operating costs	FRC Operating Costs
Labour for ongoing FRC activities	Labour - Internal Labour - SEPL Labour - Metering Dynamics
IT and Business Systems Maintenance	SPARQ (ICT) Maintenance and Support
Load Profiling	Metering Dynamics – Sample Meters
FRC Costs – Stage 2	FRC Costs – Stage 2

Note: Energex did not include “New FRC non-DUOS Service Costs” in its supplementary application.

The PBA cost categories include:

- *Project Implementation*

Project Management and Implementation. These costs represent the labour and other costs required to manage and implement the FRC project. It is common practice for businesses to record labour and related project set up costs separately from ongoing operating costs and to capitalise these costs as part of the overall project cost.

IT and Business System. These costs relate to the capital expenditure for new and modified IT and business systems acquired by SPARQ (a wholly own subsidiary of Energex) to enable Energex to meet the operating requirements of the electricity market under FRC. The arrangements whereby SPARQ charges Energex for use of these IT assets is discussed in more detail later.

- *Operating Costs*

Labour for ongoing FRC activities. These costs represent the labour costs related to carrying out new activities required following the introduction of FRC.

IT Business Systems Maintenance and Support. The costs in this category represent the ongoing software and hardware support costs relating to the business systems acquired for FRC activities and the labour provided by SPARQ to maintain and support these systems. PBA has also renamed “*Metering Dynamics – Sample Meters*” as Load profiling, which provides a more intuitive understanding of this activity.

Adopting the revised categorisations, the details of Energex’s supplementary cost pass-through application from Table 2 are represented in Table 4.

Table 4: PBA classification of Energex supplementary cost pass-through application August 2007 (\$’000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Implementation (Stage 1)						
Project Management and Implementation Costs	392	2,702	1,956	0	0	5,050
Corporate Communication	0	227	0	0	0	227
IT & Business Systems	770	82	11,781	10,861	10,123	33,617
Total (Stage 1)	1,161	3,011	13,737	10,861	10,123	38,894
Project Implementation (Stage 2)						
Project Management and Implementation Costs			1476	0	0	0
IT & Business Systems			1,110	6,424	6,024	13,558
Total (Stage 2)			2,586	6,424	6,024	15,035
Operating Costs						
Labour for ongoing FRC activities	0	142	5,736	6,588	6,884	19,350
IT & Business Systems Maintenance and Support	0	0	3,636	3,777	3,881	11,334
Load Profiling	0	0	240	247	253	740
Total Operating Costs	0	143	9,651	10,611	11,019	31,424
Less IT Costs from 2005 Final Determination	(45)	(290)	(319)	(1,033)	(999)	(2,685)
Total FRC costs	1,117	2,864	25,655	26,864	26,168	82,667

The discussion of Energex’s supplementary application from this point onwards is in accordance with these revised categories. However, it is possible to reconcile the costs associated with the revised cost categories back to Energex’s supplementary application using Table 3.

2.1 Energex’s Proposed FRC System

According to Energex, the major challenge imposed by the introduction of FRC was the requirement for Energex to provide additional functionality from its IT and business systems. A complicating factor for Energex was that these changes needed to be made within a short period of time.

On 28 September 2005, the Queensland Government announced that FRC would commence on 1 July 2007. This gave Energex 21 months to select and implement its FRC solution. Initially, it was expected that the FRC solution (and therefore costs) would be shared with Ergon Energy. However, the problem and solution became unique to Energex when it became clear that the implications of FRC for Ergon Energy would be limited.

In October 2005, Energex commenced a 3 month investigation of alternative FRC solutions. When ranking alternative options to meet its obligations under FRC, Energex sought first to re-use an existing system, then to buy an off-the-shelf product and as a last priority to build a new system. Energex also sought to ensure that, where possible, consolidation of systems would be preferred to avoid fragmentation of its IT systems.

At the end of its 3 month investigation, Energex had developed a conceptual IT architecture plan, a high level implementation plan and high level view of end-to-end FRC business processes. Accenture, a management consulting and technology services company, was employed by Energex to assist in designing the final FRC solution.

Two FRC solutions were considered by Energex: a solution based on PEACE and another solution based on FACOM/Siebel. The two systems had similar overall costs and were evaluated in detail over a three month period commencing in February 2006. The selection of the FRC solution is described in detail in Energex's supplementary application. However, in summary, Energex selected the PEACE solution for the following reasons;

- the system had already been adopted in NSW;
- as an existing system, it would benefit from previous experience;
- market interaction components could be purchased;
- PEACE did not have some of the limitations of FACOM; and
- some FACOM resources would not be available during 2006 and 2007.

