Deloitte Access Economics

NSW Distribution Network Service Providers Labour Analysis

Australian Energy Regulator

Final Addendum to 2014 Report

28 April 2015

Deloitte.

Contents

Glossary

2014 Report	Deloitte Access Economics' report *NSW Distribution Network Service Providers Labour Analysis*, November 2014
AER	Australian Energy Regulator
ASL	Average Staffing Level - the number of full-time equivalent employees undertaking standard control services work receiving salary or wages (Paid FTE) over the entire year
Ausgrid	Ausgrid, formerly EnergyAustralia
Blended Delivery Model	Outsourcing model adopted by the NSW DNSPs, where contractors work alongside employees to improve the overall productivity of the workforce.
CA RIN	Category Analysis Regulatory Information Notice Templates
Capex	Capital Expenditure
CEG	Competition Economics Group
CEO	Chief Executive Officer
DNSP	Distribution Network Service Provider
EBA	Enterprise Bargaining Agreement
Endeavour	Endeavour Energy, formerly Integral Energy
Essential	Essential Energy, formerly Country Energy
FTE	Full Time Equivalent
FY	Financial Year
IPART	Independent Pricing and Regulatory Tribunal, NSW
IRC	Industrial Relations Commission of NSW
Licence conditions	NSW DNSPs' distribution licences, issued by the NSW Government, and particularly the following provisions: 2005: Minister For Energy and Utilities, *Design, Reliability And Performance Licence Conditions For Distribution Network Service Providers*, 1 August 2005 2007: Ian Macdonald, MLC Minister for Energy, *Design, Reliability And Performance Licence Conditions For Distribution Network Service Providers*, 1 December 2007.
LSA	Local Service Agent Model
MOU	Memorandum of Understanding
MPFP	Multilateral Partial Factor Productivity
NEM	National Electricity Market
NER	National Electricity Rules
NNSW	Networks NSW, the overarching owner, operator and manager of Ausgrid, Essential and Endeavour
NPV	Net Present Value
Opex	Operating Expenditure
RAB	Regulatory Asset Base
Revised Proposals	Documents submitted by the NSW DNSPs to the AER in response to its November 2014 draft report
RIN	Regulatory Information Notice
SOC	State Owned Corporation

Executive Summary

In 2014 the AER engaged Deloitte Access Economics Pty Ltd (Deloitte) to conduct an analysis of the NSW DNSPs' labour operating costs over the 2009-14 regulatory period. Our report, entitled *NSW Distribution Network Service Providers Labour Analysis* ('the 2014 Report') was issued on 17 November 2014.[1] The report informed the AER's assessment of the DNSPs' 2015-19 capex and opex forecasts, and was referenced in the AER's Draft Decision for each of the DNSPs which were issued on 27 November 2014 (referred to collectively as 'the Draft Decision')

The key focus of our 2014 Report was the relationship between the DNSPs' capex program undertaken in the 2009-14 regulatory period and labour costs incurred during the same period, specifically the profile and pace of capital investment programs and the balance between employee and contract labour engaged to implement the capex. We also examined the overall structure and composition of the DNSPs' workforces and the wages and employment conditions over the regulatory period, drawing some comparisons with DNSPs in other states to identify potential reasons why the NSW DNSPs' labour costs exceeded those of similar businesses in other states.

We concluded that the NSW DNSPs' base year (2012-13) expenditure was not efficient due to high labour costs, which made up the majority of opex, reflecting high staff numbers associated with the 2009-14 capex program and inflexible and inefficient work practices.

The NSW DNSPs have responded to the AER's Draft Decision and our 2014 Report (a redacted version of which, excluding confidential information, was made available to each) in their Revised Proposals. In general the DNSPs disagreed with our conclusions, with particularly strong opposition to our view that the DNSPs' labour costs were heavily affected by EBAs that entrench labour costs well above their interstate peers. A number of the responses analyse DNSP wages and EBA clauses across the NEM. In addition, the DNSPs provided some new information regarding their costs and workforce planning.

This Addendum to our 2014 Report further analyses the efficiency of the DNSP's labour costs during the 2009-14 regulatory period. In doing so, it builds upon the analysis in our 2014 Report and the responses from the DNSPs. We have not addressed every labour-related issue raised in response to the 2014 Report, but we have responded to all material matters.

Evidence of high labour costs

The DNSPs' Revised Proposals suggest there was a lack of empirical analysis in our 2014 Report, such that we did not establish that the NSW DNSPs have higher labour costs than their peers.[2] Our analysis sought to understand the drivers of higher labour costs in a general sense rather than estimate an efficient labour or opex cost level.

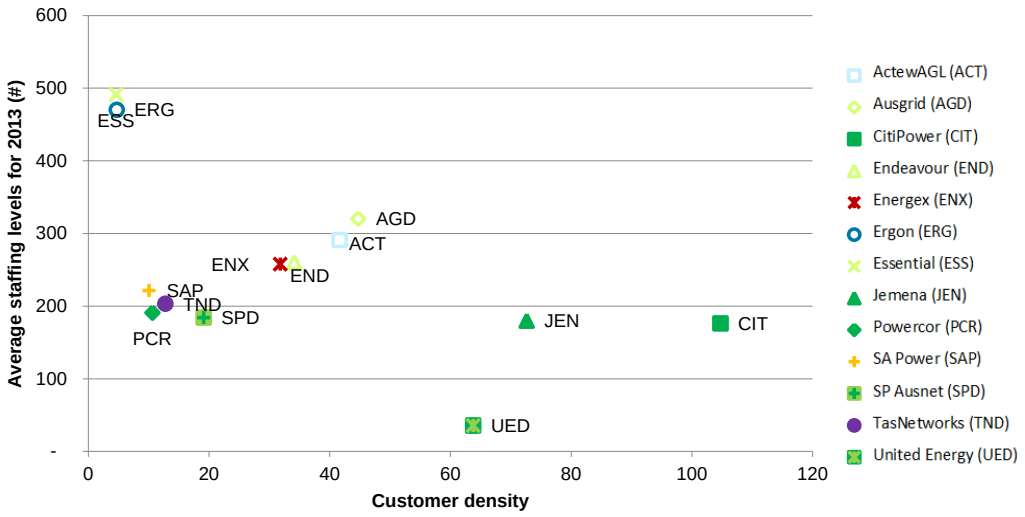
[1] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014.

[2] For example, Ausgrid, Revised Proposal, p. 158.

We note that reports by the Productivity Commission, IPART, the NSW Government and Ernst & Young all suggest that during the 2009-2014 regulatory period, the NSW DNSPs' costs were high compared to peers, and that their labour practices were not efficient. Section 2.1 of this Addendum discusses the findings of these earlier reports.

In this Addendum, we present further information on actual labour costs that confirms that the DNSPs did have high labour costs over the period 2009-14, due primarily to higher employee numbers than their peers. Figure 1 presents RIN data on Average Staffing Levels (ASL) per 100,000 customers and customer density, and demonstrates that Ausgrid, Essential and to a lesser extent Endeavour have significantly more employees (including contractors) than the DNSPs in Victoria and South Australia, which the AER's benchmarking shows to be more efficient. Although there is clearly a relationship between customer density and ASL, Ausgrid and Essential appear to be less efficient compared with other DNSPs, such as Powercor and SA Power even after taking into account customer density.

Figure 1 Average staffing levels per 100,000 customers by customer density



Source: CA RIN

Cost per employee

Our analysis of RIN data in this Addendum and the various submissions made by Competition Economics Group (CEG) and Essential indicate that the base unit labour cost of NSW DNSPs is not high in comparison with other DNSPs. It is clear that the relatively high labour costs in NSW DNSPs are not driven by baseline costs per employee, but rather by the total number of employees.

A CEG report for the NSW DNSPs shows that, for a given position, the NSW DNSPs' base wages are not overly high and are broadly consistent with those of other NEM DNSPs.[3] We do not disagree with the overall findings of the CEG analysis, but, we note that several assumptions made [redacted] are likely to have affected CEG's results. Similarly, the analysis presented by Essential confirms that the source of the efficiency gap

[3] CEG, *Ausgrid Revised Proposal Attachment 6.02 CEG: Labour unit cost –review of Deloitte Report (CONFIDENTIAL),* January 2015.

between the DNSPs' and frontier businesses' labour costs is likely to be associated with numbers of employees rather than costs per employee.

Number of employees

We have established that the NSW DNSPs' have a larger number of employees than their peers, which has been confirmed by the DNSPs' own statements about stranded labour and the need to reduce FTEs. Our objective is therefore to identify the reasons why this is the case.

In our 2014 Report, we identified that provisions in the NSW DNSPs' EBAs were constraining flexibility and efficient workforce management and therefore likely to increase the numbers of employees within the NSW DNSPs. These constraints primarily included restrictions on reductions in workforce size, permanent/part-time/casual employment, and outsourcing.

In response to our 2014 analysis of EBA provisions, a number of Revised Proposal documents have presented comparisons of EBA conditions across Australian utilities. All the Revised Proposal analyses present only selected provisions of the EBAs, as our 2014 analysis also did, but nevertheless seek to demonstrate that the NSW DNSPs' EBAs as a whole are no more generous than those of their peers.

In this Addendum, we present further analysis of the EBA clauses that constrain workforce flexibility and contribute to higher numbers of employees. We find that the majority of distributors[4] cannot mandate redundancies as a result of provisions in their respective EBAs. We also confirm that requirements to consult prior to outsourcing are fairly consistent across distributors, but the overarching statements that the NSW DNSPs must maximise their permanent employees (or that they will not use contractors to avoid increases in the permanent workforce) are limited to the NSW and Queensland DNSPs.

While we clarify that all DNSP EBAs contain some restrictive clauses, and agree that there are trade-offs between conditions in negotiation processes, because the NSW DNSPs employ a relatively higher proportion of their employees through EBAs (more than 75% compared to less than 50% in the Victorian DNSPs), restrictive clauses have a greater impact on their workforce flexibility and have contributed to their having more employees than their peers. This is also apparent in the lower proportion of expenditure outsourced by the NSW DNSPs during the 2009-14 regulatory period as compared to the Victorian DNSPs' outsourcing levels. The DNSPs which have managed to outsource a higher proportion of work despite similar EBA constraints are also those which appear to be more efficient, based on the AER's benchmarking analysis.

Outsourcing during the 2009-14 regulatory period

Our 2014 Report presented data on the proportion of total capex and opex that the Victorian and NSW DNSPs outsourced (or expected to outsource) in recent years, including a breakdown of related party contractor outsourcing and all outsourcing. We note that, even after accounting for their outsourcing to related parties and assuming this is no more efficient than an internal workforce (an assumption with which we disagree) the Victorian

[4] 8 out of 12 distributors.

DNSPs still outsource around 25% more opex than the NSW DNSPs. The Victorian distributors have previously indicated that outsourcing has yielded opex savings of 17% for Jemena[5] and overall cost savings of 21% for Powercor[6] and 45% for CitiPower.[7]

We observe that the NSW DNSPs realised some efficiency gains through outsourcing towards the end of the 2009-14 regulatory period. New information provided by Ausgrid suggests it is now pursuing efficiency improvements as a result of the competitive pressure placed on its internal workforce by contractors.[8]

In relation to the optimal level of outsourcing, we agree with comments in the DNSPs' Revised Proposals that outsourcing is not appropriate in all circumstances. However, we consider that the optimal level of outsourcing is likely to be higher than that adopted by the NSW DNSPs over 2009-14, and we maintain our view that outsourcing is one of the key reasons for the productivity gap between the Victorian and NSW DNSPs.

A report by Arup argues that Ausgrid managed its workforce appropriately over 2009-14, [redacted].[9] The Arup report does not change our view that Ausgrid 'arguably relied too heavily on internal labour resources.' This is because the increase in its permanent workforce far outweighed the limited outsourcing Ausgrid undertook. It would have been more reasonable for Ausgrid to use contractors more heavily given the restriction on forced redundancies in the EBA and the nature of the capital program which was implemented over a short period to deliver compliance with new standards.

Arup also conducted an analysis of the costs and benefits of a Memorandum of Understanding (MOU) that Ausgrid established with the Electrical Trades Union of Australia (ETU) in 2007. This purported to show that the costs of the MOU were outweighed by the benefits. [redacted]

Essential's regional depots

In its Revised Proposal, Essential argued that the dispersed nature of its network, and the lower concentration of work volumes in specific locations inherently limits its ability to rely on economies of scale to improve productivity, and constrains the open market to cost

[5] Jemena, Regulatory Proposal, 2009, p10, p. 121; JEN – *Jemena*, JAM - *Jemena Asset Management*

[6] Powercor Regulatory Proposal, 2009, p. 365

[7] CitiPower Regulatory Proposal, 2009, p. 76

[8] Ausgrid, Revised Proposal Attachment 5.05: Strategic Delivery and Workforce Plans, p. 47.

[9] Arup, *Attachment 6.01 Arup – Ausgrid labour analysis report (CONFIDENTIAL),* January 2015.

[10] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 28.

effectively provide alternate sources of labour and services in regional locations.[11] It is no doubt true that there may be fewer opportunities for private sector involvement in more remote areas than elsewhere, but in our view there is still large potential for Essential to adopt a Local Service Agent (LSA) model in some of its regional depots in order to increase productivity in its regional areas. Detailed analysis must be conducted to confirm the feasibility of such a model, however, prima facie; there would appear to be the possibility of significant cost savings for Essential akin to what Powercor achieved following privatisation in the 1990s. In our view, the differences in depot management approach likely explains some of the productivity gap between Powercor and Essential.

