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21 December 2018

Mr. Sebastian Roberts
General Manager, Transmission and Gas
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email: AERinquiry@aer.gov.au

Dear Sir,

Re: Forecasting productivity growth for electricity distributors draft decision

We are writing to you in relation to the draft decision that recommends a change in the approach to forecasting productivity growth for electricity distributors.

It is disappointing that a draft decision has been issued without prior consultation to canvas options and test the evaluation framework, assessment process or impacts. A process that commences with a draft decision might be appropriate where the proposed change is minor or uncontroversial. However, in this case, the draft decision relates to an element of the incentive based regulatory regime that has a significant impact on the operation of the regime, incentives for efficiency and the financial performance of distribution businesses.

The release of a draft decision as the first stage in the process reduces transparency and the ability for stakeholders to effectively contribute and engage on the issues. Further, the analysis, reasons and process supporting the recommended change are considerably less robust than that which supported the adoption of the current approach (outlined in the 2013 Better Regulation package) and is insufficient to support such a significant change which is contrary to the position and intentions outlined in the 2013 explanatory statement for the expenditure forecast assessment guideline.

It is also surprising that a significant change, as is being considered here, can be contemplated only a week after the final rate of return guideline was handed down (and which will be applied to all future determinations for the next 4 years). Further risk, change, poor process and engagement such as this adversely affects the risk environment which should be appropriately reflected in the determination of the rate of return for regulated businesses.

Accordingly, we recommend that the AER:

1. Does not change the current approach to forecasting productivity growth in the absence of identifying a material net benefit when compared to the current approach and additional relevant options with estimates from consistent time periods; and
2. Includes an additional stage in the review to outline the role and objective for applying a productivity growth factor in estimating operating expenditure, and present the framework and assessment of options, outcomes and impacts.

Insufficient reasons are provided for a change in the proposed approach

The draft decision does not explain why a significant change in approach and concept is required. Nor does it seek to assess the impact on incentives, investment, financial performance or the long-term interests of consumers of the change in approach. There is also no explanation as to why it is considered appropriate to move directly to a draft decision without prior consultation. Such an approach is inconsistent with, lacks transparency and does not meet the standards the AER expects from the businesses it regulates.

In the explanatory information for the 2013 Better Regulation expenditure forecast assessment guideline, the AER outlined that:

> *"Forecast opex must reflect the efficient costs of a prudent firm. To do this it must reflect the productivity improvements it is reasonable to expect a prudent NSP can achieve. This is consistent with the productivity improvements an efficient firm operating in a competitive market would be able to retain. All else equal, a price taker in a competitive market will maintain constant profits if it matches the industry average productivity improvements reflected in the market price. If it is able to make further productivity improvements, it will be able to increase its profits until the rest of the industry catches up, and this is reflected in the market price. Similarly, if a NSP is able to improve productivity beyond that forecast, it is able to retain those efficiency gains for a period through the EBSS.*
>
> *…. Over time, we intend to develop a single productivity forecast through econometric modelling of the opex cost function….. Applying this single productivity forecast helps **avoid the risk of double counting productivity growth**. Another advantage of this approach is that it should be **more transparent** than our previous approach.*
>
> *….the forecast productivity change included in the rate of change should only represent the forecast shift in the productivity frontier."*[1]

The draft decision proposes two significant departures from this position:

1. That an efficient and prudent network service provider (**NSP**) should now achieve at least the same <u>level</u> of productivity growth as the frontier NSPs[2] rather than the same <u>shift</u> in the productivity frontier; and
2. That an approach be adopted that increases the risk of double counting, reduces transparency and increases the role of regulatory judgement in the absence of access to review processes.

We agree with the AER that a business that outperforms the industry average productivity growth, estimated on the basis that 'catch up' productivity growth is excluded, should benefit from the additional gains. This strengthens the incentive to achieve efficiencies, increasing the efficiency benefits to be shared with customers over time. These benefits are two-fold, the customers of the individual NSP receives the benefits of the individual NSP outperformance in the future period and <u>all</u> customers receive the benefits from improved industry productivity in future periods regardless of the individual NSP performance.

However, if all NSPs are expected to be at the frontier of productivity growth all the time, the approach becomes asymmetric so that more businesses receive penalties rather than rewards more of the time and no NSP has an incentive to improve productivity. Further, the approach penalises those NSPs that have sustained productivity growth, albeit at lower rates, over a long period of time compared to those that have experienced higher short term but unsustainable productivity growth subsequent to privatisation.

[1] AER, Better Regulation, Explanatory Statement, expenditure forecast assessment guideline, November 2013, p. 88.

[2] Draft Decision paper, Forecasting productivity growth for electricity distributors, November 2018, p. 5.

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The draft decision outlines that a review of productivity growth is required because the results have recently changed from being negative to positive, that maintaining the status quo would result in zero productivity growth being applied, and the current method does not take into account the proportion of undergrounding or changes to technology and processes. It is not clear why these are issues that need to be addressed.