Consultant's Assessment

Of the eight parties invited to prepare competitive tenders to provide expert technical advice during the implementation phase of FRC, six proposals were received and Accenture was eventually selected by Energex. PBA considered that Energex would have required such advice given the complexity of modifying IT and other business systems to meet the requirements of FRC. PBA also considered that the tendering process resulted in the most experienced and capable tender being accepted by Energex.

PBA considered that the choice of PEACE, a highly automated system, was appropriate given the number of customers connected to the Energex network and the number of transactions (messages regarding customer services) that must be complied with under the stringent communication protocols for FRC in Queensland. Furthermore, PBA accepted that PEACE was also a proven system and, given the limited time available, would be less likely to incur problems during the short period that was available for implementation.

In normal circumstances, PBA would have expected that, once the PEACE system had been implemented, costs associated with upgrading or maintaining the system being replaced would be avoided. However, Energex claimed that it was not able to discard the old FACOM system as it was required to continue to operate and maintain this system in order to provide operational support to Allgas, Sun Retail and Powerdirect Australia, a transitional requirement imposed on Energex in the sale agreements for these retail entities.

PBA considered that maintaining two separate systems would add to complexity and, due to the short time available to Energex, meant that FACOM could not be decommissioned at the same time that PEACE was implemented. PBA noted that PEACE would initially be used to manage customers that took up market contracts under FRC while FACOM would continue to handle non-market customers until these customers could be transferred to PEACE at a later date, or to the new retail business owners. PBA considered that the retention of the FACOM system following the implementation of PEACE was appropriate.

In summary, PBA considered that Energex had:

- considered an appropriate range of options;
- made the best use of existing available systems from other jurisdictions;
- adopted sensible automation of processes and interfaces where manual processing would not work well; and
- selected a solution that could be implemented within the (limited) time available.

PBA considered that, in the absence of FRC, the new system would not otherwise have been required. However, PBA acknowledged that, at some point in the future, Energex would have been required to update its IT systems but it was not clear to PBA when this upgrade would have been required and PBA accepted that such an upgrade may not have been required during this regulatory period.

Stakeholder Comments

No comments were received from stakeholders in relation to the overall architecture of Energex's proposed FRC system.

The Authority's Position

The Authority acknowledges that Energex had limited time to evaluate, design and implement systems capable of meeting its obligations under FRC. Energex appears to have examined a reasonable range of alternative options that could fulfil its requirements.

The Authority is concerned at the additional costs incurred to install the new PEACE based system and, at the same time, to upgrade the pre-existing FACOM system. This decision does not appear to have been made by Energex in order to meet its FRC obligations but, rather, was imposed on Energex as a result of agreements entered into to facilitate the sale of Sun Retail, Sun Gas and Powerdirect.

While the Authority considers that the costs associated with the implementation of PEACE to meet Energex's FRC obligations are directly linked to the introduction of FRC, the FACOM system was in existence at the time of the 2005 Determination and any costs needed to maintain and operate that system throughout the current regulatory period were recognised at that time. The only issue concerning FACOM is the timing of decommissioning that system once its replacement had been installed.

2.2 FRC Project Implementation Costs (Stage 1)

The majority of costs discussed in this section relate to the purchase and tailoring of IT equipment and business systems that were required by Energex to operate under FRC. The other costs considered in the section relate to administrative costs that were incurred in designing and selecting the FRC IT systems and costs associated with providing information, particularly to Energex staff, regarding changes to operating procedures that would be affected by FRC.

The costs proposed for pass-through by Energex under this category are actual costs in the year in which they were incurred and forecast costs for IT and Business Systems from 2008-09 onwards (see Table 5).

Table 5: Energex Project Implementation Costs – Stage 1 (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Management and Implementation Costs	392	2,702	1,956	0	0	5,050
Corporate Communication	0	227	0	0	0	227
IT & Business Systems	770	82	11,781	10,861	10,123	33,617
Total	1,161	3,011	13,737	10,861	10,123	38,894

Project Management and Implementation

According to Energex, these costs relate to the labour (Energex staff and external contract staff) associated with the “FRC Project Team” established within Energex from 2005-06 to 2007-08 to ensure its readiness for FRC by 1 July 2007.

The internal labour component was made up of Energex staff drawn from its customer service, data management, metering, call centre and regulatory teams. Over the period 2005-06 to 2007-08, the size of the FRC Project Team averaged 15.2 full time equivalent staff (FTE). Excluding costs for staff whose positions had not been back filled, Energex estimated the cost of the FRC Project Team to be \$1.9 million (including staff on-costs but not including any allowance for corporate overheads).

