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20 September 2013

Mr Chris Pattas
General Manager, Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Dear Mr Pattas

AER Draft Expenditure Assessment Guideline and Explanatory Statement

APA Group (APA) welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) draft Expenditure Assessment Guideline and Explanatory Statement.

APA is a major ASX-listed energy infrastructure business, owning and/or operating over $12 billion of assets. These assets include significant gas transmission and distribution interests, as well as investments in the Murraylink and Directlink electricity interconnectors which operate in the National Electricity Market.

Inclusion of principles in the Guideline

APA considers that the clarity of the guideline and the transparency of the AER's approach would be enhanced if the proposed principles set out in the draft Explanatory Statement were included in the Expenditure Assessment Guideline.

Currently, the draft Guideline describes how the AER will apply a raft of different assessment methodologies. The draft Guideline does not, however, include details as to how the AER will choose between these methodologies, and the consideratio that will be relevant in deciding how much weight to place on different methodologies. This is particularly important in relation to the use of benchmarking data in regulatory resets, which is arguably in its early stages, and is likely to be beset with data adequacy and consistency issues, at least in early reviews.

APA considers that this further level of guidance is an important part of the guideline, and is arguably required under the National Electricity Rules (NER) where it states that the guidelines must specify the approach the AER proposes to use to assess forecasts of operating and capital expenditure.[1] APA considers that this necessarily includes guidance as to the AER's choice between techniques, alongside descriptions of those techniques.

Comments on proposed assessment techniques

Assessment of operating expenditure step changes

APA is concerned about the AER's proposed approach to assessing steps changes in operating expenditure. The Explanatory Statement and Guideline set out the AER's intent to attempt to

[1] National Electricity Rules cl 6A.5.6

distinguish between historic 'average' changes in obligations, and those that are 'demonstratively different' from historic changes. The AER intends only to adjust base year operating expenditure in respect of those step changes it considers to be 'demonstratively different', and to assume that the other changes are included in the average productivity measure.[2]

The AER does not set out how it will make this assessment, and APA does not consider that such an assessment of regulatory obligations can reasonably be made. APA considers that the AER's proposed approach will by necessity be highly subjective, unable to be tested, and unable to be applied consistently across businesses. APA also considers that this approach, if implemented as the AER appears to intend, is at high risk of not providing a service provider with a reasonable opportunity to recover at least the efficient costs of providing regulated services, as required under the revenue and pricing principles under both the national electricity and gas laws.[3]

APA encourages the AER not to apply its proposed 'trend' approach to operating expenditure step changes and to instead assess each proposed step change on its merits.

Interaction between the expenditure assessment approach and the expenditure incentive approach

APA has concerns over the AER's proposed approach to interactions between the expenditure assessment approach and the Efficiency Benefit Sharing Scheme (EBSS). In the draft Explanatory Statement the AER states:

> In particular, if an opex forecast plus any EBSS increment/decrement is more than efficient costs plus the NSP's share of efficiency gains or losses, then we are justified in moving away from the revealed cost forecasting approach. In such a case, the level of historical costs plus any carryover would not lead to an efficient forecast.[4]

The AER's proposed approach appears to contemplate adjustments for forecast operating expenditure in order to negate the effect of an efficiency gain made in the earlier period. This approach is akin to an ex post adjustment to incentives.

APA considers that it is very important for any incentive scheme to be fully specified up front so that the regulated business can understand and calculate likely efficiency rewards and penalties before making expenditure decisions. In contrast, the AER's proposed approach would remove any incentive for businesses to make efficiency gains. This is because any expected rewards from those efficiency gains may not be awarded to the business in the following period, as forecasts costs may be adjusted to offset the efficiency gain.

APA urges the AER to reconsider its approach such that the efficiency of forecast expenditures is assessed on a forward looking basis, without consideration of efficiency rewards arising from the previous period.

The AER appears to intend to only apply this approach where it considers that the business is not responding to incentives, or that the retention of efficiency gains would be unfair for consumers due to issues with the forecast:

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[2] Australian Energy Regulator 2013, *Better Regulation: Draft Expenditure Forecast Assessment Guidelines for electricity distribution and transmission – Explanatory Statement*, August, p 38
[3] National Electricity Law section 7A; National Gas Law section 24
[4] AER 2013, *Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement*, p 61

> Where a NSP does not respond to incentives the sharing of rewards or penalties would not be in the long term interests of consumers. This problem is compounded when the initial forecast was inaccurate (due to error or changing circumstances). Where a NSP responds to incentives, it will make efficient expenditure decisions regardless of the forecast. These efficient (historic) expenditures can then be used as the basis for opex forecasts. However, where a NSP does not respond to incentives, the inaccuracy in the initial forecast may be perpetuated in carryover amounts, as well as in the NSP's expenditures not moving towards their efficient level.[5]

APA's key concern is how the AER would determine that a business was not responding to incentives, or that the forecast was inaccurate.

