

Submission to the Essential Services Commission

Re: Electricity Distribution Price Review 2006 – 2010 Draft Decision

Operating and Maintenance Expenditure



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TABLE OF CONTENTS

1	INTRODUCTION.....	2
2	OVERVIEW OF PROPOSED BENCHMARKS.....	3
3	2004 REPORTED EXPENDITURE.....	4
4	FORECAST OF 2005 EFFICIENCIES.....	6
5	GUARANTEED SERVICE LEVELS (GSLs).....	8
6	SCOPE CHANGES.....	9
7	RATE OF CHANGE	12
	7.1 Approach Contrary to Law	13
	7.2 Regard to History	13
	7.3 Consistency of Assumption Regarding Efficiency Improvements	13
	7.4 Effect of Growth	15
8	AGEING ASSETS.....	16
9	CONCLUDING COMMENTS.....	18

1 Introduction

This submission sets out United Energy Distribution's (UED) response to the operating and maintenance benchmarks proposed in the Essential Service Commission's (Commission's) Electricity Distribution Price Review 2006 – 2010 Draft Decision.

This submission establishes a number of errors made by the Commission in its draft decision. If these errors, both of law and fact in a material respect, are not corrected in the Final Determination the Commission will fall into error and the Final Determination will be subject to challenge.

The submission is structured as follows:

- Section 2 provides an overview of the operating and maintenance expenditure benchmarks proposed by UED, and those proposed in the Draft Decision;
- Section 3 summarises UED's position in relation to 2004 reported expenditure;
- Section 4 demonstrates why the Commission cannot forecast an assumed 2005 efficiency gain;
- Section 5 details UED's expected Guaranteed Service Level (GSL) payments under the proposed criteria;
- Section 6 provides details on the proposed scope changes as well as further information of additional scope changes;
- Section 7 presents UED's position in relation to rate of change;
- Section 8 summarises UED's position on ageing assets; and
- Section 9 provides concluding comments.

2 Overview of Proposed Benchmarks

The table below provides an overview of the operating and maintenance expenditure benchmarks proposed by UED in its original Price Service Offering (PSO), and compares these to the Essential Services Commission's Draft Decision and the revised benchmarks now proposed by UED after taking into account the most recently available information.

Table 2.1 – Derivation of Annual Operating and Maintenance Expenditure Benchmarks (\$M in real terms at June 2004)

	Original PSO	Draft Decision	Revised Submission
2004 reported expenditure	85.3	84.3	85.6
Assumed 2005 efficiencies	(0.6)	(0.6)	0.0
Metering	(0.4)	(0.4)	(0.4)
GSLs	(0.0)	(0.0)	0.45
Licence Factor	(0.0)	(0.6)	(0.6)
Scope Changes	6.7	2.9	6.0
Rate of Change	0.0	0.0	1.5
Ageing Assets	0.3	0.0	0.3
Total Benchmarks	91.3	85.5	92.9

This table has been structured to inform the reader of the status of UED's proposed operating and expenditure benchmarks.

Column 1 – UED's original PSO submitted October 2004.

Column 2 – Commission's draft decision.

Column 3 – UED's revised costings.

Details of UED's revised costings are contained in this submission

3 2004 Reported Expenditure

UED has revised its 2004 actual operating and maintenance expenditure to be consistent with the reported regulatory costs that have been independently audited by Ernst and Young and submitted to the Commission on 30 April 2005. At the time of submitting the company's PSO in October 2004 the full year figure for 2004 was based on an internal annual forecast. The difference between that forecast and the final audited result is less than 0.4%

In making its Draft Decision the Commission has adjusted the independently audited accounts for two significant items. On 22 July 2005, UED wrote to the Commission seeking further clarification of these adjustments. The Commission advised that these adjustment relate to:

- a. Excluded Service adjustment; and
- b. Provisions.

UED believes the Commission's proposed Excluded Service adjustment to UED's reported cost for 2003 and 2004 is a factual error.¹ If not corrected in the final decision, this error will cost UED about \$14.5 million over the next regulatory period.