Over this same period, Energex also engaged 23 consultants from 4 separate consulting firms at various times to assist the FRC Project Team. The consultants engaged by Energex included business analysts, project managers and system testers. Based on actual costs for 2005-06 and 2006-07 and forecast costs for 2007-08, Energex estimated consultant costs to be \$2.3 million in total.

In addition, Energex identified costs associated with a range of other activities as part of the FRC project implementation phase. These costs included staff training, legal expenses, travel, stationery and additional photocopying equipment. Between 2005-06 and 2007-08, these costs were estimated to be \$0.8 million.

Corporate Communications

In its application, Energex identified \$0.2 million in costs for corporate communications. These costs related to a public safety campaign, an information DVD developed for internal staff and an educational program for external stakeholders and contractors. In undertaking these activities, Energex sought to ensure that its staff, contractors and customers understood the role of Energex in an FRC environment. According to Energex, it was important that its staff understood and would be able to explain to affected parties the changes relating to FRC. For example, Energex wanted to ensure that customers would understand its ongoing role as the contact point for electrical emergencies.

IT & Business Systems

Energex has claimed it incurred significant expenditure for upgraded IT and Business Systems in preparing for FRC. Over the current regulatory period, Energex has identified expenditure of \$33.6 million for this purpose. The majority of this expenditure, around \$33.3 million, related to system changes required to meet the increased number of data and information flows required under the FRC operating protocols. The remaining costs, around \$0.3 million, related to an upgrade to Energex’s customer service voice recognition system.

The process by which the IT system chosen by Energex to meet its FRC requirements was selected was discussed above. The selected IT solution comprises 13 separate modules (see Table 6 for a full listing), with the major components including:

- PEACE (a new system to provide customer billing and premises management);
- TOHT (meter reading and related service order management);
- FACOM (upgrade to pre-existing billing system in order to link with new FRC systems);
- FFA-FRC (upgraded system to support field work and service order functionality);
- ArcFM (integration of Energex’s existing GIS system with PEACE);
- Integration (web interface for FRC systems); and
- TCE (upgraded ‘trouble call’ systems required due to FRC)

For each of these FRC system modules, Energex outlined the associated hardware, software and developer costs. More detailed descriptions of each module were provided in Energex’s supplementary application.

The IT assets required to meet Energex’s FRC obligations were mostly purchased by SPARQ Pty Ltd, a jointly owned subsidiary company of Energex and Ergon Energy, with Energex required to pay SPARQ for access to the systems through an annual service charge. The annuity cost claimed by Energex was based on the capital cost of the IT assets using an assumed expected life of 5 years and including interest costs incurred by SPARQ during the construction period. Energex proposed that costs incurred by SPARQ during the design phase of the project in 2005-06 and 2006-07 would be charged directly to Energex and treated as an expense rather than being capitalised and included in the annuity payment.

In its supplementary FRC cost pass-through application, Energex removed forecast IT costs that had already been recognised in the Authority’s 2005 Final Determination which would now be superseded by the systems it expected would be put in place to meet its FRC obligations.

Stakeholder Comments

Origin Energy stated that it was unclear when the recovery of the implementation costs commenced.

Queensland Treasury suggested that, while it supported the pass-through of costs incurred by Energex as a result of FRC, it considered these should be limited to costs that are incremental, prudent and efficient.

Consultant’s Assessment

In order to assess the FRC Project Implementation costs proposed by Energex, PBA undertook a detailed assessment of the underlying costs, including those capital costs incurred by SPARQ and proposed to be paid by Energex as an annuity.

PBA assessed these costs with respect to the amount of time that was devoted to the task by Energex staff and external consultants and by comparing the unit labour costs for external consultants and Energex staff with those available in the marketplace. Based on its analysis, PBA considered the proposed costs were within ranges it considered to be reasonable.

In terms of the amount of time allocated to FRC related activities, PBA was satisfied that the equivalent of 15.2 full time Energex staff employed for a year and 23 consultants for 6 months was, in total, reasonable given the size and complexity of implementing the FRC solutions over a three year period. PBA noted that, in relation to Energex staff costs, oncosts had been included but corporate overhead costs had not. PBA accepted this approach was reasonable given that corporate overheads were not avoidable costs and, therefore, were not incremental.

Overall, PBA considered the costs proposed by Energex for FRC Project Management and Implementation were reasonable and had been demonstrated to be incremental to Energex’s pre-FRC requirements.