In respect of responding to incentives, APA does not consider that the AER has adequately addressed concerns raised already in the consultation process as to how to differentiate between (i) a business that is not responding to an incentive, and (ii) a business that is not able to reduce costs in line with the AER's expectation of efficient costs because the AER's expectation is incorrect.

In practice these outcomes may look identical, and the AER has not provided any information as to how it would determine the difference. The key risk is that the AER will not provide the service provider with a reasonable opportunity to recover at least the efficient costs of providing regulated services, as required under the revenue and pricing principles under both the national electricity and gas laws.[6]

In respect of inaccurate forecasts, APA is concerned that the AER will create an asymmetry in forecasting risk for regulated businesses. The AER states that forecast costs that are below efficient costs will provide businesses with incentives to reduce costs.[7] The AER makes no suggestion that penalties or rewards under the EBSS will be adjusted if, in retrospect, forecast costs are found to be manifestly inadequate compared to the benchmarked efficient costs of the business.

On the contrary, the AER is suggesting in the statement above that only those forecasts that turn out to be above efficient costs will be adjusted. This creates an unacceptable asymmetric risk on businesses that inevitable forecasting errors will lead to one-sided adjustments to future costs to claw back forecasting gains, without matching adjustments to allow recovery of forecasting losses. APA considers that the AER's suggested adjustments would be inconsistent is incentive regulation, and ought not to be pursued in the final Guideline.

<u>Application of benchmarking in general</u>

APA recognises the recent significant changes made to the NER, in particular (for this process), the increased focus and reliance on gathering and publishing benchmarking information in order to understand and assess the efficiency of electricity NSPs. APA acknowledges that these changes to the NER are a key driver of the focus in the draft Expenditure Assessment Guideline and Explanatory Statement on benchmarking information gathering and techniques, and their application to NSPs as part of the reset process.

It is important that benchmarking data be robust, consistent, and indicative of the efficient operation of the business being benchmarked. APA acknowledges the AER's efforts in respect of this draft Guideline, and in relation to its benchmarking templates, to ensure that the

[5] AER 2013, *Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement*, p 61
[6] National Electricity Law section 7A; National Gas Law section 24
[7] AER 2013, *Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement*, p 62

information that it gathers is robust and fit for purpose. Notwithstanding these comments in relation to the potential for benchmarking to be used to a greater extent in the future assessment of pricing proposals, APA considers that there are some key issues surrounding the use of benchmarking data in the near term that are relevant to the AER's draft Expenditure Assessment Guideline. These issues are discussed below.

Application of benchmarking to other market sectors

Gas sector generally

APA notes that the *Issues Paper* released by the AER at the start of the guideline development process anticipated that some of the techniques set out in the guideline would also be applied in the gas sector, in particular benchmarking, trend analysis and expert engineering review. Specifically, the *Issues Paper* stated:

> At this point we are more concerned with developing the Guidelines for application to electricity NSPs. There are likely to be some techniques that will also be applied, in a general sense, to gas NSPs, such as benchmarking, trend analysis and expert engineering review. It is not anticipated, nor is it our intention, however, that the Guidelines would have practical implications for assessing expenditure in the gas context given different drivers for and definitions of expenditure, as well as inputs and outputs for economic benchmarking techniques. The only exceptions to this we can identify at present may be in the case of overheads assessments where expenditures and drivers may be generic to businesses in many industries.[8]

While the AER's intent is not explicitly stated in the draft Guideline or Explanatory Statement, APA is concerned that the AER will decide inappropriately to use data gathered from the electricity sector to benchmark gas businesses in some areas. APA considers that differences between the electricity and gas sectors, in particular differences between cost drivers, would make this data inappropriate for application to the gas sector.

For example, gas businesses incur significant commercial and marketing costs as a result of the emphasis in the regulatory regime on bilateral contracts, and the position of gas in the market as a fuel of choice. These types of costs are not generally incurred by regulated electricity businesses. It is therefore critical to ensure that any benchmarks applied to the gas sector are relevant to the sector and derived from gas business data.

It is also important in any benchmarking process that the target business (that is, the business to which the benchmark will be applied) is included in the dataset that is applied to assess the efficiency of its costs. This partly ensures that the efficiency (or otherwise) of the target business compared to the benchmark is not presupposed in the process of comparing that business to the benchmark; the choice of datasets and identification of 'like businesses' is therefore a key issue in any benchmarking process.

