REVIEW OF APT ALLGAS RESPONSE TO DRAFT DECISION ON FRC COST PASS-THROUGH

Prepared for

QUEENSLAND COMPETITION AUTHORITY

PB *Quality System:*

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SECTIONS

GLOSSARY

Capex	Capital Expenditure
FRC	Full Retail Contestability
FTE	Full Time Equivalent
GB	Gigabyte
Opex	Operating Expenditure
QCA	Queensland Competition Authority
QLD	Queensland
TJ	Terra Joule

EXECUTIVE SUMMARY

APT Allgas Energy Pty Limited (APT Allgas) owns the South-eastern Queensland and northern New South Wales gas distribution system which is regulated by the Queensland Competition Authority (the Authority). In June 2007, APT Allgas made an application to the Authority to pass-through costs to customers related to the introduction of full retail contestability (FRC) in Queensland. The Authority engaged PB to review the application and a report was finalised in April 2008 detailing PB's findings. The analysis and recommendations made by PB were considered by the Authority when making its *Draft Decision on APT Allgas's FRC Pass-through Application* published in September 2008.

In October 2008 APT Allgas responded to the Draft Decision and in December 2008 the Authority engaged PB to review the APT Allgas submission to the Draft Decision and to decide whether the new information provided in the submission would lead PB to revise its opinion of the prudent and efficient incremental costs of enabling FRC. PB requested further clarification on some of the issues raised by APT Allgas; answers to PB's questions were received in January 2009.

PB has considered the information provided by APT Allgas in its response to the draft decision along with the additional information provided by APT Allgas in response to PB questions. Based on the response to the draft decision and subsequent answers to PB's questions, PB recommends that the Authority makes three adjustments to the following categories of costs in its draft decision on pass-through of FRC costs.

Network Billing meters - This cost should be reduced from $1.011million to $853,000 to reflect the reduction in this category of expenditure identified by APT Allgas.

Overheads - Overheads should be increased from $360,000 to $523,000 to reflect the actual expenditure identified by APT Allgas.

Software Licencing - This cost should be increased from $923,000 to $1.181 million to reflect the evidence on invoiced licensing costs provided by APT Allgas.

The recommendations are for an allowance of total costs for the FRC project of $11.257 million, an increase of $263,000 above the Authority's draft decision of $10.994 million. Table 3-1 shows the original amount which APT Allgas applied to pass-through to customers for the costs of establishing systems to comply with FRC. The table shows PB's original adjustments to APT's figure together with the recommendations included in the Authority's draft decision. APT Allgas's proposed revisions to the Authority's figures are included together with PB's recommendation following analysis of APT Allgas's response.

1. INTRODUCTION

In September 2005 the Queensland Government announced its intention to introduce Full Retail Competition (FRC) into the Queensland retail gas market from 1 July 2007. In order to facilitate FRC, APT Allgas was required to undertake the development of new information technology systems and metering equipment to accommodate the requirements of the gas retail market rules.

The Queensland Competition Authority (the Authority) decided that the costs relating to the implementation of FRC would not be included in the access arrangement which will expire in 2011 but could be passed through to customers under a separate approved arrangement.

Consequently APT Allgas made a submission to the Authority in June 2007 outlining the level of costs which it wished to pass through to customers. Subsequently the Authority engaged PB to review the submission. PB's independent advice was considered by the Authority it its Draft Decision on the appropriate level of costs which the company should be allowed to pass through to customers. The Authority published its draft decision in September 2008. Subsequently APT Allgas responded to the Authority in October 2008. In its response, APT Allgas provided the Authority with more information on costs and highlighted several areas where it still disagreed with the Authority's findings.

1.1 SCOPE OF REVIEW

The Authority engaged PB to review APT Allgas's response to the draft decision paper. This paper presents PB's views based on the new information it has received.

1.2 REVIEW PROCESS

PB reviewed the submission to the Draft Decision made by APT Allgas. PB then prepared a set of questions for APT Allgas requesting clarification of information or additional information. PB received a response to the questions in January 2009. Parts of the response to the PB questions were provided by APT Allgas on a Commercial in Confidence basis.

This report considers the APT Allgas response to the Draft Decision and the APT Allgas response to PB's questions.

1.3 STRUCTURE OF THIS REPORT

Chapter 2 of this report outlines the main points made by the QCA in its draft decision and APT Allgas's response the draft decision. Chapter 3 sets out PB's review of APT Allgas's response and the clarifications which APT Allgas has made following PB's questions.

2. SUMMARY OF THE AUTHORITY'S DRAFT DECISION AND APT ALLGAS'S RESPONSE

2.1 THE QCA DRAFT DECISION

In September 2008 the Authority published its draft decision on the APT Allgas FRC cost pass-through application. The decision was based on an initial application for cost pass through by APT Allgas in July 2007. APT Allgas revised its application following a workshop in August 2007. The draft decision was also informed by advice from PB and submissions from stakeholders.

The draft decision proposed a total pass-through cost allowance of $10.994 million. This was less than the APT Allgas application for $21.927 million. The following sections summarise the different cost categories which were adjusted by the Authority and APT Allgas's response to the decisions taken.

2.2 CAPITAL EXPENDITURE

The APT Allgas proposed that $10.7 million in capital expenditure was required for IT systems it considered necessary to perform its functions under FRC. The Authority accepted $3.227 million as the appropriate capital cost to be passed through to customers. (This latter figure includes $1.357 million of costs for the Logica contract which were included as Opex in the original application but deemed to be more appropriately treated as Capex). The reasoning for this adjustment is set out under each cost category below.

