AER ‘Better Regulation’

Expenditure Forecast Assessment Guidelines

Submission on Draft Guidelines and Explanatory Statement

20 September 2013

The Energy Networks Association (ENA) is pleased to have this opportunity to respond to the Australian Energy Regulator's (AER) draft expenditure forecast assessment guidelines for electricity distribution and transmission (draft Guidelines) and associated explanatory statement. The ENA appreciates the open and interactive approach adopted by the AER in this consultation. The ENA supports consultation that supplements written submission with face-to-face stakeholder workshops.

The issues discussed in this submission relate to both the distribution and transmission guidelines, as the AER's approach and explanatory statement are common to both guidelines. Specific matters relating to transmission networks are discussed in a submission by Grid Australia and not included in this submission.

Key messages

The Expenditure Forecast Assessment Guidelines are a critical new element of the economic regulatory framework for electricity Network Service Providers (NSP). They should clarify and give NSPs and other stakeholders certainty about how the AER will assess the forecast expenditure that NSPs submit to the AER in their regulatory and revenue proposals. In order to do this, the ENA considers that it is important that the draft Guidelines be amended to:

- Acknowledge that it is open to NSPs to use expenditure forecasting methods they consider appropriate in developing the forecast expenditure amounts that are incorporated in their regulatory proposals;

- Detail the process that the AER will use to assess a NSP's expenditure forecast, rather than simply list the assessment techniques that it could apply. The Guidelines should acknowledge that the procedural starting point for the AER's assessment should be the NSP's proposal;

- Include the assessment principles that the AER will use when it is choosing between assessment techniques, applying individual techniques or deciding on its data requirements;

- Not pre-emptively determine a productivity adjustment for opex forecasts but rather assess any proposal made by the NSP against the National Electricity Rules (NER);

- Commit to releasing publicly during each determination process all of the models that the AER will use to undertake its expenditure assessment; and

- Detail how the AER will determine what weight to apply to assessment techniques over the coming five years where there is evidence that the data used may be fit for purpose.

Recommendations

The ENA recommends that the AER makes the following amendments to the Draft Guidelines and Explanatory Statement:

A. *General issues*

Recommendation 1 - Reflect the fact that the Guidelines' primary role is to set out the approach that the AER proposes to use to assess the forecasts of operating and capital expenditure that are contained in a NSP's Regulatory / Revenue Proposal and to set out the information the AER requires in order to undertake that assessment. Their role is not to set out how a NSP must build up their forecasts in order to satisfy the requirements of the NER. The Explanatory Statement should explain and justify the contents of the Guidelines but not add substantive content about the AER's approach;

Recommendation 2 - Clarify specifically how the assessment principles, assessment techniques and information requirements will each be used to assess whether the NSP's expenditure reflects the expenditure criteria, having regard for the expenditure factors;

Recommendation 3 - Clarify the AER's assessment approach which will specify a process that the AER will follow to assess a NSP's expenditure forecast, rather than simply list the assessment techniques that it will, or may, apply;

Recommendation 4 - Acknowledge that, consistent with the Australian Energy Market Commission's (AEMC) Final Rule Determination, the NSP's proposal will be the procedural starting point for the AER to determine an expenditure allowance and the NSP's proposal will, in most cases, be the most significant input into the AER's decision;

Recommendation 5 - Acknowledge that it is open to NSPs to use the expenditure forecasting methodologies they consider appropriate. The AER should not impose any constraints or prescriptions on the methodologies that NSPs may use to prepare their expenditure forecasts;

Recommendation 6 - Remove any reference from the Draft Guidelines and Explanatory Statement to the AER determining revenues based on "minimum costs" and rather refer only to "efficient costs" or (as it does elsewhere in the Explanatory Statement) "the reasonableness of a NSP's proposal"[1] to achieve the expenditure objectives;

Recommendation 7 - Clarify that the AER will seek to find "consensus" by applying multiple assessment techniques, rather than trying to find outliers for individual techniques to identify a "minimum" cost. The AER should avoid cherry-picking the results of a particular assessment technique that gives a "minimum cost" outcome, as selective use of information may in fact deliver an outcome that reflects less than the genuinely efficient costs;

Recommendation 8 - Clarify that the AER will consider the individual circumstances of NSPs in assessing their expenditure proposals and that, as noted by the AEMC, this is essential in order to give effect to the first expenditure capex and opex criterion in the NER;

Recommendation 9 - Clarify that the information listed in Chapter 6 of the Guidelines is indicative only, that NSPs do not need to provide this information to the AER, that the AER will issue Regulatory Information Notices (RINs) and Regulatory Information Orders (RIOs) on the basis of the information listed in Chapter 6 and that it is only this information that NSPs will need to provide to the AER; and

Recommendation 10 - Provide that the AER will issue RIOs for information to be provided next year at the same time as it issues RINs for this year in order to give as much certainty as possible to NSPs about information provision requirements.

B. <u>Assessment principles in Guidelines</u>

Recommendation 11 - Include in the Guidelines the matters to which it will have regard in identifying and selecting between assessment techniques in relation to a specific determination and commit in the Guidelines to the AER using the assessment principles in its decision making;

Recommendation 12 - Apply the matters that the AER will have regard to in identifying and selecting between assessment techniques and its associated data requirements;

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[1] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 21.

Recommendation 13 - Clarify that the AER will apply the principles when it is choosing (for either assessment or any substitution purposes) between techniques, applying individual techniques or deciding on its data requirements;

Recommendation 14 - Amend the matters to which regard will be had in selecting between assessment techniques so that those matters explicitly reference – and are treated as giving effect to – the NER requirements;

Recommendation 15 - Exclude "validity" and "parsimony" from the assessment principles, include a new principle for "consistency and predictability" and amend the description of "accuracy and reliability", "robustness", "transparency" and "fitness for purpose" from what currently appears in the Explanatory Statement; and

Recommendation 16 - Include (non-numeric) weighting factors in the Guidelines which can be used to justify the relative weightings given to alternative techniques, where more than one technique is being used to assess an expenditure category.

C. <u>Contents of Guidelines and Explanatory Statement</u>

Recommendation 17 - Transfer substantive content about the AER's assessment approach from the Explanatory Statement into the Guidelines.

D. <u>Relationship between the Guidelines and other Regulatory Instruments</u>

Recommendation 18 - Detail in an attachment to the Guidelines how the AER considers the suite of regulatory instruments will fit together as a coherent, integrated package so that the sequencing of information provision and decision making is clear to all parties; and

Recommendation 19 - Set a five year term for the new Guidelines and commit to formally review them before they are renewed for a further period.

E. <u>Pre-emptive basis for forecasting productivity change</u>

Recommendation 20 - Ensure that the AER does not pre-emptively determine a productivity adjustment for opex forecasts but rather assesses any proposal made by the NSP against the NER.

F. <u>Step changes unreasonably constrained</u>

Recommendation 21 - Increase the number of matters in the Guidelines that can be treated as step changes and allow each NSP to nominate and justify other matters in its Expenditure Forecasting Methodology and Regulatory / Revenue Proposal as it deems necessary.

G. <u>Refine approach to information collection and disclosure</u>

Recommendation 22 - The AER should detail in an attachment to the Guidelines how its information requests fit together as an integrated package.

Recommendation 23 - Commit to the AER publishing all of the data on which it relies for its benchmarking and, in the interests of transparency, not to use any confidential data for benchmarking unless it is included in higher level categories of data such that the confidential data is not disclosed and could not be inferred from the published data;

Recommendation 24 - Clarify that NSPs will not be required to provide information that they do not have or that could be materially misleading or unreliable; and

Recommendation 25 - Commit to the AER not relying on information for its decision making that is materially misleading or unreliable.

H. Make all AER models publicly available

Recommendation 26 - Clarify that the AER will publicly release during each determination process all of the models that it will use to undertake its expenditure assessment.

I. Expenditure and capitalisation policy audit and sign-off obligations

Recommendation 27 - Commit to preparing Regulatory Accounting Guidelines that set out in detail the AER's regulatory accounting and assurance requirements in relation to the provision of historical and forecast financial information by the NSPs, in particular under its RINs and RIOs.

J. Transitional arrangements

Recommendation 28 - Ensure the Guidelines apply the assessment principles to determine what weight should be applied in the resets over the coming five years to a benchmarking (and other assessment) techniques that has rely on unreliable data;

Recommendation 29 - Ensure that the Guidelines afford all NSPs due process in the application of benchmarking techniques, including those NSPs that will be assessed first in the next round of resets;

Recommendation 30 - Ensure the Guidelines require the AER to weigh up the unintended consequences of any decision to substitute a forecast based on a benchmark, including the fact that this substituted forecast could be set inefficiently low. The AER should also have regard for the strong incentives on NSPs not to spend above a substituted forecast and the impact on the long term interests of consumers if a forecast is set inefficiently low.

Attachment 1 provides a detailed discussion of these and other issues.

Next steps

The ENA appreciates the work that the AER has undertaken in developing the Draft Guidelines and Explanatory Statement and looks forward to continuing to work with the AER as it finalises them by 29 November 2013. We would be pleased to discuss our submission with the AER as it finalises these documents.

Attachment 1 – Detailed Discussion of Specific Issues

A. General issues

Role of the Guidelines

The National Electricity Rules (NER) require the AER to make and publish the Expenditure Forecast Assessment Guidelines (Guidelines).[2] The NER provide that these Guidelines are not mandatory and, as such, do not bind the AER or anyone else.[3] However, if the AER makes a determination that is not in accordance with the Guidelines, the AER must state, in its reasons for the determination, the reasons for departing from the Guidelines.[4] The NER also provide that the Guidelines must specify the approach the AER proposes to use to assess the forecasts of operating expenditure and capital expenditure that form part of the NSP's Regulatory / Revenue Proposal and the information the AER requires for the purpose of that assessment.[5]

In the framework and approach paper that the AER makes in respect of a specific NSP, the AER must set out the AER's proposed approach in the forthcoming determination to, amongst other things, the application to the NSP of the Guidelines.[6] It is a requirement that the Regulatory / Revenue Proposal of a NSP is accompanied by information required by the Guidelines as set out in the framework and approach paper.[7]

Recommendation 1 - In light of the above, the Guidelines should reflect the fact that their primary role is to set out the approach that the AER proposes to use to assess the forecasts of operating and capital expenditure that are contained in a NSP's Regulatory / Revenue Proposal and to set out the information the AER requires to undertake that assessment. That is, how the AER, starting with the NSP's proposal, will assess whether those forecasts reasonably reflect the operating and capital expenditure objectives, as relevant. For the avoidance of doubt: the role of the Guidelines is not to set out how a NSP must build up their forecasts in order to satisfy the requirements of the NER. The Explanatory Statement should simply explain and justify the contents of the Guidelines but not add substantive content about the AER's approach.

These amendments should be reflected into section 1.3 of the Guidelines and section 3.4 of the Explanatory Statement that deal with the role of the Guidelines, with consequential changes made elsewhere.

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[2] Clause 6.2.8(a)(1); 6A.2.3(a).

[3] Clause 6.2.8(c); 6A.2.3(c).

[4] Clause 6.2.8(c); 6A.2.3(c).

[5] Clause 6.4.5(a); 6A.5.6(a).

[6] Clause 6.8.1(b)(2)(viii); 6A.10.1A(b)(5).

[7] Clause 6.8.2(c2); 6A.10.1(h).

Primacy of the National Electricity Rules

The Guidelines cannot, and should not purport to, set out a test to be satisfied or a burden to be met that is any different to that set out in the NER before the AER is required to accept a NSP's operating or capital expenditure forecast. The test that must ultimately be applied is that set out in the NER – whether the NSP's forecast reasonably reflects the operating and capital expenditure objectives, as relevant.

