Attachment A - Expenditure forecast assessment guideline (Q 1-19)

Scope of current consultation

Question 1
Should we anticipate the application of some assessment techniques to gas service providers as part of this consultation?

The AER should not have regard to the application of assessment techniques to gas service providers as part of this consultation.

There are significant differences in characteristics of gas pipeline and electricity network service providers (**NSPs**). In addition, under the NER, the AER is required to accept expenditure proposals and must only substitute forecast expenditure if it is satisfied that the forecast expenditure reasonably reflects the prudent and efficient costs of meeting the expenditure objectives. The expenditure assessment tests under the National Gas Rules (**NGR**) differ significantly. The question of what assessment techniques should be employed must be resolved by reference to the NER requirements and not the potential applicability of techniques in the gas context or the suitability of those techniques in light of the provisions of the NGR.

Question 2
Do stakeholders have any preliminary comments on the development of guidelines that will be different for transmission and distribution businesses? Should consultation be separate for these businesses?

A separate consultation process and separate guideline are necessary to address specific transmission issues.

As noted by the AER, differences exist between transmission and distribution businesses which will need to be addressed in the development of these guidelines. For instance, the paper only currently considers:

- the inputs, outputs and environmental variables pertaining to distribution network service providers (**DNSPs**)
- expenditure categories for DNSPs
- assigning expenditure techniques to DNSP expenditure categories

Transmission businesses have been regulated by the AER, and previously the ACCC, for over ten years. As a result of regulation by a common regulator, transmission has consistent categories established in the AER's submission guidelines and templates, and has had comparative performance reports published over several years. This is further discussed in the Grid Australia submission.

Question 3

How should linkages between expenditure assessment, information collection and storage, cost allocation and incentive arrangements be dealt with in the development of our overall assessment framework?

Incentive arrangement

Expenditure assessment and incentive arrangements are inextricably linked. The NER require the AER to develop an EBSS for opex, which provides for the fair sharing between DNSPs and users of efficiency gains and losses. The AER developed its EBSS on the basis that, in assessing opex forecasts, the AER would place significant weight on the actual opex in the base year of the current regulatory control period (i.e. would adopt a revealed cost approach). Changing the approach to expenditure assessment would necessarily change the impact on incentives arising from the EBSS, with the result that the incentives established by the scheme may no longer be effective or appropriate, including in the light of the NER requirements to provide for a fair sharing of efficiency gains and losses.

Information collection and storage

The AER must have regard to the costs associated with information collection and storage in the selection of expenditure assessment techniques. Seeking to apply expenditure assessment techniques that would require the AER to impose costs on NSPs for the collection and storage of information required to implement those techniques that would not be outweighed by the benefits associated with those techniques would not promote the NEO.

Cost allocation

Changes to the AER's cost allocation guidelines can only be made within the limits of the NER, which given the relevant NER requirements differ across jurisdictions, may not permit the AER to standardise cost allocation methods for the purpose of assisting expenditure assessment. The AER should have regard to the costs associated with changing the guidelines to avoid any undue costs to NSPs. To the extent changes to cost allocation would involve significant costs to NSPs, this should be highlighted to the AER.

Objectives for expenditure assessment

Question 4

Have we appropriately characterised the role of benchmarking in expenditure assessments, and set an appropriate objective in expanding and formalising our approach in consultation with stakeholders?

The Businesses consider that the response to this question must be in the context that the guideline should primarily provide guidance for the next round of regulatory reviews. Accordingly, the Businesses find that the Issues Paper has characterised benchmarking as having a role of greater significance than possible for the next round of determinations. Benchmarking techniques will need to be developed over time, and cannot play the role contemplated by the AER until such time as they are sufficiently robust.

The Issues Paper indicates:

- the AER's desire to significantly improve their approach to expenditure assessment and analysing the proposals of regulated NSPs;

- an expectation that benchmarking could deliver a more effective approach than detailed 'bottom-up' assessments.

The Businesses agree with the first point, however, we consider that benchmarking will complement rather than replace "bottom-up" analysis.