2.2.1 Core systems expenditure

These costs relate to the purchase of new hardware and software as well as the costs associated with tailoring the IT systems to APT Allgas's requirements. PB considered that APT Allgas's application should be reduced by $500,000 because these costs related to a Maximo works management system which was optional and there was no certainty that the expenditure would take place.

The Authority noted that the costs to deploy a system (the PEACE system) that included the functionality of Maximo were included in the APT Allgas costs when the Authority approved the access arrangement in 2006.

The Authority stated that APT Allgas's cost pass through application should only be for the additional cost of providing any further capability that was not in the original proposal accepted as part of the access arrangement approval. The Authority therefore included the costs of Maximo for pass through but offset these by deducting the allowance for the PEACE system approved in the access arrangement. This in effect reduced the allowance for optional deployment costs by $500,000.

In its response APT Allgas stated that it believed that draft decision was flawed in its approach of deducting costs allowed for in the access arrangement from the new FRC system costs.

APT indicated that it is currently undertaking relevant works management processes manually but at a future point in time if automation is required it will seek to recover the costs of this IT system through the relevant access arrangement.

PB understands this to mean that APT Allgas has accepted the $500,000 reduction from its original core systems expenditure application.

2.2.2 Interval meter capex

The draft decision accepted APT Allgas's application for $828,000 for the installation of interval meters. However in order for these costs to be allowed in the final decision, the Authority stated that it required the company to identify the 31 sites involved and the original asset values for these sites.

APT Allgas's response identified the 31 interval metered sites. It stated that these sites were fitted with flow computers prior to 2000 and that given the age of this capital, its book value had been fully depreciated by the start of the FRC. It also stated that the original book value of this equipment was not known.

2.2.3 Internal and other costs

This category refers to the installation of network meters to delineate between the distribution network and embedded networks. APT Allgas proposed installing 205 network meters at a cost of $1,011,015. Additional costs for travel, vendor evaluation and IT code access were included in this category at a value of $304,547.

The Authority stated in its draft decision that APT Allgas had not provided sufficient information to demonstrate that all of the 205 inlet points required upgrading. The Authority required that APT Allgas provide information regarding the existing metering at each of the 205 points and furnish an explanation of why they needed upgrading. If the company was unable to justify the upgrade of all of the meters then the Authority stated that it would make an appropriate adjustment in its final decision.

APT Allgas responded by stating that on further investigation it was able to design alternative and lower cost metering solutions for 32 of the sites. It stated that the remaining 173 sites needed upgrading to delineate the network from consumer piping as well as to provide a reconciliation point for any un-metered supply. The 173 meters were installed at:

- multi-tenanted premises to provide a discrete metering point on locations which previously had meters located at various points around the building, and
- previously unmetered cooker customers.

APT Allgas proposed that the cost recovery for this item should be reduced from $1,011,000 to approximately $853,000 due to the reduction of the number of sites by 32.

2.2.4 Integration and GIS costs

The integration costs proposed by APT Allgas are associated with the costs of deploying the new IT systems within its businesses. Having had regard to PB's assessment of these costs the Authority made several reductions in its draft decision on the level of costs that should be allowed under this category.

Specifically, the Authority did not accept costs of $80,000 relating to new desktop/laptops for existing staff. It reduced allowed integration costs for additional staff from $50,000 to $33,000 because of the assessment that 7.5 new FTE staff and not 11.5 FTE staff as proposed by APT Allgas was appropriate. (see section 2.3.2 below). The Authority accepted PB's assessment that costs relating to the Maximo system upgrade should be reduced from $221,000 to $142,000 and that $500,000 should be excluded from the Maximo Hansen interface project and also that $170,000 of integration costs associated with that excluded project must also be excluded.

As it was unclear whether the $420,000 claimed for the Maximo project management costs related to the interface or the upgrade, these were excluded. The Authority also accepted PB's advice that "other integration costs' should be reduced to $102,000.

The Authority agreed with PB that there is insufficient evidence to support the argument that a GIS system is required solely to meet FRC obligations. The application for $1,908,000 of costs for a new GIS system was therefore rejected.

In total the Authority reduced allowed costs in this category from the $3.198 million applied for by APT Allgas to $403,000.

APT Allgas responded by stating that it had taken a prudent approach to integrating GIS into its new FRC systems. It stated, however, that it was undertaking a further review of the GIS system. If it decides to proceed with the system it will seek to recover the costs through the access arrangements and not through the FRC pass through.

2.2.5 Other Items

The draft decision accepted the application for $90,000 in costs for a new PABX telephone system but approved only $58,000 of the $69,000 applied for for user acceptance testing.

The Authority considered that a contingency allowance of $488,000 was not warranted given the fixed cost nature of the contracts and the fact that at the time of the draft decision the retail gas market had been open to competition for over one year.

APT Allgas stated that it has some concerns that the FRC cost recovery process has made no allowance for unforeseen operating costs and it may be warranted to make an allowance for this over the remaining period of the current access arrangement. APT Allgas also stated that due to the extent that Capex was not allowed then Opex should be increased to compensate for the disallowed Capex.

2.2.6 Overheads

APT Allgas proposed a 20% allocation ($1.1 million) to cover overhead costs associated with the introduction of FRC.

The Authority considered that it would be unlikely that FRC would place a significant burden on shared corporate services that would result in substantive incremental overheads. The Authority excluded all overhead claimed by APT Allgas for the purposes of its draft decision. It stated that it was open to APT Allgas to provide the necessary detailed information to support these costs.

