# Better regulation program

# Consumer reference group

# Discussion document

August 2013

AUSTRALIAN ENERGY REGULATOR

# Contents

# 1 Purpose

The purpose of this document is to assist discussion at the next face to face meeting of the Consumer Reference Group (CRG) being held on the 22 August 2013.

At this meeting, members of the CRG will discuss the draft guidelines released as part of the Better Regulation program. Comments from CRG members will be taken as submissions on the draft documents.

It is suggested that this document be read in conjunction with the factsheets, draft guidelines and explanatory statements:

Expenditure forecast assessment http://www.aer.gov.au/node/18864

Expenditure incentives http://www.aer.gov.au/node/18869

Shared assets http://www.aer.gov.au/node/18878

Confidentiality http://www.aer.gov.au/node/18888

This Discussion document sets out the key reasons for AER's proposed approach.

# 2 Expenditure forecast assessment

## 2.1 Reasons for proposed approach

With the expenditure forecast assessment guidelines we aim to significantly improve our approach to expenditure assessment. This will better equip the AER to critically analyse and challenge the proposals put to us by network service providers (NSPs). We consider that comparing expenditures across NSPs through the use of economic benchmarking techniques is the next important step to achieve this aim. We have also expanded on the category assessment techniques we already use.

We have used this opportunity to expand on the data we request from NSPs, and to ensure consistent reporting across categories. This is necessary to effectively use our proposed benchmarking techniques.

This document sets out progress on:

- Our approach to expenditure assessment, set out in the Guideline
- Benchmarking (category analysis and economic benchmarking)
- Data collection timings and how our transitional data requests will become part of our annual data requests.

### 2.1.1 Standardised data reporting will contribute to rigorous and transparent forecast assessment

Nationally consistent data will facilitate the development of more sophisticated benchmarking techniques and other expenditure forecast assessment techniques. Having consistent data will also allow us to compare the relative efficiency of NSPs, and track changes in efficiency over time.

We are collecting a standardised data set to enable us to validate and test our economic benchmarking models. More detailed and disaggregated capex and opex information will facilitate our use of various assessment tools such as the models for replacement expenditure (repex) and augmentation expenditure (augex) in future determinations.

### 2.1.2 A greater suite of assessment techniques will expand our scope for forecast assessment

We are expanding our regulatory toolkit to make greater use of benchmarking. In particular, we are implementing top down benchmarking techniques as recommended by the Productivity Commission (PC) and endorsed by the AEMC and the Australian Government.

Economic benchmarking allows us to compare electricity network businesses against each other and determine how efficient they are by comparison. For example, where an NSP appears to be relatively inefficient or does not show improving efficiency performance, economic benchmarking results can be analysed to identify the sources of inefficiency. Category analysis will enable us to analyse expenditure drivers and the costs of conducing similar activities across businesses. These tools both provide guidance to targeted reviews of expenditure.

### 2.1.3 We are taking a holistic approach to economic benchmarking

We will determine which techniques to apply at the time of determinations, rather than specify economic benchmarking techniques in our Guideline. This will allow us to refine our techniques over time, and place increasing reliance on them when more data becomes available.

Economic benchmarking will allow us to analyse NSPs' efficiency over time and assess performance in comparison to peers. It will also allow us to estimate a top-down forecast of expenditure and estimate productivity change.

We will integrate our new and refined techniques into our assessment approach, but they will not displace our existing techniques. Rather, we will use them in combination with existing techniques to form a view about forecast expenditure. However, we anticipate placing increasing reliance on benchmarking techniques as more data becomes available.

### 2.1.4 We will use the same general approach in assessing either capex or opex forecasts

A broader range of assessment techniques and consistent data will facilitate our assessment. Consistent with our past approach, we will generally develop an efficient starting point or underlying efficient level of expenditure that we will then adjust for changes in demand forecasts, input costs and other efficient increases or decreases in expenditure. This will allow us to determine a total forecast that we are satisfied reasonably reflects the expenditure criteria.

### 2.1.5 NSPs will have reasonable time to compile data and opportunity to consult with us on data issues

We think it is important to provide NSPs sufficient time to gather and validate their own data before providing it to the AER for the purposes of benchmarking reports and determinations. To facilitate the data collection process we:

- issued preliminary expenditure information templates with the draft Guidelines
- will issue draft RINs in September 2013 to all NSPs to collect back cast economic benchmarking data to enable a testing and validation process in early 2014. We intend to issue RINs in order to maximise the time available for data to be provided in advance of a model testing and validation process in 2014
- will issue RINs in late 2013 to all NSPs for the purposes of gathering information for the 2014 benchmarking report and in assessing regulatory proposals submitted in 2014. All subsequent data requests for the benchmarking report will be RIOs and be issued annually.

