4 January 2010

Mr Steve Edwell
Chairman
Australian Energy Regulator
Level 35, 360 Elizabeth St
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Dear Steve

Benchmarking and AER Electricity Network Determinations

Following your recent discussions with our Chairman, Mr. Mark Grenning and a presentation that we commissioned by Mr. Bruce Mountain on this matter at the recent AER public hearings on the Ergon Energy, Energex, and ETSA Utilities draft determinations, the EUAA undertook to write to you to provide a more detailed analysis of the AER's approach to benchmarking. This letter, and the appendix to it, contains that analysis. We would welcome further engagement on this important matter between the AER and the EUAA.

Our analysis builds on previous submissions we have made to the AER during the recent New South Wales and Transend reviews, and the current Ergon Energy, Energex and ETSA Utilities reviews.

We attach great importance to benchmarking because we see in it the ability to establish efficient expenditure levels by regulated energy network businesses, with much greater certainty. The benefits of benchmarking are recognised by a number of Australian regulatory authorities. For example, the recently published draft report by IPART uses the "efficient Standard Retailer" concept extensively to calculate allowable increases in NSW retail prices. As you would be aware, several overseas and jurisdictional regulators have made significant use of benchmarking when regulating energy and other monopoly businesses. In his presentation at the pre-determination conferences, Bruce Mountain described Ofgem's approach to benchmarking. We commend that description to you, and would welcome discussion on how to apply it in Australia.

We are extremely concerned that in the absence of robust benchmarking, the AER's reliance on so-called "bottom-up" approaches could well result in rewarding failure rather than success. There is strong evidence from the ACCC/AER's regulation of transmission networks, and now also of distribution networks, that the least efficient network businesses are being rewarded with the largest expenditure increases. This has come at the expense of our members, and we believe that it is not in accord with the National Electricity Objective.

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Energy users are facing what the EUAA has described as a “perfect storm” in relation to rising energy costs on multiple fronts at the one time, eg network prices, wholesale electricity, carbon, renewable energy targets and gas. Increases in network charges are foremost in this. As I am sure you know, benchmarking is one of the key means that energy users have of re-assurance that they are only paying for the efficient costs of network services. This becomes even more important at a time when network charges are under significant upward pressure. If these costs are not efficient, they will further erode the competitiveness of Australian businesses.

For this reason, we have advocated that the AER should pay greater attention to benchmarking. As you know from our previous submissions and discussions, we are concerned that the AER has publicly stated that benchmarking is just a “long term proposition”. The most recent benchmarking of opex in the Energex/Ergon and ETSA decisions, whilst a welcome first step towards the use of benchmarking by the AER, still falls significantly short of the minimum standard that the Rules require and the type of benchmarking that we believe is needed. Additionally, it is particularly concerning that there has apparently been no effective benchmarking of capex. Since more than 80% of expenditure is capitalised, the AER’s failure to have regard to benchmarks for such expenditure is particularly worrying.

I would like to, again, stress the desire of our members for constructive engagement with the AER on this and all matters where our paths cross. There is a long history to the benchmarking debate in Australia, and from this there is evidence to suggest that the least efficient distributors have typically – and quite understandably - been the staunchest opponents of benchmarking.

We welcome the commitments you made at the pre-determination conferences in Adelaide and Brisbane to work with energy users to promote the implementation of benchmarks and would like to see further advancement of this before the current reviews are finalized. We look forward to being able to support your efforts to make greater use of benchmarking as provided for in the Rules in these and all future reviews.

Finally, we would be grateful if this letter and the appendix could be placed on the public record as a submission to the AER in the context of the AER’s review of distribution prices and revenues in Queensland, Victoria and South Australia.

We look forward to your response to this letter and the appendix on how energy users may be able to become more effectively engaged in supporting the AER in the effective implementation of benchmarks

Yours sincerely

Roman Domanski
Executive Director

Appendix: EUAA Critique of the AER's use of benchmarking and the Ergon/Energex and ETSA draft decisions

This short paper provides the EUAA's views on benchmarking in the context of AER regulatory reviews of energy network businesses. There are two parts to this appendix. The first part sets out our views of what the National Electricity Rules requires the AER to do on benchmarking. The second part is our critique of benchmarking in the Energex/Ergon and ETSA draft decisions.

1. What the Rules requires the AER to do on benchmarking

Chapter 6 and 6A requires the AER to "have regard" to the " ... benchmark opex / capex that would be incurred by an efficient Distribution Network Service Provider over the regulatory control period."

We draw four things from this:

Firstly, we interpret the obligation to "have regard" as one that requires the AER to develop benchmarks, show that it has considered the information derived from this, and then acted upon that information in reaching its decision. Acting upon that information means, we suggest, that the AER expressly and quantifiably shows how it took account of that information in setting expenditure allowances. For example, if the benchmarking shows that a distributor's allowed expenditure will be measurably far from the efficient benchmark, then we expect that the AER will act upon this information. It should do this (unless there was good reason not to) by providing that distributor with a reduced expenditure allowance in line with the AER's defined efficient capex/opex expenditure benchmark.

Contrary to the inference in the AER's Draft Determination Reports on Energex, Ergon and ETSA, we are not suggesting that the AER should rely entirely on benchmark information in the determination of expenditure allowances, and neither do we suggest that the AER *must* alter the allowed revenue decision in light of the benchmark information. However, if this benchmark is established as the Rules require (i.e. efficient expenditure), we consider it will generally be appropriate for the AER to act on the information provided by that benchmark.