Stranded labour

Our 2014 Report noted that all of the NSW DNSPs had reported stranded labour at the end of the 2009-14 regulatory period, following the reduction in their capex programs.[12] Endeavour's Revised Proposal suggested that its stranded resources primarily arose from the Blended Delivery Model, which is increasing capex outsourcing,[13] and stated that it does not have any stranded labour, which contradicts information provided during our review.[14]

While the Revised Proposals argue that reductions in employee numbers resulting from the current Networks NSW (NNSW) efficiency programs flow from decisions to outsource, or the recent drop in energy consumption and peak demand, or the impact of the sale of the retail business, we note that this does not acknowledge the broader intent of the NNSW reforms to improve the efficiency and productivity of the DNSPs.[15]

NNSW's intentions are aligned with the broader concerns expressed by the NSW Government, Productivity Commission and other organisations about the relatively low productivity of the NSW DNSPs and particularly their relatively high total labour costs.

Efficiency programs and base year efficiency

Using the new information provided on efficiency programs conducted by Endeavour and Ausgrid, we have undertaken some new analysis of the timing of reductions in FTEs (see Figure 13). This highlights that the NSW DNSPs have managed to achieve significant reductions in labour costs through reducing the number of staff, and forecast further savings, but that most of the reductions took place after the base year, 2012-13.

[11] Essential Energy, Revised Proposal Attachment 7.6, p. 3.

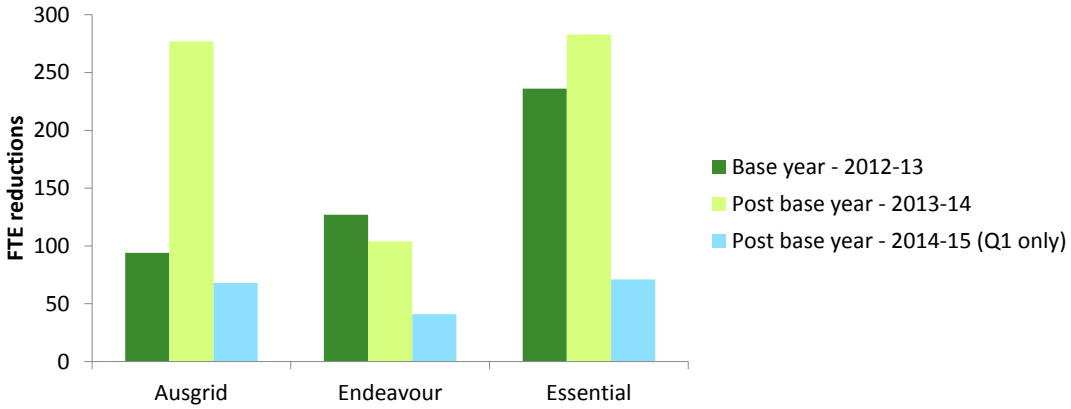
[12] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 31.

[13] Endeavour Energy, Revised Regulatory Proposal attachment 6.01, p. 16-17.

[14] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 31.

[15] For example, *NNSW Strategic Plan 2014/15 to 2018/19*.

Figure 2 Non TSA FTE reductions in and after base year (capex and opex)



Source: Ausgrid 6.04 – Transformation in the electricity distribution network industry

Efficiency programs implemented as part of the NNSW reform packages primarily target reductions in capital expenditure. Despite this focus on capex, many of the labour force inefficiencies identified in our 2014 Report apply to both capex and opex. Some of these inefficiencies relate to outsourcing, cultural challenges, workforce efficiency and overtime.

Conclusions

While the additional information on efficiency programs and counter arguments presented in the NSW DNSPs' Revised Proposals have been useful in helping us to understand the causes of their high labour costs, the conclusions we reached in our 2014 Report have not changed. Our view remains that the NSW DNSPs have higher labour costs than their peers (driven by the number of employees rather than costs per employee) due to in restrictive EBA provisions, a high degree of unionisation and inefficient labour practices, which means that their base year opex was not efficient.

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1 Introduction

1.1 Project objectives

In 2014 the AER engaged Deloitte Access Economics Pty Ltd (Deloitte) to conduct an analysis of the NSW DNSPs' labour operating costs over the 2009-14 regulatory period. Our report, entitled *NSW Distribution Network Service Providers Labour Analysis* ('the 2014 Report') was issued on 17 November 2014. The report informed the AER's assessment of the DNSPs' 2015-19 capex and opex forecasts, and was referenced in the AER's Draft Decision for each of the DNSPs which were issued on 27 November 2014 (referred to collectively as 'the Draft Decision').

The key focus of the 2014 Report was the relationship between the large capex program undertaken in the 2009-14 regulatory period and labour costs incurred during the same period by the DNSPs, specifically the profile and pace of capital investment programs and the balance between employee and contract labour engaged to implement the capex.

For the 2014 Report we were initially asked to answer the following three questions:

1. Did the NSW DNSPs (a) interpret and (b) resource the change in Ministerial licence requirements in a manner consistent with a prudent and efficient DNSP?
2. In addition to changes in licence requirements, do the NSW DNSPs have practices that suggest their labour is inefficient?
3. How would the above issues impact on the recurrent expenditure towards the end of the 2009-14 regulatory period?

Over the course of our engagement, the focus of questions 1 and 2 changed slightly so that the emphasis was not only on the implications of the licence changes, but the resourcing and efficiency of the capital program more generally. We also examined the overall structure and composition of the DNSPs' workforces and the wages and employment conditions over the regulatory period, drawing some comparisons to DNSPs in other states to identify potential reasons why the NSW DNSPs' labour costs exceeded those of similar businesses in other states.

1.2 Conclusions in the 2014 Report

Our 2014 Report concluded that the NSW DNSPs' base year (2012-13) opex was not efficient due to inefficient labour costs, which make up the majority of opex, and caused by excess staff (stranded labour) associated with the 2009-14 capex program and inflexible and inefficient workforces.

1.2.1 Ministerial licence requirements and the capital program

Changes to Ministerial licence conditions in 2005 and in 2007 placed considerable pressure on DNSPs to deliver a significant volume of capital works in the years leading up to and

during the 2009-14 regulatory period. Their actions appear to have been based on setting goals to be largely compliant with the 2007 Ministerial licence conditions by 1 July 2014. The first question the 2014 Report considered is whether, by aiming to do so, the DNSPs were acting *in a manner consistent with a prudent and efficient DNSP*, given their licence requirement to be:

> *…as compliant as **reasonably practicable*** [emphasis added] *with the applicable design planning criteria in Schedule 1 in relation to all network elements by 1 July 2014; and fully compliant with the applicable design planning criteria in Schedule 1 in relation to all network elements by 1 July 2019*.[16]

The 2014 Report set out our view that, given the licence requirement to be 'as compliant as reasonably practicable', the DNSPs acted in a manner consistent with a prudent and efficient DNSP by aiming to be largely compliant by 2014. Had they not strived to do so, and particularly had a major network incident occurred that could have been avoided had compliance with the new standards been achieved, the DNSPs would rightly have been criticised.

However, in respect of the labour costs incurred in delivering the capex program (labour-related capex), the 2014 Report found there was strong evidence to suggest that the expenditure and approach to resourcing the program was not consistent with that of a prudent or efficient DNSP. In particular, the 2014 Report stated that:

- All businesses arguably relied too heavily on hiring permanent internal labour resources rather than using temporary external contractors to undertake the capex program.
- In 2007, Ausgrid entered into a MOU with the ETU which appears to have driven its costs up, or at a minimum, entrenched them at a relatively high level.
- All the DNSPs' labour related capex was impacted by a unionised workforce that was relatively inflexible, high-cost and unproductive compared to their peers.

The 2014 Report noted that these matters did not affect all businesses equally and Endeavour's capex is likely to have been relatively more efficient than Ausgrid's. It also identified that with the advent of Networks NSW (NNSW) a range of efficiencies were identified and implemented during the latter half of the regulatory period. Nevertheless, the 2014 Report suggested the ease and level by which the efficiencies have been achieved – both in terms of projects deleted or deferred, as well as reductions in costs for projects that have proceeded [redacted] – is an indicator of the likely inefficient business practices occurring prior to this time.

1.2.2 Labour costs

The 2014 Report noted that the NSW DNSPs were part way through a reform program which began in mid-2012. It agreed that significant improvements had been made to leadership, workforce alignment and workforce flexibility, all of which were improving their cost efficiency and productivity.

[16] Ian Macdonald, MLC Minister for Energy, *Design, Reliability and Performance Licence Conditions For Distribution Network Service Providers*, 1 December 2007, cl. 14.2.

[17] [redacted]

However, the 2014 Report suggested it was unlikely that the opex base year (2012-13) reflected efficient labour costs because for much of the 2009-14 regulatory period it appeared that the DNSPs' labour costs were heavily impacted by:

- A relatively inflexible workforce with limited ability to innovate or respond to changing circumstances
- Labour costs entrenched in EBAs which are well above peer costs, particularly caused by restrictions that limit the flexibility of the DNSPs' workforces, such as no involuntary redundancy and outsourcing constraints
- In some cases, poor management of labour costs – for example in relation to overtime
- Union opposition to management attempts to reduce costs and/or improve productivity.

The efficiency programs underway in each of the DNSPs largely commenced in 2012-13 and 2013-14, such that the majority of the efficiency gains realised to date were not reflected in the base year (2012-13) opex, although we noted that Endeavour commenced its efficiency program before Ausgrid and Essential.

1.3 Response to the 2014 Report

The DNSPs responded to the issues raised in the 2014 Report and the AER's Draft Decision in their Revised Regulatory Proposals (Revised Proposals) submitted to the AER in January 2015.

The responses have taken the form of comments from the DNSPs themselves, as well as a number of consultant reports commissioned by the DNSPs. These responses have comprised:

- Attachment 7.5 to Essential's response entitled *NSW DNSP Labour Analysis* ('Essential Attachment 7.5') which provided comparative analysis of EBA conditions and work practices across DNSPs
- Attachment 7.6 to Essential's response entitled Productivity ('the Essential Productivity report) which comments on the AER's benchmarking approach and matters including the extent of contracting across DNSPs
- Attachment 6.01 to Ausgrid's response entitled *Ausgrid labour analysis report,* prepared by ARUP ('the ARUP report') which amongst other things provides a view on the size, composition and cost of Ausgrid's workforce from 2000 to 2014
- Attachment 6.01 to Endeavour's response entitled *Responses to AER's comments on inefficient labour practices* ('Endeavour Attachment 6.01')
- A report by K&L Gates for NNSW entitled *Comparison and Analysis of Enterprise Bargaining Agreements for Distribution Networks* ('the K&L Gates Report')
- An attachment to all of the DNSPs' Revised Proposals entitled Labour unit cost – review *of Deloitte report,* prepared [redacted] CEG ('the CEG report') which estimated total unit labour costs for representative employees for the NSW DNSPs and other DNSPs in the NEM
- Attachments to each DNSP's Revised Proposal containing statements from their Chief Operating Officers and relevant appendixes ('COO Statements')
- Comments in the main body of the DNSPs' Revised Proposals.

Further, the responses to the 2014 Report have provided both:

- Some new information about the DNSPs' labour costs which was not available to us in preparing the 2014 Report
- In some cases a more detailed analysis of some of the key themes and issues we raised in more general terms in the 2014 Report.

In general the DNSPs disputed our conclusions, with particularly strong views expressed in opposition to our proposition that the DNSPs' labour costs were heavily impacted by labour costs entrenched in EBAs which are well above peer costs. Key issues raised were in relation to:

- Relative wages and allowances between different DNSPs
- Restrictions on outsourcing
- The benefit of Ausgrid's MOU
- Our approach and methodology.

In preparing this Addendum we have carefully considered all of the comments and reports listed above. While we do not agree with all of the analyses conducted and conclusions reached, on the whole we have found them very helpful in advancing discussion of the issues at hand.

1.4 Purpose of this Addendum

This report provides further analysis on the efficiency of the DNSP's labour costs during the 2009-14 regulatory period. In doing so it builds upon the analysis in our 2014 Report in light of the responses from the DNSPs and their consultants.

We have not attempted to respond to every labour-related issue raised in response to the 2014 Report, however we have addressed all material matters.

In general we have not revisited the first matter addressed in the 2014 Report of whether, given the DNSPs' licence requirement to be 'as compliant as reasonably practicable' with the Ministerial reliability requirements, the DNSPs acted in a manner consistent with a prudent and efficient DNSP by aiming to be largely compliant by 2014. Our conclusion, that indeed this was the case, was not disputed by respondents.

1.5 Structure of this Addendum

The purpose of this Addendum is to respond to issues raised and new information provided in the DNSPs' Revised Proposals, and discuss any implications for our original analysis and conclusions in the 2014 Report. Accordingly, this Addendum is structured according to the broad issues raised in Revised Proposals:

- Chapter 2 discusses drivers of labour costs, and the reasons for such higher labour costs in the context of the NSW DNSPs. This chapter also references several other sources which draw similar conclusions to our 2014 Report in relation to NSW DNSP labour costs.

- Chapter 3 discusses outsourcing, including the optimal level of outsourcing, outsourcing over the 2009-14 regulatory period and Ausgrid's 2007-12 Memorandum of Understanding with unions

- Chapter 4 addresses comments made in relation to stranded labour towards the end of the 2014-19 regulatory period and discusses the new information provided in relation to the DNSPs' ongoing efficiency programs; and

- Chapter 5 addresses the issues that were raised with the approach we undertook in developing the 2014 Report.

1.6 Confidentiality

While this Addendum is, in part, based on public information it also contains a range of information which has been provided to the AER by the DNSPs and NNSW on a confidential basis. Besides containing commercially sensitive information, the public release of this information could materially harm the interests of the DNSPs in EBA negotiations. We therefore emphasise that the un-redacted version of our report is prepared solely for the use of the AER and must not be distributed beyond the AER, NNSW and NSW DNSPs. It is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity.

