



ETSA Pre-determination Conference

Comment on the AER's benchmarking

9 January 2009

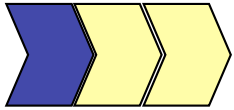
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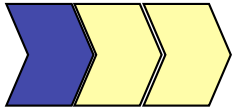
What the Rules require on benchmarking

Benchmarks to encompass aggregate cost definitions (viz. “opex” and “capex” i.e. not just unit cost or similar narrow benchmarks)

Efficient DNSP to be defined

“ ... benchmark opex / capex that would be incurred by an efficient Distribution Network Service Provider over the regulatory control period.”

The proposed opex/capex over the coming regulatory period, not historic opex/capex to be benchmarked



What has the AER said about benchmarking ?

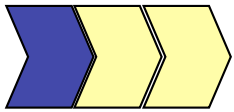
“benchmarking is one of only ten factors ... thus ... should be limited to a top down test of more detailed bottom up assessments”

“... limitations of the benchmarking work ... limits the use of the benchmarking results as a tool for justifying amendments to opex forecasts”.

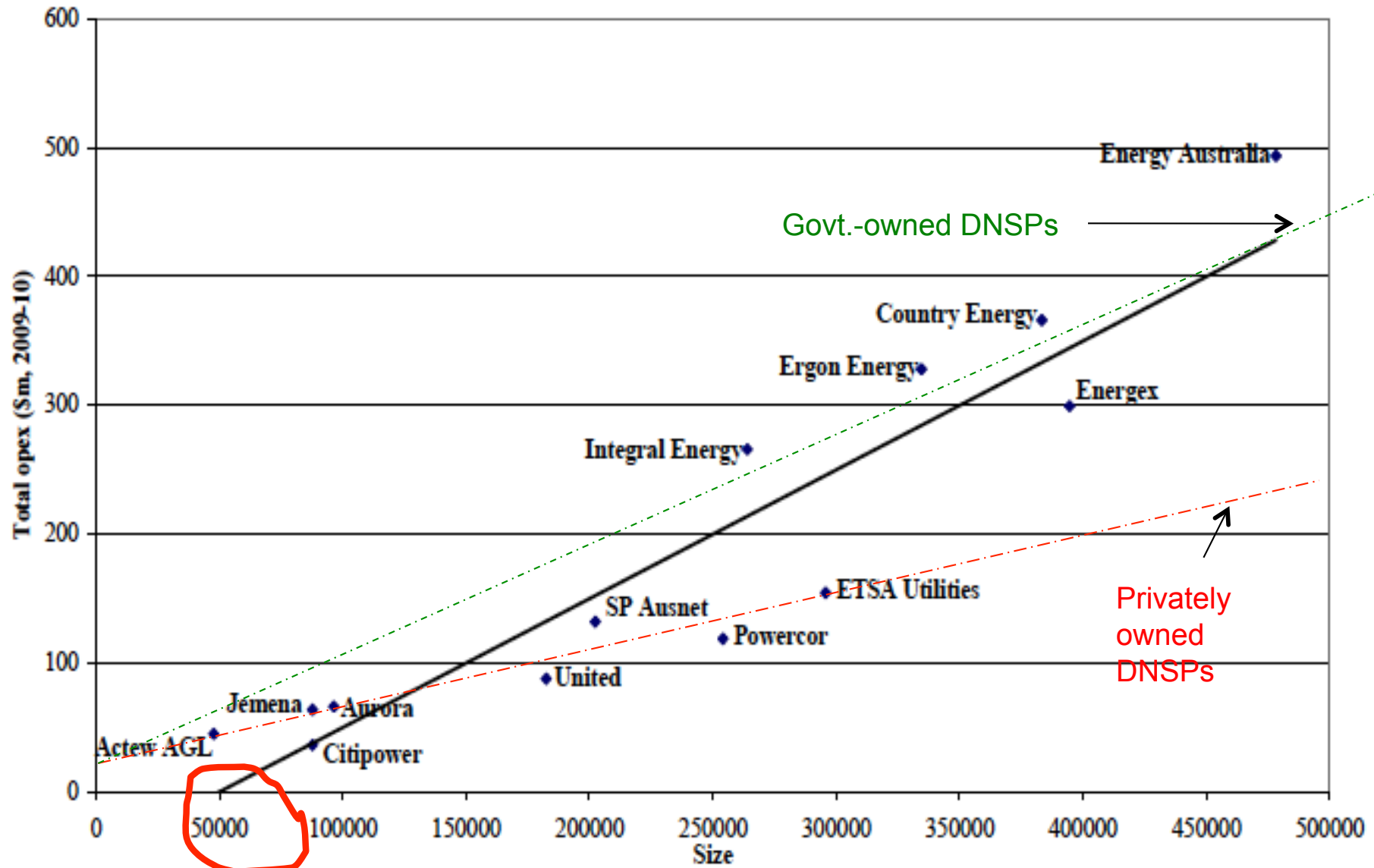
“... the general limitations of benchmark analysis are recognised by the NER, as benchmarking is only one of ten factors that the AER must have regard to when assessing a DNSP’s proposed opex forecast”

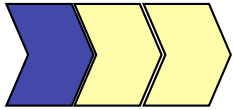
Playing it back it seems that the AER is saying that:

1. Its benchmarks are not reliable and so have “limited use” in setting opex allowances;
2. Benchmarking is of limited significance anyway (because it is just 1 of 10 factors);
3. Because it is just 1 of 10, this implies that the Rules recognises the limitations of benchmarking (does the same logic apply to the other 9 factors as well ?).



