

23 February 2010

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001



Dear Chris,

Submission to Australian Energy Regulator on Draft Decision on ETSA Utilities regulated revenues & prices 1 July 2010 to 30 June 2015

The Energy Users Association of Australia (EUAA) welcomes the opportunity to participate in this review and this opportunity to provide a submission to the Australian Energy Regulator (AER) on the AER's draft decision on the regulated revenue and price proposals from the ETSA Utilities in South Australia for the period 2010-2015. Thank you for granting us a short extension of time in which to submit this.

In this submission we outline our views on the AER's decision and on the adverse impacts that the allowed expenditure increases would have on energy users. We particularly highlight the substantial tariff increases facing users if the AER accepts these proposals, these rises averaging 45% in nominal terms across the State when compounded over 2010-2015. Increases of this magnitude will adversely affect the operations of South Australian businesses that use electricity, including their operating costs, competitiveness (especially those that are trade exposed), investment opportunities and ability to create and sustain jobs in the State. They will also affect the South Australian economy more broadly including its productivity, growth prospects and inflation pressures.

The EUAA looks to the AER to discharge its regulatory obligations reasonably and fairly so as to protect the interests of users by setting approved costs and energy volume forecasts at no more than efficient levels. To achieve this outcome fully and satisfy users, the AER must fulfil the requirement under the National Electricity Rules to consider all the capex and opex factors, including the requirement to benchmark these expenditures. The EUAA is disappointed that the AER did not fulfil its benchmarking obligations under the rules in this draft determination and we urge them to take the opportunity to do so in the final determination.

We urge the AER to fully consider the views of energy users throughout this review.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Roman Domanski".

Roman Domanski
Executive Director



**Submission to Australian Energy Regulator on Draft Decision
on ETSA regulated revenues & prices 1 July 2010 to 30 June 2015**

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Executive Summary

The AER's is currently reviewing the revenue and price allowances for ETSA Utilities, a process that will determine distribution prices in South Australia for the next five years. These comprise around 50% to 60% of the electricity charges paid by business users. For South Australian households they are around 55% of the cost of electricity. The AER's draft determination would, if confirmed, result in average distribution prices in South Australia rising by 45% over the five years from 1st July 2010. This compares to 17% over the past five years. It would result in average electricity prices rising by between 20 to 30% over the next five years. In the first year alone, distribution prices would increase by 14%.

This is an outcome that electricity users and the general economy in South Australia can ill afford, especially when - as the analysis in this submission shows - the costs that the AER appears willing to approve for ETSA are unnecessarily high and not efficient as required by the National Electricity Rules (NER). Nor would such an outcome meet the Electricity Market Objective in the National Electricity Law (NEL), which seeks to ensure that decisions made are "*in the long term interests of consumers of electricity*", including with respect to price.

The higher distribution prices resulting from the AER's draft decision will have adverse consequences on electricity users in South Australia. Their operating costs will increase, and they will have less capacity to sustain investment and jobs in the State. They will have to either pass on such cost increase to other industries and final consumers (if they can) or absorb them.

Industries in trade exposed sectors, such as manufacturing and mining, both of which are important in the South Australian economy, would be unlikely to be able to pass on the cost increases and their operations would be especially badly affected. South Australian businesses and households would also see impacts in terms of higher input prices and higher prices for many of the goods and services they buy. As consumer and producer indices released following implementation of the AER's final determinations in New South Wales and Tasmania last year showed, the price impacts will also translate through into higher inflation. This was evident in the 2009 September quarter CPI figures where electricity prices were the largest single driver of the CPI increase both nationally, where they contributed to 21.7% of the 1.0 percentage point CPI increase, and in NSW and Tasmania, where they contributed 37% and 14% respectively, to those States CPI increases. Likewise, in the September quarter, the fastest growing component of producer prices was the electricity, gas and water component, which grew 12.1%.

The EUAA notes that the AER has reduced ETSA's proposed capex by some 29% and its opex by 7%. Whilst this is welcome, we note the capex would still increase by 104% compared to the last regulatory period and opex by 44%. We therefore remain alarmed that the AER's draft decision for ETSA undoes much of the good that has been achieved over past regulatory decisions in South Australia and would push ETSA in the direction of being a less efficient and higher cost distributor than it has been in the past for no apparent reason. As stated above, it allows ETSA to increase its prices by 45% over the next regulatory period. We attribute this failure to contain ETSA's price increases to three things:

A very high allowed cost of capital. Privatised electricity distributors in Britain have recently accepted a proposal by their regulator for a cost of capital that is about half the level that the AER has allowed in Australia. We question how the AER can sustain its view that returns to distributors in Australia need to be around 80% higher than those in Britain? We think the implausibility of the AER's decision is made quite clear by evidence that Australian network service providers are borrowing money on off-shore capital markets at rates that are far below what the AER is requiring energy users to pay.

The ineffectiveness of what the AER refers to as "detailed bottom-up reviews". The AER's assessment centres on a review of "governance frameworks, processes and procedures". We are disturbed that the end point of the AER's review in most areas is little more than assertions that ETSA has governance frameworks, processes and procedures that accord with "good electricity industry practice". From this rather flimsy and opaque basis, the AER concludes that ETSA's proposed expenditure of \$2608m for the next regulatory period, which will increase by 75% on the current period, will be efficient. Electricity users in South Australia should be provided with a more evidence based and transparent assessment than this, especially given the extent of the price increases that would flow from the AER's draft determination.

The AER's failure to benchmark ETSA's expenditure as required under the Rules. The AER has attempted to show that since it had regard to some limited comparison of unit costs that ETSA undertook, in association with its (ETSA's) consultants, this satisfies its obligation to benchmark capex. This is insufficient, in our view, to satisfy the AER's obligations under the National Electricity Rules (NER). On opex, the AER has made further progress on benchmarking than it has on capex. However, it still falls well short of the requirement to benchmark opex under the NER, because the AER has failed to benchmark ETSA's proposed expenditure, and the AER has failed to define the benchmark against which ETSA's expenditure is to be assessed. We have, however, defined such a benchmark and it shows that the AER's decision on opex will move ETSA from a position where it was slightly in front of the benchmark to one where it now lags some way behind it. This confirms the concerns expressed above that the AER's draft decision, if confirmed, would provide ETSA with an excessive cost allowance and undo a lot of the good achieved over previous regulatory periods.

The submission also comments on the proposed Pass Through arrangements and the Service Performance Target Incentive Scheme (SPTIS). In relation to the former, it notes our serious concerns about the asymmetric nature of Pass Through arrangements in general which will always provide cost increases that favour the distributor and are very unlikely to ever deliver any cost reductions. The AER needs to be mindful of this and ensure that any Pass Through events are strictly contained.

In the area of service targets, we raise a serious concern about the proposed use of historical averaging which rewards underperformance in service quality and instead argue that the most appropriate methodology would be to have established data on service classes across the distribution sector and set at the upper quartile. Furthermore, we remind the AER that there is already a functioning power quality service incentive scheme administered by ESCOSA and it should be used until the AER develops its own.

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1 Introduction and our interest in the AER's review

This is the Energy Users Association of Australia's (EUAA) submission to the Australian Energy Regulator (AER) on its draft decision on the price cap to apply to ETSA Utilities for the period 1 July 2010 to 30 June 2015.

The EUAA has around 100 members, including significant energy users in South Australia. They will be significantly impacted by the AER's draft decision to allow ETSA to increase its prices by 45% over the regulatory period. This increase is on top of significant price increases in other parts of the electricity industry value chain, including the significant increase in retail prices over the past few years reflecting an unhealthy degree of market power in SA and the introduction of an emission trading scheme and the expanded renewable energy target.

The EUAA is disappointed with the AER's draft decision. Under ESCoSA, ETSA has been successful in providing a secure and reliable supply of electricity, with a trend of rising reliability, and broadly constant costs in real terms per customer. Under incentive-based regulatory arrangements, ETSA's shareholders have benefited from this, and users in South Australia have been protected from the large cost increases that so many other government-owned distributors have delivered in other parts of Australia.

The EUAA is alarmed that the AER's draft decision for ETSA undoes much of the good that has been achieved over past regulatory decisions. It allows ETSA to increase its prices by 45% over the regulatory period. We attribute this failure to contain ETSA's price increases to three things:

- **A very high allowed cost of capital.** Privatised electricity distributors in Britain have recently accepted a proposal by their regulator for a cost of capital that is almost half the level that the AER has allowed in Australia. We question how the AER can sustain its view that returns to distributors in Australia need to be around 80% higher than those in Britain?
- **The ineffectiveness of what the AER refers to as "detailed bottom-up reviews".** The AER's assessment ultimately reduces to a review of "governance frameworks, processes and procedures". What value is to be found in this? We are disturbed that the end point of the AER's review in most areas is little more than assertions that ETSA has governance frameworks, processes and procedures that accord with "good industry practice". From this rather flimsy and opaque basis, the AER concludes that ETSA's proposed expenditure for the next regulatory period, which will increase by 75% on the current period, will be efficient. Electricity users in South Australia should be provided with a more convincing assessment than this.
- **The AER's failure to benchmark ETSA's expenditure as required under the Rules.** The AER has attempted to show that since it had regard to some limited comparison of unit costs that ETSA undertook, in association with its (ETSA's) consultants, this satisfies its obligation to benchmark capex. This is insufficient, in our view, to satisfy the AER's obligations under the National Electricity Rules (NER). On opex, the AER

has made further progress on benchmarking than it has on capex. However, it still falls well short of the requirement to benchmark opex under the NER, including because the AER has failed to benchmark ETSA's proposed expenditure, and the AER has failed to define the benchmark against which ETSA's expenditure is to be assessed. We have, however, defined such a benchmark and it shows that the AER's decision on opex will move ETSA from a position where it was slightly in front of the benchmark to one where it now lags some way behind it. This confirms the concerns expressed above that the AER's draft decision, if confirmed, would provide ETSA with an excessive cost allowance and undo a lot of the good achieved over previous regulatory periods.