2 Labour costs over 2009-14

Our findings that the NSW DNSPs' labour costs reflect inefficiencies are consistent with a wide range of reports and comments made in recent years. While we acknowledge the new analysis of wages and EBA conditions in the Revised Proposals, we maintain that the NSW DNSPs' high labour costs are a function of them having more employees than their peers, which has been driven in part by restrictive EBA provisions, exacerbated by the large proportion of employees they cover.

2.1 Other reports on costs

The DNSPs' Revised Proposals have suggested that there was a lack of empirical data analysis in our 2014 Report such that we did not establish that the NSW DNSPs have higher labour costs than their peers.[18]

We acknowledge that we did not carry out a line-by-line or occupation-by occupation wages comparison across the DNSPs in different States.[19] Instead we focussed on the overall level and drivers of workforce costs. The purpose of our 2014 Report was to identify areas of inefficient work practices rather than to determine the level of efficient labour opex.

We note that while our analysis of the NSW DNSPs' labour costs looked to understand the drivers of higher labour costs in recent years, other analyses, reports and statements comparing electricity network costs and prices have identified higher costs in NSW than elsewhere. Some of these are discussed below.

IPART

In 2010 IPART undertook an analysis of the productivity of State Owned Corporations (SOCs), using its own benchmarking approach, and identified that as well as overall productivity declining over 2001-02 to 2008-09, 'labour productivity at each of the DNSPs also declined as, among other things, they employed more workers to manage their capital programs and prepare for the ageing of their workforces.'[20] IPART also noted that its research had highlighted that within the DNSPs, '…some inefficient work practices are deeply entrenched.'[21]

IPART also outlined views expressed by the DNSPs during its consultation for the analysis, which suggest that outsourcing restrictions were a major barrier to productivity:

[18] For example, Ausgrid, *Revised Proposal,* p. 158.

[19] However in response to the Draft Decision the DNSPs have undertaken some of this work and it is discussed in section 2.3.

[20] IPART, *Review of the Productivity Performance of State Owned Corporations - Other Industries — Final Report*, July 2010, p. 5.

[21] Ibid, p. 67.

Some SOCs also asserted that there are government constraints and interventions on hiring and firing (including a 'no forced redundancies' policy), and on out-sourcing and in-sourcing, and the conditions and types of employment offered. However, this was not the experience of all SOCs, and some seemed to be more subject to government involvement than others. These SOCs put the view that any substantial improvements in productivity are contingent on being able to make decisions on such matters. For example, outsourcing may not only provide a way of managing skills shortages and reducing costs, but it facilitates changes to business practices and allows internal staff effort to be re-directed towards strategy and planning, rather than on service functions that could equally be undertaken by others. Crucially, they considered that such constraints on authority made it difficult to create high performing cultures. SOCs advised that constraints on changes to labour practices may exist within and across companies.[22]

Productivity Commission

In 2012, the Productivity Commission carried out a comprehensive review of electricity network regulatory frameworks, and in doing so analysed the price and cost impacts of different DNSP ownership models.[23] After identifying that costs in publicly owned networks exceeded those in privately owned peers, the Productivity Commission discussed a range of incentives and drivers for these cost outcomes:

- Requirements for State-Owned Corporations (SOCs) to take into account non-commercial considerations, including local procurement and employment;

  For instance, in New South Wales, s. 8 of the State Owned Corporations Act 1989 (NSW) requires state-owned corporations to give equal weight to commercial success, social responsibility, ecological sustainability, and a sense of responsibility towards regional development and decentralisation.[24]

- Higher wage rates paid in publicly owned utilities[25], although we note elsewhere in this Addendum that higher labour costs are more likely to be driven by the NSW DNSPs having more employees rather than more expensive employees

- More generous non-wage employment conditions, which was noted by the NSW Government in its October 2012 submission to the Senate Select Committee on Electricity Prices, and quoted by the Productivity Commission:

  It is important to note that inefficient work practices have been occurring across the energy industry and have been allowed to become part of the expected wage structure within network and generation businesses. Examples include:

  - *Excessive overtime payments because rostering arrangements do not take into account that electricity networks operate 24 hours a day, 7 days a week;*
  - *Generous long service leave provisions providing additional leave for long-term employees;*

[22] IPART, *Review of the Productivity Performance of State Owned Corporations - Other Industries — Final Report*, July 2010, p. 67.

[23] Productivity Commission, Electricity Network Regulatory Frameworks – Inquiry Report (9 April 2013).

[24] Productivity Commission, Electricity Network Regulatory Frameworks – Inquiry Report (9 April 2013) Volume 1, p 270.

[25] Ibid, p 274.

- *Employer contributions to superannuation well above standard level for some employees;*
- *Bonuses paid to permanent employees just to allow contractors to undertake capital projects;*
- *Planned night work is paid at double time with employees then stood down the next day effectively receiving triple time for the shift;*
- *Income supplements that can double or triple the base level income of regular employees.*[26]

NSW Government

In its October 2012 submission to the Senate Select Committee on Electricity Prices, the NSW Government also noted that:

> *The NSW Government has made it clear that customers should not be paying for inefficient work practices in NSW energy businesses. Inefficient work practices in the past have included excessive overtime pay-outs, unjustified bonuses and workplace agreements, such as paid shower time, that no longer fit in today's energy sector.*[27]

Issues have been raised with Governance practices, particularly related to the appointment of board members in the NSW DNSPs. Prior to an amendment in 2013, the *Energy Services Corporations Act 1995* required that the NSW DNSPs' must have a Board of Directors that includes a Unions NSW nominee.[28] The Productivity Commission noted the perceived, if not actual conflict of interest that having a Unions NSW representative on the DNSP Boards could create in relation to decisions on outsourcing.[29]

Ernst & Young

In 2013, Ernst & Young (EY) was engaged by NSW Treasury to undertake an analysis of long term trends in DNSP prices and costs, specifically focusing on the differences in prices and costs of the publicly owned NSW and Queensland DNSPs, as compared to the privatised Victorian and South Australian DNSPs. EY found that:

> *In NSW and Queensland, the distribution networks over the period of the analysis:*
>
> *• Increased their underlying operating costs per unit of energy distributed in real terms*
>
> *• Spent more on operating and capital costs than the allowances provided by the regulator over the past two complete regulatory periods (which covers a total of 10 years)*
>
> *In Victoria and South Australia, the distribution networks over the period of the analysis:*
>
> *• Reduced their underlying operating costs per unit of energy distributed in real terms*

[26] NSW Government, Senate Select Committee on Electricity Prices - NSW Government Submission, October 2012, p 3.

[27] Ibid, p 4.

[28] Parliament of NSW, *State Owned Corporations Legislation Amendment (Staff Directors) Bill 2013* – Explanatory Note.

[29] Productivity Commission, Electricity Network Regulatory Frameworks – Inquiry Report (9 April 2013) Volume 1, page 279.

• *Spent less on operating and capital costs than the allowance provided by the regulator over the past two complete regulatory periods*.[30]

The NSW DNSPs have acknowledged inefficiency within their opex and labour costs and that causes of this are associated with their industrial relations environment. [redacted]

[redacted][31]

The NSW DNSPs have also argued in response to our 2014 Report that their NNSW efficiency programs which commenced in 2012 had delivered efficiency gains such that the 2012-13 base year reflects an efficient starting point for deriving their opex forecasts.[32] We present further discussion on this below, however we note that the comments of the NSW Government about its intentions to make changes to DNSPs to address workforce inefficiencies were made in October 2012, during the opex base year. We consider it improbable that the full extent of the efficiencies sought by reforms were reflected in the DNSPs' opex in 2012-13, a finding we made in our 2014 Report.[33]

AER benchmarking

The AER conducted a range of cost benchmarking which informed the 2014 draft decision on NSW DNSPs' allowable opex. Figure 3 demonstrates there are significant gaps in opex efficiency between the NSW service providers and the Victorian service providers. These gaps exist despite the AER's modelling taking into account differences in operating environment including customer density, the ratio of overhead and underground lines and the different delineation between transmission and distribution networks across jurisdictions.

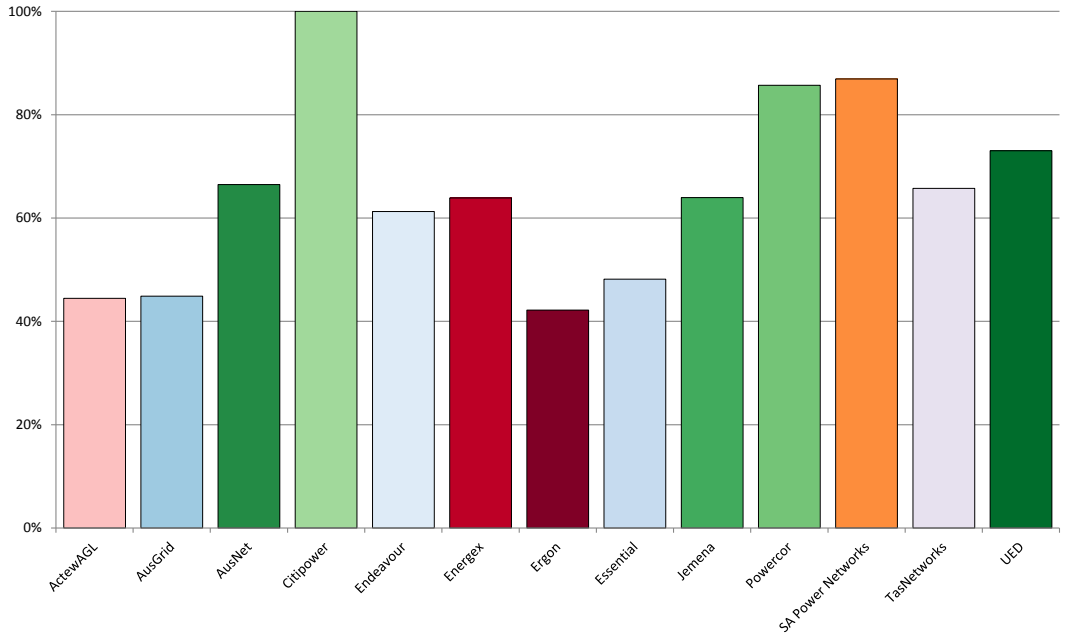
[30] EY, *Electricity network services Long-term trends in prices and costs*, 2013, p. 11.

[31] Essential Energy, *Revised Proposal Attachment 7.5*, pp. 21-22.

[32] For example, Endeavour Energy, *Revised Proposal Attachment* 6.01, p 5.

[33] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 57-8.

Figure 3 Opex MPFP performance (average 2006–13)



Source: Economic Insights Pty Ltd, Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs, November 2014, Denis Lawrence, Tim Coelli and John Kain. Note that MPFP is expressed relative to the best performer, which in this case is CitiPower.

While the opex benchmarking covers total opex costs, and not just labour costs, we note that labour costs represent approximately 70% of the businesses opex.[34] In its draft decision, the AER was not satisfied that the NSW DNSPs' total forecast opex reasonably reflected the opex criteria. After undertaking benchmarking analysis the AER considered the efficient opex a prudent operator would require would be lower than that proposed by the DNSPs to achieve the opex objectives.[35] Additionally, the AER benchmarking found that opex was high in 2012-13 compared to other DNSPs.

The issue of the AER benchmarking is discussed further in section 6.1.

Conclusion

There are a significant number of reports and analyses which suggest that during the 2009-2014 regulatory period the NSW DNSPs' costs were high compared to peers, and this was due to high labour costs caused by inefficient labour practices.

The next sections address issues associated with the reasons we identified for the NSW DNSPs' labour costs being higher than their peers.

[34] Based on CA RIN data, categories tab, total labour plus other costs, which we have been advised is predominately internal corporate staff and management time.

[35] AER, Draft decision; Ausgrid distribution determination 2014–19, Attachment 7: Operating expenditure, p. 7-25.

2.2 Drivers of high labour costs

The direct labour cost incurred by a DNSP is a simple function of the number of employees and the payments to each employee. Ultimately the two cannot be considered in isolation from each together. All other things being equal a regulator should be happy to consider one DNSP as efficient as another if that DNSP has 20% higher payments to each employee but also 20% fewer employees. Table 1 below provides a summary of the different determinants of direct labour costs, categorising each determinant into a factor of either the number of employees or the payment to each employee.

Table 1 Determinants of direct labour costs

Factor	Determinants include

Number of employees	• Number of hours of paid work by each employee. The greater the number of hours worked the fewer the number of employees required. The number of hours of paid work by each employee will depend on such things as:
	  • Length of a standard working week
	  • Number of hours of leave undertaken (e.g. sick leave, holiday, long service leave)
	  • Time spent training
	  • Time lost to disputes
	  • Requirements to pay for a minimum number of hours
	  • Mandatory breaks between work
	• Productivity of each employee. The greater the number of productive tasks undertaken in an hour the fewer the number of employees. This will be influenced by:
	  • Skills and training of the employee
	  • The amount of 'dead time' e.g. waiting for other tasks to be completed or commuting between tasks
	  • Employee engagement, co/operation and collaboration
	  • Scheduling and rostering decisions
	  • Workforce culture
	• The level of contracting out. A greater level of contracting means fewer direct employees. Where businesses are artificially restricted in their use of contractors more internal employees will be used

Payment to each employee	• Base hourly wage • Superannuation payments • Overtime rates • Allowances and penalties • Redundancy payments

The following two sections further discuss determinants of direct labour costs relating to the cost per employee and the number of employees.

