



15 August 2008

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Dear Mr Hall,

Re: Response to letter of 29th July re QCA Draft Decision on cost pass through application, Ergon Energy – Tropical Cyclone Larry

We refer to your letter of 29 July 2008 enclosing the Queensland Competition Authority's Draft Decision on 'Cost Pass-through Application, Ergon Energy - Tropical Cyclone Larry'.

In line with the Queensland Competition Authority's (QCA) request for comments, please find attached Ergon Energy's submission in relation to the Draft Decision.

Ergon Energy's submission seeks for the QCA to amend its Draft Decision in order to:

- Allow Ergon Energy's 2006/07 operating and capital costs, as claimed. These costs meet the materiality threshold set out in the 2005 Final Determination and the costs have been found by the QCA's independent consultant, Evans & Peck to be incremental and to reflect prudent and efficient expenditure ; and
- Allow Ergon Energy's application for accelerated depreciation costs to be included in the pass-through amounts, as claimed. These costs are legitimate and are required to ensure that Ergon Energy is compensated for the depreciation costs of an asset over the life of that asset. The QCA's rationale for excluding these costs is inconsistent with other Australian jurisdictions and without reasonable basis.

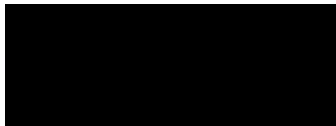
Ergon Energy also seeks to meet with the QCA to discuss development of process and other guidelines necessary to support cost pass-through applications and ensure that such applications are able to be developed with a clear understanding of the QCA's information requirements.

Ergon Energy thanks the QCA for the opportunity to comment on the Draft Decision and looks forward to receiving your response in due course.

In the meantime, on behalf of the Board of Ergon Energy I would also like to take this opportunity to once again thank and recognise our people and our business partners for their magnificent effort in relation to the restorative work involved in getting the people of Innisfail and surrounding areas back onto supply and into some form of normality following Severe Tropical Cyclone Larry.

If you have any queries or issues to discuss in relation to this, please contact Ian McLeod, Acting Chief Executive, on 4932 7446 (Rockhampton) or 3228 7687 (Brisbane) or ian.mcleod@ergon.com.au

Yours sincerely,



Keith Hilless
Chairman

Ergon Energy Corporation Limited

**QCA Draft Decision on Cyclone Larry
– Submission**

15 August 2008

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1 Overview

Ergon Energy acknowledges the release on 28 July 2008 of the Queensland Competition Authority's (QCA) Draft Decision on Ergon Energy's application to pass-through costs in relation to the restoration work consequent to Cyclone Larry.

Ergon Energy is concerned with the outcome of the QCA's Draft Decision to allow a cost pass-through amount of only \$10.8 million - \$9.9 million less than Ergon Energy sought.

Furthermore, Ergon Energy strongly disagrees with the basis on which the QCA has made its Draft Decision.

Ergon Energy considers that the QCA has not acted in conformance with clause 6.2.3(e)(6) of the National Electricity Rules (NER) to "provide reasonable certainty and consistency over time of the outcomes of regulatory processes" or in conformance with clause 6.2.7 of the NER to "publish full and reasonable details of the basis and rationale of the decision". These clauses underpin the 2005 Final Determination as the most recent version of the NER prior to the introduction of the new Chapter 6, as per the grandfathering arrangements contained in clause 11.14.3 of the NER.

As the QCA notes in the Draft Decision, the intent of the general pass-through mechanism is to allow for events that have a material impact on the distributor's revenue, with a pass through event being defined as a major exogenous and unforeseen event outside the control of the distributor. Ergon Energy's position in preparing the Application and the Supplementary Application has been to seek clear, accessible and easy to apply guidelines and information requirements to address this issue from the QCA.

Since the release of the Final Determination in 2005 and despite previous submissions from Ergon Energy suggesting more detailed guidelines were necessary, the QCA has not published any guidelines, rulings or discussions papers expanding on the above criteria. Prior to the impact of Cyclone Larry and the subsequent lodgement by Ergon Energy of its pass-through application, the extracts from the Final Determination contained in the Draft Decision represented the entirety of the regulator's framework for decision-making in this area.

Ergon Energy considers that maintenance of the QCA's position in its Draft Decision in relation to the non-inclusion of 2006/07 operating and capital costs, and rejection of accelerated depreciation, would be arbitrary and without any reasonable basis of support. The QCA's Draft Decision provides no evidence or other material to justify the decisions that these costs should be rejected or omitted.

The QCA has made several errors of fact, has disallowed 2006/07 expenditure as being immaterial when it is not, and has made numerous statements in its Draft Decision that are inconsistent with the views of their independent consultant, Evans and Peck.

This submission seeks two amendments to the Draft Decision. This submission also provides a response to the concerns raised by the QCA in relation to the adequacy of the information supplied by Ergon Energy to support its cost pass-through claim.

