



SANKOFA  
CONSULTING

# TasNetworks Distribution Alternative Control Services

Review of the Australian Energy Regulator  
Draft Decision

November 2018

# Introduction

## Purpose and Scope of Review

This report focuses on the draft determination by the Australian Energy Regulator (AER) for TasNetworks' distribution network Alternative Control Services (ACS). The determination is set out in Attachment 15 of the AER draft decision documentation. Specifically, we have reviewed:

1. The basis of the decision to impose an overheads cap of 25 per cent of direct costs for public lighting; and
2. The basis of the decision to substitute a lower labour rate for Administration than that proposed by TasNetworks.

Each of the above decisions are analysed in the following sections.



# The Draft Decision for Public Lighting

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The current difference between TasNetworks' proposed costs for public lighting and the AER draft decision is that:

1. TasNetworks have amended the rate of overhead allocation to public lighting costs based on activity based costing methods that it describes as the source of identification of a shortfall in the true cost of provision of public lighting services.
2. The AER did not accept the overhead component of proposed TasNetworks' public lighting costs, based on what it believes to be a benchmark efficient rate of overheads – being 25% of direct costs.

The AER cites<sup>1</sup> benchmarking analysis of the TasNetworks public lighting model and historical data as mechanisms it considered in making its draft decision. This section explores some of the issues with the decision basis and presents some public lighting benchmarking data.

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<sup>1</sup> Page 15-9, Attachment 15 - Alternative control services, TasNetworks Distribution determination

Benchmarking of public lighting charges and costs is problematic. There are a number of reasons for this, including:

- There are a number of current and historical differences in the mechanism for determining public lighting charges. Specifically, some jurisdictions are based on a building block model where the RAB is used to recover costs, whereas other jurisdictions – such as Tasmania – use an annuity charge model.
- There is great variation in the material costs for different luminaire types. The different luminaire type mixes each network manages means that total average costs are not comparable.
- There are differences within and between networks in the ownership of the assets and responsibility for maintenance, repair and replacement. Furthermore, there is significant penetration of newer, energy efficient luminaires in Victoria (only 19% of lights in Victoria are Mercury Vapour 80W type, compared to 47% in Tasmania). Whilst this historically required an uplift in capital, there are savings through longer lamp life and the potential to push cleaning cycles out to longer timeframes.

There will also be inevitable variances in the estimates of inputs in a cost build up for the forecast of public lighting costs and the actual costs incurred through application of the Cost Allocation Methodology (CAM).

In making its decision, the AER refers to the Marsden Jacobs report which recommends an overhead cap of 25 per cent on directly incurred public lighting costs. However, the Marsden Jacobs report sources the benchmark of 25 per cent from a previous AER decision. As such, the AER is referring to its own benchmark in its decision; a value that has little discernible quantitative justification. The fact that the value is the upper end of the range applied by the Victorian networks does not mean that TasNetworks proposed rate is inefficient, for the Victorian networks manage and report overheads differently to other jurisdictions. Some of those differences, and the consequences for reliance on 25 per cent as a benchmark, are detailed below.

## Cost Allocation Methodologies – Direct vs Indirect Costs

The use of a percentage as an overhead benchmark presents issues due to Cost Allocation Methodology variances. In particular, Victorian networks allocate the costs for several functional activities to direct costs, which would otherwise be allocated to overheads in other jurisdictions. The public lighting models of the Victorian networks list call centre, complaints handling, account management and GIS as direct opex costs. These costs are listed as “Other Direct Costs” in their respective public lighting models. These are all costs that are included in the overhead category for TasNetworks. Figure 1 below shows the percentage of Public Lighting Operations and Maintenance expenditure that these costs categories represent for each of the Victorian networks.

