



1 May 2012

Philip Weickhardt
Electricity Network Inquiry
Productivity Commission, GPO Box 1428
Canberra City ACT 2601

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Our Reference: REG.13.01.01

Dear Mr Weickhardt,

Electricity Network Inquiry

United Energy welcomes this opportunity to make this submission to the Productivity Commission's Electricity Network Inquiry. It is noted that the purpose of the inquiry is to advise the Australian Government:

- whether there are any practical or empirical constraints on the use of benchmarking of network businesses and then provide advice on how benchmarking could deliver efficient outcomes, consistent with the National Electricity Objective; and
- whether the regulatory regime is delivering efficient levels of interconnection to support the market.

United Energy is licensed by the Victorian Government to distribute electricity across Melbourne's south-eastern suburbs and the Mornington Peninsula. We serve some 630,000 customers and we own and manage more than 210,000 poles and 13,000 kilometres of wires. Given United Energy's role as an electricity distributor, this submission focuses only on issues relating to benchmarking.

In this submission, United Energy highlights some of its experience in relation to benchmarking and the key implications for the Productivity Commission's inquiry.

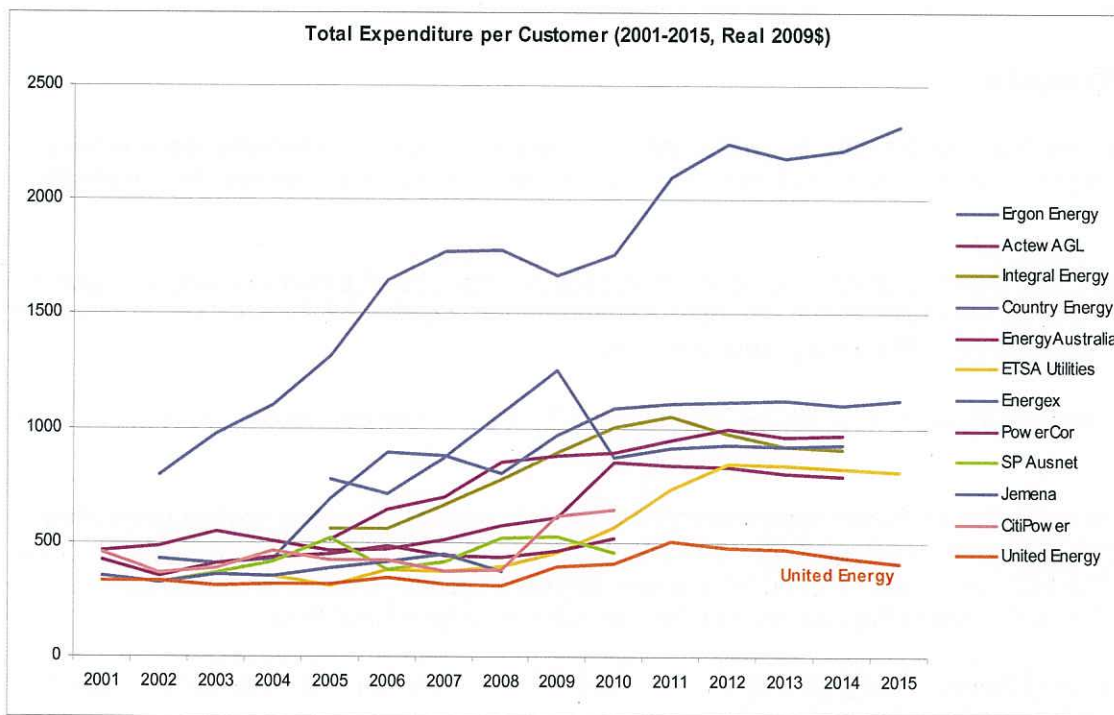
United Energy's benchmarking experience

United Energy was established in 1995 and privatised in 1997, following the disaggregation of the State Electricity Commission of Victoria. United Energy has been subject to incentive based regulation since 1997, first under the auspices of the State-based regulation administered by the Office of the Regulator-General and subsequently the Essential Services Commission. Since 1 January 2009, United Energy has been regulated by the Australian Energy Regulator (AER) in accordance with the National Electricity Law and National Electricity Rules.

In October 2010, the AER completed its first price control review for the Victorian electricity distribution businesses. The issue of benchmarking was raised by United Energy during the course of that review. We consider that it would be useful for the Productivity Commission to be apprised of United Energy's experience in the application of benchmarking during that review, so the following overview is provided.

United Energy’s original Regulatory Proposal¹ explained that United Energy had delivered lower prices and better reliability to customers over the course of the current and previous regulatory periods. United Energy’s original Regulatory Proposal included Figure E1² (reproduced below), which shows United Energy to be the lowest cost performer across the 12 distribution businesses in the mainland National Electricity Market. The figure shows that while costs have tended to drift upwards for a number of distributors, United Energy has maintained its position as a low cost performer. In its regulatory proposal, United Energy argued that a proper application of the National Electricity Law and Rules would reward low cost performers such as United Energy, rather than impose yet further price reductions.

Figure E1: Comparison of total expenditure per customer for distribution companies



The AER’s Draft Decision proposed a materially lower operating expenditure allowance than forecast by United Energy. In response, United Energy expressed concerns that the AER had sought to impose reductions in the company’s proposed operating expenditure allowance without properly considering the available benchmarking information. United Energy’s Revised Regulatory Proposal³ highlighted the benchmarking study by Bruce Mountain and Professor Stephen Littlechild⁴, which included the following findings:

“Peak demand in the Victorian power system has grown at a compound annual rate of 4.5% between 2002 and 2008 compared to 3.0% growth in NSW. Distributor customer numbers in Victoria have been growing

¹ United Energy, Regulatory Proposal for Distribution Prices and Services January 2011 – December 2015. 30 November 2009.