With respect to “Corporate Communications”, PBA considered that, while it is important for customers to understand who should be contacted in case of an electrical safety issue, the provision of such information to customers by Energex would be required irrespective of the introduction of FRC. PBA considered that these costs were incurred primarily through obligations on Energex that arise from the Electrical Safety Act 2002 and were not directly related to the FRC.

The most significant of the Project Implementation costs were those designated for IT and Business Systems. In undertaking its assessment of these costs, PBA examined the costs incurred by SPARQ in establishing the FRC systems on behalf of Energex and subsequently considered the charges that SPARQ sought from Energex in order to recoup its costs. As noted in section 2.1 above, PBA accepted the IT systems selected by Energex to meet its FRC obligations were appropriate. Consequently, what remained to be established was whether the costs that Energex proposed to implement its FRC systems were appropriate.

PBA examined the capital costs incurred by SPARQ for Energex’s FRC systems (refer to Chapter 5 of PBA’s report). PBA considered each of the different functional modules that comprise the overall systems that would meet Energex’s FRC obligations. The capital costs proposed by Energex for each module and the amount recommend by PBA are shown in Table 6.

Table 6: PBA recommended FRC capital costs (\$’000, nominal)

	Energex proposed costs	PBA recommended	Variation \$’000	Variation %
FDU-PEACE	15,429	12,658	-2,771	-18.0
TOHT	4,293	3,284	-1,009	-23.5
FACOM	4,834	3,958	-876	-18.1
Force	369	249	-120	-32.5
Nemlink	889	710	-179	-20.1
Integration	5,780	4,557	-1,223	-21.2
FFA-FRC	1,983	1,906	-77	-3.9
Arc FM	2,538	2,367	-171	-6.7
Reporting	534	513	-21	-3.8
TCE	509	469	-40	-7.9
GUS	292	265	-27	-9.2
EMAS	188	172	-16	-8.5
Hardware	1,387	1,387	0	0.0
Total	39,023	32,494	-6,529	-16.7

The costs proposed in Table 6 were derived by Energex to account for the combination of input costs consumed in assembling each module. These input costs included:

- SPARQ labour costs;
- Accenture Labour costs;
- Energex labour costs;
- system supplier costs;
- hardware costs; and
- software costs.

The overall value of capital expenditure for FRC related IT and business systems was \$39 million, with \$33.6 million requested by Energex for pass-through during the current regulatory period, with the balance to be recovered in the next regulatory period, years 4 and 5 of Energex's assumed 5 year asset lives. Energex calculated this amount based on an assumed asset life of 5 years for most IT assets (3 years for FACOM and Force owing to their imminent phase out). In addition, costs in 2005-06 and 2006-07 that were largely related to system design were expensed in the year they were incurred. Consequently, only the costs to be incurred in 2007-08 and beyond were included in the annuity amount expected to be paid by Energex to SPARQ for use of these assets. As Energex had assumed an asset life of only 5 years (or less) for IT components, the IT capital costs to be recovered during the current regulatory period represent 86 % of total capital costs.

PBA examined each of the capital costs components listed in Table 6 and recommended that a number of adjustments should be made to the capital costs proposed by Energex in its supplementary application, including:

- that the overheads rates for the NemLink (32 %) and SPARQ (30 %) labour charges were significantly higher than for other vendors (all 18 %). Based on knowledge of overhead rates for other IT vendors, and the lack of any reason why the NemLink and SPARQ overhead rates should be higher, PBA recommended that an overhead rate of 18 % should be adopted for all vendors and the total costs associated with overheads be reduced by \$0.9 million (as detailed in section 5.2 of PBA's report);
- that capital costs incurred by SPARQ in 2005-06 (\$0.25 million) had not be adequately justified because a detailed break up could not be provided by Energex. PBA recommended that these costs should be rejected;
- that, in relation to Accenture, the systems integration consultant engaged by Energex;
 - capital costs incurred in 2005-06 (\$2.6 million) not be accepted as Energex was unable to provide any breakdown of these costs to explain the purpose of the payments; and
 - 12 Accenture consultants providing advice on business delivery systems in 2006-07 was excessive (\$5.1 million) and that this task should have been able to be accomplished with six consultants given the additional expertise already available from SPARQ. Accordingly, PBA recommended that Accenture costs be further reduced by \$2.6 million; and

- that all Energex staff costs for 2005-06 (\$0.21 million) not be accepted on the basis that, as with SPARQ and Accenture costs previously, Energex was unable to provide any detailed breakdown of these costs.

Aside from the reductions, PBA considered that the remaining costs proposed by Energex should be accepted. Further detail on PBA’s assessment of these costs is provided in the report prepared by PBA for the Authority.

