

10 November 2020



Ms Claire Preston
Director, Network Expenditure
Australian Energy Regulatory (AER)
GPO Box 520
Melbourne, Vic 3001

Dear Ms Preston

AER 2020 DRAFT ANNUAL BENCHMARKING REPORT

Endeavour Energy appreciates the opportunity to respond to the AER's draft 2020 Annual Benchmarking Report (ABR or draft report). The ABR includes the primary benchmarking measures relied upon by the AER, stakeholders and networks to assess the relative productivity and efficiency of networks.

The ABR results and rankings are an important management tool in monitoring performance and driving efficiency improvements. For several years we have engaged with our staff, community and customers through benchmarking and have committed to improving our performance. Our Multilateral Total Factor Productivity (MTFP) score and Opex Multi Partial Factor Productivity (MPFP) score have both improved by 0.9% and 5.8% respectively in 2019, continuing a positive trend since 2016.

We note the 2020 ABR includes a number of methodological updates which have resulted in material changes to the scores and rankings of networks. The draft report also flags a number of areas for future refinement and investigation. Consistent with our earlier feedback, we provide the following commentary on these areas of change.

Methodology updates

As noted in the draft report, the benchmarking methodology has been updated for:

1. Correcting non-reliability output weights;
2. Values of Customer Reliability (VCR) from the AER's 2019 review; and
3. Changes to the indexing method used in the TFP benchmarking.

The correction to the non-reliability output weights is the primary driver of the material changes that have occurred in network scores and rankings. Overall, these changes improve Endeavour Energy's productivity results but result in a reduction in our ranking given the more material improvement of rural networks, namely Ergon Energy, following the changes.

We note that the AER's intention as noted in the final 2018 ABR is to review the output weights periodically¹:

Consistent with our current approach, we will only update our output weights periodically (e.g. every five years) going forward to provide consistency in the benchmarking scores over time.

Similarly, Economic Insights noted that the updated weightings were to improve the accuracy of the model and such changes should be made on an infrequent basis²:

....the weights do need to be updated periodically to improve their currency and to take advantage of larger sample sizes which become available over time. We recognise there will be an inevitable trade-off between maintaining stability of the weights and maintaining their currency and accuracy. In our view, the best response to this trade-off will be to update the weights every several years.

¹ AER, *Electricity distribution network service providers – final annual benchmarking report*, November 2018, p. 56

² Economic Insights, *Economic Benchmarking Results for the Australian Energy Regulator's 2018 DNSP Annual Benchmarking Report*, 10 August 2018, p. 1

However, the AER note that having been made aware of errors in its methodology it should instead address them as soon as reasonably practicable³:

We consider it is appropriate to incorporate the corrected output weights in this report, rather than as part of a broader review of the output specification. Our view, and that of Economic Insights, is that errors, once identified, should be corrected as soon as possible.

We are supportive of incremental improvement and refinement of the AER's techniques and for more fundamental and material changes to be considered on a more infrequent basis subject to a broader and deeper level of consultation. Whilst error correction would generally fall into the less material and incremental changes that could be expected each year, the changes in this draft report represent a fundamental change in the AER's benchmarking methodology.

Whilst the errors should still be corrected as soon as reasonably practicable they highlight that the changes made in the 2018 ABR should have been subject to further consultation. In 2018 the output specifications were re-weighted in the first instance in a change that was characterised as immaterial⁴:

The expanded database allows the models to attribute infrastructure-related costs more directly. Using the updated weights does not make a large change to the productivity levels results although the rural DNSPs do somewhat better under the updated weights and some urban DNSPs do slightly less well.

At the time we considered these changes to be material, for instance the re-weighting resulted in 15% and 10% improvements for Ergon Energy and Essential Energy's MTFP scores respectively and for the industry more broadly the changes had a larger impact on network performance than actual performance over the following 12 month period. We raised our concerns with the changes⁵ in response to the draft 2018 ABR which apply even more so with further changes to this draft ABR.

The correction of errors means the changes made in the 2018 ABR were actually more material than envisaged and suggested in the draft 2020 report. We question whether the trade-off between accuracy and stability remains appropriate following the second iteration of changes to output weights in a three year window and the continued divergence from the original AER and Economic Insights position as outlined in the table below:

Output	2014 ABR (original)	2018 ABR (revised)	2020 ABR (corrected)
Energy throughput	12.8%	12.5%	8.6%
Ratcheted maximum demand	17.6%	28.3%	33.8%
Customer numbers	45.8%	30.3%	18.5%
Circuit length	23.8%	29.0%	39.1%

The draft report suggests the corrected weightings are a more accurate reflection of network cost drivers and therefore preferable to previous weightings⁶:

