

9 February 2018

Mr Evan Lutton
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Australian Energy Regulator
2 Lonsdale Street
Melbourne VIC 3000
Via: AERinquiry@aer.gov.au

Dear Evan

Benchmarking operating environment factors review

SA Power Networks welcomes the opportunity to respond to the draft report jointly prepared by Sapere Research Group and Merz Consulting (**Sapere-Merz**) on Operating Environment Factors (OEFs).

Due to the importance and reliance on benchmarking outcomes to assess the relative efficiency of Distribution Network Service Providers (DNSPs), SA Power Networks believes that consistent reporting and measurement of data is critical to all stakeholders. However, we believe that a stronger focus is required on consistency of existing reporting before adjusting for differences in operating environments.

The review of OEFs is aimed at improving comparability of DNSPs in benchmarking. Limiting the exercise to exogenous factors does not account for very material factors that need to be considered, such as capitalisation, trade-offs, and other data reporting consistency issues. These need to be considered first and only once accounted for should attention turn to exogenous OEFs.

Capitalisation in particular is something that will be reflected in all OEFs. Whilst capitalisation policy does not meet the exogeneity criterion contained in Sapere-Merz's brief, it represents a clear and material difference between DNSPs that is not accounted for in econometric benchmarking. SA Power Networks understands from the report that the AER is currently reviewing differences in cost allocation and capitalisation policies between DNSPs, and their effect on benchmarking¹, and considers that consistency in reporting should be the AER's primary focus before it considers environmental factors.

This issue is likely to grow in the future due to the take-up of certain new technologies (eg cloud solutions) and consideration of non-network solutions, driven particularly by the AER's new demand management incentive scheme.

¹ Sapere Research Group and Merz Consulting, *Independent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, December 2017, page 16.

Decisions on trade-offs are made to improve overall efficiency and/or to reduce costs to customers in line with the National Electricity Objective, and consideration needs to be given to addressing the impact of these on efficiency measurement. However, the current benchmarking models rely on only physical quantities to measure capital efficiency, versus operating expenditure being used to measure operating efficiency, thereby ignoring this trade-off effect of prudent actions.

We note that Sapere-Merz highlights a number of concerns with data consistency in its report (eg in assessment of vegetation, taxes and levies and emergency response OEFs) and also their statement that *"The (OEF) estimates are the best possible with the available data"*². This reinforces our belief that the AER's focus should firstly be on consistent data reporting and measurement.

Notwithstanding this, for OEFs to be considered, we agree that a transparent, robust and replicable process is required to identify costs and responsibilities that are unique to a specific DNSP. Sapere-Merz's discussion on vegetation management is a clear example of the challenges associated with assessing OEFs for each DNSP.

All distributors have electricity networks that must be operated in accordance with safety and technical standards specific to their jurisdiction. Customer densities and terrains also differ widely. Relative measurement will always be difficult and imprecise for this reason. If adjustment for OEFs is made, it needs to be concerned with material items only and be consistently and fairly applied to all DNSPs.

For example, the largest individual OEF adjustments made by Sapere-Merz relate to sub-transmission assets. We understand that this is largely due to higher maintenance costs associated with assets installed to meet state-based reliability standards. However, higher reliability standards should mitigate costs in other opex categories, for example emergency response costs. We are concerned therefore that the OEF adjustment calculated for sub-transmission assets may be duplicative.

Further, all service standard frameworks and associated Guaranteed Service Level (GSL) inconvenience payments to customers are state-based and vary widely across jurisdictions. Payments made range from zero up to \$30 million in annual compensation to customers. These schemes are exogenous to DNSPs and potentially very material, but do not appear to have been adequately considered in Sapere-Merz's report.

We believe that further discussion and consideration of the application of OEFs is required, and reiterate our belief that they should only be considered once the AER is comfortable that data is reported and measured consistently for all DNSPs.

Detailed discussion on the above matters and exogenous factors that specifically impact SA Power Networks is contained in the following attachment. Please contact Trevor Gusling on (08) 8404 4325 (or trevor.gusling@sapowernetworks.com.au) if you require any further discussion or clarification.

Yours sincerely



Wayne Lissner
Head of Regulation

² Sapere Research Group and Merz Consulting, *Independent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, December 2017, Executive Summary, page 1.