Proposed Amendments to Draft Decision

The first amendment to the Draft Decision is for the QCA to allow Ergon Energy's 2006/07 operating and capital costs on the basis that the QCA has adopted an incorrect and unreasonable interpretation of the materiality criteria applicable to cost pass through events as set out in the 2005 Final Determination.

The materiality of Ergon Energy's pass-through claim has nothing to do with the materiality of the individual components of costs within it. The QCA's consideration that

2006/07 costs are not material, and therefore do not deserve consideration, cannot be maintained unless accelerated depreciation is removed from the claim. These 2006/07 costs must be re-considered.

The second amendment to the Draft Decision is for the QCA to reconsider Ergon Energy's application for accelerated depreciation costs, and to include these in the approved pass-through amounts. The QCA's rationale for excluding the accelerated depreciation costs is unclear and reasonable details of the basis for this decision are not contained in the Draft Decision.

The claim for accelerated depreciation is legitimate and required to ensure that Ergon Energy is compensated for the depreciation costs of an asset over the life of that asset. As requested by the QCA, Ergon Energy has also supplied information which demonstrates that the approach proposed by Ergon Energy is consistent with approaches in other Australian jurisdictions and the Draft Decision does not take adequate consideration of this data.

Issues Regarding QCA's Information Requirements

Ergon Energy notes the QCA's concerns regarding the level of detail supplied in the application and supplementary application, however, Ergon Energy considers that it has provided the QCA with all of the necessary information for the QCA to make its decision in relation to Ergon Energy's cost pass-through application.

From the QCA's Draft Decision, it seems that the QCA has sought to assess the incremental cost of the Cyclone Larry event having regard to the notional plans and programs required to support Ergon Energy's forecast expenditure at the time the Regulatory Submission was lodged in September/October 2004 and subsequently readjusted at the macro-level when the Final Determination was issued in 2005.

Such an approach is understood, and has been acknowledged by both the QCA and Ergon Energy regulatory staff, to be very difficult to achieve, as the notion of 'incremental' implies a baseline contained in the 2005 Final Determination which was never made clear by the QCA. In the Supplementary Application, Ergon Energy highlighted the practical difficulties associated with adopting this approach in the context of Cyclone Larry, however, Ergon Energy is unclear on the reasons why these arguments were not generally accepted by the QCA.

In the circumstances, Ergon Energy considers that the approach taken in relation to recording and capturing its costs was reasonable in the context of the Cyclone Larry event. Independent reports examining our response to the Cyclone Larry event from Sinclair Knight Merz (SKM) and from Evans & Peck have both confirmed the approach adopted as being appropriate and understandable in the context of the emergency response activated by Ergon Energy to the Cyclone Larry event in seeking to restore supply to customers.

Ergon Energy also notes that throughout the cost pass-through application process it has worked collaboratively with the QCA and its independent consultants, Evans & Peck. The company has provided information in a timely manner in accordance with its understanding of the requests and advice supplied to it by QCA officers and the QCA's independent consultants, Evans & Peck.

In the nine month period since providing the additional information contained in the supplementary application to the QCA of 6 November 2007 and prior to the release of the draft decision in July 2008, Ergon Energy was not aware and had received no feedback from the QCA or its consultants that the QCA had major concerns with the

quality of any of the information provided to it or that the supplementary data supplied to the QCA and Evans & Peck was in any way inadequate or failed to meet the QCA's requirements.

The QCA's Draft Decision itself contains insufficient detail as to the areas in which Ergon Energy's application did not meet the QCA's information requirements for cost pass-through applications. For the benefit of this application and future cost pass-through applications, Ergon Energy is willing to meet with the QCA to understand in detail in what areas more specific information is necessary to meet the requirements set out in the Final Determination. Ergon Energy also repeats its offer of assistance made in the lead up to the Final Determination in 2005 to work with the QCA and other stakeholders to develop more detailed guidelines as to how the cost pass-through application mechanism works.



2 Chronology of Events

Ergon Energy considers that the QCA's chronology of events¹ is incomplete and does not adequately represent the work undertaken by Ergon Energy in the development of the Cyclone Larry cost-pass through application. The Draft Decision does not detail the impact on the content of the material Ergon Energy supplied during the application process as a result of the various requests and advice supplied by QCA officers and Evans & Peck.

Following preliminary discussions with QCA officers, Ergon Energy submitted its pass-through to the QCA for costs associated with Cyclone Larry in May 2007. The application set out information relating to the event itself, why Ergon Energy believed the event was "unforeseen" and "material", and included a pass-through amount of \$19.1 million in 2005/06 and \$10.2 million in 2006/07 (\$29.33 million in total). The application was released for public consultation and no submissions were received by 13 July 2007.

On 29 June 2007, the QCA wrote to Ergon Energy noting that it had not provided sufficient detail in its application to allow the QCA to assess the application or demonstrated that the amounts were incremental to that allowed in the 2005 Determination or "gross amounts". (That is, the amount that Ergon Energy spent, rather than the difference between the amount spent by Ergon Energy and the amount allowed in the Determination for the areas affected by Cyclone Larry.) That letter sought additional information on a number of specific points, and included an Attachment which set out a list of matters – albeit a non-exhaustive list - that the QCA required Ergon Energy to address in a Supplementary Application.