APA further notes that the draft Expenditure Assessment Guideline and Explanatory Statement have been drafted in line with specific requirements and processes under the National Electricity Law and NER for electricity distribution and transmission businesses. These electricity requirements and processes differ significantly from those in place under the National Gas Law and National Gas Rules, including in such areas as:

- Expenditure objectives for capital and operating expenditure;

[8] Australian Energy Regulator 2012, *Better Regulation: Electricity forecast assessment guidelines for electricity distribution and transmission – Issues Paper*, December, pp12-13

- Expenditure factors for capital and operating expenditure;
- References to benchmarking in the assessment of expenditure proposals;
- The requirement for the AER to prepare and publish annual benchmarking reports;
- The requirement for the AER to prepare and publish the Expenditure Assessment Guideline; and
- Differences in the processes for assessing proposals, including:
    - Requirements for each electricity network service provider to notify the AER of its approach to forecasting expenditure;
    - The Framework and Approach process; and
    - The requirement for the AER to prepare and publish an issues paper on the NSP's proposal early in the review process.

These procedural and decision-making steps all contribute to a legislative and regulatory framework in electricity that anticipates the use of benchmarking data in assessing and/or determining regulatory outcomes. The specific requirements and decision-making steps operate to ensure that the use of exogenous data is done in such a way that affords procedural fairness to NSPs. For example, the publication of annual benchmarking reports allows NSPs to track and understand their performance against their peers, and the framework and approach document prepared by the AER will state how the AER intends to apply the expenditure assessment guideline to an individual business, including the proposed use of benchmarking data.[9]

In the absence of similar processes to assist in ensuring procedural fairness for regulated gas businesses, APA does not consider that it is appropriate for the AER to seek to apply benchmarking techniques to the gas sector.

Gas transmission sector

The electricity and gas sectors (and their associated regulatory regimes) have developed separately. Most notably, the gas access regime is based on access arrangements that cover all aspects of service delivery for the reference service. These access arrangements operate alongside scope for contractual arrangements between gas businesses and shippers to differ from regulated outcomes in respect of both service and price. Contractual arrangements that differ from the access arrangement are particularly prevalent in the gas transmission sector.

Contractual outcomes provide more scope for individual arrangements than are available under the electricity regime. These arrangements mean that it is difficult to compare gas transmission assets as the contractual arrangements in place, and the markets they serve, can differ significantly.

For example a pipeline that operates 'point-to-point' and predominantly serves the mining sector cannot be meaningfully compared to a pipeline system that operates similar to a network and that serves a high proportion of residential customers. The drivers for investment and expectations for service delivery are vastly different under these two examples. Robust

[9] AER 2013, *Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement*, p 64

comparative benchmarking data may therefore be difficult to obtain in the gas transmission sector.

Existing contractual arrangements place pressure on gas transmission businesses in respect of service delivery and competitive market forces. Gas transmission businesses are therefore subject to counterparty pressure in relation to service delivery and prices. Private sector ownership also imposes pressures from investors to perform. This provides strong incentives for efficiency for gas businesses. These drivers operate in addition to regulatory drivers that incentivise efficient behaviour. As a result, APA considers that benchmarking may have limited value in the gas transmission sector.

APA therefore recommends that the AER consider the value and applicability of benchmarking to the gas transmission sector before embarking on a process of information gathering similar to that being undertaken in conjunction with the AER Expenditure Assessment Guideline.

Murraylink and Directlink

APA has previously sought clarification from the AER as to its intent to include Murraylink and Directlink in the data collection and subsequent benchmarking processes that are associated with the draft Explanatory Statement and Guideline. The AER has advised APA that it does not intend to include Murraylink and Directlink in these processes.

We consider that this decision is appropriate given the key differences between Murraylink and Directlink and other Australian transmission businesses. These differences centre on the fact that Murraylink and Directlink are Direct Current (DC) interconnectors, and as such there are no other comparator regulated transmission businesses in Australia.

APA considers that it would be inappropriate for the AER to apply data derived from businesses that are significantly different in terms of structure, asset type, service provision and revenue driver to assess historic and forecast costs for Murraylink and Directlink. APA therefore supports the AER's advice that it will not include Murraylink and Directlink in any benchmarking data gathering or analysis arising from this process. Notwithstanding the AER's previous advice, APA seeks further clarification of the AER's intent in light of references to the upcoming Directlink regulatory proposal in the AER's discussion of implementation issues on page 69 of the draft Explanatory Statement.

Please contact Alexandra Curran, Regulatory Manager on 02 9275 0020 if you would like further information on this submission.

Yours sincerely

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