

# Expenditure Forecast Assessment Guidelines

## Working Group meeting No. 16

### Summary of meeting – 16 May 2013

#### *Category assessment – Overheads and accounting issues*

Held via video link between AER's Melbourne and Sydney offices.

On 16 May 2013, the AER, as part of its Better Regulation package, hosted a working group meeting on the development of the expenditure forecast assessment guidelines (the Guidelines). The meeting was chaired by AER Director Lawrence Irlam. A full attendee list can be found in Attachment A.

This summary outlines the key topics and themes of the meeting, including views expressed at the meeting, without ascribing particular comments to any one individual or organisation. The outline broadly follows that of the agenda.

#### **1** *Summary of main discussion*

The objectives of the workshop were to:

- discuss the context for assessing overheads and accounting issues
- discuss potential assessment methods and data requirements for expenditure categorisations, cost drivers and firm-specific normalisations, and
- discuss cost allocation, capitalisation, and other NSP reporting inconsistencies that affect cost comparability.

Workshop participants discussed three main categories of overheads assessment as proposed by AER staff:

- Direct overheads
- Non-system capex
- Indirect overheads

The discussion covered the working definitions of each category above, how NSPs currently report their activities in each category, potential cost drivers, and normalisation factors to take into account differences between NSPs.

Participants also discussed 'accounting issues' raised by the AER, i.e., issues the AER believes affect the comparability of expenditure reported by the NSPs, which in turn will impact on benchmarking and expenditure analysis. These 'accounting issues' were:

- Capitalisation policy
- Cost allocation
- Related-party margins
- Service classifications
- Jurisdictional voltage variations, and
- Reporting-year variations.

## **2     *General matters raised***

NSPs raised issues about the usefulness of benchmarking when comparing overheads, and whether individual differences among NSPs can be accounted for properly. NSPs' major comments centred on the following:

- what a direct cost is and what an overhead is should be clarified and defined
- at what level of benchmarking (at high-level or detailed cost categories) does the AER want to conduct its benchmarking
- what level of detail on cost categories, overheads and cost allocation is needed by the AER
- how the AER can account for individual NSP differences when conducting benchmarking
- the AER should not assess cost categories in isolation but should analyse these together with other costs (e.g. one cost may be increasing because it contributes to reducing another cost).

The importance of examining corporate overhead allocations was discussed. The recent case of APA Group taking over GasNet was noted, in particular where it was expected that synergies from the takeover should result in a reduction to GasNet's overheads; however, these appeared to increase after the APA acquisition. It was noted that the overhead costs of the APA Group had themselves increased which contributed to those reported by GasNet, and it was dangerous to make presumptions regarding the efficiency of such changes without proper analysis.

NSPs considered that the AER should give precedence to general commercial incentives that guide firms' actions, rather than relying on benchmarking to determine efficiency. They pointed out that a NSP may have both regulated and unregulated activities and will make commercial decisions based on its structure. AER staff noted that one of the functions of benchmarking was to examine the effectiveness of incentives on particular activities, and to understand how the different practices of each NSP affected their costs.

User groups stated that energy network businesses are not unique and their overhead costs could be benchmarked against other sectors to assess whether corporate overhead costs "contain fat" or are inefficient. Industry data from IBIS World, for example, could be used. NSPs commented that, if they were to be compared with other sectors, sectoral differences should be taken into account such as the size of the business, structure, age of assets, types of assets, etc.

Some NSPs questioned the AER's definition of a benchmark firm. It was noted that NSPs forming part of a larger corporate group would be able to exploit economies of scale and scope that cannot be achieved by stand-alone businesses. Setting benchmarks by reference to the lower costs of subsidiary NSPs would destroy the incentives of the overall group to achieve such efficiencies and would also unfairly penalise stand-alone businesses. It was suggested that for monopolistic network businesses, the most efficient firm (in terms of overheads) is a single regulated monopoly business,

but this is not necessarily a desirable or realistic outcome and would not (or should not) be used as a benchmark by the regulator. AER staff explained that there was currently no suggestion of defining a benchmark in terms of structure/ ownership, and that a key point of benchmarking is to make robust comparisons of the cost forecasts by regulated entities and to understand the factors driving these costs.

Some NSPs noted that they already provide the AER with a lot of information on shared-cost allocation and reconciliation with statutory accounts, and they want to clarify with the AER when it will move to use benchmarking.

