

Attachment C11 - ActewAGL Distribution's response to the AER's detailed review of labour and vegetation management (PUBLIC)

The AER has conducted a detailed review of ActewAGL Distribution's labour and workforce practices and vegetation management expenditure in 2012-13. The AER considers that the SFA benchmarking results are corroborated by the findings of the AER's review of labour and workforce practices and vegetation management.

ActewAGL Distribution has identified a series of flaws with the AER's detailed labour review and detailed vegetation management review. ActewAGL Distribution finds that the AER's analysis does not support the SFA benchmarking results and in turn undermines the AER's approach to use these results to mechanistically set opex allowances.

This attachment provides ActewAGL Distribution's response to the AER's detailed reviews.

1 Detailed review – Labour

The AER undertook a ‘detailed review’ of ActewAGL Distribution’s labour levels, costs and practices and claimed that it ‘uncovered labour and workforce inefficiencies’.¹ However, the AER’s conclusions are based on flawed analysis and as such fail to serve as evidence to support its claims regarding ActewAGL Distribution’s level of inefficiency and its alternative opex forecast.

This Section summarises ActewAGL Distribution’s response to the AER’s claims:

- of inefficient labour levels;
- of inefficient labour costs;
- of inefficiency with respect to:
 - outsourcing practices;
 - the use of redundancy provisions; and
 - organisation structural issues.

ActewAGL Distribution’s labour levels are efficient

In its comparisons of labour levels, the AER is not undertaking an ‘apples-with-apples’ comparison. The AER adopts a simplistic approach of comparing Average Staffing Levels (ASL) across businesses. However, the AER fails to recognise that its analysis does not fully account for differences in outsourcing practices. Where a DNSP outsources a task it will report lower ASLs than a DNSP who undertakes the task internally, and hence appear more efficient in the AER’s analysis. The results of such a comparison are driven by the sourcing models of the DNSPs and are not a measure of efficiency. As ActewAGL Distribution efficiently outsources less tasks than both New South Wales and Victorian DNSPs it is disadvantaged by the AER’s simplistic analysis.

Further, the AER by comparing ASLs against customer numbers, fails to recognise that it is actually the characteristics of the network that drive costs rather than customer numbers. In addition, a simplistic analysis of customer numbers takes no account of economies of scale. Larger networks are more likely to be able to access economies of scale and hence appear more efficient on a simple comparison of workforce numbers in comparison with a small DNSP such as

¹ AER 2014, *Draft decision – ActewAGL distribution determination 2014-19, Attachment 7: Opex*, November, p.7-32

ActewAGL Distribution. Economic Insights have identified the need to recognise scale impacts in reference to Envestra Qld, a small gas distribution network, where they state:

Simply comparing Envestra Qld opex partial indicators relative to group averages as WCC [a consultant] do takes no account at all of the all-important scale, customer density, energy density and opex/capex trade-off differences.²

Similarly, Mr Glyde and Mr Mudge notes the synergies available to Victorian DNSPs (against which ActewAGL Distribution is compared) and states:³

These synergies were available due to the co-location of networks. This impacts AAD uniquely as these synergies are not available in the ACT due to the small size, geographical isolation of the ACT and absence of co-located networks within the same jurisdiction.

ActewAGL Distribution considers that the AER has failed to substantiate its claim of inefficient labour levels and maintains its position that the labour levels of ActewAGL Distribution as implied in this revised regulatory proposal are efficient.

ActewAGL Distribution's labour costs are efficient

The AER claims that ActewAGL Distribution's labour costs are higher than other NEM service providers with respect to both labour cost per ASL and on a per customer basis.

In addition to the data comparability issues identified, the analysis presented by the AER is misleading. The AER's analysis of labour cost per ASL shows ActewAGL Distribution to be above the NEM average and the Victorian average (excluding United Energy). However, when this data is presented for the DNSPs individually, it is clear that ActewAGL Distribution is within the range of the Victorian DNSPs, with the exception of AusNet which has significantly lower reported labour costs and appears to be an outlier from the remaining businesses. This more detailed analysis also shows that the two most 'expensive' firms, using labour cost per ASL, are Powercor and CitiPower, the frontier firms from the economic benchmarking.

The AER has also previously recognised higher labour costs in the ACT through granting a real labour cost escalator above any other jurisdiction for the previous regulatory period. There are also a range of other factors which lead to labour cost pressures in the ACT. These include the size of the market, competitors for labour hire within the market and skill shortages. Despite these pressures, analysis undertaken by Australian Business Lawyers & Advisors Pty Limited

² See Attachment C68, Economic Insights, 2011, *Review of AER Draft Decision on Envestra Queensland's Base Year Opex*, March, p.16

³ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, page 93

(ABLA) shows that ActewAGL Distribution does not stand out from its peers in regard to salaries contained in Enterprise Agreements (EAs).⁴

ActewAGL Distribution's workforce practices are efficient

The AER fails to provide evidence to support its claims on sources of labour inefficiency. It has also not afforded ActewAGL Distribution procedural fairness by failing to provide labour analysis undertaken by Deloitte upon which the AER relies to form its conclusions.

The AER's simplistic word-for-word comparison of the outsourcing provisions of EAs across DNSPs does not recognise that each EA provision interacts with other EA provisions, which in turn have a cumulative effect on operational flexibility. The AER has not provided evidence that supports its assertion that the restrictiveness of ActewAGL Distribution's EA is a source of inefficiency relative to its peers. ABLA found that contrary to the AER's conclusions, ActewAGL Distribution's EA is no more restrictive than most of its peers and in many respects is less so in relation to outsourcing, redundancy and business change generally.⁵ The AER has also failed to provide evidence that demonstrates that higher levels of outsourcing deliver more efficient expenditure. Mr Glyde and Mr Mudge note:⁶

the question of whether network Opex or Capex tasks are carried out by internal or external labour is largely irrelevant to the efficiency of the outcome

With respect to redundancy provisions, the AER claims that ActewAGL Distribution's access to involuntary redundancy is in contrast to the other DNSPs and that this may come at a cost to ActewAGL Distribution and be a driver of inefficiency.⁷ Unlike other DNSPs, ActewAGL Distribution can undertake organisational restructuring from both voluntary and involuntary redundancies. While the cost of this may be high in the short term, the benefit is that change can be effected in a relatively short timeframe. ActewAGL Distribution considers the AER's contention that ActewAGL Distribution's relatively high redundancy payments during the 2009-14 period is evidence of inefficiency is flawed in the context of the incentive mechanism in place

⁴ See Attachment C72, ABLA, 2015, *Review and Comparison Of ActewAGL's Enterprise Agreement Provisions Against Other Electricity Network Service Providers*, January, page 4

⁵ See Attachment C72, ABLA, 2015, *Review and Comparison Of ActewAGL's Enterprise Agreement Provisions Against Other Electricity Network Service Providers*, January, pages 4 and 5

⁶ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, page 96

⁷ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-79

during this period and ActewAGL Distribution's investment in achieving longer term dynamic efficiencies.

The AER also cites structural and cultural issues identified in a major organisational review undertaken in 2011, and that as base opex has not materially reduced since this time, that these issues remain and provide evidence that ActewAGL Distribution has inefficient labour costs. ActewAGL Distribution has in fact implemented the review's recommendations. The AER's reliance on its identification that opex has not materially reduced fails to recognise that the achievement of efficiencies are factored into ActewAGL Distribution's implicit productivity growth rate factored into the opex forecast. Moreover, the incentives provided by the EBSS have provided the incentive to incur an efficient level of opex.

1.1 Overview of AER detailed review findings

The AER's simplistic category analysis identifies ActewAGL Distribution's labour costs as being a key driver of its operating expenditure inefficiency, prompting the AER to undertake a detailed review of labour costs. This includes analysis of past expenditure and benchmarking performance, which the AER claims to provide evidence of material inefficiency, as well as identification of specific drivers of this inefficiency. The AER concludes:

We uncovered labour and workforce inefficiencies arising from:

- *significantly lower proportions of outsourcing than more efficient peers*
- *workplace structure, culture and performance issues that have been identified by its own consultant.*
- *large increases in the number and cost of permanent employees leading up to and during the 2009–14 period*
- *restructuring that has led to an outlay of costs but little evidence of corresponding quantifiable benefit*
- *An enterprise agreement that contains, in some instances, more restrictive provisions on labour engagement and management than the enterprise agreements of ActewAGL's peers.⁸*

The AER's detailed labour review presents analysis of ActewAGL Distribution's labour costs during the 2009-14 regulatory period together with analysis of other DNSPs' labour costs across

⁸ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-32

the 2008/09 – 2012/13 period. The AER's analysis looks at trends in ActewAGL Distribution's labour costs across the period as well as compares total labour costs on a per employee and per customer basis, and number of employees on a per 100,000 customers basis. This analysis indicates ActewAGL Distribution has both high labour levels and labour costs relative to others in the NEM.⁹ The AER's detailed review also attempts to identify reasons why ActewAGL Distribution's labour costs are materially higher than its peers with respect to: inability to outsource core work; potentially generous EBA provisions; and inefficiency within the workforce.

ActewAGL Distribution disputes the validity of the AER's analysis of both labour quantities and costs, as well as the AER's claims regarding sources of inefficiency. ActewAGL Distribution's response is structured as follows:

- Response to the AER's claims of inefficient labour levels;
- Response to the AER's claims of inefficient labour costs;
- Response to the AER's claims of inefficiency with respect to:
 - Outsourcing practices;
 - Use of redundancy provisions; and
 - Organisation structural issues.

1.2 Claims of inefficient labour levels

In the draft decision, the AER bases its assertion that ActewAGL Distribution has inefficient labour levels on increases during the 2009-14 regulatory period and by comparing ActewAGL Distribution's average staffing level (ASL) per 100,000 customers with those of its peers.

Based on this analysis, the AER concludes that ActewAGL Distribution's ASL per 100,000 is 17 per cent higher on average than the NEM average over the period 2008/09 – 2012/13, and 67 per cent higher than the average over the Victorian DNSPs. In drawing this conclusion, the AER has excluded United Energy on the basis that it is an outlier due to very low ASLs and labour costs over the period. There are three distinct issues with the AER's analysis.

