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Dear Mr Roberts

Comments on the AER's Draft Annual Benchmarking Report

Thank you for the opportunity to provide comments on the Australian Energy Regulator's (AER's) Draft Annual Benchmarking Report for Electricity Distribution Network Service Providers (DNSPs) for 2016.

Ausgrid's comments fall into three areas:

1. recognising where value is generated, not just costs;
2. comparing like with like; and
3. recognising step changes in productivity improvements more quickly.

As you are aware, the validity of the Economic Insights (EI) models used to perform the benchmarking analysis is currently the subject of judicial review. Ausgrid's views on the Economic Insights models have been well documented throughout this process. For this reason we do not intend to replicate those concerns in this submission. Rather, this submission focuses on other issues that we have identified with the 2016 Draft Benchmarking Report.

We look forward to continuing to work with the AER to improve its approach to benchmarking. The remainder of this submission sets out specific areas with respect to the draft report that we would like the AER to consider.

Recognise the value of all types of expenditure

Ausgrid is concerned that the productivity models do not appropriately value key outputs associated with certain types of expenditure.

For example, while the capital costs associated with replacement expenditure are included in the partial performance indicators (PPI) and multilateral total factor productivity (MTFP) models, the

resulting value of this expenditure is not taken into account. This is because replacement expenditure does not add to line length (in many cases it may reduce it), or contribute to other measures of output such as customer numbers, energy through put, or maximum demand. To the extent that it contributes to reliability, the effect is very small as its impact is localised, and in any event, is swamped by the impact of environmental factors such as storm activity. One way to address this mismatch between costs and value created would be to remove replacement expenditure from the analysis and assess it separately, so as to appropriately benchmark expenditure that is necessary to extend the life of the network.

Linked to this, the models do not appear to factor in the impact that the age and/or condition of an asset may have on costs and hence productivity. It is to be expected that a 15 year old car would have higher operating and maintenance costs than a brand new car – similarly, an aging network asset is likely to incur greater operating and maintenance costs than a brand new asset. A network's decision to renew its assets to reduce costs in the future will result in further productivity declines under the AER's model (see point above). It may be helpful for the AER to conduct further analysis into whether there are cost differences due to network age and condition, and reflect these in its benchmarking.

Finally, a key driver in the increase in opex costs for Ausgrid between financial years 2014 and 2015 has been costs associated with reforms to improve our efficiency base specifically the cost of voluntary redundancies to reduce our future labour costs. In addition, the draft benchmarking report has not adjusted for the \$43 million expenditure Ausgrid incurred in the last quarter of the financial year 2015 to restore the network as the April 2015 storm. The AER acknowledges this to some extent, however no additional analysis is performed to isolate the impact of these changes, nor is there any recognition of the resulting productivity improvements. This is partly due to the backward looking nature of the analysis, as discussed further below.

Ausgrid would be pleased to provide the AER with a more detailed breakdown in costs to assist with further analysis to demonstrate the underlying productivity improvements that are being achieved now and over the next few years. The AER might also like to consider incorporating forecast expenditures into its analysis to see how networks are transforming over time. We note that Ofgem utilises forecast as well as historic expenditure to inform their views of productivity and relative efficiency.

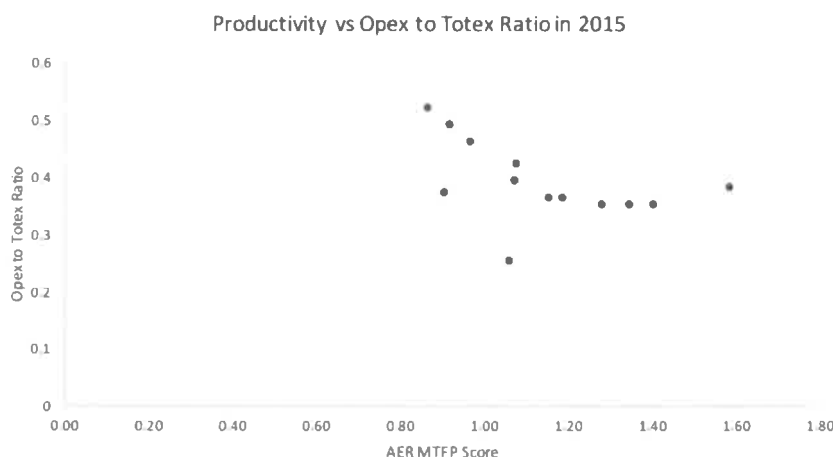
Comparing like with like

There are a number of areas where Ausgrid is concerned that the AER may not be making appropriate comparisons due to underlying differences between networks. These include:

- The split between capex and opex is based on individual DNSPs' cost allocation methods. It is not clear whether the AER has conducted any analysis to determine whether costs allocated by DNSPs to opex include the same type of costs across all

businesses. Ausgrid considers that in order to undertake a valid benchmarking exercise, the cost categories used must be the same across all businesses.

