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Dear Evan

Consultation on draft 2018 Annual Benchmarking Report

Jemena Electricity Networks (Vic) Ltd (**JEN**) welcomes the Australian Energy Regulator's (**AER**) draft 2018 Annual Benchmarking Report for comments. The report continues to provide a view to customers and distribution network service providers (**DNSPs**) on the relative efficiencies of the DNSPs over time. In the 2018 draft benchmarking report the AER has made several changes and updates in relation to its benchmarking techniques. We have also noticed potential omissions and errors in the analysis undertaken and presented in the draft report. We welcome this opportunity to respond to these and have provided our feedback below –

1. Possible error in reporting of SFA CD efficiency scores for longer sample period

The 2018 AER draft annual benchmarking report may have mis-reported the SFA CD scores for 2006 – 2017 sample period in Figure 5.1 of the report. We derived the efficiency scores using the Economic Insights benchmarking Stata file titled 'vc med BM 24-07-18' and resulted in different scores than that reported in Table 3.7 of the 2018 Economic Insights report and plotted in Figure 3.4 of that report, which is reproduced as Figure 5.1 of the AER draft benchmarking report. We request the AER to confirm the scores and update its annual benchmarking report accordingly. We also note that there is a possible error in Ontario DNSP 3016's price index for 2005. It is currently 1.267450555 but the correct value is 1. We recommend the AER corrects this error in the final benchmarking report.

2. Possible error in OEF analysis

The OEF calculation for JEN in Sapere Merze's analysis uses incorrect number of transformers. The analysis uses 43 transformers whereas the 2015 CA RIN (29 April 2016) for JEN sets out that the number of transformers with a 66kV primary voltage is 61 (Ref: Template 5.2 asset Age Profile, sum of cells F85:EJ91). We request the AER

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to communicate this error to its consultant to amend the OEF results accordingly. This is likely to increase the OEF for JEN from -1.06% to -0.01%.

Sapere Merz has also incorporated information published by CSIRO on termite prevalence. While the granularity of the information may not be perfect, it represents a step in the right direction to use best available information. We note that the calculation assumes that all of JEN's network area is west of 145°E (the Melbourne West zone). In fact, a significant portion of assets is east of this (the Melbourne East zone) and should attract a higher prevalence rate. We note that the line between the Melbourne East and West zones adopted by CSIRO at 145°E is arbitrary and that CSIRO warn that:

"This interim termite hazard map should not be seen as definitive, but rather a starting point that might encourage further research that can be used for its modification and improvement." (Ref: pg.6)

We believe that it is not completely accurate to simply apply the Melbourne West zone to JEN's network area. Given the uncertainty in the data, particularly when applied to the small area represented by JEN's network area in comparing to the Termite Prevalence zones we believe a conservative approach is required. We recommend applying an average of the Melbourne West and Melbourne East zones (9.2%) which yields an OEF adjustment on Termite exposure of -0.07%, compared to -0.08% in Sapere Mertz's OEF calculation.

3. Omissions in OEF analysis

We note that in the report Sapere Mertz do not consider two candidate OEFs that apply to JEN (letter dated 9 Feb 2018 submitted to the AER). These candidate OEFs are:

- the Victorian obligation for transmission connection point planning
- the Victorian obligation with respect to inspection and testing

The first is for the obligation imposed on us to undertake transmission connection point planning. We note that this is not considered in the Sapere Merz report, which only makes comment on planning requirements that are common to all state jurisdictions (pg. 48). The obligation to undertake transmission connection point planning applies only in Victoria. We ask that the AER considers an OEF for transmission connection point planning in its final decision on OEFs.

We also proposed a candidate OEF for imposed inspection and testing obligations. Sapere Merz comments on differences in asset inspection regimes in section 4.3, concluding that more work is needed, and they appear to favour a review of fundamental differences in asset inspection plans between DNSPs (pg. 13). We believe that this approach misses the point that the inspection and reporting requirements imposed on JEN by Energy Safe Victoria are additional to those otherwise required in other jurisdictions. In our proposal, we only included those costs for the portion of our inspection and reporting requirements that relate directly to the imposed obligations. Without those obligations, JEN would not incur these costs. We are not aware that any other state safety regulator imposes similar obligations and hence DNSPs in those jurisdictions do not bear such costs.

4. Overall impact on OEF for JEN

We believe once the above errors and omissions are addressed by the AER, we consider it would result in the following impact on the OEF for JEN -

Table 1 - Proposed changes to Sapere Merz's estimate of JEN's OEF		OEF
OEF as per Sapere Merz Report		-1.06%
OEF when corrected for transformer number error		-0.01%
OEF when corrected for transformer and termite data error		0.00%
OEF when corrected for above error and including OEF for* –		0.05%
<ul style="list-style-type: none"> • Victorian obligation for transmission connection point planning • Victorian obligation with respect to inspection and testing 		
Proposed new OEF for JEN		0.05%

*Refer Jemena letter dated 9 Feb

If the transformer number is corrected the OEF adjustment will increase from -1.06% to -0.01%. If JEN's proposed OEFs are accepted and the errors in relation to transformer number and termite data are corrected it will result in an OEF of 0.05%.