Firstly, the AER's data is not comparable across DNSPs as it does not account for differences in outsourcing practices. The ActewAGL Distribution RIN, the source of the data used for the comparison, states that:

⁹ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, pages 8 and 9

*Labour used in the provision of contracts for both goods and services, other than contracts for the provision of labour (i.e. labour hire contracts) must not be reported in these tables.*¹⁰

The definition of 'labour hire' used in the RIN is expenditure:

- *incurred or forecast to be incurred under labour hire contracts.*
- *Excludes expenditure required under contracts other than labour hire contracts, irrespective of whether or not the contract includes a labour component.*

There is uncertainty in this as to what is considered a labour hire contract. For example, in hiring a firm to clear vegetation or maintain poles, ActewAGL Distribution would interpret these contracts are not part of labour as counted in the CA RIN. This interpretation is assumed to be consistent with the CA RIN provided to the AER by United Energy, as it fully outsources direct network labour and so does not report these values. The AER recognises United Energy as an outlier but does not consider the level of outsourcing of other DNSPs included in the comparison.

Using this reasonable interpretation, ActewAGL Distribution is significantly disadvantaged in terms of ASL numbers since it outsources its core network activities less than both NSW and Victorian DNSPs. For example, a task that ActewAGL Distribution performs using internal labour would count as labour (i.e. ASLs), as well as labour cost, but that same task, if contracted out by another DNSP, would not be reported as a labour cost. Therefore the results of this comparison will depend on the sourcing models of the DNSPs, which are not in itself a measure of efficiency, as discussed further in Section 1.4.1.

A related data issue is that of quality. The data provided to the AER by CitiPower and Powercor has the feature of "little or no data available" with the notional allocations and estimation techniques being "complex".¹¹ This indicates that the raw data itself has a significant amount of uncertainty associated with it, and that in some cases it is estimated data rather than actual data. The AER has not considered this issue of data quality as discussed in Section 3.4.4.5 of ActewAGL Distribution's revised regulatory proposal.

The second issue with the AER's analysis is the normalisation of ASLs by customer numbers. The quantity of labour an electricity distribution business chooses to hire does not directly depend on customer numbers, but rather depend on the quantity of work required in the network.

¹⁰ See Attachment 65, AER, 2014, *Regulatory Information Notice under division 4 of part 3 of the National Electricity (ACT) Law*, March, page 53

¹¹ See Attachment C66, CitiPower, 2014, *AER Category Analysis RIN – Basis of Preparation, Part A*, June, page 148 and Attachment C67, Powercor, 2014, *AER Category Analysis RIN – Basis of Preparation, Part A*, June, page 143

Normalising the quantity of labour by customer number does not reflect the drivers of a DNSP. This point is discussed in detail in Section 3.4.4.7 of the revised regulatory proposal.

A final issue not considered by the AER is that of scale. Larger networks are more likely to be able to access economies of scale and hence appear more efficient on a simple comparison of workforce numbers. Economic Insights, the AER's own consultants, have stated, in reference to Envestra Qld, a small gas distribution network¹², that:

Simply comparing Envestra Qld opex partial indicators relative to group averages as WCC [a consultant] do takes no account at all of the all-important scale, customer density, energy density and opex/capex trade-off differences.¹³

Mr Glyde and Mr Mudge note with respect to ActewAGL Distribution's ability to access economies of scale that it:¹⁴

(a) represents the smallest DNSP in the NEM by customer numbers;

(b) is geographically isolated from other networks (other than a sparsely populated portion of the Essential Energy network);

(c) has limited options to pursue the mergers or other co-operative arrangements that have been, or are being, implemented in Victoria, NSW, Qld or Tasmania;

(d) is not able to achieve the scale of the operations in other states such as SA due to the small size of the ACT.

The smaller Victorian urban DNSPs, to whom the AER makes direct comparisons have been able to overcome the smaller scale of their networks by realise operating synergies that are simply not available to AAD.

¹² Economic Insights states that "industries which are most likely to have similar characteristics to the gas distribution industry are other infrastructure network industries. And of these industries, electricity distribution is likely to be the most similar" which makes the comparison to electricity DNSPs valid (see Attachment C42, Economic Insights, 2011, *Regulation of Suppliers of Gas Pipeline Services – Gas Sector Productivity*, February, page 33).

¹³ See Attachment C68, Economic Insights, 2011, *Review of AER Draft Decision on Envestra Queensland's Base Year Opex*, March, page 16

¹⁴ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, page 87

Mr Glyde and Mr Mudge also note:¹⁵

the Victorian DNSPs have realised economies of scale through common management (CitiPower/Powercor) and shared operations (CitiPower/Powercor, United Energy/Jemena) arrangements that effectively allow the business to operate as much larger businesses of around one million customers. These synergies were available due to the co-location of networks. This impacts AAD uniquely as these synergies are not available in the ACT due to the small size, geographical isolation of the ACT and absence of co-located networks within the same jurisdiction.

This issue of scale is discussed in more detail in Sections 3.4.4.5 and 3.4.4.7 of the Revised Regulatory Proposal.

ActewAGL Distribution contends that the AER's conclusion that ActewAGL Distribution's employee levels are higher than its peers is based on invalid data and analysis and therefore does not serve as evidence in support of the AER's findings that ActewAGL Distribution's labour costs are materially inefficient.

1.3 Claims of inefficient per ASL labour costs

In reviewing ActewAGL Distribution's labour costs, the AER has found labour costs to be higher than other NEM service providers on both a labour cost per ASL and per customer basis.

The AER's analysis found ActewAGL Distribution's total real labour costs per ASL to be 10 per cent higher than the average of NEM service providers, and four per cent higher than the Victorian service providers when United Energy is excluded (on the basis of it being an outlier due to very low ASLs and labour costs over the period being reported in its RIN data).¹⁶

The AER's analysis of labour costs per customer found that ActewAGL Distribution's costs are on average 22 per cent higher than the NEM average over the period 2008/09 – 2012/13, and 33 per cent higher in the 2012/13 base year. Further to this, the AER concludes that ActewAGL Distribution's labour costs per customer are on average 70 per cent higher than the Victorian DNSPs (excluding United Energy) across the period, and 66 per cent in the base year.

The data comparability issue detailed in Section 1.2 in reference to labour quantity applies equally to labour cost. Similarly, the labour cost data, as described by Powercor and CitiPower, is

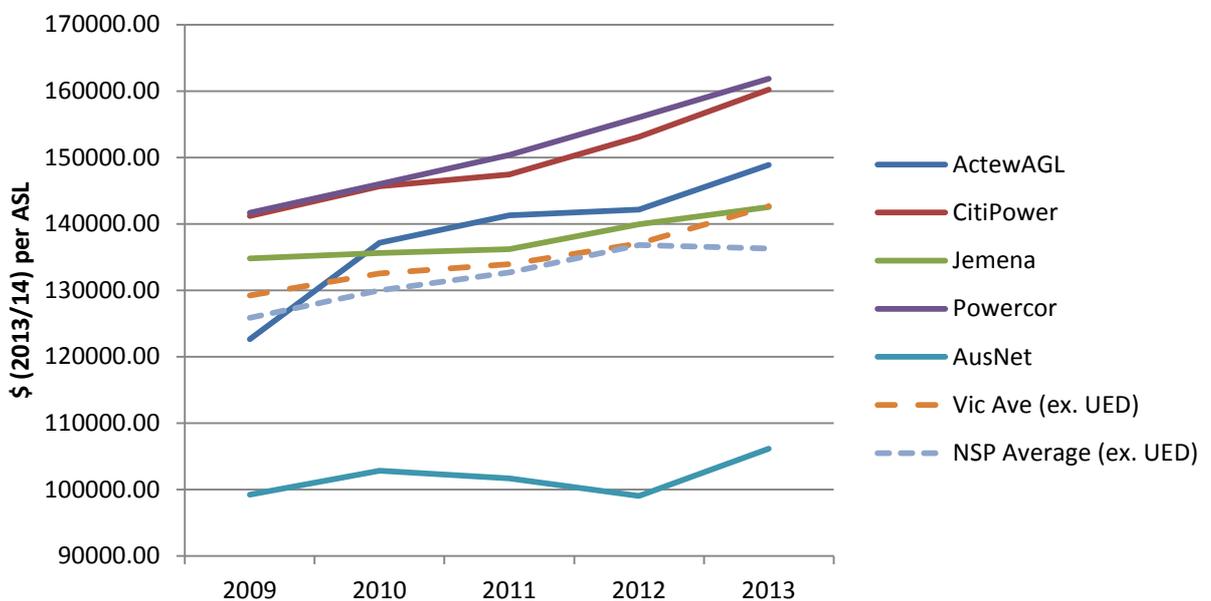
¹⁵ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, page 93

¹⁶ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 8

not actual data but rather a complex estimation of that data. This issue is entirely overlooked by the AER.¹⁷

Finally, ActewAGL Distribution considers the analysis undertaken and claims made by the AER as presented in Table A.1 of the Confidential appendix to Attachment 7¹⁸ to be misleading. The AER’s analysis shows ActewAGL Distribution to be above the NEM average and the Victorian average (excluding United Energy). However, when this data is presented for the DNSPs individually as shown in Figure 1.1, it can be seen that ActewAGL Distribution is clearly within the range of the Victorian DNSPs, with the exception of AusNet which has significantly lower reported labour costs and appears to be an outlier from the remaining businesses.

Figure 1.1: Labour cost per ASL for Victorian DNSPs, ActewAGL Distribution and the NEM average.



Despite the data comparability issues, relative to the ‘frontier’ firms of CitiPower and Powercor, ActewAGL Distribution has consistently lower cost per ASL. The comparison to the Victorian average is misleading as AusNet’s cost per ASL significantly reduces the Victorian average.

¹⁷ See Attachment C66, CitiPower, 2014, *AER Category Analysis RIN – Basis of Preparation, Part A*, June, page 152 and Attachment C67, Powercor, 2014, *AER Category Analysis RIN – Basis of Preparation, Part A*, June, page 147

¹⁸ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 8

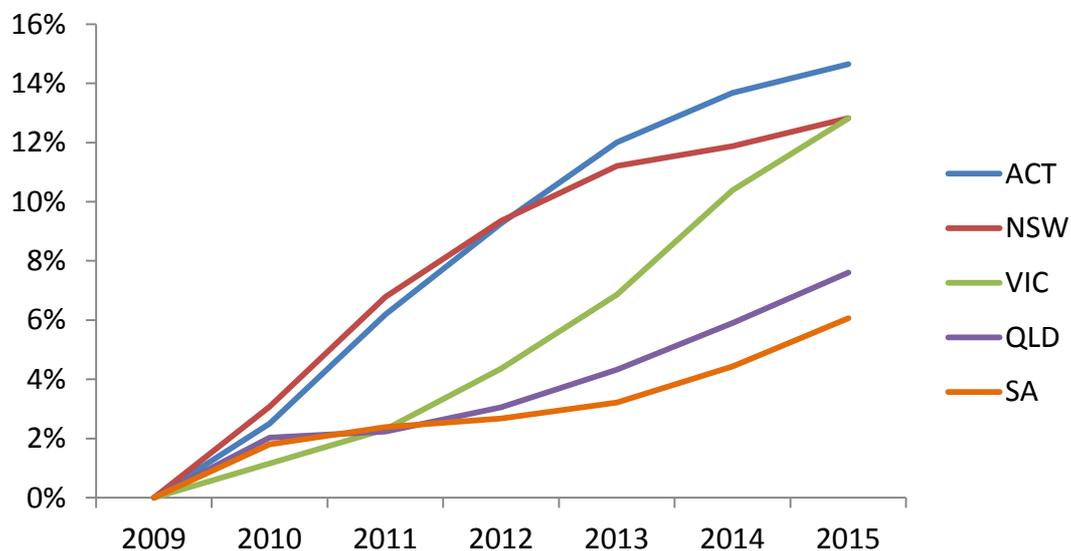
Three additional valid points discussed in Section 3.4.4.7 of the Revised Regulatory Proposal are that partial analysis does not consider any differences between DNSPs; that economies of scale are not considered as a factor of any differences; and that a linear relationship between labour costs and ASL is assumed, which is clearly not the case given United Energy outsource most of their labour (and hence labour costs). The AER has not had regard to any of these issues in its analysis.