The rest of this submission sets out our views on the AER's draft decision on ETSA in detail in further detail. It is laid-out as follows:

- Section 2 explains the impact of the AER's draft decision on prices;
- Section 3 comments on the cost of capital;
- Section 4 comments on the AER's review of capex;
- Section 5 comments on the AER's review of opex;
- Section 6 comments on the AER's review of pass-throughs; and
- Section 7 comments on the AER's review of service standards.

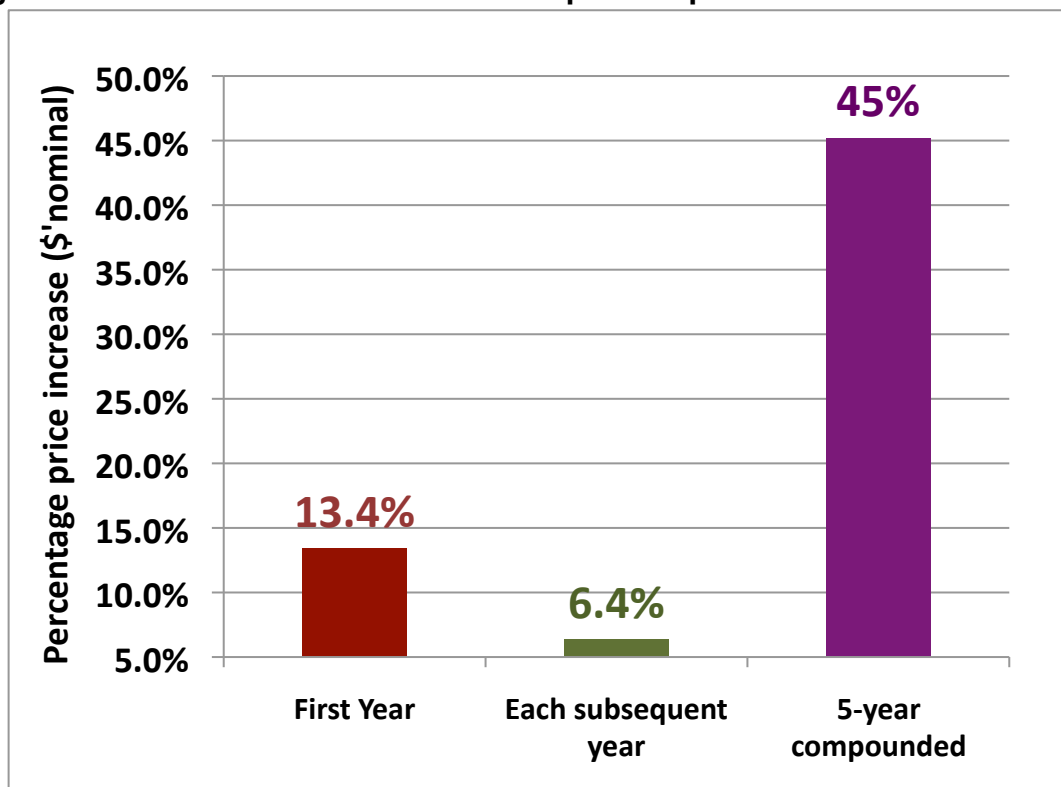
2 The impact of the draft decision on prices

The AER's draft determination on ETSA Utilities revenue proposals results in significant price rises across the five-year period from 2010-2015. These rises will result in a compounded increase in users' distribution costs of 45% in nominal terms by July 2014. We calculated this using the X-factors the AER provided in the draft determination. This compares with 17% price increases accumulated during the previous regulatory period.

The increases are weighted towards the beginning of the regulatory period with a nominal increase of 14% in the first year. This is of concern to EUAA members, who prefer a smoother approach to price increases, especially as these are regulated charges. We appreciate that the AER is simply following the Rules in its calculation of the distribution price increases over the regulatory period, but nonetheless wish to bring this to the AER's attention.

The severity of these distribution price increases must be considered in a broader context of rising prices in other parts of the electricity supply chain., including due to the expanded Renewable Energy Target and the impending Carbon Pollution Reduction Scheme (CPRS). These price pressures will progressively increase as we approach the end of the regulatory period.

The AER's draft determination would, if confirmed, result in average distribution prices in South Australia rising by 45% over the five years from 1st July 2010. This compares to 17% over the past five years. It would result in average electricity prices rising by between 20 to 30% over the next five years. In the first year alone, distribution prices would increase by 14%. The price impact are summarized in Figure 1 which also shows the annual price increases

Figure 1: Nominal end user distribution price impacts - based on X-factor

This is an outcome that electricity users and the general economy in South Australia can ill afford, especially when (as the analysis in this submission shows), the costs that the AER appears willing to approve for ETSA are unnecessarily high and not efficient as required by the National Electricity Rules (NER). Nor would such an outcome meet the Electricity Market Objective in the National Electricity Law (NEL), which seeks to ensure that decisions made are “*in the long term interests of consumers of electricity*”, including with respect to price.

The higher distribution prices resulting from the AER’s draft decision would have adverse consequences on electricity users in South Australia. Their operating costs would increase, and they would have less capacity to sustain investment and jobs in the State. They would have to either pass on such cost increase to other industries and final consumers (if they can) or absorb them.

Industries in trade exposed sectors, such as manufacturing and mining, both of which are important in the South Australian economy, would be unlikely to be able to pass on the cost increases and their operations would be especially badly affected. South Australian businesses and households would also see impacts in terms of higher input prices and higher prices for many of the good and services they buy. As consumer and producer indices released following implementation of the AER’s final determinations in New South Wales and Tasmania last year showed, the price impacts will also translate through into higher inflation. This was evident in the 2009 September quarter CPI figures where electricity prices were the largest single driver of the CPI increase both nationally, where they contributed to 21.7% of the 1.0 percentage point CPI increase, and in NSW and Tasmania, where they contributed 37% and 14% respectively, to those States CPI increases. Likewise, in the September quarter, the fastest growing

component of producer prices was the electricity, gas and water component, which grew 12.1%.

The EUAA's own calculations suggest that the network price increases being approved by the AER, together with these other factors, will result in a near doubling of electricity costs across the National Electricity Market by 2015. The Business Council of Australia published an estimate in its 2009 infrastructure report prepared for them by Port Jackson Partners.¹ that shows an increase of 95% in retail electricity prices between 2009 and 2015. This is a significant increase over such a short period. The AER needs to be particularly sensitive to this when considering its final decision. We note also that electricity users in South Australia are also very susceptible to the exercise of market power by generators and a lack of retail competition, further compounding the electricity cost pressures they face.

2.1 Price impacts could be reported more clearly

The AER has determined X-factors for the business based on its draft decision. It would be helpful if the AER stated clearly how it has then translated this into average distribution tariff changes. The AER calculated average price changes of 25% (nominal) for end users, but has not specified how it has calculated this. We have not been able to replicate the AER's calculation of price impacts.

Similarly, with respect to residential customers, the AER calculate price increases of 18% over the regulatory period. It is not clear what assumptions underlie this calculation and so again we have been unable to replicate this calculation.

A clear calculation of the impact of its decisions on end users is essential for effective consultation. We call on the AER to pay much greater attention to this in its final decision. Given that the AER's Chair has written to ETSA's CEO and sought his co-operation in providing better and more timely notification of likely price increases to end users, it would be helpful if the AER also provided more accurate, extensive and relevant analysis of the price impacts of its draft and final determinations.

2.2 A need for early notification of tariff increases

EUAA members in South Australia are commercial and industrial users who have market-based retail contracts where the distribution component is treated separately as a pass-through and can be one of the many tariffs used by ETSA.

These tariffs typically have several components such as monthly peak demand kVA component as well as the kWh energy based components. They need to understand how the AER's draft decision impacts each of the relevant components of the tariffs. Only the distributor, ETSA Utilities, is capable of

¹ *Seizing the opportunity to restore and reform Australia's economic infrastructure*, Rod Sims, Port Jackson Partners, October 2009. Part of the BCA's *Groundwork for Growth* Report

providing this information, and given the large increases expected, users need sufficient notice of this in order to be able to incorporate the information into their budgeting cycle. Across the NEM this has not been handled well. In NSW after the AER's 2009 final determination for distribution and transmission, energy users were notified of price increases as high as 55% two weeks before the start of the 2009-10 financial year, when these applied.