Ergon Energy established a work program to respond to each of the points made by the QCA in its letter. Ergon Energy's response was directed specifically at the two distinct "themes" in the QCA's letter. It specifically addressed:

- The extent to which the costs presented in the pass-through submission were incremental to that already submitted by Ergon Energy and approved by the QCA in its 2005 Determination; and
- The need for Ergon Energy to provide greater clarity about how its costs were derived, and how the pass-through was calculated.

The Supplementary Application stated that Ergon Energy had given serious consideration to each of the issues raised by the QCA in its letter, and amended some aspects of its original submission as a consequence of that work. Specifically, Ergon Energy cleansed its:

- Operating and maintenance expenditure and capital expenditure for costs that may have been included in the operating and capital expenditure 'building blocks' for the 2005 Determination. This resulted in reduced 'allowable' opex and capex for Cyclone Larry; and
- Depreciation costs, as a consequence of changes to the capital expenditure data. This is because the AARR approved by the QCA included an allowance for depreciation which could be applied to assets destroyed by Cyclone Larry.

These reductions were a consequence of significant internal work by Ergon Energy during which it became clear that while Ergon Energy believed it was entitled to seek

¹ Refer to QCA Draft Decision July 2008 section 1.3 Ergon Energy's Application for Pass-through.

the full amount previously submitted. During that period, however, QCA staff indicated to Ergon Energy informally that the Supplementary Application claim should not include corporate overheads or ordinary time wages paid to staff working on the restorative effort. Both elements were arguably legitimate costs, however Ergon Energy took a view that it was appropriate to be, and to be seen to be, conservative in these matters.

The Supplementary Application also made clear the way in which Ergon Energy had calculated the pass-through amount, in particular noting that capital expenditure data could not be separated into asset classes (and instead was captured in one asset category in the asset register) because of the pace at which the restorative work had to be done by Ergon Energy. It noted that a work program was underway within Ergon Energy's finance group to appropriately record these assets and explained the basis on which this would be done.

Once these matters had been amended, the Supplementary Application sought a reduced pass-through amount of \$20.7 Million.

When the Supplementary Application was lodged with the QCA on 6 November 2007, Ergon Energy offered to provide QCA officers with the pass-through financial model setting out the pass-through calculations, including capex, opex, return on asset and depreciation calculations. This was offered to make clear to the QCA staff assessing the Application how the numbers were derived and to provide a greater level of detail in relation to operating and capital expenditure. The QCA declined to receive the model, on the basis that it was interested only in the Supplementary Application.

The QCA did not request any further information from Ergon Energy or note any dissatisfaction with the information included in the Supplementary Application. As of November 2007, Ergon Energy believed it had provided all information that had been requested of it, by the QCA.

On 21 November 2007, Ergon Energy again contacted the QCA by email to check the progress of the Supplementary Application and to inquire if any further information was required. The QCA provided no other feedback other than to state that it was still assessing the Supplementary Application.

On 22 November 2007, the QCA publicly released the Supplementary Application, with interested parties able to comment on the Supplementary Application until 24 December 2007. No submissions were received.

On 17 January 2008, QCA staff contacted Ergon Energy staff to advise that the QCA had appointed Evans and Peck to assess Ergon Energy's pass-through Supplementary Application.

On 21 January 2008, Ergon Energy staff met with Evans and Peck in order to understand what information was required from Ergon Energy to further support its Supplementary Application. A range of data requests were provided to Ergon Energy, including a request to provide access to Ergon Energy's pass through model. As well as this, Ergon Energy offered access to the materials that it had used in drafting the Original and Supplementary Applications, including Emergency Team Meeting notes and internal reports.

Ergon Energy's first data response was sent to Evans and Peck on 25 January 2008. The model and various other reports were sent on 30 January 2008.

On 4 February 2008, Evans and Peck in discussions with Ergon Energy noted that:

- They had identified a small error in the model relating to the manner in which Ergon Energy had included defect replacement expenditure, which Ergon Energy agreed

with. The model was rectified accordingly and resulted in a pass-through amount of \$20.1M;

- They strongly believed that Ergon Energy had been “conservative in its Application”; and
- They strongly believed that Ergon Energy had been “conservative in taking out the normal time, and having claimed only the overtime for normal labour”.

Ergon Energy’s contact with Evans and Peck continued intensively and collaboratively until early April 2008.

One of the principal documents that Ergon Energy provided to Evans and Peck, and which was referred to by Ergon Energy in its Original and Supplementary Application, was a Review of Ergon Energy’s response to the Cyclone Larry event conducted by SKM. This Report had been extensively referenced in Ergon Energy’s Original Application.