In this regard, it is clearly inappropriate to set out in the Guidelines absolute statements to the effect that, if a NSP's proposal does not satisfy a particular matter, the AER will reject that forecast. The AER does this in the Draft Guidelines in a number of places. For example, it states that:

> *If a DNSP's total capex or opex forecast is (or components of these forecasts are) greater than estimates we develop using our assessment techniques and there is no satisfactory explanation for this difference, we will form the view that the DNSP's estimate does not reasonably reflect the expenditure criteria. In this case, we will amend the DNSP's forecast or substitute our own estimate that reasonably reflects the expenditure criteria.*[8]

The AER is fundamentally bound to apply the NER in assessing forecast operating and capital expenditure. The AER cannot, and should not purport to, bind itself to a particular decision where the NER do not bind it to a particular decision. Further, where the AER is not satisfied that NSP's forecast expenditure amounts satisfy the relevant criteria, the AER is also required to set out the reasons for that decision. The reasons must reflect why the AER is not satisfied that the forecast expenditure amounts reasonably reflect the relevant criteria. It will not be sufficient to state that, in the way that the Draft Guidelines suggest, the AER has not accepted the forecasts because they are greater than the estimates the AER has developed using its techniques and there is no explanation that is satisfactory to the AER as to this difference.

The Guidelines should therefore not:

- Be seen in any way as an end in themselves; or
- Introduce "quasi-rules" that might undermine, or divert anyone from, the primacy of the NER or be seen as a substitute for them.

The NER are what need to be satisfied and complied with at all times. The Guidelines should provide a basis for doing this without interfering with the assessment framework provided for in the NER.

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[8] AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 7; in respect of transmission: AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Transmission*, August 2013, p 7.

Recommendation 2 - For this reason, the AER should amend the Guidelines and Explanatory Statement to clarify specifically how:

- The assessment principles (currently detailed in section 4.5 of the Explanatory Statement);
- The assessment techniques; and
- The information requirements;

will each be used to assess whether the NSP's expenditure reflects the expenditure criteria, having regard for the expenditure factors. This will ensure that there is a clear connection retained at all times between the NER and the Guidelines and that the primacy of the NER is retained.

These amendments should be reflected into section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

Draft Guidelines do not effectively detail the AER's assessment approach

The Draft Guidelines detail various techniques that the AER indicates that it either will, or may, use to assess a NSP's expenditure forecast. However, the ENA is concerned that the Draft Guidelines do not effectively set out the AER's "approach" to assessing a NSP's expenditure forecast, as required by clauses 6.4.5 and 6A.5.6 of the NER.

In the ENA's view, the AER's "assessment approach" should specify the process that it will follow to assess a NSP's expenditure forecast. This should include:

- Examining the NSP's Expenditure Forecasting Method and the expenditure forecasts contained in its Regulatory / Revenue Proposal;
- Choosing which assessment techniques the AER will use to assess the NSP's forecast expenditure, either in total or by category – this should involve applying the assessment principles that are discussed below;
- Determining how the AER will apply the assessment techniques, including the form that this will take and the information that it will require to do this;
- Applying the assessment techniques;
- Weighting the outcomes of the assessment techniques – this should involve applying the weighting factors that are discussed below; and
- Forming a view about the NSP's forecast expenditure in light of the NER requirements.

The assessment approach should also explain how the AER will:

- Engage with NSPs and other stakeholders, where necessary, at various stages of its assessment; and
- Make its assessment publicly available, including by publishing data, models, explanations of its assessment techniques and justifications of its decisions. This would constitute the

'decision related matter' under the Standing Council on Energy and Resources' draft amendment to the NEL to reflect its policy decision on limited merits review.[9]

The assessment approach should indicate in which regulatory instruments the AER will give effect to its assessment approach. The ENA expects that this will include a combination of the AER's:

- Regulatory Information Notices (or Orders);
- Framework and Approach papers;
- Annual Benchmarking Reports; and
- Draft and Final Determinations.

Recommendation 3 - The AER should amend the Guidelines and Explanatory Statement to clarify its assessment approach will specify a process that it will follow to assess a NSP's expenditure forecast, rather than simply the assessment techniques that it will, or may, apply.

This amendment should be reflected into section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

NSP's proposal should be the starting point for expenditure allowance

As noted above, the role of the Guidelines is to set out how the AER will assess the forecast operating and capital expenditure contained in a NSP's Regulatory / Revenue Proposal, albeit the framework and approach paper will specify how the Guidelines will be applied to an individual NSP.

The NER require the AER to commence the assessment process with the NSP's proposal. This is clear from the drafting of the NER which provide that the AER must accept the forecast of operating or capital expenditure of a NSP that is included in a building block proposal if the AER is satisfied that the total of the forecast operating or capital expenditure reasonably reflects the operating or capital expenditure criteria, as relevant.[10] If the AER is not so satisfied, then the NER provide that the AER must not accept the forecasts, in which case the AER is required to set out its estimate of those forecast expenditure amounts that the AER is satisfied reasonably reflect the operating and capital expenditure criteria, as relevant.

While recognising that the manner in which the AER may approach the task of developing forecasts that it is satisfied reasonably reflect the operating and capital expenditure criteria is related to how the AER may approach the assessment of the forecasts in a NSP's proposal, the Draft Guidelines are largely focussed on how the AER will build up its own forecasts, not how it will assess the forecasts of a NSP. For example, in the section on base operating expenditure, the Draft Guidelines state:

[9] South Australia Statutes Amendment (National Electricity and Gas Laws—Limited Merits Review) Bill 2013, Proposed amendment 6, Insertion of section 28ZJ 'Record of reviewable regulatory decisions'.

[10] Clause 6.5.6(c); 6.5.7(c); 6A.6.6(c); 6A.6.7(c).

> *The 'revealed cost' approach is our preferred approach to determining base opex. If actual expenditure in the base year reasonably reflects the opex criteria, we will set base opex equal to actual expenditure for those cost categories forecast using the revealed cost approach.*[11] (Emphasis added)

The section of the Draft Guidelines regarding operating expenditure does not so much set out how the AER proposes to assess forecast operating expenditure in a NSP's Regulatory / Revenue Proposal, as it sets out how the AER will build up the forecast operating expenditure amount that it considers will be consistent with the requirements of the NER. Another example is the text concerning the rate of change which states:

> *We will forecast opex for the forecast regulatory control period by applying an annual rate of change for each year of the forecast regulatory control period. We will determine the annual rate of change….*[12] (Emphasis added)

The AER details in the Draft Guidelines and Explanatory Statement several important interpretations of the NER and its intention to apply several assessment approaches. In particular, the AER intends:

- That assessing a NSP's proposal and determining an appropriate substitute will not be separate exercises[13];
- Not to be constrained to amending or substituting expenditure forecasts based on a NSP's proposal;[14]
- Not to be limited in the information on which it can rely in assessing a NSP's expenditure proposal[15];
- To develop a top down forecast of NSPs' total costs, which it will treat as the counterfactual to NSPs' Regulatory / Revenue Proposals[16]; and
- To substitute a NSP's forecast with its own forecast where it is not convinced there is a satisfactory explanation for the differences between the two and it considers that the NSP's forecast does not reflect the expenditure criteria.[17]

The ENA is concerned that, when applied together, these interpretations and intended approaches may result in a NSP's forecast simply serving as a check for the AER's own predetermined forecast, rather than the AER conducting a detailed assessment of what the NSP has submitted in its proposal. This concern is heightened by the fact that:

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[11] AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 15; in respect of transmission: AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Transmission*, August 2013, p 15.

[12] AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 16; in respect of transmission: AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Transmission*, August 2013, p 16.

[13] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 21.

[14] *Ibid.*, p 10.

[15] *Ibid.*, p 20.

[16] *Ibid.*, p 88.

[17] *Ibid.*, p 22.

- The AER will only form a view on total capex and total opex, not individual projects or programs; and
- The Draft Guidelines would not bind the AER to apply any particular assessment technique, including to review the NSP's expenditure forecasting methodology.

The AER noted in its Explanatory Statement that the AEMC reaffirmed in its Final Rule Determination that the NSP's proposal should be the starting point for analysis.[18] In particular, the AEMC noted that:

> *The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance. The NSP has the most experience in how a network should be run, as well as holding all of the data on past performance of its network, and is therefore in the best position to make judgments about what expenditure will be required in the future. Indeed, the NSP's proposal will in most cases be the most significant input into the AER's decision.*[19]

The AEMC went on to state that:

> *The Commission remains of the view that the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own.*[20]

However, it is not clear that the AER will give practical effect to the AEMC's intent through its Guidelines. Rather, it appears that the AER intends that the "counterfactual" forecast will be its starting point. The NSP's proposal will merely be used to check it, with the NSP being required to justify any differences.

The ENA also notes that the AER's proposed approach goes beyond the scope of clauses 6.4.5 and 6A.5.6 of the NER that directs the AER to specify in its Guidelines "the approach the AER proposes to use to assess the forecasts of operating expenditure and capital expenditure that form part of Distribution [Transmission] Network Service Providers' regulatory [revenue] proposals". In fact, these clauses make no mention of the Guidelines specifying how the AER will determine any "substitute" forecast. They simply direct the AER in assessing the NSP's forecast.

Recommendation 4 - The AER should amend the Guidelines and Explanatory Statement to acknowledge that, consistent with the AEMC's Final Rule Determination:

- The NSP's proposal will be the procedural starting point for the AER to determine an expenditure allowance; and
- The NSP's proposal will, in most cases, be the most significant input into the AER's decision.

These amendments should be reflected into section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

[18] *Ibid.*, p 7.

[19] AEMC, Rule Determination National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, November 2012, p 111.

[20] *Ibid.,* p 112.

The AER should not prescribe a NSP's forecasting methodology

In the same way that the Guidelines cannot, and should not purport to, constrain the AER in its determination of whether a forecast meets the requirements of the NER, the Guidelines cannot, and should not purport to, constrain the manner in which a NSP develops its forecasts. The discussion on the AER's operating expenditure assessment approach, for example, strays into language which seeks to confine the manner in which the forecasts may be developed. In relation to "step changes", the Draft Guidelines state:

> *Step changes must be made only for changes in outputs not captured by the output growth variable. Step changes should only include the forecast costs of non-discretionary changes in inputs, other than capex/opex trade-offs. The drivers for the step change should be external to the control of the DNSP.*[21]

The AER appears to expect the Guidelines to operate in a manner that does, in fact, change the way NSPs develop their proposals. In the Explanatory Statement, the AER comments:

> *While the NER place no restrictions on NSPs' forecasting methods, some of the techniques and data requirements specified in the Guidelines and F&A paper (which NSPs must comply with) may draw NSPs away from methods they employed in the past. In particular NSPs may find it useful to devote more effort to justifying their proposed opex allowances through the base-step-trend approach, where the AER has a strong preference to rely on revealed costs, if they have not used it in the past.*[22]

As noted above, the Explanatory Statement contends that assessing a NSP's proposal and determining an appropriate substitute are not separate exercises. The ENA does not contest this view and notes that the AEMC expressed a similar view in its Final Rule Determination[23].

However, the ENA is concerned that the manner in which the AER has conflated its assessment and (potential) substitution tasks in the Draft Guidelines and Explanatory Statement has resulted in it inappropriately prescribing some, or all, aspects of the expenditure forecasting methodologies that NSPs must use for particular categories of expenditure.

Further to the opex example given above, the AER's Draft Guidelines state that "Using the base-step-trend approach, we will determine forecast opex in year *t* as . . . ."[24]. In justifying this approach and in rejecting the use of a "bottom up" forecast of all or part of opex, the AER states in its Explanatory Statement that:

> *We are unlikely to accept alternative forecasts where NSPs are responding to incentives because:*
>
> - *the revealed cost approach is unbiased, non-intrusive and well accepted*

[21] AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 16; in respect of transmission: AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Transmission*, August 2013, p 16.

[22] AER, *Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution: Explanatory Statement*, August 2013, p 3.

[23] See, for example, AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 Final Rule Determination*, November 2012, p 112.

[24] AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 15; in respect of transmission: AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Transmission*, August 2013, p 15.