We and our consultant Economic Insights consider that from an economic and engineering perspective these revised weights are more reflective of the drivers of total cost for distribution networks than the previous weights. In particular, the reallocation of weight away from energy throughput and customer numbers towards circuit length and ratcheted maximum demand better reflects the main function of the distribution network, which is to transport electricity from bulk supply points to end users. As such, we would expect circuit length and ratcheted maximum demand to be the most important outputs when considering

³ AER, *Electricity distribution network service providers – draft annual benchmarking report*, November 2020, p. 51

⁴ Economic Insights, *Economic Benchmarking Results for the Australian Energy Regulator's 2018 DNSP Annual Benchmarking Report*, 10 August 2018, p. 2

⁵ Endeavour Energy, *Response to AER Draft 2018 Economic Benchmarking Report for DNSPs*, 18 October 2018, p.2-3

⁶ AER, *Electricity distribution network service providers – draft annual benchmarking report*, November 2020, p. 4

the allocation of total cost among the included outputs. This is because total costs are significantly influenced by the fixed costs of holding long-lived assets in this industry

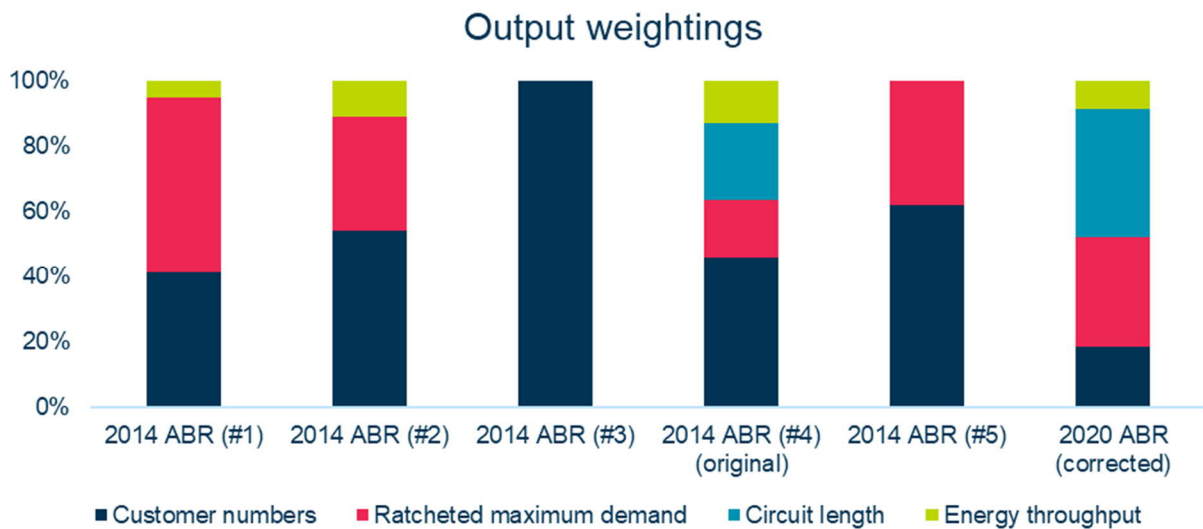
It is concerning that what is considered accurate can change so fundamentally over time as more data points become available. An extensive review process was undertaken during 2013 whereby Economic Insights concluded that customer numbers were the most significant output measure⁷:

The results obtained using output specification #4 did not appear to favour any particular type of DNSP with both rural and urban, and small and large DNSPs interspersed. Along with its superior in principle characteristics, this lent further support to using output specification #4 as the preferred specification.

The AER accepted this conclusion and considered it appropriately reflected the drivers of total costs for both urban and rural networks⁸:

The input/output specification presented here is Economic Insight's preferred specification. We also consider that this is the best specification. Other specifications tested, unlike this specification, appeared to disadvantage either urban or rural distributors.

It is now suggested that customer numbers are the third most important driver of total costs after being the primary driver for the last several years. This is a markedly different position to what was even consulted on during the 2013 process:



*Note: Output specification #1 had 54% allocated to MVA*Kms rather than ratcheted maximum demand. Output specification #3 was weighted by customer class; residential (13%), commercial (57%), small industrial (25%) and large industrial (5%).*

We accept that as additional data becomes available the AER will be able to refine existing techniques and ensure businesses are heading towards a realistic and desirable endpoint. However, organisational change is a long-term exercise, which needs to be supported by clear and static targets (i.e. the 'goalposts'). Our concern with the 2020 draft report is whether the trade-off between accuracy and stability has been properly considered. A pattern of frequent and material changes to the model will undermine stakeholder confidence and the credibility of the benchmark.

A key purpose for the publication of benchmarking data is transparently measuring performance and encouraging DNSPs to respond accordingly. Amending how measures are calculated can inhibit a DNSPs ability to establish long term plans and organisational commitment to respond and improve. We therefore favour stability over precision in best incentivising DNSPs to respond continuously and positively to the ABR.

