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Dear Evan

Re: Draft AER 2019 Benchmarking Reports

AusNet Services welcomes the opportunity to provide feedback on the AER's draft 2019 Benchmarking Reports prior to their finalisation and publication. AusNet Services has consistently supported the development of a robust benchmarking framework for network businesses in Australia, to assist stakeholders to compare the productivity performance of electricity distribution businesses within the NEM and over time. We will continue to work constructively with the AER towards this end.

The current productivity benchmarking measures are meaningful when applied over time. However, currently the comparability of the businesses is severely limited, due to the following significant shortcomings in the benchmarking framework. We were pleased to see that the AER began to address some of these inconsistencies for this Report but significant ones remain. These are:

- The AER's inconsistent treatment of corporate overhead capitalisation practices across businesses;
- A range of other data reporting inconsistencies between the distribution businesses, particularly opex reporting more generally and data for OEF calculation (including data reported in the Category Analysis RINs);
- The inadequate OEF framework which does not quantify the impact of the most material operating environment factors for AusNet Services (and possibly across the NEM). In particular, the framework currently excludes bushfire mitigation regulatory obligations faced by the Victorian distribution networks. These obligations drive materially higher capital and operating costs. The increased capital costs relate to bushfire reduction assets such as undergrounding and covering of power lines in high risk bushfire areas and the current installation of Rapid Earth Fault Current Limiter (REFCL) technology. The increased operating costs are associated with higher standards of vegetation management and asset inspection. The lack of adequate adjustment for OEFs not only biases the AER's view of our base year opex efficiency, it provides a misleading impression of AusNet Services' actual performance on the full range of efficiency measures including opex, capex and total factor productivity.

Over the past 18 months, including in response to last year's draft benchmarking report, AusNet Services has suggested ways in which the framework can be modified to address these issues. Importantly, these solutions include practical ways to improve comparability without requiring

extensive additional data. Given the increasing focus of investors and market analysts in using the benchmarking reports to assess the operational performance of distribution businesses, and the proximity to the next Victorian distribution revenue reset, it is disappointing that the AER has not progressed these matters over the last 12 months. It is imperative that these are dealt with to increase confidence in the results. In particular, it is vital that the annual benchmarking report progress from reporting simple 'raw' scores, to more robust and meaningful efficiency scores that include adjustment for material operating environment factors.

These issues are discussed further below.

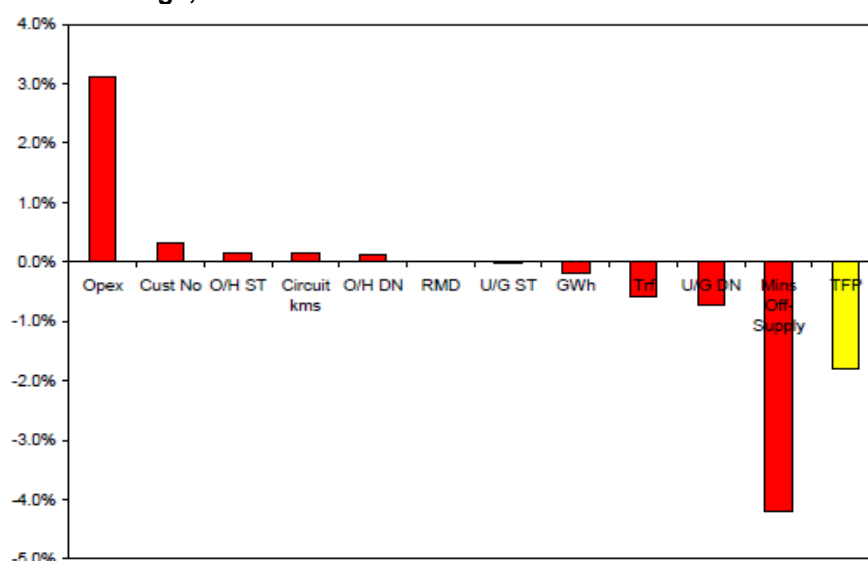
2019 Distribution Benchmarking Report

The AER's benchmarking report notes that between 2017 and 2018, AusNet Services' productivity, as measured by MTFP declined by 2.9%. This decline is driven almost exclusively by reliability performance. 2017 was AusNet Services' best reliability performance on record. As such, an apparent reduction in productivity from a return to more normal levels of reliability was to be expected in 2018. Unfortunately 2018 was a below average performance in terms of reliability for AusNet Services and this has exacerbated the decline in productivity. However, as the Economics Insights report states:

AND's drivers of TFP change for the whole 13-year period are broadly similar to the industry as a whole except that opex makes far and away the largest negative contribution to TFP growth for AND and relatively much larger than for the industry. Opex makes a negative contribution over the period for AND of –1.8 percentage points compared to –0.5 percentage points for the industry.

