



Submission on the Draft Decisions: NSW and ACT distribution determinations 2015–16 to 2018–19

13 February 2015

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Australian Energy Regulator

13 February 2015

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Introduction

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its Draft Decisions for New South Wales (NSW) and the Australian Capital Territory (ACT) DNSPs for the 2015–16 to 2018–19 period.

Ergon Energy is interested in the determinations for NSW and the ACT DNSPs given the coincidence of timing with our own regulatory determination process and the indications from the AER that it is intending to apply similar assessment and benchmarking techniques to the Queensland DNSPs as occurred in NSW and the ACT. We therefore expect that in some areas the AER's analysis or basis for decisions in NSW and the ACT is likely to be similarly applied in, or relevant to, the decisions for Queensland and South Australia.

As highlighted in our submission to the AER's Issues Paper on the Queensland regulatory proposals,¹ we are concerned by the approach taken by the AER in relation to benchmarking and it appears, from the revised regulatory proposals, these concerns are shared by NSW and ACT DNSPs. Our response below discusses these concerns.

Additionally, the AER has considered the proposals put forward by the NSW and ACT DNSPs based on a number of common expert reports. The positions put forward by the AER with respect to these common expert reports, in the absence of further consideration, are likely to impact our Preliminary Determination and contain various errors and flaws. Ergon Energy supports the use of robust benchmarking to provide insight for further assessment and understanding of performance across DNSPs, however, Ergon Energy urges the AER to exercise extreme caution in utilising its latest benchmarking report to effectively determine expenditure allowances.

Our submission therefore largely focuses on the following common areas:

- the Weighted Average Cost of Capital (WACC)
- benchmarking and the AER's decision framework in respect of forecast operating expenditure
- safety impacts and the use of risk assessments and cost-benefit analysis
- metering and other technical issues.

We have also provided a number of general comments on other aspects of the AER's Draft Decisions.

Our submission has been prepared in the context of the AER's Draft Decision for NSW and the ACT, although many of the comments in this submission, as with those in our Issues Paper response lodged with the AER on 30 January 2015, are relevant to other regulatory proposals currently under review by the AER, specifically:

- the proposed access arrangement for the gas distribution network operated by Jemena Gas Networks (NSW) (Jemena)
- the regulatory proposal for the NSW electricity transmission network operated by TransGrid

¹ Ergon Energy (2015), *Submission on the Queensland electricity regulatory proposals 2015-16 to 2019-20 Issues Paper*, 30 January 2015, <http://www.aer.gov.au/node/20186>.

- the regulatory proposal for the South Australian and South East Queensland electricity distribution networks operated by SA Power Networks and Energex respectively.

This is especially so with respect to our submissions on the rate of return, where we anticipate that there will be a high degree of uniformity in the approach taken by the AER in making decisions for the different service providers currently under review. Consistent with the approach we took in the Issues Paper response, we therefore request that the AER also take our comments in this submission into account when making its Preliminary Determination for Ergon Energy, as well as the other proposals identified above.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AER require.

Weighted Average Cost of Capital

Ergon Energy notes the AER's Draft Decisions for the NSW and ACT DNSPs in relation to WACC.

Like the NSW and ACT DNSPs and other service providers identified above, Ergon Energy proposed a number of departures from the AER's Rate of Return Guideline (the Guideline) in our Regulatory Proposal (see Appendix C, Table 53). This is because we considered that certain aspects of the Guideline would not satisfy the requirements of the National Electricity Rules (NER) and the allowed rate of return objective.

We noted in our Regulatory Proposal that, because the return on capital made up more than half of Ergon Energy's total revenue requirement, the method used to calculate the return on capital is one of the more contentious issues when establishing future revenue allowances. Because of the subjectivity and sensitivity to future revenues, and the fact that a forward-looking rate of return is an inherently subjective exercise, the rate of return has been the most heavily debated issue in recent policy developments and regulatory reviews. We urge the AER to take the submissions and supporting material relating to WACC and gamma in our Regulatory Proposal into account in setting these parameters for the NSW and ACT DNSPs and other service providers who currently have proposals before the AER.

Consistent with the principles of incentive regulation, the NER requires that the allowed rate of return is based on the efficient benchmark costs of raising debt and equity from the capital markets to fund investment in the network. The NER establish a framework that is equally applicable to both publicly and privately owned Network Service Providers (NSPs). The application of this assumption to government and non-government owned businesses was explicitly considered and endorsed by the Australian Energy Market Commission (AEMC)² and AER.³

We relied on a number of expert reports to support the proposed rate of return in our Regulatory Proposal. Several of these were common expert reports and presented as evidence by the NSW and ACT DNSPs. We relied on the following:

- SFG Consulting: The required return on equity for regulated gas and electricity network businesses
- SFG Consulting: An appropriate regulatory estimate of gamma
- SFG Consulting: Cost of equity in the Black Capital Asset Pricing Model (CAPM)
- SFG Consulting: The Fama-French Model
- SFG Consulting: Alternative versions of the Dividend Discount Model and the implied cost of equity
- CEG: WACC estimates, A report for NSW DNSPs
- Kanangra: Credit ratings for regulated energy network services businesses.

We note the AER rejected many of the positions put forward by the NSW and ACT DNSPs and their experts. We assume the AER is likely to reach the same conclusions in our first determination.

Ergon Energy therefore jointly commissioned expert advice on the AER's Draft Decisions (refer to the table below). This advice is attached to our submission.

² AEMC (2012). *Final Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*.

³ AER (2013b), *Better Regulation, Explanatory Statement, Rate of Return Guideline*, December 2013.

Firm	Report	Attachment number
SFG Consulting	FFM	1
	Beta/Black CAPM	2
	Dividend Discount Model	3
	Overall Cost of Equity	4
Incenta	Independent expert reports	5
NERA	MRP	6
	Model Testing	7

A high level summary of our concerns is also provided below. We hope the AER will take these concerns into consideration in its final determination for NSW and the ACT DNSPs and other service providers, as well as our own Preliminary Determination.

Rate of return

Return on equity

Ergon Energy notes the AER's decision to reject the NSW and ACT DNSPs' proposed departure from the AER's Guideline and its application of the foundational model approach to derive an alternative estimate. Ergon Energy does not believe the method adopted by the AER will result in a cost of equity that is consistent with the rate of return objective.

The AER's method involves several errors:

- The AER has maintained its foundation model approach, despite the changes to the NER (which were made after extensive consultation by the AEMC), which required the AER to give broader consideration to other models and methods, and despite considerable evidence during its own consultation and during the NSW, ACT and Queensland determination processes that its approach will lead to inappropriate outcomes.
- The AER has erred in concluding that the Sharpe-Lintner Capital Asset Pricing Model (SL CAPM) is the "superior" cost of equity model.⁴ This finding is not supported by evidence before the AER. In particular:
 - This does not appear to be the view of the AER's consultants.⁵
 - Evidence from SFG Consulting, which accompanied the DNSPs' proposals, identified the limitations of the SL CAPM.
- The AER has failed to adequately have regard to all relevant estimation methods, financial models, market data and other evidence as required by clause 6.5.2(e)(1) of the NER – specifically, the AER has identified certain material as relevant but has then failed to give it any meaningful weight in its estimation of the return on equity.
- The AER has erred in its findings that the SL CAPM will produce unbiased results.⁶ Evidence was provided in the DNSPs' proposals of the bias in the SL CAPM. The AER has

⁴ See, for example, the AER's Draft Decision for Essential Energy. Attachment 3 (Rate of return), p172.

⁵ See, for example, McKenzie, M. & Partington, G. (2014), *Report to the AER, Part A: Return on Equity*, October 2014, p9.

erred in its estimation of the SL CAPM equity beta – neither the AER’s range nor its point estimate are supported by empirical evidence. This finding is inconsistent with the recommendation of the AER’s consultant who suggested a point estimate in the range of 0.3 to 0.8,⁷ as well as evidence accompanying the DNSPs’ proposals from SFG and CEG which indicated a range of 0.82 to 0.91.⁸

- The AER has erred in its finding that adopting the top of its range for the SL CAPM equity beta will adequately correct for any bias in the SL CAPM – there is no evidentiary basis for this finding.
- The AER has failed to take into account relevant and current evidence in relation to the market risk premium and therefore its estimate of this parameter will not reflect prevailing market conditions.
- The AER has erred in concluding that its return on equity estimate is consistent with other market evidence.

We noted in our Regulatory Proposal that the AER should:

1. identify relevant return on equity models
2. identify relevant evidence which may be used to estimate parameters within each of the relevant return on equity models
3. estimate model parameters for each relevant return on equity model, based on relevant market data and other evidence
4. separately estimate the required return on equity using each of the relevant models
5. synthesise model results to derive an estimate of the required return on equity.

This is consistent with the approach adopted by the NSW and ACT DNSPs in their regulatory proposals.

Ergon Energy submits that the approach outlined in our Regulatory Proposal, and in other submissions now before the AER, will produce a rate of return that best meets the allowed rate of return objective under the NER, and urges the AER to re-consider its approach to the determination of the cost of equity for Ergon Energy and other service providers.

Return on debt

Ergon Energy agrees with the AER’s draft decision to estimate the cost of debt using a 10 year trailing average portfolio approach and to update the return on debt estimate annually in each year of the regulatory period. Ergon Energy also supports the 10 year transitional arrangements proposed by the AER in moving from the current ‘on the day approach to the new ‘trailing average portfolio’ approach based on the ‘QTC method’ (Queensland Treasury Corporation).

Ergon Energy, however, does not agree with the AER’s choice of data series or its decision to use a simple average of the Reserve Bank of Australia (RBA) and Bloomberg BVAL curves, specifically:

- the RBA broad-BBB rated 10 year curve (the RBA curve), and
- where available, the Bloomberg broad-BBB rated 7 year BVAL curve, (the BVAL curve), otherwise the Bloomberg broad-BBB rated 5 year BVAL curve.

⁶ See, for example, the AER’s Draft Decision for Essential Energy. Attachment 3 (Rate of return), p47.

⁷ Henry, O. T. (2014), *Estimating β : An update*, April 2014, p63.

⁸ SFG Consulting (2014), *Equity beta: Report for Jemena Gas Networks, ActewAGL and Networks NSW*, 12 May 2014, p42.

Ergon Energy considers the RBA series is a credible, independent and robust data source for estimating the yields on Australian Corporate bonds and should be preferred over the BVAL curve. The BVAL curve is relatively new, requires extrapolation from seven years to 10 years (or where the seven year curve is not available, from five years to 10 years) to match the benchmark debt term. Bloomberg also recently ceased publishing the BVAL seven year curve in September 2014 before recommencing publication in November 2014, raising concerns regarding its suitability for implementation. Ergon Energy considers that the AER's decision to use the BVAL curve adds additional complexity to the estimation of the return on debt which is not warranted or necessary and could be simplified if the RBA curve was used as the sole third party data series. The RBA is a highly reliable independent data service provider for estimates of yields on 10 year BBB rated Australian corporate bonds.

Notwithstanding our comments above, Ergon Energy agrees with the AER's draft decision to extrapolate the RBA and BVAL curves so they are consistent with a 10 year benchmark term. However, Ergon Energy considers the QTC extrapolation method for extrapolating the RBA curve to a 10-year tenor based on swap spreads and target tenors for three, five, seven and 10 years using the Excel SLOPE function and as outlined in our Regulatory Proposal will produce more robust estimates that are less volatile than the approach adopted by the AER. The QTC extrapolation method uses all data points on the RBA curve whereas the AER's method only uses two data points. Ergon Energy recommends the AER reconsider its extrapolation method for the RBA data and closely examines the merits of the QTC extrapolation method.

As outlined in Ergon Energy's Regulatory Proposal, we support a weighted average approach for updating the trailing average return on debt, with the weighting approach based on the debt component of the forecast capital expenditure approved in the PTRM. The AER's decision to use a simple average rather than a weighted average to estimate the return on debt will create a certain mismatch between the NSP's actual and regulated cost of debt, which is inconsistent with the requirements of clause 6.5.2(k)(1) of the NER. For further details regarding our proposed weighted trailing average approach please refer to our Regulatory Proposal.

Ergon Energy also notes that Standard and Poor (S&P) was engaged to assess the financial impact of the AER's Draft Decision on Essential Energy by examining the revenues contained in the AER's Draft Decision and the capital, operating and interest costs as set out in Essential Energy's revised regulatory proposal. S&P's report indicates that Essential Energy's credit rating under these criteria would fall well short of the AER's benchmark credit rating of BBB+ and would result in a credit downgrade to sub-investment grade.