The final cost component of the IT and Business Systems related to voice recognition and related customer data presentation equipment (\$0.3 million) which PBA considered to be reasonable.

Overall, the costs for IT and Business Systems recommended by PBA were \$32.8 million (see Table 7), a reduction of around 16 % on the costs proposed by Energex.

Table 7: PBA Recommended FRC Project Implementation Costs – Stage 1 (\$’000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Management and Implementation Costs	392	2,702	1,956	0	0	5,050
Corporate Communication	0	0	0	0	0	0
IT & Business Systems	335	82	9,855	9,057	8,441	27,770
PBA Total	727	2,784	11,811	9,057	8,441	32,820
Energex Total	1,161	3,011	13,737	10,861	10,123	38,894

The Authority’s Position

The Authority notes that, despite several attempts to obtain information, Energex was unable to provide an adequate explanation of the SPARQ and Accenture capital costs it had claimed as directly related to the introduction of FRC in 2005-06. The Authority is of the view that it should have been clear to a regulated business such as Energex that regulatory approval of these costs would be required and that detailed record keeping would need to be an integral part of managing FRC implementation.

As noted at the outset, the responsibility for establishing 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. If it is relying on forecasts, these must be established “with absolute certainty”.

The Authority has provided several opportunities for Energex to establish its case but, at the end of the day, there remains considerable doubt surrounding many of the costs claimed by Energex to be directly related to the change in its obligations due to the introduction of FRC. The capital costs claimed by Energex for 2005-06 are a case in point and the Authority therefore rejects these.

The Authority accepts that a rate of 18% for overheads rates applicable to SPARQ and NemLink consultancies is consistent with the rates generally applicable in the market. The Authority has therefore adjusted the costs for these two service providers accordingly.

With respect to the recommended reduction in costs for Accenture in 2006-07, the Authority notes that the costs attributed to Accenture represent around a third of the total FRC capital costs proposed by Energex. Given the extensive use of IT consultants from numerous external sources, including from Energex's half owned specialist IT provider SPARQ, the Authority agrees with the advice from PBA that these costs are excessive and do not represent prudent and efficient costs. Based on the advice from PBA, the Authority considers the prudent level of cost for the task undertaken by Accenture in 2006-07 to be \$2.6 million less than that proposed by Energex.

In addition to the recommendations from PBA, the Authority does not accept that SPARQ should be paid for services it provides to Energex via an annuity designed to recover costs based on assumed asset lives of 5 years (3 years for FACOM and Force). Services provided by related third party businesses should be transacted at arms length and reflect competitive pricing for equivalent services in the marketplace. Energex did not undertake a competitive tendering process to establish the reasonable cost for the services to be provided by SPARQ. Accordingly, the Authority has reviewed the basis for these annual charges.

The Authority considers that the asset lives adopted for the purpose of calculating depreciation should reflect a reasonable expectation of how long the asset will remain useful. The Authority notes that, while PBA accepted the five year life proposed by Energex, it indicated that the typical life for major IT assets is in the vicinity of 7 to 10 years. The Authority recently adopted a useful life for similar IT assets of 10 years for IT equipment that was purchased by Envestra to meet its FRC obligations. The Authority also notes that the system being replaced (FACOM) was first introduced 18 years ago. The Authority is therefore of the view that an assumed asset life of five years is insufficient and not in line with asset lives attributed to major IT assets in other contexts or by Energex to similar assets already in its regulatory asset base. In the absence of any convincing argument to the contrary, the Authority has assigned these assets a 10 year asset life and recalculated the annuity payment proposed to reflect SPARQ's costs on this basis. This change will not reduce the amount of costs to be recovered, only the period over which they are recovered. However, as a greater proportion of the costs will now be recovered in the next regulatory period, the amount needed to be passed through in this regulatory period will be reduced.

Finally, the Authority does not accept that Energex is entitled to claim any additional costs associated with upgrades to FACOM and Force. These systems were in place at the time of the 2005 Final Determination and the costs of operating and maintaining these systems was recognised in the cost building blocks for the 2005 Determination. Moreover, retail competition has been a reality for large customers for many years and the systems Energex had in place at the time of the 2005 Determination should have been capable of meeting Energex's obligations in relation to customer transfer for these customers, albeit that the volume of transfers would have been considerably less prior to the introduction of full retail competition. Upgrading these systems in order for them to run in parallel with the new replacement systems does not appear warranted, particularly when all transferring customers will be accommodated on the new PEACE system and the FACOM system is (on the basis of asset lives proposed by Energex) well past its use by date. Accordingly, the Authority has removed all costs associated with future upgrades to FACOM, which total \$4.6 million.