- *deviation from this approach may incentivise inefficient behaviour and prevent consumers from receiving a fair share of efficiency gains.*[25]

The ENA believes strongly that:

- It is not the AER's role to prescribe any aspect of the forecasting methodology that a NSP should use;

- NSPs should be free to prepare their expenditure forecasts on any basis they consider appropriate and to propose them to the AER in their expenditure forecasting methodologies and their regulatory or revenue proposals. In relation to opex, NSPs should be free to use a "bottom up" (or zero based) methodology to forecast some or all of its expenditure if they think it provides the best means of determining and justifying this forecast. The ENA notes that, in its recent Victorian gas access arrangement review, the AER accepted a zero-based cost approach to forecast debt raising costs and certain items of opex that had previously been capitalised, following a change in capitalisation policy[26].

  Another example of where it is more appropriate to use a zero-based forecast, than a base-step-trend, is for the estimation of debt and equity raising costs. Until the draft rate of return guideline was published, the ENA had understood that these costs would be addressed under that guideline. This is because, in the rate of return issues paper, the AER raised the prospect of rolling these costs into the overall WACC rather than providing a discrete opex allowance. However, the draft rate of return guideline was silent on the issue. As a result, these costs should now be dealt with in the expenditure forecast assessment guidelines. Given the AER's apparent change in treatment, the ENA seeks the opportunity to continue to engage with the AER on this matter after this submission has been lodged in the lead up to the finalisation of Guidelines.

- The Guidelines should provide a roadmap for how the AER will apply techniques to assess NSPs' forecasts in order to reflect what a reasonable decision maker would do in the context of the NSPs' Regulatory / Revenue Proposal having regard for the National Electricity Law (NEL) and the NER.

To be clear, this should not be interpreted as the ENA suggesting that the AER should constrain the techniques that it should use to assess or substitute a NSP's forecast – as discussed above, the ENA recognises that the AER is free to determine how best to meet its NER requirements.

Rather, the ENA's views reflect the fact that, as the AER rightly notes in its Explanatory Statement, "the NER place no restrictions on NSPs' forecasting methods".[27] Just because the AER is conflating its approaches to assessing and (potentially) substituting NSPs' proposals does not mean that it has a right to mandate NSPs' forecasting methodologies in order to align them with the AER's approaches.

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[25] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 61.

[26] AER, *Access arrangement final decision, SPI Networks (Gas) Pty Ltd 2013–17 Part 2: Attachments*, March 2013, pp 136-137.

[27] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 3.

Recommendation 5 - The AER should:

- Amend the Guidelines and Explanatory Statement to acknowledge that it is open to NSPs to use the expenditure forecasting methodologies they consider appropriate; and

- Not impose any constraints or prescriptions on the methodologies that NSPs may use to prepare their expenditure forecasts.

These amendments should be reflected into section 1 of the Guidelines and sections 1 and 3 of the Explanatory Statement that deal with the role, purpose and authority for the Guidelines, with consequential changes made elsewhere.

Reasonable cost not minimum cost

The Explanatory Statement notes[28] that section 7A(2) of the National Electricity Law (NEL) provides that:

> *A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in—*
>
> *(a) providing direct control network services; and*
>
> *(b) complying with a regulatory obligation or requirement or making a regulatory payment.*

As the ENA has previously noted in submissions to the AER[29], codifying the term “at least” into the NEL reflects policy makers’ recognition that the societal cost of under-investment in essential infrastructure is greater than the societal cost of a slight over or early investment.

However, the AER indicates that it interprets section 7A(2) to mean that it should “set NSP revenue allowances at the minimum cost required to provide the level of service consumers expect”[30] (Emphasis added). The ENA does not consider this to be an accurate reflection, or appropriate interpretation, of the NEL requirement.

The matter of minimum (and maximum) costs has been the subject of considerable regulatory debate in the context of what constitutes a “reasonable range” of expenditure forecasts.[31] The AER, in response to questions from the AEMC on its proposed Rule change on this matter, stated in February 2012 that:

> *It is not the AER’s general practice to identify a maximum possible number and a minimum possible number when assessing a capex or opex proposal.*

[28] *Ibid.*, p 16.

[29] See, for example, p 10 of the ENA’s “AER Efficiency Incentives Guidelines for Electricity Network Service Providers - Response to Issues Paper”, available at - http://www.aer.gov.au/sites/default/files/ENA%20-%20submission%20-%20incentives%20issues%20paper%20-%2017%20May%202013%20-%201%20of%202.pdf

[30] *Ibid.*, p 17.

[31] See, for example, AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 Final Rule Determination*, November 2012, p 112.

> *The AER recognises that there are a range of possible forecasts that "reasonably reflect" the capex or opex criteria. Whether a NSP's proposal falls outside the range of possible forecasts is a matter of regulatory judgment for the AER, in satisfying itself whether the forecast reasonably reflects the capex or opex criteria having regard to the capex or opex factors. In the event the AER is not satisfied, the substitute forecast it must determine is also similarly a matter of judgment. The many considerations that must be balanced in assessing a NSP's proposal does not lend itself to precisely identifying a maximum or minimum possible number. This is not an exact science, nor can it be.*[32]

By making reference to "minimum cost" in its Explanatory Statement, the AER is re-opening this debate, which the ENA had assumed was closed, given that in its Final Rule Determination the AEMC stated that:

> *The AER has confirmed that it does not generally approach capex and opex allowances by determining a maximum and minimum possible allowance, and indeed the lack of precision inherent in this exercise would mean this has little benefit.*[33]

Recommendation 6 - The AER should amend the Guidelines and Explanatory Statement to remove any reference to it determining revenues based on "minimum costs" and rather refer only to "efficient costs" or (as it does elsewhere in the Explanatory Statement) "the reasonableness of a NSP's proposal"[34] to achieve the expenditure objectives.

Recommendation 7 - The AER should amend the Guidelines and Explanatory Statement to clarify that it will seek to find "consensus" by applying multiple assessment techniques, rather than trying to find outliers for individual techniques to identify a "minimum" cost. The AER should avoid cherry-picking the results of a particular assessment technique that gives a "minimum cost" outcome, as selective use of information may in fact deliver an outcome that reflects less than the genuinely efficient costs.

These amendments should be reflected into section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

Consideration of NSPs' circumstances

The Explanatory Statement asserts that:

> *The AEMC also removed the requirement to consider the circumstances of the particular NSP when determining the costs a prudent operator would incur to meet the capex/opex objectives.*[35]

The ENA does not consider that this accurately reflects what the AEMC either did by, or intended as a result of, removing reference to "individual circumstances" from the NER. The AEMC's Final Rule Determination stated that:

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[32] Available at http://www.aemc.gov.au/Media/docs/AER-Response-to-AEMC-Clarification-Questions-0e1cf599-029f-41c7-9575-aecdea7b3f6b-0.PDF

[33] AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 Final Rule Determination*, November 2012, p 112.

[34] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 21.

[35] *Ibid.*, p 107.

> *The Commission is of the view that the removal of the "individual circumstances" clause does not enable the AER to disregard the circumstances of a NSP in making a decision on capex and opex allowances.*[36]

It went on to state that:

> *The Commission considers that the removal of the "individual circumstances" phrase will clarify the ability of the AER to undertake benchmarking. It assists the AER to determine if a NSP's proposal reflects the prudent and efficient costs of meeting the objectives. That necessarily requires a consideration of the NSP's circumstances as detailed in its regulatory proposal.*
>
> *Under the first expenditure criterion the AER is required to accept the forecast if it reasonably reflects the efficient costs of achieving the opex objectives. These include references to the costs to meet demand, comply with applicable obligations, and maintain quality, reliability and security of supply of services and of the system. These necessarily require an assessment of the individual circumstances of the business in meeting these objectives. So to the extent that different businesses have higher standards, different topographies or climates, for example, these provisions lead the AER to consider a NSP's individual circumstances in making a decision on its efficient costs.*[37]

Recommendation 8 - The AER should amend the Guidelines and Explanatory Statement to clarify that it will consider the individual circumstances of NSPs in assessing their expenditure proposals and that, as noted by the AEMC, this is essential to giving effect to the first expenditure capex and opex criterion in the NER.

This amendment should be reflected into section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

<u>Clarify the relationship between Guidelines and RINs / RIOs</u>

The ENA recognises that clauses 6.4.5 and 6A.5.6 of the NER require the AER's Guidelines to specify the information the AER requires in order to undertake its expenditure assessment.

In the Explanatory Statement, the AER noted that:

> *The Guidelines specify the information we require to assess expenditure. Ultimately, however, we expect to give effect to the Guidelines through RIN templates to streamline compliance for NSPs (by ensuring RINs are consistent with and encompass the F&A requirements). This is outlined in more detail in chapter 6.*[38]

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[36] AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 Final Rule Determination*, November 2012, p 107.

[37] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 21.

[38] *Ibid.,* p 107.

In Chapter 6 of the Draft Guidelines, the AER stated that:

> *This Guideline must specify our information requirements for expenditure assessment. The regulatory information notice (RIN) issued in advance of a DNSP (TNSP) lodging its regulatory proposal will specify the exact information we require.*[39]

Currently, there is some ambiguity in the Draft Guidelines about whether, if information specified in Chapter 6 is not subsequently detailed in a RIN, a NSP needs to provide that residual information to the AER. In the ENA's view, the AER should not ask for more information through the Guidelines than it intends to ask for under a RIN or RIO. The Guidelines should therefore not be a source of any information requests in, and of, themselves. In this regard, we suggest below that it is:

- More appropriate for the AER to use a RIO than a RIN to collect comparative information; and
- Not appropriate to require a NSP to provide information that is not in existence or cannot be objectively derived from information that is in existence.

Recommendation 9 - For clarity, the AER should amend the Guidelines and the Explanatory Statement to state that:

- The information listed in Chapter 6 of the Guidelines is indicative only and NSPs do not need to provide this information to the AER; and
- The AER will issue RINs and RIOs on the basis of the information listed in Chapter 6 and it is only this information that NSP will need to provide to the AER.

RIOs should be used to collect comparative information

The Explanatory Statement notes that:

> *The Guidelines provide for a nationally consistent reporting framework that will allow us to benchmark expenditure at the category level. This means we can compare drivers of expenditure and the accompanying costs of conducing similar activities by each NSP across the National Electricity Market (NEM).*[40]

As discussed further in section G, the ENA believes strongly that a RIO is the appropriate instrument for the AER to use to collect comparative information from NSPs. This will maximise the potential for information to be nationally consistent and comparable as they will require common information to be prepared on a common basis. This consistency and comparability will not necessarily be achieved through the use of RINs, given that they may request different information and may provide for that information to be provided on different bases.

Recommendation 10 - The AER should issue RIOs for information to be provided next year at the same time as it issues RINs for this year in order to give as much certainty to NSPs as possible about information provision requirements.

This amendment should be reflected into section 6 of the Guidelines that deal with information requirements.

[39] AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 7; in respect of transmission: AER, *Draft Expenditure Forecast Assessment Guideline for Electricity Transmission*, August 2013, p 18.

[40] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p vii.

B. Assessment principles in Guidelines

We provide the following comments on the assessment principles that are currently included in section 4.5 of the Explanatory Statement. As a preliminary point the ENA notes that the proposed principles contained in the Explanatory Statement may be more accurately described as matters that the AER would have regard to in identifying and potentially selecting between the assessment techniques available to it in any particular determination process. The AER's manner of resolving a similar question in its draft rate of return guideline was to identify these items as 'criteria'[41].

