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Submission to the 2015-19 Electricity Distribution Price Review for Ausgrid, Endeavour Energy, Essential Energy and ActewAGL

Jemena Electricity Networks (Vic) (**JEN**) welcomes the opportunity to respond to the Australian Energy Regulator (**AER**) consultation on the Electricity Distribution Price Review (**EDPR**) covering 2015 to 2019 for the Ausgrid, Endeavour Energy, Essential Energy and ActewAGL distribution businesses.

In this submission JEN wishes to raise two substantive issues with the AER in relation to the EDPR in NSW and ACT that it believes will result in determinations that are inconsistent with the National Electricity Object (**NEO**) and specifically not in the long term interests of customers.

1. Pass through events

The AER is slowly narrowing the scope of the pass through regime. The AER has achieved this through incremental changes to businesses' pass-through events at each regulatory review, and subsequently taking the position that the most recently approved set of events are the 'new precedent' from which subsequent proposals will be assessed. This is at odds with the propose-respond regulatory framework. It is not for the businesses' to explain departure from the AER's preferences. The AER must justify departure from the regulated businesses' proposal as better meeting the requirements of the relevant rules.

We believe the likely driver for the AER's approach is a desire to standardise cost pass through events across all distributors, both electricity and gas. For example, the AER has proposed changes in wording to JGN's proposed the regulatory change event and service standard event which do not materially change the scope of the event. Rather, they appear to be changes proposed to perfectly align the wording with that set out in the National Electricity Rules. The supporting reasoning is weak, and clearly it is not established that JGN's proposal did not promote the NGO or did not better promote the NGO relative AER-preferred wording:

> *However, we propose minor drafting changes—set out below— to these events to ensure consistency with the equivalent events that apply to electricity network businesses under the NER. These definitions were developed by the AEMC to achieve consistency with*

> *the NEO. The NEO and NGO are sufficiently similar that they will serve the same purpose here. The amended definitions are preferable to those proposed by JGN and are consistent with the NGO and NGR. (JGN draft decision, p 11-20)*

In circumstances where there are potentially significant benefits from harmonising important features of the regulatory framework across all regulated business, good regulatory practice would be to establish a guideline following consultation with all stakeholders. We feel that this practice of making incremental, and often pedantic, changes to every business' pass through event proposal is inefficient and frustrates stakeholder consultation on the regime.

In these circumstances, we would encourage the AER to initiate a market consultation on cost pass through events for gas and electricity distributors in calendar year 2015 through the development of a regulatory guideline.

2. Deterministic use of economic benchmarking

The AER published its draft decisions for the NSW and ACT electricity distributors on 27 November 2014. On the same day, the AER published the first annual distribution benchmarking report pursuant to rule 6.27 of the National Electricity Rules (**Rules**).

We have reviewed the benchmarking report and the AER's proposed application of that report to assessing the forecast operating expenditure contained in the regulatory proposals of the NSW and ACT electricity distributors and in determining substitute forecast amounts in the AER's draft decisions.

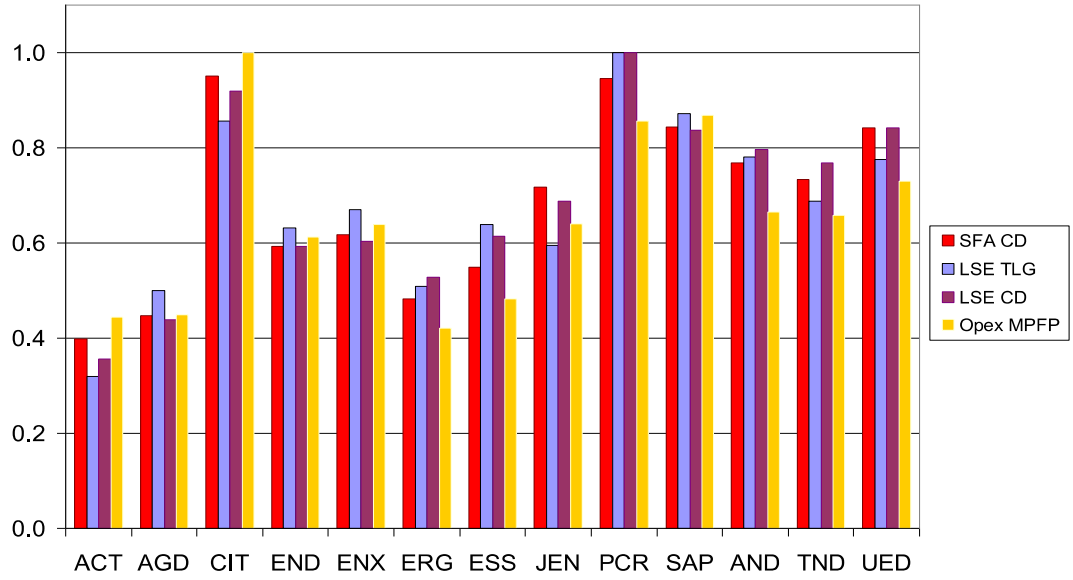
JEN is concerned as to the robustness of the benchmarking exercise undertaken by Economic Insights, which the AER relies upon in the benchmarking report. These concerns have been significantly heightened by the manner in which the AER has indicated it will rely on the outcomes of the benchmarking exercise in assessing forecast operating expenditure amounts and, where forecasts are not accepted by the AER, determining substitute forecast amounts. These concerns are set out below.