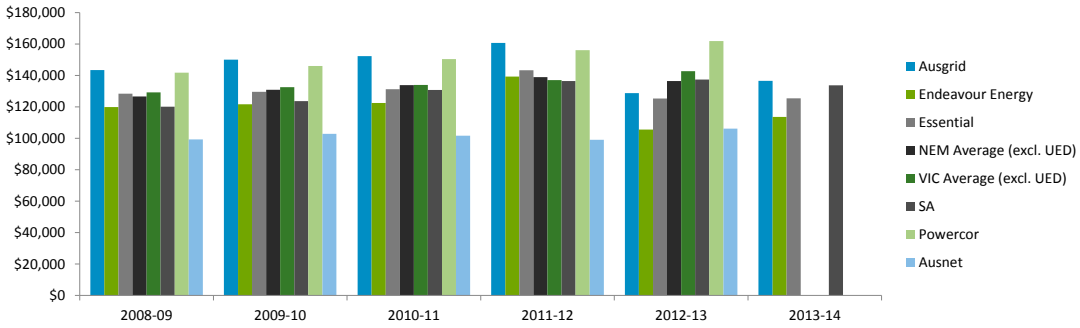
2.3 Costs per employee

Labour costs are ultimately a function of both the cost per employee, primarily driven by wage costs but also influenced by non-wage factors, and the number of employees. This section reviews information relating to the cost per employee provided by the NSW DNSPs as part of their revised proposals.

RIN Labour cost data

Data provided in the CA RIN submissions to the AER provide an indication of the average wage cost of DNSP employees. Figure 4 shows the labour cost per average staffing level (ASL) of the NSW DNSPs compared to the NEM average, the Victorian average and South Australia Power Networks. In 2012-13 (the base year), average unit labour costs for Ausgrid, Endeavour and Essential were all lower than both the NEM, SA and Victorian averages. This suggests that high wage costs are not the main factor driving high labour costs in NSW.

Figure 4 Labour cost per ASL, 2008-09 to 2013-14 (2014-15, $real)



Source: CA RINs. Note: This graph is in financial years, but the Victorian DNSPs report on the basis of calendar years. Note that the Victorian DNSPs have not yet reported their 2014 data.

Wage analyses in Revised Proposals

In their Revised Proposals, the NSW DNSPs have provided multiple analyses of the base wage rate among NSW DNSP employees. The Competition Economics Group[36] (CEG) and Essential Energy both argued that the base wage for electricity workers in NSW DNSPs is not any higher than in equivalent positions in other states, and supplement this argument with a detailed analysis of base wage rates and allowances for employees. [redacted]

[36] Via an attachment to the NSW DNSPs' Revised Regulatory Proposals.

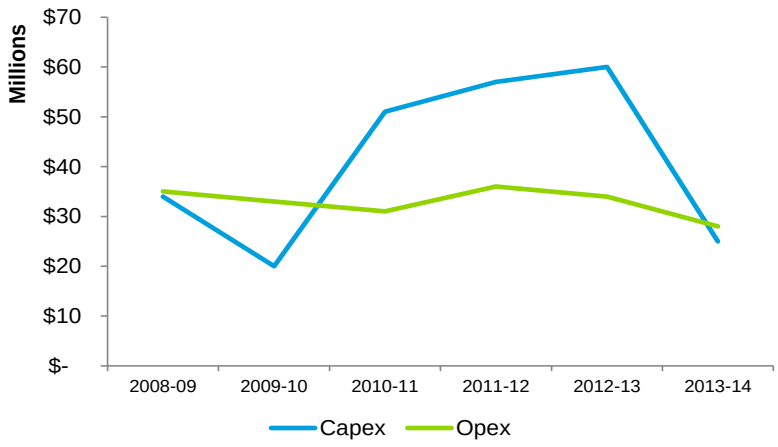
[37] CEG, *Ausgrid Revised Proposal Attachment 6.02 CEG: Labour unit cost –review of Deloitte Report (CONFIDENTIAL),* January 2015. Arup, *Attachment 6.01 Arup – Ausgrid labour analysis report (CONFIDENTIAL),* January 2015.

CEG

The CEG report shows that for a given position, wages, allowances and conditions in the NSW DNSPs' are not overly high and are broadly consistent with that of other NEM DNSPs. We do not disagree with the overall findings of the CEG analysis, however, we note that several assumptions have been made [redacted] which are likely to have affected the results of the analysis.

[redacted]

Figure 5 Ausgrid annual expenditure on overtime 2008-09 to 2013-14 ($m, nominal)



Source: Ausgrid regulatory proposal, p 50; Ausgrid response to AER information request 'AER AUSGRID TBAb – workforce planning' 8 October 2014, q. 8.

[38] *Ausgrid Revised Proposal Attachment 6.02 CEG: Labour unit cost –review of Deloitte Report (CONFIDENTIAL),* January 2015, p. 22.

[39] NSW Auditor General, *New South Wales Auditor-General's Report - Financial Audit, Volume Four 2013 Focusing on Electricity*, November 2013, p. 30

Essential Energy

[redacted]

We acknowledge that this analysis is useful in examining unit labour costs and do not disagree with the conclusions reached in the analysis. As noted above, this confirms that the source of efficiency gap between the DNSPs' and frontier businesses' labour costs is likely to be associated with the number of employees rather than costs per employee.

Conclusions

Our analysis of RIN data and the various submissions made by CEG and Essential indicate that the unit labour cost of NSW DNSPs is not high in comparison to other DNSPs. This suggests that the relatively high labour costs in NSW DNSPs are not driven by baseline costs per employee, but are driven by the total number of employees. The following section further explores this.

2.4 Number of employees

In our 2014 Report, we found, based on the information before us, that the NSW DNSPs had a large number of employees compared to their peers. One of the key reasons for this was their EBA provisions, which we considered to be restrictive because amongst other things they do not allow for forced redundancies and constrain outsourcing. Our view has not changed materially from the 2014 Report. We remain of the view that inflexibilities existed within the DNSPs' EBAs which made it difficult to quickly and flexibly adjust their workforces during the 2009-14 regulatory period. We accept that other DNSPs may have similarly restrictive provisions, however, other DNSPs have managed to operate more efficiently within these constraints.

In section 2.3, we concluded that unit labour costs in the NSW DNSPs are unlikely to be responsible for relatively high labour costs per customer in NSW and therefore the driver for relatively high labour costs in NSW is the number of employees in each of the NSW DNSPs. This section reviews information relating to the number of employees and constraints around reducing the number of employees.

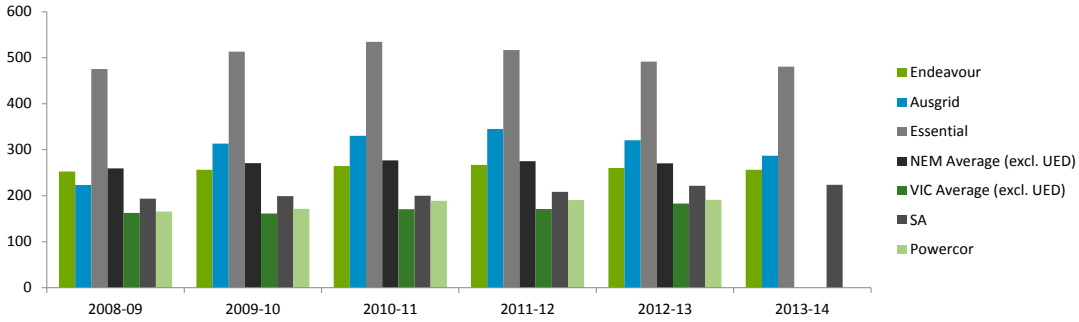
RIN data

Data taken from the regulatory reset RIN highlights the large differences between the average staffing level (ASL) in the NSW DNSPs and the Victorian and South Australian DNSPs. Figure 6 below shows the ASL per 100,000 customers. Ausgrid and Essential are consistently above the NEM average, and all three NSW DNSPs are above the Victorian

[40] Arup, *Attachment 6.01 ARUP – Ausgrid labour analysis report (CONFIDENTIAL)*, January 2015.

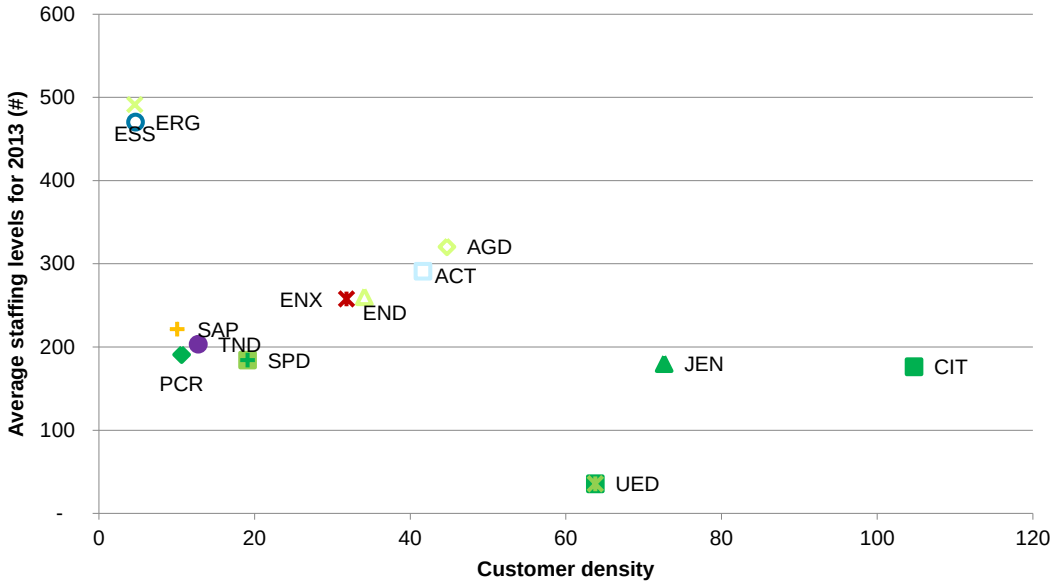
average (excluding United Energy) and South Australia in terms of number of employees per 100,000 customers. Even accounting for differences in network characteristics, in 2012-13, Ausgrid and Essential have relatively high levels of staffing (see Figure 6) and are on the wrong side of the customer density versus ASL curve (see Figure 7).

Figure 6 Average staffing levels per 100,000 customers, 2008-09 to 2013-14



Source: CA RINs. Note: This graph is in financial years, but the Victorian DNSPs report on the basis of calendar years. Note that the Victorian DNSPs have not yet reported their 2014 data.

Figure 7 Average staffing levels per 100,000 customers by customer density



Source: CA RINs

Key EBA workforce flexibility constraints

In our 2014 Report, we identified several provisions in the NSW DNSPs' EBAs as constraining flexibility and efficient workforce management. These included restrictions on reductions in workforce size, permanent/part-time/casual employment, and outsourcing. We also made comments on selected other EBA provisions where the conditions for NSW DNSPs' employees appeared more generous than in other states, for example, superannuation and long service leave entitlements.

In response to our 2014 analysis of EBA provisions, a number of Revised Proposal documents have presented comparisons of EBA conditions across Australian utilities. All the Revised Proposals present only selected provisions of the EBAs, as our 2014 analysis also did, but nevertheless seek to demonstrate that the NSW DNSPs' EBAs as a whole are no more generous in terms of base level wages and other employee conditions than those of their peers. We agree with this view but note that the EBAs contain a range of generous terms and again cite Essential's view that:

[redacted]

After reviewing the information submitted in Revised Proposals, and confirming that the primary driver of the NSW DNSPs' labour costs being higher than their peers is the number of employees rather than cost per employee, we have focussed on specific clauses of the EBAs that are likely to impact workforce flexibility, or the number of employees.

Table 2 shows a comparison of key EBA clauses that affect workforce flexibility among distributors in the NEM, with statistics showing the proportion of the workforce employed under each EBA, which is an indicator of the degree to which the provisions impact the overall businesses. The flexibility conditions that we examined relate to:

- the ability of a DNSP to make an employee compulsorily retrenched, or forced redundancy
- the 'parity requirement', where a DNSP, must provide conditions to outsourced labour that are no less favourable than would be provided to an internal employee
- the requirements for DNSPs to consult with unions and the workforce prior to outsourcing work.

[41] Essential, *Revised Proposal Attachment 7.5*, pp. 21-22.

[42] K&L Gates, *Networks NSW: Comparison and Analysis of Enterprise Bargaining Agreements for Distribution Networks*, p. 3

Table 2 Comparison of key EBA constraints on flexibility

DNSP	EBA name	Allow forced redundancies	Outsourcing – parity	Outsourcing – consultation	% workforce under EBA
CitiPower	CitiPower (ASU; APESMA; NUW) Enterprise Agreement 2013	No – Clause 24	Yes – Clause 6	Consultation required	<50%
Powercor	Powercor Australia LTD (ASU; APESMA; NUW) Enterprise Agreement 2013	No – Clause 24	Yes – Clause 6	Consultation required	<50%
Powercor (CEPU)	Powercor Australia LTD (CEPU) Enterprise Agreement 2011	No Clause 25	Yes – Clause 54	Consultation required	<50%
Jemena (ETU)	Jemena Asset Management - ETU Victorian Electricity Enterprise Agreement 2010	Yes – Clause 5.2	No	Consultation required	50 % – 75 %
Jemena Asset Management	Jemena Asset Management Agreement (Vic) 2013	Yes – Clause 14	No	Consultation required	50 % – 75 %
SP AusNet (APESMA, ASU)	SP AusNet/ APESMA/ASU Enterprise Agreement 2013	No – Clause 44	No	Consultation required	<50%
SA Power Networks (ETSA)	Utilities Management Pty Ltd Enterprise Agreement 2014	Yes	Yes - Clause7.6	Consultation required	>75%

Energex	ENERGEX Union Collective Agreement 2011	No – Clause 4.3	Yes – Clause 13.11.4 b	Consultation required	>75%
Ergon	Ergon Energy Union Collective Agreement 2011	No – Clause 1.10	Yes – Schedule 8 Clause 1.5b	Consultation required	>75%
ActewAGL	ActewAGL and Combined Unions Enterprise Agreement 2011	Yes – Clause 68	No	Consultation required	>75%
Ausgrid	Ausgrid Agreement 2012	No –Ausgrid Redundancy and Redeployment Policy	Yes – Clause 6.4	Consultation required	>75%
Endeavour	Endeavour Energy Enterprise Agreement 2012	No – Endeavour Energy Policy 7.8.2 version 4	Yes – Clause 27.4	Consultation required	>75%
Essential Energy	Essential Energy Enterprise Agreement 2013	No – Essential Energy Redundancy Policy (Management of Surplus Employees)	Yes – Clause 6.1.4	Consultation required	>75%
Essential Energy	Essential Energy Far West (Electricity) Enterprise Agreement 2013	Yes – Clause 10	No	Consultation required	>75%
TasNetworks (formerly Aurora Energy)	Aurora Energy Agreement 2011 2013 Variation	Yes – Clause 65	No*	No*	>75%

Source: Various DNSP EBAs as referenced in table. *Aurora Energy's EBA has an express policy of not outsourcing work.

