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Mr Sebastian Roberts
General Manager, Transmission and Gas
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

570 George Street
Sydney NSW 2000
All mail to GPO Box 4009
Sydney NSW 2001
T +61 2 131 525
F +61 2 9269 2830
www.ausgrid.com.au

Lodged via email

Dear Sebastian

Ausgrid submission: AER Draft Decision Paper, Forecasting productivity growth for electricity distributors

Ausgrid welcomes the opportunity to provide this submission in response to the Australian Energy Regulator's (AER) *Draft Decision Paper, Forecasting productivity growth for electricity distributors*. We agree with the AER and the Consumer Challenge Panel that Electricity Distributors are expected to make ongoing efficiency improvements that reflect the frontier shift, and that this is in alignment with the National Electricity Objective and the long-term interests of consumers.

We wholly support the AER's undertaking of the current review, as part of the continuous improvement of regulatory techniques. In particular, we welcome, and support the AER's use of multiple sources of data rather than relying on a single model to forecast productivity gains.

We engaged Cambridge Economic Policy Associates (CEPA) to provide technical advice in responding to the AER's consultation and to provide additional sources of relevant evidence on forecast productivity gains. Their report is attached.

Our main observations regarding the AER's proposed approaches are:

- The AER proposes using the opex MPFP estimates only for the period 2012-16. The approach of using such a short time period can result in misleading estimates, particularly if the start- and end-points are affected by one-off impacts. Therefore, this estimate should be viewed with caution.¹ In particular, we note:
 - Average annual productivity estimates are extremely sensitive to the choice of the start- and end-points. The AER's choice of 2012 as the starting point for its MPFP analysis results in the highest possible average annual productivity estimate out to 2016, when compared to other start-points. This is because opex in 2012 appears to be an outlier year, as it is materially higher than the preceding and following year, and is out of step with the industry trend during the 2006-16 period.
 - The subset of 'not materially inefficient' DNSPs' year-on-year efficiency results selected by the AER to estimate frontier shift do not appear to be solely down to frontier shift. We do not consider an estimate of frontier shift that is based on a subset of data that include both negative productivity change and productivity changes of 7.7% pa as being plausible indicators of future opex productivity growth

¹ It is standard practice to consider TFP growth over complete economic cycles (OECD, 2003, *Measuring Productivity: Measurement of Aggregate and Industry-Level Productivity Growth*, p. 119) The ABS notes similarly that the effects of temporary influences can be minimised by analysing averages of productivity statistics between growth cycle peaks (ABS website, 5260.0.55.002 – Estimates of Industry Multifactor Productivity, 2016-17). The Australian Energy Market Commission noted in its 2011 review into the use of TFP that at least 8 years of robust and consistent data will be required to establish a TFP growth rate that could be used in a TFP methodology for price and revenue determinations (AEMC, 2011, *Review into the use of total factor productivity for the determination of prices and revenues*, p 23).

- The DNSPs' reported opex performance, including the upper quartile performers, can be affected by capitalisation changes which are not related to frontier shift or catch-up efficiency.
- The AER relies on ABS productivity data for 2012 to 2017 for its labour productivity analysis, which relates to an incomplete economic cycle. However, the ABS data should only be considered on the basis of full productivity cycles or a very long time period, which minimises the influence of temporary effects (such as the underutilisation of capacity) that can occur. Further, we do not consider that the utilities' sector estimates should be used, as it may capture catch-up efficiency improvements
- The AER's recent econometric models (from November 2018), using only the 2012-17 time period, indicates that DNSPs' opex needed to increase to deliver the outputs used to drive the AER's opex forecasts. Introducing an external productivity challenge, not captured in the econometric models, and therefore not aligned with the outputs used to drive the opex forecasts, increases regulatory risk, and this risk is higher for those DNSPs for which the AER makes a catch-up efficiency adjustment
- Undergrounding is not a productivity driver and is undertaken for a variety of reasons. In recent years, a large part has been driven in response to regulatory requirements. Using the historical average growth across all DNSPs to set a frontier shift target would set perverse incentives for DNSPs to achieve a certain level of undergrounding regardless of whether it was prudent and efficient. Instead, if the AER seek to incorporate undergrounding into its opex forecasts, then the DNSPs' individual undergrounding forecasts could be incorporated into the AER's opex forecasting process using the econometric modelling coefficient.

CEPA's analysis includes consideration of further evidence and alternate approaches to developing a productivity estimate. Their analysis considered the following alternative approaches:

- Developing an alternative (unweighted) labour productivity estimates using selected sectors that carry out similar activities to parts of the DNSPs' opex program and are less susceptible to the issues captured in the ABS' utilities sector
- Estimating labour and intermediate inputs productivity for selected sectors, which captures the impact of other non-labour (e.g. materials and services input changes) elements of opex
- Precedent from current ongoing efficiency challenges set by regulators in other sectors in Australia, and internationally.

Their analysis suggests a holistic range across the alternate sources of information and approaches of 0% to 0.7%, shown in the table below.

We recommend the AER consider adopting this broader range of alternative approaches to inform their holistic approach to forecast productivity growth. Further, we recommend the AER seek to continue to improve the information base supporting the opex MPFP analysis, which could be used in future, when a robust and consistent data set is available over a sufficiently long period of time.

Ausgrid would be pleased to discuss this submission with the AER and would welcome further engagement on the AER's approach to forecasting productivity growth in the lead up to Ausgrid's 2019-24 determination. We look forward to working with the AER, other DNSPs and interested stakeholders on these important issues.

If you have any queries, or wish to discuss this matter in further detail, please contact myself on (02) 9269 2695 or via email iomar@ausgrid.com.au.

Yours sincerely,



Iftekhar Omar
Head of Regulation