The AER cannot simply change its approach to expenditure forecast assessment, for example by adopting forecasts based on benchmarking in the event that benchmarking indicated that actual opex was inefficient. A wholesale review of incentives facing DNSPs, including in light of the EBSS, would be required to ensure that the AER complies with the NER and that the overall regime promotes the NEO. Put simply, no current benchmarking techniques exist that, even with perfect data quality, would be able to replace revealed cost approach and base step and trend methods for operating expenditure or bottom up cost assessments for capital expenditure.

Question 5
Do stakeholders have views on the use of revealed costs and the reliance on incentive mechanisms, and how this should change with the increased reliance on benchmarking to assess expenditure allowances?

The Issues Paper suggests that not all DNSPs have responded to the incentive mechanisms. As evidence, they point to the trend for some DNSPs to overspend. However, spending at a level in excess of the AER's expectations does not necessarily suggest inefficiency or imply a lack of response to incentives. The 'problem' of differing responses to incentives needs analysis into the causes and possible solutions to the problem.

The Issues Paper suggests that it potentially could abandon incentives and use only economic benchmarking and category based techniques. The Businesses consider that this to be an inappropriate approach. The existing carry-over and incentive mechanisms ensure that regulatory decisions remain effective despite significant changes in the industry environment (e.g. technological change).

The extent to which benchmarks could be relied on at any point in time would depend on the confidence that participants, including the regulator, have in the accuracy of the benchmarking techniques and the quality and quantum of supporting data. This was noted by the Productivity Commission in its recent review of Electricity Network Regulation, where it stated that:

"It is quite conceivable that over-confident benchmarking modellers might make errors analogous to this (the Challenger disaster) — at least in terms of the consequences for a business (or consumers). This suggests the importance of engineering and financial analysis as a supplement in interpreting statistical benchmark results." [1]

It goes on to state that;

1 Productivity Commission Draft Report, *Electricity Network Regulatory Frameworks*, October 2012p 174.

"..the degree of rigor required is dependant [sic] upon the extent to which benchmarking is used to determine the regulatory outcomes for the businesses"[2] *and the importance of "…a linkage between the strength of the incentives and the level of confidence regulators have in their forecasts of efficient spending (the more accurate the forecast the stronger the incentive can be)"*[3].

Given the current state of benchmarking analysis, it does not provide a robust basis for proposing to depart from the revealed cost approach for operating expenditure forecasting in the expenditure forecast assessment guidelines. If anything, the AER could strengthen the incentives if it considers that DNSPs are not responding to those incentives. Similarly the Businesses encourage the establishment of capital expenditure incentives which work in tandem with the operating expenditure incentives to drive overall efficient outcomes.

Principles for the selection of assessment techniques

Question 6
Are there any other principles that you think that should be added to this list? Should we include principles that guide the selection of the assessment techniques to be applied in the framework and approach stage, from the list of appropriate techniques (that will be) outlined in the Guideline? If so, do you think that the principles outlined here provide appropriate guidance on technique selection?

The principles outlined by the AER are very high level and offer little guidance to NSPs as to the approach the AER will adopt in a given set of circumstances. Greater certainty would be offered if the AER identified potential techniques and outlined the circumstances in which each technique is appropriate as well as how the AER will go about determining whether one technique should be favoured over another. The Businesses also observe that the principles do not appear to reflect the expenditure factors.

As to the principles identified, the Businesses note that:

- Principle 1 notes the need to balance the dual role of the assessment approach in setting immediate price levels and encouraging ongoing expenditure efficiency. The Businesses are concerned that the AER in encouraging ongoing expenditure efficiencies will impose arbitrary blanket efficiency targets over the regulatory period.

- The final sentence in Principle 2 does not identify in what circumstances the AER might find benefit in using a subjective project review. The circumstances in which a subjective review would be beneficial should be outlined.

- Principle 3 seeks to strike at the trade-off between detail, complexity and accuracy on the one hand and imprecision but simplicity on the other. However, the test for the AER under the NER is whether it is satisfied that a forecast reasonably reflects the expenditure criteria. The AER needs to make an assessment as to whether, having regard to all of the material before it, it can reach the requisite level of satisfaction on the basis of a simplistic

2 Ibid. p139

3 Ibid. p181

assessment. The Businesses observe that the AER can only do this at the distribution determination stage once it has the DNSP's regulatory proposal before it.

