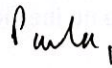


04 March 2015

Ms Paula Conboy
Chair
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Ms Conboy 

ActewAGL Distribution submissions on the AER's Draft Decision ActewAGL distribution determination 2015-16 to 2018-19

Thank you for the opportunity to present our key concerns to you and the AER Board, as well as the General Managers, on 26 February 2015.

I would like to address the following four issues that arose out of our discussion with you and other Board members on 26 February: who should bear the costs of any transition to the AER's efficiency frontier; the correctness of the AER's approach to assessing forecast operating expenditure (**opex**) and its reliance on benchmarking; the AER's obligation under the Work Health and Safety Act 2011 (Cth) (**WHS Act**); and the opportunity for further engagement before the final decision is made.

Several of these matters are addressed in the Counsel Opinion¹ provided to you on 13 February 2015. I urge the AER Board to read this important opinion, which highlights how the AER misconstrues the opex setting process and makes a number of errors that lead to the decision being unlawful.

Who pays for the costs of transition

In response to your question posed to me last week about who is to pay the costs of any "inefficiency" involved in transition to a new level of efficient opex, ActewAGL Distribution drew the Board's attention at our meeting to some specific points in the opinion of Neil Young QC attached to our submission. Counsel's opinion is powerful in its simplicity, and I recommend that the Board takes the time to consider it. To encapsulate the key point, the premise of the question is false: if the final decision is made in accordance with the NER, the issues of a glide path and of who pays for any "inefficiency" involved in a transition do not even arise for consideration. The specific points we mentioned are at paragraphs 88 onwards of the opinion.

Counsel reason (at paragraphs 90 to 92) that, in the present circumstances, having regard to in particular to *"the magnitude of the reduction in opex determined by the AER in its Draft Decision, its retrospective effect, its sudden impact, and the submissions made by ActewAGL about the effect of the Draft Determination on its ability to ensure the safety and reliability of its services"*:

"...the AER not only has the power to consider endogenous factors particular to ActewAGL in making its decision under clause 6.5.6 and 6.12.1(4)(ii) of the NER, but in our view is required to do so."

Some of this is particularised at paragraph 88:

¹ N Young QC and A McClelland, *Memorandum of Advice in the Matter of ActewAGL Distribution, - AER Draft Decision on Operating Expenditure for 2015 to 2019 Regulatory Control Period*, 13 February 2015.

"...the AER has an obligation to consider the manner in which ActewAGL has structured its business in reliance on previous determinations made by the AER, and its ability to transition to much lower levels of opex immediately."

Counsel concludes (at paragraphs 95 and 96) that, as a consequence of the AER's obligation to consider endogenous factors including the time and costs required to allow ActewAGL Distribution to restructure in an orderly way, its efficient expenditure properly assessed and determined would reflect those factors such that:

"...there would not be a formal "glide path" to lower levels of opex; rather, it would be implicit in the distribution determination that opex was being allowed at a higher level than might be incurred in later regulatory control periods, because of transitional issues that it may not be appropriate to take into account in those future regulatory control periods".

As we read Counsel's opinion, a decision on ActewAGL Distribution's opex allowance made in accordance with the NER would obviate any need to consider a glide path and would also obviate the question of who bears the costs of any "inefficiency" implicit in a transition. There would be no inefficiency to consider in that decision.

ActewAGL's current business structure was developed in good faith reliance on the AER's prior determinations on what is efficient opex, and if it is required to align its expenditure with a reduced level of opex determined by a new and substantially different method, then the reasonable costs incurred by ActewAGL Distribution in the course of doing so must be considered to be efficient. Such a result would be consistent with the NEO, in that the AER's decision would otherwise-

- have the serious adverse effects on safety and reliability described in detail in our RRP and submission; and
- deter, rather than create incentives for, efficient investment.

It is almost impossible to believe that the contemplated decision on ActewAGL Distribution's expenditure allowances, which introduces such a large and uncompensated risk into the industry, could promote efficient investment, or would allow a return commensurate with that risk as required by the NEL. All the more so bearing in mind that if a decision that assesses opex on day one of a new regulatory period as materially inefficient compared with efficient on the day before, it is plain that this could recur at the next regulatory reset. This would be a new regulatory paradigm quite lacking the essential predictability to which you referred in your recent CEDA address on 17 February 2015. It is very difficult to see how the NEM regulatory regime ever contemplated such large step changes between regulatory periods.