The Commission has requested that UED provide:

"corrected work papers for both the 2003 and 2004 regulatory accounting statements with the same sign-offs as provided with the regulatory accounting statements, that is, by the directors and auditors"²

The total reported operating and maintenance costs are undeniably correct. The confusion arises regarding the allocation between excluded and prescribed services and even within those headings the allocation of costs across sub-headings.

The Commission's adjustment is flawed in that it removes actual expenditure from UED's reported costs. UED accepts that the Commission can review and question the company's allocations, however it has no power to remove costs.

Notwithstanding that the Commission has made the adjustment to UED's audited accounts without power, UED will undertake to provide the assurances that the Commission is seeking in order to ensure that the Commission's error is not perpetuated in the final determination.

1 UED also considers the adjustment is an error of law. UED does not accept the Commission is entitled to make any adjustment to the company's reported costs. Amongst other things, this position arises from the regulator's representations about how the long-term mechanism for setting expenditure benchmarks and rewarding efficiency gains would work.

2 Commission's response to Excluded Services Adjustment dated 27 July 2005



Operating and Maintenance

UED reserves its right to provide further comments on the Commission's adjustment in relation to provisions and in relation to the excluded services adjustment if the error described above is not corrected in the final determination.

4 Forecast of 2005 Efficiencies

In UED's original PSO the company complied with the Commission's requirements as to how their spreadsheet should be filled in. This had the effect of defining the setting of operating and maintenance benchmarks in a way we do not agree with – specifically in relation to the forecast of 2005 efficiency gains. However, on advice, we challenge the Commission's approach and UED now considers that this process is inconsistent with the Tariff Order and has the potential to double count efficiency savings that have already been made.

Firstly UED notes that clause 2.1(c)(2) of the 2005 Tariff Order requires the Commission to have regard to the need to ensure a **fair sharing** of the benefits **achieved** through efficiency gains between customers and the distributors (our emphasis).

If the Commission anticipates future efficiency gains in setting operating expenditure benchmarks, customers enjoy an immediate benefit of 100% of that forecast gain. This is neither a "fair sharing" nor is it an outcome derived from a gain actually "achieved" and is contrary to law. UED challenges the inclusion of any implied efficiency gain for 2005, which is speculative and unrealised, in setting the operating expenditure benchmarks for the next regulatory period.

The annual efficiency gain (the Commission's words) implied by the original forecasts for the years 2004 and 2005, by which the Commission adjusts the 2004 reported expenditure, is a immediate gain to customers of 100% of an efficiency not yet achieved. The adjustment is contrary to law.

It is also an error of fact in a material respect to imply a 2005 efficiency gain and thereby preclude the businesses from receiving a fair sharing of the benefits of efficiency gains.

In the 2001 Determination, the Office argued that a 70:30 sharing ratio in favour of customers satisfied this requirement for fair sharing of efficiency gains. UED's repeats its view that 50:50 would be more consistent with the common application of the concept of fair sharing.

Secondly, the approach adopted by the Commission takes no account of the timing of when the actual efficiency is achieved. For example the original forecast for 2004 and 2005 may have been based on an assumed efficiency gain of \$1.0m in each year. Had UED achieved a \$2.0m efficiency in 2004, it would then be required to achieve another \$1.0m efficiency based on the Commission's methodology.

Thirdly, even if it was legitimate to forecast efficiency gains, the Commission's Draft Decision provides no valid basis whatsoever for the \$0.6 million efficiency that has been assumed, other than that it is the number the Commission came up with 5 years ago.



Operating and Maintenance

In UED's case the benchmark level of expenditure for 2005 is \$85.4m. The company has already achieved this level one year in advance and is now expected to produce a further efficiency of \$650,000 despite the efficiency having already been made.

This is clearly a case of double-counting efficiencies, (which are yet to be made). Such an approach is inconsistent with the Tariff Order.

5 Guaranteed Service Levels (GSLs)

Page 100 of the Commission's Draft Decision states:

"The thresholds for GSL payments were set for the current regulatory period on the basis of the reliability experienced by the worst served 1 per cent of customers. The Commission's view is that this should continue to be the basis for making GSL payments, and the thresholds should be reduced accordingly."

UED has no particular objection to the overarching principle applied by the Commission, however it needs to consider the costs associated with providing GSL payments to customers in accordance with the new thresholds.