1.3.1 Factors affecting ActewAGL Distribution’s labour costs

ActewAGL Distribution’s base year opex reflects the efficient costs that a prudent operator would require to achieve the opex objectives. As a prudent operator, ActewAGL Distribution has had regard to factors affecting its ability to meet the opex objectives relating to labour in determining efficient costs, such as market pressures leading to shortages in appropriately skilled staff.

Past AER electricity distribution decisions have acknowledged that labour costs are higher in the ACT. Figure 1.2 shows the compound real labour cost growth rate since 2009 allowed by the AER in its decisions for electricity distribution businesses. This shows that the AER has allowed for higher labour cost escalation over this period in the ACT than in any other state.

Figure 1.2 Compound real labour cost growth rate since 2009 allowed in AER electricity distribution decisions*



**Note: ACT and NSW 2014/15 rate based on draft decision*

Further, as shown in Section 3.5.3.1 of the revised regulatory proposal, actual ACT wage growth was significantly higher than determined by the AER and higher than in other jurisdictions.

This evidence should be taken into account by the AER when comparing the labour costs of ActewAGL Distribution to those of its peers in other states and making assessments on the efficiency of ActewAGL Distribution's labour costs. The AER should also continue to have regard to the differing economic conditions affecting labour markets when making decisions on appropriate cost escalation to be applied within the rate of change in the assessment of a DNSP's expenditure proposal.

Higher labour costs in the ACT have been driven by the size of the market, competitors for labour hire within the market and skill shortages. ActewAGL Distribution faces difficulty in attracting and retaining appropriately skilled staff into the electricity distribution business in a small city.

One contributing factor is that none of the three universities in the Canberra offer an electrical engineering undergraduate degree, which leads to a limited supply of graduate engineers. As the only distribution business in the ACT, ActewAGL Distribution also faces difficulties recruiting experienced professionals, particularly at senior management levels.

Therefore, ActewAGL Distribution has been required to extend its recruitment activities beyond the ACT labour market, including internationally in some cases. In order to compete effectively in a wider labour market, it has been necessary to offer remuneration and conditions at a level that provides adequate incentive for candidates to elect to move interstate (or in some cases internationally).

In terms of recruitment of roles that are not engineering or trade based, the majority of roles are recruited locally from within the ACT and surrounding districts. Within this market ActewAGL has faced strong competition from the Australian Public Service (APS), which has typically had a strong presence and offers attractive remuneration and conditions as well as more generous superannuation arrangements. For example, the EAs of the Australian Competition and Consumer Commission, the Treasury, and the Department of Human Services all provide annual superannuation contributions of 15.4 per cent, flex time, sixteen weeks paid maternity leave, and flexible working arrangements, among other attractive conditions.¹⁹

Despite the evidence providing justification for higher labour costs, ActewAGL Distribution's own analysis presented above as well as analysis undertaken by Australian Business Lawyers & Advisors Pty Limited (ABLA) at the request of ActewAGL Distribution shows that ActewAGL

¹⁹ See, for example, Attachment C69, ACCC, *ACCC Enterprise Agreement 2011-14*, Attachment C70, Australian Government Department of Human Services, *Department of Human Services Agreement 2011-2014* and Attachment C71, Australian Government Treasury, *Treasury Workplace Agreement 2011 - 2014*

Distribution does not stand out from its peers in regard to salaries contained in Enterprise Agreements (EAs).²⁰

1.4 Sources of inefficiency identified by the AER

The AER reviewed three areas of what it determined were inefficiencies and inflexibilities of ActewAGL Distribution's labour force: ActewAGL Distribution's outsourcing practices; ActewAGL Distribution's use of redundancy provisions and the outcome of the review by Marchmont Hill Consulting (MHC). ActewAGL Distribution refutes these findings in the following section and provides evidence to support the efficiency of its base year opex.

1.4.1 Outsourcing practices

The AER cites ActewAGL Distribution's outsourcing levels as a likely source of material inefficiency. In its draft decision, the AER purports to rely upon this analysis undertaken by Deloitte, entitled: *NSW Distribution Network Service Providers Labour Analysis*.²¹ The Deloitte report found that ActewAGL Distribution outsources a smaller share of its operating expenditure than the NSW service providers, who outsource much less than their more efficient peers, and that ActewAGL Distribution's outsourcing provision in the EA is more restrictive than even the NSW service providers.²²

The Deloitte report was not made available to ActewAGL Distribution at the time of the draft decision (despite a request on 19 November 2014 by ActewAGL Distribution that such material be provided by the AER with its draft decision). A further request, specifically for the Deloitte report, was made on 8 December 2014. However, the Deloitte report has still not been made available to ActewAGL Distribution by the AER. ActewAGL Distribution is unable to understand and respond to the labour outsourcing aspect of the AER's draft decision in full without access to the report. Further, ActewAGL Distribution has been unable to have the report considered by an expert as part of preparation of this revised regulatory proposal. The AER has therefore failed to afford procedural fairness to ActewAGL Distribution and is accordingly unable to rely upon the Deloitte report in making its draft decision or its final decision.

²⁰ See Attachment C72, ABLA, 2015, *Review and Comparison Of ActewAGL's Enterprise Agreement Provisions Against Other Electricity Network Service Providers*, January, page 4

²¹ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 18

²² AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-78

ActewAGL Distribution's response to the AER's conclusions on outsourcing arrangements as a source of inefficiency is therefore based on the information available in the draft decision.

A further issue is that the AER's simplistic word-for-word comparison of the outsourcing provisions of the EAs across DNSPs does not recognise that each EA provision interacts with other EA provisions which can have a cumulative effect on operational flexibility. This includes such provisions as prohibitions on forced redundancies, obligations for contractors to match pay and conditions and cumbersome consultation processes. In doing so, the AER has not provided evidence that supports its assertion that the restrictiveness of ActewAGL Distribution's EA is a source inefficiency relative to its peers.

At the request of ActewAGL Distribution, Australian Business Lawyers & Advisors Pty Limited (ABLA) has prepared a report comparing the provisions of ActewAGL Distribution's EA with the EAs of other Australian DNSPs that relate to the use of contractors and redundancies. This report is provided in confidential Attachment C72.

ABLA found that contrary to the AER's conclusions, ActewAGL Distribution's EA is no more restrictive than most of its peers and in many respects is less so in relation to outsourcing, redundancy and business change generally.²³

ABLA identified interacting provisions within the EAs of other DNSPs that not only provide limitations in relation to outsourcing, business change and redundancy, but are likely to contribute to material inefficiency or at least inhibit the delivery of efficiencies relative to ActewAGL Distribution. For example, a number of DNSPs are required to enter into detailed and in some cases lengthy union consultation and in some cases are required to reach agreement before engaging a contractor or labour hire company or making significant workplace change, and are prohibited from making forced redundancies. This includes the EA covering Networks NSW, Powercor/CitiPower employees.²⁴

Based on this evidence it is clear that the outsourcing provisions within ActewAGL Distribution's EA are no more restrictive than those of its peers, and in many cases are less restrictive. Therefore ActewAGL Distribution contends that its EA is not evidence upon which the AER can rely to support its conclusions that ActewAGL Distribution's labour costs are inefficient relative to its peers in its assessment of ActewAGL Distribution's opex forecast.

²³ See Attachment C72, ABLA, 2015, *Review and Comparison Of ActewAGL's Enterprise Agreement Provisions Against Other Electricity Network Service Providers*, January, pages 4 to 5

²⁴ See Attachment C72, ABLA, 2015, *Review and Comparison Of ActewAGL's Enterprise Agreement Provisions Against Other Electricity Network Service Providers*, January, pages 25 to 28

Further, the AER has failed to provide evidence that demonstrates that higher levels of outsourcing deliver more efficient expenditure. In the absence of such evidence and based on its own findings, ActewAGL Distribution considers the AER's conclusions are inaccurate and therefore do not support the AER's general findings on ActewAGL Distribution's level of inefficiency.

As a prudent operator, ActewAGL Distribution makes decisions on sourcing of labour based on its individual circumstances that will enable it to deliver a safe, reliable and secure supply of electricity at the most efficient cost over the long term. Under the operation of the EBSS, ActewAGL Distribution has had appropriate incentives in place to ensure this. It is noted that differences in organisational structures and operating models across DNSPs result in different levels of outsourcing, but this in itself does not determine the efficiency of one model or structure over another. For example, each of the Victorian DNSPs outsource a significant proportion of opex, with much of this being to related party contractors.²⁵

Contract labour accounted for 21 per cent of total opex during the 2009-14 regulatory period. ActewAGL Distribution's labour sourcing decisions are based on a number of factors. Mr Glyde notes:²⁶

the question of whether network Opex or Capex tasks are carried out by internal or external labour is largely irrelevant to the efficiency of the outcome, other than determining where the costs are reported from an accounting perspective. Significantly, the efficiency (or otherwise) of any given contracting approach is ultimately dependent on how risks are shared and productivity incentives are managed through the life of a contract.