Move assessment principles from Explanatory Statement to Guidelines

In its Issues Paper on the Guidelines, the AER indicated that it intended including its assessment principles in the Guidelines, as opposed to the Explanatory Statement.[42]

However, the AER has now changed its position and has included its proposed principles only in its Explanatory Statement and not in the Guidelines. The AER stated in its Explanatory Statement that:

> *We have not, however, incorporated the principles into the Guidelines because we consider this is unnecessarily prescriptive.*[43]

The AER justified this decision on the basis that:

> *We consider our approach is consistent with the AEMC's final rule change determination, which confirmed the NER allow us to assess a NSP's proposal using any techniques we consider appropriate. Importantly, the NER do not confine us to assessing expenditure using the approach a NSP takes in its proposal. Accordingly, the Guidelines do not exclude any of the techniques we used in the past, nor do they preclude us from implementing more techniques over time.* [44]

The Explanatory Statement creates significant uncertainty about whether the AER will apply the matters to which it will have regard in selecting between assessment techniques at all, by stating that:

> *To determine which techniques to use when we assess expenditure, <u>we may consider</u> the assessment principles outlined in section 4.5.1.*[45] (Emphasis added)

This contrasts with the AER's proposed approach in its rate of return guidelines, where it noted that:

> *The new framework permits us considerable flexibility in determining the allowed rate of return. To provide a greater degree of certainty and transparency for our future determinations, we consider it helpful to outline a set of criteria that will guide stakeholders as to our decision making with respect to assessing or determining what*

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[41] AER, *Explanatory Statement - Draft Rate of Return Guideline*, August 2013, p 27

[42] AER, *Expenditure Forecast Assessment Guidelines for Electricity Distribution and Transmission - Issues Paper*, December 2012, p 17

[43] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 53

[44] *Ibid.,* p 53

[45] *Ibid.*, p 48

approaches, methods and sources of information can best be used to satisfy the rate of return objective.[46]

The ENA is concerned that the Explanatory Statement creates uncertainty about the AER meeting its NER requirement to specify its "approach" to assessing NSPs' expenditure forecasts. The ENA continues to believe that it is essential that:

- The matters to which the AER will have regard in selecting between assessment techniques are included in the Guidelines, rather than the Explanatory Statement; and

- The AER commits to having regard to those matters when determining the assessment techniques that will apply in a particular determination in assessing forecast operating and capital expenditure.

The reasons that the AER has given for its proposed approach do not relate to the principles themselves, but rather relate to it wanting its choice of assessment techniques to remain unfettered by any constraints in the Guidelines. Inclusion of the matters that the AER would have regard to in guiding its choice of assessment techniques in the specific circumstances of each determination is in fact completely consistent with the AEMC's final rule change determination. This is because the purpose behind the Guidelines is to provide information to stakeholders regarding the approach the AER "proposes to use to assess" forecasts. If the Guidelines do not provide useful information regarding the principles that the AER will use to guide its selection of the techniques that it may consider appropriate depending on the specific circumstances of each determination, arguably the Guidelines will not comply with the requirements of clauses 6.4.5(a) and 6A.5.6.

Committing to a number of matters that the AER will have regard to in identifying and selecting between appropriate assessment techniques in respect of a particular determination does not inappropriately constrain the AER's use of techniques. Rather, it operates to provide all stakeholders with a number of matters (which are rather generally expressed) that the AER will have regard to in selecting between the range of assessment techniques that are open to it. Further, as the NER explicitly provide, and as the AER states in the Explanatory Statement, the Guidelines are not binding on the AER. If the AER wishes to depart from the matters contained in the Guideline, it simply needs to state in the determination its reasons for departing. The ENA submits that the inclusion of the matters to which the AER would have regard, together with the requirement to provide reasons when departing from them, contributes to clear, open and transparent decision-making.

Confining the assessment principles to the Explanatory Statement would significantly undermine the value of having the principles, to the point where the ENA questions whether they will add any value given the relatively weak status of the Explanatory Statement compared to the Guidelines.

It is only by including them in the Guidelines, and undertaking to use them, that the AER can demonstrate its commitment to the principles.

[46] AER, *Explanatory Statement - Draft Rate of Return Guideline*, August 2013, pp 24-25

Recommendation 11 - The AER should:

- Include in the Guidelines the matters to which it will have regard in identifying and selecting between assessment techniques in relation to a specific determination; and
- Commit in the Guidelines to having regard to those matters in its decision making.

These amendments should be reflected into section 3 of the Guidelines that deals with the AER's assessment approach and section 4.5 of the Explanatory Statement that deals with the AER's assessment principles, with consequential changes made elsewhere.

Principles should relate to both data and techniques

Currently, the AER's proposed principles are principally framed to apply to assessment techniques – indeed, they are referred to in the Explanatory Statement as "Assessment Principles"[47]. However, the ENA considers that the matters the AER should have regard to in identifying and selecting between assessment techniques in relation to a specific determination should be extended to apply to data, as well as techniques, because:

- Although data are relevant to all techniques, different data are relevant to different techniques; and
- The matters are relevant to data and techniques in different ways.

We discuss below how we consider the matters that the AER should have regard to should be amended to apply both to assessment techniques and to the associated data requirements. We note that this is entirely consistent with the dual use of the equivalent criteria in the rate of return guideline.[48]

Recommendation 12 - The AER should amend the Guidelines to apply the matters that the AER will have regard to in identifying and selecting between assessment techniques to both assessment techniques and to the associated data requirements.

This amendment should be included in a new sub-section in section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

Application of principles

The AER states in the Explanatory Statement that:

> *We consider a good expenditure forecasting methodology should reflect the principles set out in section 4.5 and result in forecast expenditure that is accurate and unbiased.*[49] (Emphasis added.)

[47] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 53

[48] AER, *Explanatory Statement - Draft Rate of Return Guideline*, August 2013, p 27

[49] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 53

The ENA notes that the expectation that NSPs "should" apply the principles contrasts with the AER's position (quoted above) that it "may", but need not, apply the principles in its assessment. This difference in the application of the matters that are relevant to whether an assessment technique is a valuable one to use is not reasonable or justifiable.

The ENA does not think it is appropriate for the AER to prescribe in the Guidelines or the Explanatory Statement the nature, or features, of the NSPs' forecasting method. Rather, the Guidelines should focus on the nature and application of the techniques that the AER will apply in assessing NSPs' expenditure forecasts. This reflects the fact that:

- The NER place no restrictions on NSPs' forecasting methods; and
- Clauses 6.4.5 and 6A.5.6 of the NER direct the AER to prepare Guidelines about its assessment approach, rather than about an NSP's forecasting method.

The AER should amend the Guidelines to clarify that it will apply the principles when it is choosing (for either assessment or any substitution purposes) between techniques, applying individual techniques or deciding on its data requirements.

This amendment should be reflected into section 3 of the Guidelines that deals with the AER's assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

<u>The matters to which regard should be had should be explicitly connected with the NER requirements</u>

As noted above, the matters to which regard should be had in identifying and selecting between various assessment techniques should be framed so that they are explicitly linked to the NER requirement that the activity being undertaken by the AER is the assessment of the NSPs' forecast expenditure by reference to whether it reasonably reflects the expenditure criteria, having regard for the expenditure factors. Without this linkage, there is a danger that the principles may be seen (or may in time become to be seen) as ends in themselves and be treated in isolation from the NER requirements.

Recommendation 13 - The AER should amend the matters to which regard will be had in selecting between assessment techniques so that those matters explicitly reference – and are treated as giving effect to – the NER requirements. This amendment should be reflected into section 3.3 of the Guidelines and section 4.4 of the Explanatory Statement that deals with the AER's assessment techniques, with consequential changes made elsewhere.

<u>Comments on the proposed assessment principles</u>

The ENA provides the following comments regarding each of the assessment principles that the AER has proposed in the Explanatory Statement. Attachment 2 of this submission details the revised wording of the principles that the ENA suggests be included in the Guidelines.

Validity

The ENA does not support including "validity" as one of the assessment principles. While the ENA agrees that any data and technique need to be "valid", the qualities that the AER attributes to this principle are covered under the other principles of "accuracy and reliability" and "fitness for purpose".

In the event that the AER chooses to retain "validity" as a principle, the AER should remove reference to using reliable data "where possible" in its description. Data should only ever be used and relied upon where it can be verified as being reliable. The AER should never make decisions based on unreliable data. This is discussed further below under "accuracy and reliability".

Further, should the AER indicate in a framework and approach paper that it will use a particular technique, but after employing that technique decide that it will not use it to prepare a NSP's expenditure forecast because it is not valid, then the AER should disclose this (and the outcome of the technique) and should give detailed reasons for its decision in its Draft or Final Determinations (as relevant). This is discussed further below under "transparency".

In regards to data reliability, the ENA notes that currently NSPs are required to provide director statutory declarations that the forecasts provided in a regulatory proposal are 'the best estimates in the circumstances', and 'have been arrived at on a reasonable basis'. In the context of such certification, it is unreasonable for the AER to employ unreliable data to substitute for NSPs' forecasts.

Recommendation 15a) -The AER should exclude "validity" from the matters that the AER will have regard to in selecting between assessment techniques to be included in the Guidelines.

This amendment should be reflected into section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

Accuracy and reliability

The ENA supports including "accuracy and reliability" as one of the matters that the AER will have regard to in selecting between assessment techniques but suggests that it be described in the Guidelines in the following terms.

Data are accurate when they are fairly stated for their intended purpose. Historical data are accurate when they reflect the records that they are purported to represent and those records fairly describe the data being quantified. As with historical data, the accuracy of forecast data can only be verified after the event. It is, nevertheless, possible to form a view on whether forecast data have been prepared appropriately on the basis of reasonable assumptions and in accordance with a stated method. No data can be described as accurate in isolation from clear knowledge of what they are supposed to represent and how they are supposed to be prepared and presented. These reference points are necessary before it is possible for anyone to form a view about whether (forecast or historic) data are accurate.

Data are reliable when they are unbiased and free from material error having regard for their intended purpose and any assumptions that may be made about them. The ENA's concerns about the AER requiring NSPs to submit potentially unreliable data are discussed in section G below.

A technique is accurate when it produces unbiased results having regard for its intended purpose.

A technique is reliable when its results can be replicated by independently applying the input data. A reliable technique should produce stable results when a small change is made to the data, model specification or model assumptions. The results produced by a reliable technique should be broadly consistent with those that have been (or would be) produced by alternative, comparable techniques and should be justifiable in the light of other data. In this way, the results of a technique should be capable of being independently verified.

The ENA does not think that the distinction that the AER made under this principle between "objective" and "subjective" techniques is useful as all techniques involve choices, judgments and a level of analysis to interpret and apply their results. Nor does the ENA consider that the distinction is correct. An objective technique is simply more objective than a subjective technique, the objectivity or the subjectivity of a particular technique says nothing about the techniques accuracy.

The question is really whether a particular assessment technique will contribute in a material way to the AER's assessment of whether forecast expenditure reasonably reflects the expenditure criteria. The distinction between objective and subjective techniques should be removed from the description of the "accuracy and reliability" principle.

However, the ENA agrees with the AER that data and techniques may require testing and calibration to be satisfied of their accuracy and reliability.

Recommendation 15b) -The AER should include "accuracy and reliability" in the set of matters to which the AER will have regard in selecting between assessment techniques to be included in the Guidelines, albeit that the description should be amended from what appears in the current Explanatory Statement.

This amendment should be reflected into section 3 of the Guidelines that deals with the AER's assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

Robustness

The ENA supports including "robustness" as one of the matters to which the AER will have regard in selecting between assessment techniques but suggests that it be described in the Guidelines in the following terms.

Robust techniques remain valid under different assumptions, parameters and underlying conditions. They must be complete having regard for their intended purpose. A technique that is lacking in some material respect cannot be robust.

Data are robust when they are fairly described and presented (including by disclosing relevant assumptions) and they are fit for their intended purpose. Robust data should not be lacking in any material respect. The quality of the robustness of any data is not independent of their intended purpose. Data can therefore be robust for one purpose but not for another. It must therefore be clear what data are to be used for in order to form a view about whether they are robust for that purpose. Data used for benchmarking purposes must be complete in order to be robust (subject to the exclusion of outliers). In this regard, data may also only be robust where it is of sufficient depth such that analysis of it provides meaningful results. For example, estimated asset capacity data that was forecast at a point in time to inform network planning may be suitable for the purpose of network planning, but cannot subsequently be relied upon as evidence of the actual stock of asset capacity that existed at that date for use in economic benchmarking tools.