Ergon Energy is particularly concerned that DNSPs in similar circumstances to Essential Energy may also be downgraded to a sub-investment grade rating. Such DNSPs would face difficulties when trying to raise debt finance due to the higher price of sub-investment grade bonds in the Australian market. This is compounded by the fact that there is very limited liquidity for such bonds in the Australian market. Ergon Energy considers that this may have serious consequences for the future financial viability and stability of some Australian DNSPs which is not in the long term interests of consumers.

Ergon Energy also considers that the evidence presented in our Regulatory Proposal and in the NSW DNSPs regulatory proposals demonstrates that the benchmark credit rating is currently BBB, not BBB+. The AER should focus on more recent data (the last five years) rather than a longer time horizon in determining the forward-looking benchmark credit rating for Australian DNSPs.

Value of imputation credits (gamma)

Ergon Energy notes the AER's decision to reject the NSW and ACT DNSPs' proposed value of imputation credits ('gamma') of 0.25 and instead adopt a value of 0.4. This represents a departure from the value of 0.5 proposed in the AER's Guideline. Ergon Energy considers there are a number of errors in the method adopted by the AER to calculate gamma and that as a result, the AER's estimate of gamma does not reflect the value equity-holders place on imputation credits.

Ergon Energy agrees with the errors identified by the NSW DNSPs in relation to the AER's method for estimating gamma. In particular, Ergon Energy supports the arguments that:

- The AER's revised definition of the value of distributed credits (theta) – which seeks to exclude the effect of certain factors on the value of imputation credits – is conceptually incorrect and inconsistent with the requirements of the NER.
- The AER incorrectly uses equity ownership rates as direct evidence of the value of theta. In fact, equity ownership rates will only indicate the maximum set of investors who may be eligible to redeem imputation credits and who may therefore place some value on imputation credits. Theta can be no higher than the equity ownership rate and will in fact be lower due to factors which reduce the value of credits distributed to Australian investors.
- The AER has erred in its interpretation of the equity ownership data – the ranges used by the AER for the equity ownership rate are inconsistent with the evidence in the NSW Draft Decision.
- The AER uses redemption rates as direct evidence of the value of theta, when in fact redemption rates are no more than an upper bound (or maximum) for this value.
- The AER has erred in concluding that market value studies can reflect factors, such as differential personal taxes and risk, which are not relevant to the task of measuring theta. Market value studies are direct evidence of the value of imputation credits to investors.
- The AER has erred in its interpretation of market value studies. The AER considers market value studies in a very general manner, rather than considering the merits of the particular market value estimate proposed by the relevant business. This is an irrational and unreasonable approach to considering the evidence put forward in relation to the market value of imputation credits.
- As well as (correctly) observing that the market-wide distribution rate is 0.7, the AER has also relied on a higher estimate of the distribution rate for listed equity only. Given that data on the distribution rate is available for all equity, it is neither necessary nor appropriate to separately identify a distribution rate for listed equity only based on a limited sample.
- The AER's ultimate conclusion as to the value for gamma is inconsistent with the evidence presented in the Draft Decision, including the AER's own analysis of the equity ownership rate and redemption rate – these measures show that the AER has overestimated the value of imputation credits.

Ergon Energy considers that the most appropriate approach should involve estimating the distribution rate using Australian Taxation Office data and estimating theta based on the value of imputation credits reflected in share price movements (i.e. using dividend drop-off analysis). Combining the observed distribution rate (0.7) with the best estimate of theta from market value studies (0.35) leads to an estimate for gamma of 0.25.

Benchmarking

We highlighted in our response to the AER's Issues Paper for Queensland our concerns in relation to the use of benchmarking as an assessment technique.⁹ We have elaborated on our concerns in this submission.

It is clear that the AER's use of benchmarking in assessing forecast expenditure represents a step change in the AER's approach and level of reliance placed by the AER on benchmarking from previous regulatory determinations. The AER's approach also appears inconsistent with the approach it previously outlined it would take during stakeholder and DNSP engagement, that is, that benchmarking would provide a useful tool to identify areas of performance for further review rather than determine allowances. The impact that this change in approach by the AER will have on those networks who are deemed by the AER to be 'inefficient' cannot be overstated. Immediate cuts in forecast expenditure in the order of 20 to 40 per cent must, of necessity, have substantial impacts on any network's ability to maintain service levels, reliability and safety.

While the AER has been gathering data for many months, its benchmarking methodology was revealed only towards the end of November 2014 after regulatory proposals were filed for DNSPs in NSW, the ACT and Queensland. The networks most seriously affected by these changes have been given only a few months to respond and consider the impacts of this approach, noting that many key DNSP subject matter experts were also away during this time over the Christmas/New Year holiday period. This is not, in Ergon Energy's submission, an appropriate way to develop a benchmarking methodology which, when used in the manner proposed by the AER, will have such serious implications for these DNSPs and Ergon Energy reiterates the call made by the Energy Networks Association and other stakeholders that the AER subject its approach to further scrutiny and refer the matter to the Productivity Commission.

The scale of this change in approach can be illustrated by contrasting the AER's use of revealed costs in assessing forecast operating expenditure, just a few years ago, with the approach the AER now proposes to adopt.

In assessing Ergon Energy's forecast operating expenditure in 2010, the AER stated:

"The AER considers that as the DNSPs are subject to commercial incentives, where a DNSP is observed to be operating prudently then audited base year unit costs can be regarded as efficient. The application of the EBSS ensures that there is a constant incentive for DNSPs to reduce costs. Appropriately designed scale escalators applied to prudent base year costs can then be used as reasonable comparators. The AER considers that this revealed cost approach is effective in ensuring that firms continually move towards an efficient standard of performance."¹⁰

The AER continued to apply this approach to the top down assessment of revealed costs as recently as 2013, when the AER said, in relation to ElectraNet's forecast operating expenditure:

"We found no reason to move away from our top down approach, because the incentive framework is predicated on the principle that the revealed actual expenditure is the best indicator of efficient expenditure."¹¹

⁹ See pp7-10.

¹⁰ AER (2010), *Final decision, Queensland distribution determination 2010–11 to 2014–15*, May 2010, pp417-418.

¹¹ AER (2013), *Final decision, ElectraNet transmission determination 2013–14 to 2017–18*, April 2013, p100; and AER (2012), *Draft decision, ElectraNet transmission determination 2013–14 to 2017–18*, November 2012, p148.

Applying this approach, Ergon Energy's base year operating expenditure would, prima facie, satisfy the AER's top down assessment for efficiency (or nearly so), since these revealed costs were incurred under the same incentives identified by the AER in recent decisions. Now, just two years later, the AER appears to believe not only that Ergon Energy's base year operating expenditure is not efficient, but that it exceeds an efficient level by as much as 30 per cent. The scale of the divergence in these outcomes, over such a short period, must call into question whether the AER's benchmarking methodology is fit for the purpose to which it has been put. The expert analysis submitted by Ergon Energy and other DNSPs points strongly towards the conclusion that it is not.

Ergon Energy does not dismiss the role of benchmarking in the AER's assessment of a DNSP's forecast expenditure. The AER has used benchmarking extensively as an input into its assessment of regulatory proposals for many years.¹² This is consistent with the requirements of the NER, and the role of benchmarking in the context of incentive regulation, as outlined in a report prepared for Ergon Energy by Synergies Economic Consulting (**Attachment 8**).

However, the approach now foreshadowed by the AER uses benchmarking, to the near exclusion of every other relevant consideration, to produce expenditure forecasts that diverge wildly from those which would have been produced by the same regulator only a few years ago.

Ergon Energy urges the AER to take heed of the observation made by Synergies in **Attachment 8**:

"All forms or processes of benchmarking are to some degree imperfect. Whilst a great deal of trouble is taken to ameliorate these imperfections, the results must be interpreted with considerable caution, particularly where they are being used to inform revenue control decisions, the results of which could be materially adverse to the long run interests of users if prices are set below the level of efficient costs of the regulated firm."

Ergon Energy submits that the AER's benchmarking model is not fit for the purpose to which it has been put, and cannot be relied upon to adjust a DNSP's base year operating expenditure by reference to the inefficiencies perceived by the AER.

In their revised regulatory proposals, NSW DNSPs mounted a very compelling case which questions the AER's analysis and use of benchmarking techniques, as well as its decision making framework. These proposals are supported by strong evidence, analysis and opinion by experts including:

- Frontier Economics¹³
- Huegin¹⁴
- David Newbery¹⁵
- Pacific Economics Group Research¹⁶
- Advisian¹⁷
- PWC.¹⁸

¹² AER (2010), *Final decision, Queensland distribution determination 2010–11 to 2014–15*, May 2010, p421.

¹³ See <http://www.aer.gov.au/sites/default/files/Ausgrid%20-%201.05%20-%20Frontier%20Economics%20-%20Review%20of%20benchmarking%20-%20January%202015.pdf>.

¹⁴ See <http://www.aer.gov.au/sites/default/files/Ausgrid%20-%201.06%20-%20Huegin%20response%20to%20draft%20determination%20-%20January%202015.pdf>.

¹⁵ See <http://www.aer.gov.au/sites/default/files/Ausgrid%20-%201.07%20-%20David%20Newbery%20expert%20report%2C%20Jan%202015%20-%20January%202015.pdf>.

¹⁶ See <http://www.aer.gov.au/sites/default/files/Ausgrid%20-%201.08%20-%20Pacific%20Economics%20Group%20%28PEG%29%20-%20Statistical%20benchmarking%20for%20NSW%20distributors%2C%20Jan%202015%20-%20January%202015.pdf>.

¹⁷ See <http://www.aer.gov.au/sites/default/files/Ausgrid%20-%201.09%20-%20Advisian%20review%20of%20AER%20benchmarking%2C%20Jan%202015%20-%20January%202015.pdf>.

These reports provide compelling evidence that the AER's approach and conclusions are unsafe and unreliable, and therefore provide an inappropriate foundation upon which to base the AER's decisions as to whether the expenditure forecast by DNSPs is sufficient to meet regulatory obligations and maintain safety. As noted by the NSW and ACT DNSPs this raises doubt as to whether the AER is also properly complying with its own obligations under applicable OHS legislation. In this context, we note and adopt the submissions that have been made by the ACT & NSW DNSPs on the AER's Occupational Health and Safety (OHS) obligations and we urge the AER to take this into account in making its distribution determination for Ergon Energy.

We agree with many of the positions put to the AER by the ACT & NSW DNSPs, including:

- The observation that the AER misdirected itself by vigorously pursuing an outcome that could be used as a substitute for all NSP allowances, without proper safeguards or due diligence of its process, analysis or results.
- The AER appeared to ignore strong evidence supporting concerns with the use of benchmarking in an Australian context, to mechanically derive large adjustments to forecast expenditure, based on untested and unproven models.
- The AER did not properly reflect the Revenue and Pricing Principles when exercising its discretion to reject and substitute operating expenditure. It appears to have incorrectly formed the view that it is not obliged to look at the individual circumstances of a DNSP when it is assessing expenditure proposals.
- It is not open to the AER to set an amount that it knows is insufficient for the DNSP to meet the operating expenditure objectives having regard to the Revenue and Pricing Principles. The issue of how things are funded or who funds them is the wrong question based on a false premise and does not need to arise if the AER properly carries out its decision making under the NER.