One excerpt from SKM’s Report specifically addressed the issue of Ergon Energy not being able to disaggregate capital expenditure. The SKM Report noted at section 2.2 “Measure of Damage”, that *“The logistics group raised a single overarching job number for all STC Larry stores issues and maintained inventories at the warehouse level only. Local depot stores became clearing houses with an open door method of operation. Due to the extent of the exercise, this was likely the most appropriate response, however it does not allow for detailed post event analysis of asset performance, to the extent that might otherwise be expected”*.²

Evans and Peck provided the QCA with its Report³ on 9 April 2008. Evans and Peck’s Report stated that:

- On page 1 – *“Understandably, Ergon Energy’s initial priorities following the cyclone were operational rather than regulatory, and cost data collected reflected this. Significant effort has since been required to re-aggregate this data into a form which will provide the information to the standard required by the QCA to assess the pass-through application”*;
- In relation to the operating costs sought by Ergon Energy on page 3 – that *“analysis of the supporting data leads us to conclude that the amount claimed in the pass-through application:*
 - *Can reasonably be attributed to Ergon Energy;*
 - *Has been conservatively adjusted to remove overlaps between “business as usual” operating expenditure allowed under the 2005 Determination and that incurred as a result of Cyclone Larry; and*
 - *Reflects prudent and efficient expenditures in the context of the operational difficulties faced by Ergon following Cyclone Larry”*.
- On page 3 in relation to the capital costs sought by Ergon Energy that:
 - *“detailed data supports that the total expenditure recorded by Ergon in relation to Cyclone Larry was actually incurred;*
 - *Adjustments to remove overheads were appropriate, albeit conservative;*

² SKM Review of Network Performance and Corporate Disaster Response Final 12 Sep 2006.

³ Ergon’s Pass-Through Application for Cyclone Larry Review of Ergon Energy’s Application 9 April 2008

- *that an adjustment is required to the 2005 defect replacement number in the Application which reduced the capex sought by Ergon from \$12 Million to around \$11 Million; and*
- *This level of capex reflects prudent and efficient expenditures in the context of Cyclone Larry.”*

At no stage did the QCA provide Evans & Peck’s Report to Ergon Energy for review or comment prior to the release of the Draft Decision. Ergon Energy is aware that Evans and Peck provided a draft to the QCA of the Report as early as 30 March 2008.

On 10 April 2008, the QCA advised that it expected the Draft Decision to be considered by the QCA Board on 24 April 2008.

On 29 April 2008, the QCA advised⁴ that it would allow Ergon Energy to recover \$5 million as a provisional pass-through in its 2008/09 prices, as it would not have a Draft or Final Decision completed by the time that prices were required to be released by Ergon Energy for 2008/09.

Ergon Energy received no further correspondence from the QCA in relation to the overall substance or quality of the data supporting the Supplementary Application between the period of 29 April and 28 July when the Draft Decision was publicly released.

The key points from the above chronology, as distinct from that which the QCA presented in its Draft Decision are that:

- From the time that Evans and Peck provided its Draft Report to the QCA, around 30 March 2008, the QCA was aware that the capital and operating expenditure claims by Ergon Energy were incremental, prudent and efficient. It was also aware that Ergon Energy’s claim was conservative, and that its consultant believed that there was enough information provided by Ergon Energy in order for it to make a decision;
- The QCA did not seek any additional information from Ergon Energy from November 2007 when it received the Supplementary Application and when the Draft Decision was released, other than through its consultant; and
- With the Evans and Peck Report, the cost pass-through model, the Supplementary Application and the various formal and informal meetings over the past 12 months, Ergon Energy and the QCA’s consultants have provided the QCA with an enormous amount of information on which the QCA could make its decision. This is reinforced by the views of Evans and Peck in paragraph 11 of its Report’s conclusion where it stated that Ergon Energy does have sufficient evidence to enable a pass-through decision. To devote such a large amount of the Draft Decision to absences of information following the extensive effort by Ergon Energy through the Evans and Peck engagement, and to cast broader doubts on Ergon Energy’s accounting systems at the same time, is without any basis.

Ergon Energy remains prepared to provide on request any further information that the QCA believes is required to support its application, in particular in relation to accelerated depreciation and the 2006/07 operating and capital costs.

⁴ QCA letter to Ergon Energy dated 29th April 2008

3 Key Errors of Fact & Inconsistencies in Draft Decision

The QCA's Draft Decision contains numerous errors of fact, is inconsistent with our understanding of the 2005 Final Determination and does not provide reasonable certainty in relation to the requirements necessary to support cost pass-through applications made in accordance with the terms of the 2005 Final Determination as per Chapter 6 of the NER. It is relevant to the QCA's consideration of this submission, and to its Draft Decision generally, to draw these matters to the QCA's attention.

On page 3, the QCA notes that the "report from Evans and Peck is available on the Authority's website". Ergon Energy officers note that the Evans & Peck report was not available until three-four days after the notification of the Draft Decision had been issued⁵ to interested parties. Accordingly, Ergon Energy has had less time than it would have preferred to review and understand the reasoning behind the overall Draft Decision in meeting the QCA's deadline of 15 August 2008.

