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EnergyAustralia®

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Mike Buckley
General Manager
Network Regulation North Branch
Australian Energy Regulator
GPO Box 3131
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By email to: QldSAdistribution@aer.gov.au

Dear Mr ~~Buckley~~, Mike,

EnergyAustralia submission on AER draft determinations for Queensland and South Australia

EnergyAustralia welcomes the opportunity to make a submission on the AER's draft determinations for Queensland and South Australian distributors. Our submission focuses on the manner in which the AER has used benchmarking as part of its assessment of the expenditure allowances proposed by the distributors. We support the AER's position that the role of benchmarking is to test the 'reasonableness' of a distributor's detailed expenditure proposals, and that it should not be used to set expenditure allowances. We further submit that the AER's current method to benchmarking operating expenditure does not lead to a sufficient test of the reasonableness of a distributor's proposal.

The issue of the appropriate role of benchmarking has been raised by user groups as part of the consultation process for the Queensland and South Australian regulatory determinations. For instance, submissions made by the Energy Users Association of Australia (EUAA) note that the AER is not making adequate use of benchmarking when making its regulatory decisions. EUAA's submission highlighted comments made by the Chair of the AER, which suggested that the AER will be using benchmarking to test its bottom up conclusions, and not to set expenditure allowances. EUAA noted that the AER's statement:

> "....is entirely inconsistent with the specification of the AER's benchmarking obligations in the Rules. The Rules require the AER to have regard to the benchmark operating expenditure/ capital expenditure of an efficient distribution network service provider. The benchmarking stands alone and should be developed in accordance with the instruction of the Rules... There is no provision in the Rules for this activity to be used as a testing of bottom-up detailed conclusions or as a high level sense check"[1]

[1] Energy Users Association of Australia, *Submission to the AER on Energex and Ergon Energy Regulatory Proposals for the period 2010-2015*, 28 August 2009.

In response to these concerns, the AER noted in its draft decision for Queensland distributors that:

> "In particular, the EUAA seemed to be requesting that the opex forecasts be adjusted largely on the basis of benchmarking studies. However, the limitations of the benchmarking work, in terms of the size of the data set, discrepancies in opex definitions and differing regulatory arrangements for comparator DNSPs limits the use of the benchmarking results as a tool for justifying amendments to opex forecasts. The AER also considers the general limitations of benchmark analysis are recognised by the NER, as benchmarking is only one of ten factors that the AER must have regard to when assessing a DNSP's proposed opex forecast. The AER therefore considers that while benchmarking is a useful analytical tool, its use should be limited to a top down testing of more detailed bottom up assessment, informed by due consideration of each of the factors specified in clause 6.5.6(e) of the NER."[2]

EnergyAustralia supports the AER's approach to its obligations regarding benchmarking. The Rules require the AER to have regard to ten factors when making its decisions on whether to accept or reject the proposed operating and capital expenditure proposed by a distributor. In assessing the proposals against these factors, the AER is required to assess the material supporting a distributor's proposed costs. This may include any material that the distributor has submitted in regards to benchmark costs that would be incurred by an efficient distributor over the regulatory period, or any other benchmarking analysis the AER undertakes or has regard to.

EnergyAustralia considers there are strong policy reasons why the Rules require the AER to have regard to benchmarking as one of many relevant factors when assessing a distributors cost proposals. In particular, a key limitation with benchmarking is that the 'efficient' level of costs will vary between distributors, even if the underlying data is normalised. In a recent study commissioned by the AEMC, the Network Advisory Services[3] noted a number of factors that limit a meaningful comparison of expenditure, such as differences in:

- Operating environments in respect of geographic and climatic circumstances, and in terms of customer base and historic development.
- Legislative and regulatory obligations such as specific performance outcomes.
- Approaches to capitalising and expensing expenditure.

Despite these inherent limitations, benchmarking analysis can be a useful indicator of general levels of efficiency, and may identify areas for further investigation by the AER. If a distributor is outside a reasonable range for a particular indicator, this should provoke greater review of the reasons for that variance.

To illustrate the above point, consider a case where a distributor's maintenance expenditure was relatively higher than other distributors in the data set. This could be driven by a number of reasons, for example that the distributor needs to catch up on a backlog of maintenance, that its asset base is older than other distributors, or that it expenses rather than capitalises its refurbishment costs. It may also be the case that the distributor has not adopted prudent maintenance practices of other distributors, and that this is resulting in inefficient expenditure.

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[2] Australian Energy Regulator, *Draft decision – Appendices, Queensland Draft distribution determination 2010–11 to 2014–15*, 25 November 2009, p626

[3] Network Advisory Services, *Issues in relation to the availability and use of asset, expenditure, and related information for Australian electricity and gas distribution businesses*, August 2009, p3

This type of regulatory approach also provides a sanity check on the rigour of the benchmarking analysis. As discussed below, there is no 'right' method or equation to benchmarking, and different approaches will yield different conclusions. As such, it would be dangerous to rely solely on benchmarking to establish allowances, as the analysis may be based on a flawed method, inadequate data or over-simplistic assumptions.