On 8th August 2005 UED provided the Commission with information (via e-mail) which demonstrated clearly that, based on the current criteria, UED requires an additional \$450,000 per annum to fund GSL payments to customers for reliability levels consistent with those detailed in table 3.11 of the Draft Decision, rather than the \$15,000 per annum allowed in the Draft Decision.

Based on this information, UED is of the view that the Commission has wrongly determined the level of GSL payments and thresholds required to be made over the 2006 – 2010 period. The Commission needs to give due consideration to the information provided by UED in this submission and in its e-mail to the Commission dated 8 August 2005.

6 Scope Changes

The amounts included in the table below summarise the relevant financial data in relation to scope changes. They are presented as annual costs expressed in millions of dollars.

**Table 6.1 – Scope Changes per Annum
(\$M as at June 2004)**

	Original PSO	Draft Decision	Revised Submission
Electrical Safety Regulations	2.8	1.7	3.6
Roads Management Act	0.5	0.5	0.5
Claims – Insurance Companies	0.5	0.5	0.5
Embedded Networks	0.2	0.0	0.0
GSLs	0.2	0.0	0.5
Regulatory Audit	0.1	0.0	0.0
Claims	0.5	0.0	0.0
Retailer Liquidation	0.1	0.0	0.0
Labour Rates	0.9	0.0	0.0
Skilling for the future	0.5	0.0	0.5
Land Tax	0.4	0.0	0.0
Critical Infrastructure	0.0	0.0	0.3
Demand Side Management	0.0	0.1	0.1
Total	6.7	2.9	6.0

The points below explain UED's position in relation to each of the scope change items listed Table 6.1 above:

- **Electrical Safety Regulations** – UED has lodged a separate submission on Electrical Safety Expenditure, which fully substantiates the company's revised expenditure benchmarks.
- **Roads Management Act** – UED proposes to accept the Draft Decision.
- **Claims (Insurance companies)** – UED proposes to accept the Draft Decision.
- **Embedded Networks** – UED proposes to accept the Draft Decision.

Operating and Maintenance

- **GSLs** – UED’s proposed expenditure benchmark is substantiated in section 5 of this submission.
- **Regulatory Audit** – UED proposes to accept the Draft Decision.
- **Claims** – UED proposes to accept the Draft Decision.
- **Retailer Liquidation** – UED proposes to accept the Draft Decision.
- **Labour Rates** – UED understands that labour rate escalation has been provided for in the rate of change. The company’s views on this aspect of the Draft Decision are set out in section 7 below.
- **Skilling for the future** – UED is disappointed that the Commission has chosen to not properly allow the funding for the future resourcing requirements of the business. Skilling for the future is an important initiative that should be recognised by the Commission to ensure that there are sufficient skilled resources in both the technical and operational areas of the business. The Commission’s disallowance of this modest initiative will impede UED’s ability to mitigate emerging skill shortages. This may have detrimental impacts on reliability outcomes in the future
- **Land Tax** – UED does not propose to contest the proposition that an allowance for land tax is included in the rate of change. The company’s views on the rate of change are set out in section 7 below.
- **Critical Infrastructure** – After carefully reviewing the Draft Decision it has come to the attention of UED that an insufficient forecast was made in our initial PSO for securing critical infrastructure. Accordingly, UED has included a modest figure to cover the additional costs associated with safeguarding against any damage to critical infrastructure. The relevant statutory requirements and cost drivers are summarised as follows:

The increased risk of terrorism has resulted in Commonwealth and State Governments introducing new initiatives and legislation imposing requirements on owners and operators for the protection of critical infrastructure.

In Victoria, these requirements are set out in the new *Terrorism (Community Protection) Act 2003* (TCP Act). This Act imposes requirements for establishing and implementing risk management plans, conducting reviews and audits, taking part in exercises and making all necessary improvements necessary to protect the State’s critical infrastructure such as UED’s electricity assets.

The *Terrorism (Community Protection) Act 2003* introduced a number of new obligations on distributors. These obligations involve additional capital and operating expenditure.

