

21 April 2017

Mr Chris Pattas
General Manager, Networks
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3000
By email: AERinquiry@aer.gov.au

Dear Mr Pattas

Re: AER PRELIMINARY FRAMEWORK AND APPROACH FOR NSW ELECTRICITY DISTRIBUTORS

CitiPower and Powercor Australia welcome the opportunity to respond to the Australia Energy Regulator's (AER) preliminary framework and approach for the New South Wales Electricity Distribution Networks (**F&A paper**).

Our submission covers the following key points:

- we support the principle of removing services from the negotiated service classification because it simplifies the application of the ring-fencing guideline;
- we encourage the AER to commence an open and transparent consultation process for reviewing its approach to benchmarking for the forthcoming round of regulatory reviews, including in relation to:
 - identifying and measuring operating environment factors;
 - removing the potential for distortionary incentive in relation to operating expenditure (**opex**) and capital expenditure (**capex**) trade-offs, including consideration of a total expenditure approach;
 - improving the quality and consistency of data used for benchmarking; and
 - any review of the AER's benchmarking approach following the Federal Court's decision;
- we recommend the AER provide stronger incentives under the opex and capex incentive schemes for efficient networks to make further efficiency savings and push the benchmarking frontier;
- the calculation of the Capital Expenditure Sharing Scheme (**CESS**) payment should be performed consistently with the Post Tax Revenue Model (**PTRM**) revenue allowance calculation. Attached is a demonstration model which provides a CESS calculation consistent with the PRTM calculations.

Should the AER have any queries regarding this submission, please do not hesitate to contact Megan Willcox on (03) 9236 7048, or mwillcox@powercor.com.au

Yours sincerely,



Brent Cleeve
Head of Regulation, CitiPower and Powercor

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1.1 Benchmarking

The F&A paper welcomes stakeholder comments on the application of the Expenditure Forecast Assessment Guideline, particularly with respect to the AER's approach to benchmarking.

We support the use of benchmarking as one of the tools in the AER's tool kit for assessing the efficiency of expenditure. We consider however there is room for further improving the AER's benchmarking approach.

We recommend the AER commence an open and transparent consultation process to review its approach to benchmarking for the forthcoming round of regulatory determinations, with focus on the following key areas.

Operating environment factors (OEFs)

In particular, the AER should initiate a consultation process to identify and measure the impact of OEFs that need to be taken into in the benchmarking, including:

- initiating an open process for identifying exogenous OEFs that have a material impact on networks expenditure;
- implementing a transparent process for collecting data on material OEFs across all networks and ensuring the data is publicly available;
- undertaking an assessment of the relative impact of material OEFs across all networks, rather than only for networks found to be below benchmark, and making the calculations public; and
- consulting on the appropriate method for making adjustments to the benchmarking data or models to take account of the relative impact of material OEFs and ensuring the adjustment method is statistically valid.

Opex-capex trade-offs

The AER's approach to benchmarking in the previous round of regulatory determinations was largely focused on operating expenditure. A focus solely on operating expenditure however has the potential to create distortions in business behaviour in relation to capitalisation policy and decisions between opex and capex solutions. Consequently, there is real potential for the benchmarking outcomes to be highly influenced by these distortions rather than reflecting underlying business performance.

We recommend the AER investigate benchmarking approaches which mitigate these distortions, for example total expenditure benchmarking which captures both opex and capex efficiency. Importantly, benchmarking capital based on a physical measure of the stock of network assets does not address distortions in opex-capex trade-offs which are only reflected through financial measures of capital.

Quality of benchmarking data

The quality of benchmarking models and results is highly dependent on the quality of the data used to establish and populate the models. We are concerned there is inconsistency in the data reported in the Regulatory Information Notices (**RIN**) across distributors, including for key data items that are currently used for benchmarking or may be used in the future. For example, there does not appear to be consistency in the reporting of 'opex for connections services' either within or between jurisdictions and this data item is removed from the value of opex for benchmarking and therefore has a material impact on outcomes.

The ENA is initiating a work programme to improve the consistency and quality of RIN data reported by distributors. The AER should be open to working with the industry to ensure consistency in RIN data where it would improve the quality of the benchmarking.

Outcome of Federal Court appeals

If the AER needs to review its benchmarking approach following the Federal Court decision, we recommend it undertake a thorough consultation process to develop its approach for the forthcoming round of regulatory determinations. Where relevant, this should include consultation on:

- what a bottom up review of opex involves and how it should be applied in practice;
- the development of multiple benchmarking techniques and models, and how results should be weighted; and
- the scope and application of international data.