Mr Glyde and Mr Mudge also details examples of risks under different contracting approaches that impact productivity in its report prepared for ActewAGL Distribution on opex drivers. Mr Glyde and Mr Mudge states that the efficiency of the contracting approach adopted will be determined by the specific market and expected market conditions and goes on to detail factors specific to the ACT market for specialist electrical contractors that are consistent with the need for a smaller overall level of contracting. Mr Glyde and Mr Mudge concludes that:²⁷

²⁵ See Attachment C56, AER, 2010, *Final decision - Victorian electricity distribution network service providers Distribution determination 2011–2015*, October, page 149

²⁶ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, page 96

²⁷ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, pages 97 and 98

- 1) no particular contracting strategy is inherently inefficient, provided that it is selected and managed appropriately for the specific market (taking account of the degree of certainty/uncertainty that was present at the time of entering the agreement);*
- 2) there is an inherently weaker case for outsourcing a large proportion of work in the AAD network than in more densely populated areas where contractors can achieve resourcing efficiencies by working with multiple NSP's; and,*
- 3) the contracting environment for AAD's electricity network is materially different to its gas network due to the absence of an established co-located contractor or network owner where mutually beneficial synergies can be realised.*

As explained in 1.3.1, over the previous regulatory period (and indeed in prior periods) ActewAGL Distribution experienced difficulty in attracting and retaining appropriately skilled labour. Further to this, ActewAGL Distribution's workforce analysis has shown that its ageing workforce will put further pressure on ActewAGL Distribution's ability to meet existing and future workloads. ActewAGL Distribution has responded to this risk by developing workforce strategies centred on attracting, retaining and developing internal expertise to ensure future work program needs are met in a manner that reflects efficient costs in the long term. This includes structured apprenticeship, cadet and graduate programs to develop skills in both technical trades and engineering streams.

ActewAGL Distribution therefore maintains that decisions on the sourcing model of the business must be made with regard to individual operating circumstances. Costs related to these decisions, including in the base year, have reflected the efficient costs of achieving the opex objectives and contributed to the efficient operation of electricity services for the long term interests of consumers.

The AER in its draft decision has not presented evidence to support its view that ActewAGL Distribution's level of outsourcing reflects inefficient costs, neither through evidence that ActewAGL Distribution's EA is more restrictive than its peers with respect to outsourcing provisions, nor evidence that outsourcing does in fact deliver materially more efficient costs.

Further, ActewAGL Distribution notes that the AER fails to provide evidence that loosening of EA provisions could reasonably and realistically achieve labour costs that reflect the opex criteria to a greater degree. Given the bargaining environment which sees unions seeking to negotiate relatively consistent terms across DNSPs' EAs and opposing attempts to reduce costs, regard must be had to ActewAGL Distribution's ability to negotiate changes to EA provisions that would see its EA depart further from those of its peers to be less restrictive.

1.4.2 Use of redundancy provisions

The AER's review of labour costs notes that ActewAGL Distribution's access to involuntary redundancy is in contrast to the NSW service providers and as well as other service providers'

EAs, and claims that this seems to come at a cost to ActewAGL Distribution and may be a driver of inefficiency.²⁸

The AER cites generous severance pay provisions and relatively high redundancy payments during the 2009-14 period as evidence.²⁹ In making this conclusion, the AER has compared ActewAGL Distribution's involuntary redundancy pay requirements with those of Aurora, Powerlink, SPI – ETA and Transend, noting that many EBAs do not specify redundancy pay arrangements and refers to policies which it was unable to review.³⁰

ABLA's analysis provides a broader comparison of key redundancy arrangements (including voluntary and involuntary). This shows that ActewAGL Distribution's provisions for voluntary redundancies are in line with other service providers. ABLA states that ActewAGL Distribution benefits from its arrangements relative to other DNSPs:³¹

2.5 Unlike others in the sector, ActewAGL can and has demonstrated its ability to improve efficiency through organisational change resulting from both voluntary and involuntary redundancy.

2.6 It may seem to an external observer that the cost of this can be high in the short term. However, the business benefit of this is that it can be affected in a relatively short timeframe as the business can move from improvement idea to benefit realisation faster than others in the sector.

2.7 For others in the sector that are required to engage in lengthy consultation and dispute resolution processes with employees and unions while only having access to voluntary redundancies, the ability to realise efficiencies through organisational restructuring is limited.

In comparing redundancy provisions and costs, ActewAGL Distribution notes that regard should be had to the fact that actual payments will depend largely on the tenure and level of those occupying redundant positions.

²⁸ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-79

²⁹ AER 2014, *Draft decision – ActewAGL distribution determination 2014-19, Confidential Appendix Attachment 7: Opex*, November, page 19

³⁰ AER 2014, *Draft decision – ActewAGL distribution determination 2014-19, Confidential Appendix Attachment 7: Opex*, November, page 18

³¹ See Attachment C72, ABLA, 2015, *Review and Comparison Of ActewAGL's Enterprise Agreement Provisions Against Other Electricity Network Service Providers*, January, page 4

Further, ActewAGL Distribution considers the AER's contention that ActewAGL Distribution's relatively high redundancy payments during the 2009-14 period is evidence of inefficiency is flawed in the context of the incentive mechanism in place during this period. Under the EBSS, ActewAGL Distribution had regard to the incentives in place (as detailed in section 3.4.4.4 of the revised proposal and in Mr Houston's expert report) when making business decisions on operating expenditure. In making the decision to incur redundancy costs it recognised that it would incur a penalty under the EBSS but did so with regard to the intentions of clause 6.5.8 of the Rules and specifically the need for a continuous incentive to reduce operating expenditure, which gives effect to the expectation that the EBSS would be continued, affording ActewAGL Distribution the opportunity to achieve future operating expenditure efficiencies which would deliver long term benefits to consumers through the sharing of these efficiencies.

1.4.3 Outcomes of the 2011 organisation review

In its draft decision the AER expresses a view that structural problems and cultural issues are a source of inefficiency within ActewAGL Distribution.³² In particular, the AER makes reference to the major organisation review undertaken by Marchmont Hill Consulting (MHC) in 2011 and the issues at that time identified through the review. In referring to these issues as evidence to support its general conclusions on ActewAGL Distribution's level of inefficiency, the AER expresses a view that:

Given the list of issues identified by MHC, we consider it is unlikely the restructure of management could have addressed all of the identified organisational problems by 2012–13. ActewAGL's business as usual forecast tends to support this. We would have expected such significant change to result in efficiency improvements going forward.³³

This suggests that the AER is relying on issues identified at that point in time (2011) and makes the assumption that because ActewAGL Distribution's base opex has not materially reduced since this time, these issues remain and provide evidence that ActewAGL Distribution has inefficient labour costs.

As previously acknowledged by ActewAGL Distribution to the AER, the primary objective of this review was undertaken to understand and address performance issues identified by ActewAGL Distribution's management. Acting as a prudent operator under the EBSS, ActewAGL Distribution's management made a decision to wear a penalty for the investment in the review

³² AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 7

³³ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 12

and subsequent initiatives to address the issues identified. This decision was made to ensure the opex objectives could be achieved in a manner that reflects the opex criteria over the long term. This efficient investment was made to deliver an improved structure and culture, and achieve long term benefits to the business and its consumers. It follows that under the EBSS, any efficiency gains resulting from these changes would be shared between the business and distribution network users.

Since the review, ActewAGL Distribution has implemented MHC’s recommendations. The issues identified by MHC and ActewAGL Distribution’s response to these issues are summarised in the table below.

Table 1.1 ActewAGL Distribution’s response to key issues identified by MHC

Operating model element	Key issues	How issues have been addressed by ActewAGL Distribution
Organisation Structure and Governance	<ul style="list-style-type: none"> • Lack of clarity around accountabilities and responsibilities • Silo working and limited cross functional collaboration • Key roles remain vacant for long periods and limited succession planning • Lack of clarity around delegation freedoms and decision authorities • Informal and formal information flows are lacking between individuals and teams 	<ul style="list-style-type: none"> • Recommended Strategic Asset Management (SAM) structural model implemented • Increased ownership/accountability within line management • Delivery of the ‘Winning Team Behaviours’ program between 2012 and 2014 • Establishment of Distribution Leadership Team regular meetings and collaboration • Increase in cross functional project work e.g. System Replacement Portfolio (SRP) program • Recruitment for key roles extended to national and international labour markets. • Improved succession planning through individual enhanced personal professional development program • Delegations clarified and formalised • Improved information flow achieved through development and implementation of communication and change management plans for all major organisational projects
Process and interfaces	<ul style="list-style-type: none"> • Lack of end to end business improvement • Insufficient process documentation • Duplication and multiple handoffs • Inadequate process performance reporting and data access • Lack of process compliance, reluctance to embrace new practices 	<ul style="list-style-type: none"> • Delivery of SRP program has addressed these issues through improved processes and information management • Development of asset management strategy and systems in accordance with the PAS 55 framework to achieve compliance • Processes formalised through update/ development of documentation including policies, procedures, manuals and databases • Improved training / communication on processes
Values, behaviours and competencies	<ul style="list-style-type: none"> • Growing complacency around safety • Lack of training and/or support 	<ul style="list-style-type: none"> • Delivery of the ‘Winning Team Behaviours’ program between 2012 and 2014 • Establishment of EHSQ Division in 2011 to

	<p>around corporate policies</p> <ul style="list-style-type: none"> • Embedded culture of blame, lack of urgency and commercialism • Lack of understanding of (and listening to) upstream and downstream issues • Unwritten rules and perceptions 	<p>focus expertise and leadership in in these areas</p> <ul style="list-style-type: none"> • Implementation of improved Integrated Management System • Improved training / communication on corporate policies and procedures • Training needs analysis undertaken to assess specific training requirements related to roles • Safety goals embedded in personal professional development plans • Code of Conduct revised
Delivery model	<ul style="list-style-type: none"> • Works Program and Scheduling are not prioritised in the longer term business objectives • A holistic sourcing strategy has not been developed, but at present there are too many upstream process issues for a reasonable assessment of sourcing strategy to be undertaken, therefore this is not a priority focus area 	<ul style="list-style-type: none"> • Transfer of procurement accountability to Finance and development of the procurement management framework and associated documentation • Establishment of Works Management and Logistics branches within Network Services to deliver improved works program management and scheduling • Delivery of SRP has improved works program and scheduling through Cityworks program
Business Systems and Technology	<ul style="list-style-type: none"> • Lack of system integration • Uncertainty around system ownership • User dissatisfaction with tools, systems and data integrity • Lack of clarity with BSG interface • Inadequate change management capability 	<ul style="list-style-type: none"> • Delivery of SRP program • Realignment of IT/OT accountabilities between BSD and Asset Management • Business systems analysts embedded in Asset Management and Network Services divisions • Development and implementation of communication and change management plans for all major organisational projects
Performance Management Frameworks	<ul style="list-style-type: none"> • Target setting lacks rigour and alignment to Corporate goals • Position descriptions are vague and out of date • Management lack skills to execute performance management processes • Design of bonus incentives not influencing desired behaviour 	<ul style="list-style-type: none"> • Delivery of the 'Winning Team Behaviours' program between 2012 and 2014 • Improved position descriptions for all staff to improve role definition, accountability, responsibility, clarity around requisite skills and competencies • Improved personal professional development program including better definition and standardisation of performance goals • Delivery of leadership training program • Refinement of staff incentive scheme KPIs to better reflect the needs of the business and influence desired behaviours

Key to addressing the issues identified was implementing MHC's recommended Strategic Asset Management (SAM) structural model. This involved splitting network accountabilities across mid-long term asset 'decision' accountabilities (Network Asset Management) and short-medium term asset 'action' accountabilities (Network Services Division). The restructure removed the Group Manager layer to focus accountabilities for both General Managers and Branch Managers and

improve communication flows as well as clarity around role authorities and relativities. The SAM model is consistent with models adopted by a number of ActewAGL Distribution's peer utilities and for businesses in other asset intensive industries. As observed by the AER, MHC noted a small direct benefit resulting from the restructure.³⁴ MHC also reported that the additional benefits could not be calculated meaningfully but will be driven as an outcome from implementing the recommended structure.