The ENA also notes that, in the past, the AER has avoided introducing financial incentives where it did not have the necessary robust data to support them. For example, in deciding not to apply a service target performance incentive scheme (STPIS) for the NSW DNSPs for the current regulatory control period, the AER noted that:

> *The AER maintains its draft decision to collect and monitor service performance data during the next regulatory control period in accordance with clause 6.6.2(h) of the transitional chapter 6 rules. Revenue will not be placed at risk under the data collection process during this period.*
>
> *The AER acknowledges that the NSW DNSPs may not achieve full compliance with the data reporting requirements before December 2009. However, the AER expects the NSW DNSPs to implement measures to achieve full compliance with the national distribution STPIS as soon as practical.*
>
> *In implementing the data reporting requirements, the AER expects to accumulate a reliable data series to allow the application of the national distribution STPIS to the NSW DNSPs from 1 July 2014. The application of the national STPIS for the 2014–19*

> *regulatory control period to the NSW DNSPs will be the subject of consultation under the framework and approach process, prior to the 2014–19 distribution determination.*[50]

The ENA considers that the AER should adopt a similarly conservative approach to assembling data for the purposes of assessing a NSP's forecast expenditure before using it to set a NSP's revenue requirement. Just as the AER has waited to acquire a body of robust and reliable data about the NSW DNSPs before introducing financial incentives under a STPIS, so too it should wait until it has acquired a acquire a robust and reliable body of expenditure and related data before it uses that data for benchmarking purposes to determine a NSP's forecast expenditure and, in turn, its revenue requirement.

Recommendation 15c) - The AER should include "robustness" in the set of principles to be included in the Guidelines, albeit that the description should be amended from what appears in the current Explanatory Statement. This amendment should be reflected into section 3 of the Guidelines that deals with the AER's assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

Transparency

The ENA supports including "transparency" as one of the matters to which the AER will have regard to in selecting between assessment techniques but suggests that it be described in the Guidelines in the following terms.

Transparency is a matter that is relevant to the selection of assessment techniques. There are a number of elements to transparency, including:

- The application of the technique – it should be clear how a particular technique is applied, including that it can be replicated by third parties; and

- The data used by the technique – it should be clear what data is being used. Any data that the AER uses to support its decision making should be made available to persons that may be affected by the decision.

The ENA considers that, typically, transparency requires data to be made available to persons who will be affected by a particular decision, although some data, and the results of some techniques, may be confidential to individual NSPs. Furthermore, NSPs can only provide data that are available to them. The AER should not expect an NSP to provide data relating to another NSP or to explain material differences between their respective costs (particularly, when an NSP does not have access to the other NSP's cost information). The AER should also not require a NSP to provide information that it does not have – this is discussed further in section G below.

Should the AER indicate in a framework and approach paper that it will use a particular technique, but after employing that technique decides that it will not use it to prepare a NSP's expenditure forecast, then the AER should disclose this (and the outcome of applying the techniques that are no longer being relied upon) and should give detailed reasons for its decision in its Draft or Final Determinations (as relevant). This is important in order to provide transparency about the AER's decision making.

[50] *AER, Final decision - New South Wales distribution determination 2009–10 to 2013–14, 28 April 2009, p 244*

Recommendation 15d) -The AER should include "transparency" in the list of matters that it will have regard to in selecting between assessment techniques to be included in the Guidelines, albeit that the description should be amended from what appears in the current Explanatory Statement.

This amendment should be reflected into section 3 of the Guidelines that deals with the AER's assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

Parsimony

The ENA does not support including "parsimony" as a matter to which regard will be had in selecting between assessment techniques. The ENA considers that the inclusion of such a matter may potentially create an inappropriate bias towards "simple" or "convenient" assessments. These are not relevant considerations under the NEL or the NER and should not be promoted as ends in themselves. The relevant touchstone is the extent to which an assessment technique materially assists the AER in assessing whether forecast expenditure amounts reasonably reflect the expenditure criteria. The extent to which a technique is simple or complicated is not of direct relevance to this question. The issue may go to proportionality (discussed below), but in and of itself, the relative complexity of an assessment technique should not guide a selection between techniques.

The AER's assessments should therefore be both "robust" and "fit for purpose" having regard for the circumstances of the Regulatory / Revenue Proposal in order to satisfy itself that it has addressed the NER requirements. This could mean that the AER's analysis is either complex or simple, however this should be driven by the circumstance of the Regulatory / Revenue Proposal, rather than any preconceived view of what level of analysis is "sufficient".

Without in any way detracting from this view, it is important that the AER considers the burden on all stakeholders, including NSPs, in determining its regulatory approach. This is discussed further below under the "fitness for purpose" principle.

Recommendation 15d) -The AER should exclude "parsimony" from the list of matters to which the AER will have regard to be included in the Guidelines.

These amendments should be reflected into section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

Fitness for purpose

The ENA supports including "fitness for purpose" as one of the matters to which the AER will have regard in selecting between assessment techniques and submits that it should be the first matter that guides the selection of the various assessment techniques available to the AER.

The AER notes in the Explanatory Statement that the AER will use a "holistic approach and use the techniques we consider appropriate depending on the circumstances of each determination".[51] The ENA submits that it is the individual circumstances of each determination that should be the starting point for identifying what assessment techniques are available and, of those, which will be appropriate to use. If a particular technique will not materially contribute to the AER's assessment of whether forecast capital and operating expenditure amounts reasonably reflect the operating or capital expenditure criteria, perhaps because the technique is unable to adequately take into account the individual circumstances of the service provider or there is insufficient data for the

[51] AER, *Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution: Explanatory Statement*, August 2013, p 21.

results to be statistically reliable, the technique will not be "fit for purpose" and should not be used as part of the AER's assessment.

The ENA suggests the following amendments to the "Fitness for purpose" consideration.

The data and techniques will be chosen by reference to their ability to contribute to the AER's assessment of whether forecast operating and capital expenditure amounts reasonably reflect the operating and capital expenditure criteria. An assessment technique is likely to contribute to the AER's assessment if it:

- Can be applied in a manner that has regard for the NSP's individual circumstances – the nature of the data and technique should be adapted to the specific circumstances of the Regulatory / Revenue Proposal;

- Can be applied in a manner that accounts for matters outside of the NSP's control – this should be addressed both in applying the technique and in using the results that it produces; and

- Is accurate, reliable and robust (as discussed in the other principles); and

- Is tried and tested – this means that, in the case of techniques (as opposed to data), they reflect a sound theoretical foundation and be proven to work in a similar regulatory setting.

The ENA considers that the fitness for purpose principle should also encapsulate concepts of proportionality. For example:

- The assessment technique is commensurate with the materiality of the expenditure item being assessed – relatively more time and effort should be spent on the relatively more material expenditure items in a Regulatory / Revenue Proposal; and

- Regard is had for the compliance burden on the NSP – meeting data requests takes time, costs money and results in price increases for end consumers. Larger and more complex data requests take more time, cost more money and result in greater price increases. Although the ENA fully recognises and supports the need for NSPs to provide sufficient information to the AER to enable it to undertake its assessments, the AER should consider the effect of the regulatory burden on NSPs when it makes its data requests and justify its information requests accordingly.

Recommendation 15e) - The AER should include "fitness for purpose" in the list of matters to which the AER will have regard in selecting between assessment techniques to be included in the Guidelines, albeit that the description should be amended from what appears in the current Explanatory Statement.

This amendment should be reflected into section 3 of the Guidelines that deals with the AER's assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

Consistency and predictability

The ENA notes that one of the "key changes" that the Explanatory Statement indicates that the Guidelines will introduce is "national consistency (data requirements and assessment approach)".[52] The Explanatory Statement goes on to state that:

> *The Guidelines will set out a nationally consistent approach to assessing NSPs' opex and capex forecasts. They will also form the basis for developing nationally consistent information reporting templates for NSPs. National consistency would contribute greatly towards expenditure forecast assessment approaches that are rigorous, transparent and cost effective.*[53]

However, the AER has not included "consistency" as one of the assessment principles. The ENA considers this omission should be addressed by including an additional matter of "consistency and predictability" in the Guidelines.

The ENA considers there to be three dimensions to "consistency and predictability".

First, the same techniques should be applied in similar circumstances. This logically follows as if the AER has found that a particular technique does assist it in undertaking an assessment of whether a forecast amount reasonably reflects the expenditure criteria, that technique should be applied in similar circumstances.

Secondly, a technique should be applied in such a way that it will produce accurate and reliable results over time.

These two dimensions should not be interpreted as limiting the techniques that the AER should legitimately be able to apply in assessing a NSP's forecast expenditure. Rather, they are essential to ensuring that the AER engenders confidence in the application of the regulatory regime and a sense of fairness in the treatment of NSPs. Indeed, their importance was recognised in 1999 by the Utility Regulators Forum, which included "consistency" and "predictability" as two of nine essential principles for "Best Practice Utility Regulation". It described them as follows:

> *Consistency of treatment of participants across service sectors, over time and across jurisdictions, was highlighted as a key principle for providing confidence in the regulatory regime. This principle is linked to the provision of consistent and fair rules that do not adversely affect the business performance of a specific participant.*[54]
>
> *The principle of predictability of regulation is an essential requirement for utilities to be able to confidently plan for the future and be assured that their investments will not be generally threatened by unexpected changes in the regulatory environment.*[55]

The third dimension of "consistency and predictability" involves adopting a technique that produces consensus results that generally accord with the results that are produced by other techniques. Where a technique produces outlier results then it should generally not be relied upon to inform decision making. Equally, the AER should avoid cherry-picking the results of the assessment technique that gives the "minimum cost" outcome.

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[52] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 11

[53] *Ibid.*, p 12

[54] Utility Regulators Forum, *Best Practice Utility Regulation*, 1999, p 6 – available at http://transition.accc.gov.au/content/item.phtml?itemId=374599&nodeId=3a61a9d1033d6d3a7fdfd5d59c2c30af&fn=Best%20practice%20utility.pdf

[55] *Ibid.,* p 6

Recommendation 15f) - The AER should include a new matter to which it will have regard in selecting between assessment techniques of “consistency and predictability” in the Guidelines.

This amendment should be reflected into section 3 of the Guidelines that deals with the AER’s assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

<u>Weighting of techniques</u>

The ENA understands that the AER’s assessment principles will be used to choose which techniques to apply – the choice of techniques will therefore be made by reference to these matters.

However, it is possible that several techniques could be used for an expenditure category. There may therefore be a need to determine the relative weightings that will be placed on the chosen techniques and to justify the choice of weights.

The ENA proposes that the following matters should be taken into account in determining (non-numeric) weighting factors for this purpose:

- Acceptance – techniques that have broader demonstrated regulatory acceptance and proven effectiveness should be weighted relatively more heavily than alternative techniques;

- Technique limitations – techniques that have few limitations in terms of their accuracy, reliability and robustness should be weighted relatively more heavily than alternative techniques;

- Data limitations – techniques that uses data that have few limitations in terms of their accuracy, reliability and robustness should be weighted relatively more heavily than alternative techniques that have greater data limitations;

- Corroboration – techniques whose results can be corroborated with the results of other techniques should be weighted relatively more heavily than alternative techniques;

- Accommodating NSPs’ differences – techniques that can accommodate differences in NSPs’ circumstances should be weighted relatively more heavily than alternative techniques; and

- Accommodating exogenous events – techniques that can accommodate the effects of matters outside of an NSP’s control should be weighted relatively more heavily than alternative techniques.

In apply these weighting factors, the AER should seek to find “consensus” results across multiple assessment techniques, rather an “outlier” result that may be produced by a particular technique. In this way, the AER should always test whether the results of its assessments can be corroborated by other techniques in order to avoid relying on anomalous results.

Recommendation 16 - The AER should include (non-numeric) weighting factors in the Guidelines so they can be used to justify the relative weightings given to alternative techniques, where more than one technique is being used to assess an expenditure category.

This amendment should be reflected into section 3 of the Guidelines that deals with the AER’s assessment approach and section 4.5 of the Explanatory Statement that deals with the assessment principles, with consequential changes made elsewhere.

C. Contents of Guidelines and Explanatory Statement

The ENA is concerned that the balance is currently incorrect between the contents of the Draft Guidelines and the Explanatory Statement. The AER should transfer some of the contents of Explanatory Statement into the Guidelines.

