

9 October 2019

Mr Evan Lutton
Australian Energy Regulator (AER)
GPO Box 520
Melbourne, VIC, 3001

Dear Mr Lutton,

DRAFT 2019 BENCHMARKING REPORT FOR DISTRIBUTION NETWORK SERVICE PROVIDERS

Endeavour Energy appreciates the opportunity to provide feedback to the AER on the draft 2019 annual benchmarking report for electricity distribution network service providers (DNSPs).

Over recent years we have made significant transformative changes to the way we manage our business in an effort to improve our operating efficiency and provide value for money services to our customers. These changes have produced significant cost savings and delivered reductions in network prices each year since 2013 with our customers paying the lowest network charges in NSW.

We are pleased that our efforts are reflected in our benchmarking performance. The draft report indicates that we are now the 6th most efficient DNSP in the NEM (based on MTFP scores) and 5th in terms of operating efficiency (based on opex MPFP scores). This builds on our 2017 performance which suggests that our efficiency gains are sustainable and capable of delivering long-term improvements necessary to fulfil our ambition to become a network operating at the efficiency frontier.

Despite recent refinements to the AER's benchmarking analysis, caution still needs to apply when interpreting the benchmarking report. This is because DNSPs are subject to unique and often contrasting operating factors that often are not adequately reflected in benchmarking measures but need to be considered to allow a fair and reasonable comparison of performance between networks.

We welcome the AER's intention to commence work on this issue over the next 12 months. We agree with the AER that accounting for the different (but legitimate) capitalisation approaches adopted by networks is a priority. We also support the AER resuming work to quantify material OEFs, particularly for vegetation management where differences in geographical characteristics and compliance obligations across the NEM contribute to material variations in the minimum efficient costs.

Overhead capitalisation

We agree that like-for-like comparisons are made difficult because of the different approaches in how networks assign costs to opex and capex. This most commonly effects overheads but can also apply to other expenditure categories where both capex and opex are incurred such as fleet and ICT.

Comparisons between DNSPs could be improved by aggregating the costs for these categories of expenditure. For instance, the AER have used total overheads in developing their partial performance indicator (PPI) for overheads. This ensures that "differences in a DNSP's capitalisation policy does not affect the analysis and also mitigates the impact of a DNSP's choice in allocating their overheads to corporate or network services".¹

However, the AER's primary benchmarking measures do not benchmark on a simple totex basis. Instead, opex is included as an input in the AER's MTFP and econometric models with physical measures of capital inputs used rather than capex. This means that a reallocation of overheads from

¹ AER, Annual Benchmarking Report, September 2019, p. 39

opex to capex could produce an improved benchmarking score despite achieving no real efficiency gain. This could create perverse incentives for networks to inefficiently capitalise additional costs to improve their benchmarking score and/or place networks with low overhead capitalisation rates at a relative disadvantage.

In the absence of totex based models, we believe reported expenditures should be normalised to mitigate this issue and allow meaningful efficiency comparisons. For instance, a standard capitalisation rate could be applied to total overheads for benchmarking purposes. The benchmark rate could be based on an industry average over a certain time period. We recognise this approach may produce benchmarking results that do not reflect actual costs. However, sacrificing accuracy may be necessary in order to improve data comparability.

An additional benefit of this approach is that it would also remove the need for networks to report expenditure based on their historical cost allocation methodologies.

Irrespective of how the data is normalised, we consider the adjustment mechanism should not limit a DNSPs discretion to adopt a capitalisation approach that best aligns with their circumstances and accounting practices. It would also be important for the AER to be clear that differences between the standard rate and a DNSPs actual rate is a consequence of its normalisation approach rather than an assessment of the efficiency of a particular DNSPs capitalisation policy.

Operating Environmental Factors (OEFs)

The analysis performed by SapereMerz in their OEF review demonstrates that our network is relatively disadvantaged through exposure to environmental factors that require us incur additional but efficient opex. As the AER's benchmarking measures fail to account for the exogenous nature of these cost drivers, we believe it is important that OEFs are quantified so their impact can be appropriately reflected in our benchmarking performance (ideally pre rather than post modelling).

The draft report indicates that the AER will commence working towards quantifying OEFs for Guaranteed Service Level (GSL) payments and vegetation management in the next 12 months. We note that any review of a GSL OEF should consider IPART's review of the NSW electricity distribution reliability standards as it could result in changes to how the GSL scheme operates in NSW.

Vegetation management

In their final report, SapereMerz state that "variations in vegetation density and growth rates, along with variations in regulation around vegetation management, are together likely to be a material driver of variations in efficient vegetation opex".² This finding reaffirms our view that our efficient vegetation management costs are impacted by geographic and climate factors more than most other networks because a significant portion of our network area:

- includes mountainous areas characterised by dense bushland
- has sub-transmission lines that require greater clearances
- is classified as bushfire prone by the Rural Fire Service
- is located in areas of moderate to high average annual rainfall

Vegetation management has been a historically large portion of our overall opex. We have implemented a number of initiatives in recent years to improve our compliance with clearance standards while reducing our costs. However, due to our natural cost disadvantages for this category, our vegetation management costs per km of overhead circuit are among the highest in the NEM.³ This is at odds with our performance in other costs categories and overall opex performance and demonstrates the importance of accounting for OEFs in benchmarking measures that can affect perceptions of a DNSPs relative efficiency.