We acknowledge that in response to concerns that users raised in submissions and in public forums, the Chairman of the AER has written to ETSA Utilities specifically urging it to provide sufficient notice. We have received indications from ETSA's Chief Executive, that ETSA intends to provide some pricing information for the purposes of consultation with major users and their representatives by the end of March 2010 at the earliest. Our members are keen to obtain indicative price increases at the earliest opportunity and we encourage the AER to continue to urge ETSA to ensure this happens. Our members feel that this date should be brought forward so that they have greater notice of ETSA's likely impending distribution price increases and can start to factor these into their planning.

3 Comment on cost of capital

In its draft decision, the AER has determined allowed rates of return on a similar basis to its Final Decision for the NSW distributors.

The EUAA disagrees with the AER's decision on its cost of capital. In our submission to the AER's WACC review we set out our disagreement on this, and noted that the AER's Board had set a level of WACC that was higher even than the top end of the range recommended to it by the staff of the AER and the AER's consultants.

In their recent paper Mountain and Littlechild,² compared the cost of capital allowed by the AER, for distributors in Australia, with the cost of capital allowed by Ofgem in the UK. They noted that:

“Most of the difference is explained by differences in the assumed cost of equity and debt. Ofgem assumed the cost of equity was 6.7% (real), while the AER used 9.3% (real). Much of the difference here is attributable to the AER's much higher equity beta (1.0) compared to Ofgem's (0.24 to 0.34). With respect to the cost of debt, Ofgem used a value of 3.6% (real) based on trailing yields on A and BBB-rated bonds. The AER used a value of 6.3% (real) based on a margin on top of the risk free rate, nearly twice as high as Ofgem's assumption.”

We have noted that in response to the Littlechild and Mountain paper, the Chairman of the AER has made a number of public statements on the cost of capital. Specifically, he suggested in the *Business Spectator*³ that the difference was accounted for by lower gilt rates in the UK than Australia, cross country differences meaning higher market risk premiums in Australia and that Ofgem's allowed rates of return were “perhaps” too low.

With respect to the first point, ETSA Utilities, like other Australian distributors, are not funded through Commonwealth government guilts. So the relevant comparison of debt costs in Australia to those in the UK is between the cost of debt for corporate debt raised by distributors in Australia with those in the UK. On this measure, we suggest there is no obvious reason to believe that over the long term there should be a sustained difference in the real cost of corporate debt between the UK and Australia.

In addition, we draw the AER's attention to the fact even if there are, from time to time, differences in the cost of corporate debt in Australia compared to that in

² Mountain, B. R., & Littlechild, S. C. (2009 December). “Comparing electricity distribution network costs and revenues in New South Wales and Great Britain”, Series Paper, Electricity Policy Research Group, Faculty of Economics/Judge Institute of Management, University of Cambridge.

³<http://www.businessspectator.com.au/bs.nsf/Conversations/Regulation-T55PM?OpenDocument&src=srch>

the UK, Australian distributors should be expected to meet the majority of their debt capital requirement from the cheapest sources available including through international bond markets, rather than just Australian bond markets, if the latter are more expensive. As such the relevant consideration is the cost of debt for Australian utilities in international capital markets, not just Australian capital markets. There is, of course, nothing unusual about this, as the bulk of debt raised by Australia's major corporations is sourced from off shore capital markets.

In this regard, we note a recent capital raising by SP Ausnet (SPN) in Victoria for corporate debt in off shore capital markets. In a recent research note, Credit Suisse said that:

*"We have seen a number of the Australian regulated utilities accessing attractive off shore bond issuances over the past six months, which are providing tenure longer than available in the Australian bank debt market, and more favorable rates. The Australian Energy Regulator (AER) in its draft decision for ETSA utilities proposed a debt margin of 429bps. This represents a ~280bps wind fall gain to where SPN is currently able to issue debt."*⁴

A small part of this difference – probably around 50 basis points – may be accounted for by SPN's A- credit rating (compared to the BBB+ used in the AER's WACC methodology). However, the largest parts of this difference is explained by the fact that debt capital is currently cheaper to access in off-shore capital markets. By setting a cost of debt in Australia based on the AER's theoretical construction of a debt premium on top of *Australian* risk-free rates, the AER is allowing a cost of debt that is evidently completely out of proportion to the price that companies are actually paying. This is a critically important issue. End users are paying for the windfall noted by Credit Suisse. This must be corrected in the Final Decision.

On the cross-country differences in market risk premia, the AER should produce evidence that the values of the equity beta that it has used (0.8) can be justified in comparison to the much lower values in the UK (0.2), in order to substantiate the AER Chair's comments.

On the AER Chair's suggestion that allowed rates of return are "perhaps" too low in the UK, it would be helpful if the AER justified this assertion having regard to the fact that all the distributors in Britain accepted Ofgem's proposals. If they had thought the rate was too low they had an opportunity to refer Ofgem's proposals to the Competition Commission. But the businesses chose not to. To the contrary, they quickly accepted Ofgem's proposals. Since the AER believes that Ofgem has "perhaps" made the wrong decision, the AER should explain why the British distributors accepted Ofgem's proposals.

The Chairman of the AER also recently opined on the cost of capital in a letter to the Australian Financial Review on 18 February 2009. In that letter, he asserted that *"simply applying UK rates of return to Australian businesses would mean the*

⁴ Research note on SP Ausnet, Credit Suisse, Sydney, 19 February 2010.

rates set would be too low” and that this “would lead to less investment and a diminution of service quality and reliability”.

The evidence provided by Credit Suisse contradicts this. Lenders in British capital markets have been happy to invest in Australian utilities at rates that are 280 basis points below the levels that the AER allows the businesses. If the AER has evidence to support its Chairman’s statement, we call on the AER to provide such evidence in its final decision. However, in the absence of such evidence, we call on the AER to adjust its allowance for the cost of debt to the levels that Australian utilities are paying. In this regard, the approach adopted by Ofgem of trailing yields on appropriately-rated corporate debt appears to be an appropriate measure for the AER to also use.

4 Comments on AER's review of capex

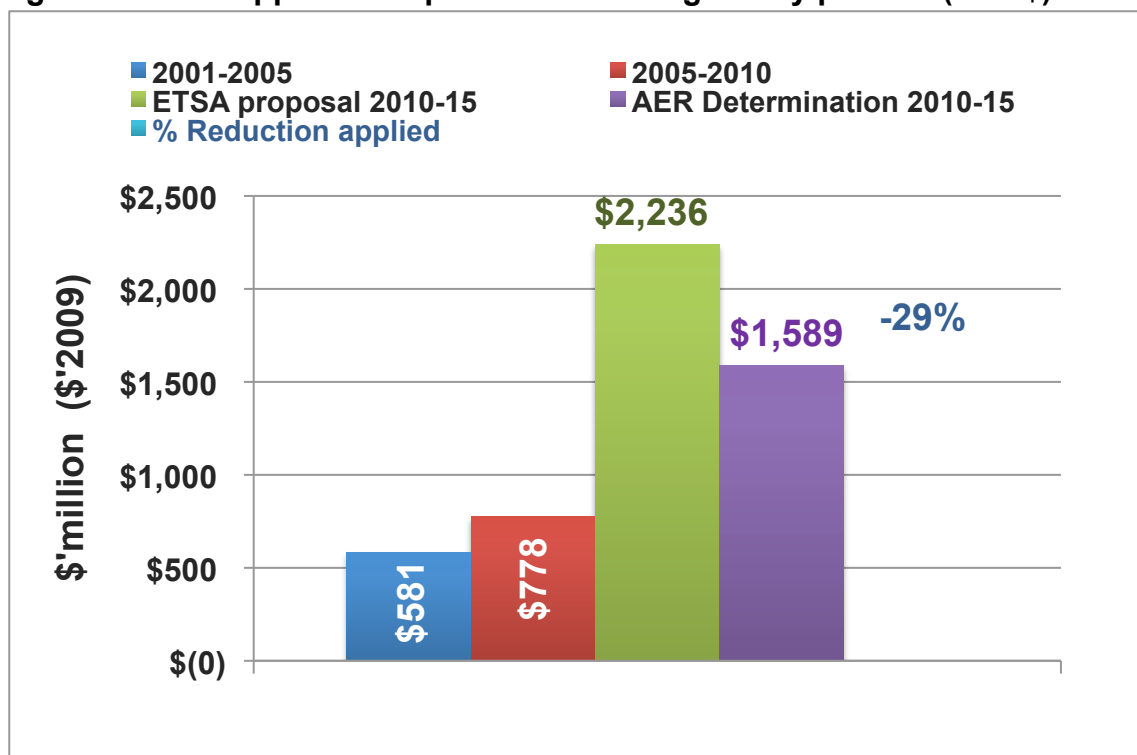
4.1 Summary of AER's decision

The capex allowance of \$2,315m (nominal, and excluding customer contributions) that ETSA requested in their June 2009 regulatory proposal for the 2010 to 2015 period is a significant (190% real) increase on the \$762m allowed by ESCOSA in the 2005 to 2010 determination.