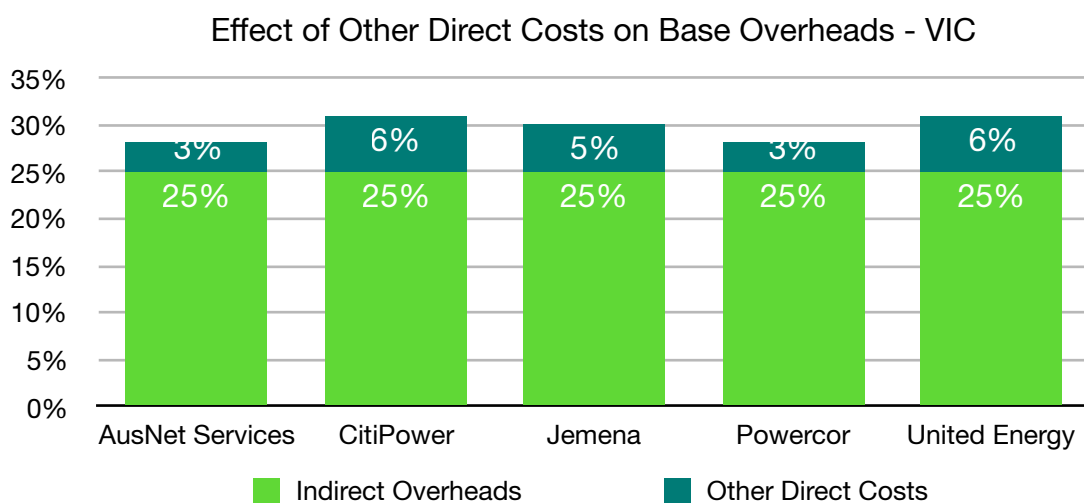


Figure 1: Indirect Overheads plus “Other Direct” Costs for Victorian Public Lighting Models

Even if it was reasonable to consider the percentage of overheads in Victoria as a suitable benchmark for the overhead rate in TasNetworks' public lighting costs, the currently reported 25 per cent benchmark is not derived from a comparable basis. Several networks also report zero overheads in their actual public lighting opex, meaning that:

1. They capitalise every dollar of overheads associated with public lighting activities; and/or
2. They categorise all activities associated with public lighting as direct activities; and/or
3. The overheads are accounted for under a different service classification.

This demonstrates that the reference figure of 25% is not a verifiable benchmark standard. For example, 25 per cent is used in the forecast cost buildup in United Energy's public lighting model, however United Energy's CAM states that public lighting costs are classified as a negotiated service and provides an example from 2013 showing that zero shared costs were allocated to negotiated services.

The other Victorian CAMs show similar incompatibilities that complicate benchmarking ACS overheads, including different allocation methods (revenue, direct cost, staff headcount, etc) to TasNetworks, which uses Activity Based Costing surveys to allocate many of its shared costs. To demonstrate the variability in actual overhead allocation for public lighting, Figure 2 below shows reported public lighting opex and overhead splits for several networks.