On page 4, the QCA notes that "Ergon Energy provided less information in its Supplementary Application than had been provided in its original application, for example no disaggregation of operating expenditure was provided". In fact, the Supplementary Application contained specific information requested by the QCA in its letter to Ergon Energy⁶, and during discussions at officer level. Since lodging the Supplementary Application in November 2007, Ergon Energy received no feedback from the QCA or Evans & Peck to indicate that the Supplementary Application was extremely difficult to assess or was unclear and lacking in sufficient detail, as indicated in the QCA's letter of 29 July 2008.

On page 4, the QCA notes that Evans and Peck "was able to provide a more detailed breakdown of the operating expenditure as well as more information on capital expenditure though this could only be based on asset disposals as Ergon Energy had failed to keep any other detailed records". In fact, Ergon Energy's pass-through model contained this detailed operating expenditure information – the QCA rejected Ergon Energy's offer to review this model. In relation to capital expenditure, SKM had independently verified the manner in which Ergon Energy had operated its warehouses during the post-disaster reparations. There was no "failure to keep detailed records" – only a temporary lack of detailed asset class information because Ergon Energy had focussed on recovering supply to customers and had chosen to record all assets as one asset class in accordance with Ergon Energy's Emergency Management Plans.

In the footnote to table 1, the QCA notes that "Evans and Peck constructed these (detailed opex) categories after extracting more information from Ergon Energy's financial systems". In fact, this information was given to Evans and Peck by Ergon Energy, from information within its Pass-Through Model.

On page 5, the QCA note that "Ergon Energy removed all overhead costs and all normal business hours labour costs.....because it had been unable to separately identify those tasks and investments that were already planned for the region affected by the cyclone....this situation only arises because of the extremely poor record keeping by Ergon Energy". In fact, Ergon Energy removed these costs because QCA officers advised it would be difficult to justify overhead costs and ordinary time labour costs because, *prima facie*, the QCA's assumption would be that these were included in the

⁵ Notification received from email address electricity@qca.org.au on 28 July 2008

⁶ Attachment in QCA letter to Ergon Energy dated 29 June 2007

2005 Determination. In the absence of any detailed guidelines as to how cost pass-through application submissions for events such as Cyclone Larry should be treated or developed, the decision to omit these from the Supplementary Application – and thus significantly reduce the pass-through amount - was principally one of putting forward a conservative application and accepting and acting in good faith on the QCA's officers' advice.

On page 5, the QCA stated that “whether these had been replaced with like assets, whether they were new assets or second hand assets that were available has not been identified”. In fact, there has never been a discussion with the QCA at any time, by any member of Ergon Energy, to suggest that Ergon Energy installs second hand assets in any situation. It does not.

On page 6, the QCA notes that “it should have been a simple matter to identify what capital expenditure had already been planned for the region, what capital expenditure actually was incurred in the wake of the cyclone and again the difference would provide the basis for determining...the cost pass-through”. This statement oversimplifies the process for making an assessment of incremental costs and is misleading in the context of the 2005 Final Determination.

Cost pass-through applications are not based on the incremental costs over and above the business as usual – they are based on incremental costs over and above that allowed in the 2005 Determination (for the period 2005 – 2010) which was a high level broad brush five year forward capital and operating expenditure “allowance” process conducted by the QCA. The QCA amended the expenditure allowance that Ergon Energy sought in 2004 without providing the level of detail, of what specific reductions were made, that would be required under these circumstances to provide appropriate guidance and readily support an assessment of incremental expenditure.

Ergon Energy could clearly identify costs incurred as part of the Cyclone Larry restoration effort. This was \$42.3M. The statement is making reference to being able to distinguish between what expenditure was included for the cyclone affected area as part of the 2005 Determination for the 2005/06 to 2009/10 period, compared with the expenditure that took place in response to Larry. The QCA therefore required Ergon Energy, for example, to state what its planned maintenance was in the Determination for the region, and what planned maintenance for the period 2006/07 to 2009/10 could be deferred by virtue of having installed new assets following Cyclone Larry. Without time boundaries and definition this cannot be easily quantified. Planned work would simply be deferred to post restoration. The only significant deferment would be costs incurred to correct defects without a Cyclone Larry event.

Further understanding of what is discretionary and what is not is also required, that is as a result of the cyclone, what work that was planned would not be done in the regulatory period. As Customer Initiated Capital Works, defects, customer services, inspection cycles etc are code and demand driven these still have to be done. The only areas that may not have to be done, or should be discounted due to the cyclone, are vegetation management and some asset replacement.

Ergon Energy is clearly able to measure what the normal asset replacement and vegetation management was for the region in normal conditions. As part of its application, normal defects were assessed and deducted (refer to page 22 Evans & Peck report). Evans & Peck state in their review of vegetation management that whilst Ergon Energy did not specifically deduct routine vegetation management costs it would have not been material, and more than offset by the conservative approach adopted by removing all normal hour costs and not factoring in additional costs incurred in other regions due to probably having to maintain those programs with overtime.