As previously explained to the AER, another key initiative in response to MHC's review findings was the 'Winning Teams Behaviour' program. The main objective of this program was to drive cultural change within the organisation with a focus on performance, collaboration and customer service. ActewAGL Distribution has explained that it is difficult to quantify direct benefits resulting from the MHC review and in turn the Winning Team Behaviours program.

Other major actions that have contributed to addressing the issues identified by MHC include the establishment of the Environment Health, Safety and Quality (EHSQ) division to drive improvement in ActewAGL Distribution's safety performance³⁵ and the SRP which included the Operational Systems Replacement Program (OSRP) and Core Systems Replacement Program (CSR)³⁶ as discussed in ActewAGL Distribution's regulatory proposal.

The benefits of the programs and initiatives delivered to address the issues identified by the MHC review primarily relate to delivering services in the long term interests of consumers through improved safety, employee engagement, customer service, and productivity. As detailed in the table above, addressing the issues identified by MHC required delivery of a number of programs and initiatives. Most of these were rolled out during 2011, however some of the activities extending throughout the remainder of the regulatory period. Some were delivered through existing resources, while others required additional expenditure. As a result, any material short term efficiencies have been offset by these increased costs, and, as noted by ActewAGL Distribution, any ongoing productivity improvements will contribute to the achievement of the implicit productivity growth rate factored into ActewAGL Distribution's operating expenditure forecast.³⁷ Indicators of ActewAGL Distribution's performance in

³⁴ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 12

³⁵ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 216

³⁶ ActewAGL, 2014, *Regulatory Proposal, 2015-19 Subsequent regulatory control period, Distribution services provided by the ActewAGL Distribution electricity network in the Australian Capital Territory*, 2 June (resubmitted 10 July), pages 190 to 192 and 198 to 199

³⁷ ActewAGL, 2014, *Information request AER ACTEW 046 – Labour*, 14 October, Question 2

addressing the issues raised are improvements in both its safety and employee engagement performance.

In drawing the conclusion that structural and cultural issues have impacted costs in the base year and driven labour inefficiency, the AER asserts:

It seems clear that the costs associated with implementing the MHC recommendations far outweigh the savings... This suggests that ActewAGL is anticipating further cost efficiencies and productivity improvements to result from the significant reforms. However, it appears that no financial savings goals associated with the reforms and the WTB Program have been articulated, aside from a general commitment to absorb costs associated with new functions and managing new assets to be built over the next regulatory control period.

In our view, this demonstrates the impact on opex of the productivity and cultural issues identified by MHC, which have likely impacted costs in the base year. Therefore, we are satisfied that the structural and productivity issues are likely to be a driver of labour inefficiency in the base year.³⁸

Under the EBSS, ActewAGL Distribution had regard to the incentives in place when undertaking the MHC review and subsequent implementation of recommendations and initiatives. In doing so, it recognised that it would incur a penalty for efficiency losses and a reward for efficiency gains that would be shared between it and customers. With regard to the intentions of clause 6.5.8 of the Rules, if ActewAGL Distribution was to achieve ongoing efficiencies as a result of the initiatives outlined above, it is consistent with the EBSS to achieve these without specifying financial savings goals to the AER in order to deliver long term benefits to consumers through the sharing of these efficiencies under the EBSS.

It is ActewAGL Distribution's view that the outcome of the MHC review and the lack of quantification of deliverable financial benefits does not provide the AER with evidence that ActewAGL Distribution's labour costs in the base year are inefficient and therefore does not support its benchmarking findings on ActewAGL Distribution's overall level of opex efficiency.

1.5 Conclusions on labour efficiency

In its detailed review of ActewAGL Distribution's labour costs, the AER has failed to present evidence to support its claim that labour costs are a source of material inefficiency, and certainly has not presented evidence to explain the huge efficiency gap it claims to exist between ActewAGL Distribution and those firms it considers to be at the efficiency frontier.

³⁸ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Opex, Confidential Appendix*, November, page 14

Rather than exhibiting material inefficiency, ActewAGL Distribution's analysis shows that more appropriate use of the RIN labour data delivers findings that ActewAGL Distribution's labour costs and staffing levels are at least comparable to its peers, and indeed more efficient under a number of scenarios.

With regard to its review of industry enterprise agreements, the AER states that ActewAGL Distribution's Enterprise Agreement (EA) limit its management's ability to efficiently and prudently manage its labour costs. In making this assertion, the AER implies that ActewAGL Distribution's labour costs could be more efficient if it had less restrictive and generous EA provisions. The AER fails to provide evidence that, having regard to its individual circumstances, ActewAGL Distribution could reasonably and realistically achieve labour costs that reflect the opex criteria to a greater degree through loosening of its EA provisions. The AER must have regard to the individual circumstances of operators in assessing proposed expenditure against the opex criteria, and therefore should have regard to factors affecting the decisions of operators on its labour costs. For ActewAGL Distribution this includes such considerations as the labour market within which it operates, the efficient use of outsourcing, and its ability to negotiate changes to EA provisions that would see its EA depart further from those of its peers in terms of restrictiveness and generosity of conditions.

As a prudent operator participating in the EBSS, ActewAGL Distribution has responded to the incentives in place and made decisions on labour expenditure accordingly to ensure it could continue to deliver efficient services in the long term interests of electricity consumers. An example of this is action taken to address structural, cultural and safety issues raised in the MHC review, which required additional expenditure without an immediate efficiency gain, but served to ensure ActewAGL Distribution continues to contribute to the NEO.

ActewAGL Distribution maintains that its revealed base year opex, including labour expenditure, reflects the efficient costs that a prudent operator would require to achieve the opex objectives and contends that the AER's detailed review of labour fails to serve as evidence to support its claims regarding ActewAGL Distribution's level of inefficiency and to support its alternative opex forecast.

2 Detailed review – Vegetation management

The second part of the AER's 'detailed review' focuses on ActewAGL Distribution's vegetation management program. The AER formed the view that "...one of the sources of ActewAGL's high expenditure in its base year opex (identified with our benchmarking techniques) is likely due to vegetation management practices."³⁹ The AER states that the detailed review corroborates the benchmarking results.⁴⁰

However, the AER provides no evidence or analysis that the purported inefficiencies identified corroborates the SFA benchmarking results, which indicate that ActewAGL Distribution is 40% inefficient.⁴¹ The AER does not identify a percentage or dollar amount of ActewAGL Distribution's proposed vegetation management operating expenditure it considers inefficient. Instead the AER simply claims that inefficiencies exist in ActewAGL Distribution's vegetation management practices.

The AER's inability to identify at least 40% of ActewAGL Distribution's vegetation management expenditure as inefficient, in a cost category the AER considers to have 'very high' relative costs⁴², undermines the SFA benchmarking results. This illustrates that the AER's draft decision opex allowance is not sufficient for ActewAGL Distribution to meet the opex objectives and will not achieve the NEO to the greatest degree.

The AER's analysis and identification of inefficiencies has the following flaws:

1. The AER's conclusion that ActewAGL Distribution's contracting arrangements were a key driver of inefficient vegetation management expenditure is based on incorrect and unsupported claims: ActewAGL Distribution primarily employs hourly rate contracting (incorrect), hourly rate contracting is potentially more inefficient (unsupported) and increasing contractor costs were a major contributor to increased costs (the increase in

³⁹ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-79

⁴⁰ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-33

⁴¹ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-27

⁴² AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-70

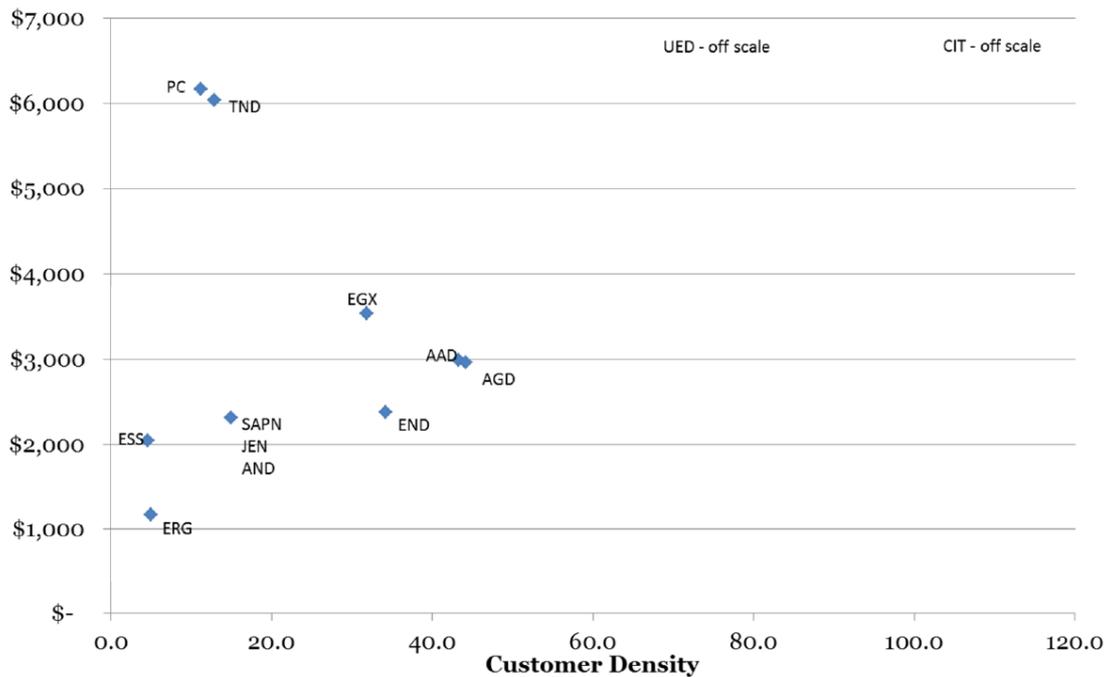
- costs were a symptom of increased vegetation growth). This is discussed in the section 2.1.
2. The AER claims, without evidence or analysis, that ActewAGL Distribution could reduce costs through more proactive vegetation management. In making this claim the AER has no regard to evidence previously submitted that ActewAGL Distribution's vegetation management program is proactive and based on risk management. This is discussed in section 2.2.
 3. The AER in concluding vegetation management performance deteriorated (by examining the increase in historical network outages due to vegetation) and fails to take into account the increase in vegetation growth over the period. While the number of vegetation related outages increased the impact of vegetation related outages did not, rural SAIDI and SAIFI declined significantly while urban SAIDI and SAIFI remained stable, indicating an improvement in performance. This is discussed in section 2.3.
 4. The AER did not assess proposed vegetation management expenditure but the expenditure included within a 'base year opex' (based on historical costs with adjustment) of the AER's own construction. The AER should instead assess actual costs proposed, which exclude the 2012/13 pass through amount which occurred due to unexpected and uncontrollable vegetation growth following two years of above average rainfall. This is discussed in section 2.4.