As part of its consultation process for developing Chapter 6A Rules (the origin of the capital and operating expenditure factors), the AEMC cautioned against placing weight on unreliable or poorly applied benchmarking:

> "...the discretion provided in the Draft Rule for the AER to consider each of the criteria as far as relevant in a given case, means that the weight placed on any benchmarking information can be expected to reflect the perceived robustness and applicability of the particular analysis presented."[4]

The approach used by the AER to benchmark the operating expenditure proposed by Queensland and South Australian distributors is a good example of why benchmarking analysis should be treated with caution, particularly if one method is relied on to make conclusions as to the relative efficiency of the business.

While the AER has not published its analysis, it is apparent that it has adopted the regression method developed by Wilson Cook as part of the NSW distribution determination process. The analysis compares the operating expenditure of Australian distributors for 2007-08, normalised for the size of the distributor.

EnergyAustralia has previously raised issues with the AER relying on this particular benchmarking method to form conclusions. On 3 September 2009, EnergyAustralia responded to a data request by the AER, noting that we had strong concerns with the AER using the information to perform a regression benchmark analysis as part of the Queensland and South Australian determination process. In our response (attached to this letter) we noted that:

- A meaningful benchmarking exercise must involve more granular and quantititative analysis of available data than a simple regression of total operating expenditure.
- The Wilson Cook method applied by the AER as part of the NSW determination process fails to meet a number of statistical tests and consequently invalidates the outcomes of the analysis.

Despite our concerns, is appears the AER continues to apply this particular regression method to test the reasonableness of the operating expenditure forecasts proposed by South Australian and Queensland distributors. The outcome of the regression analysis was presented in its draft decision and is extracted below.[5]

We note that the regression line crosses the y-axis at 50,000 customers, indicating that a company the size of ActewAGL would have zero operating costs. This suggests that the regression fails to adequately account for the size of a network.

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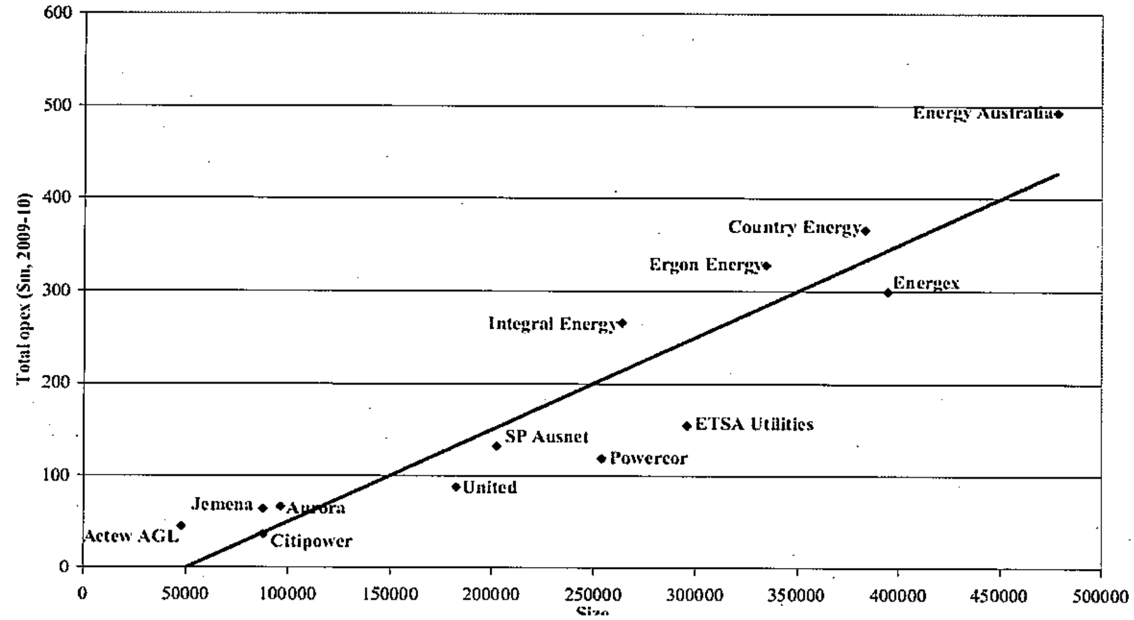
[4] Australian Energy Market Commission, Draft rule determination, Economic regulation of transmission rule, 26 July 2006, p55.

[5] Australian Energy Regulator, *Draft decision – Appendices, Queensland Draft distribution determination 2010–11 to 2014–15*, 25 November 2009, p625



We also note that the AER's analysis is remarkably different to the benchmarking analysis of its consultant, Parsons Brinkerhoff (PB), even though it is sources the same data (2007-08 data).[6] Instead of combining line length and customer numbers into one explanatory model, PB examined the information separately.