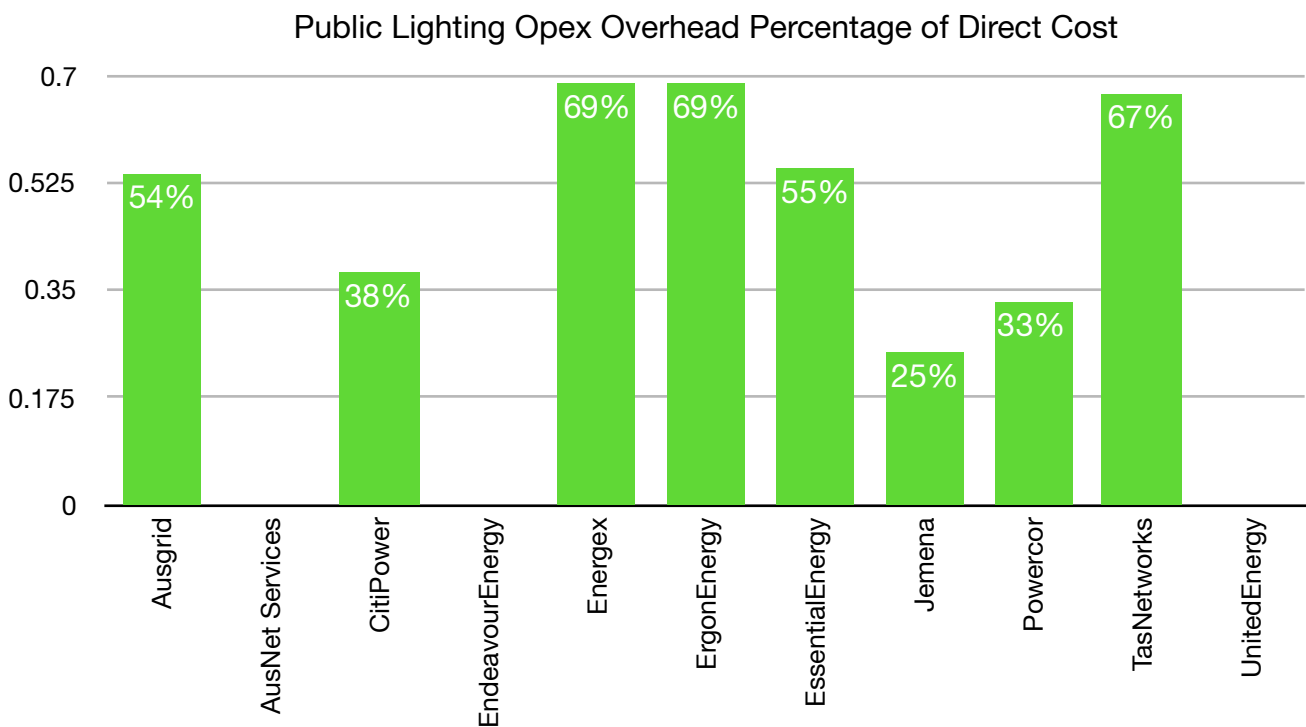


Figure 2: Variation in Public Lighting Opex Overhead, 2017 RIN data

## Benchmarking at Disaggregated Levels – Risk of Cherry Picking

Benchmarking overheads of a single cost category is problematic for many reasons, including those which were among the philosophy of the AER adopting a “top down”, total operating expenditure benchmarking model. A network will look efficient in some areas and not in others, and one category should not be considered in isolation of others.

There are two primary determinants of where shared costs are included in the structures of the AER's Regulatory Information Notices (RINs) – capitalisation rates and the working through of the CAM. Variations in these two

financial instruments make comparison of overheads as a percentage of a single cost category a practice laced with risk of false conclusions of efficiency.

As an example, 46 per cent of Powercor’s network overheads are allocated to Standard Control Services capex compared to 26 per cent for TasNetworks due, in part, to its currently larger capital works expenditure. This leaves more of TasNetworks overheads to be spread over other activities, such as ACS.

By similar logic used to set an efficient overhead rate of 25% for TasNetworks public lighting, one could argue that TasNetworks’ rate of corporate overheads to SCS direct opex (22%) is a suitable benchmark for Powercor (corporate overheads at 92% of SCS direct opex in 2017). Figure 3 below shows the result of different overhead allocation methods across networks.



Figure 3: 2017 Overheads by Services Classification and Expenditure Type

Note: All data sourced from 2017 CAT RINs. Jemena’s ACS Capex includes a balancing item significantly larger than its overheads, so its data has been excluded from the ACS Capex Overhead graph. Ergon Energy’s ACS Opex includes a balancing item almost equivalent of its overheads, so its data has been excluded from the ACS Opex Overhead graph.