The Evans & Peck report clearly identifies where Ergon Energy did try and provide incremental analysis with respect to the program of work. Ergon Energy's assessment was that the only real incremental impact would have been on the defect refurbishment program. Page 22 of the Evans & Peck report provides quite a detailed assessment of the company's effort to calculate this. The defect program was the only one considered because over the regulatory determination period, most other CAPEX initiatives would be completed (remembering no guidance as to timeframes applicable to the cost pass-through application were supplied by the QCA).

On page 6, the QCA states that "if it were not for the obvious merit of the event itself....then much of this Application would fail to meet the Authority's information requirements". In fact, the QCA has issued no documented information requirements to Ergon Energy on pass-through requirements.

Moreover, the report by the QCA's own consultant, Evans & Peck indicates that Ergon Energy's supporting information was sufficient to enable the consultant to conclude that the expenditure based components of the claim were conservative and reflected prudent and efficient expenditure in the context of the difficulties created by the Cyclone Larry event. Evans & Peck also note that analysis of the data indicated that the total value for accelerated depreciation was reasonable.

On page 6, the QCA states that "the decision by the QCA (to not allow accelerated depreciation) does not impose any burden on Ergon Energy". In fact, it does. It materially disadvantages Ergon Energy as a consequence of being forced to remove assets from its asset base which it has paid for, not recovered through tariffs, and which are uninsured because the QCA refused to accept an allowance to insure them in the 2005 Final Determination.

4 Detailed Comments on the Draft Decision

4.1 2006/07 Costs

On page 7, the QCA notes that “the amounts claimed by Ergon Energy for 2006/07 for both operating and capital related expenses do not meet the materiality threshold set out in the Authority’s 2005 Determination”. This is incorrect.

The QCA’s 2005 Final Determination established a materiality threshold to apply to pass-through events. That materiality threshold was set at 1% of the aggregate annual regulated revenue per event, based on the regulated revenue in the year of the event. The QCA’s 2005 Final Determination states that the materiality threshold was introduced to limit the number of small pass-through claims (where the regulatory costs of administering the pass-through arrangements may be higher than the value of the claim).⁷

Ergon Energy believes that the QCA’s materiality threshold has been inappropriately applied to its 2006/07 operating and maintenance costs. This is for two reasons.

Firstly, Cyclone Larry was material and the costs consequent to it are significant. Whether those costs are material has nothing to do with the timing of the financial year.

As ENERGEX noted in its recent pass-through application for its FRC related costs, *“the QCA’s decision to apply a 1% materiality threshold to each year’s actual annual regulated revenue is arbitrary and unreasonable. For example, the application of the QCA’s materiality threshold could lead to a situation whereby an entire pass-through claim is rejected as immaterial simply because its costs are spread over 4 years, while a claim of similar total magnitude is assessed as material because its cost and revenue impacts are concentrated in 2 years. It is entirely arbitrary, because whether costs fall before or after 30 June in a year has very little to do with the materiality of those costs.”*

Further, ENERGEX noted:

*“...the materiality threshold was originally intended to prevent the QCA from having to assess a very small pass-through application for a very small event, not used to block one year of a multi-year cost consequent to a major unforeseen event. Such an approach appears both illogical and arbitrary.”*⁸

Secondly, the QCA has applied the materiality threshold incorrectly by applying it to the individual components within the pass-through claim, rather than the pass-through claim overall. While 2006/07 operating and capital expenditure were both less than 1% of the Aggregate Annual Revenue Requirement for 2006/07, the addition of accelerated depreciation costs for 2006/07 which have not yet been the subject of a Final Decision, makes the pass-through claim for 2006/07 “material”.

The QCA’s statement that no further consideration of the 2006/07 costs is necessary is without reasonable basis and should be reversed. It should also be noted that the independent consultants appointed by the QCA, Evans & Peck have found sufficient supporting data to conclude the 2006/07 costs claimed as part of the pass-through application to be incremental and to reflect prudent and efficient expenditures in the context of the Cyclone Larry event (see for example, page 3 of Evans & Peck Report).

⁷ QCA Final Determination: Regulation of Electricity Distribution (May 2005), page 49.

⁸ ENERGEX FRC Submission, section 3.4

4.2 Accelerated Depreciation

Ergon Energy does not agree with the QCA's Draft Decision to disallow accelerated depreciation and considers that there is no evidence or other material to reasonably justify the QCA's decision. The Decision contains no clear discussion, assessment of analysis of Ergon Energy's claim or the QCA's rationale for rejecting it or the approaches adopted by other jurisdictions and drawn to the QCA's attention by Ergon Energy.

Accordingly, Ergon Energy considers that the Draft Decision is contrary to the requirements of clauses 6.2.3 and 6.2.7 of the NER that the QCA must follow.