The following analysis suggests that for companies with a higher level of opex relative to total cost, the AER's MTFP scores are lower. Different approaches to capitalisation may contribute to higher or lower levels of opex. By capitalising more costs, businesses display lower opex with no change to the model outputs, and therefore achieve a perceived improvement in productivity within the MTFP model. The capex / opex tradeoff and the capitalisation practices of all distributors should be an area of the AER's investigation before definitive conclusions are drawn as to relative productivity or operational efficiency.



Ausgrid has a large amount of voltage assets (i.e. 66kV and 132kV assets) that in other jurisdictions are owned by the relevant transmission company. EI has attempted to recognise this disparity in their modelling by removing assets associated with the second stage transformation. It is not clear that the AER has taken similar steps to make adjustments for the presence of high voltage assets within its MTFP modelling or in its PPI models. As a result, the costs associated with the sub-transmission layer of assets may artificially inflate costs per line length over customer density relative to jurisdictions where such assets are not owned by the distributor. The presence of these assets is a legacy network design issue and cannot be changed by the business. The AER's PPI benchmarking approach would improve if such issues were taken into account explicitly within its modelling.

Related to this issue, Ausgrid also has concerns that the use of MVA km of line assets (underground and overhead) as input variables in the AER's MTFP model which we suspect discriminates against networks with high voltage assets. The multiplicative

nature of the variable (km times average MVA rating) exacerbates the problem due to the exponential nature of MVA rating increases with voltage increases. This is highlighted by the fact that the value of 33kV and over underground cables value for Ausgrid (1.67 million customers) is 125,738 MVAkm compared to the sum of all other networks in the NEM (8.06 million customers) value of 114,670MVAkm. The materially higher value for Ausgrid is driven by the presence of approximately 600km of underground 132kV cable which account for 1.6% of our total network length, but 19% of the total line (underground and overhead) capacity using the AER's MTFP model variable definition. The AER should take steps to ensure that the models do not discriminate on the basis of legacy network design or of the fact that Ausgrid owns high voltage assets that however are owned by different network service providers in other jurisdictions, and do not include variables that exacerbate the issue further. It may be worth reconsidering the nature of the variables used by the AER in its modelling as part of industry consultation to improve the benchmarking approach.

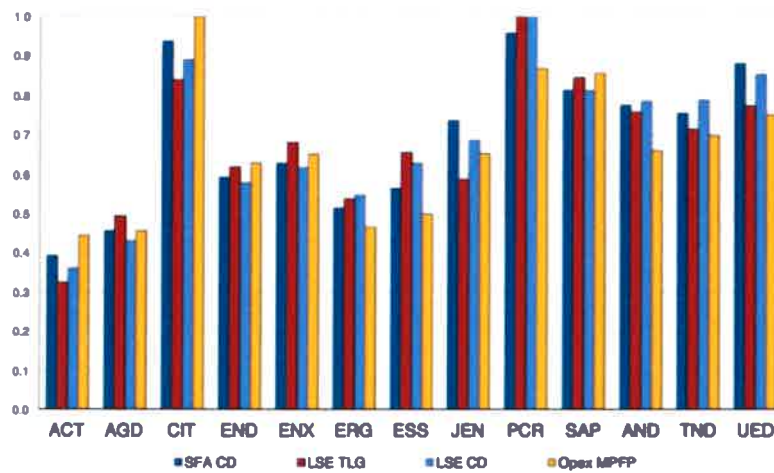
- Ausgrid has a mix of high and low customer density areas. While most of Ausgrid's assets are located in high density areas, the use of averaging hides this to some extent. Requiring DNSPs to report their costs by region (eg CBD, urban, semi-rural, remote) and comparing on this basis would be a more meaningful approach.