² SapereMerz, Independent review of operating environmental factors used to adjust efficient operating expenditure for economic benchmarking, August 2018, p. 65

³ AER, Annual Benchmarking Report, September 2019, p. 37

SapereMerz have identified that a key consideration in deriving OEF adjustments for vegetation management is how responsibilities for these cost vary across NEM jurisdictions. We support this view and consider differences in regulatory arrangements should be a key factor in developing an OEF. An example of this discrepancy is that, unlike other jurisdictions, NSW DNSPs do not share responsibility for vegetation management with local councils and bear vegetation management costs exclusively.⁴

This contrasts with the view expressed by the AER in their April 2015 determinations for NSW DNSPs where they were “not satisfied that differences in the division of responsibility for vegetation management will lead to material differences in opex between the NSW distributors and the comparison firms.” They concluded that “service providers in NSW and Victoria all share responsibility for vegetation management with other parties.”⁵

Beyond the notional allocation of responsibilities, SapereMerz also recommend an assessment of whether, and to what extent *de facto* responsibilities for vegetation management varies from *de-jure* responsibilities. This acknowledges the practicalities of providing vegetation management services may differ between jurisdictions and potentially impact a DNSPs vegetation management costs. In addition to collecting the core information requirements recommended by SapereMerz, we encourage the AER to reassess the impact of the division of vegetation management responsibilities so that accurate adjustments can be made.

Sub-transmission assets

Previous attempts by the AER, and most recently by SapereMerz, to quantify a sub-transmission OEF have produced a wide range of proposed adjustments. For our network, the most significant change was between SapereMerz’s draft report and final report where the OEF sub-transmission adjustment changed from 7.42% to 3.98%. This variation was primarily driven by moving from a capacity based to a transformer count based measure of sub-transmission asset volumes with a threshold capacity of 15 MVA.

We believe these material variations risk undermining stakeholder confidence in benchmarking. We also reiterate our concern that the change in approach by SapereMerz understates the impact of managing sub-transmission assets on our efficient opex. We do not consider it is reasonable to suggest that operating 15 MVA transformers on a distribution network is analogous to (or as costly as) managing 120 MVA transformers operating at 132 kV.

The approach adopted in the final report effectively groups assets held by DNSPs with no sub-transmission functions with those of DNSPs who are burdened by operating large capacity assets that would in other states be the responsibility of TNSPs. In our view, this approach ‘lowers the bar’ of what constitutes a genuine sub-transmission asset and departs from the intent of the OEF by failing to capture the relative disadvantage of two-stage transformation networks.

As a high impact OEF for which there was a material change in methodology between SapereMerz’s draft and final report, we encourage the AER to reassess the impact of sub-transmission assets on opex in conjunction with their review on vegetation management.

Distribution Energy Resources (DER)

The AER’s benchmarking models use a combination of inputs and outputs that reflect the traditional function of the distribution network. As the role of networks evolve towards providing a platform to facilitate increasing levels of DER and multi-directional energy flows, benchmarking specifications and the weights attributed to outputs and inputs need to also change or otherwise risk no longer being fit-for-purpose.

⁴ While NSW DNSPs do, in theory, share responsibility with private land owners in some cases, the circumstances in which this allowed, and the administrative burden in satisfying the relevant criteria, mean there is no sharing of responsibility in practice.

⁵ AER, Endeavour Energy final decision 2015–19, Attachment 7 – Operating expenditure, April 2015, p. 244

We agree that energy throughput and ratcheted maximum demand output measures are likely to be most impacted by the growth in energy being consumed from small-scale PV and battery sources. Unless the energy consumed from DER is incorporated in the model specifications, the impact of increasing DER on a network could be misconstrued for declining productivity performance. Also, without a corresponding increase in output measures there is a risk that DNSP expenditure to host DER and cater for the services they can provide could be considered inefficient and impact the prospect of networks recovering efficient costs.

Any review into how the impacts of DER should be reflected in benchmarking will require comprehensive analysis and consultation. As a starting point, accounting for DER in benchmarking should recognise that the use of local networks is no longer limited to consumption and that monitoring and managing these increasingly dynamic and multi-directional energy flows on the network from disaggregated loads and generation sources will drive network costs. Whilst we consider updates to the AER models are needed, we note that DER is currently an emerging factor. We are therefore supportive of the AER reviewing the comparability of the existing data set prior to accounting for the impacts of DER in future reviews.

If you wish to discuss this matter further please contact Joe Romiti, Regulatory Analyst at Endeavour Energy on (02) 9853 6232 or via email at joseph.romiti@endeavourenergy.com.au.

A handwritten signature in black ink, appearing to read 'Jon Hocking', is positioned above the printed name and title.

Jon Hocking
Manager Network Regulation