

16 April 2012

Electricity Network Inquiry
Productivity Commission
PO Box 1428
Canberra City ACT 2601

Dear Commissioners

Response to Electricity Network Regulation Issues Paper

ActewAGL Distribution welcomes the opportunity to respond to the Productivity Commission's *Electricity Network Regulation Issues Paper*, released in February 2012.

ActewAGL Distribution is a public-private partnership ultimately controlled by the ACT Government owned ACTEW Corporation and Singapore Power International. ActewAGL Distribution owns the electricity distribution network in the ACT and gas distribution networks in the ACT and the adjoining areas of New South Wales and the Shoalhaven region. The ActewAGL joint venture also has interests in water and wastewater services in the ACT and in energy retailing in the ACT and south-eastern New South Wales.

ActewAGL Distribution is a member of the Energy Networks Association and strongly supports the ENA's comprehensive response to the Issues Paper. In this submission we provide comments on three matters of particular concern to ActewAGL Distribution:

- The timing of the Commission's inquiry and its links to the other current reviews of the electricity network regulatory framework;
- The practical use of benchmarking tools; and,
- The drivers of network price increases.

The Commission's inquiry and other related reviews

The Commission has identified 12 other major reviews of the electricity regulatory framework currently in progress. Each of these reviews could potentially result in amendments to the regulatory framework during the Commission's inquiry period. The terms of reference for the inquiry require the Commission to take account of any such amendments.

The overlap between the Commission's inquiry and the other reviews raises some issues about the timing and basis for any amendments to the regulatory framework. The Commission is addressing a wide range of matters of relevance to the other reviews. Ideally, the Commission's findings should be informing these reviews.

However, the timing of this inquiry and the other reviews has made this difficult or impossible. For example, in the Issues Paper the Commission raises 85 sets of questions, many of which are directly relevant to the Australian Energy Market Commission's (AEMC's) current review of the Australian Energy Regulator (AER) and Energy Users' Rule Change Committee (EURCC) rule change proposals. Detailed analysis of the type the Commission intends to undertake in relation to the current and potential uses of benchmarking should ideally be undertaken *before* the AEMC makes its final determination. However, under current review timetables the AEMC will release its final determination around the time the Commission releases its draft report, in October/November 2012.

Practical use of benchmarking tools

In the Issues Paper the Commission sets out a useful list of criteria for discriminating between "good and bad" benchmarking tools and approaches. ActewAGL Distribution agrees that a critical feature of good practical benchmarking is that it must involve "like with like" comparisons. As the Commission notes, failure to adequately control for differences in operating environments can lead to biased measures or create perverse incentives. The importance of taking account of the particular circumstances of the businesses being benchmarked has also been recognised by the AEMC. In its March 2012 Directions Paper the AEMC has taken the initial position that it does not accept the AER's argument that the reference in the rules to the circumstances of the relevant network service provider should be removed.¹

The use of benchmarking in the AER's review for the 2009-14 ACT electricity distribution determination provides a good example of how benchmarking which fails to meet the basic requirement of controlling for differences between firms can result in misleading and biased results. The AER's consultants concluded that ActewAGL Distribution's proposed operating expenditure was higher than "the industry norm"². While the consultants recognised that there may be some unique cost drivers and less capitalisation relative to the other distributors which could explain the difference, they did not attempt to quantify any such factors and include them in the benchmarking analysis. In response, ActewAGL Distribution was able to demonstrate that quantifying the impact of just one of the unique drivers, the leasing of some assets which are treated as capital expenditure by other firms, significantly altered the results.