² Ibid, page XIV.

³ United Energy, Revised Regulatory Proposal for Distribution Prices and Services January 2011 – December 2015, 23 July 2010, page XVIII.

⁴ Bruce Mountain and Stephen Littlechild, Comparing electricity distribution network costs and revenues in New South Wales and Great Britain, EPRG Working Paper 0930, December 2009.

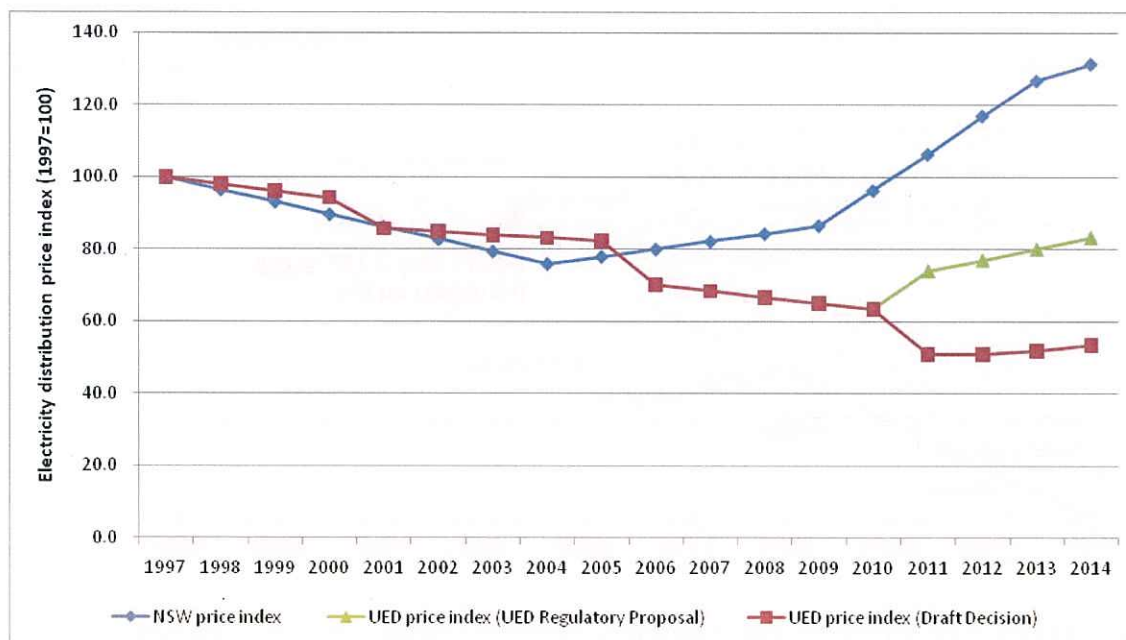
at an annual average rate of 1.9%, roughly twice the rate in NSW. Quality of supply as measured by the frequency and duration of outages has consistently been better in Victoria than in NSW.

These data suggest that, in terms of customer density, size of company and growth in demand, Victoria is faced with more demanding conditions as NSW, and has delivered better quality of service. If these factors are significant, this should lead to higher previous and projected costs and revenues in Victoria than in GB and also higher than in NSW.

The evidence suggests that the first proposition is true but the second is not.”

United Energy explained that the Mountain and Littlechild paper provides numerous benchmarking measures which indicated that the gap between the relatively high prices in NSW and the relatively low prices in Victoria should narrow. On the contrary, however, a comparison (shown in Figure E2, which is reproduced below) between United Energy’s price path under the AER’s Draft Decision and the AER’s April 2009 Final Decision for the NSW businesses illustrated that the AER’s Draft Decision would further widen the existing gap⁵. Figure E2 also shows that United Energy’s proposed price path increases at a slower pace than the AER’s approved prices in NSW.

Figure E2: Comparison of distribution prices: UED and New South Wales distributors



United Energy’s Revised Regulatory Proposal⁶ explained that the price comparison presented above illustrates that:

- The price increases originally proposed by United Energy for the forthcoming regulatory period were modest compared to those approved by the AER in its April 2009 determination for NSW distributors;

