22 May 2013

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Dear Ms Sastro

Response to AER questions addressed to the expenditure incentives work stream

Thank you for the opportunity to respond to the questions listed in your paper titled *Interaction between the EBSS and opex forecasts* dated 6 May.

The Energy Networks Association (ENA) is the peak national body representing electricity transmission and gas and electricity distribution businesses throughout Australia. Energy networks are the lower pressure gas pipes and low, medium and high voltage electricity lines that transmit and distribute gas and electricity from energy transmission systems directly to the doorsteps of energy customers.

Background

The Australian Energy Regulator's (AER) preference is to use the revealed cost approach in forecasting operating expenditure (opex). Where the Network Service Providers' opex allowance is set on the basis of revealed costs, the AER would continue to apply the existing Efficiency Benefit Sharing Scheme (EBSS).

The AER considers that the revealed cost approach may not be appropriate in some circumstances if a Network Service Provider (NSP) is not responding to the incentive to reduce opex to an efficient level. That is, the AER considers that the revealed cost approach may not provide a forecast of efficient opex in all circumstances.

To assess whether or not a NSP is responding to incentives to reduce opex, the AER proposes to:

- undertake benchmarking at a high level, as well as disaggregated category assessments, on the base year;
- consider using a different base year if concerns are identified in the initial base year chosen; and
- seek further information from the NSP to inform the need to make adjustments to base year expenditure.

Where the NSP's opex allowance is not set on the basis of revealed costs, for example where the AER makes adjustments to the base year, then it would apply a different opex incentive scheme.

Timing

The *National Electricity Rules* (NER) requires the AER to outline in its Framework and Approach (F&A) paper its proposed approach to the application of the:

- EBSS
- Expenditure Forecast Assessment Guidelines.

That said, the AER notes that the F&A paper is not binding and the AER may depart from the position outlined if there are good reasons to do so.

However, the AER must publish the F&A papers for several NSPs prior to the publication by the AER of its first annual benchmarking report, which is scheduled for 30 September 2014. The AER's staff preferred approach is to set out whether or not the NSP's opex forecast will be based on revealed costs in its Issues Paper, which is required under the NER to be released 40 business days after an NSP submits its regulatory proposal.

The ENA responses to the AER questions are set out below.

Question 1. In the interests of providing certainty on matters to be raised during a determination process, should the AER decide whether to accept or potentially adjust base year opex at the Framework and Approach stage? In considering this question, we note that:

a. new data to inform the decision to accept or adjust the base year may arise at any time after the Framework and Approach

b. in managing this uncertainty, NSPs may prepare their submissions in anticipation of addressing issues in base year opex regardless of the Framework and Approach position

c. NSPs will be required to provide various historical data, including for benchmarking techniques, as part of annual performance/ benchmarking reports, even in the event the AER considers the revealed cost approach and base year are appropriate for particular NSPs

d. Data and analysis forming part of the most recent performance/ benchmarking report would likely form the basis for the "stage one" assessment of base year opex.

The ENA supports the AER's preference for using the revealed cost approach in forecasting opex.

In the interest of providing certainty to NSPs on matters to be raised during a determination process, the ENA generally supports the AER setting out at the F&A stage whether or not it proposes to accept or potentially adjust the base year opex of the NSP. Of course, as the AER notes the F&A stage is not binding. Where the AER proposes to adjust the base year opex in the F&A paper, then it should only formalise the decision after it receives the regulatory or revenue proposal of the NSP and having regard to its obligations under sections 6.5.6 or 6A.6.6 of the NER, as applicable. Furthermore, the ENA is concerned about the AER's reliance on the benchmarking report, for the reasons set out below.

Firstly, the AER's reliance on the first annual benchmarking report in determining whether or not a NSP is responding to incentives to reduce opex is not appropriate given that the report:

- will only provide a single snapshot of relative efficiencies, and not a time series of reports indicating trends;
- may be based on an "abnormal" year for some NSPs; and
- will not have been fully tried and tested. For example, the initial results may highlight the need to undertake further normalisation adjustments to take into account other differences in operating conditions or management practices, or that further investigation is required into the comparability of certain information provided by the NSPs.

Second, the AER proposal to adjust the base year opex of a NSP in setting its forecast opex allowance should only be undertaken in the extreme scenario where there is over-whelming range of evidence that the base year expenditure is not a reasonable basis for establishing forecast expenditure – a one-off benchmarking report is not sufficient evidence for the AER to reach such a conclusion.

Third, the practical timing difficulties highlighted by the AER indicate that it is premature for the AER to utilise the benchmarking report to determine the basis for forecasting a NSP's opex allowance.

Fourth, the AER has indicated that its decision to adjust the base year will be based on whether or not a NSP has responded to the incentives contained in the EBSS. There has been little evidence put forward by the AER as to how the AER would form such a decision, other than the fact that it would be difficult to make. The ENA can only conclude that this decision would be subjective and informed strongly from the AER's benchmarking report, which is inappropriate for making such a decision.