While there are many potential pitfalls with the practical use of benchmarking tools, ActewAGL Distribution considers that benchmarking has an important role, provided unique network characteristics and drivers are taken into account. The Commission has asked how network suppliers assess the efficiency and performance of their businesses and whether this has relevance for regulatory benchmarking. Our

¹ AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper*, March, p. 29

² AER 2008, *Australian Capital Territory Distribution Determination 2009/10 to 2013/14: Draft Decision*, December, p. 88

experience with the use of benchmarking tools suggests the following points of relevance for regulatory benchmarking:

- Benchmarking cannot replace careful analysis of specific cost drivers, circumstances and context and an understanding of what is controllable and what is not. Benchmarking can supplement such detailed analysis, and provide high level cross checks, but not replace it. In the regulatory context, benchmarking can supplement the AER's analysis of a network service provider's regulatory proposal, but it cannot replace it.
- Benchmarking is most useful when applied to addressing a particular hypothesis or question about costs or performance. Broad brush ratio analysis, regression analysis or expenditure modelling, of the type applied by the AER in past reviews, involves unnecessarily onerous data requirements and provides very limited value in terms of the questions it can answer. In contrast, benchmarking which aims to address specific questions can involve less onerous data requirements (one of the Commission's criteria for good benchmarking), and is likely to provide more reliable and useful results. This more targeted approach also allows testing of rival explanations of differences in performance and inefficiency, which the Commission has identified as an important feature of useful benchmarking.
- To be robust and informative, benchmarking should recognise and quantify the impacts of uncontrollable factors associated with the physical and institutional environment and historical circumstances, as well as controllable drivers of cost differences such as differences in accounting treatments and differences in work practices and operating techniques.

Drivers of network price increases

In the Issues Paper the Commission seeks comments on the drivers of network price increases, and whether excessive investment, or "gold plating", and other factors such as failures to correctly define project scope, have contributed to the price increases.

The drivers of network price increases vary across DNSPs and over time. In the final decision for the 2009-14 ACT distribution determination, the AER explained the drivers of ActewAGL Distribution's approved network price increases as follows:

"Higher prices will be largely driven by significant investment in four major capital projects. These projects include construction of two new zone substations, which are the first to be built in the ACT since 1994, augmentation of a third substation and construction of new assets to improve the security of electricity supply to the ACT. In addition, ActewAGL has already undertaken significant capital works to reinforce and replace a large number of unsafe poles, and these costs will now flow through to consumers. While consumers within the ACT will face higher charges as a

result of this investment, they will also benefit from a more reliable and secure network.”³

The AER also identified the introduction of the ACT feed-in tariff scheme as a major driver of the network price increases.

The AER closely scrutinized each element of ActewAGL Distribution’s regulatory proposal and concluded that the scope of the proposed capital expenditure program was “appropriate and necessary”⁴.

Claims of “gold plating” have gained considerable public attention, particularly following the comments by Garnaut referred to in the Issues Paper. However, while Garnaut concluded that there is a “prima facie” case that weaknesses in the regulatory framework have led to overinvestment in networks and unnecessarily high prices, the conclusion was not supported by evidence of overinvestment and unnecessarily high prices, nor of “excessive reliability”.⁵ ActewAGL Distribution believes that the ongoing debate about whether customers are paying for excessive investment and excessive reliability needs to be informed by evidence on customer preferences and willingness to pay.

ActewAGL Distribution is keenly aware of the importance of taking account of customer preferences and willingness to pay for various service attributes. In 2003 we commissioned a comprehensive willingness to pay study, covering electricity, gas and water services. The results from the study were used in ActewAGL Distribution’s 2009-14 electricity network regulatory proposal, and this information is necessary to support claims regarding appropriate service levels. More recently, ActewAGL Distribution has been involved in further choice modelling work to assess the value of reliability to its domestic customer segment. This independent study has been conducted by researchers at the Australian National University.

ActewAGL Distribution looks forward to continuing engagement with the Commission on these and other issues relating to the use of benchmarking.

Yours sincerely

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³ AER 2009, *Australian Capital Territory Distribution Determination 2009/10 to 2013/14: Final Decision*, April, p. viii

⁴ AER 2008, *Australian Capital Territory Distribution Determination 2009/10 to 2013/14: Draft Decision*, December, p. xxi

⁵ Garnaut, R. 2011, *Transforming the electricity sector, Climate Change Review Update Paper 8*, March, pages 2 and 43