

# Expenditure Forecast Assessment Guidelines

## Working Group meeting No. 8

### Summary of meeting – 20 March 2013

#### *Economic benchmarking – network inputs*

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

On 20 March 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).

A full attendee list can be found at 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.

#### **1** *Introductions*

In this workshop, AER staff sought feedback from stakeholders on the appropriate inputs to be used in economic benchmarking of network service providers (NSPs).

AER staff also summarised the outcomes from the previous economic benchmarking workshops.

AER staff noted the next series of workshops would focus on measurement in economic benchmarking and would continue to provide briefing notes before each workshop.

The AER's consultant, Economic Insights, summarised its briefing notes on network inputs, provided a short list of potential inputs and examples of different input specifications.

The briefing notes and slides used in the presentation are available at:

<http://www.aer.gov.au/node/19508>

#### **2** *Major issues for discussion and feedback from the workshop*

##### **The separation of inputs into durable and non-durable inputs**

Economic Insights noted obtaining accurate annual cost and quantity was more difficult for capital inputs than non-durable inputs because capital inputs are durable (they provide services over a number of years). Capital service flow (their contribution to the production of outputs) is the relevant measure of capital input quantity. An asset's capital service flow depends on its physical depreciation profile.

Some stakeholders requested clarification of the difference between physical depreciation and regulatory depreciation and how this relates to capital service flow.

Economic Insights explained that the physical deterioration of an asset was the decrease in the asset's ability to deliver outputs over time. Physical deterioration may not occur uniformly. Financial depreciation, on the other hand, corresponds to the way the return of the original cost of an asset is spread over time.

Stakeholders noted assets may have a declining depreciation profile or a probabilistic function where the probability of an asset's failure increases over time. Thus, though the assets output may remain constant, its risk increases.

Some stakeholders noted the differences in how the initial opening RAB was developed varies across the networks and this should be taken into account in setting capital user costs.

Stakeholders also noted there were differences in capitalisation policy across the businesses which might affect comparisons. It was noted that consistency of capitalisation may be beneficial for benchmarking comparisons. It was also noted that the application of a uniform capitalisation policy may create inconsistencies with statutory obligations. This may require a second set of accounts to be maintained for regulatory purposes.

Some stakeholders noted that using the capital stock would be benchmarking assets already in place which may not be reflective of future costs. Further, they noted that the goal is to obtain efficiency going forward not the optimisation level of the current network. Counter to this point, other stakeholders considered that the initial capital endowment should be considered as it would affect businesses' current capacity and ability to service future network growth.

AER staff noted that economic benchmarking included both time series and cross sectional analysis and time series was important to establish the ability of a business to change its efficiency over time.

## **Input selection criteria**

A stakeholder asked how the AER would ensure that the selection of inputs would be consistent with the NEL and the NER. AER staff stated that the selection of inputs would be consistent with the requirements that the AER has to adhere to when making revenue decisions.

Stakeholders proposed that the AER's input selection criteria should also include a fifth criterion, that selected inputs should be consistent with outputs and environmental factors, and vice versa. For example, it was suggested that vegetation management and demand management costs be excluded from the measured inputs unless the benefits associated with such costs are measured and quantified as specific outputs or environmental factors.

## **Opex inputs**

Economic Insights noted a price index that accurately represents a businesses' change in opex input prices is required to obtain opex quantities.

Some stakeholders posited that there was a material difference in network opex input prices across service providers.

Some stakeholders noted that opex may be offset by other categories such as capex.

Some stakeholders noted labour prices may be endogenous and it would not be appropriate to use business specific costs. Other stakeholders noted that Enterprise Bargaining Agreements (EBAs) have a significant impact on opex. Further, they noted that approximately 20 per cent of its labour is covered by external contractors which have a different skill set to its typical workers. These external contractors generally perform asset inspections and vegetation management.

Stakeholders also noted the Australian Bureau of Statistics (ABS) did not release electricity specific data and that an index would not be able to take into account all the factors in running a service provider. In particular, there were differences between TNSPs and DNSPs in terms of inspection and easement/vegetation management requirements.

AER staff noted that input prices would be used estimate technical and allocative efficiency.

## **Capital inputs**

Economic Insights noted that capital quantity proxies could be derived indirectly by deflating RAB values by an appropriate capital goods price index or directly by using asset register physical values. It stated that the physical proxy measure using asset register values would be more accurate but may require more data than specifications based on RAB values.

Stakeholders noted their asset registers were different to the post-tax revenue model (PTRM) categories. Further, it was noted that data older than five to 10 years may not be as accurate.

Stakeholders noted that for transmission, transformers made up 50 per cent of assets by value and may not necessarily be possible to disaggregate that class of asset.

Stakeholders noted that the annual user cost is influenced by the WACC, and WACC benchmarks are set at different times which may result in a substantial difference in costs. It was noted the WACC used for benchmark purposes would be a future consideration.

Stakeholders noted easement valuations differ amongst NSPs and that the valuation method may have a significant impact on the RAB.

Some stakeholders noted that the objective was to not assess the efficiency of the starting RAB but rather to assess forecast expenditure and that easements may be assessed in some other way.

AER staff noted under the old rules it assessed efficiency of expenditure not the RAB but under the new rules it will assess what is rolled into the RAB.

Stakeholders noted that the alternative capital specifications could be used for sensitivity analysis rather than choosing one technique over another for now.

Stakeholders asked for clarification on the purpose of using physical depreciation when determining the use of assets year by year.

A stakeholder noted a potential disadvantage of the first straw man was that using the one hoss shay assumption for individual assets may not similarly apply to the aggregate depreciation profile.

Economic Insights noted that physical depreciation was used to determine the quantity of capital being used each year and whether an asset would provide the same quantity of input, or 'carrying capacity', over its entire life.

Stakeholders asked if it was the AER's intention to set out its specification of the TFP or to continue to provide straw man examples.

AER staff noted this process will require a model, however, at this stage it seeks to consult with industry on the framework and approach. AER staff further noted that this process will also provide guidance for the annual benchmarking report.

### **3     *Other matters***

AER staff noted minutes of previous workshops would be uploaded onto the AER website.

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

### **Melbourne office**

<b>Name</b>	<b>Organisation</b>
Jennifer Harris	Powerlink Queensland
Renate Tirpcou	CitiPower & Powercor Australia
Michael Seddon	Transend Networks
David Dawson	Strategic Economics Consulting group
David Headberry	Major Energy Users
Bruce Mountain	CME
Jeremy Rothfield	United Energy & Multinet Gas
Katie Yates	SP AusNet
Damien O'Connor	SA Power Networks
Su Wu	AER
Mark McLeish	AER
Andrew Ley	AER
Anthony Seipolt	AER
Jason King	AER
Kevin Cheung	AER
Lawrence Irlam	AER

### **Sydney office**

<b>Name</b>	<b>Organisation</b>
Andrew Kingsmill	TransGrid
Naomi Donohue	Energex
Warwick Tudehope	Jemena
Mark Hillsdon	Essential Energy
Jim Bain	ENA
Matt Cooper	Ausgrid
Bill Jackson	Electranet
Denis Lawrence	Economic Insights
John Kain	Economic Insights
Chris Pattas	AER
Esmond Smith	AER
Matthew Le Cornu	AER