Although benchmarking is one of 10 factors, the Rules makes no provision for it to be accorded any lesser importance than the other nine. We believe it has been included in the Rules precisely because it was seen to be important to have it there by the authors of the Rules, that is the MCE and AEMC.

Secondly, the reference to benchmark opex/capex is a reference to a high level aggregate measure of expenditure. The development of this benchmark may include benchmarking elements of expenditure – such as benchmarking unit costs – but must also include benchmarking the aggregate cost classifications "opex" and "capex".

The rationale for this is that much of the expenditure of a business is substitutable. An obvious and well-known instance of this is the ability to substitute demand management expenditure for investment in infrastructure.

We believe our understanding of this is supported by the AEMC's description of benchmarking during its Chapter 6 review – and the submissions of interested parties on benchmarking – as part of that review.

Thirdly, the Rules refer to benchmark efficient capex and opex. We suggest that the AER therefore needs to specify what the efficient benchmark is. Typically, benchmarks involve the specification of “frontiers” whether the methodology used is a stochastic frontier analysis, data envelopment analysis, or a statistical regression analysis. We interpret the requirement to establish the benchmark efficient opex/capex as a requirement on the AER to define what this means, most likely in the form of an efficiency frontier.

Finally, the expenditure to be benchmarked is the proposed expenditure in the coming regulatory period, not historic expenditure (unless of course such historically benchmarked expenditure is used directly in assessing the efficient expenditure to be allowed in the coming period).

2. Our critique of the AER’s benchmarking in the Energex, Ergon and ETSA decisions

Taking the understanding of the obligations of the AER under the Rules, as set out above, we have examined the benchmarking that the AER undertook in the Energex, Ergon and ETSA decisions. For ease of exposition, we have set out our critique, corresponding to the four issues described in the previous sub-section.

Area 1: “Having regard”

We noted above, our view that “having regard” means that the AER is required to act upon the benchmark information that it has had regard to, and explain how it has taken account of that information.

We are concerned that the AER has not done this. In the draft decision, the AER concluded that benchmarking is just one of ten factors that it is required to have regard to and hence little more than a “top-down test”. This seems to be an inappropriate diminution in the proper role of benchmarking and for the reasons described above, we do not consider that this interpretation is consistent with the AER’s obligations under the Rules or accepted good practice regulation both here and overseas.

Notwithstanding our disagreement with the AER’s stated interpretation of the Rules, we are also concerned that, in practice, the AER has failed to “have regard” (as we take this term to mean) against even the lesser requirement of a “top-down test” (as the AER takes this term to mean). Specifically, in the case of the Ergon draft decision, the AER dismissed the fact that Ergon was lagging far behind what the AER has implicitly defined as the opex efficient frontier. The AER has simply dismissed this on the basis that the accounts had been “audited”, the “prevailing economic conditions” and “changes in accounting practice”. It is not clear why this justifies dismissing the benchmark results?

Area 2: Benchmarking of capex and opex

We note in the ETSA draft decision, that the AER did mention some ratio analysis that had been undertaken for capex, and the AER said that this ratio analysis meets the requirement for benchmarking under the Rules. For the avoidance of doubt, for the reasons discussed above, and as we have submitted to the AER previously, we do not agree that this satisfies the benchmarking requirements under the Rules.

Area 3: Definition of the benchmark

We are concerned that the AER has not met the Rules obligation to define the benchmark:

1. Firstly we note that the AER seems to have expressly sought to avoid defining a benchmark. Instead it has defined one business as more efficient or less efficient than another, relative to a linear regression that, as far as we can tell represents the average “efficiency” of the dataset. This understanding of the AER’s approach was

confirmed in discussions between Bruce Mountain (our consultant) and your Mike Buckley.

2. Although the AER has expressly avoided defining a benchmark, the least-squares linear regression, is the line that the AER has used to make statements of relative efficiency and hence by implication must be the AER's definition of the efficient frontier. We suggest that the regression line that the AER has chosen – which cuts the x-axis at a positive intercept – is an implausible definition of efficient opex: an efficient benchmark that concludes that a business incurs no operating expenditure to serve customers and operate networks, is implausible.
3. We are concerned by apparent missing elements in the AER's development of the benchmark. Specifically, there is no obvious evidence that the cost drivers have been tested, or that the parameters of the composite scale variable have been tested, or that the most appropriate regression has been chosen. It would also be helpful to specifically identify data-sources and describe any data normalisation or cleansing that has been undertaken.

Area 4: Benchmarking expenditure for the coming regulatory period

The AER's benchmarking was based on expenditure for the 2007/8 year. The AER stated that its intention in this was to establish the efficient opex for the first year of the coming regulatory period, and then to use detailed bottom-up analysis to decide the opex allowance. We suggest that this does not satisfy the requirement to establish the benchmark efficient expenditure for the coming regulatory period. To do this, we suggest that the AER should have used benchmarks to assess the distributors' opex for the coming period, not its historic opex.

Notwithstanding this, we suggest that, in the absence of this, it would be reasonable to use historic expenditure benchmarks in assessing future efficient expenditure allowances, if such benchmarking translated in some direct or meaningful way to the allowed expenditure for the coming regulatory period. However, our understanding is that this is not what the AER has done. Specifically, there seems to be no discernable link between the historic cost benchmarking that the AER has done, the conclusion that the AER has drawn from it, and the opex that the AER has allowed for the coming regulatory period. This would not seem to satisfy the Rules?