The fact that a larger relative proportion of TasNetworks' overhead costs are allocated to public lighting than some other networks could be considered not so much an issue of efficiency as it is a question of:

1. How reflective of the true costs are each of the respective network business allocation methods (i.e. how accurately do they portray the reality of overhead accumulation by activity); and
2. When there is doubt, who should bear the cost of any error in exact allocation of overheads (the direct customer or the broader network customer base)?

There is not enough empirical evidence to suggest that the 25% used as a benchmark rate is an accurate representation of the overheads required for that particular network to recover its public lighting costs. Activity Based Costing conducted by TasNetworks has led it to conclude that its public lighting activities are drawing more overheads than previously realised; this does not automatically render those overheads inefficient.

In the absence of evidence that TasNetworks' management of public lighting or expenditure on overheads is inefficient, it is difficult to justify an adjustment based only on the rate that theoretically applies in the Victorian public lighting models. Further, benchmarking of TasNetworks' total overhead rate indicates that it could not be reasonably deemed to be inefficient compared to peers, as does benchmarking of TasNetworks' public lighting direct costs.

## Benchmarking of TasNetworks' Overheads

The treatment and reporting of overheads varies significantly across jurisdictions. Publicly available data in the RINs surfaces some of these issues, including:

- Differences in the treatment of non-network and overhead cost reporting, for example some networks have significant double counting at the category level (which is mitigated by balancing items in the expenditure summaries). The Queensland networks appear to have much higher overhead costs due to the management of their IT function by third party entity, SPARQ Solutions.
- Negative values for some networks due to accounting treatments, for example SA Power Networks have an adjustment for superannuation that renders their overhead costs incomparable to other networks.
- Anomalies such as the restructuring costs of the NSW businesses, which distort the business as usual overheads.

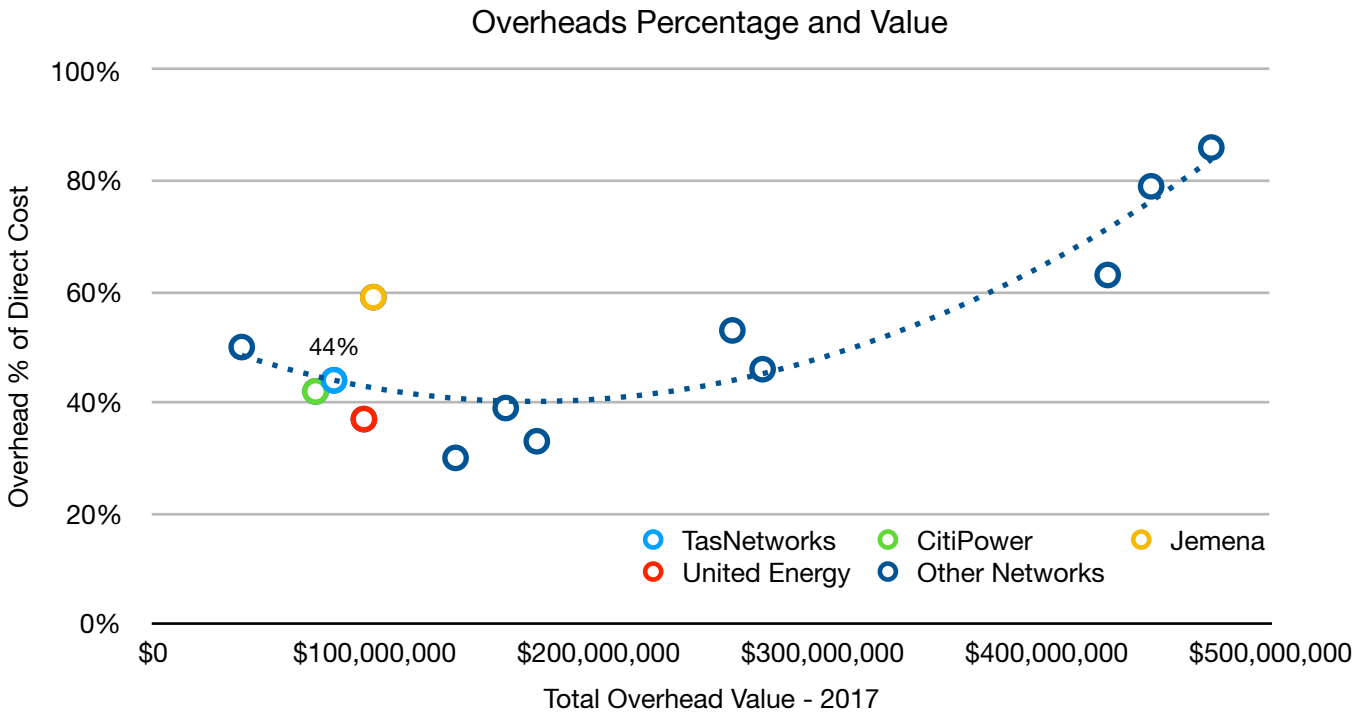
Despite these limitations, there is indicative value in examining the reporting of overheads at a macro level. Figure 4 Below shows that there is a "sweet spot" size for overheads, whereby smaller networks suffer from economy of scale disadvantage and larger networks suffer from geographical distance disadvantage.

