Interaction between the EBSS and opex forecasts

The AER's preferred opex forecasting approach is the revealed cost approach. Under this approach opex is forecast based on actual expenditure in a base year (usually the second last year of the preceding regulatory control period). This approach relies on the EBSS providing a continuous incentive to reduce opex so that the NSP does not have an incentive to inflate opex in the base year in an attempt to increase its opex allowance in the following regulatory control period. To ensure the NSP retains efficiency gains or losses for 5 years, base opex should not be adjusted, other than to remove any cost categories that will not be forecast using the revealed cost approach (such as debt raising costs).

Under the revealed cost approach the revealed cost opex forecast plus EBSS carryover amounts provides an efficient opex forecast plus the NSP's share of efficiency gains/losses accrued in the previous regulatory control period. However, the revealed cost opex forecast will not necessarily reflect efficient opex by itself. For example, it will retain efficiency gains made in the last year of the previous regulatory control period. It will also include any non-recurrent efficiency losses made in the base year. An advantage of the revealed cost approach is it is not necessary to identify and quantify these efficiency gains/losses.

However, there may be some circumstances where it is appropriate to adjust base opex to remove any identified inefficiencies. For example, if an NSP is not responding to the incentive to reduce opex to the efficient level the revealed cost approach will not provide a forecast of efficient opex. This would be inconsistent with the opex criteria in the NER which require forecast opex to reflect the efficient costs of a prudent operator. Applying the revealed cost forecasting approach to an inefficient operator will produce an opex forecast that does not meet the opex criteria. Further, applying revealed costs would reward such firms for their historic inefficiencies.

Further, it is difficult to determine whether an NSP is responding to the incentive to reduce opex. While it is possible to assess whether an NSP is becoming more efficient this does not necessarily demonstrate that it is responding to the incentive to reduce opex. It may be responding to another incentive. Consequently, staff consider the assessment to be made in determining whether to use revealed costs or not should be whether base opex is efficient. If significant inefficiencies are identified in base opex then these inefficiencies should be removed. If base opex is adjusted then the EBSS carryover calculation should be undertaken in a way that reflects this.

For these reasons, the efficiency of opex in any base year should be the key determinant of whether revealed costs are used. Whether revealed costs are used to forecast opex in turn determines which form of the EBSS will be used to determine increments/decrements under the scheme. This decision has two parts, namely the assessment approach for testing the efficiency of base year opex, and determining when in the regulatory determination process this decision should be made.

Assessment approach

The AER would use a two stage approach to assess the efficiency of the base year opex.

Firstly it would undertake benchmarking of an NSP's opex. This would include holistic economic benchmarking techniques as well as disaggregated category assessments. This first stage would provide an indicative, high level assessment of the efficiency of an NSP's opex. Should any issues be identified with the particular base year under examination, the AER may decide to adopt another base year, in preference to undertaking further review and potential adjustments to historic expenditure.

Should the first stage review identify material relative inefficiencies, the AER would seek further information from the NSP to inform the need to make adjustments to base year expenditures, as well as the potential value of such adjustment. This may include refinement to benchmarking analysis and more detailed techniques, including expert engineering assessment.

Any acceptance or adjustments to base year expenditures would be subject to the NER opex criteria and factors.

The accepted or adjusted base year expenditures would then be subject to any step changes and trend adjustments as per recent determinations / proposals. NSPs would still have the ability to propose alternative methods for forecasting opex allowances for consideration under the NER.

AER staff held a workshop on 11 April to discuss the category assessment of direct operating expenditures, principally benchmarking of base year expenditures. At that workshop, NSPs discussed the potential following techniques to assess opex efficiency:

- comparisons of unit rates and trend volumes with respect to maintenance and vegetation management activities
- consideration of fault rates and related causal information for emergency response expenditures (which are relatively difficult to predict over time).

Methods for assessing corporate and direct overheads that are expensed will be the subject of a further workshop on 16 May. The potential application of economic benchmarking techniques will be covered in a workshop on 22 May. AER staff will also hold a workshop on the base-step-trend approach on 8 May.

Timing

It is desirable to provide NSPs certainty on the assessment approach early in the determination process in order to focus information requirements and key issues for stakeholder submissions. In this context, the NER requires the AER to outline in its framework and approach paper its proposed approach to the application of the:

- Efficiency Benefit Sharing Scheme
- Expenditure Forecast Assessment Guidelines.