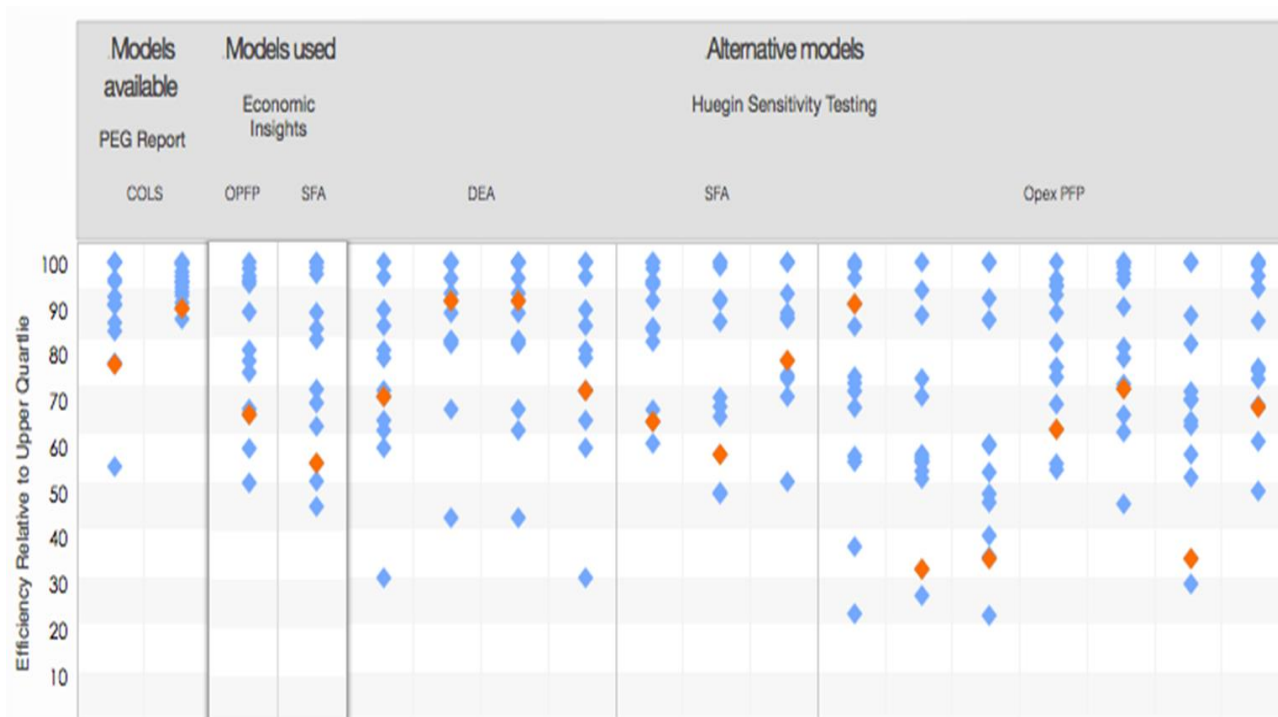
The consequences of the AER's approach highlighted in the NSW DNSPs' revised regulatory proposals are significant for Ergon Energy. Our response to the AER's Issues Paper for Queensland identifies particular aspects of our network that make benchmarking with other NSPs difficult and highlights a number of issues with the AER's approach. This is supported by expert advice from Huegin (**Attachment 9**) and Synergies (**Attachment 10**).

In summary, we maintain that:

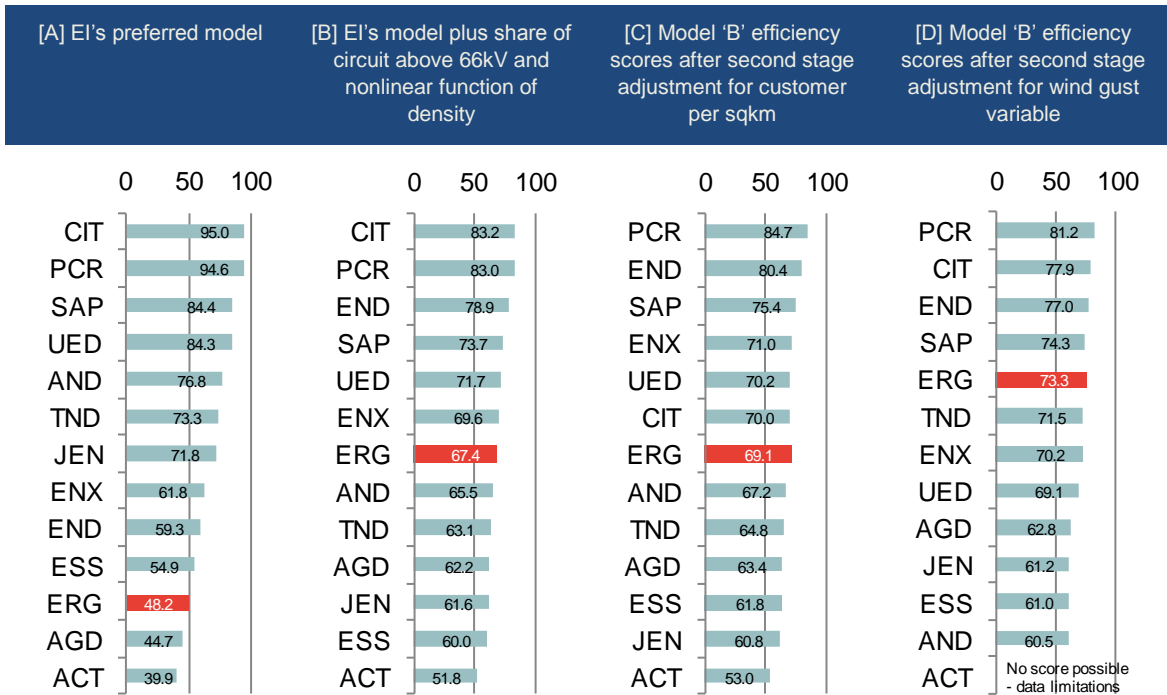
- The AER's models fail to account for most of the large differences between DNSPs in the Australian sample (e.g. differences in scale and impact of extreme weather events). This means these models tend to favour the smallest and densest networks (with a few exceptions).
- The AER's models and the AER's assessment of operating environment factors do not adequately consider a number of key factors, including the scope of activity (e.g. differing OHS requirements) and differences in the operating and capital expenditure trade-offs made by DNSPs.
- The outputs of the AER's model are overly sensitive to minor changes in data and methodology. Analysis undertaken by Frontier Economics and Huegin for the NSW DNSPs suggests that the relative 'efficiency' rankings of the Australian DNSPs can alter markedly, depending on what statistical model and techniques are used.

¹⁸ See <http://www.aer.gov.au/sites/default/files/Ausgrid%20-%201.10%20-%20PWC%20-%20Independent%20expert%20advice%20on%20appropriateness%20of%20RIN%20data%20for%20benchmarking%20comparison%20C%20Jan%202015%20-%20January%202015.pdf>.

- A wide range of results can be produced for Ergon Energy, depending on the statistic model adopted; thus illustrating the significant risks associated with placing heavy (or any) reliance on these statistical models to assess the relative efficiency of the Australian DNSPs (see below Huegin graph, noting Ergon Energy’s ranking is marked in orange).
- It appears that the efficiency rankings selected by the AER have not incorporated the potential changes in operational costs being flagged by some DNSPs in the next regulatory control period, particularly for DNSPs currently assessed by the AER as being at the efficient frontier (e.g. SA Power Networks) or DNSPs, like Ergon Energy, that have already cut operating and capital expenditure.



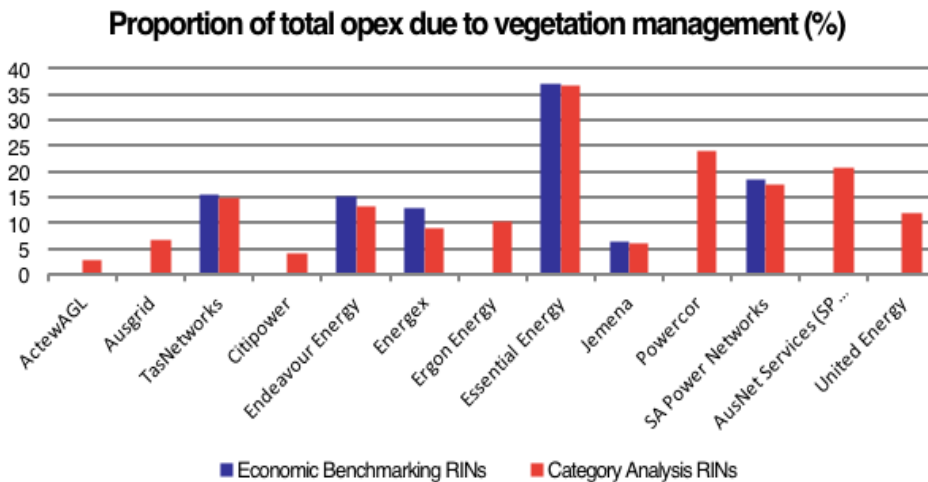
In the report we commissioned from Frontier Economics (**Attachment 12**), they observed a similar outcome in terms of changes in rankings if small modelling parameter changes are made (see Figure 2 extracted from their report below).



Our aim, in presenting this independent expert analysis, is to demonstrate that Economic Insight's benchmarking analysis has serious deficiencies in terms of failing to account for evidently large differences in genuine operational circumstances between DNSPs. Further, the above analysis demonstrates that the AER's benchmarking results for the Australian DNSPs are highly sensitive to minor modifications to Economic Insight's preferred model.

We have also commissioned Ernst and Young (EY) to analyse the quality and consistency of the data provided to the AER in response to its Regulatory Information Notices (RINs). This report is attached as **Attachment 11**. EY has identified concerns relating to the robustness of the RIN data, resulting from the use of estimates, capitalisation policies, cost allocation methods, balancing items, estimates of line length, and third party service provision and outsourcing. This report supports the submissions, already before the AER, which argue that the information obtained by the AER relating to past expenditure does not provide a suitable basis upon which to undertake the type of benchmarking analysis that has been attempted.

For example, the graph below, drawn from analysis released by Frontier Economics for the NSW business, shows only six Australian DNSPs reported vegetation management costs in their Economic Benchmarking RIN data.



Of those DNSPs that reported vegetation management costs in **both** the Economic Benchmarking and Category Analysis RINs, the analysis by Frontier Economics shows that:

- none reported these costs consistently
- in all cases the difference was 2.8 per cent or more
- in Energex’s case the difference was nearly 47 per cent.

For a number of DNSPs, there were also large differences between the total operating expenditure (Standard Control Services) reported in the Economic Benchmarking and Category Analysis RINs (in one case greater than 20 per cent). No apparent effort appears to have been made by the AER to resolve these evident discrepancies even though vegetation management seems to be a significant cost for most networks. It also appears from the analysis undertaken by PWC for the NSW distributors, referred to above, that there are numerous other issues with the RIN data that could impact the benchmarking results.

Of even greater concern is the fact that the Canadian DNSP apparently ranked by the Stochastic Frontier Analysis model used by the AER’s consultants as the most ‘efficient’ DNSP of all Australian, New Zealand and Canadian DNSPs sampled is actually ranked as being substantially less efficient by the relevant Canadian regulator when compared to its local peers.

We also note that, for the NSW and ACT determinations, the AER has specified two additional operating expenditure factors as matters that the AER will take into account:

1. The AER’s benchmarking data sets including, but not necessarily limited to:
 - (a) data contained in any Economic Benchmarking RIN, Category Analysis RIN, reset RIN or Annual Performance RIN
 - (b) any relevant data from international sources
 - (c) data sets that support econometric modelling and other assessment techniques consistent with the approach set out in the AER’s Guideline as updated from time to time
2. Economic benchmarking techniques for assessing benchmark efficient expenditure including stochastic frontier analysis and regressions utilising functional forms such as Cobb Douglas and Translog.

To assist the AER in further considering the two above-mentioned operating expenditure factors and to evidence our wider concerns regarding the AER's approach, we have attached a further report from Frontier Economics (**Attachment 12**).

Frontier Economics finds the AER has erroneously concluded that many Australian DNSPs are significantly inefficient due to the AER's failure to take into consideration the heterogeneity of circumstances across different DNSPs.

In particular, they find the Economic Insights model appears to favour those networks with the highest customer density and disadvantages those DNSPs that have invested in high voltage assets and dual levels of sub-transmission to address distance and load issues affecting the relevant network. The Frontier Economics analysis for Ergon Energy demonstrates that, in addition to the modelling and data issues identified for NSW, the AER has mechanically applied the outcomes of this analysis. In doing so, they failed to consider other factors that could contribute to these results.

To demonstrate this, Frontier Economics modelled two scenarios to illustrate the impact of the above two factors on the AER's benchmarking results. Their analysis shows that by including the share of circuits in excess of 66kV in the AER's benchmarking model, the efficiency scores of those DNSPs that have circuit in excess of 66kV have increased and decreased for those that do not.

Additionally, after adopting a two stage approach,¹⁹ Frontier Economics submits the cumulative effect of adjustments for a range of environmental factors would result in a different picture of efficiency when compared to the AER's benchmarking model.

In its report, Frontier Economics also outlines a number of 'special factor adjustments' used by European regulators to minimise errors associated with benchmarking. For example, the Office of Gas and Electricity Markets (Ofgem) has made special adjustment factors in the past to account for costs that are unique to only one company (providing they are justifiable) and exceptional costs relating to severe weather/environmental conditions. These adjustments are assessed on a case-by-case basis.

The Frontier Economics analysis for Ergon Energy confirms, with additional evidence, the AER has failed to take into account the vast latent heterogeneity between DNSPs in determining the forecast operating expenditure for NSW and ACT DNSPs.

Frontier Economics indicates that special factors affecting Ergon Energy (such as the size of our service area and exposure to weather-related events) are likely to have a material impact on our costs and therefore the AER should adopt a special factor adjustment for these costs. The same is true for other DNSPs.