The analysis also indicates that:

- TasNetworks' total overheads and overheads relative to its direct costs are within a reasonable range, comparable to CitiPower and United Energy (who, like TasNetworks have the ability to share costs across commonly owned networks) and lower than Jemena.
- No network has total overhead costs less than 30% of direct costs.

With no network achieving overhead rates of less than 30% of direct costs, it is not unreasonable that a "rule of thumb" approach would indicate that it is unlikely that overheads for smaller parts of the expenditure program are likely to be at least at the level of the total rate.

Figure 4: Total Overheads - Absolute and Relative to Total Direct Costs



## Benchmarking of TasNetworks' Public Lighting Costs

Benchmarking of TasNetworks' recent public lighting costs indicates that it is amongst the lowest per light based on direct costs of replacement, repair and maintenance (see Figure 5 below).

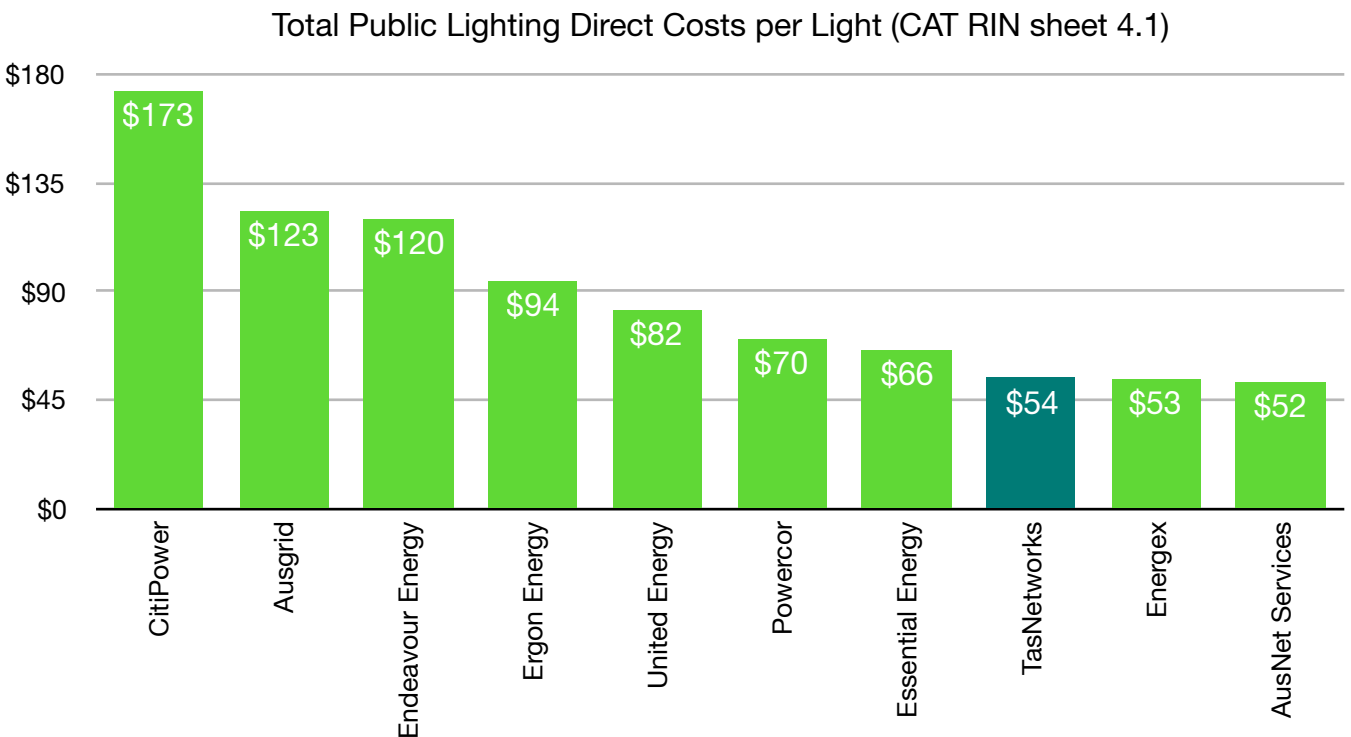


Figure 5: Public Lighting Costs per Light



The direct costs used in Figure 5 are sourced from the Category RIN. The public lighting opex overheads in Figure 2 are calculated by cross-referencing the opex data in the Annual RIN with the direct public lighting cost data in the Category RIN.



# The Draft Decision on Labour Rates

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The draft decision accepts all TasNetworks labour rates except Administration, for which the AER has substituted a maximum cap based on a recommendation of Marsden Jacobs. That recommendation is based on:

1. The assumption that all labour rates for TasNetworks will be lower than mainland distribution networks because the Average Weekly Earnings (AWE) in Tasmania are lower than mainland states; and
2. The assumption that an average rate of the average rates of several administrative categories included in the Hays labour benchmarking survey is a reliable benchmark of network administrative costs.