NSPs also suggested that the AER's assessment of overheads take into account the different asset management activities and asset types across electricity, gas, distribution and transmission networks. Some NSPs commented that, because of these differences, benchmarking should serve as a start to a conversation between the AER and the NSP about efficiency and innovation.

## **Overheads**

### *Direct overheads (opex)*

"Direct overheads" were deemed to include network operations, planning and "other" opex (including customer interface costs). AER staff suggested that some of these costs would be affected by the size or number of assets owned by the NSP as well as the number of customers serviced.

AER staff sought feedback on the proportions of these costs that are fixed and variable, whether they exhibit a trend over time and, if so, with respect to which driver(s).

NSPs replied that:

- these costs can have both fixed and variable components
- individual overhead activities (finance, regulatory, etc) can have different drivers
- the cost of collecting data on individual overhead categories and their cost drivers can be significant
- in transmission, system operations and asset management have different drivers.

With respect to network operations, a potential distinction between field versus control room activities was noted. Asset management costs were considered to be affected by a certain proportion of fixed costs (including allocated corporate overheads) while also being affected by the scale of field-based activities, including network support and planning studies. It was suggested that system operation costs would be affected by multiple drivers, including the number of switching operations, number of substations or lines, and the rate of demand or customer growth.

AER staff presented data from recent annual reporting templates, noting that currently reported expenditures were at a high level of aggregation and reported inconsistently across NSPs. Of the measures examined, some correlation appeared to exist between network operations expenditure and asset value measures, for example current replacement values. Further potential relationships would be explored once appropriate and sufficient data were obtained.

### *Non-system capex*

On IT and communications non-system capex, AER staff suggested expenditure reporting to distinguish between:

- fixed versus recurrent expenditure

- leased versus purchased items
- data versus oral communications.

AER staff noted that the basis for collecting this information was to improve upon existing reporting, where IT and communications were listed as single items with no supporting information on what was being purchased or why. It was suggested that disaggregated information would, in part, better enable trend or unit cost comparisons on the basis of employee numbers or end users served within each NSP, which were expected to be drivers for recurrent expenditures in these categories.

NSPs commented that:

- lease-or-buy issues should be taken into account when the AER assesses non-system capex
- the distinction between field IT (i.e. operational) and business systems IT (corporate) should be clarified
- the separation and collection of IT and communications data required by the AER may be uncertain, e.g. the level of detail on leased vs purchased IT, data vs oral communications, etc.

NSPs questioned the value in seeking fine details of these expenditure categories. In particular, the different purchase and lease decisions of particular NSPs would affect multiple types of technologies (e.g. around 20 categories). Some NSPs had agreed to service contracts which covered a wide array of IT and communications functions, and hence allocation of contract costs to subcategories would be difficult. The distinction between data and oral communications/ IT was also questioned, noting that this technology was already merging.

NSPs noted that IT was a particular area where the AER may expect increased expenditure forecasts in the name of expected offsetting operational efficiencies. These decisions are expected to differ significantly between NSPs, hence the issue of “cherry picking” by the AER (i.e. setting allowances in line with the lowest cost achieved in one category without consideration of offsetting impacts in other cost categories) is important here.

AER staff noted that they would further review the definitions, materiality and the level of detail required under these expenditure categories. AER staff noted that the most efficient NSPs overall could be those with the greatest overall level of IT expenditure.

On vehicle non-system capex, AER staff suggested the collection of data for:

- the cost and number of heavy/ commercial and light/ passenger vehicles used by NSPs
- vehicle costs arising from purchase and lease arrangements
- potential drivers for this expenditure including area of network covered, number of “jobs” or workload, line length and number of employees
- vehicle utilisation data (kilometres travelled or days per vehicle).

Some NSPs suggested that they collect vehicle usage data in terms of hours used rather than distance, because distance travelled in city areas is not a useful indicator and labour (time) costs are the key costs associated with vehicle usage. Others indicated that this information would not be available as fleet services were partially/completely outsourced or embedded within other network service contracts. Travel costs may be reflected in the use of taxis, hire cars or other modes of transport, e.g. helicopters. Different vehicle numbers and utilisation may reflect different network design and depot locations.

It was noted that potential drivers for this expenditure should be noted in NSP asset management plans.

Potential interactions with incentives schemes were noted, for example, poor vehicle utilisation may reflect a particular NSP's desire to provide more rapid/effective emergency response for events that happen infrequently.