We have found that the majority of distributors[43] are not allowed to carry out forced redundancies as a result of provisions in their respective EBAs. This is an important

[43] 8 out of 12 distributors.

impediment to any program of reductions in workforce size, outside of natural attrition. [redacted] Requirements relating to outsourcing are fairly consistent between distributors and most distributors[45] have parity requirements which prevent them from providing external labour with conditions less favourable than they would be for internal employees. We note that, although contractor parity requirements prevent the wages and conditions provided to contractors from being less favourable than internal employees, this does not necessarily mean that there are no opportunities for outsourcing to deliver efficiencies. If, as a result of different workplace incentive structures, contractors are more productive than internal staff it is possible that outsourcing will directly bring about cost savings, in addition to savings made indirectly through the increased flexibility associated with being able to increase and decrease the workforce in response to workload. The efficiencies realised by the Victorian DNSPs through outsourcing (discussed further below) suggest that even with parity requirements there are significant efficiencies to be gained through outsourcing.

In relation to outsourcing restrictions, our 2014 Report highlighted that while the requirements for consultation before outsourcing are common unlike other NEM DNSPs, the NSW DNSPs' EBAs contained statements such as 'Ausgrid is obliged to employ permanent employees where possible'; and 'Essential (Endeavour) must ensure that it maximises the number of permanent positions in its workforce.'[46] [redacted] We have since revisited these clauses, and while we agree that clauses relating to casual employment might be a result of the NSW IRC decision, there are other similar clauses elsewhere in the NSW DNSPs' EBAs that have the same effect, that is, requiring the prioritisation of increasing or maintaining permanent employees above alternatives. For example, Essential's EBA requires that 'permanent employment is the preferred means of employment across the business and temporary employment shall not be used as an alternative to permanent employment.'[48]

With the exception of the Queensland DNSPs' EBAs which require that Energex and Ergon must not use contractors just to avoid increases in the permanent workforce,[49] these types of provisions are not apparent in other DNSP EBAs. While we accept that these are general statements rather than specific requirements, in our view they exemplify the challenges that the NSW DNSPs have faced in outsourcing which is reflected in their lower level of outsourcing than Victorian DNSPs. They also reflect, and impact upon, the cultural issues that are described in our 2014 Report, although we note that a sole focus on EBA clauses overlooks how the agreements operate in practice and the broader relationships between

[44] K&L Gates, *Networks NSW: Comparison and Analysis of Enterprise Bargaining Agreements for Distribution Networks*, page 13.

[45] 8 out of 12 distributors.

[46] Essential Energy, *Enterprise Agreement 2013*, cl 1.22.1

[47] Essential Energy, *Revised Proposal Attachment 7.5* p. 11.

[48] Essential Energy, *Enterprise Agreement 2013*, cl 3.2(g).

[49] Ergon Energy *Union Collective Agreement 2011*, Schedule 8 cl 1.2; Energex *Union Collective Agreement 2011* cl 13.11.2.

employees and management, including the general willingness of the workforce to accept imposed change. Differences in the way that similar EBA provisions apply in practice are also likely to be a function of historical factors, management approach to decision making, as well as the influence of State Government shareholders.

Finally, in addition to the restrictions discussed above, our 2014 Report drew attention to the fact that the NSW DNSPs have a high proportion of their workforces (more than 75%) employed under EBAs. This means that the effect of EBA inflexibilities are amplified relative to other DNSPs such as the Victorian DNSPs (where less than 50% of the workforce are employed under EBAs). This poses a significant challenge for workforce management as, given the scale of excess staff in NSW DNSPs, natural attrition alone is not going to deliver the required large workforce reductions.

Essential Energy's EBA

Essential pointed out that our 2014 Report refers to the Essential Energy Far West (Electricity) Enterprise Agreement 2013 in our discussion of redundancy provisions, which covers only 3 per cent of Essential's workforce, whereas the most relevant EBA (which covers 93 per cent) is the Essential Energy Enterprise Agreement 2013. We acknowledge this, and have reflected the redundancy provisions from this EBA in this addendum, and note that our comment regarding long service leave entitlement provisions in Essential's EBA made in our 2014 Report[50] being relatively generous was made in reference to the Essential Energy Far West EBA. Essential's COO Statement provided as an attachment to its Revised Proposal highlights other areas where the Far West EBA offers more generous conditions than the broader Essential Energy Enterprise Agreement 2013. Additional paid allowances and annual leave (5 weeks per year) are among the more generous entitlements to which employees on the Far West EBA are entitled.[51]

We note generally that our review of Essential Energy's broader EBA for this Addendum has confirmed our initial findings that Essential is restricted from implementing involuntary redundancies and faces similar barriers to workforce flexibility as Ausgrid and Endeavour.

Conclusions

As shown by the RIN data on ASLs, the NSW DNSPs have a relatively high number of employees compared to private DNSPs in the NEM. Considering that labour costs represent the vast majority of opex and given that their unit labour costs do not appear to be greater than their peers', the higher number of employees in Ausgrid, Endeavour and Essential is likely the primary factor driving high opex costs per customer in NSW. Although the number of employees in NSW DNSPs is high due to historical workforce decisions, the current high number of employees is likely being sustained by restrictive EBA provisions relating to no forced redundancies[52] and a relatively high proportion of employees employed under EBAs.

[50] Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, 2014, page 39.

[51] Essential Energy, Revised Regulatory Proposal Attachment 1.1 – Statement of Gary Humphreys, paragraph 105.

[52] Note that although this provision is not unique to NSW, the fact that NSW currently has a large workforce makes this a provision more relevant as it impedes any large reduction in workforce size.

3 Level of outsourcing

Our 2014 Report found that the NSW DNSPs have relatively low levels of outsourcing, which can partly explain some of the observed efficiency gap between the NSW DNSPs and the efficient DNSPs, as defined by the AER's economic benchmarking. In addition to this, we found that the NSW DNSPs relied too heavily on internal employees when contractors could have been used.

Although significant new information on outsourcing has been provided by the NSW DNSPs in their Revised Proposals, these core findings in our 2014 Report have not changed.

We consider Arup's cost benefit analysis of the MOU ignores significant costs and therefore biases the results of the analysis.

3.1 Optimal level of outsourcing

Our 2014 Report presented data on the proportion of total capex and opex that the Victorian and NSW DNSPs outsourced (or expected to outsource) in recent years, including a breakdown of related party contractor outsourcing and all outsourcing.

In its Revised Proposal, Endeavour presented the same information contained in our 2014 Report and pointed that the level of outsourcing to external parties (i.e. non-related parties) among Victorian DNSPs was mixed, with Jemena outsourcing entirely to related parties.[53] Endeavour also suggested that the level of external outsourcing was not correlated with the AER's MTFP results, and therefore that outsourcing is 'not a panacea for efficiency.'[54] Ausgrid made similar arguments and suggested that Deloitte had not presented evidence that outsourcing was efficient in all circumstances.[55]

Even after accounting for their outsourcing to related parties and making the assumption that related party outsourcing is no more efficient than an internal workforce, which we disagree with, the Victorian DNSPs still outsource around 25% more opex than the NSW DNSPs. While outsourcing is clearly not the only strategy to improve workforce efficiency, and is not appropriate in all circumstances, it is instructive to consider the efficiency gains which Victorian and other DNSPs' have attributed to outsourcing since privatisation:

- *Jemena: 17% saving - 'By 2010, JEN will have achieved operating efficiencies totalling $54.4 million or 16.9 per cent of the ESC's opex allowance' and 'The outsourced contracts provide JAM with the flexibility to increase and decrease its requirements*

[53] We note that Endeavour appears to have incorrectly interpreted the data on outsourcing presented in our 2014 report, presenting the proportion of related party outsourcing as the level of 'outsourcing to external parties.' Endeavour, *Revised Proposal Attachment 6.01*, p. 21.

[54] Endeavour, *Revised Proposal Attachment 6.01*, p. 21-2.

[55] Ausgrid, *Revised Proposal (main body),* p. 160.

based on its work program. They also provide JEN access to a larger and more flexible workforce than it could prudently maintain on a standalone basis."[56]

- *Powercor: 21% saving - KPMG found that, if Powercor Australia had delivered its nominated services for the year ended 31 December 2008 on a standalone basis, its efficient cost of service delivery would have been $16.930 million (21 percent)($2008) more than the costs it actually incurred for these services (excluding related party margins).*[57]
- *CitiPower: 45% saving. KPMG found that if CitiPower had delivered its nominated services for the year ended 31 December 2008 on a standalone basis, its efficient cost of service delivery would have been $19.049 million (45 per cent)($2008) more than the costs exclusive of margins it actually incurred for these services.*[58]

In our view, these type of savings go some way towards explaining the productivity gap between the Victorian and NSW DNSPs suggested by the AER's benchmarking, our analysis and other reports.

Although we acknowledge that DNSPs may have an incentive to enter into a related party contract in order for shareholders to earn additional profit margins, evidence of the efficiencies made by the Victorian DNSPs suggests that the overall costs are still lower than in house services due to economies of scale and scope. In addition, where there has been an arms-length competitive tender process to engage the related party contractor, its costs are likely to reflect competitive market costs. We note that the efficiency gains that have been reported by the Victorian DNSPs, outlined above, suggest that outsourcing to a related party still yields efficiencies over and above in house provision of service.

We note that Endeavour and Essential have realised some benefits of outsourcing in terms of the competitive pressure that it places on internal work teams. As we observed in our 2014 Report Endeavour provided an example which suggested significant savings in substation fit-outs, with around 50% reduction in the man-hours needed for tasks, as a result of competitive pressure applied by external contractors.[59] We note that while Endeavour managed to achieve this particular saving during the 2009-14 regulatory period and that some of the efficiencies are reflected in the base year, the progressive increase in outsourcing that is being implemented highlights that further efficiencies are expected to be realised from outsourcing in the 2014-19 regulatory period, as discussed further in chapter 3.4.

As we also noted in our 2014 Report, while Endeavour and to some extent Essential agreed that outsourcing had the potential to generate efficiencies in their labour forces, Ausgrid argued its Alliance Strategy reflected outsourcing only as a means to increase workforce capacity.60 [redacted]

[56] Jemena, Regulatory Proposal, 2009, p. 52, p. 121 (Note that JEN is *Jemena*, JAM is *Jemena Asset Management*)

[57] Powercor Regulatory Proposal, 2009, p. 365

[58] CitiPower Regulatory Proposal, 2009, p. 77

[59] Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, October 2014, p. 52.

[60] Ibid.

[redacted] new information that Ausgrid has provided with its Revised Proposal suggests that outsourcing is being implemented as a strategy to improve the efficiency of its internal workforce. Ausgrid's *Strategic Delivery and Workforce Plans* for 2014-19 express the efficiency gains associated with the move to greater use of contractors:

> *Ausgrid seeks to drive further significant improvements in the efficiency with which works are delivered through:*
>
> - *Application of a blend of internal and external delivery across all programs/projects to enable benchmarking and competitive tension both within the external market and internally;*
> - *Identification of critical core areas where the combination of scarce experienced skills, variable scope and fast response lends itself to either internal and/or collaborative external delivery;*
> - *Efficient bundling of work into increasingly larger packages to reduce internal and external contracting costs and program management costs and to provide more attractive packages to the external market;*
> - *Emphasising the importance placed on the ability of contractors to bring cost saving innovation; and*
> - *Adoption of more collaborative contracting models where appropriate, including risk sharing, performance incentive contracts and partnering arrangements.*[62]

This aligns with the comments made by Endeavour, Essential and Networks NSW which we presented in our 2014 Report, in respect of the objectives of the new Blended Delivery Model which is being implemented as part of the Networks NSW efficiency programs.

We note that Ausgrid's Revised Proposal presented new information about the proportions of its maintenance expenditure for labour (56%), material (5%), 'contracted services' (27%) and 'other' (13%) in the 2012-13 opex base year. This new information is consistent with that we relied upon and presented in our 2014 Report, showing that between 21 and 31% of Ausgrid's opex was outsourced during the 2009-14 regulatory period.[63]

Similarly, Endeavour's COO Statement presented some new information on the proportion of SCS and Alternative Control Services opex that was outsourced in 2014-15, suggesting that 35% of its opex is outsourced ('Blended Delivery Ratio').[64] This information reflects a higher proportion of SCS opex outsourcing than the information we relied upon in our 2014 Report, which was an average of 26% opex outsourcing over the 2009-14 regulatory period. This highlights Endeavour's increasing focus on outsourcing which we noted in our 2014 Report. In relation to the optimal level of outsourcing, we agree with the DNSPs' Revised Proposal comments that outsourcing will not be appropriate in all circumstances. However, we consider that the optimum level is likely to be higher than that of the NSW DNSPs over 2009-14, and maintain our view that the benefits of outsourcing in terms of providing

[61] Ausgrid *Regulatory Proposal Attachment 6.01* pp. 13-26.