In the Draft Decision, the QCA state rejection of this component would not "impose any burden" on Ergon Energy. In the absence of clear reasons, Ergon Energy finds it difficult to develop a submission in response to the Draft Decision as it is uncertain as to the basis for the QCA's Draft Decision.

The only inference that Ergon Energy has been able to draw from the above-mentioned finding by the QCA is that the QCA suggests that the basis for including the claim would involve a demonstration that Ergon Energy is somehow disadvantaged. Ergon Energy believes this is not consistent with the 2005 Final Determination and is unable to identify any criteria set out in the 2005 Final Determination or the Draft Decision to require an assessment to be conducted as to whether Ergon Energy has been disadvantaged or 'burdened' by not allowing the claim for accelerated depreciation, when considering the process for general pass-through applications.

On page 13, the QCA states that "while Ergon Energy has undoubtedly lost a range of assets damaged beyond repair as a result of Cyclone Larry, at this point in time those assets remain in Ergon Energy's asset base and continue to earn a rate of return and to be depreciated as if they were still in use". This is not correct, and can be shown to be such.

The Supplementary Application makes very clear that future depreciation on disposed assets was removed from the pass-through application by removing the assets from the asset values from which the return on assets had been calculated.

Under the heading "*Incremental Depreciation Expense*", Ergon Energy stated that it had "*removed an amount for depreciation on assets that were disposed of during the period, on the basis of a 45 year average asset life. The net amount of depreciation is set out below. This adjustment was required in order to "back out" the depreciation on the disposed amounts that would have been included in the 2005 Determination. By backing out the depreciation on the disposed amounts, and including accelerated depreciation for the value of the assets as disposed, Ergon Energy has provided for the complete removal of the asset from the regulatory asset base*". The table provided in the Supplementary Application shows this numerically, as replicated below.

	2005/06	2006/07	2007/08	2008/09
Depreciation on new assets	121,836	263,515	284,269	292,115
Less Depreciation on disposed assets	0.00	88,458	181,799.50	186,817.16
Accelerated Depreciation	-	7,961,246	-	-
Net Depreciation on Cyclone Larry	121,836	8,136,303	102,470	105,298

However, even if Ergon Energy had not made the adjustment described above, the apparent logic behind the QCA's draft decision would still not hold. The assets that were destroyed by Cyclone Larry had a useful remaining life which extended beyond the end of this regulatory period. Had they not been destroyed, these assets would have remained within the regulatory asset base for a considerable time after the end of this current regulatory period and the depreciation payments to Ergon Energy would have 'paid back' the initial investment to construct and install the assets.

Under the QCA's proposed treatment, Ergon Energy would remove the assets from the regulatory asset base using the AER's roll-forward model at the end of this regulatory period as it does for all disposals and would forego all the remaining years of depreciation payments. This is a material amount of money - \$7.9 Million.

It is therefore difficult to see how the QCA could deduce that Ergon Energy would not be worse off by disallowing accelerated depreciation.

Ergon Energy's principal issue with the Draft Decision is that it does not seek to discuss whether accelerated depreciation is a legitimate cost, aside from the QCA's statement on page 14 that "if treated in isolation, this matter would not give rise to a cost pass-through event". Ergon Energy's clear and argued basis for these costs were set out in its Supplementary Application, and offered extensive precedent for accelerated depreciation on assets which have been removed or made redundant against a utility owner's best endeavours. For the sake of clarity, these are repeated below.

Firstly, Ergon Energy noted the Western Australian Economic Regulation Authority's (ERA's) acceptance of accelerated depreciation consequent to the under-grounding of electricity distribution assets, which caused above-ground assets to be redundant prior to the end of their useful lives. This is set out in paragraph 419 on page 122 of its Final Decision. This states that:

Western Power will apply accelerated depreciation in respect of those distribution assets that will be decommissioned as a result of the retrospective undergrounding project undertaken by Western Power on behalf of the Western Australian government.

Further, paragraph 406 of the Final Decision notes that:

For its revised proposed access arrangement, Western Power has implemented a treatment of redundant assets that is the same as the treatment applied by the Authority for the purposes of its Draft Decision. This treatment of redundant assets does not result in any financial loss to Western Power through an uncompensated write down of the value of the capital base. Rather, Western Power is compensated (in present value terms) for the removal of the value of redundant assets from the capital base by accelerated depreciation allowances of the same value.

Secondly, in its 2008 determination, the Tasmanian Energy Regulator (OTTER) determined that it would consider accelerated depreciation for assets identified by the distribution business as redundant or likely to become redundant during the regulatory control period⁹. This approach was consistent with the approach adopted by the ACCC in relation to electricity transmission businesses.