While the AER has reduced ETSA's capex proposal by 29%, the resulting increase of 104% is still of great concern, and compares to the 34% increase that ESCOSA allowed ETSA in 2005. This amounts to a compounded real growth in allowed capex of 170% over the past 10 years.

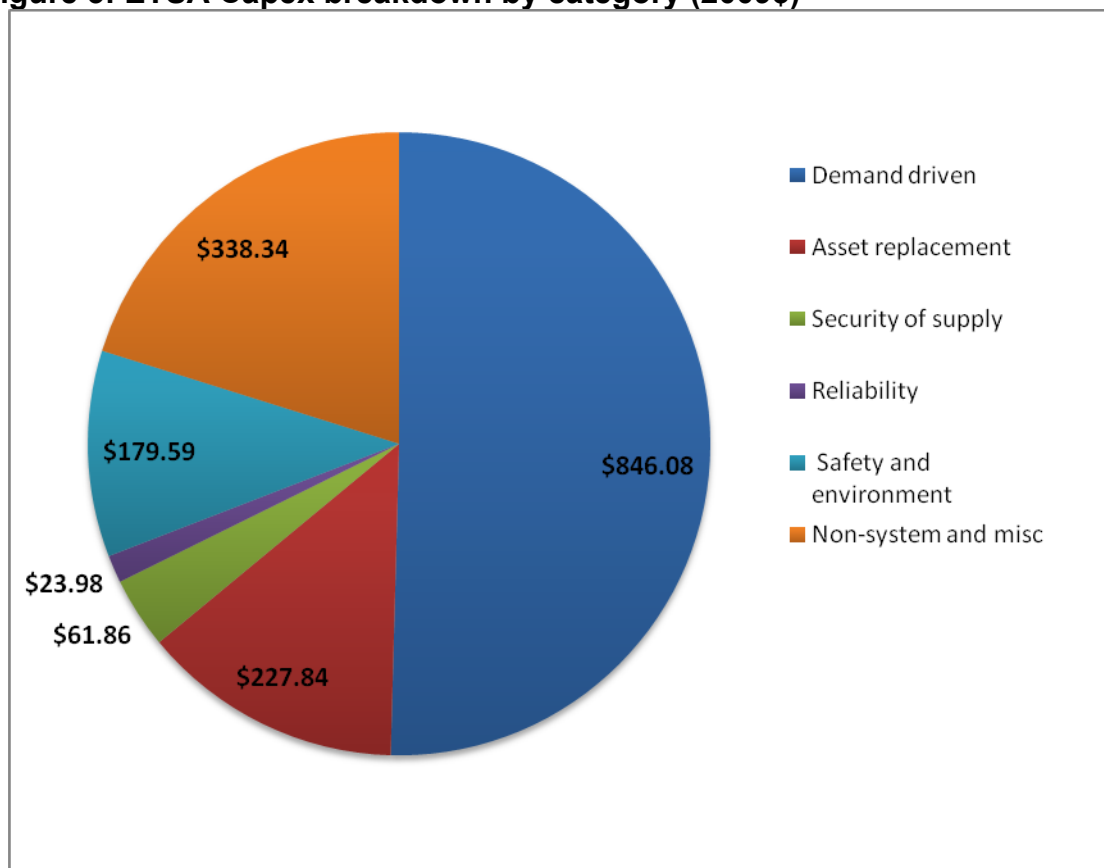
ETSA's capex trends are shown in Figure 2, where the 2000-2005 capex is shown in blue, the current period (2005-2010) allowance is shown in red and the next period under AER consideration (2010-15) is shown in green (proposed) and purple (draft determination). The percentage reduction due to the draft determination is shown in light blue. The figure clearly demonstrates the step change increase in capital expenditure that the AER's draft decision will lead to.

Figure 2: ETSA approved capex over three regulatory periods (2009\$)



The capex allowance is broken down into its constituent components in Figure 3 below. This shows that ETSA intends to roll out a significant system growth program as described in their submission.

Figure 3: ETSA Capex breakdown by category (2009\$)



4.2 Misplaced reliance on processes and governance procedures

We are very concerned that the AER has failed to produce a robust and transparent assessment of ETSA's capital expenditure proposals.

Distribution businesses in Australia are large, complex capital intensive corporate entities. They employ numerous specialist managerial and professional staff. These staff have developed functional and sectoral expertise in procuring and operating assets, over a number years. The AER regulates their core business and naturally they will expend substantial resources on ensuring an outcome favourable towards them – which resources we note are funded out of opex, which is in turn funded out of distribution charges paid by South Australian electricity users.

By contrast the regulator is at a disadvantage. They have fewer resources, are not experienced in operating a distribution business and rely on information provided by the regulated business. They also have a limited time, less than 12 months, in which to complete their review. During a review, much of the time is consumed in consultation and so the actual period of detailed expenditure review by the AER's staff and their consultants is only a small part of the overall review period.

The core of the AER's approach is what it often refers to as a detailed bottom-up review. Faced with the enormous information asymmetry, the constrained review periods, and the AER's resource constraints, it is therefore inevitable that "bottom-up" reviews becomes "*arbitrary and ad hoc*"⁵ as the learned regulatory economist, Professor Paul Joskow says.

We acknowledge that the AER, its staff and consultants have been set a difficult task. Regulatory incentives are intended to encourage efficient expenditure. However the price cap regulation also provides strong incentives for the businesses to overstate their claim, and the regulated firms will expend considerable resources and energy trying to convince the regulator of the merits of its claim. An effective regulator must make use of tools that allow it overcome information and resource asymmetries.

The Rules lists ten factors to which the AER is required to have regard in determining expenditure allowances. We suggest that the most effective of these in setting expenditure allowances as required under the Rules (i.e. expenditure must be efficient and in the long term interest of users) – and the one that the AER has so far largely ignored - is benchmarking.

In the ETSA review the AER has not benchmarked capex as provided for under the Rules (and in a manner that would accord with good regulatory practice). Rather, in attempting to implement its "bottom-up" approach the AER has turned its focus instead to ETSA's "governance frameworks", "processes" and "procedures".

Typically such frameworks, processes and procedures are deemed to result in efficient expenditure if they accord with what the AER (and its consultants) consider to be "good electricity industry practice". For example:

- The first item the AER describes in its approach to assessing capex (see page 100) is to examine whether "the governance frameworks, capex policies and procedures are likely to result in investment ... consistent with the capex objectives". On page 101, the AER expands on this to clarify that "due to the limitations of reviewing a large number of projects and programs in detail, relatively more reliance has been placed on ETSA Utilities' policies and procedures ..."
- PB Associates, the AER's consultants, also stressed the importance of "capital governance, policy and procedures ... " in its assessment of proposed expenditures. In its conclusions on system capex, the AER reports (on page 111) the first bullet points that PB gives to justify its decision being "*capital governance consistent with good electricity industry practice*". The AER also notes (page 113) PB's review of "*capex planning and governance policies and procedures as critical elements for assessing the prudence and efficiency of the capex proposal for the next regulatory period.*"

⁵ Joskow, P. (2007),. *REGULATION OF NATURAL MONOPOLIES* Regulation of Natural Monopolies. In A. M. Shavell (Ed.), *Handbook of Law and Economics*. (pp. 101-102)

- PB Associates typically reduced its assessment to whether or not it considered ETSA's procedures and processes were in accordance with "good electricity industry practice" For example, on page 115, the AER notes that PB had concluded that "*ETSA utilities has a well developed documentation framework that demonstrates capital governance practices, and is generally consistent with good electricity industry practice*".
- On page 121, the AER reaches the conclusion that "ETSA utilities has a hierarchy of policies, directives, plans and procedures, which when taken together appear to set out a robust approach to capital investment governance. On the basis of its review, the AER considers ETSA Utilities' capital governance framework demonstrates thorough capital governance processes".
- On page 117, the AER concludes that "ETSA Utilities' policies and procedures for capex planning and governance is likely to lead to prudent and efficient investment decisions."

The term "good electricity industry practice" may have some useful meaning as a description engineers might use to describe a network that is maintained to specific standard, or a transformer that is installed and operated in a particular way to ensure its reliability and safety. But what does "good electricity industry practice" mean in the lexicon of regulatory economics, and specifically the AER's obligations under the National Electricity Rules ?

Why is it reasonable to conclude that "good electricity industry practice" is synonymous with efficient expenditure ? If efficiency was so easy to determine, there would be little need for the considerable effort that policy makers in Australia and internationally put into the design of regulatory regimes and regulatory incentives. For this reason, we suggest that the AER's approach of defining "efficient" as synonymous with "good electricity industry practice" has no sound basis in the theory or application of regulatory economics. If the AER considers that this is wrong, we call on the AER to justify its approach with reference to the established regulatory economics literature.

Furthermore, as a practical matter, taking account of the time allowed for a review, and the AER's significant resource constraints, how can the AER feel that it has the resources or skill needed to reach conclusions on the "governance frameworks", and a wide variety of the processes and procedures of these large and complex businesses ?