Assessment of ActewAGL Distribution's forecast opex and reliance on benchmarking

Secondly, at the meeting you stated that the AER can make a substitute decision if it is satisfied that it cannot rely on a DNSP's forecast. This statement is, frankly, non-responsive to the issues raised by ActewAGL Distribution regarding the legal and reviewable errors inherent in the AER's approach in the Draft Decision to assessing ActewAGL Distribution's forecast opex.

In particular, in the Counsel Opinion, Counsel conclude (at paragraph 5) that the manner in which the AER assessed ActewAGL Distribution's forecast opex was inconsistent with the Rules 'in that it involves adopting the AER's own benchmarked reports as the primary reference point for making those decisions, and gives little or no weight to ActewAGL's forecast opex'. Counsel put the point in slightly different terms in concluding (at paragraph 37) that 'the AER has adopted, as its starting position, the benchmarked results, and assessed ActewAGL's forecast against that, rather than assessing ActewAGL's forecast opex against the range of opex factors prescribed by clause 6.5.6(e) of the NER'.

As set out in its draft decision,² the AER's assessment of the business' opex is driven by a comparison to an alternative estimate using benchmarking. Counsel opines on the AER's approach at paragraphs 28 to 31 as follows:

'The AER's stated methodology ... inverts the approach required by the NER. The AER's stated methodology involves using the AER's own forecast, derived from its benchmarking reports, as the starting premise for determining whether the DNSP's forecast reasonably reflects the opex criteria in clause 6.5.6(c) of the NER.

The AER has assumed, in particular, that "if the service provider's inputs and assumptions are reasonable, its method should produce a forecast consistent with our estimate". That is to say, the AER has adopted, as a starting premise, the assumption that its own forecast is correct. ...

...

...the terms of clause 6.5.6 of the NER, as well as the statement by the AEMC referred to in paragraph 27 above to the effect that the DNSP's proposal is "necessarily the procedural starting point" for determining forecast opex, is inconsistent with the AER's methodology.'

Counsel further reasons (at paragraphs 62 to 63) that the AER is not 'at large' in being able to reject a DNSP's proposed opex and replace it with its own but must instead have regard to the DNSP's forecast opex when determining a substitute opex, concluding at paragraph 64 that:

"There is nothing in the Draft Decision to suggest that the AER considered that the ActewAGL's forecast opex, and the reasons advanced in support of it, had no probative weight. Accordingly, the AER ought to have had regard to that forecast opex, and to the extent that the AER determined to depart from it, advanced reasons for doing so."

Counsel also conclude that the primary reliance placed on benchmarking by the AER in its Draft Decision is unreasonable in that it:

- elides a proper consideration of the opex factors in clause 6.5.6(e) of the Rules, in that '[t]he AER's methodology appears to assume that its own forecast, derived from its benchmarked results, is consistent with all the opex factors, without giving proper and discrete regard to each of them' notwithstanding that '[o]f itself, the magnitude of the reduction of forecast opex that the benchmarked results indicate should occur, ought to have caused the AER to have extensive regard to all of the factors prescribed by clause 6.5.6(e) of the NER' and 'the benchmarked results depart significantly from opex allowed in previous distribution determinations, and where there is no suggestion in the Draft Decisions that those decisions were incorrectly made' (Counsel Opinion at paragraphs 39 to 45 including in particular paragraphs 42 and 44);
- also elides a proper consideration of the opex criteria in clause 6.5.6(c) of the Rules, in that 'the AER appears to have assumed, for the purposes of its analysis, that each of the opex criteria in sub-clause 6.5.6(c)(1)-(3) of the NER can be conflated into a single criterion of productive efficiency' and to have 'adopted, as a starting premise, the assumption that benchmarked results properly reflect each of the opex criteria' (Counsel Opinion at paragraphs 46 to 56 including in particular paragraphs 53 and 55).

The AER then concludes that a DNSP's forecast does not reflect the opex criteria if the forecast is not consistent with the benchmarking estimate. This not only inverts the process envisaged in the Rules, as Counsel Opinion notes, but it assumes that its own forecast using benchmarking is correct—and it is not—and places the onus on ActewAGL Distribution to provide an explanation *after* the Draft Decision was made. It is no surprise that the eminent economist Greg Houston concludes that:

"the AER's contention that changes of such magnitude—driven primarily by cuts in allowances for capital expenditure, operating expenditure and the rate of return—can meet the NEO requirement stretches credulity.....the future operating expenditure arrangements completely undermine

² AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November page 7-12.