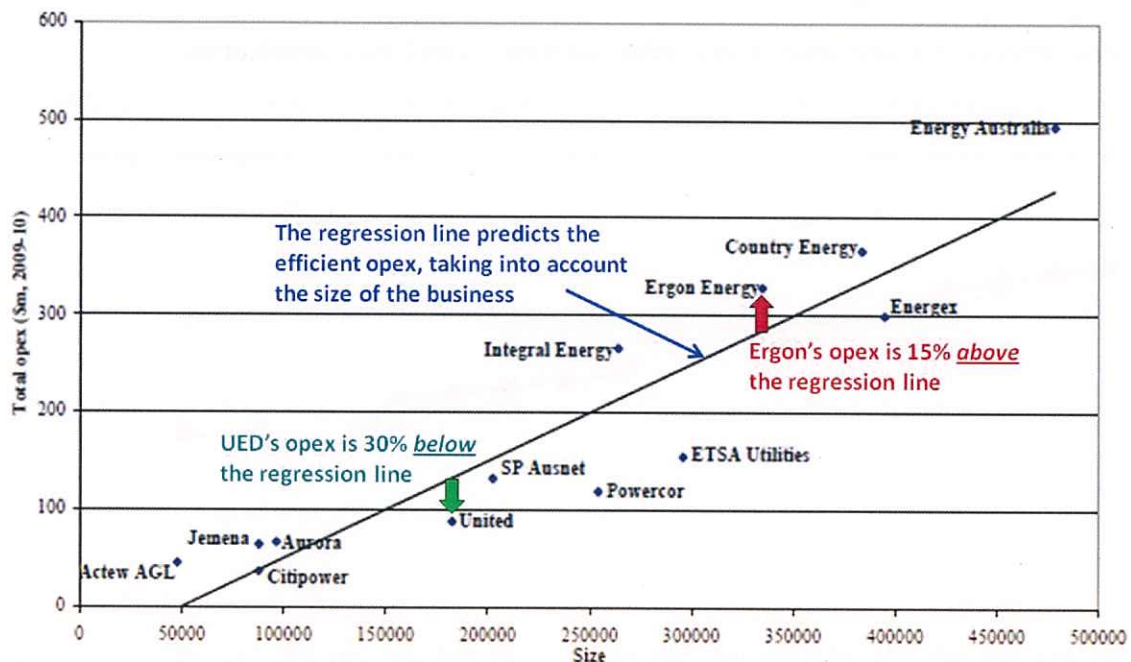
⁵ United Energy, Revised Regulatory Proposal for Distribution Prices and Services January 2011 – December 2015, 23 July 2010, page XVIII.

⁶ Ibid, page XIX.

- If United Energy’s original proposal were to be accepted, United Energy’s distribution prices in 2014 would be 37 per cent lower than those already approved by the AER for New South Wales; and
- If the price controls in the Draft Decision were to be implemented, United Energy’s distribution prices in 2014 would be 60% lower than those approved by the AER in NSW. Under this scenario, distribution prices in NSW would be more than double those of UED by 2014.

United Energy also pointed to the AER’s earlier benchmarking analysis which confirmed the above findings. Figure E3 (reproduced below)⁷ shows the AER’s regression analysis, which we have annotated, from Appendix I of the AER’s Draft Decision for the Queensland electricity distributors, dated 25 November 2009.

Figure E3 Annotated reproduction of Figure I.3 from AER’s Draft Decision for Queensland



The AER’s regression analysis benchmarks the Australian electricity distributors by comparing each company’s actual costs with its predicted cost (indicated by the straight line) based on its size. The AER’s analysis shows that United Energy’s operating expenditure is approximately 30% lower than the efficient expenditure predicted by the AER’s model.

United Energy encouraged the AER to adopt a more consistent benchmarking approach in its regulatory decisions. In particular, United Energy lodged an independent expert opinion from Philip Williams of Frontier Economics, who commented on the AER’s benchmarking analysis in the following terms⁸:

“In my view, the AER’s benchmarking analysis in Appendix I of its Draft Decision and noted above does not go far enough to allow the AER to properly assess whether UED’s forecast operating expenditure is efficient. The AER itself concedes that the data used in its analysis have not been corrected for differences

⁷ Ibid, page XIX
⁸ Philip Williams, Frontier Economics, Meaning and application of National Electricity Rule 6.5.6(c), A report prepared for Johnson Winter & Slattery, July 2010, paragraphs 70 and 71.

in regulatory environment, asset classifications, network maturity and geographical factors. In addition, the AER's findings in its draft decision on the Queensland DNSPs also appear too limited to come to firm conclusions, although they do show UED to be significantly more efficient than most DNSPs in the NEM.

Keeping these caveats in mind, I note that on their face, per customer revenues of DNSPs in Victoria appear to be significantly lower than per customer revenues for DNSPs in New South Wales and this seems to be in part the result of lower operating expenditure per customer by Victorian DNSPs. This difference in expenditures may be due to non-efficiency reasons, but the AER's analysis does not show this to be the case. In this context, I find it odd that the AER has rejected UED's operating expenditure forecast as not reflecting efficient and prudent costs."

To assist the Productivity Commission, it is instructive to set out the AER's response to United Energy's submission on benchmarking⁹:

"The AER agrees with Frontier Economics, that the AER's benchmarking analysis cannot be relied upon to assess the efficient and prudent costs of the DNSPs' opex over the forthcoming regulatory control period. The AER, in applying its regression analysis to the Queensland DNSPs, also noted the limitations of this benchmarking analysis in terms of the:

- size of the data set
- discrepancies in opex definitions
- differing regulatory arrangements.

The AER also recognised in this draft determination that while benchmarking is a useful analytical tool, its use should be limited to top down testing of a more detailed bottom up assessment, informed by due consideration of the opex factors. Consistent with the AER's previous views regarding the application of benchmarking, the AER considers that at the current time, as discussed in appendix I, it cannot establish revenue allowances based primarily on the outcome of comparative benchmarking against other businesses. The AER also considers, as discussed in appendix I, that when a more standardised approach and appropriate data becomes available and benchmarking tools give more consistent results, the emphasis given to top down benchmarking as part of the AER's assessment may be more significant. For the reasons identified above, the AER considers that while high level benchmarking is a useful tool in assessing a DNSP's opex forecast, benchmarking comparisons for this review cannot be relied upon to assess whether United Energy's forecast opex reasonably reflects efficient and prudent costs."