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[http://www.energyregulator.tas.gov.au/domino/otter.nsf/LookupFiles/Approach%20to%20the%20Calculation%20of%20Distribution%20MAR.pdf/\\$file/Approach%20to%20the%20Calculation%20of%20Distribution%20MAR.pdf](http://www.energyregulator.tas.gov.au/domino/otter.nsf/LookupFiles/Approach%20to%20the%20Calculation%20of%20Distribution%20MAR.pdf/$file/Approach%20to%20the%20Calculation%20of%20Distribution%20MAR.pdf), p.24

Thirdly, the ACCC's *Draft Statement of Principles for the Regulation of Transmission Revenues*¹⁰ provided that assets identified by a transmission business as "redundant", likely to become "redundant" or partially "redundant" would receive accelerated depreciation allowances and once fully depreciated would be removed from the regulatory asset base. The AER reflected this provision in its final revenue determinations for Transend¹¹, SPI PowerNet¹² and ElectraNet¹³ stating that it may compensate a TNSP for the expiry of the value of a transmission asset by allowing accelerated depreciation.

The QCA neither acknowledged nor considered any of these precedents in disallowing Ergon Energy's claim for accelerated depreciation on the assets destroyed by Cyclone Larry. The QCA's decision is therefore, at the least, not good regulatory practice having regard to the requirements of clause 6.3.2(e)(6) in terms of considering decisions by other jurisdictional regulators and any regulatory intentions previously expressed.

Ergon Energy further notes that the 2007 *Advanced Metering Infrastructure Price Review Consultation Paper No. 1: Framework And Approach* released by the Essential Services Commission in Victoria made provision for DNSPs to be able to charge for the costs of removing undepreciated meters from the regulatory asset base, consequent to the metering roll-out mandated by Government in Victoria. On page 23, the ESC notes that an "exit fee" is to be paid by a retailer to a distributor where a meter is removed. The Framework and Approach further notes that "The Commission must ensure, in the first regulatory period, that the established exit fee allows the distributor to recover in a lump sum payable upon the change in responsible person:

- the reasonable and efficient costs of removing the metering installation for which the distributor was the responsible person and
- the unavoidable costs (fixed and variable) that a prudent distributor has incurred or would incur as a result of the metering installation for which it was the responsible person being removed prior to the expiry of the life of that metering installation including:
 - the written down value of the meter (assuming that depreciation is calculated over 15 years on a straight line basis)
 - the proportion referable to that metering installation of the written down value of commissioned telecommunications and IT systems and

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[http://www.aer.gov.au/content/item.phtml?itemId=659998&nodeId=f5c277ba5d04828ea4e46c2c9633d5da&fn=Draft%20statement%20of%20regulatory%20principles%20\(27%20May%201999\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=659998&nodeId=f5c277ba5d04828ea4e46c2c9633d5da&fn=Draft%20statement%20of%20regulatory%20principles%20(27%20May%201999).pdf), p.25

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[http://www.aer.gov.au/content/item.phtml?itemId=661047&nodeId=0694451359e5cc7a99f82bb4fe76c3f5&fn=Decision%20\(17%20December%202003\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=661047&nodeId=0694451359e5cc7a99f82bb4fe76c3f5&fn=Decision%20(17%20December%202003).pdf), p.48

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[http://www.aer.gov.au/content/item.phtml?itemId=661095&nodeId=277999bc508cfd27aed9b6cfd56067e&fn=Victorian%20transmission%20network%20revenue%20cap%20decision%20\(11%20December%202002\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=661095&nodeId=277999bc508cfd27aed9b6cfd56067e&fn=Victorian%20transmission%20network%20revenue%20cap%20decision%20(11%20December%202002).pdf), p.4

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[http://www.aer.gov.au/content/item.phtml?itemId=660987&nodeId=49408c8eddf5ec2d4f2fd4c0fb5772c&fn=Decision%20\(11%20December%202002\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=660987&nodeId=49408c8eddf5ec2d4f2fd4c0fb5772c&fn=Decision%20(11%20December%202002).pdf), p.38

- The return on assets and depreciation are provided through metering service charges up to the removal of the meter and on the removal of the meter

On page 24, the ESC notes that “the relevant undepreciated capital costs are paid to the distributor by way of the written down value components of the exit fee. Therefore after the removal of the meter the distributor’s regulatory asset base no longer includes the value of the removed meter”.

5 Outcomes Sought by Ergon Energy

Ergon Energy seeks for the QCA to amend its Draft Decision in order to:

- Allow Ergon Energy’s 2006/07 operating and capital costs, as claimed. These costs meet the materiality threshold set out in the 2005 Final Determination and the costs have been found by the QCA’s independent consultant, Evans & Peck to be incremental and to reflect prudent and efficient expenditure ; and
- Allow Ergon Energy’s application for accelerated depreciation costs to be included in the pass-through amounts, as claimed. These costs are legitimate and are required to ensure that Ergon Energy is compensated for the depreciation costs of an asset over the life of that asset. The QCA’s rationale for excluding these costs is inconsistent with other Australian jurisdictions and without reasonable basis.

Ergon Energy also seeks to meet with the QCA to discuss development of process and other guidelines necessary to support cost pass-through applications and ensure that such applications are able to be developed with a clear understanding of the QCA’s information requirements.