In its response APT Allgas identified three items of expenditure it wished to be included in this category:

1. Actual external legal costs (Gadens Lawyers for Hansen and Logica contracts, advice on new FRC laws, Energex data separation for FRC etc) $73,916

2. Actual external Regulatory costs (Network Advisory services for tariff development work, FRC advice, FRC submissions etc) $71,900

3. Internal Regulatory cost (The APA Regulatory Manager, based in Sydney was on the FRC steering committee and involved in other FRC implementation and oversight activities, to which the manager dedicated approximately half a day a week for 12 months. During this period some of the work functions usually undertaken by the Regulatory Manager were met by outsourcing to contractors). The expense incurred is estimated at $17,000.

APT Allgas confirmed that these overhead costs were in addition to the Authority's allowance of $360,000 in the draft decision. It also stated that in addition to the above other senior APA officers were involved in FRC oversight but did not quantify the costs associated with this involvement.

2.2.7 Access arrangement allowance

The Authority stated that in approving the APT Allgas 2006 revised access arrangement it had included costs of $4.2 million to replace existing (pre FRC) IT systems with PEACE in 2006/07 to meet suggested FRC requirements. The Authority stated that "These costs are already being recovered in current prices. The IT systems now being proposed by APT Allgas to address FRC related purposes, share many of the functional capabilities of the system upgrades that were already recognised in the current access arrangement, creating the potential for significant costs to be double counted. Consequently the Authority has deducted these costs (in the year in which they were included) from the costs that have been accepted for pass-through".

APT Allgas stated that it 'believes the draft decision is flawed in its approach of taking costs allowed for in the access agreement and deducting them from the allowed costs for FRC systems. APT Allgas believes that some attempt should be made to identify the costs. Differences between the two systems should be identified. APT believes that to the extent that there is double-counting this should be addressed through the access agreement and not the FRC cost pass through approval".

"APT Allgas believes that costs of the new systems can be approximately allocated to those necessary for FRC and those not. It believes that the $4.2 million of system costs should be allowed in the FRC cost recovery process and then adjusted for the non-FRC related proportion (currently assumed to be 20%) at the time of the next access arrangement".

APT Allgas states that it would accept an approach where there is recovery of 80% of IT costs, which they state is the percentage of costs which Hansen has determined are FRC related. This percentage is based on an email dated October 23 2008 in which a representative from Hansen advised that "The percentage FRC functionality verses non-FRC functionality is 80% FRC and 20% non-FRC"

2.2.8 Depreciation

The Authority decided that in order to be consistent with the current access arrangement it considers that an economic life of five years is appropriate for APT Allgas's IT assets. The Authority has accepted an economic life of 25 years for domestic meters and 30 years for industrial meters.

APT Allgas did not respond to this decision.

2.3 OPERATING EXPENDITURE

APT Allgas's original application sought $12.429 million in pass through costs for Opex. Having redefined the $1.357 million Logica Contract as Capex, the Authority's draft decision was to allow $7.767 million for Opex cost pass through. The following sections outline the Authority's adjustments to the application figures.

2.3.1 FRC Implementation costs

These costs relate to the management, planning, issues resolution and solution finding related to the FRC project.

APT Allgas had included the proposed costs for its system integrator, Logica, in this Opex category. The Authority allowed the Logica costs of $1.357 million but agreed with PB that these should best be treated as capital costs.

With respect to project management, the Authority accepted PB's recommended costs for the project manager and IT manager of $200,000. This reduced the total allowed cost from $732,000 to $685,000.

APT Allgas did not respond to this decision.

2.3.2 FRC Staff

APT Allgas identified that it required 11.5 FTE staff to deal with new workflows resulting from the new FRC requirements.

PB took the view that 7.5 FTE posts would be reasonable given its assessment of the increase in workload. The Authority accepted PB's view stating that it was consistent with the extra staffing levels it had approved for Envestra.

APT Allgas responded that it did not agree that it should be benchmarked against Envestra for the following reasons:

- Envestra has previous experience in FRC systems and processes, and consequently has mature FRC business and IT systems and processes and existing interfaces with Vencorp;
- Envestra has more, and larger, networks which serve over 1 million customers and thus benefits from economies of scale and scope; and
- The APT Allgas FRC IT system is relatively basic, therefore it should be expected to incur relatively higher operational costs.

APT Allgas outlined its initial staffing, its proposed staff levels in its application, and its current staffing levels:

Role	Pre - FRC	Application	Present Situation
Mgr/Sup Roles	0	0.5	1.5
Market Services Mgr	0	1	1
Exceptions Mgt	0	1.5	1
Inquiries & complaints	0	1	1
HUB administration	0	1	1
Meter Data Mgt	0	2	2
Billing/Rev Mgt	1	1	1
New connections	3	4	5
Transfers & Market requests	0	1	0
Metering	2	2	2
Business improvement	0	0.5	Contractor 6 months – currently vacant
Support officers	4	5	4 plus one temporarily vacant
FRC Projects	0	1	
TOTAL FTE	**10**	**21.5**	**21**

APT Allgas gave more information on why it needed more than the original 7.5 FTEs:

"This increase in staff numbers from the start of FRC includes two staff in the Customer Connections team and a Business Improvement Analyst who was employed for 6 months under contract, to interrogate the FRC system, conduct testing for new releases and provide analysis for business reporting. This skill set is currently missing from the Market Services (FRC) team and consequently APT Allgas is looking to make this contractor role a permanent position to continue testing and enhancements to the system as well as improvement to business processes.

The consumer connections area has increased, with a team of 5 as well as a dedicated supervisor for these staff and the overall Consumer Connections Manager. This area has been more labour intensive than first estimated due to lack of automated systems and higher than expected interaction with retailers and end users. This increase is partially offset by the less than expected need for input into the transfer process which is highly automated.