Findings of the Economic Insights report

The outcomes of the Economic Insights report that the AER relies on in its benchmarking report (and subsequently in the draft decisions for the NSW and ACT electricity distributors) are best summarised in the graph below which appears in the Economic Insights report.[1]

[1] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p iv.

Figure A **DNSP average opex cost efficiency scores, 2006–2013**



Economic Insights interprets the opex efficiency scores as indicating very large efficiency gaps for the NSW and ACT electricity distributors relative to the two "frontier" performers on opex efficiency, CitiPower and Powercor.[2] Economic Insights estimates efficiency gaps of around 60 per cent for ActewAGL, 55 per cent for Ausgrid, 45 per cent for Essential Energy, and 40 per cent for Endeavour.[3]

In determining the appropriate efficiency benchmark against which to assess the performance of the DNSPs, Economic Insights considers that rather than adopt the frontier DNSP, it would be prudent to instead adopt a weighted average of the efficiency scores in the top quartile of the efficiency score range to calculate the cost efficiency "target" for the NSW and ACT electricity distributors.[4] Economic Insights calculates the weighted average efficiency score of the DNSPs with efficiency scores greater than 0.75, as being 0.86.[5] Economic Insights considers that the reduction in the efficiency benchmark (relative to where it would have been if it had been set by reference to the frontier DNSP), allows for "general limitations of the models with respect to the specification of outputs and inputs, data imperfections and other uncertainties".[6]

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[2] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v.
[3] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v.
[4] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v.
[5] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v.
[6] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v.

Economic Insights then seeks to make some broad adjustments to the efficiency benchmark in respect of the operating environment factors that it considers are not explicitly included in the models. These are:

- an "allowance" of a 10 per cent input margin on the benchmark Victorian and South Australian DNSPs to cover the fact that the NSW DNSPs have a higher system subtransmission intensiveness, and the NSW and ACT DNSPs have increased OH&S regulations. Economic Insights considers that this is a "conservative allowance" for a number of factors that, "while individually not significant, may collectively be significant"; and[7]

- in the case of ActewAGL only, an "allowance" of 30 per cent input margin on the benchmark Victorian and South Australian DNSPs to cover a miscellany of factors including: ActewAGL's capitalisation policy, different standard control services connections coverage, backyard reticulation, different jurisdictional taxes and levies, and occupation health and safety regulations. Again, Economic Insights considered that this allowance would provide for a number of factors that, while individually not significant, may collectively be significant.[8]

The wash-up of the adjustments made by Economic Insights is a reduction to 2013 network services opex of: 45 per cent for ActewAGL; 35 per cent for Essential Energy; 33 per cent for Ausgrid; and 13 per cent for Endeavour.[9]

AER draft decisions

In the draft decisions, the AER noted that its approach is to compare the service provider's total forecast opex with an alternative estimate that the AER develops.[10] The AER notes that in so doing the AER forms a view on whether it is satisfied that the service provider's proposed total forecast opex reasonably reflect the opex criteria. Further, where the AER concludes that the proposal does not reasonably reflect the opex criteria, the AER uses its estimate as a substitute forecast.[11]

Relying on the Cobb Douglas stochastic frontier analysis conducted by Economic Insights, and the post-modelling adjustments to that analysis set out above, the AER adjusts the base opex of the NSW and ACT electricity distributors as follows: ActewAGL, 36.8 per cent;[12] Essential, 34.7 per cent;[13] Ausgrid, 33.3 per cent;[14] Endeavour, 10.3 per cent.[15]

The AER then uses the adjusted base opex to forecast opex over the 2014-19 period.

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[7] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v.
[8] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p v and vi.
[9] Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, p vi.
[10] Ausgrid draft decision: Attachment 7, p 7-12.
[11] Ausgrid draft decision: Attachment 7, p 7-12.
[12] ActewAGL draft decision: Attachment 7, p 7-19.
[13] Essential draft decision: Attachment 7, p 7.20.
[14] Ausgrid draft decision: Attachment 7, p 7-20.
[15] Endeavour draft decision: Attachment 7, p 7-20.

Concerns with the benchmarking exercise and the AER's approach

JEN recognises that the AER is required to produce an annual benchmarking report and that the AER is required to have regard to the annual report in deciding whether or not the AER is satisfied that forecast opex reasonably reflects the operating expenditure criteria. However, JEN is concerned that the AER has moved too quickly to try to develop a technique that it considers will allow it to assess and determine forecast opex allowances without having to consider the detailed forecast opex proposals of DNSPs, as opposed to taking the development and application of benchmarking in a more step-by-step fashion.