ActewAGL Distribution addresses the AER's vegetation management category analysis in chapter 3 of the Revised Regulatory Proposal. ActewAGL Distribution notes the errors the AER makes with respect to data quality, one-dimensional nature of category analysis benchmarking and the assumed linear relationship between inputs and outputs. ActewAGL Distribution also notes Mr Glyde's and Mr Mudge's analysis which uses a more appropriate normaliser, vegetation management km rather than overhead line length, to produce the results below.

While data issues remain, ActewAGL Distribution and Mr Glyde and Mr Mudge note that remain Figure 2.1 contradicts the AER's conclusion that ActewAGL Distribution has very high costs relative to most of its peers.⁴³

⁴³ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, page 71

Figure 2.1 Average Vegetation Management costs per OH vegetation route km (Truncated vertical axis)⁴⁴



2.1 Contracting practices

The AER holds the view that ActewAGL Distribution’s vegetation contracting arrangements were a key driver of inefficient vegetation management expenditure as

1. ActewAGL Distribution primarily employs hour rate contracting;⁴⁵
2. Hourly rate contracting is potentially more inefficient;⁴⁶ and

⁴⁴ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, pages 70

⁴⁵ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

⁴⁶ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

3. Increasing contractor costs are a major contributing factor to increase vegetation management costs for ActewAGL Distribution.⁴⁷

However, as each of the AER's contentions above is either incorrect or unsupported the AER's conclusion cannot be reached.

2.1.1 ActewAGL Distribution primarily employs hour rate contracting

The AER incorrectly claims:

*ActewAGL employs hourly rate contracting as the primary means of undertaking vegetation management activities.*⁴⁸

ActewAGL Distribution currently employs vegetation clearance contractors through a combination of lump sum and hourly rates.⁴⁹ For vegetation inspection ActewAGL Distribution uses internal ground inspectors and LiDAR.⁵⁰

2.1.2 Hourly rate contracting is potentially more inefficient

The AER contended that hourly rate contracting is potentially more inefficient than other forms of contracting (and therefore ActewAGL Distribution's contracting arrangements were a key driver of inefficient vegetation management expenditure) based on a GHD expert report for Aurora Energy, an AER Technical Advisory Group (TAG) report and an Essential Energy document. The AER also notes that Essential Energy's vegetation management costs have increased over the 2009-14 period where, presumably, hourly rate contracting was employed.

Together these documents do not support the AER's conclusion for the following reasons:

⁴⁷ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

⁴⁸ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

⁴⁹ See Attachment C74, ActewAGL Distribution, 2014, *Vegetation management cost pass through: Response to second additional information request*, February, page 20 and ActewAGL, 2014, *Regulatory Proposal, 2015-19 Subsequent regulatory control period, Distribution services provided by the ActewAGL Distribution electricity network in the Australian Capital Territory*, 2 June (resubmitted 10 July), Attachment A2, Appendix 1-4.

⁵⁰ See Attachment C75, ActewAGL Distribution, 2013, *Vegetation management cost pass through*, November, page 14

1. As highlighted by Aurora Energy the AER has taken the GHD Report out of context. The AER cannot rely on the results without GHD understanding the particular circumstances of ActewAGL Distribution.
2. The GHD report expressly warns against comparisons of the contracting models of other distribution businesses in assessing efficient contracting model for a particular DNSP;
3. The TAG report referenced by the AER does not support the AER's contention that hourly rate contracting arrangements is typically only for emergency work;
4. The Essential Energy document is specific to Essential Energy's circumstances and does not take into account details which GHD state is required for meaningful cost comparisons;
5. Essential Energy, presumably, using hourly rate contracts compare well using the AER's preferred comparison in Figure A.16 over the 2009-13 period; and
6. All 9 networks south of, and including, Essential Energy have experience significant vegetation management expenditure increases over the 2009-13 period. The geographically consistent and widespread vegetation expenditure increases indicate that increases in cost is not due to individual DNSP's contracting policies.

The GHD expert report for Aurora Energy, the AER TAG report and the Essential Energy document are considered in turn.

The GHD expert report

In the Draft Decision the AER incorrectly states:

During the cost pass through review process, TasNetworks submitted an expert report that provides evidence that hourly rate contracting arrangements are potentially more inefficient than other forms of contracting.⁵¹

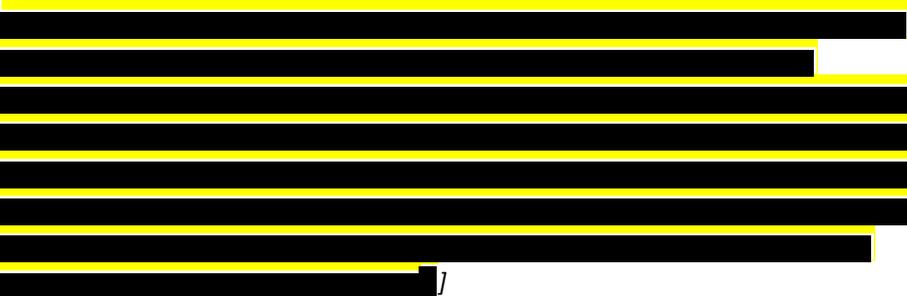
TasNetworks did not submit the GHD expert report during the cost pass through review process but as part of the Aurora 2012-17 distribution determination process. The AER was required to disclose the report to ActewAGL Distribution using its powers under the NEL.

The Aurora submission the AER references does not provide evidence that hourly rate contracting arrangements are potentially more inefficient than other forms of contracting. Instead it notes:

⁵¹ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

Aurora considers that the AER has taken this work completely out of context and that any reliance on the GHD Report cannot be extended to the Draft [pass through] Determination without GHD understanding the particular circumstances of ActewAGL.⁵²

Nevertheless, the GHD expert report does not support the proposition that unit rate contracting is superior to, or generally more efficient than, hourly rate contracting. Nor does it support any conclusion as to the relative efficiency of hourly rate and unit rate contracting in ActewAGL Distribution’s circumstances.⁵³ Rather, the GHD report expressly warns against comparisons of the contracting models of other distribution businesses in assessing efficient contracting model for a particular DNSP stating:

[c-i-c ]

AER claims not supported by TAG

The AER also claims that citing a TAG report:

Some service providers may use hourly rate contracting arrangements. However, such arrangements are typically only for emergency work, rather than for a ‘business as usual approach to vegetation management.’⁵⁵

The TAG Report referenced by the AER does not support the AER’s claim that hourly rate contracting arrangements are typically only for emergency work rather than for a business as usual approach to vegetation management.⁵⁶ The TAG report does state that:

⁵² See Attachment 81, Aurora Energy, 2014, *Submission on Draft Determination – ActewAGL cost pass through application*, June, page 2

⁵³ See Attachment C76, ActewAGL Distribution, 2014, *Vegetation management cost pass through application, ActewAGL response to AER draft determination*, June, page 21

⁵⁴ See Attachment C76, ActewAGL Distribution, 2014, *Vegetation management cost pass through application, ActewAGL response to AER draft determination*, June 21

⁵⁵ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

*The TAG agrees that DNSP's employ a range of contracting models in managing vegetation.*⁵⁷

The TAG's agreement is in reference to a supporting letter from Mr Cliff Jones attached to ActewAGL Distributions response to the AER's vegetation pass through draft determination and earlier TAG report. ActewAGL Distribution's submission noted that:

Contrary to the AER's conclusion in its Draft Determination, the contracting arrangements ActewAGL had in place to undertake vegetation clearance work were efficient and did not hinder its ability to prevent or mitigate the effect of the increased vegetation growth. Moreover, the contracting arrangements in place facilitated ActewAGL's efficient response.

[sic: Aurora: 























⁵⁶ See Attachment C44, AER, 2014, *AER Technical Advisory Group: Advice on ActewAGL vegetation management cost pass through – Review of ActewAGL response to AER draft determination*, June

⁵⁷ See Attachment C44, AER, 2014, *AER Technical Advisory Group: Advice on ActewAGL vegetation management cost pass through – Review of ActewAGL response to AER draft determination*, June

The flexibility in the hourly rate contracts in place allowed ActewAGL to effectively address the urgent operational imperative to clear vegetation encroachment resulting from the proposed increase vegetation growth pass through event without any penalties or contract variations. Further, there was a high variability in the cost of the work undertaken to address the proposed pass through event due to differences in travel time, accessibility and volume of vegetation to be cleared. As GHD notes [sic Aurora: [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]".]

GHD's analysis of hourly rate contracting is consistent with Jacobs' conclusions as follows:

Jacobs fully recognises that for certain electricity distribution activities for which the scope of work, the labour required, and where total costs for a particular task will normally fall within a small to moderate range (say $\pm 10 - 20\%$) then unit rate contracting can be used effectively to achieve a particular level of output for a fixed unit price. Typical examples of work that can be done using unit rate contracts are:

- Meter reading
- Pole inspection
- Pole replacement
- Transformer replacement
- Other tasks where there is not large variability in the possible scope of work and time taken to complete

However, it is also our experience that there are certain distribution work activities which cannot be sufficiently tightly scoped to allow for unit rate contracting to be universally applied, without the contractor pricing in a significant risk premium. Such work includes:

- Standby and after hours call-out work where the frequency and duration of call-out jobs is unknown
- Emergency response work such as during storms and cyclones
- Tree trimming/clearing and vegetation management, where the accessibility is difficult, or where the species of trees and/or volume of material to be disposed of is unknown, or difficult to estimate

The TAG report conveys the impression that unit rate contracts are more commonly used for vegetation control across the distribution industry than hourly rate contracts, and that by deduction one can only be classified as "cost effective" if a utility uses unit rate contracting for vegetation control. This is not correct, nor is it representative, in Jacobs's experience, of

the commonly used contracting methodologies for vegetation control by Australian distribution companies.