These are fundamentally important questions of regulatory approach, and we ask that the AER clarify this in its final determination.

We also suggest that much greater use of benchmarking (as we discuss further in Section 4.4) is a far more suitable approach and we encourage the AER to turn its attention to this for the Final Determination on ETSA.

4.3 Specific capex assessment issues

4.3.1 Unit costs

The use of future unit cost estimates is critical to assessing the potential future capital expenditures and can impact on a significant portion, if not the majority, of the capex proposed. While we could not find an estimate in the draft determination of how much of ETSA Utilities' capex is dependent on unit estimates, we refer to the AER's draft determination on Energex and Ergon Energy's proposals where the AER stated:

"The AER notes that 85 per cent of Ergon Energy's proposed capex is based on unit costs independently reviewed by SKM."

PB Associates, the AER's consultant had no specific requirement to benchmark unit costs. The AER staff reviewed the unit cost estimates applied by ETSA Utilities using the following approaches:

- It accepted ETSA's view that its historical costs must be efficient and then performed a spot comparison of 12 past projects' unit costs against ETSA's unit costs used to prepare the capex forecast.
- It noted and accepted the reliance on a review of the unit costs by a consultant *engaged by* ETSA.
- It claims to have "benchmarked" ETSA's unit costs against those calculated by ETSA's consultant.
-

To back up their approach the AER noted (p118) that ETSA Utilities stated that its unit costs, which reflect the historical costs achieved on similar projects, can be considered efficient because:

- it faces a commercial requirement to deliver appropriate financial returns which also drives unit cost efficiency; and
- its unit costs for a significant sample of representative asset replacement and capacity tasks compare favourably to the unit costs estimated by "an independent South Australian construction company *engaged by* ETSA Utilities." [our italics]

By referencing these statements by ETSA Utilities, the AER appears to accept the following arguments:

- ETSA's historical costs must be efficient because it faces commercial pressures.
- The comparison of ETSA's unit costs with those of their consultant substantiates efficient future costs.

As this is clearly not an independent, critical assessment how can electricity users in South Australia accept it and the AER's conclusion?

4.3.2 Non-system capex

In its proposal, ETSA had forecast \$364m (nominal) in the non-system capex category, which the AER has noted is 98% higher than during the current period.

This equates to approximately a \$180m increase. The non-system capex category in ETSA utilities proposal relates to various non-network components in four categories. These are set out below together with the associated expenditures in each category, percentage of the proposed expenditures attributed to each category and the increase in the expenditure in that category with respect to the current (2005-10) regulatory period.

Table 1. Non-system capex

Category	Explanation	Expenditure	Portion	Increase
Information Technology	Hardware and software	\$149m	41%	103%
Property	Offices and depots Commercial and passenger vehicles	\$83.4m	23%	1,090%
Fleet	vehicles	\$93.2m	26%	36%
Plant and Tools	Tools & equipment for personnel	\$37.5m	10%	11%

PB Associates advised that the entire expenditure was efficient and prudent and made a modest escalation-related adjustment down to \$334m in nominal terms. It is not evident from the draft determination whether this adjustment was incorporated by the AER since no adjustments were explicitly reported. We ask that the AER clarify this point.

We reviewed both PB Associates' report and the draft determination and found no meaningful analysis of efficiency and prudence. PB Associates described their approach as:

“A high level review is provided, including an analysis of trends in expenditures.”

They stated that, based on this “high level” review, they found that the expenditures in each of the stated categories were prudent and efficient. We have concerns with this conclusion and the approach upon which it is based. We refer below to some specific issues:

- Information Technology: “PB found that ETSA Utilities’ business-driven initiatives in IT align with its corporate strategy, including the timing of activities. ETSA Utilities’ has substantiated the estimated costs using external entities and has taken into account options outside existing vendor relationships. On this basis, PB considers ETSA Utilities’ IT expenditure prudent and efficient.”
- We note the doubling in IT costs, but cannot see how a statement that expenditure aligns with strategy, or that “external entities” helped ETSA cost its program, or that a range of service providers were considered, can justify the efficiency of this expenditure?
- Property: “PB considers that ETSA Utilities has demonstrated sufficient rigour in its cost estimation for existing facilities based on condition

assessments. PB considers ETSA Utilities' generic depot design concept as sufficient on which to estimate new facilities. On this basis, PB considers expenditures associated with ETSA Utilities' building program are prudent and efficient."

- We cannot see how a "generic depot design concept" can justify an assessment that expenditure is prudent and efficient?
- Fleet: *"ETSA Utilities has demonstrated market tested procurement, need and timing based vehicle replacement. On this basis, PB considers that the proposed fleet expenditure is prudent and efficient."*
- It is unclear what market tested procurement means? That ETSA asked for several quotes? Again, we cannot see how this justifies a \$93m program, and a substantial increase on historic expenditure?
- Plant and Tools: *"PB's high-level review of plant and tools found the proposed expenditure is in line with historical expenditure when taking into account forecast increases in staff numbers. On this basis, PB considers ETSA Utilities' plant and tools expenditure forecasts to be prudent and efficient"*
- In this final category, PB appears to infer that since the expenditures are consistent with historical trends, this implies efficiency, and that escalation by staff numbers is also efficient. There is no evidence to support the efficiency of the historical expenditures, or that any analysis has been done to substantiate the implied correlation between staff numbers and the expenditure increase.

In addition to these drivers, PB Associates repeatedly cited the following drivers across these categories:

- The expenditures are consistent with ETSA's "business as usual" expenditures.
- The increases were consistent with ETSA's workforce growth (which is supporting its increased expenditures).

Based on these, both PB and the AER have concluded that all the above expenditures were both prudent and efficient. We note that 'business as usual' is not a sufficient basis to establish prudence or efficiency. Moreover, for workforce growth to be considered a justification it would first need to be established that this growth was itself justified and efficient (and we note the large growth proposed), and that efficiency in the application of plant and tools cannot be obtained. Neither appears to have been done. In coming to these conclusions they additionally relied on a review of policies, procedures and methodologies. This is an insufficient basis for such a conclusion.

In our view, the AER has not established the efficiency of these expenditures for the following reasons:

- They have not established that the historical expenditures were efficient through benchmarking or any other approach.
- They have not (to our knowledge) performed any analysis to confirm that the workforce size was in fact a significant driver, or quantified the strength of this driver.
- We could not find any evidence provided by ETSA Utilities, PB Associates or the AER that the 29% increase in the workforce is prudent or efficient.
-

For these reasons, we suggest that the substantial increases in non-system capex can not be justified.

4.4 Failure to benchmark

The AER has failed to benchmark capex as it is required to under the Rules. The AER is aware of its benchmarking obligations, but has not fulfilled them. Electricity users in South Australia find this unacceptable. Page 121 of the draft decision states that:

“the AER considers that the benchmarking of ETSA Utilities’ unit costs against those calculated by ETSA Utilities’ consultant satisfies the capex factor (clause 6.5.7(e)(4)) that the AER have regard for the benchmark capex that would be incurred by an efficient DNSP over the regulatory control period.”

We disagree that what the AER has done meets its capex benchmarking obligations under the Rules.

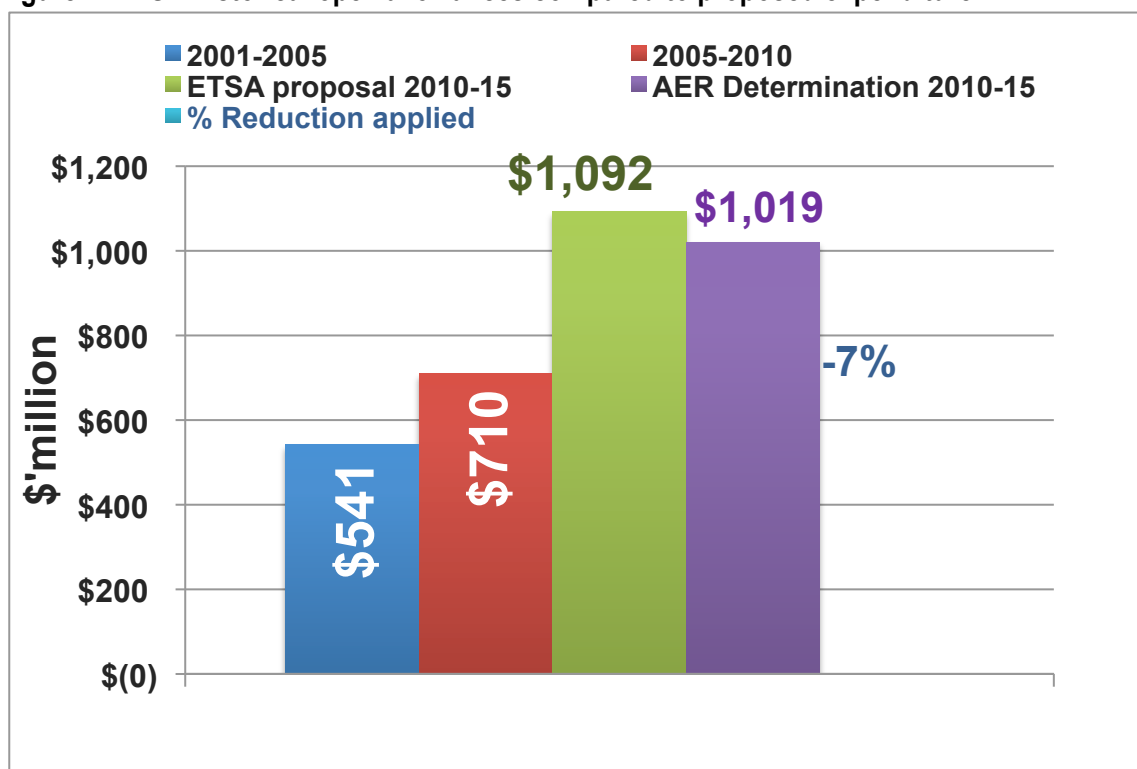
- For a start there is no evidence that the AER has undertaken any comparative analysis either itself, or through the consultants it has retained. Instead, the AER has relied on an unpublished unit cost analysis undertaken by ETSA’s consultants. How can this possibly be asserted to be an independent, critical comparative analysis as we understand the Rules to require and as would be consistent with the theory and practice of regulatory benchmarking (eg as practiced by Ofgem)?
- Secondly, the Rules are very specific that benchmarks cover capex (not unit costs or some other disaggregated element of expenditure). The AER has instead undertaken a partial comparative assessment of only a small part of one of the elements of ETSA’s capital expenditure.