The evidence suggests that many errors stem from the AER trying to do too much too quickly in order to arrive at a result. Our experts have noted that other regulators have adopted alternative applications of economic benchmarking results and techniques, which are often dependent on the length of time over which benchmarking has been developed, and the regulator's own confidence in the benchmarking outcomes.

¹⁹ In the first stage, efficiency scores are estimated using either the Data Envelope Analysis or Total Factor Productivity models. Efficiency scores are then regressed on environmental variables that cannot be incorporated in these models.

Frontier Economics contrast these approaches in overseas jurisdictions with the AER's own economic benchmarking techniques approach and makes the following suggestions and observations:

At page xii of the Frontier Economics Report, Frontier Economics confirms that the AER has failed to:

- account for the vast heterogeneity of circumstance, and hence cost to serve, between DNSPs; and
- take sufficient account of special factors, and has underestimated their potential magnitude.

Frontier Economics go on to recommend that the AER should recognise the existence of significant latent heterogeneity between DNSPs, and account more meaningfully for this heterogeneity in its benchmarking analysis and also recommend that the AER should investigate further the special factor adjustments that are required for the DNSPs in Australia.

The report notes that this would require a significant improvement in the quality of the RIN data, quantification of additional variables that are presently excluded from its coverage, and significant engagement with the DNSPs to understand their unique operational circumstances and the impact of these circumstances on costs. This would require a long and collaborative process, as evidenced by various case studies from overseas. As regulators in Europe have found, there is no single best method that can be employed uniformly to all networks, when making special factor adjustments. Therefore, Frontier Economics consider that the AER would need to consider these special factors on a case-by-case basis.

However, Frontier also indicates that “there is insufficient time within the present regulatory timetable to quantify the required special factor adjustments. This means that the quantification of the impact of special factors is a task for the medium-term”.

For the current reset, Frontier Economics reinforce the conclusions in their report to Networks NSW, and recommend that the AER consider alternative approaches for accepting or substituting expenditure forecasts, which place much less reliance on the conclusions of the AER's benchmarking analysis.

Later on in section 5.4 of the report, Frontier Economics make the following observations:

“Ei's/AER's only attempt at accounting for (a very limited number of) special circumstances in the NSW/ACT Draft Decisions involved increasing the input use of the top quartile DNSPs by 10% for the NSW networks and 30% for ActewAGL. As we argued in our report for Networks NSW, these adjustments were arbitrary and based on a very incomplete exploration of possible differences between DNSPs. They were also wholly inadequate as they still gave rise to implausibly large reductions to base year opex levels (i.e. between 13% and 45%). The very significant issues we have identified in the preceding sections all point to very material heterogeneity across the Australian networks, which has not been controlled for by the AER. There is no reason to suppose that a 10% tolerance captures these adequately.”

Based on the above, Frontier Economics conclude that the AER's failure to allow, within its benchmarking methodology, an explicit step to account for special factors suggests strongly that its application of benchmarking falls well short of best practice.

Frontier Economics go on to state that:

“We recommend that the AER considers the case for making a special factor adjustment for these costs. As there is no single best approach for making a special factor adjustment, the AER would need to consider these on a case-by-case basis. We note however that there may be insufficient time within the present regulatory timetable to quantify the required special factor adjustments, as the AER will need to account not just for Ergon’s special factors but also for any special factors that relate to the remaining 12 DNSPs. The process of identifying, understanding and quantifying special factors is an iterative one that requires time for proper engagement between the regulator and the networks. Furthermore, it is very likely that data and other information needed to assess and quantify the factors fully does not exist readily, and so will need to be compiled. This will require time.”

Ergon Energy also notes that there is nothing in the NER or the National Electricity Law (NEL) itself that would have prevented the AER from adopting such alternative economic benchmarking approaches to deliver a more sensible benchmarking outcome than has been produced by both the consultation process undertaken by the AER, or by the actual results published in the current NSW and ACT DNSP Draft Decisions.

In fact, now that the AER has explicitly introduced international benchmarking data sets into its approach and specified, for the purpose of clause 6.5.7(e)(12) of the NER, additional factors that require explicit consideration of international data sets and other economic benchmarking techniques, the AER is *obliged* under the NER to properly consider afresh and investigate the alternative approaches adopted in other jurisdictions, including those outlined by Frontier Economics and Huegin.

In particular, we note the report from Frontier Economics includes the following analysis:

- Ofgem’s approach towards accounting for special factors through a number of cost adjustments, normalisations, and exclusions from its benchmarking analysis.
- Norwegian Water Resources and Energy Directorate’s approach to accounting for special factors, both within its benchmarking model, and through a second-stage adjustment to its efficiency scores.
- A summary of a number of the special factors that are relevant in Ergon’s case.
- The medium-term recommendations for the AER with respect to special factor adjustments in Australia.

There is also a variant of econometric modelling known as latent class modelling, where algorithms classify groups or clusters of networks by categories defined by characteristic similarities within the group and differences between groups that can potentially be of assistance in benchmarking regulated firms. Latent class modelling requires reasonably large datasets, and dividing networks in Australia into classes would tend to produce several groups of very small membership. Nevertheless, in line with the additional expenditure factors identified by the AER, we commissioned Huegin to undertake a preliminary analysis of such an approach in the context of the Australian DNSPs. A copy of that report appears at **Attachment 13**.

In undertaking the above-mentioned latent class modelling analysis Ergon Energy recognises that there is no single best way to choose the clusters – there is a large variety of algorithms that could be used to identify the clusters, and the results can be sensitive to the algorithm selected. The results can also be highly sensitive to: the input variables selected; the quality/consistency of the data used; how well the data have been cleaned (e.g. have variables been normalised properly, and have outliers been identified and removed?); and the ‘distance’ measure selected (i.e. the measure that is used to decided how ‘similar’ different variables are).

That said, the results do tend to indicate that Ergon Energy often appears as a genuine outlier across various benchmarking samples, indicating the level of caution that should be undertaken by the AER in seeking to determine its revenue or expenditure allowances based purely on the benchmarking report provided by Economic Insights.

In terms of other special factor adjustments the AER has made in the draft decisions for NSW and ACT DNSPs, Ergon Energy notes that the Economic Insights report included with the AER's draft decision for the NSW DNSPs for the 2015-2019 period states that:

"AER (2014) estimates that the effect of these temporary opex increases has been a cost disadvantage to the Victorian DNSPs of just over 10 per cent for the period from 2011 onwards (i.e. their opex costs were increased by just over 10 per cent for this period compared to what they otherwise would have been). Taking the weighted average Victorian and South Australian benchmark, this would be a cost disadvantage to the benchmark of 7.8 per cent from 2011 onwards."

Further to the responses provided to the AER to date by Ergon Energy regarding bushfire costs affecting DNSPs as part of our regulatory re-set process, Ergon Energy draws the AER's attention to recent publically available analysis that casts doubt on the correctness of the AER's assessment that the efficiency impacts of bushfire mitigation undertaken by the Victorian distributors should be seen as being a 'cost disadvantage' when compared with other NSPs, including whether the AER has properly considered whether the need to introduce regulations in Victoria has been driven by a need to increase prudence of existing practices, both from a vegetation clearance and engineering practice perspective (e.g. use of vibration dampers).

For example, the Victorian 2013 Regulatory Impact Statement (RIS) for the clearance regulations applicable to Electric lines notes the changes to the regulations in 2010 came about for the following reasons:

"Amendments to the regulations which took effect in October 2010 implemented two specific recommendations from the Victorian Bushfires Royal Commission (VBRC). The VBRC had identified a number of inadequacies in respect of then current inspection and maintenance arrangements for electricity assets in high fire risk areas and made recommendations for improved practice in this area. In response to these, it recommended that the State (through Energy Safe Victoria) require electricity distribution businesses to:

- *inspect all single wire earth return (SWER) lines and all 22 kilovolt feeders in areas of high bushfire risk at least every 3 years; and*
- *review and modify practices, standards and procedures for the training and auditing of asset inspectors to ensure that registered training organisations provide adequate theoretical and practical training for asset inspectors."*

The 2013 RIS goes on to state that: "... the VBRC believed that this approach was necessary to provide a high level of assurance that the inadequacies in past performance in these areas would be addressed in the future through more frequent and higher quality inspection arrangements. The proposed regulations would retain these requirements."

At the same time, it is clear that modelling the precise cost impacts of incremental changes in the above-mentioned regulations is a complicated and complex task to undertake because the 2013 RIS states:

"the regulations and Code exist within the context of a broader range of safety obligations relating, inter alia, to the control of the risks of bushfire ignition posed by electricity assets that are established in the Electricity Safety Act and in other regulations made under its authority. This broader legislative and regulatory context

necessarily renders estimation of both the benefits and costs of the regulations and Code per se somewhat difficult. That is, the existence of a number of legislative obligations that are framed largely in process and performance based terms (e.g. requiring the development and implementation of bushfire mitigation plans) means that the clear specification of a "base case" - i.e. the determination of what actions would be taken by affected parties in the absence of regulations and a Code establishing specific vegetation clearance requirements - is rendered near impossible."

A similar concern arises in relation to whether the AER's benchmarking approach adequately accounts for jurisdictional differences relation to the vegetation management obligations DNSPs face across Australia.

We understand that Queensland DNSPs, and also NSW DNSPs, have greater vegetation clearance obligations to undertake around electric lines and differing obligations around service lines than their South Australian and Victorian counterparts due in part to the role that has been played by local Councils in undertaking this task. Ergon Energy has raised this issue in its discussions with the AER and the AER's Board through its current regulatory reset process and notes that a number of the NSW DNSPs have raised similar issues. To provide some context for the quantum of costs being met by local councils relative to electricity entities in Victoria, Ergon Energy notes that in the September 2014 Draft Regulatory Impact Statement (2014 RIS) for the proposed 2015 Victorian bushfire regulations the total combined annual clearance expenditures for Victorian NSPs and councils is estimated to be: \$122.9 million (1 Transmission Network Service Provider (TNSP) + 5 DNSPs) + \$38.9 million (67 Councils with Declared Areas) = \$161.8 million per annum. That is to say, some 25 per cent of the vegetation management costs applicable to electric line clearances are being met by Councils in Victoria, whereas in Queensland the DNSPs bear these costs as well as the costs for cutting around services, which we understand are a customer responsibility in Victoria.

A further concern Ergon Energy has with the draft NSW & ACT decisions is the assessment the AER has made of the relative impact of storm events on the costs of DNSPs.

By way of example, in the draft decision for Ausgrid, the AER made the following observations (emphasis added):

"Our category analysis data also suggest that differences in costs due to natural disasters are unlikely to cause material differences in opex between the NSW service providers and the comparison service providers. Emergency response expenditure on major events and major event days provides some indication of the effect of natural disasters on service providers costs. On average the share of major event day emergency response expenditure, as a percentage of opex expenditure is less than 1 per cent for most service providers.

Endeavour and Essential appear to incur more emergency response costs, as a percentage of total opex, than Ausgrid or the comparison service providers. However, as a percentage of total opex the difference between the percentage of opex made up of emergency response between Essential and the customer weighted average for the comparison service providers is relatively small. The difference is 0.38 per cent for Essential and 0.69 per cent for Endeavour. Further, not all emergency response expenditure on major event days will relate to natural disasters. We have, however, included this factor as part of the overall allowance for operating environment factors"

While it is unclear precisely what calculations the AER has actually made to determine that this factor is not material, it does appear that the AER has made findings about 'differences in costs due to natural disasters' by comparing only emergency response expenditure incurred on major event days. A comparison of such a narrow range of costs as disclosed in the applicable RIN data is incapable of providing any sensible estimate of the costs incurred by DNSPs as a result of

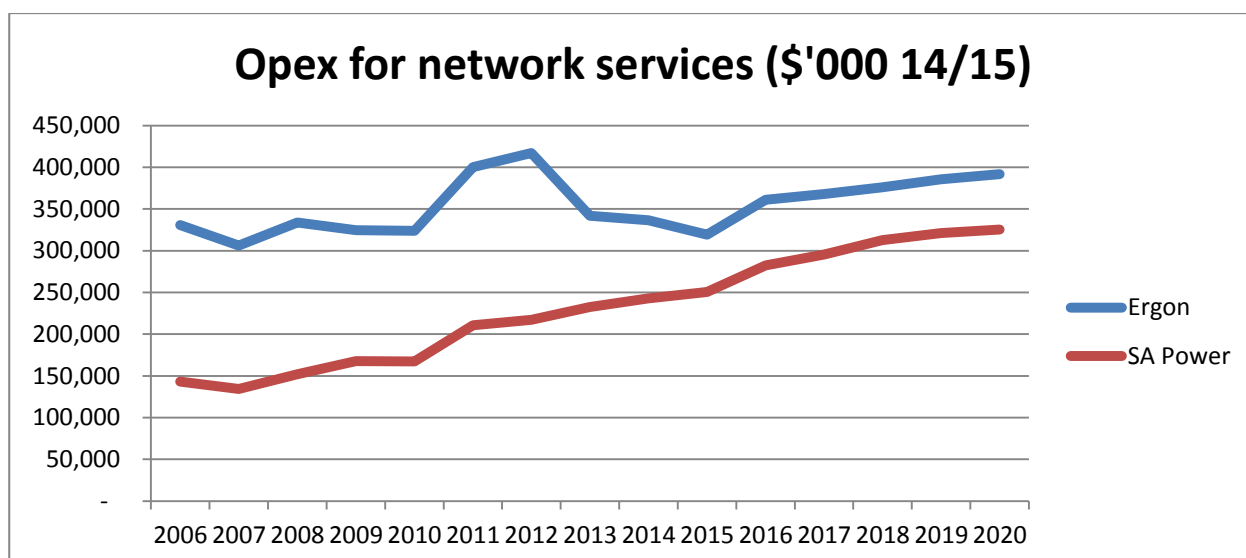
natural disasters. With events such as storms, most of the cost is incurred not on the day itself, but in the weeks and months following, when repairs and replacement expenditure is undertaken. Ergon Energy also incurs costs in preparing for a major storm event.