Key implications for the Productivity Commission's inquiry

United Energy's experience in relation to regulatory benchmarking illustrates that the AER has been reluctant to rely on benchmarking to determine whether operating expenditure forecasts are efficient and prudent. Instead, the AER's approach has been to rely on 'year 4' benchmarking, in which a company's own performance is used to set the future allowance.

United Energy considers that deriving a benchmark for a company with reference to that company's own past performance is not a recipe for superior performance because it does not embrace the principle of competition or inter-company rivalry. For companies that are not driven by the commercial imperative to outperform, a regulatory approach that focuses on own-performance is likely to lead to mediocrity. Moreover, the lesson learned by all companies, over successive price reviews, under such a regulatory model is: "You get what you spent". A regime that relies on revealed costs to derive benchmarks – and hence future revenue allowances – arguably provides very weak incentives for efficiency, innovation and out-performance.

⁹ AER, Final Decision, Victorian electricity distribution network service providers, Distribution determination 2011–2015, October 2010, Appendices, page 129.

To the extent that regulation is intended to mirror competitive market processes, it must provide opportunities to embrace benchmarking to a greater extent than it has thus far. The design of the regulatory regime must also accommodate the delivery of outcomes that are consistent with those observed in competitive markets, specifically:

- Genuine benchmarking produces both winners and losers.
- Companies that are able to achieve consistently high levels of efficiency should be permitted to sustain a rate of return that exceeds the benchmark cost of capital.

As explained in the Electricity Network Association's (ENA) submission, which United Energy supports, benchmarking is an inexact science because cost differences between companies may be partly explained by factors that are unrelated to efficiency. Consequently, it is important that mechanisms are in place to minimise the risk of the AER drawing inappropriate conclusions from benchmarking analysis. These mechanisms ultimately relate to questions regarding the burden of proof and rights of appeal.

Notwithstanding the challenges associated with any inter-company benchmarking, United Energy considers that the AER has been unduly reluctant to accept benchmarking analysis as a basis for setting building block parameters, particularly operating expenditure. The Productivity Commission's inquiry would greatly assist the regulatory regime in Australia if it provided guidance on how benchmarking should be applied in practice, and within the framework of the present National Electricity Law and Rules. As noted in the attached ENA submission, the present Rules do not restrict the AER in using benchmarking to inform regulatory decisions. Indeed, the AER has considerable flexibility in the evidence it can bring to bear at each stage of its decision making process.

In view of these considerations, we would expect that any recommended Rule changes made by the Commission's review would be aimed at providing further guidance to the AER in the exercise of its discretion, to foster the effective and appropriate application of benchmarking in regulatory decision making. United Energy does not consider that radical changes to the Rules are warranted.

The Attachment to this letter sets out United Energy's responses to the questions in the Issues Paper that relate to benchmarking.

United Energy looks forward to continuing to participate in the Commission's review. In the meantime, should you or your staff have any queries regarding this submission, please contact me

Yours sincerely

Andrew Schille
General Manager Regulation

Attachment: United Energy's responses to Issues Paper questions relating to benchmarking

No.	Question	Comments
Chapter 1: Scope of the inquiry		
1	<p>Given the various ongoing reviews and the consultations associated with them, how can the Commission best add value? Do these reviews have the same broad objective as the Commission or are they more narrowly focussed?</p>	<p>In relation to benchmarking, United Energy considers that the Productivity Commission should focus on providing guidance to the AER on the practical application of benchmarking to improve the effectiveness of regulation and the efficiency of the electricity network industry. The Productivity Commission's inquiry may lead to Rule changes that clarify the circumstances in which the AER may rely on benchmarking analysis to determine building block components, most notably operating and capital expenditure.</p>
Chapter 2: The NEM		
2	<p>Are there any other major regulations or policies that affect the electricity market that need to be considered when undertaking benchmarking or in understanding any of the possible obstacles to investment in interconnectors?</p>	<p>United Energy concurs with the response set out in the ENA submission in relation to this question.</p>
Chapter 3: What is benchmarking?		
Partial indicators		
3	<p>What are the best (and worst) aggregate measures of performance and why is this so? In which contexts (Australia and elsewhere) have these most credibly been used?</p>	<p>United Energy refers the Productivity Commission to the discussion in section 4.3 of the ENA submission. United Energy considers that it is difficult to address this question in the abstract. The appropriateness of benchmarking analysis depends on the underlying data and the purpose to which the data is to be put.</p>



No.	Question	Comments
4	<p>What partial indicators are meaningful? Are there particular parts of network businesses that are easier to benchmark? What are these, why is it easier and what have benchmarking studies revealed?</p>	<p>United Energy concurs with the response set out in the ENA submission in relation to this question.</p>
5	<p>Are there criteria beyond those identified in box 1 that are useful for discriminating between good and bad benchmarking tools and approaches?</p>	<p>United Energy generally concurs with the criteria set out by the Productivity Commission, however we suggest that the criteria could be expanded to encompass the following considerations:</p> <ul style="list-style-type: none"> • The use of benchmarking should not expose companies to unacceptable risks that may lead to inefficiently low levels of investment and / or operating expenditure. • Issues arise as to whether the right to rely more heavily on benchmarking to determine regulated prices should reside with the regulator or the regulated company. • Businesses should be able to develop their own benchmarks to demonstrate that their expenditure proposals are efficient, rather than looking to the AER to undertake the benchmarking analysis. • Benchmarking information should be employed in regulatory decision making in such a way as to enable an average company to earn a normal rate of return. It also needs to mimic competitive market conditions, by providing for the possibility of “winners” and “losers”. • Benchmarking is inherently imprecise, so there is a need to acknowledge that any assessment is likely to be imperfect, with conclusions being subject to some error. In this context, a question arises as to the “burden of proof” when such information is used in regulatory decision making. (See the answer to question 23 for further discussion).
6	<p>What are the weaknesses and advantages of full versus partial measures for benchmarking?</p>	<p>United Energy concurs with the response set out in the ENA submission in relation to this question.</p>