Therefore, FRC numbers have currently increased by an additional 3 from the immediate post FRC situation of 17.5, with the need for an additional 0.5 for business analyst (with the costs for that position actually being incurred via contract labour in 2008)"

APT Allgas claims that the costs for these 3.5 staff above the Authority's draft decision of $742,000 per annum is an additional $346,267 per annum taking the total to $1,088,267 per annum.

2.3.3 IT operating costs

The Authority stated that in the absence of adequate information it could not make an informed decision regarding other proposed third party licensing costs of $327,000 and could not accept them for inclusion in the pass through costs at that time.

It was not clear to the Authority that the $203,000 costs attributed to Brennan IT resulted solely from FRC commitments. The Authority therefore disallowed them in its draft decision unless additional evidence was provided.

The Authority did accept that there was a need for APT Allgas to test its FRC IT solution as new retailers entered the market. However the Authority agreed with PB's assessment that APT Allgas staff should have developed the necessary skills and experience to assist new retailers by the time this is required. It did not therefore accept the $183,000 proposed by APT Allgas for future testing.

Subsequently APT Allgas provided details of the actual and estimated third party licensing costs in its response to the draft decision. In its response to PB's question on this item, APT Allgas provided the invoice from Hansen for this licensing. The invoice for the first year is for $166,172 (excl. GST). APT Allgas has estimated that the software licensing maintenance fees would be $30,465 per annum for the following three years. The total amount now claimed by APT Allgas is $258,000 above the $923,000 allowed by the Authority.

APT Allgas did not provide any additional evidence on Brennan IT costs or comment further on future testing costs.

2.3.4 Interval meter operating costs

APT Allgas stated that as a result of FRC they were required to employ a field technician at a cost of $90,000 per annum. In addition APT Allgas claimed costs for some in-house residual metering administration. APT Allgas also proposed costs increased costs associated with its commercial mobile phone and communications systems. In total APT Allgas sought costs of $1.041 million under this category.

In its draft decision the Authority decided to base its allowed revenue based on the analysis undertaken by PB into what would be an appropriate level of costs.

PB recommended that allowed costs for this category should be reduced to $786,000.

APT Allgas did not comment on this reduction in their response to the draft decision.

2.3.5 Market participation

APT Allgas identified a number of new market participation commitments associated with the introduction of FRC. These included participation in the Energy Ombudsman Queensland scheme, promoting and training of FRC procedure and processes for customers and industry, and attending meetings with the Department of Mines and Energy. APT Allgas applied for a pass through cost of $1.117 million for these costs.

The Authority took into consideration PB's recommendations of appropriate cost levels and also confirmed itself some cost obligations. The Authority decided that the allowed cost pass through should be reduced to $125,000.

APT Allgas did not comment on this reduction in their response to the draft decision.

2.4 REVENUE AND TARIFFS

The Authority's draft decision also set out how its decision would impact on the company's total allowed revenue (including the access agreement allowed revenue) and how this would be translated into tariffs.

APT Allgas did not comment on this part of the report.

3. PB'S REVIEW OF APT ALLGAS'S RESPONSE TO THE AUTHORITY'S DRAFT DECISION

Having had regard to the response by APT Allgas to the Authority's draft decision and APT Allgas's response to some questions of clarification submitted by PB, PB sets out in this chapter:

- Those issues where the Authority requested further information from the company, and the company's response.
- Those issues where PB has identified that the company is still in disagreement with the Authority's draft decision.
- PB's recommendation based on its analysis.

PB has assumed that where APT Allgas did not respond to draft decision proposals then APT Allgas accepts the Authority's decision.

The chapter concludes with a table setting out the adjustments to the FRC costs which have been made through the various stages of this application and concludes with PB's recommendation for an appropriate level of allowed cost pass-through.

3.1 ISSUES WHERE THE AUTHORITY SOUGHT FURTHER CLARIFICATION / EVIDENCE

3.1.1 Interval meter data correctors capex

In its application APT Allgas included the costs of installing correctors to 31 sites consuming greater than 100TJ per annum and a seven sub gates sites at a cost of $352,000. The draft decision paper stated that the Authority required the company to identify the 31 sites it had identified for interval meter installation and also provide the original asset values for these.

In its response APT Allgas identified the 31 sites and stated that these sites were fitted with flow computers prior to 2000 and that given the age of this capital, its book value had been fully depreciated by the start of the FRC. It also stated that the original book value of this equipment was not known.

APT Allgas further stated that the current book value of the interval data collection system on the 31 sites installed prior to FRC was zero and that it was applying for the full replacement value of these installations to be approved.

PB has previously recommended a depreciation period for meter telemetry systems of 5 years. The flow computers (meter correctors) previously fitted to the 31 sites comprise computer technology that quickly becomes obsolescent and therefore we consider the life of these flow computers to be similar to that of meter telemetry systems (5 years). Since the interval meter correctors for the 31 sites were installed prior to 2000 we consider that it is appropriate for these systems to be fully depreciated prior to FRC and to have no remaining asset value.

PB understands that the introduction of FRC has led APT Allgas to replace these flow computers (meter correctors) earlier than may have been the case had FRC not been adopted. PB believes that this expenditure is warranted to avoid running two separate systems at the same time and therefore the expenditure is a direct consequence of the introduction of FRC.

PB recommends therefore that the full replacement value, $352,000, for this cost item should be allowed as pass through.

3.1.2 Internal and other costs

The Authority required APT Allgas to provide information regarding existing metering at each of the 205 inlet points and an explanation of why these needed upgraded.