AER staff considered that, large service contracts notwithstanding, collecting this information is not expected to be an excessive burden on NSPs as it should already be collected for other purposes.

#### *Indirect overheads*

AER staff highlighted that indirect overheads represented a material proportion of expenditure; however, there is limited visibility on what these costs represent. These are expected to include CEO, HR, Treasury and Regulatory functions, some of which may be stable over time or increase in proportion to employee numbers. Some of these activities should be comparable to those provided by non-regulated entities.

NSPs considered that indirect overheads should be broken up into individual functions. Some NSPs noted that expenditure for some of these categories may already be captured in their reporting templates. In comparing these expenditures, the individual circumstances of the NSP should be considered, for example, the Treasury department of an exchange-listed NSP would directly incur costs in capital/debt markets in raising finance, whereas a state-owned or subsidiary NSP may indirectly incur these costs.

## **Accounting issues**

#### *Capitalisation*

NSPs questioned the intent of clarifying NSPs' capitalisation policies, whether it relates to *ex post* reviews of the regulated asset base (RAB) following changes to policies, or for the purposes of assisting benchmarking. It was noted that there have been limited instances of NSPs changing capitalisation policies mid-period which would warrant reconsideration of RAB values. AER staff clarified that visibility of how capitalisation policies affected expenditures would be useful in the (apparently rare) event these changed mid-period (in reflection of NER provisions). A key issue for benchmarking is to ensure such capitalisation decisions across NSPs do not detract from making robust comparisons of costs.

It was noted the current TNSP submission guidelines require a recasting of historical expenditure data in regulatory proposals in the event capitalisation policies are changed.

#### *Cost allocation issues*

NSPs stated that the regulator should not prescribe a common cost allocation policy for NSPs. They noted that their cost allocation policies generally align with Australian accounting standards and statutory accounts. However, differences in reported costs between NSPs would arise with respect to the "unitisation" of assets.

AER staff indicated that prescribing a standard cost allocation policy or method across all NSPs is unlikely to be beneficial; the alternative approach is to obtain sufficient detail from NSPs on how shared costs are allocated. Enough detail would be required to quantitatively manipulate these allocations with a view of representing costs consistently across NSPs.

It was noted that potential issues arising from allocation of shared/corporate overhead costs would potentially be resolved under the suggested approach to assessing these costs. That is, overhead

costs would be identified and assessed separately from direct costs. However, the issues around potential allocation of costs (particularly labour), at the direct cost level would still need to be resolved, for example, the use of work crews who completed multiple projects but whose time was not directly recorded against each project.

NSPs noted that this information may already be captured in their capitalisation and cost allocation policies submitted to the AER. AER staff undertook to consider this further, in particular whether the policies contained sufficient detail to assist in understanding benchmark comparisons.

#### *Related-party margins*

AER staff noted that this issue related to ensuring margins and management fees were reported transparently. It was noted this is only an issue for some NSPs.

#### *Service classifications*

AER staff noted that the presence of different service classifications, for example AMI in Victoria, would need to be identified when collecting information in each jurisdiction.

#### *Jurisdictional voltage variation*

AER staff noted that this particular issue may be addressed to some extent in collecting asset/capex information by asset and voltage type. However, this may require further consideration where data are presented at an aggregate level.

#### *Reporting-year variation*

AER staff noted that submissions on the AER's issues paper perhaps correctly identified this is not a material issue in the context of other benchmarking challenges.

## ***Attachment A: Attendee list***

### **Melbourne office**

Name	Organisation
David Dawson	Strategic Economics Consulting Group
David Headberry	Major Energy Users
Heath Dillon	Transend
Eli Grace-Webb	Jemena
Mark de Villiers	CitiPower/Powercor
Tom Hallam	SP AusNet
Trevor Gusling	SA Power Networks
Mathew Abraham	United Energy and MultiNet Gas
Anthony Seipolt	AER
Toby Holder	AER
Esmond Smith	AER
Jess Manahan	AER
Cameron Smith	AER

### **Sydney office**

Name	Organisation
Bill Jackson	ElectraNet
Andrew Kingsmill	TransGrid
Rob McMillan	Jemena
Cathy Waddell	Essential Energy
Aaron Toroun	Ausgrid
Kristy Langley Gliddon	Endeavour Energy
Grant Robinson	Powerlink
Scott Young	APA Group
Guy Mutasa	Energex
Lawrence Irlam	AER