As Ergon Energy has demonstrated in our various benchmarking reports contained in our Regulatory Proposal, and in this submission, we have a much higher exposure to storm and cyclone events than any other National Electricity Market (NEM) DNSPs and do not consider it appropriate or informative for the AER to assess this factor based only on an assessment of the costs incurred on the major event day itself. For example, in the 2010-15 regulatory control period, Ergon Energy has experienced significant operational cost impacts driven by major weather events totalling almost \$75 million including:

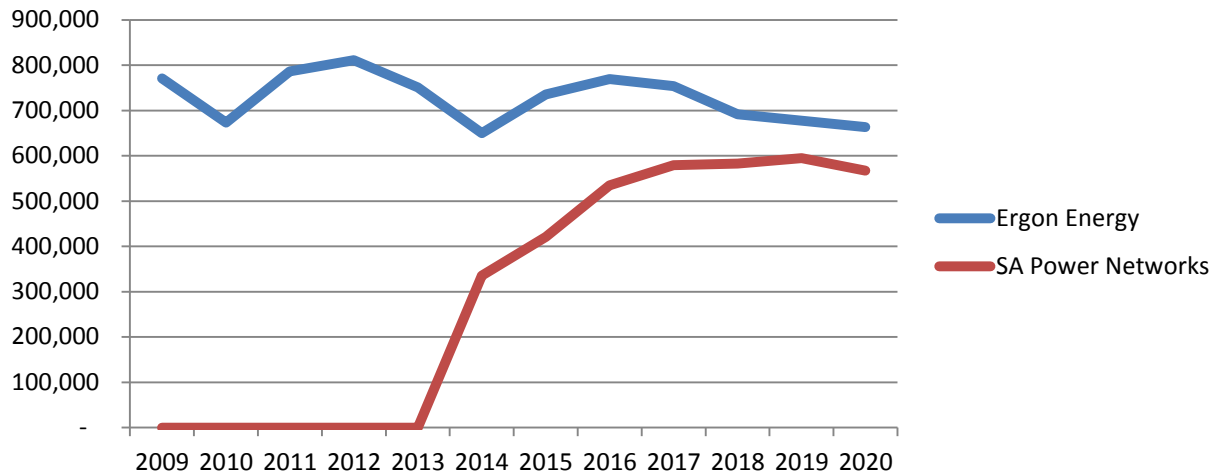
- Cyclone Yasi in 2010-11, approximately \$40 million
- major Flooding 2010-11, approximately \$5 million
- extensive storms and flooding 2011-12, approximately \$4 million
- Cyclone Oswald 2012-13, approximately \$12 million
- Cyclones Ita and Dylan, approximately \$8 million.

The reasoning behind the AER's apparent decision to exclude such expenditure from the assessment of the costs of natural disasters as outlined in the passage from the AER's draft decision is unreasonable. We note the AER has also relied upon and extrapolated the results from other analysis of the impact of natural disasters conducted by BTRE, however, that analysis appears to be based on natural disaster data up to 1999-2000 only and would not seem to allow for the impacts of other major disasters such as Cyclone Larry, Cyclone Yasi, the flooding in Queensland in 2011, Cyclone Oswald and the tragic bushfire events affecting Victoria. Victoria and Queensland are also subject to sporadic tornado activity that can cause significant repair and replacement work after the event.

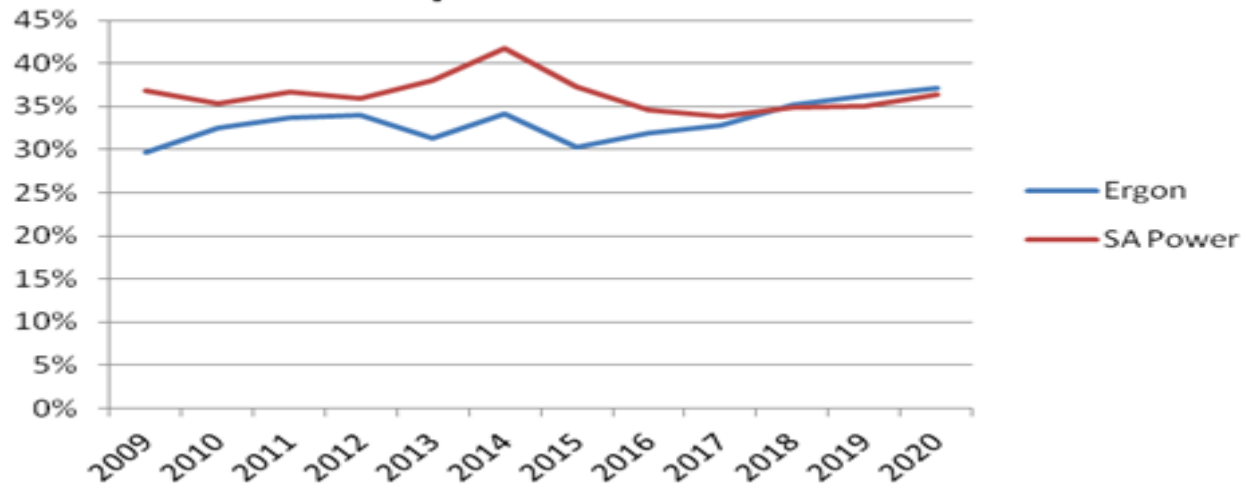
A further complicating factor that impacts the adequacy of the AER's benchmarking results is the fact that the AER has not had regard as per the requirements of the NER to the impacts of the expenditure forecasts for the forthcoming regulatory period that were released by the Queensland and South Australian DNSPs a number of weeks before the AER released the Economic Insights benchmarking report in November 2014 (see below comparison charts drawn from RIN data).



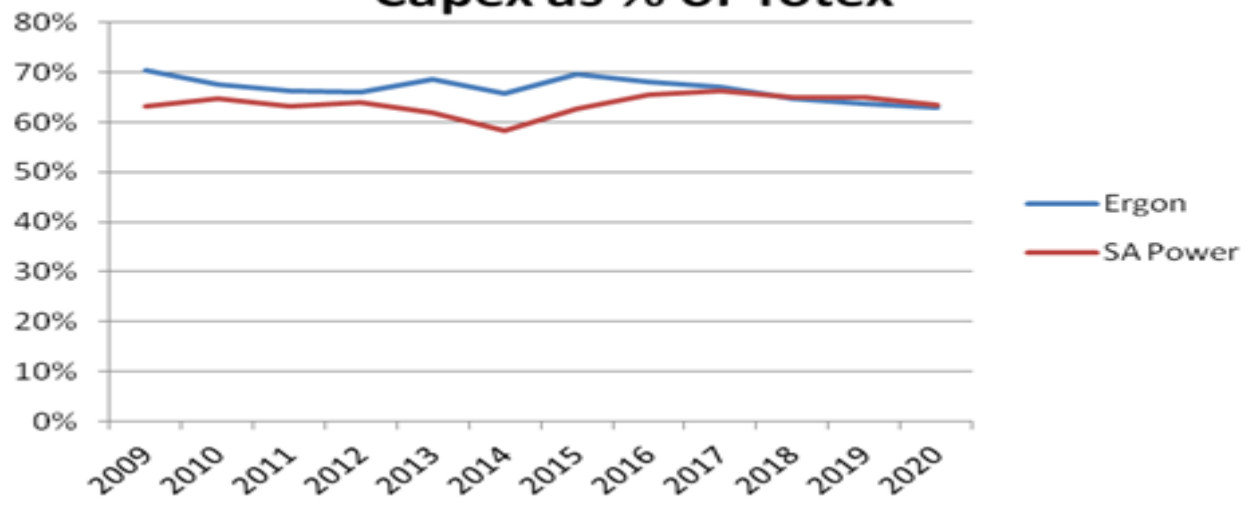
Capex including capital contributions (\$'000 14/15)



Opex as % of Totex



Capex as % of Totex



A straight comparison of Ergon Energy's operating and capital expenditure against SA Power Network's operating and capital expenditure is limited in the information it provides. Despite having around 15 per cent fewer customers and lower peak demand, Ergon Energy has:

- almost twice the network length
- almost twice the service area
- less than half the customer density
- delivers 20 per cent more energy.

For the reasons above and considering environmental differences between the states, Ergon Energy would not likely have, and could not reasonably be expected to achieve, lower expenditure than SA Power Networks. We do consider, however, that there is some use in comparing our expenditure to SA Power Networks, a network on the efficient frontier in the AER's econometric modelling approach applied in the recent NSW and ACT Draft Decisions. Ergon Energy considers that the above graphs highlight that the gaps in terms of expenditure performance or perceived efficiency levels between the two businesses are not as significant as perhaps the Economic Insights models indicate or imply.

Finally, we note that we formally sought a copy of the AER's consultant report – *Deloitte Access Economics (Deloitte), NSW Distribution Network Service Providers Labour Analysis* – supporting the AER's Draft Decision but were advised by the AER that the document was fully confidential and they did not have a redacted version. We are unable to comment on this analysis or the NSW DNSPs' responses, although we note the significant concerns raised by the NSW and ACT DNSPs regarding the general approach taken by Deloitte. The AER has engaged Deloitte to undertake a review of Ergon Energy's expenditure as well. We are concerned that Deloitte may carry through a similar methodology and approach as occurred for the NSW and ACT DNSPs despite the apparent flaws and errors that the NSW and ACT DNSPs have outlined in their revised regulatory proposals.²⁰

²⁰ See, for example, Ausgrid (2015), *Revised Regulatory Proposal and Preliminary Submission, 1 July 2014 to 30 June 2019*, 20 January 2015, pp155-162.

Operating and capital expenditure

Immediate cuts to retrospective levels of expenditure

In our response to the AER's Issues Paper for Queensland,²¹ both Ergon Energy and our experts contrasted:

- regulatory approaches overseas, which appear to temper the reliance on benchmarking outcomes, based on a reasonable examination of the risks and consequences of regulatory error, and
- the AER's approach to NSW, in which a mechanistic application of benchmarking was applied on the basis that any other approach resulted in customers 'funding inefficiency'.

Having determined a level of operating cost by mechanistically applying its own benchmarking analysis, the AER appears of the view that it must only allow recovery of operating costs that immediately moves the DNSP to what it has determined as the efficient level. For NSW DNSPs this has resulted in a substantial adjustment to operating expenditure with no transition. The AER expects the DNSP to substantially reduce programs and services or "wear the costs" of:

- any amount of expenditure above the mechanistically determined efficient level, despite the fact that operating expenditure is largely recurrent and cannot be adjusted immediately
- any additional expenditure required to reduce ongoing costs to the mechanistically determined efficient level, without considering whether these direct costs are efficient or not
- any non-compliance with regulatory obligations resulting from the need to reduce programs and services in order to stay below the mechanistically determined level.

This is a unique aspect of the AER's application that differs to regulators in other jurisdictions. For example:

- The Ontario Energy Board in Canada applies 'stretch factors' which are designed to incentivise networks to look at ways to become more efficient over time, and not punitive measures for inefficiency.
- In the past, Ofwat (the Water Services Regulation Authority in England and Wales) used benchmarking to split the water and sewerage companies into five efficiency bands that each received the same moderated efficiency discount subject to a glide path.

