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Mr Sebastian Roberts
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Australian Energy Regulator
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Via email: AERinquiry@aer.gov.au; sebastian.roberts@aer.gov.au

Dear Mr Roberts,

RE: Forecasting productivity growth for electricity distributors

We welcome the opportunity to comment on the Australian Energy Regulator's (AER's) draft decision paper on forecasting productivity growth for electricity distributors.

Operating expenditure (opex) productivity is an important measure of success for any industry, including ours. Customers and other stakeholders rightly expect energy distribution businesses like us to ensure that prices are no more than they should be – and an important contributor to achieving that is the incentive-based regulatory regime that we now face that encourages us to continuously seek productivity improvements (or avoid / minimise reductions) over time.

In this sense, the AER's review is a timely one. Ensuring that projected expenditure reflects a realistic expectation of productivity improvement is important. If too low, then customers are paying more than they should. If too high, then businesses – even efficient ones – are being set targets that cannot be achieved, and risk underfunding activities needed to deliver the service outcomes that customers and other stakeholders demand.

This letter responds to the AER's draft decision paper. First, by explaining how we see this review affecting the current distribution determination process for Power and Water Corporation (Power and Water), ensuring that productivity is not double counted. Second, by summarising our more general concerns with key aspects of the information and approaches relied on by the AER in the paper – there is room for improvement that could materially affect the AER's final position.

Need to ensure that productivity is not double counted in the opex allowance for us

We are new to regulation by the AER. We are currently working through our first regulatory determination made under the NT National Electricity Rules – and have welcomed the AER's open and transparent engagement process with us and other stakeholders, including our shareholder.

Opex is an important part of that determination process as we transition from a jurisdictional regime to one where we are compared to the performance of our network peers – a task that is made difficult because of our unique operating environment and challenges with our historical data. Recognising these challenges, we have offered up significant savings that reduce our forecast opex to a level that – although a real stretch for us – is an important signal to our customers and other stakeholders of our commitment to seek opex improvements over time.

Those savings are our expectation of what we could achieve by the end of the 2019-24 regulatory control period *if* we are successful with current and future transformation programs and other initiatives. We are not guaranteed to realise potential cost reductions from them, yet we incur the cost of implementing them.

This dynamic is important in the context of the AER's productivity review. In one sense, our proposed opex savings build in an expectation that we will realise productivity improvements over the 2019-24 regulatory period. If our proposed savings are retained in the AER's final determination for us, then to add in a further productivity factor into the rate of change applied to base opex would double count potential productivity improvements – effectively removing them from our opex forecast twice. This would significantly underfund our operating activities and put at risk the service outcomes that our customers and stakeholders demand.

In the past we have operated at levels of opex that, in hindsight, were too low. The Casuarina zone substation incident that caused significant blackouts for many of our customers was, in part, linked to underspending on maintenance activities. We, our customers and our stakeholders all want to avoid such incidents in the future; this requires that we are fairly funded for operating activities.

As such, we ask that the AER recognise that our proposed opex forecast for the 2019-24 regulatory control period *already* builds in productivity improvements. If a positive productivity factor is adopted explicitly in the opex forecast (as part of the rate of change), then the proposed savings should be adjusted accordingly. Alternatively, if the AER retains our proposed savings or an alternate, then it should retain our proposed 0 per cent productivity factor.

We welcome the opportunity to discuss our opex forecast further with the AER's opex team as part of the distribution determination process.

There is room for improvement in the productivity review final decision paper

We expect other stakeholders will engage in the detail of the draft determination paper. We support the Energy Networks Australia's submission.

For our part, we support the AER reviewing productivity factors from time to time. However, we do have some general concerns with the information and approaches used in the draft decision paper:

- **Selective use of information.** On face value, the AER's paper appears to consider a wide range of information before determining the productivity factor of 1 per cent. However, the paper appears to be selective. It ignores or discounts information that may support a negative productivity factor (e.g. parameter coefficients from economic benchmarking models applied to Australian *electricity* distribution networks such as the Cobb Douglas cost frontier model). Similarly, it incorporates information that appears less relevant than that ignored or discounted (e.g. parameter coefficients from economic benchmarking models applied to Australian *gas* distribution networks).

We ask that the AER takes a more balanced approach to looking at the information available, ensuring that the information is not – either consciously or subconsciously – being used in selective ways to achieve a given objective (e.g. a positive productivity factor).

- **No recognition that productivity could reduce over time.** As the AER notes, productivity across the industry has reduced in the past. There are valid reasons for this, including that new obligations and other changes increased costs. There are also valid reasons why productivity could be negative in the future, including because of future changes in obligations or changes to industry dynamics that make it harder for networks in the future.

  We simply ask that the AER keep an open mind that productivity could reduce in the future. It is important that the AER does not unfairly filter information that does not meet a pre-existing position that productivity must be positive.

- **Need to recognise the link between productivity and step changes.** The AER notes (at page 22) that 'a prudent and efficient distributor would not reduce its productivity over time unless it needed to increase its costs to meet a non-discretionary obligation'. The AER then says that it generally provides for 'the costs of new and material regulatory obligations through step changes' and so a zero productivity factor has been appropriate in past distribution determinations.

  However, in more recent determinations – including the draft determination for us – the AER has not allowed many step changes. This could be for various reasons, including because networks have not proposed any or many, or because the AER has not been satisfied that those that were proposed were not already funded by the rate of change or there was some deficiency in the justification. Often it is not clear what new obligations may arise during a future regulatory period. Although there is often a pass-through mechanism available, it has limits on what costs can be passed through (e.g. due to materiality thresholds) that can mean legitimate costs are incurred but not funded.

  We ask, then, that the AER explicitly recognise the interdependency – e.g. in a distribution determination – between its step change and productivity factor constituent decisions. If, as in our case, the AER rejects most / all step changes, then it would be unfair not to recognise future unknown cost increases caused by changes in regulatory obligations when determining the productivity factor.

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If you have any questions regarding our feedback in this submission, please do not hesitate to contact

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Yours sincerely

Djuna Pollard
Executive General Manager Power Services
21 December 2018