The Businesses support the AER's statement, *'….we consider that the assessment techniques should enable us to form a view on forecast expenditure in a way that is objective, unbiased, transparent and replicable'.*[4] The Businesses consider that it is fundamental for best practice regulation that these objectives are embodied in the principles for the selection of assessment techniques.

Expenditure assessment techniques

Question 7
Are there any assessment techniques that should be considered as forming part of the guidelines? What are the relative benefits and shortcomings of each of the approaches and how could the latter be addressed?

The AER has comprehensively covered known assessment techniques adopted by regulators for the purposes of assessing a reasonable level of expenditure. There are benefits and shortcomings for each of the approaches. It is therefore important that the AER's guideline sets out how it will choose which approaches to use when and for what subset of expenditure. Without such clarification, the guidelines are of little use in providing certainty to stakeholders.

Engineering review

The Businesses agree that the use of engineering assessments can potentially provide a more detailed and accurate assessment compared to other techniques. In fact, the Businesses believe that no current benchmarking techniques exist that even with perfect data quality would be able to replace a rigorous engineering assessment.

Engineering reviews should be used in a targeted way and are relevant where a particular benchmarking technique suggests greater scrutiny is required. Further, engineering reviews should be used to assess large material projects which may not be captured in benchmarking or modelling analysis.

Trend analysis

Trend analysis is a valuable tool for expenditure categories that exhibit relatively consistent levels of expenditure over time. However, if the business can demonstrate that circumstances have changed which results in a change to the expenditure profile, the AER should take this into account.

Expenditure benchmarks

Expenditure benchmarks are useful tools in providing a high-level "reasonableness view" of DNSPs' overall expenditure forecasts.

[4] AER, Issues Paper, p.g.22.

Expenditure benchmarks should be used solely as an informative tool in guiding investigations. They should be used as a starting point for a conversation with regulated utilities about the level of operating and capital expenditure being incurred and proposed.

The greatest risk with benchmarking is to apply simplistic benchmarks that do not take into account the business' network characteristics, actual cost drivers and cost structure.

More sophisticated benchmarking can enhance credibility for regulatory determinations. However, more sophisticated and extensive use of benchmarking is not a "silver bullet" for improving the credibility of the regulatory process. There will always be legitimate reasons as to why expenditure benchmarking does not accurately reflect some DNSPs network characteristics, actual cost drivers and cost structure. Effective benchmarking requires a clear understanding of those reasons. It is also useful to understand the nature of any economies of scale or scope in the industry.

It is critical to the effectiveness and stakeholder confidence of comparative benchmarking that the AER uses only robust data sets and transparent and replicable methodologies. In this regard, further work is required in developing benchmarking techniques such as:

- collecting robust consistent data over a number of years across all jurisdictions
- undertaking extensive modelling analysis and sensitivity/robustness testing that is transparent, replicable and subject to consultation, and
- ensuring that DNSPs have the opportunity to review, replicate and test the AER's preferred models.

Consideration must be given to the interaction between benchmarking and incentive schemes.

The Businesses caution the AER in applying benchmarking techniques that are applied overseas and are not appropriate in the context of Australian electricity networks. In many cases, benchmarking techniques are applied overseas in an environment where there are many homogeneous DNSPs which have contributed to a large panel data set using consistent measures over many years.

Modelling

The Businesses consider that technical models should not be relied upon solely when determining expenditure. Technical models such as the augex and repex models can be useful tools in providing a "reasonableness view" of expenditure for some specific processes or activities, but should not be determinative. As with expenditure benchmarks, technical models should be used as an informative rather than a deterministic tool to guide investigations and it is critical that the AER uses only robust data sets and transparent and replicable methodologies.

Technical models proposed by the Issues Paper such as the augex and repex models have limitations, including an incomplete list of expenditure drivers and a lack of account for different planning standards and methodologies (such as probabilistic and deterministic). Further, the models require the establishment of standardised definitions and categories. It is challenging for DNSPs to map costs which are typically recorded internally on an activity basis to the standardised definitions and categories. As a consequence, the costs recorded under the standardised definitions and categories may not reflect the actual costs of replacing and/or augmenting the network in like-for-like way.

As with expenditure benchmarks, there will always be legitimate reasons as to why technical models do not accurately reflect some DNSPs' network characteristics, actual cost drivers and cost structure.