In order to meet the requirements of section 33 of the TCP Act, the UED Critical Infrastructure Plan (which is currently being developed) outlines the Standard Operating Procedures (SOPs) to meet the requirements. Many of the SOPs

Operating and Maintenance

require increased patrols to be undertaken if the National Security Threat Alert level is raised from medium.

Nominally 10 sites would require patrols on a regular basis if the alert level was raised to high and 1 site may require permanent manning if the alert level was escalated to extreme. This is estimated to cost \$200,000 per annum.

In order to meet the requirements of Clause 33 of the TCP Act, the UED Critical Infrastructure Plan (which is currently being developed) requires United Energy to prepare risk management plans, audit that risk management plan, participate in training exercises and, if necessary, to certify the risk management plan. This is estimated to cost \$100,000 per annum.

- **Demand Side Management** – UED proposes to accept the Draft Decision.

7 Rate of Change

The proposed rate of change in the Commission Draft Decision was zero. This was based on the increase in labour costs of 1.5% being offset by an efficiency factor of the approximately same amount based on industry wide historic performance.

UED believes that Commission will make a number of errors, both of fact and law, in setting an estimate of expected efficiency.

The Commission's operating and maintenance expenditure benchmarks involve:

- Establishing the efficient operating and maintenance expenditure benchmark for 2006;
- Forecasting some ongoing efficiency improvements into the benchmarks for the 2007-10 period. and
- Basing those expected efficiency improvements on evidence of the improvements the electricity industry as a whole has been able to make in the recent past (ie. the partial factor productivity growth is calculated by multiplying the annual change in key network drivers of customer numbers, energy consumption and peak demand, by the weights or estimated coefficients computed for these same network drivers by Pacific Economics Group)³.

On the basis of the approach the Commission concludes:

"The results of this analysis suggest that the average weighted rate of change in operating and maintenance expenditure is -1.22 per cent per annum."⁴

In justifying the inclusion of expected efficiency improvements, the Draft Decision states:

"It is the Commission's view that any expected industry level productivity improvements should be included in the revenue requirement because it reflects the outcomes that could be reasonably be expected in a workably competitive market."⁵

³ The coefficients are based on US utility industry data.

⁴ Essential Service Commission, 2006-2010 EDPR, Draft Decision, June 2005, page 182.

⁵ Essential Service Commission, 2006-2010 EDPR, Draft Decision, June 2005, page 186. Moreover, it is worth noting that there are only two places in the Draft Decision where the Commission applies this principle. The other relates to establishing the starting point for assessing the capital expenditure forecasts. It is not clear why this principle, particularly given the nature of the guidance it provides, is appropriate in these circumstances but not in other parts of the Commission's Draft Decision.

Operating and Maintenance

7.1 Approach Contrary to Law

If the Commission anticipates *future* efficiency gains in setting operating expenditure benchmarks, customers enjoy an immediate gain of 100% of that forecast gain. This is neither a “fair sharing” nor is it an outcome derived from a gain actually “achieved” and is contrary to clause 2.1(c)(2) of the 2005 Tariff Order. UED challenges the inclusion of any forecast efficiency gain in setting the operating expenditure benchmarks for the next regulatory period.

Whilst it may be reasonable, under some circumstances, to consider that some level of efficiency may be expected in a workably competitive market, there is no basis under the tariff order for these efficiencies to be passed directly to consumers without the distributor first being able to access its fair share. This is particularly problematic when the efficiencies have not yet been realised and may never be realised.

The Commission seems to want to split efficiencies into two categories, those which might be anticipated, and should not be subject to sharing, and those which are unanticipated and can be shared. The Tariff Order, however, makes no such distinction. Further we point out that even if the opportunity was open for the Commission to make such a distinction, if any efficiencies were so easy to achieve that they do not deserve to be shared, then the market would have delivered them already.

7.2 Regard to History

The Commission’s assumption in regard to ongoing efficiency improvements should be consistent with its prior assumptions regarding the businesses’ current level of efficiency. Therefore expectations about future efficiency improvements should take into account where the businesses have come from and where they are at, in terms of their current level of efficiency. In other words, it is not reasonable to expect the businesses to improve their efficiency at the same rates as they were able to in the past.