Jacobs has contacted industry representatives and a highly reputable private vegetation management company that operates nationally, all of whom have confirmed that DNSPs in Australia use a mix of contracting strategies including:

- **Hourly rate** – particularly for difficult to scope and emergency response situations
- **Lump sum** – typically on a feeder by feeder basis, where the tenderers can all view and assess the amount of work to be done on a common basis, and assess the risk of variability.
- **Annual budget based contracts** – these are sometimes used to engage a single Vegetation Management Consulting firm (as distinct from the tree trimming contractors), who provides an overall vegetation management service including patrolling and recording vegetation clearance issues, scoping work, issuing works orders, engaging contractors, checking quality of work, arranging payment of contractors, and updating asset records. Sometimes these annual budget based contracts will have benchmark or unit rate targets, and financial incentive arrangements built into the management contracts to encourage productivity improvements. However, there is a “management fee” to the arrangement which often mitigates any realistic estimates of productivity gains.
- **A hybrid of all of the above** – most vegetation management specialists will advise that it is necessary and prudent to have flexible contracting arrangements which are adaptable to the situation faced. For planned clearing work, where the scope is definable, the man-hours required quantifiable, and the “unknowns” minimal, then lump sum or hourly rate approach may be appropriate. For un-programmed, unexpected, or emergency response work, such as that experienced by ActewAGL in 2012/13 it is quite appropriate for the work to have been undertaken on an hourly rate basis.

Significantly, Jacobs concludes that “[t]he use of hourly rate contracts for un-programmed, unexpected, or emergency response work is the most common practice across the Australian electricity supply industry, and we believe that it constitutes what a prudent and efficient operator would have done under the circumstances that ActewAGL experienced in 2011/12 and 2012/13”.⁵⁸

⁵⁸ See Attachment C76, ActewAGL Distribution, 2014, *Vegetation management cost pass through application, ActewAGL response to AER draft determination*, June, pages 17 to 20

Essential Energy's specific circumstances are different to ActewAGL Distribution

The AER also refers to Essential Energy's documentation that its contracting model created little or no incentive for contractors to deploy resources efficiently as all their costs are covered. ActewAGL Distribution notes these comments were made in the context of Networks NSW's, and in particular, Essential Energy's particular network and vegetation management practices. No regard is had in those documents to ActewAGL Distribution's network characteristics, vegetation management practices or the particular circumstances the subject of the vegetation management costs to which the application relates.⁵⁹

ActewAGL Distribution also notes Figure A.16 shows Essential Energy's using the AER's preferred comparison: average vegetation management costs per kilometre of overhead line length for 2009 to 2013 against customer density. In this figure Essential Energy have the one of the lowest costs despite, presumably, employing hourly rate contracts over the period.

Vegetation management expenditure increases south of Essential Energy

The AER also highlights that Essential Energy's vegetation management expenditure increases steadily over the 2009-14 period like ActewAGL Distribution. However, the average increase in vegetation costs over that period for all 9 businesses south of (and including) Essential Energy was around 250%. The geographically consistent and widespread increase in vegetation expenditure increases indicate that increases in cost is not due to individual DNSP's contracting practices but rather systematic factors affecting multiple DNSPs. ActewAGL Distribution notes its costs increased by less: only 205% or as little as 135%, after taking the unexpected and uncontrollable pass through costs into account.

2.1.3 Increasing contractor costs are not a major contributing factor to increased vegetation management costs

The AER claimed that

In our final determination on ActewAGL's vegetation management cost pass through application, we explained that information submitted by ActewAGL in that process clearly showed increasing contractor costs were a major contributing factor to increased vegetation management costs over time.⁶⁰

⁵⁹ See Attachment C80, ActewAGL, 2014, *Vegetation Management Cost Pass Through Application ActewAGL Response to Essential Energy Documents Provided by the AER on 27 June 2014*, July, pages 11 to 12

⁶⁰ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-83

To support this claim, the AER does not reference its own analysis but rather a submission from ActewAGL Distribution showing a historical breakdown of costs. The increase in supplier costs was driven by an increased volume of vegetation clearing work required not through inefficient contracting practices. The increase in work volumes is evidenced through annual comparison of first notices issued to land holders to clear vegetation in urban areas against supplier costs. Over the 2009/10 to 2012/13 period although the issuance of 1st notices increased 113% supplier costs only increased by 81%.⁶¹ Since the number of first notices can be regarded as the proxy for the volume of work and the increase in that volume is greater than the increase in supplier costs, this evidence does not support the AER's conclusion.

2.2 Proactive vegetation management and risk management

The AER claims that "ActewAGL's current reactive practices seem to be resulting in ActewAGL unnecessarily incurring inefficient expenditure."⁶² The AER considers that if a more proactive approach was adopted urgent work could be minimised by making uncooperative land holders responsible for clearance costs via the issuances of a notice.⁶³

The AER provides no evidence to support its hypothesis that ActewAGL Distribution is not sufficiently proactive or any analysis of how the costs of increasing inspection rates would be offset by a corresponding decrease in urgent clearance costs.

While the AER has relied on the AER's Technical Advisory Group previous consideration of ActewAGL Distribution's vegetation practices, the AER has had no regard to expert information submitted by ActewAGL Distribution as part of the same process.

ActewAGL Distribution submitted evidence provided by Mr Cliff Jones, who during his 35 years of electricity industry experience with direct operational and management responsibilities for developing letting and managing vegetation management contracts in Victoria and Queensland. Mr Jones in considering the May 2014 TAG report on ActewAGL Distribution's vegetation practices (the TAG authors CV's provided do not disclose any experience with vegetation management) commented that:

⁶¹ See Attachment C76, ActewAGL Distribution, 2014, *Vegetation management cost pass through application, ActewAGL response to AER draft determination*, June, pages 30 and 31

⁶² AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-86

⁶³ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-86

The TAG report closes by making the observation that "... the TAG is also of the view that ActewAGL's vegetation management strategy may be inefficient. An efficient vegetation management strategy will include monitoring rainfall and pre-emptively adjusting pruning practices to reduce the impact of the expected growth response some 18 months to two years hence." Jacobs is of the view that ActewAGL are pro-active in their approach to vegetation management, and this is evidenced by the following elements of their vegetation management policies and practices:

- Regular ground patrols on a defined cycle, as outlined in ActewAGL's November 2013 cost pass through submission*
- The practice of trimming back to allow for three years regrowth wherever possible*
- The decision to undertake aerial patrols in 2011 and 2012 when ground patrols became difficult in some areas due to ground conditions, and when the possibility of multiple clearance breaches emerged*
- The subsequent decision to programme more regular aerial patrols, to compliment ground patrols, and to further trial the implementation of LiDAR technology*
- With the potential expansion of the use of LiDAR, ActewAGL is also considering the establishment of a geographical vegetation database of the span location, height of the trees and species of trees that are within or just outside the approach distances of overhead lines, with the potential to cause interference.*
- Targeted advertising campaigns to increase the awareness of vegetation requirements and responsibility for clearance*
- Maintaining a list of suitable trees and shrubs that are suitable for planting near power lines*

Finally, the statement in the TAG report that an efficient strategy "... will include monitoring rainfall and pre-emptively adjusting pruning practices ..." does not reflect industry practice. We have checked with our industry contacts, which includes a private vegetation management company (that has worked in all the states of Australia), and they all confirm that to the best of their knowledge, no DNSP in Australia monitors rainfall (in an active and continuous sense), and adjusts pruning practice accordingly. To some extent this is what vegetation inspectors do intuitively, and ActewAGL's three year regrowth cutback is designed to accommodate.

To suggest that a "prudent and efficient operator" does continuously monitor and respond to rainfall brings into question their whole understanding of the vegetation management process.⁶⁴

ActewAGL Distribution has previously submitted that the AER has no basis for the conclusion that ActewAGL did not undertake prudent risk management in 2012/13. ActewAGL Distribution's response is in attachment C76.

In addition to the Jacob's expert advice, ActewAGL Distribution wishes to emphasise how ActewAGL distribution employs various aspects of risk management as part of the vegetation management process.

At odds with the AER's claim, ActewAGL Distribution's vegetation performance has not deteriorated. The improvement, particularly in the rural areas evidenced by reductions of SAIDI and SAIFI numbers is apparent in Figure 2.3 and Figure 2.4. This improvement in reliability performance is also an evidence of the targeted resource allocation which assist in optimising the performance outcomes.

As part of the vegetation management and bushfire risk mitigation, individual work parcels are assessed in terms of risk and prioritised accordingly. For example ActewAGL Distribution assesses every vegetation defect/work parcel and weighs its importance depending on proximity and fire risk. Whilst ActewAGL Distribution aims to remove all defects prior to the commencement of the bushfire season, it is done on a prioritised basis focusing on risk to the asset, risk to the community and the targeted resource allocation.

ActewAGL Distribution has provided the AER with the output of bushfire intensity models, developed in 2012/13 ActewAGL Distribution as part of a new Bushfire Management Plan. The Bushfire Management Plan incorporates better understanding of bushfire modelling and new technological capabilities, such as LiDAR, image stabilisation and higher resolution cameras. The management methodology based on risk mitigation. The new tools assist ActewAGL Distribution to prioritise the inspection and clearing of vegetation in the highest risk areas. ActewAGL Distribution is one of the early adopters of LiDAR technology, which is understood is currently being contemplated by other utilities.