Linked to this, Ausgrid also notes that there is an implicit assumption in the commentary that a linear relationship exists between customer density and cost. It would be useful to test this assumption. Ausgrid considers that while costs per customer may reduce as the customer base increases up to a point, costs may increase again due to the need to underground assets and work in heavily congested areas.

- Ausgrid's regulatory asset base is significantly larger than any other DNSP's, and the predominant driver of Ausgrid's capex is replacement expenditure. Until the value of replacement expenditure is recognised, as discussed above, Ausgrid's large asset costs will continue to penalise our productivity results compared to our peers.
- Finally, we are concerned by the AER's suggestion that the MPFP results are largely similar to the three EI model results used to determine Ausgrid's forecast opex for the current regulatory period.. We note that the MPFP model does not provide a point estimate from which opex can be determined. While we do not intend to extend our comments to the EI models, we note that the three EI models derive the opex levels based on the relative scores of each business, and that the relative performance of businesses changes depending on the model used. Whilst the four models results appear to be similar for each company in the AER's chart Figure 8 (below), the opex results (before the AER's post-modelling adjustments) that result from each EI model are very different and vary up to \$60m per annum (i.e. up to \$300m over a five year period) because it is the relative performance of businesses to each other that drives the

perceived inefficiency. We are therefore concerned with comments from the AER that the MPFP results are similar. Clearly, the models show a range of opex outcomes, and the AER should carefully consider the outcomes from a range of models in its benchmarking approach in future rather than rely on a single model to determine the result.

Figure 8 Econometric modelling and opex MPFP results (2006–15 average)



Recognising step changes in improvements

The benchmarking analysis is backwards looking and it so does not take into account forecast costs, which may more appropriately reflect the direction of the business. Ausgrid understands that the AER uses this approach to mitigate the effects of one-off changes in opex or assets in a particular year. However, it also means that step changes in productivity take a number of years to be fully reflected in companies' past results and therefore in the AER's benchmarking analysis. Ausgrid has been reforming its cost base for several years and considers more recent years are more likely to provide an indicator of current and future performance. We suggest that the AER consider expanding its analysis to include forecast costs, or to give consideration to giving greater weight to more recent years' results.

Ausgrid is pleased to note that the PPIs are now calculated using a five year average, which better recognises structural changes in performance than a longer averaging period might. However, for Ausgrid, even within a 5 year period significant changes have been made, the effects of which are diluted due to averaging. For example staff numbers, a large driver of costs, fell by 29% from 2011-15, but by 39% from 2012-16. Under the current methodology, and particularly as a result of the lack of analysis showing underlying performance, these significant productivity gains will not be visible in the AER's analysis for several years. As noted above,

Ausgrid incurred significant costs in the financial year 2015 to restore the network as the result of the April storm.

We note that in the financial sector where financial results are provided to the market using both headline and underlying figures, shareholders typically react to underlying results more strongly so that one-off reform costs are not seen as a decline in value, but rather an increase in value. We would welcome the AER consideration of ways to show similar information to stakeholders.

Finally, we are generally concerned with the AER's high level approach to benchmarking and the high level insights drawn, we believe inappropriately, by the AER in its draft report. Commentary around businesses being the top or bottom performers consistently over time may not point to a gap in productivity, but rather an inherent bias within the models that continues to favour or discriminate against networks with certain inherent characteristics – characteristics that cannot be changed easily in a short period of time. For example, the physical assets installed are the result of generations of investment decisions and are a legacy with which current management teams must live with for the short and medium term. The number of customers networks have, their demand and consumption is largely outside the control of the network. And the network's reliability performance is largely determined by impacts of weather, operating environments (rural / urban) and legacy network design (underground vs overhead).

We believe that the AER's benchmarking approach should be designed to enable networks and the regulator to understand how network can take steps to improve performance. We are concerned that the AER's MTFP model specification does not allow such insights given the variables within the model specification are unable to be changed (as explained above) leaving the business with reducing opex to unsustainable levels as the only lever to improve productivity.

Ausgrid would be pleased to discuss this submission with the AER and would welcome further discussions on the AER's approach to benchmarking, particularly in the lead up to Ausgrid's 19-24 determination. Please contact Catherine O'Neill on (02) 8569 6433 or by email on coneill@ausgrid.com.au in the first instance.

Yours sincerely



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