Our key concerns with the AER's use of benchmarking are:

- **Infancy of the regime**—the AER has rushed to apply a new set of benchmarking tools to the NSW and ACT decisions, despite key concerns being raised by many. The speed of implementation here contrasts to the gradual implementation by OfGem (in the UK), which it used to tease out and overcome concerns with the quality of data and robustness of the tools. Our concern is that rushing the implementation can lead to unintended consequences for both networks like JEN and their customers.

- **Illogicality of the base year opex cuts**—the AER has used opex performance over the 2006 to 2013 period to assess what cuts are required to opex from a single year—namely, the 2013 base year. This is illogical. The task should be to assess the efficiency of that single year against a benchmark. Under the AER's approach, opex in that year could still be cut even if it is efficient when benchmarked against other networks—which, in this case, would act like a clawback of past inefficiency irrespective of whether an opex incentive regime operated or not.

- **Focusing on opex rather than total expenditure (totex) performance**—the AER's approach also does not consider performance at the total expenditure level when assessing what base year opex cuts are required. Under this approach, even if a network is considered efficient at the total expenditure level, it may still get a cut to opex using the AER's approach because it operates its network in a way that means it spends more on opex and less on capital expenditure than other networks. This does not make sense as there are valid reasons why a network may operate its network in this way that actually improves overall efficiency. Applying an approach like the AER's that is one-sided can also lead to unintended consequences.

We are also concerned that the data currently available to the AER is not of a sufficient quality or depth to enable a benchmarking exercise to be undertaken and applied in a manner that would substitute for detailed consideration of a DNSP's regulatory proposal. This is clear from the fact that the technique relied upon by the AER is dependent upon data being included from networks in Ontario and New Zealand. It is possible that the homogeneity of the networks is such that techniques such as multilateral partial factor productivity may not be appropriate in the Australian context.

Overall concern

Our overall concern with the AER's approach is that it does not give adequate consideration to the costs that an efficient operator are likely to incur in operating the

network that is in fact operated by the relevant DNSP. The best information as to the efficient costs of operating the network that the DNSP operates are the costs that are actually incurred in operating that network.

We consider that—consistent with the guidance given by the AEMC in connection with the November 2012 rule change—the AER must start with, or at least have squarely before it, the information provided by the service provider as to what it costs to operate its network.

> The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance. The NSP has the most experience in how a network should be run, as well as holding all of the data on past performance of its network, and is therefore in the best position to make judgments about what expenditure will be required in the future. Indeed, the NSP's proposal will in most cases be the most significant input into the AER's decision.[16]

In assessing a forecast opex amount, and, where relevant, in determining any substitute forecast opex amount, the AER must be satisfied that the forecast reflects the prudent and efficient costs of operating the network of the relevant DNSP. It is difficult to see how—on the basis of the benchmarking exercise conducted by Economic Insights—the AER can be satisfied that an allowance that it provides based on that exercise would reflect the prudent and efficient costs of operating the relevant network under consideration. The rough adjustments that are made to "allow" for general input and data limitations, and differences in operating environments that are not captured by the model, highlight how imprecise the exercise is.

Implications of the AER's proposed approach for JEN and our customers

An application to JEN of the AER's proposed method to assess, and where relevant, substitute, forecast opex, based on the results of the Economic Insights benchmarking exercise, suggests, without more, a reduction to JEN's base year network services opex of around 15 per cent.[17]

We simply does not consider that a reduction of the magnitude that is implied by the Economic Insights benchmarking exercise to be plausible. Given the length of time since privatisation of the distribution network (1995-96), the incentive regimes applying to JEN since that time (which first applied to the 1996–2000 period), together with the management processes that JEN has in place that are focussed on sustainable efficiency improvements, JEN does not accept that the difference in efficiency scores as between it and the other Victorian networks and SA Power Networks can be wholly or substantially attributed to inefficiency. From JEN's perspective, the results of the benchmarking exercise and the suggested magnitude of the inefficiencies that are considered to exist between the networks should be a clear signal that the exercise is not robust.

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[16] AEMC, *Rule Determination – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 and National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, p 111-112.

[17] This is a rough calculation based on efficiency score ascribed to JEN in the benchmarking exercise of around 72 per cent, and the target efficiency score of 86 per cent.

We are also concerned that the AER's approach may ultimately harm customers by creating incentives (e.g. to spend more on capex rather than opex, or simply to reduce spend) or setting unrealistic benchmarks that lead to reductions in safety, service levels, and efficiency over time (by requiring catch-up spend in future periods). If these incentives or benchmarks apply to all networks across the national electricity market, then this could negatively affect customers across this market too.

If you have any questions in relation to this submission, please contact me on (03) 8544 9053 or by email Robert.mcmillan@jemena.com.au.

Yours sincerely

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