Supporting Information

Capitalisation policy

Capitalisation policy particularly relating to overheads, can have a significant impact on the benchmarking outcomes of DNSPs. SA Power Networks' policy is to expense all corporate overheads in accordance with our AER approved Cost Allocation Method. In 2015 (year ended 30 June except for Victorian DNSPs, 31 December), DNSPs capitalised on average approximately 42% of corporate overheads.³ This ranged from almost 70% for some DNSPs to zero for SA Power Networks and United Energy.

If SA Power Networks had capitalised 40% of corporate overheads, consistent with the NEM average, it would have reduced our opex by some \$26 million, or 10.5%. This clearly will have a material impact on benchmarking outcomes. We have calculated that this would have improved SA Power Networks' MTFP score by around 3.5%, and our Opex PFP by more than 10%. This adjustment is not compensated for in capital benchmarking outcomes, due to the measurement of capital stock rather than expenditure inputs.

SA Power Networks also capitalises a low portion of network overheads in comparison to other DNSPs (10% against a NEM average of 40% in 2015). As network overheads may contain jurisdictional schemes that are not consistent across all DNSPs, we have not considered this impact.

SA Power Networks had one of the lowest proportions of total corporate overheads to total direct costs (ie total cost less total corporate overheads) at almost 15% in 2015, well below the NEM average of 21%. There can be no suggestion therefore that SA Power Networks' higher opex for corporate overheads reflects inefficiency.

Unless capitalisation policies are standardised across DNSPs, or unless a total expenditure approach is considered, material differences will be unaccounted for in benchmarking measures that are not driven by efficiency. We note that the merit of moving to a Totex regulatory framework is to be considered by the AEMC in its upcoming review of the network regulation framework, and we would expect it to be discussed more as capex/opex trade-offs become more prevalent (in line with the intent of the AER's new demand management incentive scheme). In the meantime, we suggest that consistency of reporting overheads should be a focus of the AER in measuring efficiency.

We note that the Sapere-Merz report similarly refers to capex-opex trade-offs as not meeting the exogeneity criterion and therefore are not considered as an OEF. However, decisions on trade-offs are made to improve overall efficiency and/or to reduce costs to customers in line with the National Electricity Objective. Whilst immaterial up to now, the emergence of cloud based technology services and non-network solutions will likely start to emerge in this next round of DNSP regulatory proposals. This will mean that consideration must be given to addressing the impact of trade-offs in measuring DNSP efficiency in the future.

The impact of emerging generation technologies, including wind, solar and batteries, will add to this with associated and significant impacts on opex for voltage management for example.

³ Source: Category Analysis RINs, Expenditure Summary.

Sub-transmission and licence conditions

SA Power Networks is concerned with the apparent subjectivity (eg with regard to distinctions between sub-transmission and distribution maintenance costs) and potential duplication in the value of the proposed sub-transmission OEF. For example, we understand that the higher incidence of sub-transmission assets in some jurisdictions is at least in part driven by higher standards of network reliability. Reliability is a negative input in the economic benchmarking model, and benefits flowing from higher standards would be reflected in MTFP and Opex PFP outcomes. Whilst reliability is not captured in econometric models, we would expect that higher reliability will result in lower emergency response costs. Such costs are a significant component of opex and the OEF calculation does not appear to capture this benefit.

We are also concerned that the OEF does not attempt to consider the increase in sub-transmission assets that may be related to internal technical decisions rather than exogenous factors, and the proposed OEF may therefore compensate for inefficiency.

We note that the Sapere-Merz report identifies sub-transmission assets as greater than 33kV⁴. We assume that this is an oversight and should be 33kV and above, consistent with AER reporting of sub-transmission assets. SA Power Networks has many sub-transmission assets and zone substations at 33kV that incur similar levels of maintenance opex as 66kV zone substations and these should be included in Sapere-Merz's analysis.

Severe Storms

All service standard frameworks are state-based and the level and management of inconvenience payments to customers varies widely.

SA Power Networks' distribution licence and the National Energy Customer Framework requires that we comply with a GSL scheme that is significantly more onerous and costly than those applying in other jurisdictions. In contrast to other jurisdictional schemes, our GSL scheme:

- is uncapped, both in terms of total payments across all customers, and payments to individual customers;
- requires payments on Major Event Days⁵ (MEDs) (i.e. major storm type events); and
- has multiple thresholds with increasing payments for longer duration outages.

SA Power Networks' individual payments can be up to \$605 per customer, whilst it can be as low as \$80 in other jurisdictions. Additionally, we are required to provide payments to all impacted customers, whilst elsewhere it is the customer's responsibility to apply for payments. As well as the obvious impact on GSL payments, administration of the scheme is much more onerous as a result.