### 2.1.6 Our engagement with stakeholders will be expanded

We aim to facilitate engagement with stakeholders (including consumer groups) by:

- setting out our assessment approach in the Guideline so stakeholders have upfront knowledge of our likely approach to reviewing expenditure proposals
- providing an initial review of expenditure proposals, which will provide our preliminary views on the proposals

We consider these measures will enable us to identify and engage with stakeholders on key issues early in the determination process.

Consumers will also be engaged in the determination process through the release of the annual benchmarking report and the public release of NSPs' data. We are required to consider the most recent benchmarking report in making draft and final determinations, which consumers will be able to comment on.

# 3 Expenditure incentives

## 3.1 Reasons for proposed approach on capex incentives

Our proposed approach in the draft capital expenditure incentive guidelines is:

- One symmetric, continuous capital expenditure sharing scheme (CESS) to apply for all businesses.
- The penalty for efficient overspending and the reward for underspending will be 30 per cent.
- This means the business will wear 30 per cent of any efficient overspend over the regulatory period and gain 30 per cent of any underspend.
- Not to allow for any exclusions from the CESS.

We think it is important to consider the capex incentive regime as a whole. In particular, how the CESS, the ex post review and our approach to capex forecasting interact.

A symmetric CESS alongside these other measures should ensure NSPs have sufficient incentives to undertake efficient capex, and still give protection for consumers from the costs of inefficient capex overspends.

Importantly:

> Consumers will not pay for inefficient overspends due to the ex post review.
>
> Consumers will share part of the benefits of any capex efficiency saving (70 per cent).
>
> Consumers will share part of the cost of efficient overspends (70 per cent).
>
> We will assess issues of capex deferral through the forecasting assessment approach.

### 3.1.1 The ex post review alongside a symmetric CESS should minimise inefficient capex overspends

Not all NSPs have consistently overspent in the past. Since there was previously no ex post review, we do not know whether past overspends were inefficient, due to forecasting error, or unforeseen circumstances. To apply an asymmetric CESS in these circumstances could lead to perverse outcomes. In particular, NSPs would be greatly penalised for overspending whether or not their capex is efficient. This is because the CESS will apply mechanistically without any consideration of the efficiency of the overspend. The ex post review allows explicit consideration of the efficiency of the capex overspend. This, alongside a symmetric CESS, would better address the issue of less responsive or inefficient NSPs in a more targeted way than would an asymmetric CESS.

In addition we now have the ability to ensure the regulatory asset base (RAB) includes only efficient related party margins and that NSPs do not benefit from capitalising opex.

### 3.1.2 Under the CESS and the ex post review together, NSPs risk losing between 30 and 100 per cent of any overspend

NSPs bear 30 per cent of any overspend whether it is efficient or not. If, however, the overspend is found to be inefficient, the NSP will bear the entire cost of the overspend. This risk should encourage NSPs to spend within their allowances and provides an overall asymmetric approach to overspending.

### 3.1.3 Improved forecasting means a symmetric CESS is more appropriate

To the extent that we are concerned about allowances being biased upwards, we will address this through our forecasting approach rather than through capex incentives. We are undertaking considerable work as part of the Better Regulation program to improve the tools and methodologies we use to forecast capex. We believe this should lead to any forecasting error becoming more symmetric over time.

### 3.1.4 A symmetric CESS with a reward and penalty of 30 per cent provides more balanced incentives

This is because the current EBSS and the service target performance incentive scheme (STPIS) provide an incentive of approximately 30 per cent for opex and service respectively. Balanced incentives across the regime reduce the risk of perverse outcomes.

### 3.1.5 A symmetric CESS with continuous incentives alongside improved forecasting reduces the incentive for capex deferral

The power of the reward for underspending is moderate rather than high.

In the past, businesses have deferred capex and resubmitted the same capex proposal in the next regulatory control period. To address this, the incentives for capex, opex and service are balanced so that any capex deferral either increases opex or reduces payments under the STPIS.

Although declining incentives within the period may reduce the incentives for inter-period capex deferral, the issue of capex deferral is not straightforward. It is difficult to know when a decision to defer capex is efficient or opportunistic. We still favour a CESS with continuous incentives as we consider the issue of capex deferral is better addressed through our approach to forecasting and assessing proposed capex.  Further, as capex forecasting becomes better we are less likely to fund capex that is ultimately not required in the period. In some circumstances this could make use of the contingent project provisions in the NER.

### 3.1.6 We are not convinced that any categories of capex should be excluded from the operation of the CESS

On possible forecasting error, a symmetric scheme will mean that overs and unders will be treated equally. For capex that is outside of a NSP's control, application of the scheme will mean that the NSP bears 30 per cent of the cost of any unforseen event that requires additional capex. Conversely, if a cost does not arise, the NSP will save 30 per cent of the avoided cost. If the CESS did not apply however, the amount to be borne by the NSP can vary depending on the year in which the cost (cost saving) occurs. We see no reason why this should be the case and instead view 30 per cent as a fair sharing of risks between NSPs and their customers.