⁷ Economic Insights, *Memorandum: DNSP MTFP Result*, 2 July 2014, p. 4

⁸ AER, *Electricity distribution network service providers – final annual benchmarking report*, November 2014, p. 28

If the AER considers the change is necessary, we consider a more fulsome consultation process is required in the near future. We welcome the expansion of the annual consultation process to additional stakeholders. However, the annual process is more suited to error checking in the limited time available. The technical expertise required to more meaningfully review the AER's approach is difficult even for networks.

A separate consultation process on this and any other material issues related to the AER's benchmarking approach (for instance DER integration in the models) would be preferable. With respect to the change in output weighting we would like to better understand the rationale for changing the output specification, how this improves the accuracy of the model and whether this improvement is worth making against the principle of consistency.

Areas for further consideration

The draft report identifies several areas for future investigation and refinement including:

- reviewing the weight allocated to the reliability output;
- addressing multicollinearity issues in the opex cost function models;
- continuing to refine the quantification of material Operating Environment Factors (OEFs);
- reviewing the impact of cost allocation and capitalisation differences on benchmarking results;
- accounting for DER in the output specifications; and
- reviewing the benchmark comparison point for assessing opex efficiency.

As noted above, we would also suggest the changes to the output weightings that have occurred in the 2018 and 2020 ABR's are also reviewed in more detail. Otherwise we consider this list of issues to be a comprehensive and appropriate list of key issues to investigate.

With respect to the OEFs, we note the Sapere-Merz review identified areas for further consideration for each OEF and other candidate OEFs⁹. The most significant progress since the release of the report has been in the AER's approach to vegetation management. We agree with the AER that further consultation with networks is required to improve the comparability and consistency of the data in order to more accurately quantify this OEF.

We also reiterate our concerns around the sub-transmission OEF. Sapere-Merz moved away from a capacity based measure of sub-transmission to a transformer count based measure with a threshold capacity of 15 MVA in its final report. We remain of the view that this change was not sufficiently consulted on and that 15 MVA transformers are not analogous from an operating perspective to 120 MVA transformers operating at 132 kV.

However, we accept that quantifying OEFs is a complex exercise and that there should be a balance between accuracy and consistency. As noted in the previous section, our preference is for consistency. The complexity and robustness required in quantifying an OEF should be guided by the weight applied to it in the AER's decision making process. We note that the AER selected what it considered to be a conservative benchmark comparison point for assessing opex efficiency (a score of 0.75).

This conservatism is an acknowledgement of the uncertainties and imperfections of the benchmark models including the OEF quantification. Should the AER set a more aggressive comparison point we would suggest that the OEF issues noted above, and all other areas identified for further consideration in the Sapere-Merz report, would require more detailed review and accurate quantification.

Similarly, we note that if an adjustment is required to account for differences in cost allocation and capitalisation practices between networks, the AER's preference appears to be an OEF. If any adjustment is required, we would recommend it focus on the capitalisation of overheads rather than opex/capex ratios more broadly that are more likely to reflect capex/opex trade-offs. As with vegetation management, data comparability and consistency would need to be improved. However, as previously noted we would not be supportive of a solution that results in the prescription of cost allocation or

⁹ Sapere Research Group and Merz Consulting, *Independent review of Operating Environment actors used to adjust efficient operating expenditure for economic benchmarking*, August 2018.

capitalisation approaches. A case-by-case assessment of outliers may be an appropriate solution in the medium term based on the AER's analysis of the materiality of this issue in the draft report.

Also on the issue of overheads we note the AER's reluctance to update the benchmarking analysis on the basis of CAM's approved since the initial benchmarking exercise. The concern is that gaming incentives could result in networks adopting sub-optimal cost allocation approaches for benchmarking purposes. In our view it is important that the benchmarking exercise is reflective of actual performance and opex levels that customers are paying for. For some networks there is a growing and material disconnect between their actual opex and the opex used for benchmarking purposes.

This issue will continue to grow over the years and it will become increasingly untenable for networks to replicate accounting approaches that are several years out of use and disconnected from actual practices and accounting standards. We understand the AER's concerns but consider the accounting standards constrain the ability of networks to 'game' and the AER has the opportunity to scrutinise a networks approach in reviewing and approving a Cost Allocation Methodology (CAM). We suggest that any review of overheads also gives further consideration to 'unfreezing' the CAMs used for benchmark reporting purposes.

We also support further investigation of accounting for DER in the output weights. This issue is likely to become increasingly material and it is important that the benchmarking models reflect the need for networks to service demand for export hosting capacity. This issue could be considered as part of the suggested broader review of the output weighting changes that have occurred.

If you have any queries or wish to discuss our submission further please contact [REDACTED]

Yours sincerely



Rod Howard
Deputy Chief Executive Officer