ActewAGL's incentive to improve efficiency, and, in some circumstances, provide incentives to engage in inefficient behaviour."³ (emphasis added)

At the meeting last week, the AER Board also debated the question of which benchmark to use, given that no one model is better than the other. This question appears to be predicated on the AER's insistence that it must make deterministic use of benchmarking. This is despite the weight of expert evidence presented by DNSPs that concludes that the quality of the data, flaws in the econometrics and a number of other shortcomings in the AER's benchmarking analysis, including omission of explanatory variables and failing to capture differences in networks, operating conditions and business practices, should properly result in the AER adopting a cautious approach and not giving such primacy to the benchmarking analysis.

Instead, the AER seems to be forging ahead blinded by the initial set of flawed econometric results from its advisors. As ActewAGL Distribution stated at the meeting, if the AER were minded to look at alternative models that demonstrate the range of benchmarking outcomes, a very different set of discussions and decisions would follow. There is no doubt that in the presence of alternative benchmarking results, the AER must place a significantly lower reliance on benchmarking to set opex allowances, if not discard it altogether in favour of revealed costs emanating from a regulatory system with an opex incentive scheme.

The AER's heavy reliance on benchmarking is completely contrary to the advice provided to us by the AER Board at our meeting on 5 August 2014 where it was stated that there were 'thousands' of benchmarking measures⁴, that the AER would rely on a limited number of them, that some will favour us and some won't but it would be unbiased and all balance out, and it was confirmed again as well that the AER would take a cautious approach to the benchmarking results. ActewAGL Distribution is very concerned that the few measures being used are all biased against us and don't properly reflect or account for our operational circumstances. Whilst you were correct to point to the (limited) adjustments made to ActewAGL Distribution's base year opex for capitalisation and backyard reticulation, perhaps you are less aware that these adjustments were applied incorrectly in the making of the post-model adjustments, and that the AER omitted a large number of other adjustments evidenced before the AER without justifying its reasons (including correcting the benchmarking for our businesses by excluding significant one-off costs in the base year opex).⁵

Furthermore, the AER's Draft Decision for opex relied on other cost analyses performed (including assessment of labour and vegetation management cost), and an understanding of the business that was reached, without once visiting ActewAGL Distribution. The resulting desk-top analysis by what ActewAGL Distribution believes to be the AER's relatively inexperienced or junior staff is (naturally) devoid of sufficient understanding of operations, how different distribution networks are designed and maintained and the realities of labour practices and workforce management. In contrast, there is no substitute for having AER suitably qualified experts review the expenditure proposals face-to-face with our managers on-site, a practice that worked well in the past, to understand, as a basic step, whether a 42 per cent gap to the frontier is pure inefficiency or unexplained differences that need to be evaluated further.

AER's safety obligations under the WHS Act

The third concern I wish to raise is the AER's position under the WHS Act. At our public meeting on 9 December last year, it was noted that the AER is the economic regulator and information was sought from ActewAGL Distribution about how the AER is responsible for safety. That information was

³ HoustonKemp, *AER Determination for ActewAGL Distribution – Contribution to NEO and Preferable NEO Decision*, February 2015, page 48.

⁴ As referenced in ActewAGL Distribution's response to the AER's site visit questions, 3 October 2014

⁵ Refer to ActewAGL Distribution response to the AER of 3 October 2014, Section 3 of ActewAGL Distribution's Revised Regulatory Proposal and expert report from Advisian.

provided in our submission dated 13 February, in the form of an opinion from Michael Tooma⁶ of Norton Rose Fulbright and a second report from AECOM.⁷

Mr Tooma stated that:

- the AER is required to ensure, so far as reasonably practicable that the health and safety of both its workers and other persons is not put at risk as a result of the AER decisions and that this requires the AER to adopt a risk management approach to its decisions; and
- if the AER is put on notice of the specific safety impacts of a particular decision, and yet proceeds with that decision, it will be in breach of the WHS Act.