⁴ Sapere Research Group and Merz Consulting, *Independent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, December 2017, page 22.

⁵ MEDs are determined in accordance with the AER's STPIS Guideline and are excluded from our reliability performance (ie considered to be beyond a DNSPs reasonable control) for rewards and penalties under the AER's STPIS regime.

In some states compensation payments to customers for reliability are immaterial, however elsewhere payments can be greater than 10% of opex. SA Power Networks' GSL costs have averaged more than \$8 million annually since 2010, with most GSL payments (at least 80%) resulting from supply interruptions on MEDs. SA Power Networks incurred almost \$30 million of GSL payments in 2016/17 due to severe weather events.

The variation in GSL costs between jurisdictions does not represent differing levels of reliability, rather the exogenous application of the state-based service standard framework. The impact of differing schemes must be considered in OEF analysis.

Taxes and levies

Although highlighted as a potential OEF, the draft report identifies that SA Power Networks specifically reported a 'distribution licence fee' for just one year in the benchmarking period (2014).⁶ This is incorrect, we report our licence fee separately as a network overhead in the Category Analysis RIN each year (template 2.10).

SA Power Networks is required to pay a significant distribution licence fee to the Essential Services Commission of SA (**ESCOSA**). In 2015, the fee paid was \$3.327 million (note that this reduced to \$2.558 million in 2016). This fee should be considered further in the assessment of the Taxes and levies OEF in Sapere-Merz's final report.

Vegetation Management

SA Power Networks understands the complexity in assessing vegetation management costs between jurisdictions. Again, differing conditions and division of responsibility apply, and standards may also differ between states. Vegetation impacts on urban and rural networks will be diverse, and comparison will be clearly challenging. Any consideration of environmental factors also needs to incorporate exogenous differences in the requirements that are imposed on each DNSP.

South Australia has always faced significant risks from bushfires. The State often experiences hot, dry and windy weather conditions, creating high fire danger in areas that may be tinder-dry and fuel-rich. Some of the highest risk areas include those close to regional centres, in the Adelaide Hills and southern coastal areas. Vegetation management is therefore of paramount importance to mitigate bushfire and other safety risks, and costs represent a high proportion of SA Power Networks' operating expenditure.

SA Power Networks currently manages bushfire risk by managing (trimming) vegetation, programmed inspections, maintenance and using predetermined criteria to prioritise the replacement of overhead power lines 'at risk' with either insulated conductors or undergrounding.

⁶ Sapere Research Group and Merz Consulting, *Independent review of Operating Environment Factors used to adjust efficient operating expenditure for economic benchmarking*, December 2017, page 46.

SA Power Networks has stringent bushfire risk management requirements, and these continue to be improved. These include inspection regimes, design and construction standards, and tree trimming/vegetation clearance practices. We continually review our risk management programs to maintain our focus on reducing the risk of bushfires on extremely hot, dry and windy days, which includes looking at improvements being made interstate. For example, the South Australian Government reviewed the recommendations from the Victorian Bushfire Royal Commission and implemented requirements to enhance existing obligations to achieve a lower risk of bushfire starts (eg removal of hazardous trees).

Our vegetation management practices are a critical part of our duty to take reasonable steps to ensure that our distribution system is safe and safely operated (Section 60(1) of the Electricity Act) and to maintain and operate our distribution system in accordance with good electricity industry practice (NER Clause 5.2.1(a)).

SA Power Networks is subject to unique jurisdictional regulatory obligations in relation to vegetation clearance. The legislation specifies the maximum distance we can clear vegetation from around powerlines. This limiting of the maximum clearance distance results in us inspecting and clearing vegetation on a more frequent basis than the maximum three-yearly cycle obligation in the legislation. An annual inspection cycle is consequently undertaken in high bushfire risk areas where vegetation can grow quickly (eg the Adelaide Hills, South-East etc).

Additionally, SA Power Networks must also provide customers with written notice prior to entering their properties to inspect and clear vegetation. The customer can then object to that clearance to the jurisdictional safety regulator. This drives additional costs and again differs to responsibilities in some other jurisdictions.

SA Power Networks' vegetation management obligations extend to clearing vegetation around our entire network, except where powerlines extend into private land and only supply that land and the vegetation requiring clearance has been planted or nurtured (e.g. watered) by the land owner. Even in such circumstances, legislative obligations still require us to inspect these powerlines to ensure compliance. Consequently, SA Power Networks' division of responsibility for vegetation management encompasses our entire network.