8 February 2018

Mr Evan Lutton
Assistant Director, Networks
Australian Energy Regulatory
Level 17, 2 Lonsdale Street
Melbourne, VIC 3000

Dear Mr Lutton

Response to Sapere-Merz review of operating environment factors used to adjust efficient operating expenditure for economic benchmarking

On 11 December the AER circulated a draft report on economic benchmarking operating environment factors (OEFs) prepared by Sapere Research Group and Merz Consulting Engineers (Sapere-Merz) for the Australian Energy Regulator (AER). In addition, the AER provided an OEF calculations summary providing details of the calculations set out in the draft report.

Other than noting that this review is part of the continuous improvement in its economic benchmarking toolkit, the AER provided no guidance on its future intentions in relation to its benchmarking methodology or its application. Without understanding how the proposed approach to OEFs is intended to be used within the economic benchmarking framework and how the AER proposes to use the economic benchmarking results in its assessment of Evoenergy's operating expenditure, it is difficult to provide feedback on the proposed OEF approach.

Based on the Sapere-Merz report and calculation summary, it appears that efficient operating expenditure is calculated using the same methodology relied on by the AER in making its 2015 distribution determinations for Evoenergy and the NSW distributors. Efficiency scores appear to be calculated using the Economic Insights' (EI) Cobb-Douglas Stochastic Frontier Analysis populated with the same RIN and international data sources with the same application of an ex-post OEF adjustment. The Australian Competition Tribunal (Tribunal) identified the deficiencies with this approach in its 2016 decision[1], which was upheld by the Full Federal Court in 2017[2].

If the approach set out in the Sapere-Merz report and calculations summary is consistent with how the AER intends to undertake benchmarking going forward, then Evoenergy believes the results could only be afforded limited weight in assessing Evoenergy's operating expenditure forecasts or for any other purpose. The approach fails to address any of the inadequacies identified by the Tribunal in relation to the data set used, the underlying modelling assumptions, the application of ex-post OEFs (as compared with ex-ante application) and the primary reliance on a single model.

Alternatively, if the approach set out in the Sapere-Merz report and calculations summary does not reflect how the AER intends to undertake benchmarking going forward, then it would be useful for the AER to clarify its proposed approach.

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[1] Australian Competition Tribunal 2016, Application by ActewAGL Distribution [2016] ACompT 4

[2] Federal Court of Australia, Australian Energy Regulator v Australian competition Trinunal (No 2) [2017] FCAFC 79

Notwithstanding these concerns, Evoenergy provides the following specific comments on the Sapere-Merz report and calculation summary.

- The Sapere-Merz approach appears to apply the adjusted efficiency target to actual opex for a single year (2014/15). This differs from the EI/AER approach of applying the adjusted efficiency target to the average opex over the period from 2006, consistent with the period used to calculate the efficiency targets. Evoenergy requests that the AER clarify the proposed approach, and, in the case that the Sapere-Merz approach is maintained, provide explanation as to the intent of the change in approach.
- Evoenergy also notes that the Sapere-Merz analysis appears to be specific to 2014/15 and seeks clarification on how the AER intends to update this analysis going forward for application in future years.
- The Sapere-Merz OEF calculations appear to be based solely on direct network costs, however, these direct OEF costs are then applied to total efficient opex costs, which are inclusive of non-network and overhead costs. This approach seems to assume that all OEF activities are incremental in nature and do not incur any non-network, network overhead or corporate overhead costs. In Evoenergy's view, this assumption is incorrect, particularly considering the large share of costs that DNSPs allocate to non-network and overhead categories. In Evoenergy's view, it would be more appropriate for the OEF direct costs to be expressed as a percentage of total direct costs and the result then multiplied by the efficient level of total opex to determine the OEF value. Evoenergy also questions how the Sapere-Merz and AER approach to OEFs and benchmarking more generally are affected by the differences in the allocation of direct and indirect costs across DNSPs as reported in the RINs.
- Evoenergy agrees with the principle in the Sapere-Merz report that an adjustment should be made to reflect significant differences in network topology and specifically the expanded sub-transmission system. However, it is not clear that the Sapere-Merz report has given this issue sufficient weight, simply adopting the AER's 2:1 ratio for sub-transmission line costs over distribution line costs. However, Evoenergy notes that while the AER's 2:1 ratio appears to be accepted by Sapere-Merz, the costs that are eventually included in the calculation are the unadjusted costs per kilometre, which Sapere-Merz then goes on to halve before calculating the OEF[3]. The reason for this calculation is unclear and in Evoenergy's view, further consideration needs to be given to this calculation to ensure it is operating as intended.
- Evoenergy notes that the Sapere-Merz analysis excludes any discussion of the individually immaterial OEFs that were included in the AER's analysis. Evoenergy requests that the AER outline its proposed approach to these OEFs. Evoenergy also notes that Sapere-Merz did identify higher input costs as potentially meeting the OEF criteria in its discussion of the Northern Territory Power and Water Corporation and this could potentially be an OEF relevant to other DNSPs.
- Evoenergy notes that limited RIN data has been relied on in the analysis of OEFs by Sapere-Merz. Given the substantial costs involved in preparing RINs it would be useful for the AER to review its use of data collected to determine whether it continues to be necessary to collect the full suite of data, and if the standardisation of data collected in the RINs could be improved so that the data can be more confidently relied on for undertaking such analysis.
- In section 3.9 of its report, Sapere-Merz discusses the classification of standard control services connections. Sapere-Merz explains the reason that the AER made the OEF adjustment but

[3] See cell C9 and D9 of the 'Subtransmission – Select firm' tab of the Sapere Merz calculation summary

then notes that going forward, where the AER applies OEFs in the context of its annual benchmarking reports, there may not be a need to apply an OEF adjustment for connection services for ActewAGL[4]. It is unclear why Sapere-Merz comes to this conclusion based on the preceding discussion. Evoenergy notes that Sapere-Merz then go on to accept the AER's previous assessment of service classification costs. Evoenergy requests that the AER or Sapere-Merz clarify the proposed approach to this OEF going forward.

- In section 3.9.4, Sapere-Merz requests additional information from Evoenergy regarding the recovery of costs associated with backyard reticulation, including a breakdown, update or more accurate estimate of the marginal costs associated with backyard reticulation. Evoenergy will endeavour to provide this information to the AER as soon as possible.

If you wish to discuss any aspect of our response, please do not hesitate to contact Alexis Hardin, Manager Regulatory Finance and Strategy on 02 6248 3033 or alexis.hardin@actewagl.com.au.

Yours sincerely

David Graham
Director Regulatory Affairs and Pricing

[4] Sapere-Merz 2017, Independent review of OEFs used to adjust efficient operating expenditure for economic benchmarking, p. 59