The AER's analysis gives the appearance that EnergyAustralia is well above the regression line relative to other distributors. However, the graphs extracted from PB's report[7] show that EnergyAustralia is performing better than the trend line in terms of operating expenditure per customer, and is only marginally above the trend line for operating expenditure per kilometre of line.

[6] One key difference is that PB used actual 2007-08 costs incurred by the distributor. PB suggests that the AER has used regulatory allowances, although this cannot be established from the material published by the AER.
[7] Parsons Brinckerhoff, *Review of Energex regulatory proposal for the period July 2010 to June 2015*, 2009, pp118-19.

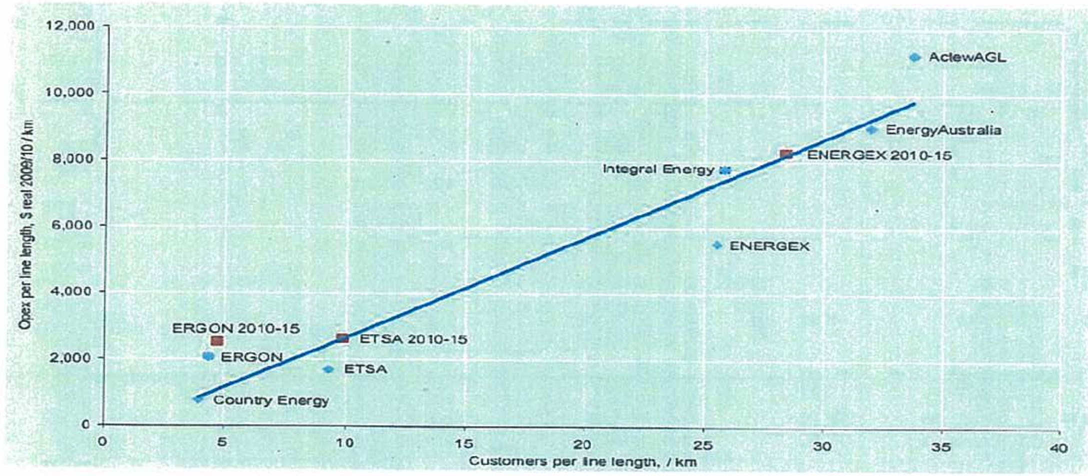


Figure 6.8 **Normalised analysis of opex per km plotted against customers per line length**

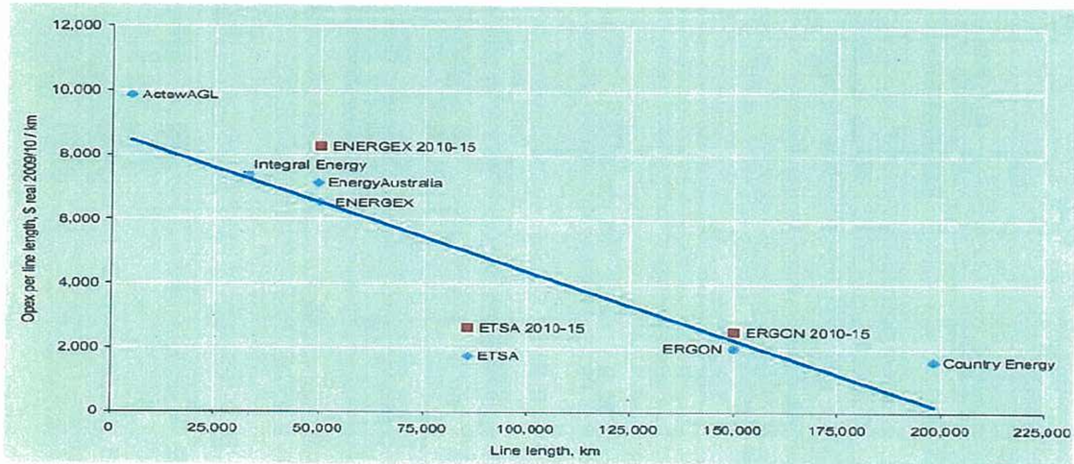


Figure 6.9 **Simple ratio analysis of opex per km plotted against line length in km**

The above analysis demonstrates that different methods can result in very different conclusions, and that it would be consequently very dangerous to use 'one method' to establish cost allowances. The contrary outcomes also demonstrates that a high level regression analysis should not be used by the AER to make any conclusions surrounding the relative efficiencies of a cost proposal. We consider that a meaningful benchmark analysis would examine the available data from several perspectives, so as to form an opinion on the relative efficiency of firms.

If you have any questions or would like to discuss any aspect of our comments in greater detail, please do not hesitate to contact Jane Smith on (02) 9269 4171.

Yours sincerely

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Attachment: EnergyAustralia letter to the AER on 3 September 2009