An immediate cut in forecast operating and capital expenditure in the order of 20 to 40 per cent in 2015–16 would likely require the NSW and ACT DNSPs to immediately review, and substantially reduce, expenditure in areas such as workforce levels and inspection and maintenance of the network. The disruption to the businesses that would result from such immediate cuts, together with the potential loss of corporate knowledge and expertise of how they would manage the network, would threaten to undermine the long term interests of electricity consumers and safety. We believe it would also jeopardise the safety of their networks.

We note that Synergies have also reached this conclusion in some recent analysis we requested they undertake on the impact of benchmarking of Ergon Energy, which we consider would apply by analogy to the NSW and ACT DNSPs – and most closely to Essential Energy (see **Attachment 10**).

²¹ pp10-13.

While the AER has suggested, in its NSW and ACT Draft Decisions, that any expenditure reductions are simply a decision for the relevant NSP,²² it also states:

"If our determined prudent and efficient allowance to achieve the opex is lower than actual past expenditure, our view is that a prudent operator would take the necessary action to improve its efficiency".²³

Consistent with the AER's views on this matter, we believe it is necessary under the NER for the AER to have regard to the consequences of expenditure reductions made by a DNSP, when the production of those reductions is the rationale that underpins the AER's decision. We consider that it is inconsistent with the requirements imposed by section 16 of the National Electricity Law (NEL) for the AER to fail to consider whether an immediate reduction in future expenditure:

- (a) contributes to the achievement of the NEM objective, and
- (b) takes into account the Revenue and Pricing Principles prescribed in section 7A of the NEL.

Ergon Energy notes the AER's observation that the NER appears not to permit a transition path where the AER's expenditure forecast is lower than a service provider's forecast.²⁴ However, in rejecting a transition path, Ergon Energy believes that the AER has not fully considered how it could apply the expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the NER.

It appears that in the AER's Draft Decisions, the avoidance of risk that customers may fund inefficient expenditure takes primacy over any other factor, including:

- The risk that the efficient level set is too low.
- The effective incentives in promoting economic efficiency associated with a NSP moving immediately to the mechanistically determined efficient level and the effectiveness of incentives applying to NSPs (and which NSPs responded to in good faith).
- The possible inefficient consequences and community safety impacts of an NSP moving immediately to the mechanistically determined efficient level.
- The regulatory risks to customers and the commercial risks to the NSP of making immediate decisions to move to its mechanistically determined efficient level.
- The risks of underinvestment associated with the NSP making immediate decisions to move to the mechanistically determined efficient level.

While the AER places, in its Draft Decisions for NSW and the ACT, an overwhelming emphasis on its assessment of 'efficiency' and its singular focus on lowest cost as an indicator of efficiency, it is important to recognise that an efficiency level of forecast operating expenditure cannot simply be equated to the figure that is produced by the mechanistic application of a series of benchmarking models and formula. The AER only determined a level of expenditure it considered efficient after a complicated combination of complex analytical techniques covering data which was gathered in 2014 and covering three countries. It was also ex post in that it reflects decisions already made.

This measure of 'efficiency' does not constitute a rigid cap on the allowable expenditure, such that any allowance above the level of this cost necessarily results in customers funding inefficient costs.

It also seems to Ergon Energy that the AER's view on 'efficiency' is largely based on what the lowest cost option is, without necessarily appreciating the specific operating risks a DNSP faces or

²² For example, see the Ausgrid Draft Decision, Attachment 7 (Operating expenditure), pp7-27.

²³ Id, pp7-54.

²⁴ Id, pp7-16.

understanding the impact on the commitments that each DNSP has to their customers, as well as the expectations the customers have of their respective DNSPs following the customer engagement processes undertaken under the NER.

Ergon Energy believes that the NER permits (indeed it requires) the AER to be satisfied not only that its total expenditure forecasts are efficient, but that they reasonably reflect the cost inputs required by the DNSP to achieve the expenditure objectives. The cost inputs in question are those facing the relevant DNSP, not a hypothetical service provider operating in another part of the world. The 2012 rule amendments referred to by the AER in its Draft Decisions for NSW and the ACT (*removing the words 'in the circumstances of the service provider'*)²⁵ related to the prudence criterion only. The remainder of clauses 6.5.6(c) and 6.5.7(c) of the NER remained untouched.

The proper application of the expenditure criteria was illustrated by the Australian Competition Tribunal (the Tribunal) in *Re Ergon Energy Corporation Limited (Labour Cost Escalators) (No 3)* [2010] ACompT 11, where the Tribunal found that the labour cost escalators to be applied in making Ergon Energy's current distribution determination were to be based on:

- (a) Ergon Energy's actual enterprise agreement for the first year of the current period (in which that agreement was in force), and
- (b) the AER's assessment of efficient labour costs in the remaining years (in which the agreement will have expired).

At paragraphs [56]-[57] of this decision, the Tribunal stated:

"[56] ...The Rules also require that the AER must accept a forecast if it is satisfied that the forecast reasonably reflects the opex criteria. However, that requirement does not rule out the need for the AER to consider the forecasts that may be presented as alternatives reasonably reflecting the opex criteria as well as the methods by which those alternatives are arrived at. Indeed, if the requirement were to rule out this consideration on the part of the AER it would deny the AER's argument that the 'transitional' risk issue it identified allowed it to weigh the importance of a DNSP's efficient costs against a realistic expectation of its cost inputs.

[57] There is substance to the concerns underpinning the AER's submission that to automatically allow a labour cost increment negotiated under an agreement that transits two regulatory periods creates an unacceptable risk of undermining the incentives to promote economic efficiency in future negotiations for such an agreement. The concerns are not, however, sufficient to conversely and automatically reject a labour cost increment so derived. Indeed, the gravamen of Ergon Energy's complaint, namely, that the AER had failed to satisfy itself in terms of cl 6.5.6(c) by investigating whether the circumstances in which the UCA [Union Collective Agreement] had been negotiated resulted in efficient costs, costs that a prudent operator in Ergon Energy's circumstance would require and costs which founded a realistic expectation of the cost inputs required to achieve the opex objectives, is well founded. The AER's reliance on the forecasts of its consultant, Access Economics, to arrive at its real escalator for the first year of the regulatory period, is no substitute for such an investigation."

Ergon Energy notes that, as in 2010, the approach implied by the AER's Draft Decisions for NSW and the ACT appears to involve no consideration of whether the DNSP's labour costs under their current enterprise agreements were negotiated in circumstances that indicate these costs are efficient. Rather, the AER, once again, appears to take an approach which rejects the efficiency of such costs by reference only to its own benchmarking.

²⁵ Id, pp7-54.

Of equal importance, these are cost inputs that are, in the short term at least, fixed. Whatever the AER may consider to be an 'efficient' level of expenditure, however determined the AER may be to impose incentives to further improve efficiency, the fact is that the cost inputs required by the DNSPs to achieve the expenditure objectives in clauses 6.5.6(b) and 6.5.7(b) of the NER will not change overnight and introduce further risks for DNSPs in terms of their ability to meet existing contractual obligations to suppliers and others.

There is no consideration of NSP decisions which were made in the context of the "efficient" allowance previously determined, even if it responded to the incentives and spent below the allowance. The AER assumes the DNSP should have been aware of its level of inefficient costs revealed by the benchmarking analysis, even though the information did not exist at the time.

While the AER can, under the NER, have regard to the need for incentives to promote efficiency, in deciding whether it is satisfied of the criterion in clause 6.5.6(c)(3) and 6.5.7(c)(3) it must assess *what is realistic*.

While the AER may consider that its assessment of efficient labour costs, and its desire to create incentives to promote efficiency, justify its decision to drive the DNSPs towards lower costs over the regulatory control period, a realistic assessment of the DNSP's labour costs (being one of the major cost inputs) must start from the recognition that, in the transition from one regulatory control period to the next, these costs will not change in the immediate short term. The same is true for most of the DNSP's cost inputs.

In deciding whether it is satisfied the DNSP's expenditure allowances satisfy *each* of the expenditure criteria, the AER must consider the use of a transition path in order to ensure that the DNSP's forecast expenditure reasonably reflects both prudent and efficient costs, *as well as* a realistic expectation of our cost inputs, over the regulatory control period.

Even if it is accepted (for the sake of argument) that the capital or operating expenditure building block cannot exceed a sum which, in the AER's view, satisfies the relevant expenditure criteria, the NER do not require that this expenditure be recovered in the year in which it is forecast to occur. As the AER itself has noted, it must approve an estimate of the *total* capital or operating expenditure required for the regulatory control period. The recovery of these costs in each year of the regulatory control period can be adjusted through the X factor. For example, a smaller reduction in operating expenditure in year one of the regulatory control period can be offset by a correspondingly greater reduction in operating expenditure in another year.

It is noteworthy in this context that clause 6.5.9(b)(2) of the NER (which would normally require the AER to minimise the variance between expected revenue and the Annual Revenue Requirement for the last year of the regulatory control period) does not apply to the AER in making its determination for the NSW and ACT DNSPs.²⁶

²⁶ NER, clause 11.56.4(c)(4). This transitional provision also applies to Ergon Energy (see NER, clause 11.60.3(b)(1)).

Given the overwhelming evidence against the AER's decision of operating expenditure forecasts, a transition path of this type would not, by itself, overcome the serious consequences that would follow from reductions in the total expenditure forecasts implied by the NSW and ACT Draft Decisions. It would, however, provide a more realistic timeframe in which the DNSPs could introduce the changes needed to achieve the efficiency improvements and likely cuts in programs and services triggered by the AER, without providing for the recovery of capital and operating expenditure costs in excess of the total forecasts which, in the AER's opinion, satisfy the relevant expenditure criteria.

Safety impacts and use of risk assessments and cost-benefit analysis

Ergon Energy notes that in light of the very substantial cuts to expenditure proposed by the AER the NSW and ACT DNSPs have raised many concerns over the approach the AER has taken to examining expenditure driven by the need to meet safety requirements and the approach taken by the NSW and ACT DNSPs to assess their various operational and other risks in developing their forecasts.

For example, in relation to Ausgrid, the AER stated:

*"In the course of our review of Ausgrid's proposal we have determined that Ausgrid's risk management practices are overly risk averse and result in higher capex forecasts than necessary. This view is supported by the independent review conducted by our consultants, EMCa. We consider that Ausgrid undertakes expenditure to avoid risks even when the cost benefit is not justified. This impacts all aspects of its proposal and as a consequence its revenue requirement and prices."*²⁷

The AER relied on statements by its consultants which were critical of Ausgrid, in part, because the consultants believed that Ausgrid's forecasts were not supported by robust cost-benefit analysis.²⁸

Ergon Energy also has concerns about the AER's reliance on such views, and the potential impacts on safety for the NSW and ACT networks (as well as our own) and the community, especially in so far as they relate to forecast expenditure that is driven by the need to comply with a firm's duties to maintain the safety of its network.

While compliance with health and safety obligations necessarily requires DNSPs to undertake risk assessments to identify and prioritise threats to health and safety, and to address such risks as efficiently as possible, works that are undertaken to address risks to health and safety are, as a general rule, not capable of being fully justified by reference to a cost-benefit analysis. This is because the chief 'benefits' of such expenditure are, typically, the avoidance of death and serious injury. Attempts to quantify such benefits and weigh them against the costs of corrective action:

- (a) are viewed as having questionable value in decision making, and
- (b) expose a firm to extremely serious consequences under relevant laws if it decides against preventative action on the basis that the cost of addressing such a risk would exceed the 'benefit' of avoiding death or serious injury.

²⁷ Ausgrid Draft Decision, Overview, pp26-27.

²⁸ Ausgrid Draft Decision, Attachment 6 (Capital expenditure), pp 6-35 to 6-36, 6-42, 6-61 to 6-63.

In relation to the first of these points, the European Agency for Safety and Health at Work (an agency of the European Union) published a report in 2014 entitled *The business case for safety and health at work: Cost-benefit analyses of interventions in small and medium-sized enterprises*. At pages 17 and 18 of this report, the agency questioned the model for making decisions on health and safety expenditure that is based the minimisation of the total cost of preventative activities and of safety incidents, stating:

“...calculations of this kind rely on oversimplified assumptions (ROWER, 2010). Risks involve too much variability and complexity to allow enterprises to be ranged on a one-dimensional safety scale. Moreover, even if a safety level can be defined, it cannot be seen as a function of preventive expenditure alone. Moreover, different OSH measures have different degrees of efficiency, which does not allow for a univocal relationship between a (hypothetical) ‘level of prevention’ and expenditure on prevention; the correspondence of an OSH level (S) to every level of OSH expenditure is simply impossible.