In the ENA's view, in order to meet the requirements of clauses 6.4.5 and 6A.5.6 of the NER, the Guidelines should contain all of the relevant detail about:

- The general nature and scope of the AER's assessment approach and information requirements; and

- How the AER will go about choosing and deploying its assessment approach for individual regulatory and revenue proposals.

The Guidelines should therefore be comprehensive and sufficiently detailed so that they can be read as a free-standing document (independent of the Explanatory Statement) in order to provide a full specification of the AER's assessment approach and information requirements (albeit that information requests will be made through RINs or RIOs). Put differently, the Guidelines should contain sufficient detailed information to enable the AER to explain and justify how it will undertake its expenditure assessment.

The Explanatory Statement should not contain new information about the AER's assessment approach and information requirements that is not contained in the Guidelines. Rather, the Explanatory Statement should simply explain and justify the contents of the Guidelines so that stakeholders understand why the AER has made the choices that it has in the Guidelines. In this way, the Explanatory Statement should rationalise the Guidelines but should not add substantive content to them. There should therefore be no requirement to comply with the Explanatory Statement, in and of itself, independent of the Guidelines.

This reflects the fact that clauses 6.2.8 and 6A.2.3 of the NER give the Guidelines a role and a status that do not extend to an Explanatory Statement (or any other document). Relevantly:

- Sub-clauses 6.2.8(c) and 6A.2.3(c) require the AER to state in its Distribution or Transmission Determination the reasons for any departures from the Guidelines; and

- Sub-clauses 6.2.8(e) and 6A.2.3(e) require the AER to consult on any amendments to the Guidelines.

None of these requirements applies to the Explanatory Statement – this document therefore has no status under the NER. Despite this, the AER should not amend the Explanatory Statement independently of the Guidelines.

Recommendation 17 - Subject to the other changes proposed in this submission, the AER should transfer substantive content about its assessment approach from the Explanatory Statement into the Guidelines, including:

- Its interpretation of the meaning of "prudence" and "efficiency" on page 24 of the Explanatory Statement;
- The two-stage conceptual framework for assessing related party contracts on pages 27 to 29;
- The basis for assessing real price escalators on pages 29 to 31;
- The approach to assessing step changes on pages 31 to 33 as amended in accordance with recommendation 21 below;
- The approach to considering the inter-connections between assessment techniques when considering capex and opex on page 43; and
- The staged assessment process to undertaking ex post reviews on page 66.

D. Relationship between the Guidelines and other Regulatory Instruments

The Guidelines are one in a suite of regulatory instruments that NSPs and the AER need to prepare that will impact on their respective expenditure forecasts and assessments (noting that some of the AER's materials are specific to individual reset processes and others are not):

- The AER needs to prepare various expenditure assessment models, its Annual Benchmarking Reports, Framework and Approach papers, Issues Papers, draft Determinations and final Determinations; and
- NSPs need to prepare, or complete, their Expenditure Forecasting Methodologies, Determination / Reset RINs, Category RINs, Economic Benchmarking RINs, Annual RINs (prepared on the current and new basis), Regulatory / Revenue Proposals (including their Overview Papers and accompanying information) and Revised Regulatory / Revenue Proposals.

The Draft Guidelines and Explanatory Statement make a variety of statements about how the AER intends each of these regulatory instruments will contribute to the expenditure forecasts and assessments in order to give effect to the requirements of the NEL and the NER.

However, the ENA is concerned that the Draft Guidelines and Explanatory Statement are not sufficiently specific about the information that NSPs will be expected to provide, and the decisions that the AER will make, in each regulatory instrument. As a result, it is currently unclear how the regulatory package fits together as a coherent, integrated whole in a way that will ensure that NSPs, the AER and other stakeholders have the information and certainty that they respectively need at each stage of the regulatory reset process.

The ENA is not seeking a restatement of the NEL and the NER requirements. Rather, it is seeking clarity and transparency about how information and decisions will be sequenced to give effect to these requirements. This includes making clear what of the AER's decisions could be deferred at each stage of the regulatory reset process to be addressed in subsequent stages. For example, what matters about the expenditure assessment process will deliberately not be specified in the Guidelines to be later addressed in the Framework and Approach paper or perhaps even the draft Distribution Determination. These matters should be made explicit in the Guidelines.

Attachment 3 provides a diagram that maps out the ENA's current understanding of the nature of the key instruments in the regulatory framework. It also details the ENA's understanding, based on the NER and the AER's draft Explanatory Statement, of the matters that the AER intends will be covered in each regulatory instrument. It would be extremely helpful if the AER expanded further on this table in its Guidelines.

Recommendation 18 - The AER should detail in an attachment to the Guidelines how it considers the suite of regulatory instruments will fit together as a coherent, integrated package so that the sequencing of information provision and decision making is clear to all parties. This should seek to minimise the prospect of duplication, gaps or anomalies in the regulatory process.

Given the nature and extent of the changes to the NER, the complexity of the responses required by the AER and NSPs to these requirements and the particularities of the transitional arrangements, the ENA considers that the initial term of the new Guidelines should be set at five years and that there should be a formal review before they are renewed for a further period. This would have the dual benefits of allowing the Guidelines to be:

- Framed to address the immediate requirements of the next round of resets; and
- Revisited and amended where necessary to meet subsequent reset processes.

Recommendation 19 - The AER should set a five year term for the new Guidelines and formally review them before they are renewed for a further period.

This amendment should be reflected into section 1 of the Guidelines that deals with introductory matters relevant to the application of the Guidelines.

E. Pre-emptive basis for forecasting productivity change

In its Explanatory Statement the AER states that:

> *Forecast productivity change will be incorporated in the annual 'rate of change' we apply to base opex. The forecast productivity change will be our best estimate of the shift in the productivity frontier.*[56]

It goes on to add that:

> *Over time, we intend to develop a single productivity forecast through econometric modelling of the opex cost function.*[57]

The ENA is concerned that the AER is inappropriately prescribing a NSP's forecasting methodology for opex by pre-emptively determining a productivity adjustment. The AER's approach would:

- Undermine the requirement in the revenue and pricing principles in the NEL for NSPs to "be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs" because an allowance for "potential productivity change" will have been removed from opex allowance;

[56] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 36.

[57] *Ibid.*

- Result in estimated productivity gains being passed through to consumers before these have actually been achieved. This will significantly undermine the effectiveness of the EBSS as the NSP would potentially receive no share in the benefit of the efficient improvement; and

- Distort the alignment between the incentive schemes for capex (the Capital Efficiency Sharing Scheme) and opex (the Efficiency Benefit Sharing Scheme) by incorporating an allowance for productivity improvements for opex that does not apply to capex.

Any consideration of pre-emptive productivity adjustments should be limited to economies of scale. Incorporation of economies of scale adjustments in particular determinations will need to be considered on the context of the NSP's overall forecasting methodology to avoid potential double-counting. A pre-emptive productivity forecast in excess of economies of scale would deliver the three above inappropriate outcomes.

Recommendation 20 - The AER should not pre-emptively determine a productivity adjustment for opex forecasts but should instead assess any proposal made by the NSP against the NER.

This amendment should be reflected into section 5 of the Guidelines and section 4.2 of the Explanatory Statement that deals with the assessment of opex, with consequential changes made elsewhere.

F. Step changes unreasonably constrained

The AER's discussion in the Draft Guidelines (see section 5.3) and the Explanatory Statement (see pages 31 to 32) suggest that they will restrict allowable step changes to:

- New obligations; and

- Capex and opex trade-offs.

The ENA is concerned that this is another example of an instance where the AER is inappropriately prescribing a NSP's forecasting methodology for opex by pre-emptively determining what can legitimately be treated as a step change. The AER's restrictions may prevent the NSP to "be provided with a reasonable opportunity to recover at least the efficient costs".

In the past, the AER and jurisdictional regulators have accepted a variety of step changes in preparing NSPs' opex forecasts under a base-step trend approach, however it is not clear from the AER's Draft Guidelines that all of these step changes would be allowed in the future. For example:

- Step changes that have been allowed in Victoria include:

  - Electricity distribution price review costs – this was recognised as an existing ongoing obligation with un-even profile of costs. This was approved for all five Victorian DNSPs;

  - Increases in the Essential Service Commission's levy – this was recognised as an existing obligation but that there had been a change in the level of cost. This was approved for all five Victorian DNSPs;

  - Insurance premium increases – this was recognised as an operation cost that was completely outside of the NSPs' control, with step changes in costs occurring occasionally (such as due to bushfires). This was approved for all Victorian DNSPs, except Jemena Electricity Networks;

  - Costs associated with the RIT-D – this was recognised as a likely new obligation and was approved for all Vic DNSPs;

- Customer communications – this was recognised that there were non-recurrent cost under existing obligation but were not in the base year. This was approved for all Victorian DNSPs;

- AMI-related data analysis and testing – this was recognised as a new activity that was backed by a business case and was in the best interests of consumers. This was approved for Jemena Electricity Networks and United Energy Distribution;

- Steady state voltage violations – this was recognised as arising from better knowledge of non-compliance with existing regulations due to Advanced Metering Infrastructure (AMI) data. This was approved for three of the Victorian DNSPs.

- Development of critical peak pricing – this was recognised as necessary for United Energy to adapt to a significant change in the circumstances due to AMI;

- Demand management team funding – this was recognised as necessary to enable better capex/opex tradeoffs through demand management. This was approved for United Energy Distribution and SP AusNet;

- Sunshine depot restoration costs – this was recognised as a result of changes in the operating environment for Jemena Electricity Networks;

- Non-pole distribution substation routine maintenance and overhead mounted switchgear inspection and maintenance – this was recognised for Jemena Electricity Networks due to changes in historical practices that were in the best interests of consumers in order to maintain the quality, reliability, safety and security of supply; and

- Broadmeadows' relocation – this was recognised as the opex cost component of a major capex project approved by the AER for Jemena Electricity Networks.

- *Step changes specific to South Australia include:*

  - Vegetation management – specific regulations apply to SA Power Networks that differ from those in other states; and

  - Guaranteed Service Level (GSL) payments – GSL payments are payable by SA Power Networks on major event days. Allowances in the current regulatory period are being exceeded due to weather events; and

  - South Australia Electricity Transmission Code (ETC) obligations - changes to the Code in 2008 resulted in a step change in SA Power Networks' capital expenditure in the current regulatory period.

In the ENA's view, NSPs should be able to propose six types of step changes:

- A change in external obligations or in the interpretation of obligations, for example changes in a NSP's reporting obligations under RINs or RIOs issued by the AER;

- An exogenous change in the volume or scale of a NSP's activity. This may relate to activities that fall outside of the five yearly cycle of a regulatory control period;

- Investments that support NSPs achieving dynamic efficiency that, by definition, is not reflected in a NSP's base year opex and that require a change in a NSP's future behaviour. The ENA reinforces the view that it included in its submission on the AER's Issues Paper, that the value from preserving dynamic efficiency and ensuring that the correct investments are made at the right time, with the right price-quality trade-offs, will likely far outweigh the value of moving firms towards the static productive efficiency frontier at a point in time and better support the long term interests of consumers;

- Changes in good electricity industry practice, which is defined in the NER as:

  The exercise of that degree of skill, diligence, prudence and foresight that reasonably would be expected from a significant proportion of operators of facilities forming part of the power system for the generation, transmission or supply of electricity under conditions comparable to those applicable to the relevant facility consistent with applicable regulatory instruments, reliability, safety and environmental protection. The determination of comparable conditions is to take into account factors such as the relative size, duty, age and technological status of the relevant facility and the applicable regulatory instruments.

  This is an evolving concept that should move with societal standards. For example, there will be higher costs of NSPs meeting the new consumer engagement requirements, which reflect an evolving view of what represents good electricity industry practice in this area.

- The opex requirement associated with new capex activity as this, by definition, will not be reflected in the base year opex; and

- New requirements to address electricity consumers' concerns identified through engagement with them, which are reflected in clause 6.5.6(e)(5A) of the NER. The AER has detailed its expectations about the nature of this engagement in its "Draft Consumer Engagement Guideline for Network Service Providers".