5 Comments on AER's review of opex

5.1 Summary of AER's decision

This section briefly outlines the opex impacts of the AER draft determination. As in the case of our capex analysis, we present the outcomes of the last period (2000-2005), current period (2005-2010) and the coming period. Figure 4 below sets out the trend in ETSA's allowed operating expenditures. It shows a significant real increase across the three periods, but the rate of increase is far higher on account of both ETSA's proposals and the AER's draft determination. In their proposal, ETSA asked for \$1,131m in nominal terms over the next period. The AER has applied a revision downwards of only 7% in real terms. The draft allowance translates to a 44% increase (in real terms) over the last period. This is on top of a 31% increase allowed by ESCOSA for the current period. When compounded these result in a near doubling of the opex, in real terms, between 2000 and 2010.

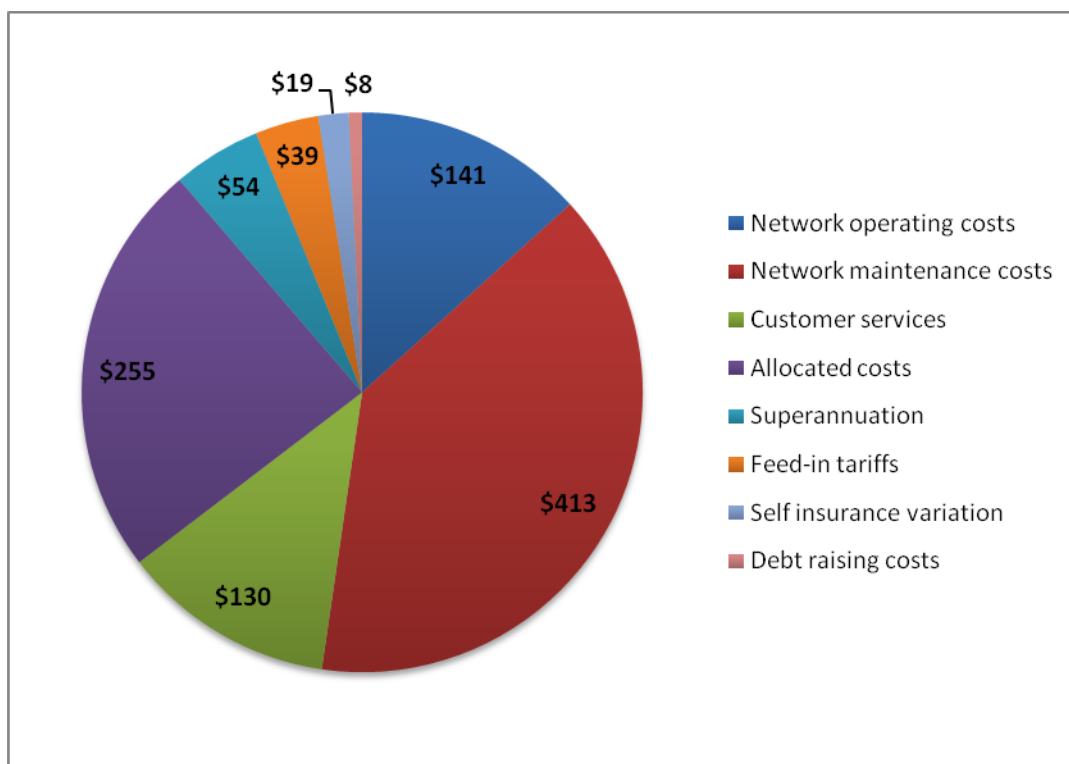
Figure 4: ETSA historical opex allowances compared to proposed expenditure



In order to understand the allowed opex better, it is broken down into its main components in

Figure 5. This shows that the dominant components are network maintenance, allocated costs, and network operating costs.

Figure 5 ETSA's allowed capex for the coming regulatory period



5.2 Misplaced reliance on processes and governance procedures

Section 4.2 set out the EUAA's concerns about the AER's misplaced reliance on an assessment of processes and governance procedures in assessing capex. This same concern applies also to opex, although perhaps not to the same extent in view of the approach of establishing opex through a base year and then variations on top of that base year. Nevertheless, we noted several instances where the AER has ultimately relied on reviews of processes and governance procedures. For example:

- On page 178 in describing its overall approach to opex assessment, the AER says that “while a range of ETSA Utilities’ projects and programs were reviewed by the AER and PB, the AER’s overall assessment has placed less reliance on the review of individual expenditure programs and projects reviews (but instead) the AER has focussed on the policies, procedures and underlying assumptions, and how these have been practically applied by ETSA Utilities, both historically and in developing the opex forecasts.”
-
- On page 178, the AER reports that its consultant, PB Associates, identified its first task in the assessment of opex being to “*understand the business as usual asset management approach and practice, including relevant policies and procedures*”. On page 189, the AER cites as the first reason in PB’s justification that 96 per cent of ETSA Utilities proposed opex was prudent and efficient, that “*policies, documentation and modelling to*

support the asset management approach and the forecasting methodology are comprehensive, transparent and reflect the needs of the business in the current environment.”

- On page 192, the AER paraphrases PB's assessment of ETSA's opex. The AER reports that PB approved of ETSA's "21 direct cost opex activities and the 41 allocated cost activities" and their "high degree of transparency", "excellent labelling and cross-referencing". PB approved of ETSA's "refined" opex model and its "high professional standard and quality". With regard to step change increases in opex, on page 202, the AER refers to PB's particular attention to the fact that ETSA's numerous reviews "culminate in formal executive management approval prior to inclusion in ETSA Utilities' regulatory proposal." While it is clearly evident from this that PB approves of ETSA's opex processes and management procedures, how does this provide any insight into the efficiency of ETSA's expenditure claim?

Again, for the reasons set out in Section 4.2, we think it is not sufficient for the AER to rely on what it thinks about ETSA's governance procedures to support a judgment on the efficiency of proposed operating expenditure of \$1131m that would result in a real increase of 44% on the current period. Energy users require a more fundamental, robust and transparent assessment of ETSA's opex by the AER.

5.3 Misplaced reliance on revealed costs in establishing starting point

The AER's approach to establishing ETSA's opex allowance is to set the starting point as the operating expenditure in 2007/8. Variations on this are then used to establish how the expenditure should vary during the regulatory period. This approach relies on the idea that the "revealed expenditure", i.e. the expenditure that the business incurred in some previous year is by definition efficient expenditure. The underlying assumption in this is that businesses have incentives to reduce operating expenditure to its efficient level.

The AER might argue that its approach is more than this since it has calibrated its assessment of the efficient starting point, by benchmarking the opex. But, as we discuss in the next section, we do not think that the AER has done this, and so we would reject this argument.

More generally, we are concerned that the regulatory cost accounts are not sufficiently well-developed to place reliance on the level of revealed operating expenditure as representative of efficient expenditure. In the absence of a consistent definition of what constitutes operating and capital expenditure, the regulated businesses have considerable latitude to define this expenditure as they see fit. It is well known that there are significantly weaker incentives to reduce capex than opex (particularly towards the end of the regulatory period).

Therefore distributors are able to maximize their shareholder returns (at the expense of users) by reclassifying their operating expenditure as capital expenditure. It can be no small coincidence that amongst all Australia's

distribution businesses, comparing actual expenditure with allowed expenditure shows consistently better performance of opex rather than capex, i.e. generally consistent underspending of opex or close to level-pegging of opex, but usually massive overspending on capex (in the case of government-owned distributors) or relatively less underspending on capex than opex (for privately-owned distributors). Until the AER has developed a reliable system of regulatory accounts to ensure consistent definition of opex and capex, we suggest that the assumption that revealed costs are efficient in setting the starting point for the opex allowance, can not be sustained.