In the event that the use of international data is limited or impractical, we envisage the AER may need to place more reliance on non-parametric models such as Data Envelopment Analysis or Total Factor Productivity. If this is the case, we recommend the AER take a more cautious, less deterministic, approach in its application of benchmarking results because non-parametric models cannot be assessed for statistical robustness or validity and therefore less confidence can be placed in the results.

1.2 Expenditure incentives

Stronger expenditure incentives for efficient networks

We encourage the AER to introduce stronger incentives for efficient networks to pursue further efficiency savings in order to push the benchmarking frontier. Providing stronger incentives for the most efficient networks provides the following benefits:

- savings made by the most efficient networks have the effect of shifting the efficiency frontier outward which encourages other networks to become more efficient to avoid falling further behind the efficient benchmark. Consumers benefit, both from the savings made by the most efficient networks as well as from the savings made by other networks due to the shift in the efficient frontier. Therefore, savings made by the most efficient networks create a positive externality for customers of other networks; and
- as networks become more efficient it becomes progressively more difficult and risky to make further savings. A stronger incentive makes it more worthwhile to expend managerial effort and take risks to achieve incremental savings which will ultimately be shared with consumers.

For example, Ofwat introduced an incentive multiplier on both its opex and capex incentive schemes for the most efficient networks identified through its benchmarking. Ofwat applied an incentive multiplier of between 1.25 and 1.5 depending on how close the networks were to the efficiency frontier. The multiplier benefit was added to the expenditure allowance in the following regulatory period.¹

Ofwat considered stronger incentives were needed to induce the best efficiency performance in the industry:²

We propose to increase the incentive for leading companies to outperform. The rewards need to be large enough to make it worthwhile for a company to invest the time, energy and money to achieve successful innovation. We have concluded that the substantial longer term benefits to customers, both nationally and in those companies that are directly affected should more than outweigh the additional costs of the rewards.

¹ Ofwat, *Our conclusions on rewarding outperformance and handling under performance*, MD191, 25 March 2004.

² Ofwat, *Periodic Review 2004: A further consultation on incentive mechanisms – Rewarding future outperformance and handling underperformance of regulatory expectations*, 24 June 2003.

Ofwat's rationale for strengthening the incentives for the most efficient networks was that doing so was likely to benefit all customers:³

Our key conclusion from this assessment of the current mechanisms and associated rules is that the rewards for top companies that set new benchmarks are weak, particularly as these improvements are of most value to all customers. Because improvements in performance by companies at the frontier have a strategic effect – by moving the efficiency benchmarks – we think it is very worthwhile to offer the potential of enhanced rewards in this area to encourage further innovation.

And:⁴

...moving the frontier forward faster and farther than the regulatory assumption is worth much more than the benefits passed back to customers by the single company at the next price review. As we have outlined earlier stimulating current top performing companies to become even more efficient is very valuable both to their own customers in the longer-term and to customers as a whole.

We therefore recommend the AER provide stronger incentives under the EBSS and CESS for networks identified as efficient through its benchmarking.

CESS clarifications

The calculation of the CESS payment ought to be performed consistently with the Post Tax Revenue Model (**PTRM**) revenue allowance calculation. Attached is a model which provides a CESS calculation which is demonstrated to be consistent with the PTRM calculations. For simplicity, the model assumes that the nominal rate of return and inflation are the same through the regulatory control period. To ensure an actual 30 per cent sharing is achieved, the model should be modified to accommodate the annually changing nominal rate of return and inflation rate.

We make the following observations:

- the real rate of return should be applied because the incremental revenue reward (penalty) that networks derive from a capex underspend (overspend) is the real return on the unspent (overspent) capex. The revenue allowance is calculated as the nominal return on the opening nominal Regulated Asset Base (**RAB**) less the forecast inflation return on the opening nominal RAB (via regulatory depreciation), which is equivalent to the forecast real return on the opening nominal RAB.
- there is no half-year return on underspend (overspend) in the year that it occurs because the business does not receive this benefit (penalty) in the same regulatory control period as the underspend (overspend).
- the attached CESS model performs the calculations in nominal terms because the PTRM calculations are also in nominal terms. The calculations could equally be expressed in real terms, to calculate the same CESS reward (penalty).

If you would like to discuss the CESS calculations, please contact Mark de Villiers on 03 9683 4907 or by email on mdevilliers@powercor.com.au.

³ Ofwat, *Periodic Review 2004: A further consultation on incentive mechanisms: Rewarding future outperformance and handling under-performance of regulatory expectations – A consultation paper*, para. 20.

⁴ Ofwat, *Periodic Review 2004: A further consultation on incentive mechanisms: Rewarding future outperformance and handling under-performance of regulatory expectations – A consultation paper*, para. 36.