It is simply wrong to assume that distributors who have achieved efficiencies in the past can achieve efficiency faster or at the same pace in subsequent periods.

7.3 Consistency of Assumption Regarding Efficiency Improvements

The Commission’s approach to setting operating and expenditure benchmarks and the assumptions underpinning its approach have important implications for the assumed level of efficiency improvements in the next regulatory period.

Under the Commission’s long term mechanism, it argues that its incentive mechanism allows it to infer that reported costs are efficient. Moreover, it is clear from the Commission’s proposed approach that it is establishing what it believes to be the efficient costs of each distributor. This is evident both from the:

- Wording of the Draft Decision; and

Operating and Maintenance

- “Adjustments” the Commission has been prepared to make to the reported costs of the businesses, to exclude costs it believes to be inefficient.

In relation to wording, the Commission states:

‘In some cases, adjustments have been made to the information reported in the distributors’ regulatory accounting statements to obtain an estimate of the efficient costs of service provision...’⁶

There are a number of other statements in the Draft Decision and in letters to UED from the Commission which reiterate that it is providing the efficient cost of service provision.

The adjustments that the Commission is currently proposing to make further emphasise that it believes it knows what the efficient cost are. Some of the adjustments are quite small (eg. less than \$500,000). This suggests that the Commission believes it knows what the efficient costs of the distributors are with a sufficient degree of accuracy to justify such adjustments.

If, however, the Commission already considers that the businesses are efficient either by virtue of its efficiency carryover mechanism or by virtue of its adjustments to the reported costs, then this has implications for what might be a reasonable assumption on the scope for ongoing efficiencies.

Productivity improvements can occur at a number of levels in the economy including at the:

- Economy-wide level;
- Industry level; and
- Individual firm level.

The Consumer Price Index already captures productivity improvements at the economy wide level. So the distributors allowed price increases within the price control period, already ensure that those economy wide efficiency improvements are passed through into prices.

For industries and firms that are already efficient, the pace of technological change and the nature of the cost structure of the activity drive the feasible level of productivity improvements at the industry and firm specific level.

Given the pace of technological change in electricity distribution and its cost structure, and the Commission’s prior assumption in respect of the efficiency of the underlying costs, productivity cannot grow in this industry or amongst these firms faster than the economy generally. Productivity growth in the electricity distribution sector must be lower than that of the economy generally. This is simply because

⁶ ESC, EDPR 2006-10: Draft Decision, June 2005, p. 156.

Operating and Maintenance

sunk capital costs are such a large part of the cost base and it takes a long time to turnover the capital stock.

Efficiency improvements in excess of zero cannot be justified; indeed, efficiency improvements of less than zero are the only feasible outcome.⁷

The Commission's assumption in regard to ongoing efficiency improvements should be consistent with its prior assumptions regarding the businesses' current level of efficiency. Otherwise, it is not adopting consistent assumptions, which risks unduly penalising the businesses and weakening incentives.

It is wrong to assume that distributors who are provided with efficient costs can improve their efficiency faster or at the same pace as the economy generally.

7.4 Effect of Growth

It is also worth noting that since the Draft Decision the Commission has released an open letter to all stakeholders (dated 27 July 2005). In that letter the Commission has adjusted UED's rate of change formula from zero to 2.3%. This is based on the Commission's Draft Decision on consumption growth forecasts.

UED does not agree with the Commission's Draft Decision on growth. UED's comments on this issue are explained in further detail in a separate response. Accordingly UED has substituted the Commission's growth forecast with its own, and has recalculated the rate of change as 1.80%.

Consistent with the principles embodied in the Commission's open letter to stakeholders of 27 July 2005, this figure must be consistent with all aspects of UED's submission and expects that the Commission will be consistent in its final decision.

⁷ Under true price based regulation, this assumption would be reflected in the X assumed in the CPI-X formula. Under the Commission's cost based approach, the X is an output of the regulatory process rather than an input to it. Its operating cost benchmarks include estimates of "expected" efficiency improvements.

8 Ageing Assets

The Commission's approach to rate of change does not explicitly account for the ageing assets of the networks. This is even more relevant given the Commission's Draft Decision on capital expenditure, which significantly deteriorates the average remaining life of the asset base.