[62] Ausgrid, *Revised Proposal Attachment 5.05: Strategic Delivery and Workforce Plans*, p. 47.

[63] Ausgrid, Revised Regulatory Proposal Attachment 1.02 – Statement of Chief Operating Officer of Ausgrid, January 2015, paragraph 55.

[64] Endeavour Energy, Revised Regulatory Proposal, Attachment 1.08 – COO Statement, paragraph 103.

competitive pressure on the internal workforce to improve productivity realised by the Victorian DNSPs is one of the key reasons for the productivity gap between them and the NSW DNSPs.

3.2 Outsourcing during the 2009-13 capex program

Our 2014 Report found that all three NSW DNSPs 'arguably relied too heavily on internal labour resources rather than used external contractors to undertake the capex program' over 2009-14.[65] This finding was based on data that showed:

- The NSW DNSPs significantly increased their permanent workforces in the lead-up to, and the first few years of the 2009-14 regulatory period, which had contributed to stranded labour in the later years of the period
- The level of outsourcing undertaken by the NSW DNSPs' during the 2009-14 regulatory period was significantly less than the Victorian DNSPs, even after excluding related party contracts
- The NSW DNSPs' EBAs contain constraints on redundancy which prevent reductions to the workforce, which were also in place at the time the permanent workforce was being expanded.[66]

Arup Report – workforce planning information

In their Revised Proposals, the NSW DNSPs have argued that the level of outsourcing they undertook to implement the 2009-14 capex program was appropriate. In particular, Ausgrid engaged Arup to produce a report [redacted].[67]

Firstly, we note that while Arup provides a comprehensive summary of the factors that might have affected Ausgrid's decision making on its workforce during the 2009-14

[65] Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, October 2014, p. 35.

[66] Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, October 2014, pp. 17-34.

[67] Ausgrid *Regulatory Proposal Attachment 6.01* p. 1.

regulatory period, it does not address our argument that Ausgrid's decisions on its workforce structuring 'arguably relied too heavily on internal labour resources.'

Secondly, there is a significant volume of new information presented in the Arup report which outlines how Ausgrid responded to the Ministerial Licence Condition changes in 2005 and 2007, and how it planned its workforce during the period. During our review, the AER requested that Ausgrid provide all documents considered by Ausgrid's board and/or management relating to the interpretation of the 2005 and 2007 Ministerial Licence conditions, including the implications for resourcing (labour) requirements to achieve the work program and the resourcing options and their relative costs (i.e. hiring new permanent employees versus outsourcing) and cost benefit analysis of using internal labour to complete the work program.[68] While some information was received from Ausgrid in response to this question, the Arup report references a number of new documents that were not provided earlier,

The Arup report also presents new data on the balance between Ausgrid's internal permanent workforce and labour hire and Alliance labour.[75]

[68] AER, *information request to Ausgrid* 025.

[69] Ausgrid, *Regulatory Proposal Attachment 6.01* p. 19.

[70] Ausgrid Regulatory Proposal Attachment 6.01 p. 20.

[71] Ibid, p. 21.

[72] Ibid, p. 42.

[73] Ibid, p. 25.

[74] Ibid.

[75] Ibid, p. 25, Figure 12.

[redacted]

This finding contradicts information provided by Ausgrid that indicates its increase in the permanent workforce of 38% between 2008-09 and 2013-14 was predominantly needed to deliver the increased capex program associated with the Ministerial licence condition changes in 2005 and 2007.[78]

In summary, the new information which is summarised in the Arup report does not contradict our finding that Ausgrid 'arguably relied too heavily on internal labour resources.' The increase in its permanent workforce far outweighed the limited outsourcing Ausgrid undertook, particularly in view of the restriction on forced redundancies in the EBA and the nature of the capital program which was implemented over a short period to deliver compliance with new standards.

Drivers of the 2009-14 capital program and resourcing decisions

[redacted]

Our 2014 Report expressed the view that it was a prudent decision for the NSW DNSPs to attempt to meet the 2007 Ministerial Licence conditions by 2014, given the licence requirement for them to be 'as compliant as reasonably practicable,'. Nevertheless, our view that the DNSPs 'arguably relied too heavily on internal labour resources' in doing so, given the nature of the capital program and the restrictions on forced redundancies in the EBAs, remains unchanged.

[76] AER, information request to Ausgrid 025.

[77] Ausgrid *Regulatory Proposal Attachment 6.01* p. 56.

[78] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 19.

[79] Ausgrid Regulatory Proposal Attachment 6.01 p. 56.

3.3 Ausgrid's 2007-12 Memorandum of Understanding with the ETU

Our 2014 Report noted that Ausgrid had entered into a MOU with the ETU in 2007, attempting to increase its labour flexibility but at what appeared likely to be a significant cost to the organisation.[80] While Arup's original report on Ausgrid's 2009-14 expenditure program provided as an attachment to Ausgrid's regulatory proposal did not mention the MOU, the Arup report included as an attachment to Ausgrid's Revised Proposal contains an analysis of the costs and benefits of the MOU, [redacted][82]

[redacted]

[redacted]

[redacted] We note that Ausgrid's overtime costs raised the concerns of a number of parties during the 2009-14 regulatory period, including the NSW Auditor General, as we noted in our 2014 Report. Ausgrid's annual overtime costs from 2008-09 to 2013-14 are presented in the following chart.

[80] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 28.

[81] Ausgrid *Regulatory Proposal Attachment 6.01* p. 50.

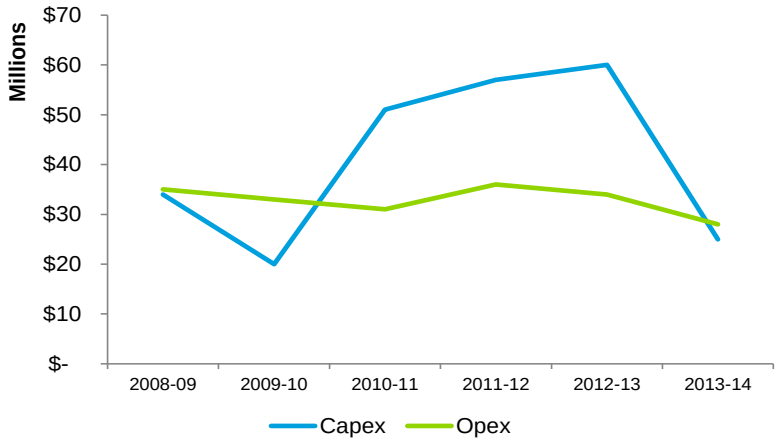
[82] Ausgrid *Regulatory Proposal Attachment 6.01* p. 52-3.

[83] Ausgrid *Regulatory Proposal Attachment 6.01* p. 52.

[84] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 28.

[85] Deloitte Access Economics, NSW Distribution Network Service Providers Labour Analysis, October 2014, p. 27.

Figure 8 Ausgrid annual expenditure on overtime 2008-09 to 2013-14 ($m, nominal)



Source: Ausgrid regulatory proposal, p 50; Ausgrid response to AER information request 'AER AUSGRID TBAb – workforce planning' 8 October 2014, q. 8.

[redacted]

3.4 Conclusions

Evidence from Powercor, CitiPower, Jemena and Ausgrid indicate that although outsourcing is not a 'panacea for efficiency', the use of outsourcing to manage fluctuations in workload and to instil competitive workplace culture can bring about significant efficiency gains. As found in our 2014 Report, we consider that the NSW DNSPs could attain further efficiency gains by outsourcing more of the current workload, however, we note that current workforce inflexibility in the NSW DNSPs' EBAs may make the outsourcing of work unfeasible in the short term. Additionally, we do not consider that the MOU entered into by Ausgrid was necessary in order to facilitate outsourcing.

[86] Ausgrid *Regulatory Proposal Attachment 6.01* p. 47.

4 Essential's regional depots

In its Revised Proposal, Essential has argued that the dispersed nature of its network, and the lower concentration of work volumes in specific locations inherently limits its ability to rely on economies of scale to improve productivity, and constrains the open market to cost effectively provide alternate sources of labour and services in regional locations. It is no doubt true that opportunities for private sector involvement in more remote areas may be less than elsewhere, but Essential could consider the potential for a Local Service Agent (LSA) model in some of its regional depots in order to increase productivity in its regional areas.

Detailed analysis must be conducted to confirm the feasibility of such a model, however, prima facie; there would appear to be a possibility of significant cost savings for Essential akin to what Powercor achieved following privatisation in the 1990s. In our view, the differences in depot management approach likely explains some of the productivity gap between Powercor and Essential.

4.1 Essential's regional depots

Essential Energy's distribution network is divided into five regions: north coast, northern, south eastern, southern and far west (see Figure 9) and covers over 700,000km^2.[87] Essential operates 112 local depots[88] spread over NSW which act as staging points for network maintenance and emergency response.[89] Of these 112 local depots, approximately half have less than 15 employees.[90]

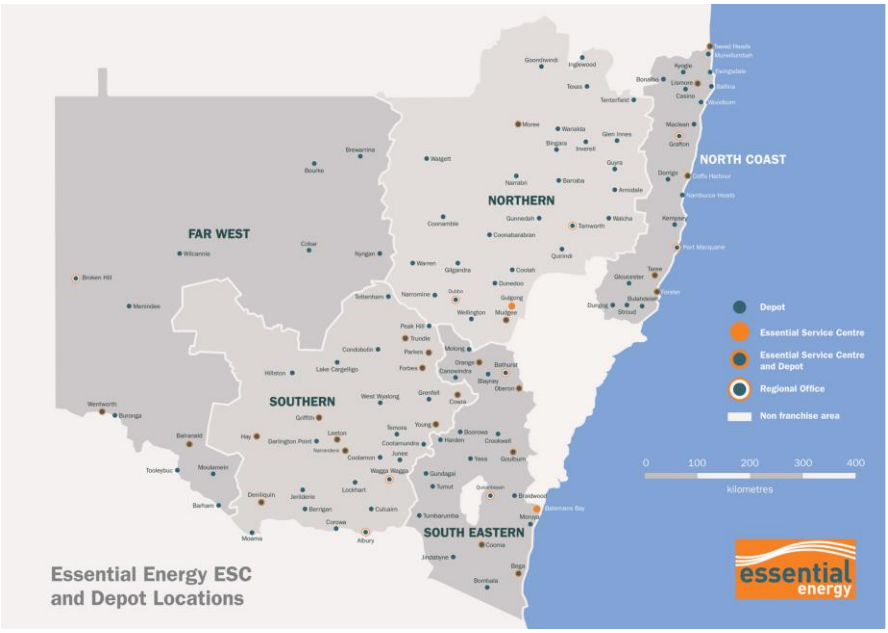
[87] Essential Energy, *Essential Energy Revised Regulatory Proposal*, January 2015.

[88] Essential Energy, File note of meeting with AER, Deloitte and Essential Energy on 17 September 2014.

[89] Essential Energy, *Network Management Plan*, April 2014, p.10.

[90] Essential Energy, File note of meeting with AER, Deloitte and Essential Energy on 17 September 2014.

Figure 9 Essential Energy – map of depots, offices and services centres in 2014



Source: Essential Energy, Network Management Plan, 2014, p.7.

Essential has highlighted its low customer density and dispersed, small depots as barriers to economies of scale and efficiency improvements.[91] In considering the impact of these factors on Essential's labour costs, we have conducted some research into Victorian rural distributor Powercor, which implemented privately owned depots, known as LSAs, following privatisation in the 1990s. Our research has drawn on the experience of parties who are familiar with the model and were involved in its establishment.

4.2 Powercor's experience

Prior to the introduction of the LSA model, Powercor owned depots in regional centres, major towns and a number of smaller communities in Western Victoria, which locations and staffing arrangements it had inherited from the pre-privatisation era, when networks were owned by the State Electricity Commission of Victoria. Small depots were staffed around an eight person minimum roster, with a minimum of two staff members rostered on at any one time. Some depots faced periodic shortages of staff, during which resources were drawn from neighbouring towns as required to meet peak workload or to support availability rosters.

The driver for change was a need for increased cost efficiency following privatisation. Powercor conducted analysis of the workload of smaller depots close to major towns and identified a number of areas where depots could be closed altogether without adverse outcomes, and sought to implement outsourcing in some areas where a presence was still required. In the majority of the smaller regional areas, depot staff carried out metering and servicing, customer connections/reconnections and responded to faults, with very little augmentation or growth related projects. Powercor also recognised that a number of core

[91] Essential Energy, *Revised Proposal Attachment 7.6,* p. 3.

tasks could be carried out utilising single person work practices or supported by a second person with fewer qualifications, rather than two technicians. Response times were a major consideration, with one hour's drive considered a reasonable maximum for most depots to respond to faults.