No.	Question	Comments
7	<p>What methods should be used for benchmarking (indexes, corrected ordinary least squares, data envelopment analysis, simple ratios) and what are their strengths and weaknesses?</p>	<p>As noted in detail in ENA submission, the selection of the most appropriate benchmarking method(s) will depend on the available data and the activity being analysed. United Energy notes that section 7 of the ENA submission contains case studies which provide a useful starting point in thinking about approaches to benchmarking under the Rules.</p>
	<p>Using benchmarks to assess regulatory performance</p>	
8	<p>Could benchmarking be used to assess the effectiveness and efficiency of different regulatory settings (such as reliability standards)?</p>	<p>Examination of outcomes, standards, practices and arrangements in other jurisdictions (including overseas) can provide useful information in assessing different regulatory settings. It is doubtful whether quantitative or statistical benchmarking studies alone would provide a meaningful basis for making decisions on regulatory settings such as reliability standards.</p>
9	<p>Are there examples where regulatory benchmarking has been used in electricity networks in Australia or overseas?</p>	<p>United Energy refers the Productivity Commission to the response set out in the ENA submission in relation to this question.</p>
10	<p>Are there any other broad benchmarking approaches not discussed above and where and how have these been used?</p>	<p>United Energy concurs with the response set out in the ENA submission in relation to this question.</p>
	<p>Chapter 4: But is benchmarking practical?</p>	
	<p>Is imperfect benchmarking still useful?</p>	



No.	Question	Comments
11	<p>Is there a big enough problem to justify new approaches to benchmarking and to incorporate it into regulatory incentive arrangements? To what degree could perceptions of inefficiency reflect the newness of the current regulatory regime or a failure to sufficiently adjust for the differing starting points of different distribution businesses?</p>	<p>United Energy concurs with the response set out in the ENA submission in relation to this question.</p>
12	<p>How do existing network suppliers assess the efficiency and performance of their own businesses and how do they use these results? Could these results have relevance to regulatory benchmarking and, if not, why not?</p>	<p>United Energy has commissioned benchmarking studies or referred to benchmarking studies adopted by other network companies, independent experts or industry regulators. These studies provide useful insights into performance and changes in performance over time, particularly in relation to operating expenditure. Benchmarking capital expenditure is more problematic because of network-specific issues, which may include the age and design of the network, as well as the level of asset utilisation. In terms of delivering operational excellence, United Energy has adopted a business model that relies on outsourced service providers. Contracts for outsourced services are subject to competitive tender exercises, which is the most effective means of benchmarking cost and service performance. United Energy concurs with the Productivity Commission's observation that benchmarking is a means to an end, not a goal in itself. In this regard, United Energy considers that all of these matters are relevant in assessing whether a company's forecasts are efficient and prudent.</p>



No.	Question	Comments
13	<p>How should benchmarking be used by the regulator? For example, to what degree could and should it be used a 'high powered' incentive regulation: as a basis for determining the weighted average cost of capital and efficient spending or as public information to provide moral suasion for efficiency?</p>	<p>United Energy agrees with the ENA's submission that the use to which benchmarks are put depends on whether the analysis can be regarded as reliable. For expenditure benchmarks, it must be accepted that the analysis will never be 100% reliable. This is because cost and service performance differences will be partly explained by efficiency differences and partly by factors that are beyond the company's control. However, the imperfections in any benchmarking analysis should not lead to the conclusion that benchmarking cannot be relied upon for the purposes of setting expenditure benchmarks. As illustrated by United Energy's own experience (outlined in the covering letter), there may be overwhelming evidence that the company's operating expenditure forecasts are efficient and prudent, even if the benchmarking analysis is subject to a degree of error.</p> <p>In relation to the cost of capital, it is important to recognise that the allowance already reflects a benchmarking approach. In particular, market data is used in a well accepted financial model to determine the WACC. Furthermore, in order to provide appropriate incentives, a company's own financing costs are not used to determine the regulated allowance.</p> <p>United Energy considers that financial incentives, rather than 'moral suasion', provide the best means of delivering efficient performance. The challenge is to ensure that benchmarking is a means of allowing better performing companies to earn a higher rate of return, as would be the case in a competitive market. A benchmarking approach that only produces 'losers' is very unlikely to drive any meaningful performance improvements.</p>
14	<p>What is the magnitude of the benefits from using benchmarking in regulatory decision-making in terms of lower unit costs or other performance measures?</p>	<p>More broadly, it is helpful to consider the potential benefits from 'better regulation with stronger incentives', noting that benchmarking may play an important role in delivering better regulation. It is difficult to propose a particular estimate of the benefits, noting that this may include cost reductions; slower rates of cost increases; better service improvements and/or lower service risks. As a broad indication, it might be expected that increases of 2% per annum – similar to economy wide productivity improvements – may be expected from a well designed regime.</p>
15	<p>What are the lessons from overseas about their benchmarking approaches and what aspects should Australia copy or avoid?</p>	<p>A well known problem arises if functional areas are benchmarked and the regulator expects all companies to be efficient for each functional area. In reality, apparent differences in performance at a disaggregated level may reflect different business models and cost definitions. It is important, therefore, that benchmarking captures the aggregate performance of the companies, and provides all companies with a reasonable opportunity to recover their efficient costs, in accordance with the National Electricity Law.</p>