Proposals for further work

Question 8
Do stakeholders agree with our general approach of attempting to derive quantitative relationships between expenditures and drivers? Are there better, more cost effective alternatives to assessing disaggregated expenditures?

The Businesses support in principle the general approach of attempting to derive quantitative relationships between expenditures and drivers. The AER must however ensure that it has identified and accounted for all of the expenditure drivers to provide an efficient level of expenditure which ensures that a DNSP is funded to meet all of its obligations.

The AER will need to ensure that it does not 'force' this analysis in circumstances where it is not appropriate. For NSPs to be able to alert the AER to shortcomings in its analyses, it will be important for the AER to ensure that it obtains, and makes available to NSPs, detailed information in respect of potential comparators.

Whilst the Businesses consider that there is value in disaggregating expenditures to assist in explaining why there could be differences in the more aggregated benchmarking outcomes, the Businesses are strongly of the view that disaggregated data can not be used for comparative purposes. This point is further elaborated in our response to question 9.

Question 9
Do stakeholders have any in-principle comments about the level of expenditure disaggregation given our expectation that lower levels of aggregation e.g. by asset type, are likely to be conducive to more robust benchmarking and other quantitative analysis?

The Businesses are comfortable with aggregation at an asset type level. However, the AER must be cognisant that obtaining unit costs and volumes for each asset type will not necessarily provide robust data for the purposes of benchmarking in the short to medium term. For example, given the differences in operating environments, the cost of maintaining a feeder in a remote inaccessible area will be significantly different to the cost of maintaining a feeder in a coastal area or a central business district.

Also, the level of disaggregation should not be greater than DNSPs use to manage their own costs. This will need to recognise that DNSPs will use "unit costs" to monitor and manage its costs, which are defined differently and comprise different levels of aggregation. For example, DNSPs may track the cost of maintaining a SWER feeder whilst another business may monitor the cost of managing the maintenance of poles on that feeder and other feeders.

Question 10
Do stakeholders agree that economic benchmarking will be an important adjunct to more detailed expenditure assessments?

The Businesses agree that economic benchmarking has potential to be an adjunct to more detailed expenditure assessments. However, as noted in the response to question 7, economic

benchmarking should only be used to inform the AER of a 'reasonableness view' of expenditure and should not be used for deterministic purposes due to the reasons provided.

Expenditure assessment process

Question 11
Do stakeholders agree that the first-pass process described above is a useful and appropriate application of expenditure assessment techniques?

The AER's proposal presents a welcome opportunity for early engagement on expenditure forecasting assessment methodologies.

To ensure that stakeholders benefit from the AER's proposed approach in this upcoming round of regulatory reviews, the Businesses encourage the AER to adopt a similar approach of publishing preliminary analysis prior to the draft determination, even though an Issues Paper is not mandatory.

In the publishing of benchmarking data in the first pass process, the Businesses advocate that the benchmarking data should be appropriately qualified in order that stakeholders understand that it is solely to inform and not to determine expenditure levels. In this respect, the Businesses recommend that the benchmarks are represented as a range rather than a single value.

Expenditure incentive schemes and their application

Question 12
Do stakeholders have any views on the relationship between the assessment tools that we have identified, and our existing incentive schemes? Given the interrelationship between the two, and that our incentive schemes are to be revised over 2013, what processes should we follow to ensure there are appropriate incentives on NSPs to make efficiency gains, while at the same time implementing appropriate expenditure assessment techniques?

Please refer to the Businesses' responses in relation to question 3 and 5.

The guideline, benchmarking reports and determinations

Question 13
Do stakeholders have any comments on how best to manage the interrelationships between the guidelines, F&A processes, determinations and annual benchmarking reports?

Each of the guidelines, the F&A Paper, the annual benchmarking reports and the determinations have fundamentally different roles to play, and regard should be given to these roles in managing the interrelationships. The regulatory determination is the document of consequence, both to NSPs and consumers. The AER has an obligation to determine expenditure allowances in accordance with the NEL and the NER above all else, including where this is inconsistent with a matter outlined in the guidelines, the F&A Paper and benchmarking reports.

The process of expenditure assessment will be a process of continual refinement, with the AER's learning in making regulatory determinations feeding into both the expenditure forecast assessment guidelines and the annual benchmarking reports.