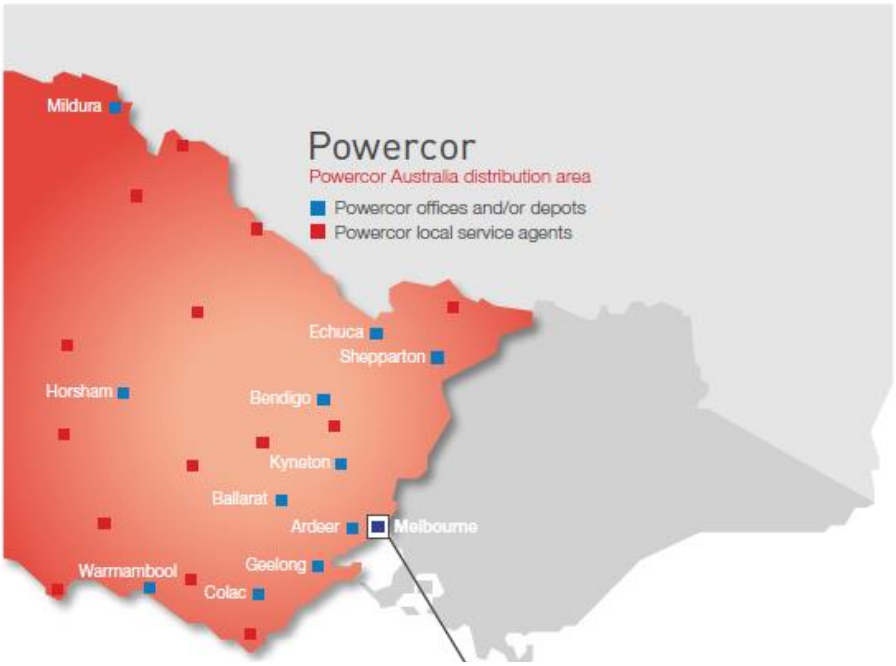
After identifying four test sites for the LSA model (being found small towns in regional Victoria), Powercor publicly advertised for expressions of interest and also directly approached the existing depot staff and local electricians, seeking expressions of interest from them for taking over the depot's workload on a contract basis. After a formal selection process, the Powercor depots at the four test sites were closed, with those existing workers not involved in the LSA offered redundancies or relocation packages to other Powercor depots in major centres.

Powercor supported the early LSAs by providing business and financial management training; however no assets (depots, vehicles, and equipment) were transferred to the LSAs without payment. Initially, the LSAs were mostly run as open-book businesses, with Powercor reviewing their financial status annually. LSAs were paid based on agreed unit rates and later added both construction and maintenance work packages. A retainer base was also established which has been progressively wound back as both the LSAs and Powercor have grown more confident in the arrangement. Where LSAs were taken over by incumbent depot staff, Powercor also encouraged them to seek other similar business opportunities, such as local electrician work to improve their business sustainability.

Today, as outlined in Figure 10, Powercor continues to operate 12 regional depots and has a network of 14 LSAs, some of which have common owners, but many of which compete among each other for work packages. LSAs are fully qualified to work on lines and operate on the network. For emergency work, LSAs travel to support the Powercor depots and vice-versa, as required.

Powercor continues to provide all equipment (cross arms, conductors, meters), retaining its economies of scale in equipment purchase. LSAs are contracted on agreed rates for five year period, through competitive processes. Packages of work are competitive in terms of total cost (hours per job).

Figure 10 Powercor – Depots and LSAs in 2015



Source: CitiPower and Powercor Customer Charter, p.4.

Although it is difficult to quantify the impacts which have occurred over the period since 1997, it is clear that the LSA model has increased the operational efficiency of Powercor's regional network areas. These efficiency outcomes result from:

- Reductions in the absolute number of depots and sites
- Reductions in staff per depot, with more flexibility in rostering
- Cultural change, driven by the small business incentives to reduce costs. Once the LSA model was established, significant efficiencies were identified and achieved in a range of existing processes, driven by a more cost-conscious approach and the need to reduce overtime.

We understand that AusNet Services also implemented a similar model as Powercor, however we have not reviewed that model.

4.3 Applicability of Powercor's LSA model to Essential

Essential's Revised Proposal suggests that the AER's draft decision to reduce its opex would require it to close and consolidate 20 to 30 depots to reduce labour and property costs.[92] It has submitted that although this would reduce costs, it would result in longer travel times for employees and therefore reduced productivity, reduced customer service standards, and loss of local knowledge such as access roads into properties and network

[92] Essential Energy, Revised Regulatory Proposal Attachment 1.1 – Statement of Gary Humphreys, paragraph 138.

configuration.[93] We have considered these comments in relation to the LSA model and Powercor's efficiency savings in developing this Addendum.

Given that many of the key elements that existed in Powercor prior to the implementation of the LSA model currently exist in Essential (low labour cost efficiency, many small rural depots[94]) it is not unreasonable to expect that Essential would realise similar benefits from implementing a LSA model. Essential was formed as an amalgamation of small council networks, similar to Powercor, and therefore the location of many of its sites and depots remains a function of historical arrangements.

In its Revised Proposal, Essential provided details on its current outsourcing and plans for future outsourcing, [redacted] We note that one of the benefits of the LSA model is that it relies on existing (or potential) other small business activities to supplement network services, such that opportunities for private sector involvement are increased.

Essential also provided information on the travel times between depots for emergency response services, and the challenges of servicing outages in vast terrain. [redacted] data on the reliability of Essential's network (see Figure 11 and Figure 12) suggests it has a low level of reliability with both the length (SAIDI) and frequency (SAIFI) of unplanned network interruptions being greater than the NEM average. This will be largely due to the nature of its network,[98] but in our view, reliability concerns should not prevent Essential investigating alternative models for the management and ownership of its regional depots. We also note that the LSA model did not result in detrimental service standard outcomes for Powercor, in fact, improvements in service standards were realised at the same time as costs were reduced.

[93] Ibid, paragraphs 140- 143.

[94] 'Essential already bring crews in from neighbouring depots to get jobs done safely and efficiently' (Essential Energy, *Essential Energy Revised Regulatory Proposal*, January 2015, p 62.)

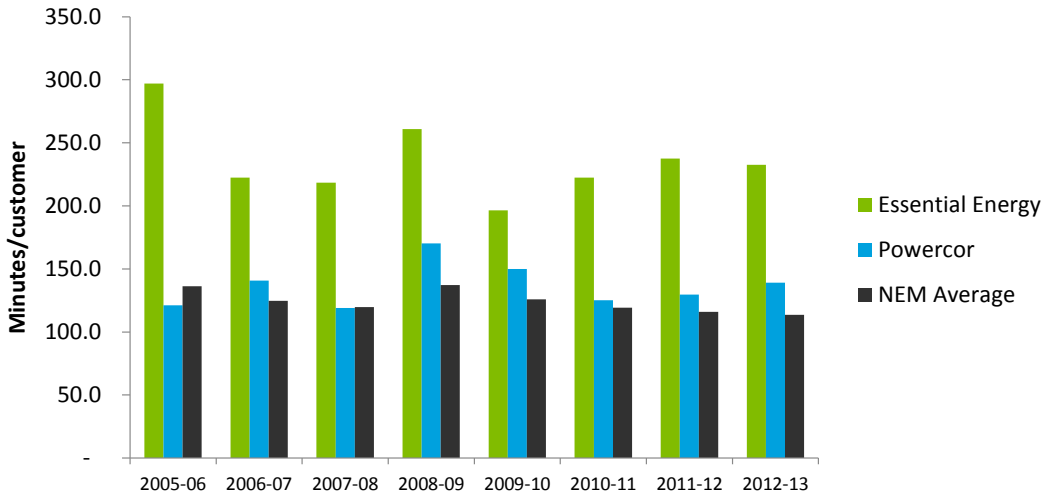
[95] Essential Energy, *Essential Energy Revised Regulatory Proposal*, January 2015, p 62; *Attachment 7.6 [CONFIDENTIAL] Productivity*, January 2015, p. 13.

[96] Ibid, p. 15.

[97] Ibid, p. 4.

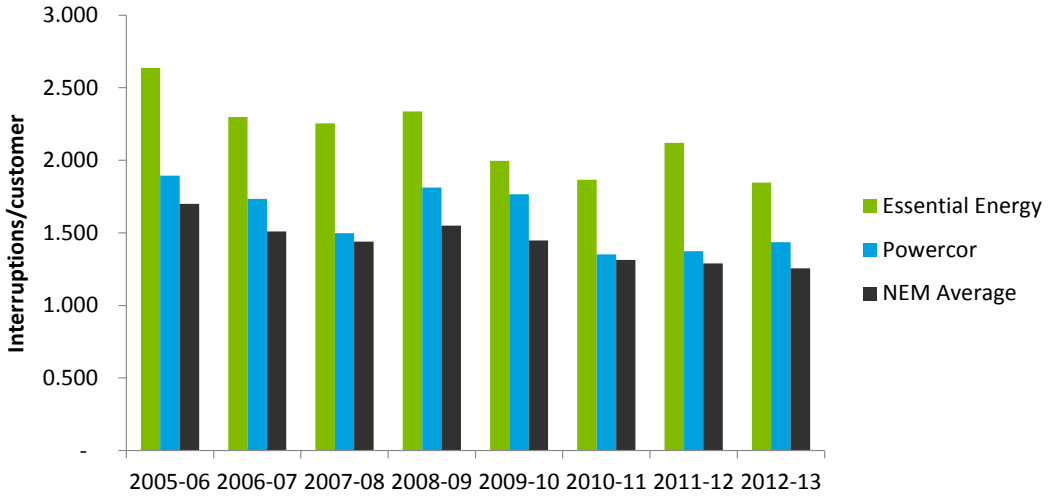
[98] As a result of both its expansive network and low customer density – Essential Energy, *Essential Energy Revised Regulatory Proposal,* January 2015, p. 19.

Figure 11 Whole of network unplanned SAIDI excluding excluded outages (exclusive of MEDs)



Source: Economic Benchmarking RIN 2014. Note: This graph is in financial years, but the Victorian DNSPs report on the basis of calendar years. Note that the Victorian DNSPs have not yet reported their 2014 data.

Figure 12 Whole of network unplanned SAIFI excluding excluded outages (exclusive of MEDs)



Source: Economic Benchmarking RIN 2014. Note: This graph is in financial years, but the Victorian DNSPs report on the basis of calendar years. Note that the Victorian DNSPs have not yet reported their 2014 data.

In its Revised Proposal, Essential suggested that the 'open market' is constrained from providing cost effective alternate sources of labour in its regional locations, considering the absence of long term work programs.[99] We note that the Powercor LSA model draws on local small business opportunities, including hardware businesses, local electricians and tradespeople), such that gaps in network service delivery are able to be productively filled with other work.

[99] Essential Energy, *Revised Proposal Attachment 7.6*, p. 3.

4.4 Conclusion

Essential is the longest electricity network in Australia with one of the lowest customer densities, which means it legitimately faces uniquely higher costs than denser, and particularly urban, networks. However, rural DNSP Powercor's experience in reducing costs in its regional depots through the LSA model suggests that a similar approach could offer significant efficiencies for Essential, and in our view, the differences in depot management approach likely explains some of the productivity gap between Powercor and Essential.

5 Efficiency programs and stranded labour costs

5.1 Stranded labour

Endeavour's Revised Proposal suggested that its stranded resources are primarily a function of the Blended Delivery Model which is increasing capex outsourcing.[100] It also stated that '*As it currently stands, however, Endeavour Energy does not have any underutilised or stranded resources, owing to the success of the current workforce transformation strategies.*'[101] This contradicts information provided by Endeavour and noted in our 2014 Report [redacted],[102] however it is possible that since the stranded labour was identified in March 2014, Endeavour has managed to reduce staff numbers through voluntary redundancies and redeployment through its Mix and Match Programs. We note that this does not affect our findings that the base year labour costs were inefficient and reflected a higher number of employees than is required going forward.

[redacted]

[redacted]

[100] Endeavour Energy, *Revised Regulatory Proposal attachment 6.01*, p. 16-17.

[101] Ibid, p. 17.

[102] [redacted]

[103] Ausgrid *Regulatory Proposal Attachment 6.01* p. 9.

[104] Ibid, p. 29.

[105] Ibid, p. 5.

[106] Ausgrid, *Revised Proposal Attachment 5.05: Strategic Delivery and Workforce Plans*, p. 9.

[107] Ibid, p. 8.

[redacted] Ausgrid's COO Statement also contained some new information on total employees (headcount) as at the end of December 2014. A comparison of this new data with the information we received in August 2014 suggests that the majority of redundancies in late 2014 occurred within the Corporate Services division of Ausgrid.[110] It also indicated that Ausgrid had redeployed 197 retail employees into its business following the expiry of the Transitional Services Agreement.[111]

Essential did not provide any additional information on its stranded labour in its Revised Proposal, however it did provide updated FTE numbers in its COO Statement which was attached to its Revised Proposal.[112] The updated FTE data was categorised in a different way to the headcount information we received during our 2014 review, which makes a comparison of outcomes since August 2014 difficult.[113]

While the Revised Proposals have argued that the reductions in employee numbers resulting from the current NNSW efficiency programs are associated with decisions to move to greater outsourcing, or the recent drop in energy consumption and peak demand, or the impact of the sale of the retail business, this does not acknowledge the broader intent of the NNSW reforms to improve the efficiency and productivity of the DNSPs.[114] NNSW's intentions are aligned with the quotes above expressing broader concerns by the NSW Government, Productivity Commission and other organisations about the productivity of the NSW DNSPs' and particularly their workforces.

5.2 Efficiency programs

As part of the NSW DNSPs Revised Proposals to the AER, it has been highlighted that efficiency gains were made prior to 2012-13 as part of the DNSPs' efficiency programs.[115] In support of these statements, Ausgrid and Endeavour have provided new, updated information on their business and NNSW efficiency programs. In particular, Endeavour provided new information on the impacts of its efficiency programs on scheduling, designing capex projects and delivery.[116] This information confirmed that savings have been realised since the 2012-13 base year, which was a finding of our 2014 Report.

[108] Ibid, p. 8.

[109] Ibid, p. 13.

[110] Ausgrid, Revised Regulatory Proposal Attachment 1.02 – Statement of Chief Operating Officer of Ausgrid, January 2015, paragraph 121.