In 2018, further reductions in our opex had a 3% positive impact on our TFP (before the other factors were included). This opex reduction is expected to be sustained going forward, while the reliability outcomes are more volatile. This is important context to the headline productivity reduction. . This effect is shown in the chart below from the Economics Insights report.

Figure 1 AusNet Services' output and input percentage point contributions to annual TFP change, 2018



Source: Economics Insights

Future benchmarking development

As noted above the concerns we highlighted last year about the robustness and transparency of the benchmarking report remain. The most material of these concerns relate to:

- Inconsistent treatment of corporate overhead opex; and
- Lack of progression in quantifying a bushfire risk management Operating Environment Factor (OEF), while developing and quantifying far less material OEFs.

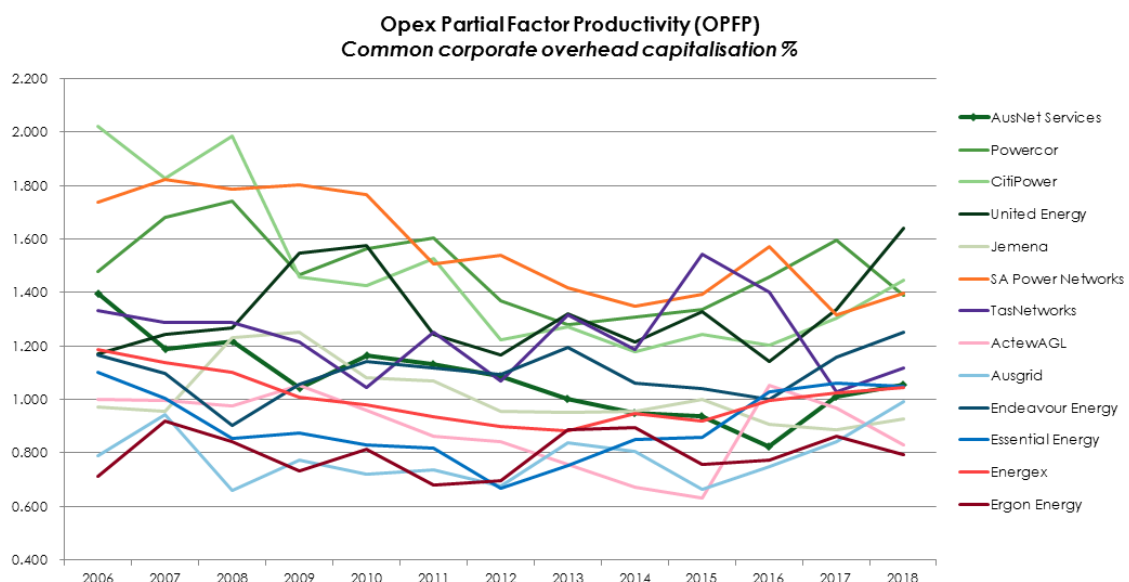
1. Inconsistent treatment of corporate overhead opex

Different businesses adopt very different capitalisation approaches to corporate overheads. These accounting decisions are unrelated to the productivity of different networks, but can materially impact the AER's benchmarking results.

Compounding this discrepancy, some businesses' actual capitalisation practices are reflected in the benchmarking results, while others are not. This is not transparently presented in the benchmarking reports. This is problematic as the customers of some networks are funding corporate overhead opex which is stripped out of the benchmarking opex and so does not appear in their opex productivity results.

The AER has the data it needs to apply a fixed capitalisation ratio to every businesses corporate overheads, which would equalise this impact and enable more meaningful conclusions to be drawn about the relative productivity of different networks. AusNet Services has reproduced the OPFPs applying the NEM average capitalisation rate for corporate overheads as shown in Figure 2 below.

Figure 2 OPFP assuming NEM average overhead capitalisation rate



The AER's econometric models are also sensitive to this difference. These include the Cobb-Douglas SFA model, on which the AER has previously placed weight in its opex decisions.

The chart below shows the sensitivity of the Cobb-Douglas SFA modelling to capitalisation policies as current in 2006 and 2016. It can be seen that the different corporate overhead capitalisation treatments shift several networks either above or below the 75% benchmark that the AER has used to conclude whether a network is inefficient, despite these differences being pure accounting treatments only, unrelated to actual business productivity.