5. Volatility of results across models and large spread in efficiency scores

There is a considerably large spread in efficiency scores for each DNSP across the four models used by the AER, which is as large as 21% for some DNSPs (such as United for the 2006 – 2017 sample period). This is extremely concerning and reflects that results may not be a clear-cut indicator of efficiency levels of the service providers, especially in case of LSE models. This potentially indicates that the LSE models are less able to separate heterogeneity between the DNSPs from inefficiency compared to the SFA models. Although Jemena's preference is to use an SFA-CD model only due to its application by the AER over past few years we understand that the AER is attempting to address the concerns raised by the Australian Competition Tribunal (ACT). We recommend further work on the models to reduce volatility in results.

6. Volatility in ranking

While introducing more econometric models may address concerns raised by the ACT, we consider that the results from the four models have potential of creating confusion for customers and other stakeholders. For example, the below Table 2 shows that JEN would rank 7 under one set of results and 11 under another. Similarly, the benchmark firm if defined as the 5th most efficient firm would change under each model. For example, Essential appears to be the 5th most efficient firm under LSE TL but not under any other model.

Table 2 - DNSP ranks under 4 econometric models							
Period	2012 - 2017				2006 - 2017		
Models	SFA CD	SFA TL	LSE CD	LSE TL	SFA CD	LSE CD	LSE TL
ActewAGL	12	13	13	13	12	12	13
Ausgrid	13	12	12	12	13	13	12

Table 2 - DNSP ranks under 4 econometric models							
Period	2012 - 2017				2006 - 2017		
Models	SFA CD	SFA TL	LSE CD	LSE TL	SFA CD	LSE CD	LSE TL
CitiPower	2	2	2	2	2	2	2
Endeavour	10	10	11	10	10	10	9
Energex	9	8	9	9	8	9	8
Ergon	11	9	10	8	11	11	11
Essential	8	6	7	5	9	8	7
Jemena	7	11	8	11	7	7	10
Powercor	1	1	1	1	1	1	1
AusNet	6	7	6	7	5	5	4
SAPN	5	4	5	3	4	4	3
TasNetworks	4	5	4	4	6	6	6
United	3	3	3	6	3	3	5

These results also make it difficult to undertake efficiency comparisons between DNSPs and also to previous AER determinations based on SFA-CD only. At this stage we would recommend AER discuss the risks with interpreting the volatility in rankings under the four models in its report.

7. Need to account for economies of scale

The AER's econometric analysis indicates that there are increasing returns to scale across many of its models. Since the opex and scale variables in the AER's econometric models are specified in logs, these can be interpreted as elasticities. When the sum of elasticities across the scale variables in a model is less than one, this indicates that there are economies of scale (in other words, if scale increases by 1%, opex would increase by less than 1%). Table 3 below shows that many of the AER's models exhibit economies of scale (the exceptions being the SFA CD models and the LSE CD for the shorter sample).

However, JEN is unable to benefit from these economies of scale to the same extent as the larger DNSPs owing to its small size relative to the rest of the DNSPs.

Table 3 - Estimated Coefficients							
Scale Variables	LSE CD	SFA CD	LSE TL	LSE CD	SFA CD	LSE TL	SFA TL
	2006-17			2012-17			
Customer numbers	0.69	0.716	0.566	0.682	0.712	0.507	0.66
Circuit length	0.017	0.127	0.11	0.119	0.169	0.136	0.171
Ratcheted maximum demand	0.201	0.157	0.297	0.207	0.119	0.338	0.149
Total	0.908	1.000	0.973	1.008	1.000	0.981	0.980

There are some Victorian businesses that are able to spread their corporate costs across 3 networks due to common ownership and geographic location that provides greater synergies (CP, PAL and UE). Such economies associated with geographic location are unlikely to be available for other networks especially JEN which is the smallest network business in Victoria. We recommend the AER consider a

normalisation mechanism when comparing a small-scale network such as JEN to businesses that can spread their corporate costs across more than one network in the same geographical location.

8. Issues with short sample period

We note that while industry-wide productivity has increased over the last two years, the primary factors driving the increase in industry productivity were reductions in opex achieved through business restructuring, including significant reductions to the workforce in jurisdictions such as NSW and ACT. These large and one-off restructuring gains may not be sustainable in the longer-term. In addition, by relying on the shorter sample period from 2012-2017, it is less comparable with results in previous reports. Hence, JEN recommends that the AER's assessment of productivity be based on the longer sample period from 2006 – 2017.

Conclusion

We also request the AER consider above proposed recommendations in relation to –

- correcting the 2005 price index for Ontario DNSP
- adjustment to JEN's OEFs for possible errors and omissions in Sapere Merz's analysis as per Table 1
- undertake further work to reduce volatility in results
- discuss the risks with interpreting the volatility in ranking under the different models in its report; and
- using longer sample period which is more comparable with previous reports and not influenced by single year cost reductions that may not be sustainable in the long run

We are committed to work constructively with the AER and welcome any further queries in relation to the above mentioned feedback. Please contact Jerrie Li on (03) 9173 8143 if you would like to discuss this letter further.

Yours sincerely



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