The only question remaining in relation to these systems is at what point cost savings will emerge (or would have emerged had other obligations not required these systems to be maintained for longer) as they are decommissioned following the introduction of new systems (see section 2.5).

The Authority's assessment of Energex's project implementation costs – stage 1 – is summarised in Table 8.

Table 8: QCA FRC Project Implementation Costs – Stage 1 (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Management and Implementation Costs	392	2,702	1,956	0	0	5,050
Corporate Communication	0	0	0	0	0	0
IT & Business Systems	335	82	5,103	4,862	4,622	15,004
QCA Total	727	2,784	7,059	4,862	4,622	20,054
Energex Total	1,161	3,011	13,737	10,861	10,123	38,894

2.3 FRC Project Implementation Costs (Stage 2)

According to Energex, these costs will provide for migration of customer data from FACOM to PEACE and to upgrade several of the systems put in place prior to FRC commencement on 1 July 2007. In its supplementary FRC cost pass-through application, Energex stated that this data migration would occur by mid 2008-09, rather than after three to five years as assumed in its original application which did not include any costs for this item.

Energex's claimed costs for Project Implementation (Stage 2) are provided at Table 8.

Table 8: Energex Project Implementation Costs – Stage 2 (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Management and Implementation Costs	0	0	1,476	0	0	1,476
IT & Business Systems	0	0	1,110	6,424	6,024	13,558
Total	0	0	2,586	6,424	6,024	15,035

Energex advised that the detailed costs and timing for Stage 2 were uncertain at the time its supplementary application was made.

Stakeholder Comments

Origin Energy commented that insufficient information had been provided by Energex for any detailed scrutiny of the Stage 2 costs.

Consultant's Assessment

As Energex had acknowledged that the forecast costs associated with Stage 2 of its Project Implementation were unreliable, PBA was unable to recommend acceptance of any of these costs. PBA also considered that the data migration costs should be able to be accommodated using the forecast IT costs that had already been recognised in the Authority's 2005 Final Determination. Regarding the proposed upgrades to PEACE and other FRC related business systems, PBA considered that these upgrades could wait at least until the end of this regulatory period and should be considered as part of the next regulatory determination.

Table 9: PBA Recommended FRC Project Implementation Costs – Stage 2 (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Project Management and Implementation Costs	0	0	0	0	0	0
IT & Business Systems	0	0	0	0	0	0
PBA Total	0	0	0	0	0	0
Energex Total	0	0	2,586	6,424	6,024	15,035

The Authority's Position

The “stage 2” costs proposed by Energex rely entirely on forecasts. The pass-through provision in the Authority’s 2005 Determination requires that:

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.*

In its application, Energex has acknowledged that its forecast costs for “stage 2” are unreliable. As a result, these costs cannot be considered for pass-through to customers at this time.

2.4 FRC Operating Costs

Having set out the costs associated with the design and implementation of its FRC systems, Energex outlined the anticipated costs to operate and maintain these systems over the current regulatory period. According to Energex, these costs are incremental to the cost of existing operational activities. Energex’s expected FRC operating costs are summarised in Table 10.

Table 10: Energex FRC Operating Costs (\$'000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Labour for ongoing FRC activities	0	142	5,736	6,884	6,884	19,350
IT Maintenance and Support	0	0	3,676	3,777	3,881	11,334
Load Profiling	0	0	240	247	253	740
Energex Total	0	142	9,651	10,611	11,019	31,424

Labour for ongoing FRC activities

In its supplementary cost pass-through application, Energex indicated that, as a result of the introduction of FRC, additional staff would be required to undertake activities including customer transfers, service order management, energy data management and network billing. While these sorts of activities had previously been performed by Energex, FRC would result in a significant increase in the volume of these activities that would need to be performed.

According to Energex, additional staff would also be required to undertake metering related activities that are a consequence of FRC. Energex expected collection, validation and processing of meter data to increase metering costs overall by around 10%.

The additional staff would be employed by Energex, Service Essentials Propriety Limited (SEPL) and Metering Dynamics (both wholly owned subsidiaries of Energex). In total, Energex forecast that these costs would amount to \$19.4 million over the current regulatory period.

IT Maintenance and Support

Under the service agreement between SPARQ and Energex, SPARQ is to maintain and operate the FRC systems for Energex. As part of this arrangement, SPARQ will also meet the cost of software and hardware licence fees. According to Energex, these costs are expected to be just under \$4 million per year and total \$11.4 million through to the end of the current regulatory period.