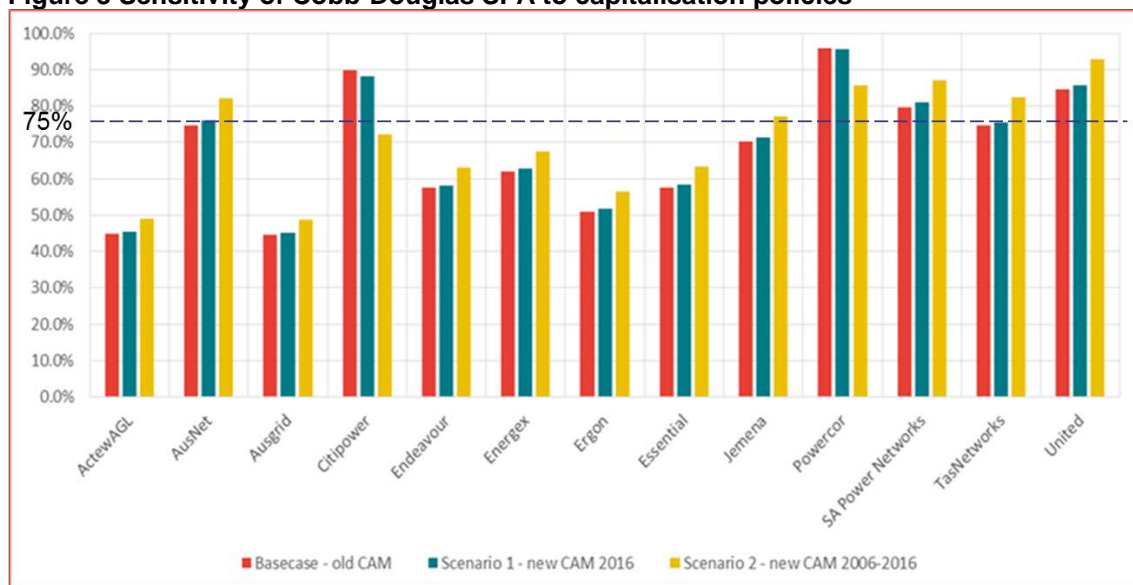
The different coloured bars represent the following:

- Red – reflects the AER’s current benchmarking approach i.e. applying the 2006 Cost Allocation Methodology (CAM).
- Blue – applies the CAM that was current in that particular year. This will reflect the changes for the businesses that changed their CAM part way through the period.
- Yellow – applies the latest CAM to the years from 2006-16 (i.e. the data is backcast to apply the most recent CAM to all years from 2006 to 2016).

This analysis does not include 2017 and 2018 data, but this update may increase the impact of the different treatments as:

- The impact of the differences in capitalisation have become more pronounced (i.e. more opex is impacted).
- More businesses have changed their capitalisation policies since 2016, such as the Queensland distribution businesses in 2018.

Figure 3 Sensitivity of Cobb-Douglas SFA to capitalisation policies



We strongly agree with the AER that it is time for the impact of the differences in capitalisation policies to be reconsidered. The AER’s previous considerations concluded that it is better to look at capex to opex ratios overall, rather than distinguishing between direct and indirect costs when considering capitalisation approaches. As these looked broadly consistent between the businesses, the AER concluded there was no cause for concern.

AusNet Services agrees that this analysis should be revisited, and the impact of the treatment of corporate overheads on the overall ratio should be examined. It is not clear why the

capitalisation treatment of corporate overheads would be linked to the capitalisation of other cost categories – particularly as some businesses explicitly allocate 100% of corporate overheads to opex – so it could be appropriate to look at this significant expenditure category in isolation, to facilitate better comparisons.

2. Operating Environment Factor Framework

The latest quantified OEF adjustments contained in the SapereMerz report indicate that AusNet Services has the most favourable operating environment in the NEM. This is despite the fact that the AER itself acknowledges the reverse is true, that AusNet Services' distribution network area faces the highest bushfire risk and most difficult terrain within Australia. Clearly there are significant gaps and shortcomings in the OEF framework that needs to be addressed.

As raised above, urgent action is needed to develop OEFs for bushfire risk management. AusNet Services is subject to stringent vegetation management and asset inspection regulations that very materially increase its opex compared to distributors not subject to those obligations, including all distributors outside of Victoria.

The AER's benchmarking approach does not account for this as it:

- Includes all vegetation management and inspection-driven opex as an input; and
- Omits any safety-related measures as an output.

The intent of the OEF framework is to account for factors that drive material differences in the productivity of networks, but are not included in any other part of the AER's benchmarking approach. Bushfire risk management obligations fall squarely into this category.

While the AER recognises that further work is needed and it will consult on the next steps, for the framework to be useful and not further distort the benchmarking results, a robust bushfire mitigation OEF (covering both vegetation management and inspection-related opex) should be developed. Until this is done, the OEF framework should not be given any weight or be said to offer any additional explanatory power to the benchmarking results.

AusNet Services would be pleased to work with the AER in further developing this OEF. In addition to the bushfire OEF, action is needed to re-estimate OEFs that are currently applied by the AER to improve their accuracy. As an example, there has been a recent change to the definition of our opex for benchmarking to include tax and levies. This means that our OEF relating to tax and levies needs to be re-estimated.

Please contact Deirdre Rose, Principal Economist on 03 9695 6435 with any questions in relation to this submission.

Sincerely,



Charlotte Eddy
Manager Economic Regulation
AusNet Services