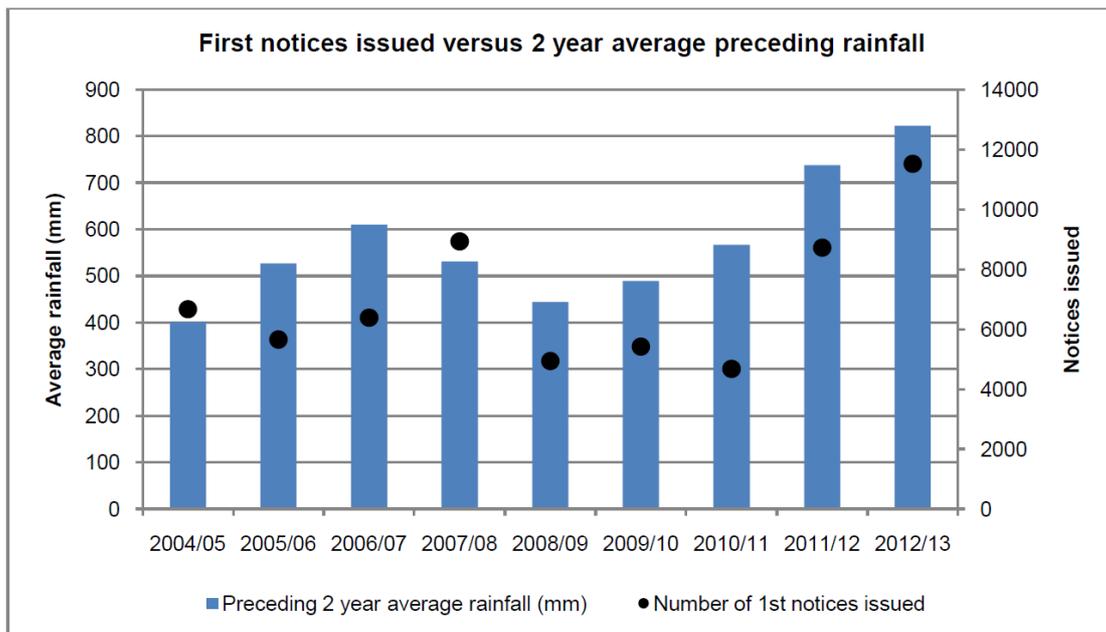
⁶⁴ ActewAGL, 2014, *Attachment 1.1 to ActewAGL's submission on the AER's draft decision on ActewAGL cost pass through application (PUBLIC) - Jacobs Group report*, June, pages 5 and 6

2.3 ActewAGL Distribution’s vegetation management performance has improved

The AER states that ActewAGL Distribution’s vegetation management performance deteriorated between 2009-10 and 2012-13. The basis for the AER’s claim is the yearly increase in historical network outages due to vegetation.⁶⁵ There are two issues with the AER’s analysis.

Firstly, the AER has not taken into account vegetation growth over the period. The driver of increased vegetation outages is increased vegetation growth which also increased vegetation management costs. Indeed it was unexpected and uncontrollable vegetation growth in 2012-13 that was the subject of ActewAGL Distribution’s cost pass through application to the AER. ActewAGL Distribution showed the AER the historical rainfall and number of notices issued to landholders to clear vegetation in urban areas to highlight the increase in vegetation growth. ActewAGL Distribution’s vegetation management performance over the 2009-13 period cannot be assessed without consideration of cost drivers such as vegetation growth.

Figure 2.2 First notices issued versus 2 year average preceding rainfall⁶⁶

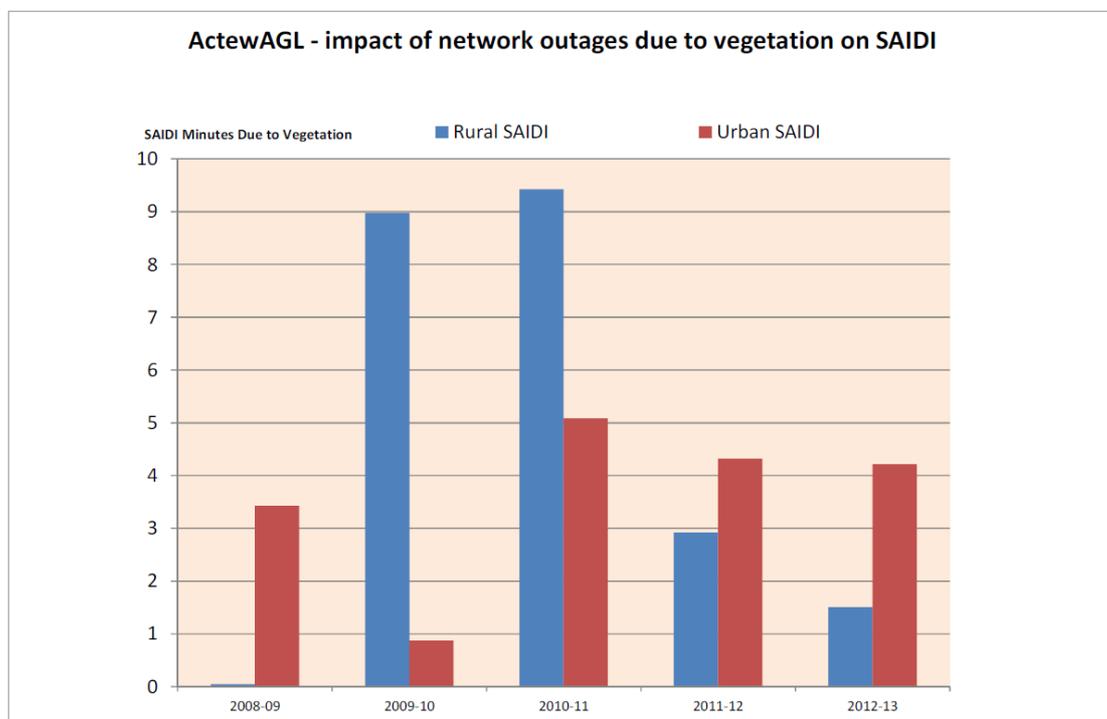


⁶⁵ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-80

⁶⁶ See: Attachment C75, ActewAGL Distribution, 2013, *Vegetation management cost pass through application*, November, pages 13

Secondly, as Mr Glyde and Mr Mudge note that while the number of events may have risen, the impact on rural SAIDI and SAIFI has significantly declined while urban SAIDI and SAIFI remained relatively stable. Mr Glyde and Mr Mudge conclude that while there have been more incidents their impact has been smaller and that ActewAGL Distribution’s vegetation management program has been improving.⁶⁷ ActewAGL Distribution notes that this improvement has occurring despite an increase in vegetation growth over the period.

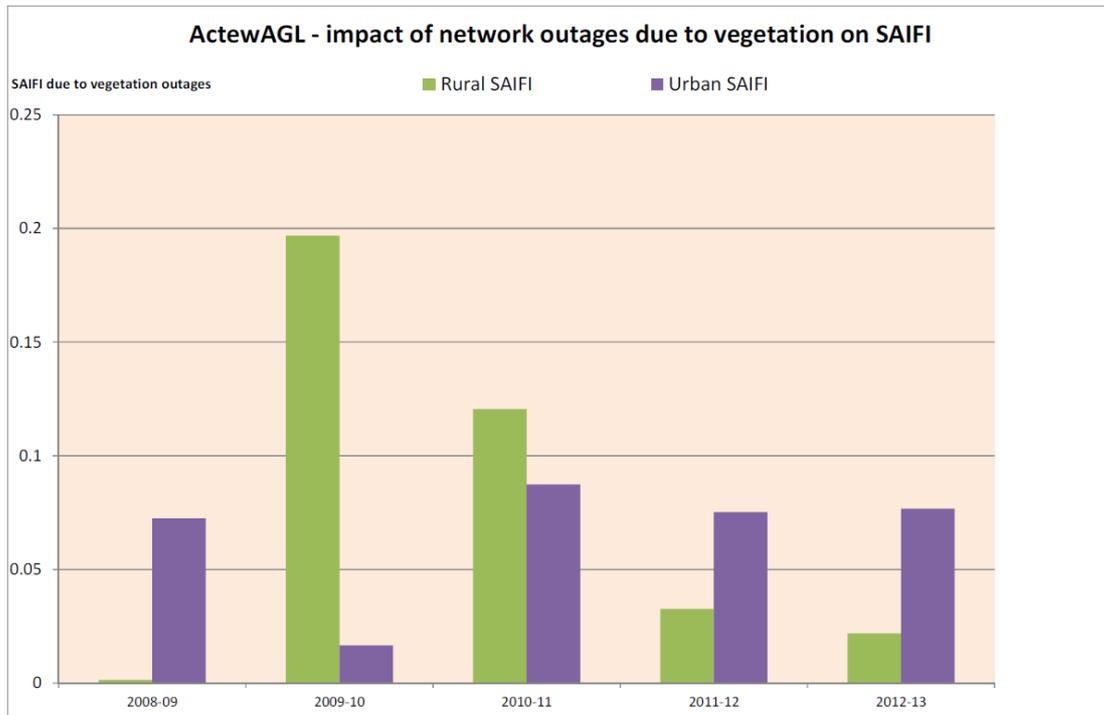
Figure 2.3 Mr Glyde and Mr Mudge analysis: Impact of network outages due to vegetation on SAIDI⁶⁸



⁶⁷ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, pages 73

⁶⁸ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, pages 72

Figure 2.4 My Glyde and Mr Mudge analysis: Impact of network outages due to vegetation on SAIFI⁶⁹



2.4 Analysis of historical rather than proposed costs

In the draft decision the AER does not examine ActewAGL Distribution’s forecast vegetation management expenditure rather the AER examines expenditure explicitly not included in ActewAGL Distribution’s regulatory proposal forecast.

The AER considered ActewAGL Distribution’s historical vegetation management costs stating in its draft decision that:

For the purposes of assessing base year opex, we are interested in historical actual expenditure rather than forecast expenditure, but it is useful to compare the expenditure trend over time.⁷⁰ ...

⁶⁹ See Attachment C2, Advisian, 2015, *Opex cost drivers: ActewAGL Distribution Electricity (ACT)*, January, pages 73

ActewAGL proposed 2012-13 as the base year for estimating (the majority of) its total forecast opex proposal using a hybrid base-step-trend approach. ... This means that while we are interested in understanding ActewAGL's historical inefficiency, we are particularly interested in its practices as at 2012-13.⁷¹

The AER then came to the view that:

...one of the sources of ActewAGL's high expenditure in its base year opex (identified with our benchmarking) is likely due to vegetation management practices.⁷²

However, ActewAGL Distribution's regulatory proposal did not use revealed costs for vegetation management (or network maintenance) costs; instead ActewAGL Distribution employed a zero based forecasting approach. The 'base year opex' the AER assessed, unadjusted vegetation management costs pass through costs, is one of the AER's own construction and irrelevant to assessing whether ActewAGL Distribution's forecast operating expenditure reasonably reflects the operating expenditure criteria.

In this revised regulatory proposal ActewAGL Distribution, responding to the AER's comments in the draft decision, has moved to a revealed cost approach for vegetation management and network maintenance expenditure. However, this approach still adjusts actual vegetation management expenditure to take into account the 2012/13 positive pass through amount of \$1.85m. Accordingly any assessment of ActewAGL Distribution's proposed base year expenditure needs to assess expenditure proposed by ActewAGL Distribution, which would require the removal of the 2012/13 positive pass through amount of \$1.85m from actual 2012/13 costs.

⁷⁰ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-79

⁷¹ AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-82

⁷² AER, 2014, *Draft decision ActewAGL distribution determination 2014-19 Attachment 7: Operating expenditure*, November, page 7-79