In their response to the Authority's draft decision, APT Allgas identified that it was able to design alternative and lower cost solutions for 32 out of the originally identified 205 sites requiring network meters. As the actual number of sites is less than the original submission APT Allgas proposed that the allowed costs for this item should be reduced from the previous allowed amount of $1,011,000 to $853,000. APT Allgas explained why the upgrade was necessary as described in section 2.2.3.

PB believes that, as APT Allgas has provided details of the 173 sites requiring upgrade, reasons why the upgrade is required, and the upgrade costs are consistent with the costs accepted in the draft decision, the figure of $853,000 should be allowed under the network billing meters category.

3.1.3 Overheads

In its draft decision the Authority allowed an amount of $360,000 that excluded many of the overheads claimed by APT Allgas. However, the Authority stated that "It is open to APT Allgas to provide the necessary detailed information to support these costs in responding to [the] Draft Decision".

APT Allgas's response detailed three items which it stated were deemed as overheads. These were

- Actual external legal costs (Gadens Lawyers for Hansen and Logica contracts, advice on new FRC laws, Energex data separation for FRC etc) $73,916

- Actual external Regulatory costs (Network Advisory services for tariff development work, FRC advice, FRC submissions etc) $71,900

- Internal Regulatory cost (The APA Regulatory Manager, based in Sydney was on the FRC steering committee and involved in other FRC implementation and oversight activities, to which the manager dedicated approximately half a day a week for 12 months. During this period some of the work functions usually undertaken by the Regulatory Manager were met by outsourcing to contractors). The expense incurred is estimated at $17,000.

APT Allgas confirmed that these overhead costs were in addition to the QCA's allowance of $360,000 in the draft decision.

PB believes that these costs appear to be reasonable for this type of advice and that such advice would be necessary when establishing systems to allow FRC. PB therefore proposes that the Authority allows these costs to be included in the total cost pass through allowance.

3.1.4 IT operating costs

In its draft decision the Authority stated that it accepts that licensing is a necessary part of an IT system and accepted APT Allgas's proposed vendor software licence costs of $923,000. however the Authority stated that "in the absence of adequate information, [it] could not make an informed decision regarding other proposed third party licensing costs of $327,000 and therefore could not accept them for inclusion in the pass-through at that time".

Subsequently APT Allgas provided details of the actual and estimated third party licensing costs in its response to the draft decision. In its response to PB's question on this item, APT Allgas provided the invoice from Hansen for this licensing. The invoice for the first year is for $166,172 (ex GST). APT Allgas has estimated that software licensing maintenance fees would be $30,465 per annum for the following three years. The total of the invoice from Hansen and the estimate of ongoing fees is $257,565

In response to PB's questions APT Allgas confirmed that there is an ongoing requirement to pay third party licence fees and that these were for:

- QAS Pro Web x1
- MS Windows Server 2003 x2
- IBM WebSphere MQ x2
- Microfocus Application Server x 2
- Oracle database Enterprise x 2
- HP Data Protector x2

PB considers that the company should be allowed to pass these necessary costs through to customers and that the estimates for the next three years are appropriate for this type of fee.

PB therefore recommends that the Authority allow a figure of $1,180,567 ($923,000 plus $257,567) for total software licensing fees.

3.2 ISSUES OF DISPUTE

PB has identified areas where APT Allgas disagrees with the Authority's draft decision paper.

3.2.1 FRC related costs approved in access arrangement

In approving the 2006 APT Allgas access arrangement the Authority included costs of $4.2 million to replace APT Allgas's existing (pre FRC) IT systems with PEACE in 2006/07 to meet ringfencing and other requirements such as FRC. The IT systems established by APT Allgas share many of the same functional capabilities of the system upgrades that were already recognised in the access arrangement. The Authority stated that this created the potential for double counting and consequently deducted this from the costs that have been accepted for pass through.

APT Allgas's response to this decision is outlined below:

> *APT Allgas believes the Draft Decision is flawed in its approach of taking all the costs allowed for in the Access Arrangement and deducting them from the cost of the Hansen system. APT Allgas believes that some attempt should be made to identify and costs differences - even if this attempt is imperfect. The Draft Decision appears to tacitly acknowledge that the two systems are not identical, as the Draft Decision takes the position that the two systems "share many of the same functional capabilities" - this position implies that while the systems may have similarities they also have some differences. These differences should be identified and costed separately if possible.*
>
> *APT Allgas strongly believes that the most appropriate time to review the expenditure outlined under the Access Arrangement is at the review of the current Access Arrangement in 2010 -2011. Costs incurred in relation to FRC should be recovered through the FRC recovery process, and to the extent there is the "double counting" anticipated by the Draft Decision this can be addressed via the Access Arrangement process.*
>
> *Section 3.3.4 of the Access Arrangement provides for the recovery of FRC related costs separate to the assessment of costs under the Access Arrangement. The recovery of FRC related costs is intended to allow a recovery of all prudent costs relating to the development, implementation and operation of FRC related systems and activities, including IT systems, so that service providers such as APT Allgas, are not required to bear the cost consequences of a government policy decision. APT*