In general, it has been widely discussed (Owen, 1996; Miller, Whynes and Reid 2000; Miller, Rossiter and Nuttall, 2002; Mossink and Nelson 2002) that it is not easy to show a causal and quantifiable relationship between interventions and actual improvement in OSH, and in fact this might not even be necessary for an SME.”

While this report was focused on small and medium sized enterprises in particular, these propositions apply equally to a larger enterprise such as DNSPs.

Australia's peak safety body has highlighted the shortfalls of treating safety risk management in the same way as other business risk. Safe Work Australia was established by the Safe Work Australia Act 2008 with primary responsibility to lead the development of policy to improve work health and safety and workers' compensation arrangements across Australia.

It recently released a report "The Business Case for Safe, Healthy and Productive Work" which states:

“For too long, the business case for investing in measures to ensure the health and safety of workers has been viewed in restrictive financial terms and based on inadequate and inherently biased data. Rather than strategically examining the cost benefit to business of work health and safety, the typical 'silo'-driven analysis produces a narrow focus on a very different concept; the cost benefit to business of health and safety intervention. This has obscured much of the potential for improving organisational productivity and operational decision making. Even then, the quality of traditional cost benefit analysis appears fundamentally poor. On the one hand, the direct cost of health and safety intervention has a measurable impact on the bottom line. On the other, both the anticipated benefits of the intervention and the costs of failing to intervene are difficult to quantify. Aside from the significant costs disregarded as 'externalities' and therefore deemed largely irrelevant many of the costs and benefits to organisations are hidden. Others are consciously ignored because they are perceived as too difficult to quantify reliably or to tease out of aggregated cost categories. As a result work health and safety decisions tend to rely on vastly incomplete financial data. This renders cost benefit analysis partial and unreliable and has a tendency to bias financial analysis against investment in work health and safety interventions.”

More importantly, an approach to decision making which proceeds by reference to cost-benefit analysis would leave a firm exposed to a serious risk of prosecution in the event of a safety incident.

The legislative basis for investment in health and safety was also highlighted in Safe Work Australia's report. It states:

"In Australia, the legal requirements alone present a clear business case for investment. Those conducting a business or undertaking have a primary duty to ensure the health and safety of workers (and others including contractors). Cost benefit or budgetary concerns generally provide no legal defence for failing to comply with this duty. Furthermore potential fines and penalties for breaching the requirements are significant and insurance options such as directors' and officers' insurance have proven problematic and counter productive. Capacity to pay is not relevant. This means that what can be done should be done unless it is reasonable in the circumstances for a duty holder to do something else. The more likely the hazard or risk is or the greater the harm that may result from the hazard the less weight should be given to the cost of eliminating the hazard or risk."

It is inconceivable that a prudent firm, operating under the applicable workplace health and safety laws, would decide against taking action to eliminate a safety risk on the basis that its cost would exceed the value placed by the firm on the life that would be saved by that action. It is highly unlikely that a company or its directors and officers could successfully defend itself against a prosecution for a contravention of the relevant safety legislation on the basis of such an assessment, or avoid the potential fines and potential criminal sanctions (including imprisonment) arising from such a contravention.

The appropriateness of using cost-benefit analysis in making decisions relating to safety was considered in the review of Victoria's workplace health and safety laws undertaken by Chris Maxwell QC (as he then was) in 2004.²⁹ The Maxwell Report described the 'orthodox' approach to cost and risk prevention in the following terms: *"Cost must be considered in relation to the level of risk, as determined by likelihood, exposure and severity"*. Put another way, *"is the expenditure justified by reference to the degree of risk to be prevented?"*. The report described the unstated premise as being that the required expenditure should be (no more than) that which is proportionate to the risk.³⁰

However, the Report goes on to state:

"[532] It is often argued that to balance risk and cost in this way is simply inappropriate, because it does not involve a comparison of like with like. In essence, the argument is that:

"the risk is borne by the worker, while the cost is borne through the employer and through the cost structure by the employer's clientele (and ultimately the community at large). In other words, the scales are false."

[533] There is, in my view, considerable force in this argument. The so-called cost/risk balance is simply a form of cost-benefit analysis. It inevitably involves quantifying in dollar terms the benefit of preventing an injury or a death. The very notion that the value of a person's life can be weighed in the scales at a particular dollar value is a disquieting one."

The Maxwell Report recommended that Victoria's legislation be amended to include a test of "gross disproportion". That is, once the severity and likelihood of the risk have been assessed, the

²⁹ Maxwell, C. (2004), *Occupational Health and Safety Act Review (the "Maxwell Report")*, March 2004, <http://www.dtf.vic.gov.au/Publications/About-publications/Occupational-health-and-safety-legislation-review-report>.

³⁰ Maxwell Report, paragraph 524-525.

relevant safety measure should be implemented unless the cost of doing so would be grossly disproportionate to the risk as assessed.³¹ The Report stated:

[565] ... this clarification should greatly simplify the task of inspectors and dutyholders. It would henceforth be clear that cost should not be an obstacle to risk prevention unless there is such a manifest disproportionality between the cost of a preventive measure and the benefit (in risk prevention) that it would be clearly unreasonable to expect the measure to be implemented.

[566] By promoting a “transparent bias” in favour of safety, the “gross disproportion” test would reinforce a precautionary approach. It would establish a presumption in favour of safety. That is, the test would require the requisite preventive measure to be taken unless there was a stark imbalance between the cost and the risk.”

The 'grossly disproportionate' standard has been incorporated into the national framework for work health and safety³² (but not, it is worth noting, into Victoria's legislation).

Safe Work Australia has published an interpretative guideline on what is 'reasonably practicable',³³ which states (at page 5):

“Cheaper, available and suitable options may be used instead of a costlier option that may further minimise the risk or severity of harm, where the cost of the costlier option is grossly disproportionate to the risk. This will only apply where the cost is high and the likelihood or degree of harm is low (e.g. a slight chance of minor cuts or strains and the cost of replacing plant would be very high).

Choosing a low-cost option that provides less protection simply because it is cheaper is unlikely to be considered a reasonably practicable means of eliminating or minimising risk.

If the degree of harm is significant (e.g. death or serious injury is at least moderately likely) then it is unlikely that the cost of implementing available and suitable safety measures to eliminate or minimise the risk would ever be so disproportionate to the risk to justify a decision not to do so.”

Clearly, in addressing risks to safety, consideration of the costs of preventative action, as well as the nature and magnitude of the risk, is a relevant consideration. However, in complying with safety laws operating in the relevant jurisdiction, the role of cost-benefit analysis is not to determine whether the benefits of proposed expenditure will outweigh the costs, but rather whether that cost is *grossly disproportionate* to the risk in question.

A finding by the AER, which discounted forecast expenditure necessitated by safety considerations on the basis that it was unsupported by a cost-benefit analysis, would be a flawed finding, based on an incorrect understanding of the obligations created by safety legislation in the relevant jurisdiction.

Only if there is reason to believe that forecast expenditure would be grossly disproportionate to the risk involved would the absence of a cost-benefit analysis be a material consideration in determining that the expenditure was not prudent or efficient.

Ergon Energy is also concerned about how the AER has accounted for the differences across the NEM in terms of OHS compliance costs in benchmarking DNSPs, including the impact of OHS harmonisation.

³¹ Id, paragraph 563.

³² *Work Health and Safety Act 2011 (Qld)*, section 18.

³³ Safe Work Australia (2011), *Interpretive Guideline – Model Work Health and Safety Act: The Meaning of ‘Reasonably Practicable’*, September 2011.

Since the AER has relied upon PwC's 2012 findings in relation to the potential costs for Victorian businesses of adopting the OHS laws and the level of adjustment that should be made to the operating expenditure for the NSW & ACT DNSPs, Ergon Energy asked PwC to undertake some further analysis of this aspect. The reason that the AER has made this adjustment to the operating expenditure for the NSW and ACT DNSPs is because Victoria did not implement the OHS harmonisation package. A copy of PwC's analysis is attached to this submission (**Attachment 14**).

PwC have advised Ergon Energy that they agree with the AER that the implementation and ongoing costs associated with the OHS laws are material and that an operating environment factor adjustment is required to be made by the AER, particularly as the AER's benchmarking model does not take into account these differences.

Significantly, however, PwC indicate that PwC's analysis in 2012 did not consider the costs faced by businesses in other jurisdictions, nor did it purport to provide a cost differential between jurisdictions. As a result, it is PwC's opinion that the AER's methodology for adjusting for differences in OHS obligations between Victorian distributors and other distributors in the NEM is "necessarily simplistic" and "potentially understates the costs faced by Queensland distributors in implementing and complying with the new WHS laws".

Employment conditions

Background

In its Draft Decisions for the NSW DNSPs, the AER highlighted comments suggesting that employment conditions in these DNSPs were a material contributor to their perceived inefficiency relative to DNSPs in other jurisdictions.

Ergon Energy submits that the AER must be extremely careful before attributing perceived inefficiencies to differences in employment conditions. The employment conditions operating within DNSPs in different jurisdictions are inevitably influenced by the history of enterprise bargaining and industrial disputes in each jurisdiction. While this can result in differences between DNSPs, conditions must be examined carefully before a conclusion can be reached that they are a cause of relative inefficiency.

The AER cannot, in Ergon Energy's submission, dismiss the efficiency of employment conditions negotiated vigorously with unions and employees by reference to a theoretical benchmarking exercise. To do so flies in the face of the decision of the Tribunal in *Re Ergon Energy Corporation Limited (Labour Cost Escalators) (No 3)* [2010] ACompT 11.

This point can be illustrated by reference to Ergon Energy's own experience with enterprise bargaining. We explain this below.

Enterprise arrangements

Under the *Fair Work Act 2009* (Cth) (the FW Act), parties may elect to enter into an enterprise agreement. Agreements are not, in and of themselves 'laws', but when made are given the force of laws of the Commonwealth or States. Once an agreement is approved by a majority of relevant employees and the Fair Work Commission, the parties (including the employer, employees and any named union association) are bound by its terms. Ergon Energy is therefore required to comply with our current Agreement until it is replaced, or terminated, including paying pay rates, allowances etc. in accordance with the Agreement.

Ergon Energy's network supplies electricity to around 710,000 customers across a vast operating area of over one million square kilometres (as compared to the approximately 150,000 square kilometres of Powercor in Victoria) and employs over 4,000 employees. Ergon Energy's network contains 160,000 kilometres of 'poles and wires' (as opposed to the approximately 84,000 kilometres of Powercor). Ergon Energy's current Agreement assists in ensuring consistency in approach with employment and industrial practices across the entirety of the network (including in relation to dispute resolution procedures, pay rates etc.) regardless of location.

Ergon Energy's enterprise arrangement reflects the industry and market in which Ergon Energy operates (and which differs from the market of other DNSPs). The arrangements in place under Ergon Energy's enterprise agreement do not differ significantly from other DNSPs and, where differences do exist, such differences are justifiable given historical arrangements and network requirements.

For example, when comparing the 2011 Agreement to the two agreements in place for Powercor it is evident that:

- the enterprise agreements apply to similar classes of employees

- consultation obligations apply to both employers
- Powercor and Ergon Energy both provide different allowances and entitlements to employees depending on the conditions in which they work (night work, working away from home etc)
- termination provisions are similar across both entities
- similar percentage wage increases apply across the life of the agreements (noting that the Powercor agreements apply until 2016 and Ergon Energy's agreement is currently under negotiation). Powercor's percentage increases are 2.25 per cent and 4.5 per cent respectively, Ergon Energy's is 2.5 per cent plus a 1 per cent productivity payment for all employees under the 2011 Agreement
- both entities have employment security clauses and must follow set processes before engaging contractors.

Ergon Energy's current Agreement does contain processes and procedures in relation to matters such as training, dispute resolution, safety, consultation, opportunities for career progression which are not in the Victorian enterprise agreement. However, it does not automatically or conclusively follow that these processes result in inefficiencies. For example:

- the processes to be followed for dispute resolution provide for streamlined resolution of matters with agreed processes already determined, including steps that must be taken internally before a matter is referred to the Fair Work Commission, rather than being agreed as individual matters progress. These also ensure consistency in procedures across all Ergon Energy worksites.
- processes in relation to training and career progression set clear guidelines for employees about training and development opportunities, the path that is to be taken for progression and can assist in improving job satisfaction.
- the use of a Safety Committee demonstrates Ergon Energy's commitment to safety, including ensuring safety across the entirety of its network.
- comparison of pay rates at similar levels across other DNSPs in Australia demonstrates that some DNSPs pay higher rates than those applicable at Ergon Energy.
- there is no evidence that using a contractor is necessarily less costly than direct employees.