## 3.2 Reasons for our approach on opex incentives

We propose that the current EBSS should continue largely in its current form.

Our proposed changes would only affect how carryover amounts are calculated for future regulatory control periods. They will not affect the calculation of carryover amounts from the current regulatory control period.

Our decision on the EBSS is intrinsically linked with our likely approach to forecasting as outlined below.

### 3.2.1 The current EBSS provides effective incentives where we continue to use revealed costs (base-step-trend) to forecast opex

In our draft assessment guidelines we outline our preference is to continue to use base-step-trend to forecast opex. The current EBSS is intrinsically linked to a base-step-trend forecasting approach. Our preference is to continue with this approach. Under this approach we consider the current EBSS is an effective mechanism for constraining a NSP's incentive to increase its opex in the expected base year. The explanatory statement for the proposed EBSS shows how this is achieved.

We have not found evidence of overall systematic overspending by NSPs in the base year, and consider the current EBSS works well to address the incentive to inflate the base year.

Concerns about applying the EBSS when opex is inefficient are, at least in part, likely to be addressed through our opex forecasting approach (historic cost will not be used as the base where an NSP is materially inefficient).

Maintaining the current EBSS combined with a base year approach leads to balanced opex, capex and service improvement incentives.

### 3.2.2 The current EBSS will provide effective incentives when used with the 'base year minus adjustments' forecasting approach

We will address concerns about inefficient spending on opex through our forecasting approach. Our draft expenditure assessments guideline outlines that where a NSP is materially inefficient, we will consider adjustments to opex in the base year to remove identified inefficiencies. We will combine the adjusted base year with our revealed cost approach to set a forecast opex allowance. We won't use a business' past spending to set its expenditure allowance where a business is materially inefficient.

Even with adjustments to the base year, a NSP may possess an incentive to increase its opex in the base year unless an EBSS is in place.

Where a NSP expects us to apply the current EBSS in combination with a base year minus adjustments forecasting approach, it is likely to increase their incentive to reduce opex.

We consider a higher powered incentive to be appropriate, particularly where a NSP is relatively unresponsive to financial incentives. A higher powered incentive increases the likelihood that a NSP will reduce its opex over time and become efficient in the future. If a NSP does not respond to the higher powered incentives, it will bear a greater portion of any inefficient overspend. This will help to ensure that consumers do not pay for more than the efficient amount of opex.

### 3.2.3 We will no longer allow specific exclusions for uncontrollable opex and/or network growth

We consider there is no compelling reason why the forecasting risk associated with uncontrollable opex or growth should be shared differently between NSPs and consumers when compared with how the forecasting risk associated with controllable opex is shared.

If the cost of an uncontrollable event is significant, a NSP may apply for it to be a recognised pass-through event.

# 4 Shared Assets

## 4.1 Reasons for proposed approach

The draft shared asset guidelines set out how we propose to share the benefits earned by NSPs from using regulated assets to provide unregulated services with electricity customers. Before the recent changes to the National Electricity Rules (NER), electricity customers were unable to benefit from the use of regulated assets to provide unregulated services.

Importantly, under our draft guidelines:

> Consumers receive benefits when regulated assets they pay for are used to provide unregulated services (when the use is material).
>
> Incentives are retained for NSPs to seek out opportunities to provide unregulated services.
>
> By retaining such incentives, ongoing customer benefits will also be promoted.

### 4.1.1 We will reduce service provider regulated revenue by around 10% of the value of unregulated revenue earned from shared assets

NSPs have sought lower proportions and customer groups higher proportions. We think that customers should receive a reasonable benefit from unregulated services.

To ensure customers continue receiving such benefits, service providers must retain a reasonable incentive to facilitate unregulated services.

We accept that in many, if not all cases, service providers incur at least some incremental costs when providing unregulated services using shared assets.

### 4.1.2 Profit sharing is inconsistent with the NER

The NER do not support a profit sharing approach. Under the NER, consumers should receive a benefit when use of regulated assets to provide unregulated services is material. That is, the benefit to electricity customers should not be dependent on whether the NSPs derive a positive commercial outcome from the use of the asset for unregulated services.

The AEMC argued the commercial risk of providing unregulated services should be carried by service providers, not consumers.

Assessing a service provider's incremental costs of providing unregulated services may mean going beyond our role under the NER. As the services in question are not distribution services (they are unregulated) they are outside our authority.