> *Allgas considers that if a FRC system was to be built without any pre-existing IT, which it was, then the total costs of the IT system should be included as FRC costs.*
>
> *However, APT Allgas appreciates that such an IT system could be considered to have the two purposes - one related to FRC and the other related to more general network information management and operations. The Draft Decision takes the approach that the $4.2 million allowed for IT in the Access Arrangement has not been allocated between FRC related costs and general network operations as there has been no information provided to assist in the allocation. Consequently the Draft Decision makes the assumption that, in the absence of an allocation, none of the $4.2 million must be FRC related. APT Allgas believes that this reasoning is flawed. To the extent an allocation can be made, even if it is not without doubt, then the allocation should be used. APT Allgas previously sought the advice of the system provider on what the relevant cost split could be considered to be. Hansen in an email dated 23 October 2008 advised that:*
>
> *"The percentage FRC functionality versus non-FRC functionality is 80% FRC and 20% non FRC".*
>
> *APT Allgas believes that, for the reasons outlined above, all of the $4.2 million of costs should be allowed in the FRC cost recovery process and then adjusted for the non FRC related proportion (currently assumed to be 20%) at the time of the next Access Arrangement.*
>
> *Alternatively, given that there is an allocation of the $4.2 million between FRC related costs (80%) and general network operations (20%), this allocation could be used to more accurately apportion the costs than the current Draft Decision approach, which assumes that none of the $4.2million is FRC related.*
>
> *APT Allgas would accept an alternative approach where there is recovery of 80% of IT costs, which is the percentage of costs Hansen has determined are FRC related. Note that this email was effectively a re-statement of a previous email from Hansen in 2007.*

In seeking clarification of the Allocation of costs PB asked APT Allgas to provide the basis for the 80/20 split outlined in the one line email quoted above.

APT Allgas replied

> *This split was based on advice sought and received from the solution vendor. APT Allgas sought advice as to the percentage FRC functionality verses non-FRC functionality in the solution vendor's system. Attachment 1 provides specific detail on the breakdown of modules related to FRC versus a replacement billing system.*
>
> *In short, when one considers the functionality and the incremental cost, a simple replacement billing system would have cost about 20% of the value of a compliant FRC system due to complexities in interfacing and customisation to suit the specific QLD market rules.*

PB believes that an important consideration in this matter is to ensure that the customer does not pay twice for IT systems, once through the access arrangement and again through the FRC cost pass-through.

In PB's assessment, APT Allgas has made two main arguments:

1. That any allowances made in the access arrangements should be revisited at the time of the next access arrangement review

2. That the expenditure on the Hansen systems can be allocated to FRC necessary (in which case they should be allowed as a cost pass through) and non-FRC related (in which case they should not be passed through).

PB believes that in situations like this the first argument is not valid. Under the prevailing regulatory regime in Australia the Regulator sets controls on regulated companies which are designed to reward efficient and prudent expenditure with the aim of allowing a company sufficient revenue to cover costs which a company in an competitive market would be expected to face. In setting an allowed revenue under an access arrangement, the Regulator takes into account the predicted future capital expenditure requirements of the company. Under this incentive regime it is always possible for the company to increase its profits by not undertaking the forecast capital expenditure (while delivering the agreed level of service). The regime is designed so that cost savings through reduced capital expenditure are captured for the customers at the time of the periodic reviews. One of the basic principles of this Regulatory arrangement is that the Regulator does not attempt to 'claw-back' capex underspends from the previous period. Doing so would undermine the nature of the incentive and increase the risk to the regulated companies.

A risk in this incentive arrangement is if the Regulator mistakenly sets too generous a capex allowance based on the belief that all identified projects are necessary, then if it turns out that the expenditure is not necessary, this simply leads to greater profitability for the company at the expense of customers. The companies are always in a better position to identify their capital requirements than the Regulator.

In this instance it appears that the Regulator did allow an element of expenditure in the access agreement which with hindsight was patently not necessary given the subsequent development of the Hansen systems which undertake the same functions.

PB believes that the Authority is justified in deducting the amount of costs to be passed through in the FRC project by the amount already awarded in the access arrangements. PB notes that the Authority subtracted all costs relating to the PEACE system when it considered Envestra's FRC cost pass-through application and therefore this action is not without precedent.[1]

APT Allgas has proposed that the Authority should not deduct any of the $4.2 million allowed in the Access Arrangement but should deduct the portion of the current IT expenditure that is not FRC related. The method proposed by APT Allgas to determine which portion of the expenditure is FRC related and which portion is non-FRC related is based on an allocation of functionality. If the Authority were to allow an amount in the FRC cost pass-through based on the portion of IT costs that relate to FRC functions and the portion that do not relate to FRC functions, the split of costs would need to be determined on a reasonable basis. One method that might be considered to apportion costs would be to assume that APT Allgas had already implemented the Hansen system as its meter data and billing system before FRC commenced (rather than the PEACE system proposed at the time of the access arrangement). The cost of implementing the Hansen system could then be estimated and compared with the actual cost incurred by APT Allgas to implement an FRC ready system and, from the difference in the two costs, the portion relating to FRC could be determined. Another method might be to assume that APT Allgas had already implemented the PEACE system as its meter data and billing system before FRC commenced and then to estimate the cost of modifying the PEACE system to accommodate the required FRC functionality. PB notes that, had this second method of estimating the cost been adopted, that the cost of implementing the required FRC functionality may have been minimal as PEACE is a system commonly adopted by utilities to manage FRC functionality.

APT did not adopt either of the approaches described above. Instead APT Allgas has proposed that the split of costs should be based on an allocation of 80% to FRC and 20% to non-FRC. In its response to the draft decision APT Allgas cited a one-line email from

[1] QCA : APT Allgas FRC cost pass-through Application : Draft Decision September 2008 p10

Hansen as the source of the 80/20 apportionment. In response to PB questions, APT Allgas provided an allocation of the system functions provided by the Hansen HUB modules and these were approximately split in 83% of functionality required to meet Queensland gas industry requirements for FRC and 17% of functions for additional APT processes. This method of apportionment is not based on costs. From the information provided PB has no way of telling which functions are major and require a lot of expenditure and which are trivial. PB does not consider that the method proposed by APT Allgas is an appropriate method of allocating costs between FRC and non-FRC tasks in the Hansen system.