No.	Question	Comments
16	To what degree could the AER use international benchmarking?	<p>United Energy notes that there is a broader question as to whether the AER or network companies are responsible for presenting the benchmarking analysis. United Energy's view is that companies ought to be able to set out benchmarking analysis in support of their pricing proposals. This may include international benchmarking. United Energy notes that the challenges associated with international benchmarking are essentially the same as benchmarking across the domestic industry – it is important to ensure that the comparators are reasonable and that operational differences between companies are properly accounted for.</p>
17	How can a good benchmarking model be identified since data and methods always have some imperfections?	<p>United Energy concurs with ENA's submission that statistical measures of the accuracy of predictions exist and can be used to assess robustness. The challenges for benchmarking from a regulatory perspective are:</p> <ul style="list-style-type: none"> • Identifying genuine efficiency differences; • Establishing expenditure allowance that provide incentives to 'catch up'; and • Ensuring that regulation rewards 'winners', rather than only penalising the weaker performers. <p>United Energy does not regard 'year 4' benchmarking, in which a company is benchmarked against itself, as a good benchmarking approach. The key feature of benchmarking is inter-company competition and rivalry. This cannot be obtained by looking inwardly at the company's own historic performance, as this approach does not genuinely reward the better performing companies, nor penalise the worse performing ones.</p>
18	Is there value in 'rough and ready' benchmarking models and how would these be used?	<p>This expression probably describes the AER's approach to date. The difficulty is that the AER is reluctant to set expenditure allowances on the basis of 'rough and ready' benchmarking. Moreover, United Energy's experience at the last price review demonstrates the AER's reluctance to use broader benchmarking studies as a means of corroborating the reasonableness of expenditure allowances proposed by the company.</p>
19	What are the most important control factors for benchmarking network businesses (for example, lot frontage, asset vintage, topography, weather variations, customers types, reliability standards, ratio of peak to average demand and any strategic behaviour by generators and retailers)? What matters less?	<p>United Energy concurs with the response set out in the ENA submission in relation to this question.</p>

No.	Question	Comments
20	What are the main differences in the potential for, and methods of, benchmarking transmission versus distribution businesses?	United Energy does not have any particular comments on this issue.
21	Should benchmarking results and methodology be publicly available and, if not, why not?	<p>United Energy notes that some benchmarking studies are conducted on the basis that each company can only observe its position relative to its peers, and peer companies' names are not disclosed. Such studies may also provide information to participants about the practices and processes employed by their peers, and this information is used by participants to improve their own performance. On-going participation in such studies is usually contingent on the preservation of confidentiality, and this must be recognised in the use of information provided by such studies.</p> <p>Other benchmarking studies use publicly available information and therefore confidentiality is not an issue.</p>
22	What are the consequences of errors in benchmarking? To what extent do these costs vary for positive versus negative errors? How could the costs of any error be reduced?	<p>The consequences of errors in benchmarking depend on the use to which they are put, the burden of proof and rights of appeal. United Energy considers that the design of the regulatory framework needs to accommodate benchmarking without exposing network companies to the risk of regulatory error. The Productivity Commission could assist greatly in setting out principles that would guide the development of effective benchmarking and its application in the context of the existing regulatory framework.</p>
23	To what extent would it be helpful to give the AER some discretion in deciding how much weight should be given to benchmarking and other tools when making regulatory determinations?	<p>The question of discretion, and which party should exercise that discretion, is of central importance to managing regulatory risk and providing effective incentives for efficiency improvements. United Energy does not consider that discretion regarding the use of benchmarking should necessarily reside with the AER as opposed to the network companies.</p> <p>One issue is whether companies should be allowed to employ benchmarking approaches to set their expenditure allowances, while other companies adopt a more traditional 'cost of service' approach. Evidently, network companies may choose their preferred regulatory model depending on their relative efficiency. In these circumstances, the AER may ultimately need to place greater weight on benchmarking information even if a company continues to adopt a 'cost of service' approach.</p> <p>From United Energy's perspective, an important step forward will be achieved if the Rules provide an opportunity for benchmarking information to be used to set the expenditure allowances. In the short term, the potential benefits of enhanced incentives will probably outweigh the costs of some companies electing not to participate in benchmarking-based regulation.</p>