Both of the instruments used as references for benchmark labour rates (AWE and the Hays reports) are surveys of employers. Advice on both the Australian Parliament House website and the Australia Bureau of Statistics declare the limitations of AWE, in particular that it is the aggregate of earnings for a particular jurisdiction divided by the number of employees and therefore has limited explanatory power. The Hays survey is an ongoing survey of a set of employers from various industries. It too has limited explanatory powers in the context for which it is being used (as a benchmark rate for TasNetworks ability to recover its true costs).

Assuming that a labour rate for a particular field (Administration in this case) should be set at the lower end of the range for TasNetworks because the average Tasmanian wage is lower than mainland states ignores the fact that there are industry-based competitive forces also. Specialist skills, such as those required to work at a network service provider, are in demand across state borders. TasNetworks may be able to pay a generally lower rate for some skills than mainland states due to overall lower average wages and cost of living, however there will be a limit to this due to the willingness of some staff to relocate for higher wages.

The Hays survey data also has many disciplines included in the Administration which are irrelevant to electricity network administration.

Analysis of RIN labour data shows that:

1. TasNetworks' corporate and network overhead support staff (as a proxy for administration) actual hourly rate is already reasonable compared to industry averages<sup>2</sup>.
2. TasNetworks' proposed labour rate for Administration is very close to the actual labour rate realised for support staff.

Given that the actual labour data is representative of the Administration rate proposed by TasNetworks and this rate is at the lower end of the range of rates realised by all electricity network service providers, it stands to reason that the originally proposed rate by TasNetworks should stand.

Figure 6 below shows the support staff labour rate for distribution networks that provide the data in the RINs.