PB considers that APT Allgas has not provided sufficient information to support its proposed cost split between FRC and non-FRC. Further APT Allgas has provided no evidence that its implementation of the Hansen system incurred any additional cost than that which would not have been incurred had it proceeded to implement a modern IT system such as PEACE following the access arrangement.

PB concludes therefore that the Authority is justified in deducting the $4.2 million already allocated in the access arrangements from the FRC pass through allowance.

3.2.2 Increased FRC staff

The Authority accepted PB's recommendation that an additional 7.5 FTE staff would be required to manage the additional workload resulting from the introduction of FRC. PB believed that 7.5 new staff members represented an efficient resourcing level. In its second application in June 2007 the staffing levels proposed by APT Allgas had increased to 11.5 FTE without any explanation being given.

As noted in section 2.3.2 APT Allgas has now given an explanation of the new roles and functions it considers necessary with the introduction of FRC.

In addition APT Allgas answered the following questions from PB as follows:

The original APT Allgas submission assumed that 0.5 FTEs would be required for management/supervision roles. This has now increased to 1.5 FTEs. Why has the need for management/supervision relating to FRC increased so significantly?

APT Allgas response:

> *APT Allgas made the initial estimation of management time required to facilitate FRC systems and processes based on actual market experience. Since the introduction of FRC actual experience has shown a much greater requirement for supervision than initially anticipated, partially due to the lack of automated interfaces in some processes, and the requirement for extra staff in these areas (e.g. works order management and new connections supply investigations)*

What level of additional enquiries and complaints is being experienced to require an additional FTE to process these FRC related enquiries and complaints?

APT Allgas response:

> *A significant increase in the number of enquiries coming primarily through retailers from End Users and from retailer internal staff has occurred with the introduction of FRC due to changes in processes and systems. For the second half of 2007 alone, APT Allgas received 1,122 manual MIRN discoveries via email. To date, in 2008 we have received 5,004 manual MIRN discoveries (via email). Also in excess of 2,000 general enquiries have been received via email from customers/retailers for reasons ranging from next scheduled read dates, FRO enquiries, Ombudsman referrals, Retailers Ombudsman referrals, MIRN/Meter status and updates on service (this number does not include phone enquiries).*

The effort required to manage new connections will be dependent upon both the level of manual effort required to process the new connections and the volume of new connections. What volume of new connections is APT Allgas experiencing?

APT Allgas response:

New connection numbers for FY08 were 3,055 and FY09 is currently forecast to be 3,433.

What is the role of "Support Officers" in relation to FRC?

APT Allgas response:

Support Officers are responsible for the issuing, coordination and closing of market service orders received through the FRC systems such as disconnection orders, reconnection orders, meter/service relocations and other activities not associated with new connections or meter reading. A Support Officer is located in each of the regional areas to support activities in each respective area.

The Authority noted in its draft decision that APT Allgas suggested that the increased workload would arise from an additional 7,500 customer transfers per year, 38,375 services orders per year and 6,500 weekly meter data transactions.

From the answers to PB's questions it appears that Allgas is not experiencing significant volumes of transaction in excess of forecast.

In its draft decision the Authority noted that an additional 7.5 FTE staff was consistent with the additional staffing approved by Envestra. APT Allgas responded that it believes a direct comparison of staffing levels between Envestra and APT Allgas is not valid as:

- Envestra has previous experience in FRC systems and processes, and consequently has mature FRC business and IT systems and processes, and existing interfaces with Vencorp;
- Envestra has more, and larger, networks which serve over 1 million customers and thus benefits from economies of scale and scope; and
- the APT Allgas FRC IT system is relatively basic, therefore it should be expected to incur relatively higher operational costs.

The company further argued that it has a much smaller network footprint and is new to the FRC environment, therefore it is reasonable to assume that the number of staff required to operate in the market should be more than a larger network organisation that has been through the FRC process a number of times in other jurisdictions.

PB remarked in its previous assessment of FRC related staff costs that it considered that there would be a period of bedding down of systems and processes during which there would be a requirement for some additional staff and made an allowance for two FTE staff for a period of six months to cover this.

None of the information received from APT Allgas subsequently has led PB to revise it opinion of the appropriate number of staff required to meet FRC requirements. Based on (i) the information provided on the levels of transactions with customers and (ii) the benchmarking with other companies, PB can see no justification for such a high staffing level. PB recommends therefore that the Authority retains its proposed allowance for FRC staffing costs made in the draft decision.

3.3 ISSUES WHERE APT ALLGAS HAS ACCEPTED THE DRAFT DECISION

3.3.1 Core systems expenditure

As noted in section 2.2.1 the Authority reduced the proposed allowance for optional deployment costs by $500,000. APT Allgas indicated that is currently manually undertaking relevant works management processes and will seek to recover costs of any automated IT system through the relevant access arrangement.

PB understands this to mean that APT Allgas has accepted the $500,000 reduction from its original core systems expenditure application.

3.3.2 Integration and GIS costs

In total the Authority reduced allowed costs in this category from the $3.198 million applied for by APT Allgas to $403,000.

APT Allgas responded by stating that it had taken a prudent approach to integrating GIS into its new FRC systems. It stated, however, that it was undertaking a further review of the GIS system. If it decides to proceed with the system it will seek to recover the costs through the access arrangements and not through the FRC pass through.

PB therefore believes that it is appropriate that $403,000 is allowed in total for this cost category.

