Ref: TG:NL

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Dear Evan

Response to 'Draft Annual Benchmarking Report, Electricity distribution network service providers'

Essential Energy appreciates the opportunity to provide comments on the AER's 2018 Draft Annual Benchmarking Report (the 'draft report' or 'ABR').

Benchmarking is considered by Essential Energy as a valuable tool that can provide meaningful insights into the relative performance of network businesses, However, benchmarking is also a tool that must be 'sense checked' using a bottom-up approach to ensure that the selected model parameters are representative of the actual business being reviewed.

As Essential Energy has previously stated, the econometric benchmarking modelling fails to adequately consider customer density or cost per kilometre of line. More specifically, placing a large weighting on customer numbers as a driver of costs materially disadvantages distributors providing services to rural, regional and remote customers who are required to operate and maintain a disproportionately high amount of assets to provide services to relatively few customers. Less than five customers are supplied per kilometre of line for Essential Energy, meaning that the primary cost drivers are the number of assets and the size of the area in which those assets are located. Examples of asset related costs that are independent of the number of customers supplied include asset inspections, asset defect rectification, and vegetation management, and clearly the underlying capital cost of the network has a material impact.

Essential Energy welcomes the improvements in the Draft 2018 Annual Benchmarking Report but is also concerned at the significant repetition of approach and the findings of previous reports. We remain concerned that the AER continues to draw conclusions on the relative efficiency of DNSPs based on a predominant focus on cost per customer and suggests the analysis and benchmarking tools should be further expanded to ensure customer density is adequately reflected in outcomes.

To inform this response Essential Energy has drawn on evidence from two reports prepared by Frontier Economics that accompanied Essential Energy's 2019-24 Regulatory proposal. These reports are on the subject of Economic Benchmarking Analysis and Operating Environment Factors (OEFs) and are attached to this response.

Potential Improvements to Annual Benchmarking report

As noted, Essential Energy welcomes the improvements to the AER's ABR. However, further improvements can be made. After a thorough analysis of Essential Energy's proposed base year opex using a range of benchmarking approaches, including those used by the AER, Frontier Economics had the following conclusions and recommendations regarding economic benchmarking for the AER, these are included in the attached report and summarised below:

- **There is a strong case for relying on a broad range of evidence.** The AER should rely on a broad range of evidence to determine its target base year opex and efficiency adjustments for Essential Energy, including evidence from any bottom-up benchmarking and engineering assessments, and evidence on other opex factors such as the safety and reliability of the network. Reliance on a single, or limited number of, benchmarking models that do not adequately capture a wide range of factors may not accurately reflect the relative efficiency of Australian DNSPs.
- **There is a need to recognise the limitations of benchmarking analysis at present**. Owing to the lack of data to measure a large number of factors that may drive differences in performance between the DNSPs (such as differences in operating environment), relevant factors have not been adequately captured in the ABR. The AER may attempt to improve the range and quality of data available for benchmarking in the longer term in collaboration with the DNSPs. This could be achieved by creating a working group, in collaboration with the networks, tasked with developing empirical methods that may help it overcome the challenges it faces in regulating a sector within which there is such extensive heterogeneity. This may involve developing, defining and collecting additional measures, or considering methodologies to justify firm-specific adjustments to benchmarked costs, or adjustments to the outcome of benchmarking models. Essential Energy's comments on the OEFs are given below.
- **There is a need to develop a cautious approach in the application of benchmarking results.** Frontier Economics recommend that the AER adopt a conservative approach in the application of its benchmarking analysis should it decide to make base year efficiency adjustments for any of the DNSPs. This can be done in one, or in a combination of ways. For example, the AER could potentially:
    - consider lowering its criterion for choosing the target DNSP from the top 5th DNSP to a more conservative target owing to the limitations of the benchmarking approaches that are presently feasible
    - consider determining base year allowances on the basis of a weighted average of the DNSPs' proposed base year opex and target base year opex, and/or
    - consider splitting the 13 DNSPs into groups or cohorts, determined by evidence on their base year efficiency, and apply different levels of base year opex reductions to each cohort.

Changes to OEF framework is welcome, but further improvements are needed

Essential Energy considers that the material differences in operating environments across DNSPs in the NEM should be included, to the extent possible, in the analysis underpinning the ABR. Therefore, we welcome the updated analysis on OEFs that was done as part of this years' ABR. However, there are a number of factors that are yet to be included in the analysis.