5.4 Inadequate benchmarking

The AER claims to have benchmarked opex in its draft decision. However, the AER says that it has only used it as a “top down test of more detailed bottom-up assessments” (draft determination, p. 195). The AER also “noted” that benchmarking is just one of ten factors that the AER must have regard to and that:

“the general limitations of benchmark analysis are recognised by the NER as benchmarking is only one of ten factors that the AER must have regard to when assessing a DNSP’s proposed opex forecasts.” (draft determination, p. 200)

The main elements of the AER’s opex benchmarking are summarised below and explained afterwards:⁶

- The AER developed a composite scale variable as the explanatory factor in a single variable regression.
- It then produced a scatter plot of total opex for 2007/8 against the composite scale variable for distribution network service providers in Australia, except those in Western Australia and the Northern Territory.
- A linear ordinary least squares regression line on that scatter plot was drawn.
- The AER drew conclusions for ETSA on the basis of the data points in relation to the regression line.

Composite scale variable

The underlying hypothesis in the AER’s benchmarking is that the efficient total operating expenditure of a distributor varies as a function of the length of the network of the distributor and the number of customers of that distributor. This hypothesis was developed by the AER’s consultants, Wilson Cook, for the AER’s review of the price control for the New South Wales distributors.

⁶ This explanation of the AER’s benchmarking is not available from the published material but rather is based on information specifically provided to us by the AER, in correspondence. The correspondence is not confidential and is available on request.

These two expenditure drivers – length of network and number of customers – were then combined in a “composite scale variable”. They were combined on the basis of the assumption that the size variable should be calculated as 3.3626 multiplied by the length of the network and that the total number of customers should be multiplied by 0.1306.

The use of a composite scale variable has been adopted by the Office of Gas and Electricity Markets (Ofgem) in Britain in its benchmarking, although Ofgem’s benchmarking included energy sales in a composite scale variable that was therefore calculated on the basis of three elements. In this sense, the AER’s use of a composite scale variable replicates aspects of the benchmarking methodology adopted by Ofgem.

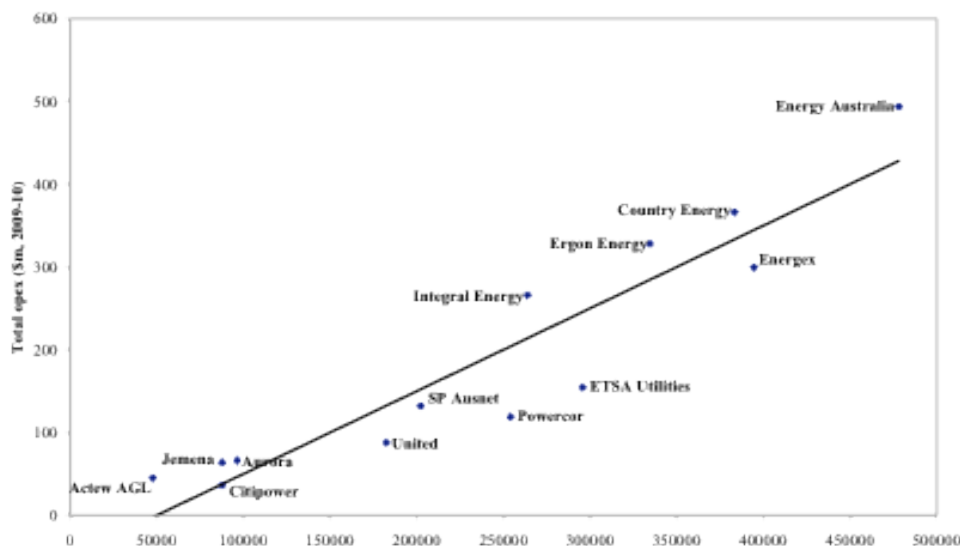
Scatter plot

The AER then plotted the Total Opex against the composite scale variable for all distributors (except those in NT and WA) for the year 2007/8.

Linear Regression

The AER then drew a straight line based on an ordinary least squares regression. In other words, a line that comes as close to all data points as possible. The AER emphasised in the Draft Decision and in subsequent correspondence with us, that the line is only taken to represent the line of best fit, not an estimate of the efficient benchmark, as required under the Rules. The scatter-plot, with the line of best fit is reproduced in Figure 7 below.

Figure 7. AER's scatter plot with regression



Drawing conclusions

The AER then noted that ETSA was below the line of best fit but then dismissed the observation that ETSA was below the line of best-fit saying that “... *there are reasonable explanations for this outcome*”. (Australian Energy Regulator, 2009a, p. 200)

5.4.1 Why does the AER's benchmarking fall short of its Rules

We suggest that the AER's opex benchmarking falls short of its Rules obligations in four ways, summarised below and then explained in the rest of the subsection:

- The AER has defined a role for benchmarking that is inconsistent with the Rules;
- The AER has failed to define the benchmark efficient opex;
- The AER has benchmarked historic expenditure; and
- The AER has failed to act on, or have regard to, the outcome of its benchmarking.

The role of benchmarking

The AER played down the role of benchmarking, describing it merely as a “*top-down test of detailed bottom-up assessments*”. As noted earlier, the Rules do not give the AER freedom to down-play benchmarking, or any of its other capex or opex factors in this way. Specifically, the Rules identified benchmarking as one (of ten) factors that the AER is required to have regard to and presumably the creators of the Rules expected the AER to do so (and inform itself about the application of benchmarking in the theory and practice of regulatory economics). We suggest that the AER does not have discretion under the Rules to define benchmarking as a subsidiary approach, merely for “top-down” testing of other methodologies. Benchmarking stands alone – just like the other 10 factors – and should be considered just like the other factors.

Failed to define benchmark efficient opex

The Rules require the AER to determine the benchmark opex of an efficient network service provider. The AER has failed to do this. Instead, as noted above, the AER emphasised in the Draft Decision that the line it has drawn is simply the line of best fit, not an estimate of the efficient benchmark, as required under the Rules. Having failed to define what the benchmark efficient opex is, it is impossible for the AER to claim that it has had regard to it.

However, there are other important issues to draw attention to here. The AER's line of best fit, the “ordinary least squares”, is conceptually a line that represents the average relationship between opex and the composite scale variable. In other words, it represents the average efficiency. Although the AER has been at pains to point out that its line does not represent the efficient frontier, it has used its line to draw conclusions about the relative efficiency of ETSA. As such, as much as it disavows it, the AER has indeed used the ordinary least squares line as the key to its “benchmarking”.

This is wrong both conceptually and in practice. Conceptually, the efficient benchmark or efficient frontier is meant to represent the efficiency of the *leading* service providers, not the *average* service provider. In every application of benchmarking that we are aware of, and in all surveys of international experience in benchmarking where regression techniques are used (see for example, Pollitt

& Jamasb, 2000, p. 7, Mehdi, Aurelio, & Massimo, 2007, p. 9, Haney & Pollitt, 2009, p. 17) it is the “corrected” ordinary least square that is used, not the ordinary least square.⁷ The “correction” establishes the benchmark based on the leading service providers, with the only point of contention being whether “leading” is defined as the most efficient participant, or the top decile or upper quartile.

The AER has benchmarked historic expenditure rather than expenditure for the coming regulatory period

The AER’s benchmarking is based on expenditure for the year 2007-8. This is three years before the start of the regulatory control period to which the current price/revenue controls relate. It is legitimate to build the dataset for all comparators at this date, but the expenditure that should have been benchmarked, is the allowed expenditure for the coming regulatory period (as is required by the Rules), not the expenditure by ETSA in 2007/8.

The AER has failed to act on the outcome of its benchmarking

Notwithstanding our criticism that the AER’s benchmarking is inadequate, they have nevertheless failed to act on the information contained in their own benchmarking. Specifically, the AER concluded that ETSA is more efficient than the average but then asserted (on page 201) that “ *there are reasonable explanations for this outcome*”.

5.4.2 How would the price/revenue control decisions differ if the AER had properly had regard to the efficient benchmark ?