### 4.1.3 Materiality will be assessed in aggregate, against the 1% threshold already in the NER for cost pass throughs

Service providers sought materiality assessment per service and higher materiality thresholds. Customer groups sought aggregated assessment and lower thresholds.

The cost of administering customer benefits will be equivalent, whether large or small. However, small unregulated revenues translate into insignificant customer benefits.

The 1% threshold is consistent with the AER's stated position on materiality on other regulatory issues, like cost pass through.

Assessing materiality in aggregate avoids the complexities of defining individual services and, reduces the likelihood of conflicts with service providers.

### 4.1.4 Limited annual information reporting and comprehensive reporting for regulatory determinations

We require some information about unregulated services to fulfil our obligations under the NER. However, we seek to minimise the regulatory burden faced by service providers, and therefore minimise the administrative costs passed through to consumers.

Limited annual reporting will allow us to efficiently monitor the accuracy of revenue forecasts provided by service providers.

More comprehensive reporting will be required with regulatory proposals, at five yearly intervals. It is this information we will rely upon when determining shared asset cost reductions.

# 5 Confidentiality

## 5.1 Reasons for proposed approach

Our aim has been to balance protecting confidential information with disclosing information for an open and transparent regulatory decision making process. This balance involves all stakeholders having access to sufficient information to understand and assess the substance of all issues affecting their interests. This is not equivalent to public disclosure of every piece of information that NSPs provide, especially where public disclosure is likely to harm the long term interests of consumers.

We are seeking to encourage NSPs and other stakeholders to develop their own arrangements for proper assessment of the NSP's regulatory proposal (noting that there may be particular arrangements for particular stakeholders), prior to submission to the AER. Where this does not occur, we may need to use our powers under the National Electricity and Gas Laws to authorise disclosure.

Importantly:

> Consumers will be provided with sufficient information to enable them to understand the substance of all issues affecting their interests.
>
> We intend to work with NSPs and consumers to reach a shared, practical understanding of confidentiality issues, prior to submission of the regulatory proposal.
>
> NSPs will be required to submit a confidentiality template with each regulatory proposal. We will publish this on our website as soon as possible after receipt.
>
> We will undertake a case by case approach to assessing confidentiality claims based on its merits.
>
> Compliance with the guideline is relevant to our assessment of whether a regulatory proposal is compliant. We may seek resubmission where there has been a failure to comply.

### 5.1.1 Confidentiality information categories

We have determined the list of categories of documents that we believe should be protected.

- information affecting the security of the network—information that may jeopardise security of the network or its ability to operate effectively
- market sensitive cost inputs—such as supplier prices, internal labour costs, or information affecting the business' ability to obtain competitive prices
- market intelligence—information that may advantage the business' competitors for non-regulated or contestable services
- strategic information—such as the acquisition of land and easements, which might impact the business' ability to negotiate a fair market price for these items
- personal information—information about an individual or customer which raises privacy considerations
- other—information the business claims is confidential but doesn't fit into any other category.

We intend to take a case–by–case approach to assessing confidentiality claims. Classification into a category does not guarantee protection.

### 5.1.2 Guidance on what information stakeholders should have access to

We have included an indicative list of the types of documents NSPs often submit with regulatory proposals that we generally consider should be placed in the public domain. This is contained in Attachment 3 of the guideline.

Consumers suggested we disclose additional items of information, such as related party transactions and non-regulatory activities. Although this material may be important to understanding and assessing the substance of the issues affecting consumers, it may contain confidential information and we have not accepted such a blanket approach. We will apply our case–by–case approach to this information.

We have included a confidentiality template. The key points of the template are:

- include a brief description of the nature of the information and topic to which the information relates.
- include reasons why information submitted, if disclosed, would cause detriment.
- an optional requirement to address the public benefit.
- we have not included a requirement to set out the materiality of each document. This requirement would be difficult to implement, however, we consider a description of the nature of the information and the topic will assist consumers to identify information that they want to access.

### 5.1.3 Process to deal with confidential information

We have included a two–stage process to deal with confidential information.

The 'pre-lodgement' stage proposes a collaborative approach between NSP's and consumers, which would enable the parties to explore options to understand and assess the substance of the information. This might include the provision of public information in sufficient detail without disclosing details that might negatively impact on the long term interests of consumers, or providing detailed information subject to confidentiality undertakings.

Where agreement cannot be reached, we will use our information disclosure powers under the Law as appropriate.

We propose to make greater use of our ability to disclose information for the purposes of according natural justice to a person affect by our decision. This would involve limited information disclosure subject to a confidentiality undertaking.

Where we are required to use our information disclosure powers, the timelines of disclosure depends on the amount of information we are seeking to disclose. As a result we are unable to provide precise timelines. However, we consider our stage one and two processes will assist all stakeholders to access information in a timely fashion.