3.3.3 Other items

APT Allgas stated that it has some concerns that the FRC cost recovery process has made no allowance for unforeseen operating costs. However in the absence of any further information on costs PB can see no justification for making an allowance for unforeseen operating costs.

PB does not consider there is sufficient justification to increase costs in this category above the allowance of $148,000 in the draft decision.

3.3.4 Depreciation

As APT Allgas did not respond to this item, PB understands this to mean that APT Allgas accepts the Authority's draft decision.

3.3.5 Interval meter operating costs

As APT Allgas did not respond to this item, PB understands this to mean that APT Allgas accepts the Authority's draft decision.

3.3.6 Market participation

As APT Allgas did not respond to this item, PB understands this to mean that APT Allgas accepts the Authority's draft decision.

3.4 PB'S RECOMMENDATION

Table 3-1 below shows the original amount which APT Allgas applied to pass through to customers for the costs of establishing systems to comply with FRC. The table shows PB's original adjustments to APT's figure together with the recommendations included in the Authority's draft decision. APT Allgas's proposed revisions to the Authority's figures are included together with PB's recommendation following analysis of APT Allgas's response.

Based on the response to the draft decision and subsequent answers to PB's questions, PB recommends that the Authority makes three adjustments to the following categories of costs in its draft decision on pass through of FRC costs.

Network Billing meters

This cost should be reduced from $1.011million to $853,000 to reflect the reduction in this category of expenditure identified by APT Allgas.

Overheads

Overheads should be increased from $360,000 to $523,000 to reflect the actual expenditure identified by APT Allgas.

Software Licencing

This cost should be increased from $923,000 to $1.181 million to reflect the evidence on invoiced licensing costs provided by APT Allgas.

The recommendations are for an allowance of total costs for the FRC project of $11.257 million, an increase of $263,000 above the Authority's draft decision of $10.994 million.

Table 3-1 APT ALLGAS COST PASS THROUGH APPLICATION FOR FRC

	APT Allgas Application	PB Recommended costs	QCA Draft Decision	Allgas response	PB further recommendation
CAPITAL EXPENDITURE					
Core Systems					
Fixed Deployment Costs	1,200	1,200	1,200	1,200	1,200
Allowance deployment costs	900	900	900	900	900
Optional deployment costs	647	147	147	147	147
Modification allowance recommended by Hansen	400	400	400	400	400
Travel allowance	55	55	55	55	55
Change Requests	49	49	49	49	49
Hansen Related	263	263	263	263	263
	3,514	**3,014**	**3,014**	**3,014**	**3,014**
Interval Meter capex					
Interval meters	301	301	301	301	301
Interval meter data correctors	352	352	352	352	352
SCADA system works	123	123	123	123	123
Interval meter data collection	28	28	28	28	28
Project management costs	25	25	25	25	25
	829	**829**	**829**	**829**	**829**
Internal and other costs					
Network billing meters	1,011	1,011	1,011	853	853
Travel	177	177	177	177	177
Vendor Evaluation, system design	125	125	125	125	125
ESCROW agreement	3	3	3	3	3
	1,316	**1,316**	**1,316**	**1,158**	**1,158**
Integration and GIS costs					
Integration costs - servers	42	42	42	42	42
Integration costs laptops, desktops etc	102	102	22	22	22
Integration costs for additional FRC staff	50	50	33	33	33
ARC FM GIS system	62	62	62	62	62
Maximo system upgrade	221	142	142	142	142
Maximo Hansen interface estimate	670	0	0	0	0
Maximo project manager	20	0	0	0	0
Other integration costs	123	102	102	102	102
GIS	1,908	0	0	0	0
	3,198	**500**	**403**	**403**	**403**
Other Items					
PABX Telephone	90	90	90	90	90
UAT	69	58	58	58	58
Contingency	488	0	0	0	0
	647	**148**	**148**	**148**	**148**
Overheads	**1,150**	**717**	**360**	**523**	**523**
TOTAL CAPITAL EXPENDITURE	10,654	6,524	6,070	6,075	6,075
minus FRC related costs approved in access arrangement	0	-4200	-4200	-840	-4200
plus Capitalisation of LogicaCMG costs	1,357	1,357	1,357	1,357	1,357
TOTAL CAPITAL EXPENDITURE	**12,011**	**3,681**	**3,227**	**6,592**	**3,232**
OPERATING EXPENDITURE					
FRC Implementation					
LogicaCMG costs - now capitalised above					
Project Management (incl 486 of project establisment)	732	685	685	685	685
AGL testing	184	184	184	184	184
	916	**869**	**869**	**869**	**869**
FRC Staff					
Additional FRC staff	5,341	3,260	3,260	?	3,260
Increased call centre staff	576	0	0	?	0
	5,917	**3,260**	**3,260**	**4,300**	3,260
IT operating Costs					
Hosting	1,804	1,804	1,804	1,804	1,804
Software licensing	1,250	923	923	1,181	1,181
Brennan IT support & management	203	203	0	0	0
New entrant retailers	183	0	0	0	0
	3,440	**2,930**	**2,727**	**2,985**	**2,985**
Interval meters	**1,039**	**786**	**786**	**786**	**786**
Market Participation					
promotion and training	550	0	0	0	0
Ombudsman scheme	460	377	85	85	85
DME & Vencorp post FRC committee	107	107	40	40	40
	1,117	**484**	**125**	**125**	**125**
TOTAL OPERATING EXPENDITURE	**12,429**	**8,329**	**7,767**	**9,065**	**8,025**
TOTAL EXPENDITURE	**24,440**	**12,010**	**10,994**	**15,657**	**11,257**