In order to show to members how the application of benchmarking would change the AER’s draft determination, we have developed our own analysis of an efficient benchmark. There are a few key points to this analysis:

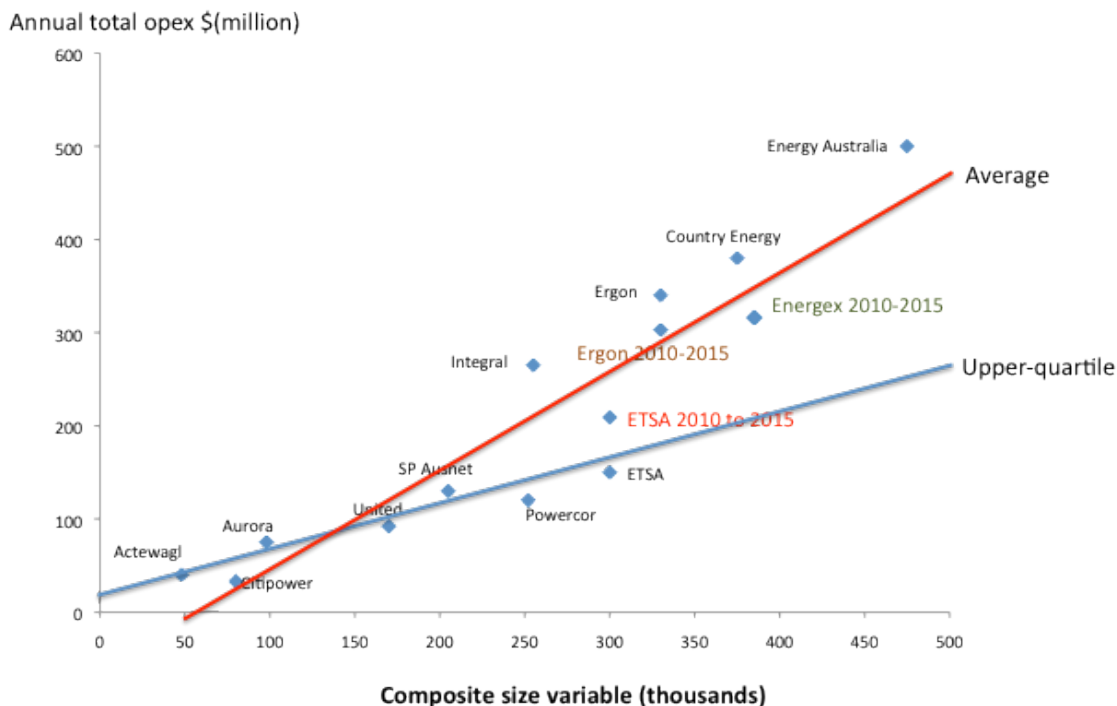
- We have used the AER’s dataset – specifically their own calculation of the composite scale variable and revenues for all distributors for 2007/8;
- We have used the average revenues for the coming regulatory period (as required under the Rules) for ETSA
- We have chosen an efficient frontier based on the top-quartile performance. As noted in the previous sub-section, a “corrected” ordinary least square is needed to establish an efficient frontier. The choice of the top-quartile for the regression conforms with the approach that Ofgem has used in Britain.

The results of this regression are illustrated in Figure 8 below. The Red line is the AER’s ordinary least squares (average), while the Blue line is the upper-quartile (corrected) ordinary least squares that we suggest is the appropriate benchmark.

⁷ We note for completeness that Pollitt, M. G., & Jamasb, T. (2000) mention ordinary least squares approaches but this is in the context of regulatory incentives, not efficiency benchmarking.

With the AER's approach, their decision of the average allowed revenue for ETSA for 2010 to 2015 is less than their benchmark. By comparison, using the upper-quartile as the benchmark, the AER's decision shows that the allowed revenue for ETSA is now far from the benchmark.

Figure 8. Upper-quartile regression and OLS (average) regression



We have quantified the opex reductions that would be needed to bring ETSA's average allowed opex for the coming regulatory period to be in line with the benchmark. This is quantified in the table below. The first column is the average allowed opex based on the AER's Draft Decision. The second column is the benchmark level of opex assuming these businesses were required to raise their efficiency to the upper quartile. The third column is the reduction in opex required to bring the businesses' opex expenditure in line with the benchmark. The last column is the expenditure reduction stated as a percentage of the AER's draft decision allowance.

Table 2. Opex reductions required

	Average allowed total opex for coming reg period (\$million)	Upper-quartile benchmark opex (\$million)	Difference between draft decision and benchmark (\$million)	% reduction
ETSA	\$209	\$153	\$55	27%

5.5 Debt and equity raising costs

The AER's denigration of the role of benchmarking of total opex quite clearly contradicts the approach to benchmarking that it has adopted in relation to debt and equity raising costs.

For debt and equity raising costs (which are counted as "uncontrollable opex") the AER relies exclusively on benchmarking to set this expenditure.

Contrary to what the Chairman of the AER has publicly alleged, the EUAA has never suggested that the AER should rely only on benchmarks to set expenditure. It is right that the AER should have regard to all the other factors mentioned in the Rules. In the case of debt and equity raising costs, the AER had no regard to the other nine factors set out in the Rules. We think it should have.

In the specific case of ETSA, it is part of the Spark Infrastructure Group, a listed business. We think the AER needs to take account of ETSA's ownership structure. Specifically, the AER needs to understand how ETSA is funded in deciding the extent to which the AER's benchmark approach to the calculation of debt and equity raising costs should apply to ETSA.

6 Comment on pass-throughs

We do not support pass-through as a matter of principle and believe that it will always be asymmetric in favour of the network businesses given their information advantages over the regulator and end users. Consequently, during any regulatory control period it is highly likely that only cost increases will be the subject of pass through and any cost reductions that emerge will almost certainly never be passed through. This situation is likely to be even more asymmetric at a time of large regulatory expenditure increases.

Whilst the NER and the NEL permit pass through and it has been feature of energy network regulation for some time, this asymmetry in outcomes ought to be recognised in the assessment of pass through arrangements. We would urge the AER to also consider this matter in the broader context of its regulation of network businesses, including the option of a Rule change that will lead to more balanced outcomes in future.

In this context we note that the application of economic regulation to energy networks in Australia has been founded on the principle that the outcomes ought to mimic those found in competitive markets. With regard to pass through, this clearly has limited application. In competitive markets, pass through only applies where costs are the result of factors outside the control of the business and then only if the business is in a position to be able to pass through these costs. In the case of regulated businesses, this needs to be recognised by the regulator with one eye to the risk of strategic behaviour by the regulated business.

The EUAA notes that the AER, in the draft determination (p331) shares our concerns regarding pass through risk avoidance as it has stated that the application of section 7A (3) of the National Electricity Law "*It is limited in its application as it has the potential to undermine the incentive to effectively manage risk in a least cost manner*". We welcome this comment.

Within the confines of the existing regulatory approach, the EUAA has concerns over ETSA's proposed pass through events. We would urge a rigorous assessment of ETSA's proposed pass through events by the AER to determine their validity. The EUAA would like to draw particular attention to:

- **CPRS event:** A distribution business has minor costs that it would incur as a result of the CPRS. All businesses in Australia will have some carbon impost and many will have to manage the risks associated with these costs internally and will have limited scope to pass them on to customers. Giving the DNSPs allowances to pass on costs associated with the CPRS would allow them to eliminate any incentive on them to reduce these costs.
- **Feed in Tariff event:** the EUAA questions the feed-in tariff event which requires DNSPs to make payments for electricity generated by solar power systems and then put on to the grid. These feed in tariffs will be part of

business as usual over this period and into the future and should be managed by the business appropriately. The EUAA also notes that ETSA have forecast expenditures for feed in tariffs in relation to their opex. The AER has determined that a pass through cannot be accepted if there is provision for these costs to be factored into opex or capex. In this case, it seems reasonable that the variation should be captured within the opex allowance. We ask the AER to clarify how this relates to the Feed in Tariff pass through.

- **Native Title event:** the EUAA recognises the sensitivity surrounding issues of native title in Australia. However, it does not support a blanket native title pass through. The EUAA believes that there should be a sharing of costs between ETSA Utilities and its customers associated with native title claims on existing networks. The EUAA does not support native title pass through for new distribution projects. ETSA should be exposed to incentives to reduce costs related to native title claims for new distribution projects.

7 Comment on service standard incentives

The EUAA has issues with the setting of performance targets under the Service Target Performance Incentive Scheme (STPIS). The AER sets targets using averages and therefore the averaging takes into account under-performance in the setting of new targets. The most appropriate methodology would be to have established data on service classes across the distribution sector and set at the upper quartile. When looking at the historical chart on SAIDI performance it is clear that SAIDI improvement has been declining. In addition, by averaging SAIDI performance as an average they are not taking into account the downward trend in SAIDI performance.

The AER stated in its draft position that the EUAA considered the STPIS a 'welcome development' and that quality of supply was an important factor for its customers. The STPIS leaves open the potential for power quality to be included in a service target scheme. Furthermore, as we previously noted in our submission to the NSW DNSP review, the AER has promised to consult with the DNSPs (and we would hope also end users) in setting the values for performance targets for the 2014-19 period.⁸ The EUAA requests that the AER begin this consultation with the businesses and end users for power quality to be included in the STPIS for the 2014-19 regulatory period.

We therefore draw the AER's attention to the current Service Incentive scheme in South Australia which both measure and implements power quality and has done so for some time. Additionally, ESCOSA has said⁹ that after the AER takes responsibility for the implementation of the Service incentive scheme, it will continue to measure power quality performance. We believe the AER needs to simply apply the currently running ESCOSA power quality incentive scheme as the power quality component of the STPIS until it develops its own version in consultation with users as well as the DNSP's. Not doing so would be a serious step backwards.

⁸ EUAA, *Submission to Australian Energy Regulators' Draft Decision & Revised DNSP Proposals – Review of NSW Distributors' Regulatory Proposal*, p. 21 (2009)

⁹ "South Australian electricity distribution service standards: 2010-2015 final decision" – ESCOSA, November 2008

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