Load profiling

NEMMCO requires use of system load profile data to ensure the safe operation and accurate management of energy loads across the network. Around 400 meters have been located across the Energex network specifically for this purpose. Metering Dynamics will undertake load profiling activities for Energex to meet Energex's market settlement obligations. The cost of obtaining this information was expected to be around \$600 per meter per year. Energex forecast the total cost to be around \$240,000 in 2007-08, increasing by inflation thereafter.

Stakeholders' Comments

No submissions commented on specific aspects of the operating costs proposed by Energex. However, several of the submissions, including those by TRUenergy and Origin, suggested that Energex's proposed costs included in its supplementary application were higher than FRC costs approved in other jurisdictions. Further, TRUenergy was concerned that costs associated with parts of Energex's previous retail business that had not been sold may have been included in the FRC cost pass-through application.

Consultant's Assessment

In considering Energex's operating costs, PBA examined how the three cost categories had been derived. Where costs included labour components, PBA examined labour rate benchmarks to determine whether the rates were reasonable. Similarly, the amount of labour (numbers of days) was also examined to determine whether the scope of work and time allocated to the task was reasonable. Based on this analysis, PBA suggested that the forecast operating costs set out in Energex's supplementary application compared favourably with costs approved by jurisdictional regulators in Victoria and South Australia. However, the costs proposed in Energex's original application were significantly higher than those approved elsewhere.

Labour for ongoing FRC activities

In considering these operating costs, PBA examined a model used by Energex to estimate its labour requirements under FRC. PBA noted that the model used by Energex was very detailed and, based on its assessment of the model, suggested that estimates of effort for each of 200 different activities produced by the model should be robust. PBA was also satisfied that activities that should not be ascribed to FRC, such as excluded non-DUOS services, were separately identified in the model outputs.

With respect to unit labour costs, PBA accepted that the labour costs proposed by Energex were reasonable on the basis that these costs were typical of those across the electricity industry. However, PBA did not accept that labour rates should be escalated by 4.5% each year beyond 2007-08 in line with Energex's enterprise agreement. PBA considered that such increases in wages should be offset, to some extent, by productivity improvements. Therefore, PBA

recommended that wage rates only be inflated each year by the consumer price index (CPI) used in the Authority’s 2005 Final Determination of 2.5 %.

Overall, PBA recommend that labour costs of \$17.8 million be accepted by the Authority rather than the \$19.4 million that was sought by Energex.

IT Maintenance and Support

Due to the complexity of the IT systems that Energex selected to meet its FRC obligations, PBA considered that an additional 10.5 FTEs for IT administration support was justified. In addition, PBA recommended that annual software licences for the PEACE and TOHT systems that would cost around \$2.5 million each year were consistent with the industry standard of around 20 % of the initial system purchase costs. Overall, IT Maintenance and Support costs of \$3.7 million per year (rising by CPI each year) were recommended by PBA.

Load profiling

PBA acknowledged that Energex would be required to provide load profiling data to NEMCCO as a requirement of FRC. According to PBA, the costs of obtaining this data proposed by Energex were below costs that could be obtained in the market. On this basis, PBA recommended that the forecast costs should be accepted.

Table 11: PBA Recommended FRC Operating Costs (\$’000, nominal)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Labour for ongoing FRC activities	0	143	5,736	5,893	6,056	17,828
IT Maintenance and Support	0	0	3,669	3,770	3,874	11,313
Load Profiling	0	0	240	247	253	740
PBA Total	0	143	9,645	9,910	10,183	29,881
Energex Total	0	143	9,651	10,611	11,019	31,424

The Authority’s Position

As noted by TRU energy in its submissions, the Authority was also concerned that there was the potential for costs remaining after the sale of Energex’s retail business to be reallocated to Energex under the guise of FRC costs. However, in moving from its original application to its supplementary application, Energex reduced its proposed operating costs by almost \$11 million (not including the removal of almost \$33 million in excluded non-DUOS services).

Given the favourable comparison of the overall FRC retail operating costs identified by PBA, the Authority is satisfied that the costs forecast by Energex are reasonable. However, the Authority also accepts PBA’s advice regarding the escalation of labour cost components by CPI, rather than the higher rate included in Energex’s enterprise agreement, in light of productivity gains that could reasonably be expected. On this basis, the Authority has accepted FRC operating costs consistent with the recommendations of PBA, as shown in Table 11 above.