No.	Question	Comments
24	<p>What, if any, alternative policies may be superior to benchmarking? What, if any, policies could complement the use of benchmarking?</p>	<p>The current Rules already provide an alternative to benchmarking. United Energy considers that regulation could be augmented if benchmarking were used to set expenditure allowances. It is not necessary or desirable to restrict the regulatory tool box to a single preferred approach which is regarded as 'superior'. In reality, each regulatory approach has pros and cons.</p>
<p>The importance of testing rival explanations</p>		
25	<p>What are the principal reasons for the apparent decline in the productivity of the electricity networks and for the associated increases in electricity prices? In particular, what have been the effects of rising input prices, past underinvestment, building ahead of use, rising peak demand, underground cabling and requirements for reliability investments? To what extent have investment responses to the above factors been economically efficient?</p>	<p>United Energy refers the Productivity Commission to the ENA's submission on this issue. United Energy notes the difficulty in measuring productivity improvements in an industry where the outputs are multi-faceted and the inputs are 'lumpy' in terms of capital additions. United Energy does not regard apparent movements in productivity performance as prima facie evidence of a deficiency in the regulatory design.</p>
26	<p>To what extent have rising network costs reflected failures to correctly identify project scope, to adequately control project costs and 'gold plating'?</p>	<p>As a commercially focused distributor, United Energy does not 'gold plate' its network. The company is focused on achieving the best outcome for its customers while minimising expenditure. As a privately-owned utility, the company is also subject to the strong discipline imposed by the capital markets. Management is acutely aware that the capital markets punish companies that exhibit ineffective project control, cost over-runs or 'gold-plating', and the company has internal controls in place to ensure that all expenditure is efficient.</p> <p>From a regulatory perspective, the best way of ensuring that all companies focus on delivering efficient outcomes is to enhance the commercial incentives to do so. Benchmarking has a role to play in this regard, providing that it is implemented appropriately.</p>

No.	Question	Comments
27	If there has been gold plating by network businesses, how has this been realised (premature investment, over-specification of network elements, excessive reduction in service interruption risks)?	See answer to question 26 above.
28	What is the evidence about the comparative roles of the above factors?	See answer to question 26 above.
29	To what extent have Garnaut, Mountain and Littlechild identified genuine inefficiency in electricity networks?	United Energy notes that this is a contentious and difficult topic. From United Energy's perspective, the evidence demonstrates that the Victorian businesses have performed well. This observation is supported by the price path described in the covering letter. The causes of the performance differences are more difficult to determine. United Energy notes, however, that a benefit from benchmarking analysis of this kind is that it drives companies to better understand cost differences.
Chapter 5: The interaction of benchmarking with the regulatory framework		
<i>The process for approving future investment and operating expenses</i>		
30	Do the current Rules limit the use of benchmarking? If so, how do they do so, to what extent and what would be the appropriate remedy?	No. As evidenced by United Energy's experience, however, the AER has been reluctant to accept benchmarking information as a basis for setting the expenditure allowance. In this regard, the guidance provided to the AER by the existing Rules may be regarded as deficient.



No.	Question	Comments
31	<p>In particular, do the Rules restrict the weight that the AER can apply to benchmarking analysis compared with the information that distribution businesses make available in the building blocks proposals? For example, could the AER reject the evidence from the building blocks analysis if it found compelling alternative evidence of lower required spending from benchmarking?</p>	<p>See answer to question 30.</p>
32	<p>Must the AER forensically examine each aspect of the building blocks approach even if it believes that a more simple and robust benchmarking approach was available?</p>	<p>No. The regulatory framework allows the AER to draw inferences regarding the efficiency of actual and forecast expenditure.</p>
33	<p>Are there any other limitations faced by the AER in using benchmarking such as the merit review process?</p>	<p>United Energy concurs with the ENA's submission on this question. The merits review process imposes accountability on the AER to undertake robust assessments, as it should.</p>
34	<p>What restrictions, if any, should apply to the AER's use of benchmarking or other analytical tools?</p>	<p>As already noted, implementation issues arise regarding the burden of proof, the exercise of discretion and rights of appeal. The overall objective should be to provide an opportunity to enhance the ability of network companies and the AER to employ benchmarking to set expenditure allowances and to strengthen the incentives for efficiency improvements.</p>
35	<p>Should the AER select the best performer as the benchmark or choose a benchmark close to, but not at, the frontier? What criteria could be used to determine the threshold between unreasonable and reasonable costs?</p>	<p>In a competitive market, prices are not determined by the most efficient company. Instead, prices are set to allow the most efficient companies to earn additional returns; average companies may expect to earn normal rates of return; and inefficient companies will need to improve efficiency or accept lower rates of return. It follows that a similar range of outcomes should be capable of being delivered to regulated network companies. It would be a retrograde step if benchmark regulation only provided downside for network companies by setting benchmark performance at the frontier. Such an approach would be inconsistent with outcomes in competitive markets,</p>

No.	Question	Comments
36	<p>In cases where the AER's benchmarking findings cast doubt on building block proposals but do not provide an exact alternative, should there be scope for the AER to negotiate a settlement with network businesses? How would that be achieved?</p>	<p>Possibly yes. However, if the Productivity Commission has an administrative settlement in mind, it is important to note that this is not contemplated by the existing Rules process.</p>
37	<p>Could benchmarking reduce prescriptive regulation in the Rules? How? Which ones?</p>	<p>United Energy considers that benchmarking could provide a valuable tool for the AER and network companies to assess the efficiency of an expenditure proposal. Benchmarking would require a different type of analysis and scrutiny from a cost of service approach. It is unclear whether benchmarking would involve more or less prescription, but such considerations are secondary to the question of incentives to deliver efficiency improvements.</p>
38	<p>How would a regulator use benchmarking analysis that produced cost estimate significantly different from those from the building blocks approach? What approaches have other countries used in such instances?</p>	<p>There are two possible sources of difference. Firstly, the AER could accept an expenditure proposal if benchmarking demonstrated that it is efficient and prudent. In the covering letter, United Energy explained that the AER refused to accept United Energy's operating expenditure forecasts, even though benchmarking demonstrated that it was efficient. Secondly, the expenditure forecast itself could be derived from benchmark analysis. For example, a company could be remunerated according to the operating expenditure predicted by an econometric model that employed industry-wide data, rather than according to the company's own costs.</p>
39	<p>Has the AER used benchmarking effectively? Should it adopt different practices? Are there any major process or resource obstacles to the AER's use of benchmarking?</p>	<p>As explained in the covering letter, United Energy considers that the AER has not used benchmarking effectively. As noted elsewhere in this submission, the Rules do not constrain the AER from applying benchmarking in the manner advocated by United Energy during its last price review.</p>