This could include whether the AER proposes to use revealed opex to assess the opex forecast and thus which form of the EBSS would be used to determine efficiency carryover amounts (option 1).

The framework and approach paper is not binding, however, and the AER may depart from the position outlined if there are good reasons to do so.

Alternatively, the framework and approach paper would outline the process the AER would use to determine whether revealed costs will be used to assess forecast opex (option 2). In these circumstances the AER would outline at a later stage, such as in the issues paper, how it will apply the EBSS. In any case, absolute certainty on the incentive framework is not necessarily required (or possible) prior to the AER's final determination, however any transitional impacts of moving to a different incentive framework will need to be consulted on prior to this time.

Timing option 1

The AER could state in its framework and approach paper whether it intends to use revealed costs to assess an NSP's opex forecast or whether it will make adjustments to remove inefficient expenditure. However, this will require the AER to have sufficient evidence at the framework and approach stage to make this assessment.

The data provided by NSPs for the AER to produce the annual benchmarking report would be a key input in making this assessment. The annual benchmarking reports will include much of the analysis that would be relied upon to make the assessment of whether base opex is efficient. In that sense, the discussion over whether an NSP's opex if efficient (and thus whether revealed expenditure should be used to forecast opex) will commence with the production of the annual benchmarking report.

However, the AER must publish the first annual benchmarking report by 30 September 2014. This is after the AER must publish its framework and approach papers for the following determinations:

- TransGrid and Transend (January 2014)
- New South Wales DNSPs and ActewAGL (January 2014)
- Ergon, Energex and ETSA Utilities (April 2014)
- Directlink (January 2014)

Consequently option 1 is not feasible for these determinations. These timing considerations are highlighted in table below, which outlines the indicative timeline for the NSW NSPs, ActewAGL and Transend determinations and the 2014 annual benchmarking report.

Table 1 Indicative timeline for NSW/ACT/TAS determinations

29 Nov 2013	30 Jan 2014	Early Feb 2014	30 Apr 2014	25 June 2014	30 Sep 2014	Nov 2014	30 Apr 2015
Guidelines published	NSW F&A published	Benchmarking RIN/RIO issued	Regulatory proposals/ benchmarking RIN/RIO submitted	Issues paper released[a]	Annual benchmarking report published	Draft decision released[b]	Final decision

[a] Issues paper to be released 40 business days after regulatory proposal has been submitted.
[b] No prescribed release date for the draft decision.

Timing option 2 (preferred option)

The NER now requires the AER to release an issues paper 40 business days after an NSP submits its regulatory proposal. The AER could outline at this stage whether it intends to use revealed costs or not to assess an NSP's opex forecast. This is staff's preferred approach. This approach enables the AER to have regard to an NSPs opex forecast when undertaking this assessment but also provides all stakeholders an opportunity to respond prior to the AER releasing its draft decision. In undertaking this assessment the AER would have regard to both economic benchmarking and category analysis.

Questions for stakeholder comment

1. In the interests of providing certainty on matters to be raised during a determination process, should the AER decide whether to accept or potentially adjust base year opex at the Framework and Approach stage? In considering this question, we note that:

    a. new data to inform the decision to accept or adjust the base year may arise at any time after the Framework and Approach

    b. in managing this uncertainty, NSPs may prepare their submissions in anticipation of addressing issues in base year opex regardless of the Framework and Approach position

    c. NSPs will be required to provide various historical data, including for benchmarking techniques, as part of annual performance/ benchmarking reports, even in the event the AER considers the revealed cost approach and base year are appropriate for particular NSPs

    d. Data and analysis forming part of the most recent performance/ benchmarking report would likely form the basis for the "stage one" assessment of base year opex.

2. What are the risks and other practical implications of the AER attempting to determine the effectiveness of the opex incentive framework by reference to an NSP's performance, which may be the result of other incentives or exogenous factors?

3. Should the AER consider placing a higher threshold on making adjustments to the base year and departing from the current revealed cost framework? (How) could this be accommodated in the staged assessment process outlined above? For example, should the AER base its decision on several years of identified inefficiencies or upon a certain quantum of inefficiency?

4. Are there preferable alternatives to addressing material inefficiencies in an NSP's base year expenditure to simply adjusting the expenditure of that year (prior to applying step and trend changes)? For example, are there circumstances where it would be appropriate for opex allowances to reflect the progressive removal of inefficiencies over several years?