2.5 IT Costs from 2005 Final Determination

In its supplementary cost pass-through application, Energex removed all IT related costs that had been included in the 2005 Final Determination. The Authority considers this was inappropriate both because cost pass-throughs are to be sought and assessed on an incremental basis, not as a complete reworking of the existing Determination, and because two years of the regulatory period had already passed by the time FRC commenced and the

costs included for those years had (presumably) already been incurred. However, the IT related costs included in the Final Determination for the years following the commencement of FRC should have provided some offsetting savings once the new PEACE system was installed.

While the tight timetable imposed on Energex may have made it difficult to decommission existing systems at the same time as new systems were commissioned, the key question is what is a reasonable period to allow for decommissioning redundant systems. In the absence of any evidence on this issue, it has been assumed that an additional year (2007-08) should have been sufficient and costs beyond 2007-08 associated with redundant IT systems (following the introduction of PEACE) that were included in the 2005 Determination have been removed (\$2.0 million).

2.6 Summary

The costs assessed in the previous sections as being eligible for pass-through to customers due to the introduction of FRC are summarised in Table 12.

Table 12: FRC cost pass-through (\$'000, nominal)²

	2005-06	2006-07	2007-08	2008-09	2009-10	Total	Energex Total
Project Implementation (Stage 1)							
Project Management and Implementation Costs	392	2,702	1,956	0	0	5,050	5,050
Corporate Communication	0	0	0	0	0	0	227
IT & Business Systems	335	82	5,103	4,862	4,622	15,004	33,617
Total (Stage 1)	727	2,784	7,059	4,862	4,622	20,054	38,894
Project Implementation (Stage 2)							
Project Management and Implementation Costs			0	0	0	0	1,476
IT & Business Systems			0	0	0	0	13,558
Total (Stage 2)			0	0	0	0	15,035
Operating Costs							
Labour to conduct ongoing FRC activities	0	143	5,736	5,893	6,056	17,828	19,350
IT & Business Systems	0	0	3,669	3,770	3,874	11,313	11,334
Maintenance and Support							
Load Profiling	0	0	240	247	253	740	740
Total Operating Costs	0	143	9,645	9,910	10,183	29,881	31,424
Less IT Costs from 2005 Final Determination				(1,033)	(999)	(2,032)	(2,685)
QCA Total FRC costs	727	2,927	16,704	13,739	13,806	47,250	82,667
Energex Total FRC costs	1,117	2,864	25,655	26,864	26,168	82,667	

² As provided in the Energex application, all values are in nominal dollars. Whilst it would be preferable to provide values in constant dollars, for comparative purposes, all values in this report have been similarly provided in nominal dollars.

Having considered the various cost elements proposed by Energex for pass-through, it is clear that costs incurred in 2005-06 and 2006-07 do not meet the materiality threshold. As noted at the outset;

...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.

This was the case even with the original amounts proposed by Energex and before any adjustment by the Authority. As a result, total amounts considered eligible for pass-through are as indicated in Table 13 in section 3.

3. REVENUE IMPACTS

Based on the assessment outlined in section 2, Energex is entitled to pass-through costs as shown in Table 13.

Table 13: Total cost pass-through (\$m, nominal)

	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Total</i>	<i>NPV</i>
FRC Revenue	0.0	0.0	16.7	13.7	13.8	44.2	32.2

In 2007-08 and for 2008-09, the Authority has allowed Energex to over-recover \$15 million of revenue in each year in anticipation of a decision being made on the agreed costs to be passed through to customers due to the introduction of FRC. This was done in order to recognise some level of FRC costs in distribution prices from the commencement of FRC and to avoid a situation where costs would have to be passed through in one large lump, causing a price spike for consumers.

Having already allowed these two instalments of \$15 million, the balance of the approved cost pass-through will have to be accommodated in 2009-10. To maintain the net present value of the pass-through amount Energex is entitled to, a further \$14 million of revenue needs to be raised in 2009-10. The revenue requirements are summarised in Table 14.

Table 14: Recovery of total cost pass-through (\$m, nominal)

	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Total</i>	<i>NPV</i>
FRC Revenue	15	15	14.4	44.4	32.2

4. DRAFT DECISION

The Authority's Draft Decision is to approve the pass-through by Energex of costs associated with the introduction of FRC of \$20.1 million in implementation costs and \$29.9 million in operating expenditure during the current regulatory period.

Based on the parameters used in the 2005 Final Determination, the Authority has determined the total revenue impact of the cost pass-through to be \$44.4 million (in nominal terms) over the remaining years of the current access arrangement.

The additional revenue to be targeted by Energex in its prices is shown in Table 17.

Table 13: Target revenue for Energex FRC costs (\$m, nominal)

	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Total</i>	<i>NPV</i>
FRC Revenue	0.0	15	15	14.4	44.4	32.2