What has the AER done on opex benchmarking ?



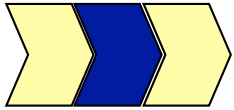


How has the AER used benchmarks in setting revenues?

- Energex, Ergon and ETSA are all far from the “efficient” frontier (as is Energy Australia, Integral Energy and Country Energy which AER said it previously benchmarked), and yet the AER made no changes to the opex allowance for any of these.
- Outcome of benchmarking has been explained away (e.g. “ ... **Ergon Energy’s actual opex in the base year has been verified by an audit of the regulatory information provided to the AER, overspend ... is explained by prevailing economic conditions and changes in accounting practise (therefore) AER considers it represents an efficient amount from which to forecast opex in the next regulatory control period).** “

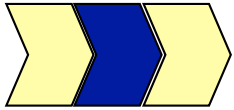


AER says benchmarking is used as a “top-down test”. But in what sense is this a fair description if the results of the “test” are dismissed ?



Benchmarking the AER's benchmarking

	AER	Ofgem
Scope	Opex only (less than 20% of total expenditure)	Recurrent expenditure (~ 66% of total expenditure); unit cost benchmarks play major role in capex
Technique	Regression of “size” against “total opex”; No statistical testing of drivers ? No cross-check ?	<ul style="list-style-type: none"> •Loglog Least Squares (4 different cost drivers); •Cross check with Data Envelopment Analysis and Stochastic Frontier Analysis •Cross check with Composite Scale Variable •Cross check with international comparison •Extensive statistical analysis of drivers to determine correlation
Definition of efficient frontier	Not defined, but assumed to be line of best fit (average)	•Upper quartile corrected loglog least squares regression
Data	<ul style="list-style-type: none"> •Not referenced; •One year •Data inconsistency concerns 	<ul style="list-style-type: none"> •Publicly available; •Four years •Established after extensive effort into normalisation and consistency

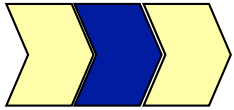


What has Ofgem said about benchmarking ?

“Applying sensible benchmarking ... has allowed us to cut network investment expenditure (allowance) by 11 per cent.”

“ We have generally arrived at our view of the network operating and indirect costs by benchmarking ... in most cases this approach means that the benchmark costs for less efficient companies will be brought in line with those that are more efficient and customers will not carry the cost of inefficient operations.”

“In general our approach is to use the upper quartile, which means that all but the top 25 per cent will have to be more efficient ... if they are to live within the operating cost allowance we have set. “



How has Ofgem used benchmarks to set expenditure allowances ?

Results: Ratio of actual costs in 2008/9 to benchmark



DNO	NOCs	Indirects
CN West	135%	103%
CN East	101%	85%
ENW	86%	117%
CE NEDL	108%	91%
CE YEDL	111%	79%
WPD S Wales	91%	97%
WPD S West	98%	88%
EDFE LPN	91%	120%
EDFE SPN	114%	105%
EDFE EPN	107%	126%
SP Distribution	112%	98%
SP Manweb	115%	106%
SSE Hydro	59%	104%
SSE Southern	77%	79%
Upper Quartile	91%	89%
Lower Quartile	111%	106%

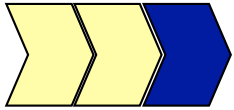
How benchmark results were used to set allowed revenues

For Indirect costs: adjusted all DNOs' costs in 2008-09 to the upper quartile.

For Network Operating Costs:

1. adjusted DNOs' costs that are performing worse than the average (greater than 100) down to the average.
2. DNOs which have scores better than the upper quartile, moved to the upper quartile.
3. DNOs between the average and upper quartile, no adjustment to their 2008-09 costs

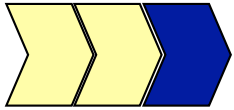
Adjusted 2008/9 costs rolled-forward for coming regulatory period based on (essentially) 1% per annum reduction for efficiency improvement



Issues of concern with AER benchmarking ... 1/2

1. Accountability to the National Electricity Rules

1. Capex does not appear to have been benchmarked.
2. Rules requires AER to benchmark and then have regard to the results. AER said it developed a benchmark; that it was “limited”, and then dismissed the results. Not clear that this is what the Rules intend.
3. AER has diminished the role of benchmarking (“just 1 of 10 factors”) and suggested its role is just as a “top-down test”. Not clear that this is consistent with the Rules.
4. Comparison is of historic opex in 2007/8, instead of opex over the coming regulatory period. Doesn’t seem consistent with the Rules.
5. No justification for the selection of the line of best fit (i.e. average) as the “efficient DNSP” (if the average is an “efficient DNSP” then what is a DNSP that performs better than the average ?). Not clear that using the average is consistent with the Rules



Issues of concern with AER benchmarking ... 2/2

Methodology and implementation

1. The parameters of the line of best fit are implausible: how can a business with customers and assets have no opex ?
2. No justification for the choice of cost driver (why size ?) – statistical analysis needed to determine significance;
3. Data sources need to be identified to ensure analysis is replicable;
4. Lack of transparency on specification of “size”;
5. No cross-check or verification of analysis;
6. Choice of single year in analysis.