Finally, the AER preferred approach to identifying in its Issues Paper whether or not it intends to forecast opex based on revealed costs does not accord with the principles of natural justice in that:

- the AER is likely to have early indications of the benchmarking results at the time of publishing its Issues Paper, which may influence its thinking;
- the NSPs are unlikely to be able to ascertain the weight placed by the AER on the benchmarking report and on the category analysis in reaching its decision in the Issues Paper, given that the annual benchmarking report may not have been published;
- the one month period between the AER releasing its first annual benchmarking report and the submission of the Regulatory Proposal by Queensland and South Australian DNSPs is not sufficient to allow a thorough analysis of the conclusions reached in the benchmarking report and to amend the Regulatory Proposal; and
- the 6 month period between the AER releasing its first annual benchmarking report and the final decision for the New South Wales, Australian Capital Territory and Tasmanian final decisions, per Table 1 of the AER paper, is not sufficient time for a NSP to undertake thorough analysis of the conclusions reached in the benchmarking report, respond to the AER and for the AER to fully take into account the comments of each NSP.

For those NSPs impacted by timing issues, the ENA therefore considers that the AER should not utilise the benchmarking reports in determining whether or not the NSPs are responding to incentives to reduce opex.

Question 2. What are the risks and other practical implications of the AER attempting to determine the effectiveness of the opex incentive framework by reference to an NSP's performance, which may be the result of other incentives or exogenous factors?

The AER notes that it is difficult to determine whether an NSP is responding to the EBSS incentive to reduce opex. Where a NSP is not responding to the EBSS, this may reflect that the NSP has other competing objectives. There are cases where the business decision not to reduce costs, despite the incentive, is entirely appropriate and in the long term interests of consumers.

The ENA agrees that there is significant risk and practical difficulty of assessing whether or not a NSP is responding to the EBSS incentive to reduce opex. A mechanical application of benchmarking will never of its own be appropriate, particularly in the early stages of benchmarking analysis where information is likely to be inconclusive.

Importantly, and as alluded to in the previous response, the ENA considers that there is considerable practical risk to rely on benchmarking to make judgements on the effectiveness of the incentive framework. This reflects the known difficulties in benchmarking techniques to adequately account for different operating environments, accounting practices and management practices (i.e. opex and capital expenditure trade-offs made in asset management).

Over time, if the NSP is not responding to the incentives to reduce opex and there is a change in the other factors influencing the NSP's behaviour, then this will likely become visible to the AER through the opex contained its Regulatory Information Notice (RIN) submissions.

In respect of the modelling provided by the AER, the ENA would like to understand how the AER would apply the model with more detailed case studies and a better understanding of the link between its decision framework and the out-turn modelling. This would be beneficial for all stakeholders and would allow ENA members to provide more input into the practical implications of the AER's approach.

Question 3. Should the AER consider placing a higher threshold on making adjustments to the base year and departing from the current revealed cost framework? (How) could this be accommodated in the staged assessment process outlined above? For example, should the AER base its decision on several years of identified inefficiencies or upon a certain quantum of inefficiency?

The ENA considers that the revealed cost framework is the default mechanism for expenditure assessment and other techniques such as benchmarking and trend analysis should only be used as an indicator to guide the AER in relation to further areas of enquiry to establish the appropriate forecast of efficient expenditure.

There is nothing under the current framework that precludes the AER from making adjustments to base year actual expenditure for the purposes of establishing an efficient forecast. The AER has undertaken this approach in previous determinations.

However, the AER's paper refers to the AER making a decision to "adopt another base year, in preference to undertaking further review and potential adjustments to historic expenditure".[1] The AER should only make adjustments to the base year in the extreme scenario where there is over-whelming range of evidence that the revealed cost by the DNSP is not a reasonable starting point for the forecast of future expenditure.

If the AER considers that the base year expenditure is inefficient and requires adjustment, the adjustment should be informed by category analysis and applied to individual category.

In building evidence on whether or not an NSP is responding to the EBSS, the ENA considers that benchmarking should be used in the "first pass" as a high level filter to identify any areas of concern.

If as a result of the "first pass" assessment the AER identifies areas of concern, the ENA proposes the following approaches:

- benchmarking at the category level;
- variance explanation from the NSP;
- governance review;
- engineering/ technical assessment; and
- bottom-up analysis.

The ENA considers that only if inadequacies are found at one stage, should the analysis progress to the next stage.

The AER should not cherry pick the outcomes of each of the approaches and the businesses' internal forecast. A standard benchmarking approach should be used across all businesses.

The ENA believes that the proposed approach recognises that every benchmarking technique is prone to error and uncertainty and that only part of any unexplained variance for a NSP can be attributed to inefficiency.

Question 4. Are there preferable alternatives to addressing material inefficiencies in an NSP's base year expenditure to simply adjusting the expenditure of that year (prior to applying step and trend changes)? For example, are there circumstances where it would be appropriate for opex allowances to reflect the progressive removal of inefficiencies over several years?

The ENA believes the revealed cost approach is central to the current scheme and changing to a completely different approach increases regulatory risk and potentially undermines the principles underpinning the scheme.

Where evidence of inefficiency is found the current framework can cater for this by incentivising the NSP to gradually improve its performance over time

[1] AER, *Interaction between the EBSS and opex forecasts*, 6 May 2013, page 2.

The current scheme already allows for the AER to gradually amend the opex allowance of the NSP over time. This will provide achievable incentive targets to the NSP to reduce opex costs over time, without resulting in cost shocks to the NSP that may lead to reductions in service quality and reliability to consumers.

As the forecasts are still based on the costs already revealed by the NSP, it removes the risk of regulatory error in substituting a different amount which does not reflect the efficient costs of providing distribution services for that NSP.

We look forward to discussing the issues raised in these responses with you in more detail at the next workshop. Please feel to call me to discuss any queries the AER has regarding the matters in this letter at any time on (02) 6272 1555.

Yours sincerely

G. Crawford

Garth Crawford

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