[111] Ibid, paragraph 137.

[112] Essential Energy, Revised Regulatory Proposal Attachment 1.1 – Statement of Gary Humphreys, paragraph 95.

[113] Ibid, based on a comparison of data provided in Essential's response to AER Information Request 015 Question 9. We note that the new information provided by Essential in its COO Statement appears to contain an error – the total FTE numbers in the 'Breakdown of full time equivalent employees' table do not reflect a sum of the total of all divisions, with 50 FTEs missing from the Network group.

[114] For example, *NNSW Strategic Plan 2014/15 to 2019/19*.

[115] For example, Endeavour Energy, *Revised Proposal Attachment 6.01,* pp. 26-27.

[116] Endeavour Energy, *Revised Proposal Attachment 6.01,* Appendix B.

In its COO Statement, Endeavour has presented further information on efficiencies it has managed to achieve in standard maintenance activities in June to August 2014, measured against a baseline of July 2010 to March 2012.[117] The reported employee time savings as compared to the baseline average are significant:

- Maintenance of MD4 Switchgear – 23.4%
- Routine maintenance of an air break switch – 21.9%
- Low voltage crossarm replacement – 8.3%
- High voltage crossarm replacement – 17.1%
- Pole replacement – 17%
- Distribution transformer replacement – 21.2%.

An appendix to Endeavour's COO Statement presents a comparison of different teams carrying out emergency works, with a 'rapid response' team demonstrated as 30% more efficient than the 'regions' team, resulting in a $600,000 saving over 12 months.[118]

These opex savings are significant, and stem from the 'standard job analysis' that Endeavour has undertaken for the last several years, focusing on improving performance and efficiency.[119] In relation to the base year, the period of analysis chosen is a baseline close to the base year, with efficiencies realised as at mid-2014. This further supports our argument that Endeavour's base year expenditure does not reflect the full realisation of efficiencies it has achieved in recent years.

Essential has provided some updated information regarding its efficiency programs, but has not provided any other new information.[120]

Using the new information provided on efficiency programs conducted by Endeavour and Ausgrid, we have undertaken some analysis of the timing of reductions in FTEs (see Figure 13). This analysis highlights that the NSW DNSPs managed to achieve significant reductions in labour costs through reducing the number of staff. However, most of the reductions shown in Figure 13 take place after the base year, 2012-13. The scale and speed of these reductions suggest that there are still cost efficiencies to be realised – this point was made in our 2014 Report and was not challenged by the DNSPs[121] in their Revised Proposals.

[117] Endeavour Energy, Revised Regulatory Proposal, Attachment 1.08 – COO Statement, paragraph 105.

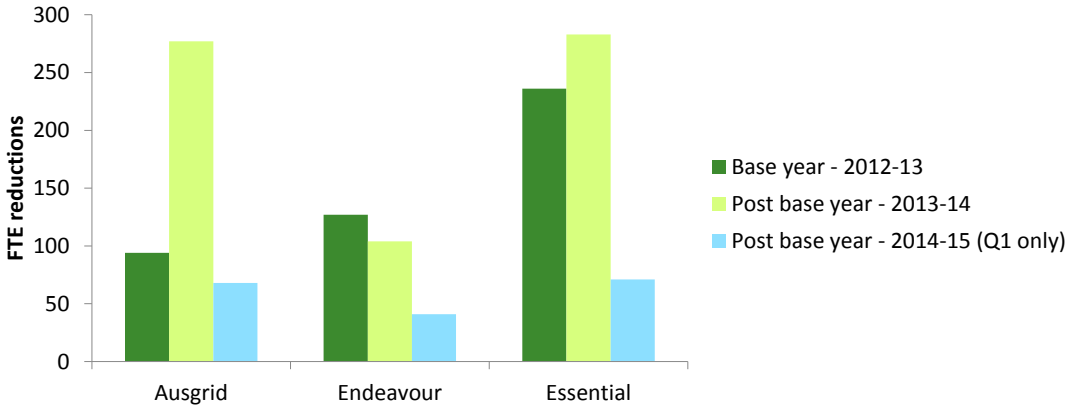
[118] Ibid, page 477.

[119] Ibid, paragraph 104.

[120] Essential Energy, *Essential Energy Revised Regulatory Proposal*, January 2015, p.195.

[121] Endeavour pointed out an error in our interpretation of some data relating to efficiency programs, however, ultimately confirmed our hypothesis that there are further efficiency gains to be made.

Figure 13 Non TSA FTE reductions in and after base year (capex and opex)



Source: Ausgrid, *Revised Regulatory Proposal Attachment 6.04 – Transformation in the electricity distribution network industry*

In our 2014 Report, we noted that NNSW had provided a breakdown of actual and forecast savings for opex and capex for each of the NSW DNSPs. As part of Endeavour's Revised Proposal to the AER, it was highlighted that we had interpreted the forecast efficiencies, provided by NNSW, as cash savings when in fact they should be reviewed and considered in context of the base step trend model.[122] We have reviewed the information and agree that the forecast efficiency gains show opex savings much lower in the base year and, in fact, show opex increases relative to the base year in 2013-14 and 2014-15. These forecast opex increases are likely, in part, to be associated with the transition of some capital program staff into opex, due to the reduced capex forecast.

Despite the magnitude of capital program reductions outweighing reductions in opex, in its Revised Proposal, Endeavour confirmed that 'it is expected that underlying cost structure improvements will continue' indicating an understanding that there are still operational cost efficiencies to be realised.[123]

Efficiency programs implemented as part of the NNSW reform packages primarily target reductions in capital expenditure. Despite this focus on capex, many of the labour force inefficiencies that were identified in our 2014 Report apply to both capex and opex. Some of these inefficiencies/opportunities for increased efficiency include:

- Outsourcing
- Cultural challenges
- Flexibility
- Overtime.

The NSW DNSPs indicated they are seeking to address these sources of inefficiency during the 2014-19 regulatory period. Given that efficiency gains in the above areas apply to both capex and opex and there was relatively small reported efficiency gain in opex, it is likely that some opex labour efficiencies are being masked by employees shifting from the capex side of the business to the opex side as the capital program of works wind down.

[122] Endeavour, *Revised Regulatory Proposal, Attachment 6.01*, p 24.

[123] Ibid, p. 24.

Conclusions

The NSW DNSPs have made significant cost savings as a result of efficiency programs and are expected to continue to make reductions. However, the timing of these savings, taking place both before, during and after the base year, 2012-13, indicate that the NSW DNSPs were not efficient in the base year and are yet to realise all current opportunities for efficiency.

6 Our approach

6.1 The AER's benchmarking

A number of the Revised Proposals suggested that we did not challenge the AER's benchmarking results, using the benchmarking as a starting point for our analysis as an unquestioned fact.[124]

We are aware that the benchmarking undertaken by the AER has been criticised by the DNSPs in their responses to the Draft Decision.[125] We have not reviewed the benchmarking in any detail, and nor have we been asked to. Indeed, from industry benchmarking work we undertook in 2013 and 2014 we are aware of the challenges it poses. Nevertheless, we consider that given the magnitude of the difference between the calculated productivity of the NSW DNSPs (particularly Ausgrid and Essential) and their peers it is reasonable to conclude that over the period considered by the AER that the NSW DNSPs were less productive than their peers.

6.2 Selective quoting

A number of the Revised Proposals were critical of our use of quotes from the NNSW CEO Mr Vince Graham in our 2014 Report. It was suggested that the quotes had been taken out of context.[126]

The quotes included in our 2014 Report were presented as they were relevant to our discussion that the NSW DNSPs were undergoing significant labour reform but also restricted in their workforce flexibility by EBA clauses.

In their Revised Proposals, the DNSPs have also acknowledged that these two factors were the subject and purpose of Mr Graham's articles. For example, Essential noted that:

> *'What Mr Graham's public comments also included was an acknowledgment of the difficulty in rolling back legally binding terms and conditions of employment embedded in certified agreements under the Fair Work Act.*
>
> *Mr Graham's article was a transparent acknowledgment that continuing labour reform was necessary and set a pathway to progressively achieve that reform.'*[127]

We note there were a significant number of media articles on the subject of the NSW DNSPs' labour reforms and union negotiations published whilst we were undertaking our analysis, with material written by the NNSW CEO, NSW Treasurer and union

[124] For example, Endeavour Energy, Revised Proposal Attachment 6.01, p. 13.

[125] For example, see Attachment 1.05 of Ausgrid's submission to the Draft Decision which is a report by Frontier Economics entitled *Review of AER's econometric models and their application in the draft determination for Networks NSW*

[126] For example, Essential Energy, Revised Regulatory Proposal, p. 193.

[127] For example, Essential Energy, Revised Regulatory Proposal, p. 193-4.

representatives, as well as investigative journalists. The suggestion that we have selectively quoted the NNSW CEO overlooks the quantity of arguments and evidence that is available on the issues we have identified. The quotes and the way they were used in our report is consistent with our interpretation of the message that Mr Graham was seeking to regarding the impact of restrictive EBA clauses on the DNSPs' workforce flexibility and overall efficiency.

6.3 Lack of empirical data analysis and evidence

The DNSPs' Revised Proposals have suggested that there was a lack of empirical data analysis in our 2014 Report, such that the analysis could not be relied upon and does not meet an evidentiary standard.[128]

We acknowledge that we did not undertake a detailed analysis of DNSP wages in the NEM, and are grateful for the analysis subsequently undertaken by the DNSPs' consultants in response to our 2014 Report. We refer to this analysis in section 2.3.

Although the 2014 Report did not present analysis of the RIN data on ASLs and Labour costs2014 Report this data informed our findings. This addendum presents some of that data, in sections 2.3 and 2.4.

We note that in the NSW DNSPs' Revised Proposals new information has been presented which falls within the remit of the questions and information requests the AER issued during our review, particularly referred to by Arup in a report for Ausgrid submitted as an attachment to its regulatory proposal, discussed in chapter 3.

However, our 2014 Report presented a large volume of evidence that the DNSPs' labour costs were not efficient in the 2009-14 regulatory period, including:

- Details the DNSPs' stranded labour towards the end of the 2009-14 regulatory period
- Details on the ongoing NNSW and DNSP efficiency programs, in particular achieved and expected future savings
- Evidence that the NSW DNSPs had realised some significant efficiency gains from the limited amount of outsourcing they had undertaken and that as a result, they were seeking to increase the level of outsourcing going forward
- Evidence of significant cultural challenges within the DNSPs which drive inefficiency, which are linked to EBA conditions and are being addressed through comprehensive cultural change programs commenced late in the 2009-14 regulatory period
- Analysis of clauses in the DNSPs' EBAs which highlight the inflexibility in their labour forces, particularly with regards to involuntary redundancy
- Information on the DNSPs' use of overtime, and evidence of excessive average Gross to Base Salary levels.

[128] For example, Essential Energy, Revised Proposal Attachment 7.6, p. 3.

6.4 Generalised findings

Endeavour expressed concern that our 2014 Report did not adequately acknowledge the extent to which it had moved to improve its labour cost efficiency earlier than Ausgrid and Essential.[129]

However, we are of the view that our report did clearly identify and acknowledge Endeavour's achievements and noted they were likely to have been more efficient towards the end of the regulatory period than the other two DNSPs.[130] [redacted]

[redacted]

[129] Endeavour, *Revised Regulatory Proposal, Attachment 6.01*, p. 13.

[130] Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, October 2014, p. 58.

[131] Ibid, p. iii and 40.

[132] Ibid, p. 26

[133] Ibid, p. 33.

[134] Ibid, p. 39.

[135] Ibid, p. 57.

[136] Ibid, p. 57.

[redacted]

6.5 Our approach to information collection

The DNSPs' Revised Proposals have suggested that our approach to collecting information and engaging with the DNSPs was not adequate to produce the findings in our report.[142]

We acknowledge the tight timeframes under which we carried out our analysis, which are specified in the National Electricity Rules. However, we consider the research and analysis we carried out was sufficient to identify inefficiency in the labour costs of the NSW DNSPs.

We were provided with a significant volume of information in response to questions (over 300 documents), which enabled us to identify areas of inefficiency within the DNSPs' workforces.

In addition, we conducted detailed interviews with senior staff of the DNSPs and NNSW, (4 hours with Endeavour, 3 hours with Essential, 2 hours with Ausgrid and 2 hours with NNSW). The interviews with the DNSPs were very informative discussions which gave us an understanding of the magnitude of the issues we identified in documentation.

[137] Ibid, p. 59.

[138] Ibid, p. 60.

[139] Ibid, p. 61.

[140] Ibid, p. 63.

[141] Ibid, p. 64.

[142] For example, *Ausgrid, Revised Proposal*, p. 156.

We note that the information provided by NNSW and the DNSPs, as part of their original regulatory proposals, on the efficiency programs was particularly instructive as to the areas of inefficiencies in the 2009-14 period. In addition, the material provided by NNSW on the Network Reform Program during our review was informative as to the scope of the labour force changes currently being implemented by the NSW DNSPs.

Limitation of our work

General use restriction

This report is prepared solely for the use of the Australian Energy Regulator under our contract dated 4 June 2014. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose of analysing the labour resources used by NSW DNSPs to inform the AER's decision on their revenues for the 2014-19 regulatory period. You should not refer to or use our name or the advice for any other purpose.

While this Addendum is, in part, based on public information it also contains a range of information which has been provided to the AER by the DNSPs and NNSW on a confidential basis. Besides containing commercially sensitive information, the public release of this information could materially harm the interests of the DNSPs in EBA negotiations. We therefore emphasise that the un-redacted version of our report is prepared solely for the use of the AER and must not be distributed beyond the AER, NNSW and NSW DNSPs. It is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity.

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