Page 192 of its Draft Decision states:

"Given that there is not a sharp increase in the age of assets (but rather a steady increase in the age of assets) over time, increasing costs for maintaining ageing assets are reflected in the reported costs and are therefore incorporated in the rate of change."

This comment by the Commission appears to be in response to Wilson Cook who states:

"Having considered the issues, our opinion is that this item does not constitute a new function of obligation and thus should not be a step change. However, the Commission could consider it when determining the rates of change for the distributors. If not considered, it could theoretically be an incentive for distributors to make uneconomic decisions in relation to their expenditure."

Whilst it may not be a new function it is a cost that needs to be recognised in the establishment of future benchmarks. UED requires a modest increase in operating and maintenance expenditure over the 2006 - 2010 regulatory period, based on internal modelling and engineering assessments. This allowance amounts to \$300,000 per annum.

As previously noted UED does not consider it reasonable to expect the businesses to improve their efficiency at the same rates as they were able to in the past. Moreover, the Tariff Order does not allow the forecasting of efficiencies rather the sharing of them when achieved. On this basis it is not appropriate for the Commission to conclude that the ageing of the assets is included in the rate of change formula.

Further, it is an error for the Commission to conclude that ageing is included in the rate of change formula. There is no input into the formula for the 2006 – 2010 period that allows the businesses to input the opening and closing average asset lives.

In addition, if the Commission is to proceed with its proposed cuts to replacement capital, then rate of aging will be greatly increased and the impact of the ageing on Opex costs will require a substantial and detailed review. UED has not done that analysis at this time for two reasons:

- there has been insufficient time since the draft decision, given the effort required to address the many hundreds of pages of other issues raised by the Commission; and
- it seems pointless going down this path when it would be totally inconsistent with the Commission's own framework for it to proceed with a final determination which abandoned the concept of "reliability and quality maintained" by forcing an

Operating and Maintenance

assumption of material aging of the assets through cuts to the capex spend needed to maintain the asset age profile close to stable over the 5 years (as proposed in the UED PSO).

During the consultation process the Commission has demonstrated that unless items fit neatly into the required templates they have been excluded from the revenue benchmarks. UED is concerned that legitimate cost variances such as age related expenditure are not included on this basis.

The Commission is required to provide for the efficient level of costs irrespective of individual categorisation. It is wrong for the Commission to fail to recognise the costs associated with the ageing assets into the revenue benchmarks.

9 Concluding Comments

In relation to operating and maintenance expenditure benchmarks, UED's response to the Draft Decision is summarised as follows:

- The Commission's proposed adjustment to UED's reported cost for 2003 and 2004 is in error. If not corrected in the final determination, this error will cost UED about \$14.5 million over the next regulatory period.
- There should be no adjustment to 2004 actual costs to incorporate assumed efficiencies in 2005 for the purpose of establishing the expenditure benchmark for 2006 and beyond. Any such adjustment is inconsistent with the Tariff Order, which does not allow the forecasting of efficiencies, but rather the sharing of them when achieved. It is contrary to law.
- The Commission has made an error in determining the level of GSL payments required to be made over the 2006 – 2010 period. The Final Determination should include an allowance of an additional \$450,000 per annum to fund GSL payments to customers for reliability levels consistent with those detailed in table 3.11 of the Draft Decision.
- This submission has substantiated scope changes costing \$6 million per annum, which should be incorporated into the expenditure benchmarks for the 2006-10 regulatory period.
- The Commission makes a number of errors in establishing a rate of change. Errors are made by forecasting efficiencies contrary to the Tariff Order, and by assuming future efficiencies can be made at the same or a faster pace than in the past or as in the economy generally.
- The growth rate applied in the rate of change calculation should be consistent with that applied in the consumption growth forecasts. UED has submitted information in a separate submission to substantiate its view that the appropriate growth rate is 1.8%. This rate should also be applied for the purpose of determining the rate of change allowance in the expenditure benchmark.
- It is wrong for the Commission to conclude that asset ageing is included in the rate of change formula.
- Based on the information provided in this submission, UED's proposed operating and maintenance expenditure benchmarks are set out in Table 2.1 of section 2 of this submission.