Frontier Economics found in its assessment of OEFs that "it is not possible to draw meaningful conclusions about the relative efficiency of regulated DNSPs unless OEFs are controlled for appropriately. Failure to control properly for OEFs would defeat the objective of conducting economic benchmarking: namely, to identify the true scope for efficiency improvements for the DNSPs."[1]

The report recommends that with further data collection and time, a bespoke methodology could be developed for assess OEFs that are considered to be material by the AER, DNSPs and relevant stakeholders.

Specific comments on the changes to the OEFs are given below.

<u>Sub-transmission:</u>

Essential Energy supports the revisions to the methodology for the sub-transmission OEF estimate and corresponding OEF adjustment. As the network with the longest sub-transmission circuit length of all DNSPs in the NEM, this is of particular relevance to Essential Energy. The new OEF for sub-transmission appropriately recognises that Essential Energy does incur higher costs as we have relatively more equivalent sub-transmission assets than other DNSPs

[1] See Frontier Economics "Operating Environment Factors – A report prepared for Essential Energy", p.1.

Network terrain and topology:

The ABR notes that the Sapere-Merz report also considered that two other operating environment factors have the potential to be material. These are:

- Differences in DNSP terrain and topology (e.g. the proportion of radial and meshed network configurations that varies between DNSPs)
- Differences in the obligations and value of payments under Guaranteed Service Levels schemes in different jurisdictions.

Essential Energy would welcome further consideration of both of these OEFs, but in particular an OEF related to differences in DNSP terrain and topology.

We agree with the proposition noted in the Sapere Merz report that line length output in the econometric model may not fully account for variations in network topology and topography.

An OEF of this nature would be of particular importance for a more sparse radial network such as ours with 83,612 km of overhead powerlines and a low customer density of just 4.6 customers per km of powerline. The nature of our network means that staff have to travel much larger distances relative to other DNSPs. This is evidenced by the fact that each year Essential Energy employees travel 40 million kilometres. Such differences between urban and rural DNSPs should be factored into economic benchmarking to provide a more accurate comparison of relative efficiency.

Severe storms and weather:

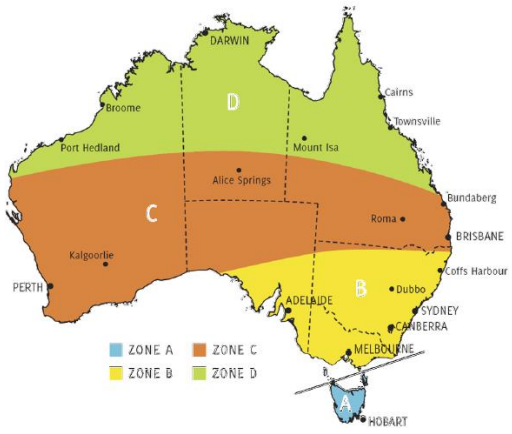
Essential Energy considers that an OEF related to severe storms and weather should be included as an OEF.

We note that Sapere Merz state that a severe storm related OEF, exclusive of high impact low probability (HILP) events, could meet all the OEF criteria. We note the finding that proponents of a severe storm OEF (excluding HILP events) need to provide positive evidence for the likelihood of a comparatively material outcome to justify further effort on severe storms.

Essential Energy is supportive of this finding and notes that the attached Frontier Economics report on OEFs provides evidence of Essential Energy's exposure to a diverse range of weather-related events.[2]

Termite Damage:

Essential Energy considers that the current Sapere Merz report doesn't consider the geographical susceptibility of timber poles to termite attack, nor the influence that the type of timber pole utilised by DNSP's has on the propensity for termite attack. CSIRO work shows distinct differences in termite attack for timber. The following susceptibility figure as derived from CSIRO work is based on timber damage for combining treated and untreated timbers.



[2] See Frontier Economics "Operating Environment Factors – A report prepared for Essential Energy", pp.10-34

Essential Energy would welcome further consideration of the other candidate OEFs mentioned in the Sapere Merz report, including labour and material costs, advanced metering infrastructure/demand management, asset inspection regimes and Guaranteed Service Level (GSL) payments.

If you or your officers have any questions in relation to this submission please contact our Head of Regulatory Affairs, Natalie Lindsay, on 02 6589 8419 or via email Natalie.lindsay@essentialenergy.com.au

Yours sincerely

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General Manager Strategy, Regulation and Transformation