Question 14

How would it be best to maintain a degree of consistency in assessment techniques and associated data reporting, while at the same time allowing improvements in techniques?

The AER needs to satisfy itself that each expenditure forecast reflects the prudent and efficient costs of achieving the expenditure objectives, and it is this requirement that drives the selection of techniques above all else. The Businesses understand that regulatory practice is continually evolving and indeed consider that the AER would fail in its obligations under the NER if it were to hold off on implementing an improved technique. However, the AER should only implement an improved technique if it has available robust data. If the AER were to make a radical departure from its previous practice than it must revise the Guideline and seek consultation in accordance with the NER.

Question 15

Are there any ways the expenditure assessment process, including in preparing NSP forecasts, could be improved by linking the Guidelines, the F&A process and the NSP's obligation to notify us of its forecasting methods?

The Businesses can see value in linking the Guidelines, the F&A process and the NSP's obligations to notify the AER of a forecasting methodology, if it provides NSPs with more certainty in regard to how the AER is going to assess expenditure forecasts. Further, linking these consultation steps will encourage early engagement between NSPs and the AER.

Detailed timing and transitional issues

Question 16

Keeping in mind the preference to use up to date and nationally consistent data in all benchmarking analysis, what would be the best time to issue RIN templates? Would these need to be for all NSPs? How frequently should we do this?

The Businesses consider that the RIN timing for each business should continue to align with each business's regulatory year and regulatory period cycle.

The Issues Paper appears to anticipate a need for all data to be collected at the same time nationally in order for results to be comparable. In reality, it is unlikely that data collected will have such a degree of accuracy that timing differences in the collection of data between NSPs will have a significant impact on the comparability of data. Consistency in data definitions across all NSPs is more important factor in ensuring comparability of data.

In practice, the required degree of consistency will take several iterations to achieve and the annual RIN process will need to support an evolutionary development of the data requirements.

Further, simply setting out consistent definition is not sufficient, as it takes time for NSPs to align their operational and financial processes to new definitions. Also, it will take time to understand whether all NSPs are interpreting the definitions in the same way. Until consistency of application (as opposed to definition) is achieved, benchmarking is likely to experience large discrepancies that would simply reflect different interpretations, rather than different performance.

Question 17

Should we try and limit the collection and analysis of benchmarking data to annual benchmarking reports? Alternatively, should we focus our effort on benchmarking analysis at each draft and final decision stage, with less attention to annual benchmarking reports?

It is not practical to limit the collection and analysis of benchmarking data to annual benchmarking reports. The appropriateness of benchmarking analysis for the purposes of assessing expenditure forecasts will inevitably turn on the particular proposals and thus will always need to be assessed at the regulatory review process stage.

Question 18

Are there alternative, more flexible means to gather data for benchmarking purposes in annual reports and in determinations, such as requests outside the NEL provisions?

All information provided to the AER must be robust. Even information provided on a more informal basis that does not require formal sign off would still need to be fully reconcilable with information produced in response to regulatory processes. There is a severe risk that the AER may make an assessment of the Businesses' efficient costs based on data collected from other DNSPs which may be incorrect due to a lack of rigorous collation.

Question 19

Should we be considering the alignment of regulatory years and of regulatory control periods for transmission and distribution NSPs to overcome some of these challenges? If so, should regulatory years reflect the Australian financial year? How would the alignment of regulatory control periods be best achieved?

The Businesses do not believe that it is necessary to align regulatory control years and periods for transmission and distribution NSPs, or to align regulatory years with financial years. In terms of benchmarking, there is no practical reason why the AER's analysis should not be based on the most recently reported data for each DNSP.

It is important to remember that there is no consistency even between financial years across DNSPs, for example as some are overseas owned with financial years in the shareholder's jurisdiction being different to the financial year of the Australian DNSP.

The staggered nature of regulatory periods provides an opportunity for regular review of the effectiveness of the benchmarking and assessment process and to include learnings from one revenue determination into the process applied to the following determination.

The introduction of a range of new expenditure assessment techniques in a wholesale manner would represent a significant change for both the AER and the NSPs, and would need to be managed effectively if it is to be successful and result in the outcomes desired by the AER. A process whereby smaller incremental steps are taken and the results assessed and processes modified accordingly is more likely to result in a successful implementation.