Further, differences in employment conditions including pay rates and allowances etc. are the result of the circumstances in which Ergon Energy operates. Including:

- the challenges Ergon Energy faces as it delivers electricity across an operating area of over one million square kilometres and employs over 4,000 employees
- competition to attract and retain staff particularly in rural and remote areas and in circumstances where other industries offer higher pay rates and conditions. Ergon Energy must attract and retain staff across a large geographic area and competes with the private sector (including the Queensland mining industry) for employees. Pay rates and conditions must be competitive
- obligations under Queensland specific legislation, including compliance with safety requirements across our extensive network.

Enterprise negotiations

Negotiations for enterprise agreements for Ergon Energy have historically been hard fought. Enterprise agreements are entered into only after following a prudent process and ensuring all

steps are taken to achieve a competitive agreement – with any increase in wages fully offset by productivity outcomes. Enterprise negotiations historically involve lengthy negotiations and both the potential threat and taking of industrial action including work stoppages.

The 2011 Agreement reached its nominal expiry date on 1 October 2014 and negotiations will continue into 2015 for a replacement agreement. As it has done historically, Ergon Energy is negotiating prudently with consideration given to modernising our industrial arrangements, considering changes within the industry, the needs of our customers, taking steps to keep network price increases for 2015–20 below inflation and considering the needs of our employees, including providing career paths.

Shareholder requirements

While Ergon Energy is a Queensland Government Owned Corporation, requirements imposed by Ergon Energy's shareholders highlight directives to *limit* wages growth. Ergon Energy conducts bargaining in accordance with applicable Queensland government policies and legislation including complying with the applicable Cabinet Budget Review Committee approved wages policies and directions in relation to employment conditions and entitlements etc.

Shareholding Ministers have communicated to Ergon Energy their expectation of cost efficiency and controlled expenditure (including limiting wages growth). Steps have been taken across the business to ensure this occurs. This remains a key priority for Ergon Energy in current negotiations; Ergon Energy is working towards a simplified, modern and more flexible agreement.

Metering

Metering exit fee

In their regulatory proposals, NSW DNSPs proposed to charge an exit fee to customers choosing an alternative service provider for Type 5 and 6 metering services. The exit fee formed part of the Type 5 and 6 metering services group, which was classified as an Alternative Control Service in the NSW Framework and Approach.

The AER's draft decision was to classify the residual capital costs component of the metering exit fee as a Standard Control Service. The AER also rejected the administration fee on the grounds that DNSPs did not provide sufficient evidence that they will face incremental administration costs. The AER indicated it would reconsider the administration fee if the DNSPs provided this evidence in their revised regulatory proposals.

Residual capital costs

Classification

As highlighted in our response to the AER's Issues Paper for Queensland,³⁴ Ergon Energy is concerned with the legitimacy of classifying metering exit fees as a Standard Control Service when the service to which it relates is an Alternative Control Service.

In its Framework and Approach Paper for Queensland, the AER adopted the following position (in the context of wasted attendances) regarding the cost elements of a service and how they should be classified:

*"we consider wasted attendance to be an element of a service provided by the distributors. That is, it is not a service in itself. We further consider the cost of a wasted attendance should be recovered consistently with the classification of the related service"*³⁵

Ergon Energy also questions whether transferring the portion of the metering Regulatory Asset Base (RAB) attributable to a stranded meter to the Standard Control Services RAB is permissible under the NER. Clause 6.5.1(a) of the NER requires the RAB to only include the value of those assets used to provide Standard Control Services. We consider that a stranded meter is not providing a service at all, and even if it was, it would be used to provide an Alternative Control Service.

Concerns regarding barriers to competition can be overcome by other mechanisms. Firstly, the AER can ensure that the exit fee is appropriate, clearly defined and transparent. Secondly, the AER may wish to consider other options to recover the forecast residual capital costs through the annual depreciation charge of the existing meter service. It is not clear the extent to which the AER has properly considered all options on this issue and how it has explained these to customers.

³⁴ p7.

³⁵ AER (2014), *Final Framework and approach for Energex and Ergon Energy, Regulatory control period commencing 1 July 2015*, April 2014, p49.

Applying residual capital costs to the Standard Control Services RAB

We note the AER's and stakeholders' concerns around the value of the RAB for DNSPs, including Ergon Energy.³⁶ However, the AER's approach represents the not uncommon regulatory practices of the past which defer impacts on customers in the short term by placing expenditure in the RAB which, in turn inflates the value of the RAB.

Administration fee

Ergon Energy supports the NSW DNSPs' contentions that the administration costs do not need to be incremental to be justified.³⁷ We consider the fee should reflect the administration costs associated with performing the end-to-end removal process for a Type 5 or 6 meter.

Upfront charge for new or upgraded meters

Ergon Energy notes the AER's draft decision requiring ActewAGL to have upfront charges to recover the costs of new and upgraded meters. Like ActewAGL, Ergon Energy proposed a single annual metering charge in our Regulatory Proposal. Should the AER adopt a similar position in Queensland, we would appreciate the opportunity to discuss the calculation of the charges prior to the release of the AER's Preliminary Determination for Ergon Energy.

³⁶ See, for example, AER (2014), *Issues paper: Qld electricity distribution regulatory proposals 2015–16 to 2019–20*, December 2014, p19.

³⁷ See, for example, Endeavour Energy (2015), *Revised Regulatory Proposal to the AER – 1 July 2014 to 30 June 2019*, p234.

Other issues

This section outlines a number of other areas of concern we have with the AER's Draft Decisions.

Control mechanism (Standard Control Services)

Standard Control Services

Revenue cap formulae

In Attachment 14 of Ausgrid's Draft Decision, formula one states the annual revenue requirement in year t should be greater than or equal to the sum of p (price) and q (quantity). Ergon Energy believes this should be less than or equal to.

We also query the ARR_t terminology used in formulas one and two. Ergon Energy expects that formula one would need to encompass the Distribution Use of System (DUOS) under or over recovery amount, which is not included in the ARR_t component in formula two. This means there are two different values attributable to ARR_t . We are therefore unsure how DNSPs can demonstrate compliance with formula one, unless the AER adjusts formula two to explicitly include a formula component for DUOS under/over recoveries.

DUOS unders and overs

The AER considers that its approach to including the under/over recoveries for year $t-2$ and $t-1$ will smooth DUOS under and over recovery amounts. While this approach may result in under/over recoveries being cleared 'quicker', it is unclear how such an approach will effectively manage the magnitude of DUOS under/over recoveries, particularly in instances when the $t-2$ and $t-1$ under recoveries are substantial. We are also uncertain what the AER envisages DNSPs can practically do through their pricing strategy to smooth out price shocks as an alternative to tolerance limits.

The AER has also stated that Queensland DNSPs account for DUOS under/over recoveries in the same way as proposed by the NSW DNSPs.³⁸ This is not correct. Ergon Energy's (and Energex) DUOS unders and overs account only includes under/over recoveries for year $t-2$ (subject to tolerance limits). In Ergon Energy's view, this is a more preferable and administratively simpler approach to managing DUOS unders and over recoveries.

Ergon Energy also notes the AER's comment that the decision to apply a tolerance limit for Energex in 2010 has had an undesirable result.³⁹ We disagree that tolerance limits have been ineffectual in Queensland and consider the tolerance limits that Ergon Energy applied to our DUOS unders and overs account have been successful in striking an appropriate balance between minimising volatility in prices over the current regulatory control period (so as not to exacerbate future under or over recoveries) and clearing under/over recoveries over a reasonable timeframe. Ergon Energy cleared the vast majority of our under recoveries in setting prices within the regulatory control period 2010–15.

Further, the circumstances surrounding the unprecedented level of under recoveries experienced in the current regulatory control period was heavily influenced by outcomes of feed-in tariff policies

³⁸ See, for example, the AER's Draft Decision for Ausgrid. Attachment 14 (Control mechanism), p12.

³⁹ See, for example, the AER's Draft Decision for Ausgrid. Attachment 14 (Control mechanism), p11.

and the significantly greater than expected uptake of solar photovoltaic installations. The pass through of these costs contributed to additional pricing pressures and increased uncertainty in predicting energy consumption over the current regulatory control period.

Side constraints

Side constraints apply to tariff classes related to the provision of Standard Control Services only. Therefore, the side constraints formula should not include a Transmission Use of System unders/overs factor.

Alternative Control Services

Fee based services

For fee based services, the AER has applied X factors which are consistent with the AER's draft decision on labour escalation factors. The AER states that, by doing so, they are "allowing for increases in labour costs in addition to CPI [Consumer Price Index]".⁴⁰ However, this does not appear to take into account other drivers in real costs which may impact prices (e.g. contractor services and materials). Ergon Energy therefore queries whether it is appropriate to apply a labour escalation to all underlying cost components.

Metering

The control mechanism formula for metering indicates that no X factors are to be applied. This suggests the AER is only allowing for annual escalations for CPI through the control mechanism formula. Ergon Energy considers that real cost escalators should also apply to metering services. This is consistent with the AER's draft decision for fee based services, which allows for increases in labour costs.

The AER has also proposed to apply tolerance limits which would cap how much extra revenue associated with the residual capital costs may be added to network tariffs. To the extent that tolerance limits are met, it is unclear how the AER intends the DNSPs to track and report on recoveries to be accounted for/cleared in future pricing years. For example, will DNSPs be required to adopt a mechanism like the DUOS unders and overs account and will interest be paid on amounts cleared over multiple regulatory years? If a Standard Control Service classification remains, it is important for the AER's Final Decision to provide detail on these matters to assist the DNSPs in outworking the decision.

Incentive schemes

Efficiency Benefit Sharing Scheme

The AER has decided not to apply the Efficiency Benefit Sharing Scheme (EBSS) to NSW and ACT DNSPs in the 2015–19 period on the grounds that DNSPs will already face incentives to improve their efficiency. Ergon Energy supports the arguments put forward by the NSW DNSPs in their revised regulatory proposals that:

- the operation of the EBSS would not need to be suspended if the AER makes the correct decision on operating expenditure

⁴⁰ See, for example, the AER's Draft Decision for Ausgrid. Attachment 16 (Alternative Control Services), p15.

- the AER's reasoning demonstrates that its substitute forecast operating expenditure is unachievable.⁴¹

Cost pass throughs

Insurer credit risk event

Ergon Energy does not support the AER's draft decision to reject the insurer's credit risk cost pass through event for the NSW and ACT DNSPs on the grounds that a prudent service provider could reasonably prevent an event of that nature from occurring.

We agree that a prudent service provider would assess an insurer's financial viability and capacity to satisfy any claims under a policy. In Ergon Energy's case, we rely on our insurance broker's advice to choose a reputable insurer with a good credit rating. We understand the NSW and ACT DNSPs do the same.⁴² However, despite this, there will always remain a risk of an insurer becoming insolvent or other changes occurring beyond a service provider's control.

This risk seems to be recognised by the NER, which prescribes an insurance event for Transmission Network Service Providers (TNSPs). This event is very similar in nature to the insurer credit risk event proposed by the NSW and ACT DNSPs. We consider its inclusion as a prescribed event for TNSPs infers that service providers are not able to take steps to mitigate or prevent this event from occurring. We also note that the AER has previously accepted an insurer credit risk event in its determinations for Victoria and Tasmania.⁴³

Ergon Energy contends that rather than rejecting the insurer credit risk event, the AER should use its discretion through the pass through application assessment process under Chapter 6 of the NER to determine whether the service provider has taken adequate steps to mitigate or prevent the event from occurring. We note the AER has previously concluded that the criteria set out in Chapter 6 takes into account whether the DNSP could have done anything to mitigate the costs, therefore a DNSP is unlikely to select a cheap, but unstable, insurance company to affect the event.⁴⁴

⁴¹ See, for example, Endeavour Energy (2015), *Revised Regulatory Proposal to the AER – 1 July 2014 to 30 June 2019*, p5.

⁴² See, for example, ActewAGL (2015), *Revised Regulatory Proposal: 2015–19 Regulatory control period*, January 2015, p544.

⁴³ AER (2010), *Final decision: Victorian electricity distribution network service providers, Distribution determination 2011–2015*, October 2015, p797; and AER (2012), *Final Distribution Determination: Aurora Energy Pty Ltd 2012–13 to 2016–17*, April 2012, p183.

⁴⁴ AER (2011), *Draft Distribution determination: Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p287.