It would clearly be incumbent upon each NSP to justify in its Expenditure Forecasting Methodology, its submission on the AER's Framework and Approach paper and its Regulatory / Revenue Proposal which step changes are relevant to it in its forthcoming regulatory control period.

In addition, a NSP should be able to propose other step changes – over and above the six types detailed above – for the AER to assess on their merits in its Distribution or Transmission Determination based on the NER requirements. This is consistent with the approach that the AER set out in its Distribution Determination for the Victorian DNSPs, where it stated that:

> *. . .in the draft decision and in this final decision, the AER has assessed step changes solely against the opex criteria and the opex factors in clause 6.5.6 of the NER, in a manner consistent with the NEO and which takes into account the RPP.*[58]

This will also be consistent with the NER placing no restrictions on a NSP's forecasting method and the AER assessing that method in accordance with the NER and NEL, rather than having a pre-conceived view of what it should, or should not, contain.

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[58] AER, *Final decision - Victorian electricity distribution network service providers, Distribution determination 2011–2015*, October 2010, p 317 – available at http://www.aer.gov.au/sites/default/files/Victorian%20distribution%20determination%20final%20decision%202011-2015%20%2829%20October%202010%29_1.pdf

Recommendation 21 - The AER should increase the number of matters in the Guidelines that can be treated as step changes and allow each NSP to nominate and justify other matters in its Expenditure Forecasting Methodology and Regulatory / Revenue Proposal as it deems necessary.

This amendment should be reflected into section 5.3 of the Guidelines and section 4.2 of the Explanatory Statement that deals with the assessment of opex, with consequential changes made elsewhere.

G. Refine approach to information collection and disclosure

The ENA has a number of concerns about the AER's proposed approach to information collection and disclosure and has various suggestions for how these concerns could be addressed.

Demonstrate net benefits of data requests

As noted above, completing detailed data requests takes time, costs money and results in price increases for end consumers. Larger and more complex data requests take more time, cost more money and result in greater price increases. The ENA considers that it would be incorrect to suppose that even more detailed information will necessarily allow the AER to make better and better assessments and decisions.

In its Explanatory Statement, the AER states that:

> *We consulted on and carefully considered the additional cost and burden of this new information (which is ultimately borne by consumers) and balanced this against the significant expected improvements in the robustness of our assessments.*[59]

The AER should explain more fully in its Explanatory Statement how it has considered the costs and benefits of information provision so that it is clear to all stakeholders why it has concluded that more detailed and onerous information requests outweigh the costs. This is important to provide transparency about its decision making.

In reviewing the AER's indicative category analysis templates, it is not clear that all of the categories and individual data items that the AER is seeking will assist it in understanding NSPs' cost drivers and enable pragmatic cost category trend and benchmarking analysis.

For example, current industry experience in conducting benchmarking of IT & Communications expenditure suggests that some of the non-network data being sought in template 5.1 is likely to be of limited or no use for cost category benchmarking purposes. This is because the template aims to collect opex and capex forecasts by direct labour, direct materials, contractors/outsourced costs, and other costs, without taking into account the fact that DNSPs have different IT service delivery models that affect the distribution of direct labour and outsourced costs.

Australian DNSPs already have information that is categorised for benchmarking purposes, which can also be used to benchmark global metrics. Examples of opex costs categories include: software, hardware, outsourced costs, management, internal labour. Further, the performance metrics to calculate ratios for spend per total corporate expenses and spend per user or device already exist with clear data composition definitions.

The ENA and its members would welcome the opportunity to explain to the AER the nature of this existing IT benchmarking in order to streamline the AER's data requests.

[59] *Ibid.*

Indicative category analysis data templates

The AER released indicative category analysis data templates with the draft Guidelines. These comprise over 40 templates that seek extremely detailed, disaggregated back-cast and forecast data from the NSPs. The AER recently provided a survey to the ENA members that sought their comments on the data templates.

ENA members are currently assessing their ability to complete the AER's data templates. Typically, given the breadth of the information being sought, this requires each NSP to undertake extensive consultation and interrogation across their business. The NSPs are therefore not yet in a position to complete the AER's survey. The ENA members expect that this will take a further six to eight weeks to assess.

In the first instance, the ENA members each intend submitting a colour-coded version of the data templates to the AER which will highlight what information they are in a position to provide. When taken together, these colour-coded versions of the data templates will indicate the breadth of data that NSPs are either able, or unable, to provide to the AER.

Streamline information collection

As discussed in section D, the ENA considers that there is a need to clarify how the suite of regulatory instruments that are relevant to the AER's expenditure assessment fit together as a coherent, integrated package.

This is important, amongst other reasons, to ensure that the information that the AER requests NSPs to provide is appropriately coordinated and streamlined and that there is no unnecessary or duplicated information being requested.

Further, the AER should only request information that it considers it will use either to test the sensitivity of its data and model specifications or for its final model specification –otherwise this will impose an unnecessary burden on NSPs.

Recommendation 22 - The AER should detail in an attachment to the Guidelines how its information requests fit together as an integrated package.

Publish all information

The ENA believes that all RINs and RIOs should be published, albeit accounting for the fact that some data may be confidential to individual NSPs.

Recommendation 23 - The AER should publish all of the data on which it relies for its benchmarking. In the interests of transparency, the AER should not use any confidential data for benchmarking unless it is included in higher level categories of data such that the confidential data is not disclosed and could not be inferred from the published data.

This amendment should be reflected into section 6 of the Guidelines that deals with information requirements.

Information that NSPs cannot provide

The ENA observes that it will not always be possible for a NSP to provide information that the AER requests. In particular, a NSP cannot provide information that it does not have, including information about another NSP. A NSP should be required to use its best endeavours to provide requested information. However, if a NSP cannot genuinely provide information, it should not be unfairly disadvantaged, for example by the AER simply adopting information for another NSP. The AER should find an alternative basis for making its decision that does not rely on this information.

Furthermore, a NSP should not be required to provide information that could be materially misleading or unreliable. If, for whatever reason, the AER receives information that is materially misleading or unreliable then it should not use that information for regulatory decision making. The ENA is concerned that the AER may have a contrary intention, as it states on page 56 of the Explanatory Statement that it will "(where possible) use reliable data". Sound, reliable information is essential for good regulatory decision making – relying on sub-standard information would undermine the credibility of the AER's decision making.

These matters are discussed further below in relation to back cast data.

"Back cast" economic benchmarking data

In the Explanatory Statement, the AER notes that it proposes to issue draft RINs under the NEL on all NSPs in September 2013 to collect "back cast" economic benchmarking data to enable a testing and validation process in early 2014, and then to issue RINs in late 2013 on all NSPs for the purposes of gathering information for the 2014 benchmarking report and in assessing regulatory proposals submitted in 2014.[60]

As a preliminary matter, the ENA considers that it would be more appropriate for the AER to seek to collect the relevant information pursuant to a RIO, as opposed to individual RINs. Pursuant to section 28C of the NEL, a RIO is an order made by the AER that requires each regulated NSP of a specified class to do either or both of: (a) provide to the AER the information specified in the order; (b) prepare, maintain or keep information specified in the notice in a manner and form specified in the order. As the collection of data to enable benchmarking is intended to be standardised across NSPs (or at least across NSPs of a specified class, being distribution or transmission NSPs) it would seem more appropriate to issue RIOs to obtain this information as opposed to RINs.

There are few differences between RIOs and RINs, however these differences between these types of instruments are significant and provide an indication of the circumstances in which it may be more appropriate to use one type of instrument over another.

Two important differences between RIOs and RINs include the obligations to consult with the public where the AER proposes to issue a RIO pursuant to section 28H of the NEL and the requirement to publish a RIO as soon as practicable after it is made pursuant to section 28I of the NEL. There is no requirement to consult with the public when issuing a RIN, there is only a requirement to invite the NSP to make representations to the AER as to whether the AER should serve the RIN.[61] There is also no requirement to publish a RIN that has been issued by the AER.

In circumstances where the AER proposes to use the information it collects from NSPs as an input to its decision on regulatory determinations that apply to individual NSPs, it is obviously appropriate that there is an opportunity for those NSPs, together with third party stakeholders, to comment on the information the AER proposes to compel NSPs to provide. Further, it is appropriate for such instruments, once they have been made, to be made public so that all stakeholders, including NSPs understand the information that NSPs are required to provide and / or the information that they are required to prepare, maintain or keep, as well as the manner and form in which that information is required to be prepared, maintained or kept. These considerations strongly suggest that where the AER is seeking to compel the provision of information for the purposes of benchmarking, the appropriate instrument to use is a RIO, and not RINs issued to individual NSPs. In the explanatory statement, the AER indicates that from 2015

[60] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution*, August 2013, p 68.

[61] Section 28J.

the data for annual benchmarking reports will be obtain by issuing RIOs[62], however it is not clear why the information prior to this time is proposed to be collected via RINs.

In response to concerns raised by NSPs about providing back cast data, the AER has said that while it has considered these concerns, the AER's view is that the data must be of a high quality and reliable.[63] The AER notes that while it may not be a simple task to provide reliable back cast data, the AER expects the NSPs to allocate the requisite resources to ensure that the back casting is conducted properly.[64] The AER reiterates in the Explanatory Statement that it requires back cast data to be independently audited.[65] The ENA's response to the AER's auditing requirements is set out in detail in section I below.

It is important to note that in order to attempt the back casting that appears will be required by the AER, NSPs will have to not only dedicate significant resources to collect the necessary data to undertake the back casting, but NSPs will also have to make significant assumptions about what information is contained in the data that is contained in the records of the NSP going back 10 years and also make what are likely to be quite arbitrary decisions about how that data may need to be manipulated in order to attempt to respond to the AER's information requests. The AER's response to this in the Explanatory Statement is that it is acceptable for NSPs to make assumptions or exercise judgment to comply with the AER's information requests, provided that NSPs are transparent about the assumptions and processes that they use.[66] NSPs have also indicated to the AER that in some circumstances the data the AER has indicated it may require is not actually data that the NSP has. The AER's response to this in the Explanatory Statement is that if NSPs are unable to provide the requested data, the AER expects the NSP to reasonably approximate or estimate that data.[67]

The ENA submits that the information requests that the AER had foreshadowed it will issue that will require NSPs to provide back cast data for the purposes of economic benchmarking going back 10 years is not supported by the regulatory information instrument provisions in the NEL.

First, in considering whether it is reasonably necessary to serve a regulatory information instrument, the AER must have regard to the likely costs that may be incurred by an efficient network service provider in complying with the instrument. It is no answer to that requirement to say, as the AER has done in the Explanatory Statement, that NSPs would already be undertaking the necessary preparations to provide the information likely to be sought by the AER.[68] What the NEL requires is the AER to actively turn its mind to the matter to be addressed by the service of the RIN or the making of the RIO and the likely costs of an NSP in complying with the regulatory information instrument. Relevant to this consideration must be how fit for purpose the information to be obtained via the back casting process will be. NSPs have submitted to the AER, and continue to submit, that given the amount of data that may have to be approximated or estimated, and the assumptions that NSPs may have to make as to what matters are or are not captured by the data that the NSPs actually have, the data will not be fit for the purpose intended—that of benchmarking expenditure categories across NSPs. The burden that the back casting exercise will place on NSPs is not justified, particularly in light of the fact that the output of the exercise

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[62] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution*, August 2013, p 69.

[63] *Ibid.*, p 74.

[64] *Ibid.*, p 74.

[65] *Ibid.*, p 74.

[66] *Ibid.*, p 74.

[67] *Ibid.*, p 73.

[68] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution*, August 2013, p 74.

cannot be relied upon as providing useful information that can be properly deployed in an economic benchmarking analysis.