No.	Question	Comments
40	<p>Is there scope to introduce competition in parts of the electricity network? If so, where and when? Would that reduce any need for benchmarking in those parts? To what extent could performance in competitive segments be used as benchmarks for non-competitive segments?</p>	<p>United Energy subjects its outsourced services to competitive tender. This provides useful information for forecasting the company's costs and future revenue requirements. Regulation should only apply to services that are monopolistic in nature. Therefore, if there are segments of network services that are competitive, these services should not be regulated.</p>
	<p>A potential excess cost of capital for regulated cost recovery</p>	
41	<p>To what extent, if any, are there flaws in the AER's current benchmarking of the WACC and, if so, how could it be improved?</p>	<p>As noted by the ENA's submission, this matter is currently the subject of Rule change proposals before the AEMC from the AER and energy users. United Energy regards the issue of the WACC as fundamentally different to the broader question of benchmarking. Benchmarking is most useful in examining differences in operating and capital expenditure across regulated businesses. In contrast, the WACC is derived with reference to market data using well accepted financial models. The WACC assessment is therefore already benchmarked against the market. The questions relating to the determination of the WACC are focused on the benchmarks derived from capital market data, and whether these provide an appropriate WACC estimate in the context of the regulator's task under the National Electricity Law.</p>
42	<p>Is there evidence that the regulatory WACC should be different for government-owned compared with private network businesses? What implications would differential WACC's have for the eventual privatisation of such businesses?</p>	<p>No. Competitive neutrality principles dictate that Government businesses face the same cost of capital considerations as private companies.</p>

No.	Question	Comments
43	What, if any, are the effects of the various WACC determinations on: the incentives of private versus government-owned network businesses and choices about spending on capital expenditure versus operating expenditures?	See answers to questions 42 and 41.
44	How can different patterns between forecast and realised spending between private and government-owned network businesses be explained?	United Energy has no comments on this question.
45	How does the efficiency of private distribution businesses compare with government-owned ones and, if different, why and how would this be remedied?	This is an empirical question which can be examined using benchmarking.
46	Do government-owned network businesses have any non-commercial objectives? How do these vary by business type or jurisdiction? How do they affect the behaviour or efficiency of the businesses? Should they be removed or altered? Should they be factored into benchmarking analysis?	United Energy has no comments on this question.

No.	Question	Comments
47	<p>While government-owned businesses pay corporate taxes to state governments – consistent with competitive neutrality principles – are those principles undermined by the shareholder status of governments or any other governance issues? Does that affect investment decision-making by government-owned businesses or the determination of reliability standards and other policies by governments?</p>	<p>United Energy has no comments on this question.</p>
48	<p>If any biases towards excessive investment posed by the WACC and the rollover arrangements of the regulated asset base were removed, would that eliminate the need for any further development of benchmarking?</p>	<p>United Energy concurs with the ENA's submission that the development of improved benchmarking data and practices is valuable in its own right. The WACC provisions and the issues of stranded asset risk are separate considerations. That said, United Energy would be concerned with any suggestions – such as those appearing on page 16 of the Issues Paper – that benchmarking could be used to test whether assets might be redundant and therefore possibly subject to removal from the regulated asset base.</p>
<p>Reliability standards and planning</p>		
49-52	<p>These questions relate to the setting of reliability standards.</p>	<p>United Energy refers the Productivity Commission to ENA's submission. United Energy considers that inter-company benchmarking has a limited role to play in establishing reliability standards, although the setting of those standards is an important cost driver and may explain cost differences between companies.</p>
53	<p>How are existing reliability incentive schemes functioning and how could benchmarking contribute to their design?</p>	<p>United Energy has been subject to different versions of service incentive scheme since 2001. The schemes have created problems historically because of their complex operation and unintended consequences. The AER's scheme is comparatively simple by comparison to the earlier arrangements, and is likely to provide appropriate incentives to improve performance. The targets for the scheme are based on historic performance. Given the variation in network performance across companies, an approach that bases the targets on historic performance is appropriate. It is unlikely that benchmarking will assist further in the design of the scheme.</p>
54-55	<p>These questions relate to the setting of reliability standards.</p>	<p>United Energy concurs with the ENA's submission.</p>
<p>Demand side management</p>		



No.	Question	Comments
56-58	These questions relate to the role of demand side management and regulatory obstacles to its adoption.	United Energy supports demand side management and various initiatives are underpinned by the Advanced Metering Infrastructure in Victoria. These initiatives include critical peak pricing; load control via home area network; and direct load control. The regulatory framework has provided United Energy with funds to investigate new demand management initiatives. While demand side remains in the development phase, United Energy does not regard the regulatory framework as undermining these initiatives.
59	How could benchmarking or other tools identify the degree to which network businesses have efficiently used demand-side management as substitutes for building redundancy in their networks?	It is difficult to use benchmarking to assess the efficiency of demand side initiatives.