The (second) AECOM report was included in the 13 February 2015 submission to provide the AER with additional details⁸ of the expected safety impacts of a final decision in terms similar to the draft so that it would have relevant safety information on which to make the final decision. The (second) AECOM report was compiled in a very short time and I am concerned that the key impacts identified by AECOM may have seemed buried in the some of the detailed analysis. I therefore extract and repeat them in summary form below for your ease of reference:

- ActewAGL Distribution's initial assessment is that a reduction of 42% in opex overall would translate into a 25% reduction in funds available for preventative inspections, leading to an increase in the inspection cycle from 5 to 6.5 years for urban assets and from 4 to 5.5 years for rural assets. This is clearly illustrated in graphic form at Figure 5 in the Report.
- These 18 month increases in the period between inspections would lead to a reduced ability to detect and prevent future failures of poles and overhead assets because some symptoms are not observable an extra 18 months in advance. These reduced rates of preventative condemnation in turn would lead to an increase in actual failures, resulting in increased rates of asset-caused fires and decreased network reliability. These failures will be concentrated in the final 18 months of the cycle leading to the next inspection.
- Reliability would be further adversely affected by increased response times arising from reduced opex.
- AECOM was able to quantify the worst case effects of these issues by assuming that each missed condemnation arising from insufficiently frequent inspections would result in an asset failure (on the basis that condemnations result from an assessment by experienced inspectors of likely asset failure prior to the next inspection):
 - an increase in bushfire starts caused by ActewAGL Distribution's assets from the present average of only 0.8 per year to 25.6 per year;
 - a potential additional 21 lives and 208 homes lost each year to major bushfires caused by failure of ActewAGL overhead assets;
 - an increase in the number of outages, which is estimated to result in an increased SAIFI of at least 2.0;
 - an increase in response times to outages, which is estimated to increase average outage duration to the point that ActewAGL Distribution will be operating right at its statutory SAIDI limit; and

⁶ Norton Rose Fulbright, Legal Opinion: *Liability of the AER in relation to Draft determination on the ACT electricity distribution revenue proposal*, 16 January 2015.

⁷ AECOM, *The Impact of the AER's Draft Decision on ActewAGL's Service Reliability and Safety Performance (Supplementary Report)*, 13 February 2015.

⁸ See also the first AECOM report attached to the RRP and the statement of Stephen Patrick Devlin attached to the subsequent submission (AECOM, 2015, *The Impact of the AER's Draft Decision on ActewAGL's Service and Safety Performance*, January)

- a potential increase in the pole failure rate from the current two failures in the past seven years, to a worst case scenario of 162 failures in 2019.
- The report mentions that for at least two reasons, actual rates of asset failure would be less than worst case:
 - it may be possible to predict and prevent some failures that would occur in the final 18 months of the 5.5 year rural inspection cycle, for example by using more conservative condemnation criteria⁹; and
 - it is likely that some symptoms that were undetectable at inspection would be later picked up and acted upon during normal business activities prior to the next inspection.
- It is also likely that some symptoms determined by inspectors to be potentially terminal will not develop to the point of causing the asset to fail prior to elapse of the 5.5 years until the next inspection.

Opportunity for further discussion before reaching a final decision

Finally, I want to raise the matter of on-going engagement ahead of the final decision. At the time the business submitted its Revised Regulatory Proposal in January, it highlighted the need for a very robust discussion to ensure that the final decision is in the long term interests of consumers. Until now, there has been little discussion, let alone robust debate.

Unfortunately, the opportunity for the AER to engage further with ActewAGL Distribution seems to be diminishing rapidly in light of the evidence, analysis and likely governance processes within the AER that need to be completed between now and the end of April.

The current process has given us at this point little comfort that the AER is serious about revisiting its approach to the numerous flaws in the Draft Decision. However, after hearing from you that the AER is listening to our contentions, will not disregard evidence, will explain and provide reasons for any disagreement by the AER with those contentions, I am hopeful that progress can be made. My team is ready to engage in meaningful discussions with the AER.

Please do not hesitate to contact me at any time should you have any queries or alternatively, your staff may wish to contact Usman Saadat on 6248 3806.

Yours sincerely



Michael Costello
Chief Executive Officer

⁹ But on the other hand, reduced funding would probably reduce the numbers of pole replacement crews, so even if some additional failure predictions could be made, it is not possible to say that they would be acted on in time.