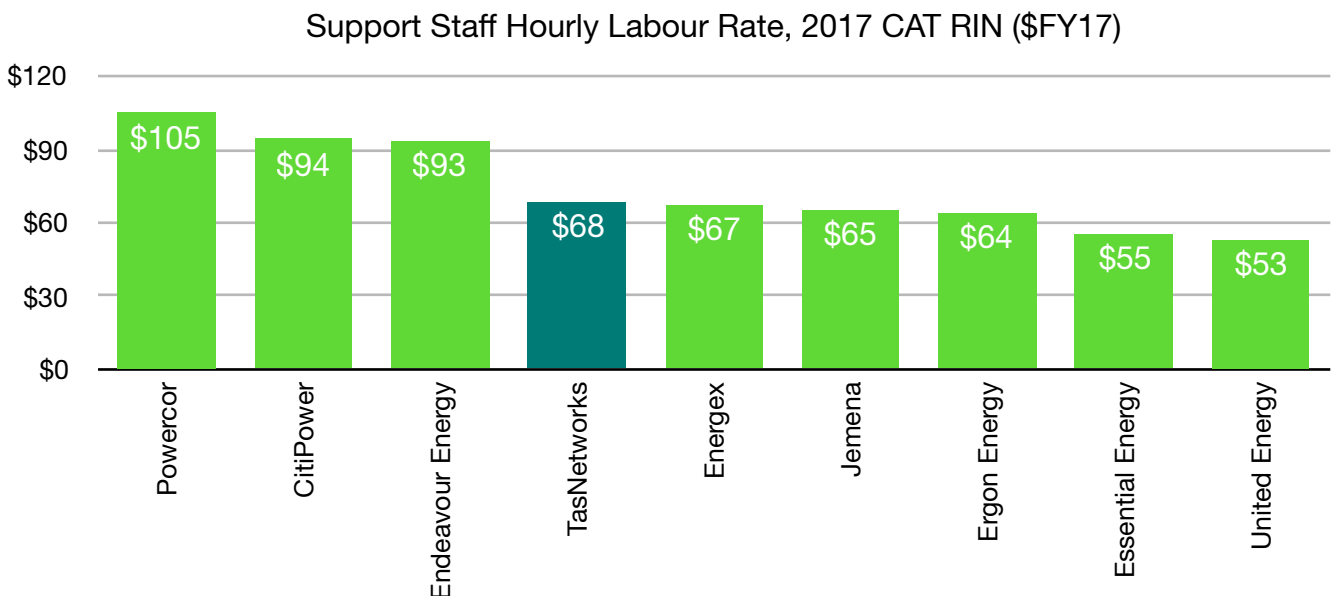


Figure 6: Support Staff Labour Rates

<sup>2</sup> Hourly rates were calculated by dividing the expenditure on the category by the Average Staffing Level (ASL) for the category, then divided by the average number of productive hours for ASLs in that category.



# Conclusion

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Based on our review of the draft decision for ACS for TasNetworks and our analysis, we observe that there are valid arguments against the two adjustments (public lighting overheads and Administration labour rate). Specifically, for public lighting we found:

- The 25% benchmark used as a cap on overheads is not reflective of the actual overheads incurred by the Victorian networks (or others) in the undertaking of public lighting activities.
- Using a percentage of a single cost category at such a disaggregated level as a benchmarking basis is bound to provide false signals of efficiency.
- The significant variation in CAMs across networks greatly distorts the eventual realisation of overheads classification.
- Not a single network achieves 25% overhead rates at the aggregated level.

For the labour rate of Administration category we found:

- The two sources of data relied upon to find a benchmark labour rate are broad surveys which include many irrelevant industries and job types.
- TasNetworks' actual labour rate for Support Staff is very close to its proposed rate for Administration in its original regulatory submission.
- TasNetworks' actual labour rate for Support Staff is not demonstrably inefficient when benchmarked against other networks.