The draft decision excludes consideration of reasonable alternative options and has not provided a transparent framework for assessing options. Six options for forecasting productivity are assessed in the draft decision. The lowest estimate is 0% based on the current approach (Option 1) which is excluded when establishing the range, and the top of the range is set at 1.6% based on an approach that takes the average opex multi-lateral partial factor productivity (**MPFP**) for those NSPs the AER does not consider to be materially inefficient over a four-year period between 2012 to 2016 (Option 4). The 1% productivity growth proposed in the draft decision reflects a value determined by the AER under Option 6 which is described as a holistic approach based on all the available information and regulatory judgement. This value also corresponds to the productivity growth calculated from an econometric study that includes an increased proportion of undergrounding (Option 3).

The options that establish the range from which the recommended estimate has been chosen, are not necessarily relevant to the task, do not represent all relevant options and include estimates from different time periods. For example:

- The relevance of the gas distribution time trend to electricity distribution is not explained;
- The AER's preferred stochastic frontier Cobb Douglas cost frontier model and its current approach that applies a zero estimate of productivity growth have been excluded from the range simply because they are inconsistent with other estimates;
- Other options that may include operational factors not captured by the current approach have not been identified, estimated, or compared with the impact of undergrounding over a consistent time period; and
- The MPFP estimate reflects an arbitrarily constrained period, compared to that adopted to estimate productivity growth from increased undergrounding, when an estimate from the same time frame is available.

The analysis could be strengthened considerably by:

- Developing a framework to assess options and present the analysis and reasoning against the framework for each option;
- Identifying a fuller set of options and provide reasons for including or excluding options in the assessment process; and
- Referencing the reasons for the recommended option to the assessment framework and objectives.

We recommend that the AER clarifies and confirms the role, objective and conceptual framework for a productivity growth estimate in forecasting efficient operating expenditure and outline a framework for including and assessing options against that objective.

The process does not provide for effective engagement, increases regulatory risk and undermines the credibility of the regulatory process

The draft decision represents a significant departure from the 2013 Better Regulation package and an increase in regulatory discretion in the absence of any review of merit or prior consultation. A process that commences with a draft decision that proposes a significant change in approach and values suggests a disregard for maintaining stability, predictability and transparency that will have significant impacts on

incentives for future investment. This will lead to a deterioration in services, and higher prices, for consumers over the long term. This is exacerbated where the draft decision has not adequately considered the implications of other reviews underway or consistency in data and effect across periods.

We continue to hold significant concerns regarding pressure being brought to bear on the regulated sector and its relative attractiveness for investment from domestic and global capital markets. Lack of investment will increase the cost of debt and equity and comes at a time when more investment is needed in networks, not less, to transition to a lower cost, low emission, reliable and secure energy system. Networks play a critical role in efficiently utilising and optimising existing generation and supporting new and more distributed renewable energy sources.

These concerns are shared as highlighted by the recent Infrastructure Partnerships Australia's Australian Infrastructure Investment Report 2018:

> "*Participants suggested that the increased preference for unregulated assets can be partly attributed to increased uncertainty surrounding regulated assets and the expected returns on investment. A myriad of regulatory reviews and proposals, some influenced by a perception of political objectives, is making investors rebalance their interest toward unregulated assets*."[3]

We note the AER's recognition of these issues in its recent report on the performance of the wholesale electricity market:

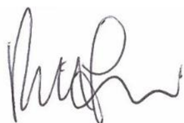
> *"Initiatives to address reliability or affordability concerns also distort market signals and have unintended effect on drivers for future investment."*[4]

We accept that reviewing elements of the building blocks from time to time under an incentive based regulatory regime is appropriate. However, we do not consider that this review has identified any credible problems with the current approach and we consider that there is a real and significant risk of a break in the consistency of data and methodology that will reduce the strength of incentives and the value of reported information.

We encourage the AER to ensure that engagement on these issues is meaningful and credible by providing a further opportunity to respond to the AER's findings and analysis prior to making a final decision. This will enable the AER and stakeholders to properly consider the combined financial implications, impact on incentives and outcomes for customers of all the reviews and rigorously tested together to ensure that NSPs are afforded the opportunity to recover their efficient costs, and that the efficient benchmark capital structure (and assumed credit ratings) of these businesses can actually be maintained at the levels predicted by the AER in the future.

Please do not hesitate to contact myself or Sally McMahon (Spark Infrastructure Economic Regulatory Adviser, phone 0421057821) to discuss further.

Yours sincerely,



Rick Francis
Managing Director & CEO
Spark Infrastructure

[3] Infrastructure Partnerships Australia, Australian Infrastructure Investment Report 2018, p. 8.
[4] AER, Wholesale electricity market performance report, December 2018, p.60.