Second, and related to the above point, before issuing a regulatory information instrument the AER must form a view that the serving of the RIN or the making of the RIO is “reasonably necessary” for the performance or exercise of its functions or powers under the NEL or the Rules.[69] In considering whether it is “reasonably necessary” for the performance or exercise of its functions or powers, the AER is required to have regard to the matter to be addressed by the service of the RIN or the making of the RIO, and the likely costs that may be incurred by an NSP is complying with the RIN or the RIO. The AER does not appear to have fully considered whether the information that it may require to be provided to it is reasonably necessary for the performance or exercise of its functions or powers. Obviously the AER will need to step through this when formulating the relevant regulatory information instruments and satisfy itself that the information will be of such quality that the AER will be able to use it in its determination processes—that is, the information is reasonably necessary for the performance of its functions or powers. The ENA submits that the discussion in the Explanatory Statement of the requirements that will be placed on NSPs to provide back cast information does not set out the basis upon which the AER has or will satisfy itself as to the information being reasonably necessary for the performance of its functions or powers.

Finally, section 28K of the NEL requires that a regulatory information instrument must specify the information required to be provided to the AER, or the information required to be prepared, maintained or kept in the particular manner and form specified in the instrument.[70] The NEL also provides that the instrument may specify the manner and form in which the information is required to be provided to the AER or the manner and form in which the information is to be prepared, maintained or kept.[71]

Whilst section 28L and section 28M of the NEL are expressed to not limit section 28K, both of these sections provide useful guidance as to the nature of “information” that the AER may require to be provided to it, or prepared, maintained or kept.

Section 28L provides that the information that may be required to be provided to the AER, or to be prepared, maintained or kept may include:

- Historic, current and forecast information; and
- Information that is or may be derived from other information in the possession or control of the service provider.

Section 28M provides that a regulatory information instrument may require that the information specified in the instrument:

- Be verified by way of statutory declaration by an officer of the NSP to whom the instrument applies; and
- Be audited.

The ENA submits that, with the exception of forecast information, it is not appropriate to use a RIN or RIO to require a NSP to provide information that is not information that is in existence or cannot be objectively derived from information that is in existence. That is, a RIN or RIO should not be

[69] Section 28F(1).

[70] Section 28K(1)(a).

[71] Section 28K(1)(b).

used to require a NSP to conduct a back casting exercise where more is required than extracting historic data and undertaking various calculations with respect to that data. An exercise which requires NSPs to approximate or estimate data, or to make arbitrary judgments, is not appropriately the subject of a RIN or RIO. This is reinforced by the ability of the AER in section 28M to require information to be verified by way of statutory declaration or to be audited. If the information that is purportedly required to be provided pursuant to a RIN or RIO cannot properly be the subject of a statutory declaration or audit, including because the data has not historically been kept in a manner that permits the NSP to provide the information sought by the AER with confidence that the information is not incorrect or misleading, that information should not be the subject of a RIO or RIN. Alternatively, the NSP will not be able to provide that information to the AER pursuant to the RIO or RIN because they are unable to give the required declaration or audit in respect of that information.

A recipient of a RIO or RIN can only be required to furnish information which is within the knowledge of the NSP. This is consistent with a decision of the Federal Court which considered the scope of the powers of the Australian Competition and Consumer Commission to compel the provision of information pursuant to section 155 of the *Competition and Consumer Act 2010* (Cth).[72] In this case the Federal Court noted that it is true that “the recipient of a notice can only be required to furnish information which is in his knowledge or control and cannot be required to undertake a general investigation of matters beyond his control”.[73] Whilst a NSP may be required to make inquiries of responsible officers, employees and agents as to relevant information in order to comply with a RIO or RIN, the AER’s back casting requirements go well beyond such a requirement. The ENA submits that in some cases, the back casting “information” that may be sought to be required by the AER will not properly be information that lies within the knowledge or control of the NSP. In such circumstances the AER cannot insist that the NSP does whatever is required in order to provide some response to the information notice.

Recommendation 24 - The AER should amend the Guidelines to clarify that NSPs will not be required to provide information that they do not have or that could be materially misleading or unreliable.

Recommendation 25 - The AER should amend the Guidelines to commit to it not relying on information for its decision making that is materially misleading or unreliable.

These amendments should be reflected into section 6 of the Guidelines that deals with information requirements.

H. Make all AER models publicly available

The ENA understands that the AER will publicly release the actual repex and augex models and the associated data that it will use to assess NSPs’ expenditure forecasts.

However, it is not clear from the Guidelines or the Explanatory Statement that the AER will release the actual benchmarking models that it will use. The ENA strongly believes that the AER should publicly release these benchmarking models during a determination process so that NSPs and all other stakeholders can fully understand the basis on which the AER undertake its expenditure assessment.

[72] *Dunlop Olympic Ltd v Trade Practices Commission* 62 FLR 145, 149-150.

[73] *Dunlop Olympic Ltd v Trade Practices Commission* 62 FLR 145, 150.

Recommendation 26 - The AER should amend the Guidelines to clarify that it will publicly release during each determination process all of the models that it will use to undertake its expenditure assessment.

This amendment should be reflected into section 3 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

I. Expenditure and capitalisation policy audit and sign-off obligations

Section 28M(e) of the NEL provides that the AER may require a NSP to have the information audited that it provides under a RIN or RIO.

The Explanatory Statement for the draft Expenditure Forecast Assessment Guidelines provides that:

> *. . .we will require back cast data to be independently audited. It is acceptable for NSPs to make assumptions or exercise judgment to comply with our data requirements. However, NSPs must be transparent about the assumptions and processes they use. We will require auditors to review compliance with our framework.*
>
> *Reasonable (positive) assurance on back cast information should be provided on financial and non-financial data where possible, in accordance with ASA 800 and ASAE 3000, respectively.*[74]

The Explanatory Statement goes on to state that:

> *In the interests of receiving data as soon as possible, we will accept data from NSPs once it has been audited but prior to Board signoff. NSPs can subsequently provide Board signoff and changes to the data and audit report (if applicable). We consider the timeframes in section 6.1.1 allow sufficient time for NSPs to provide us with audited data prior to signoff. Attachment A discusses back casting of data in more detail.* [75]

The draft Capital Expenditure Incentive Guidelines also provides that:

> *The AER may also require the NSP to provide details of its capitalisation of expenditure as part of the annual Regulatory Information Notice/Regulatory Information Order process, including a statement of its capitalisation policy with auditor's sign-off.*[76]

These requirements provide broad statements of the AER's intent that leave a number of key matters unexplained.

The ENA is concerned that NSPs may bear risks of impaired regulatory outcomes, non-compliance with regulatory requirements and expending inefficient effort and cost that could arise from incompletely designed or unworkable, regulatory audit or assurance requirements.

The ENA seeks guidance regarding how the AER will obtain assurance and regarding the relationships between the AER's assurance requirements and the regulatory framework that governs the provision of audit and assurance reports in Australia. This guidance should:

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[74] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution*, August 2013, p 74.

[75] *Ibid.*

[76] AER, *Draft Capital Expenditure Incentive Guideline*, August 2013, p 19.

- Indicate that the AER intends to rely on the existing regulatory framework for the appointment of auditors and the conduct of their work and not to introduce unnecessary additional or alternative requirements;

- Provide clear guidance, which might be through a Regulatory Accounting Guideline that details the basis on which the AER expects RINs, RIOs and other regulatory information to be prepared and presented. This is necessary to allow a NSP to report and to enable an auditor to opine on that report. This should take into account the fundamentally different basis of preparing historic and forecast information;

- Clarify how the AER will set the terms of reference and form of report required of auditors; and

- Reconsider the suggestion on page 74 of the Explanatory Statement that "NSPs can subsequently provide Board signoff and changes to the data and audit report (if applicable)". This is unworkable as an auditor cannot report without first having a NSP's sign off.

These, and several other matters relevant to the audit and sign-off obligations, are discussed in detail below.

<u>Auditor qualification and independence</u>

The Explanatory Statement for the Expenditure Forecast Assessment Guidelines has identified Auditing Standard ASA800 *"Special Considerations – Audits of Financial Reports Prepared in Accordance with Special Purpose Framework"* and Standard on Assurance Engagements ASAE3000 *"Assurance Engagements Other than Audits or Review of Historical Financial Information"* as potential standards under which an auditor may report on RINs and RIOs.

Auditing Standards are issued by the Australian Government Auditing and Assurance Standards Board. ASA800 and ASAE3000 are part of a framework of Auditing and Assurance Standards (Standards) that operate as a whole, to regulate the conduct of audit and assurance engagements in Australia and that are consistent with international standards. The Standards as a whole cover matters such as ethical requirements, independence, quality control, agreeing terms of engagement, matters to be taken into consideration by the auditor when undertaking an engagement, as well as reporting. The members of relevant professional bodies, such as the Institute of Chartered Accountants in Australia, are obliged to follow all relevant Standards. Accordingly, it is not meaningful for the Explanatory Statement to select specific Standards alone to provide the framework for an audit or assurance report.

The ENA believes that the Expenditure Forecast Assessment Guidelines and the Capital Expenditure Incentive Guidelines should affirm that their audit and assurance requirements are to be fulfilled by a person qualified, and hence obliged, to report under Australian Auditing and Assurance Standards.

<u>Terms of reference</u>

Australian Auditing Standards provide in relation to an audit that:

In conducting an audit of a financial report, the overall objectives of the auditor are:

> (a) *To obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework; and*

(b) To report on the financial report, and communicate as required by the Australian Auditing Standards, in accordance with the auditor's findings.[77]

The identification of an "applicable financial reporting framework" is a necessary requirement. In general terms, a financial reporting framework normally sets out guidance on polices for the preparation and presentation of the financial information being reported. Absent such a framework, an auditor would have no point of reference to independently assess whether a financial report, such as a RIN or a RIO, may be misstated.[78] This is exemplified by ASA 800 which requires an auditor to report by reference to a "special purpose framework" where:

Special purpose framework means a financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.[79]

The distinction between a "fair presentation framework" and a "compliance framework" is relevant to the AER's requirements and is clarified as follows[80]:

For purposes of the Australian Auditing Standards, the following terms have the meanings attributed below:

(a) Applicable financial reporting framework means the financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial report that is acceptable in view of the nature of the entity and the objective of the financial report, or that is required by law or regulation.

The term "fair presentation framework" means a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial report, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial report. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" means a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

In other words, while an auditor may opine on whether information is compliant with the AER's financial framework, an auditor may concur with a NSP's departure from that framework to achieve fair presentation. These acknowledgements appear to recognise that strict adherence to required forms of presentation may not result in information that is fairly presented.

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[77] Australian Government Auditing and Assurance Standards Board, October 2009, Auditing Standard ASA200 *"Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*", paragraph 11.

[78] Similarly a NSP would have no basis on which to determine whether it would have prepared and presented a RIN or RIO in accordance with the AER's expectations. This is a critical requirement which is further explained overleaf.

[79] Australian Government Auditing and Assurance Standards Board, July 2013 Auditing Standard ASA800 *"Special Considerations – Audits of Financial Reports Prepared in Accordance with Special Purpose Framework ,* Definitions , paragraph 6(b).

[80] Australian Government Auditing and Assurance Standards Board, October 2009, Auditing Standard ASA200 *"Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*", para 13.

To allow an auditor to provide reasonable assurance, the AER's guidance should explicitly identify the applicable "financial reporting framework" for each RIN or RIO. This suggests a requirement for the AER to consider whether a financial reporting framework may need to be tailored for each, albeit with an objective of minimising unnecessary inconsistency. This also suggests that, in the financial reporting frameworks for RINs and RIOs, the AER should clarify the relative precedence that the AER accords to compliance with form and fairness of presentation. The ENA also notes the precedents provided by Australian regulators which emphasise requirements for "Substance over form".[81]

Historical and forecast information

There is a fundamental, inherent difference between the bases on which historical and forecast financial information are prepared. This will need to be recognised by the AER's audit and assurance requirements. For example, Assurance Standard ASAE 3450 "*Assurance Engagements involving Corporate fundraising and/or Prospective Financial Information"* is relevant to requirements for assurance reports on forecasts.

Appropriate levels of assurance

The requirements of the Explanatory Statement for the Expenditure Forecast Assessment Guidelines and of the Capital Expenditure Incentive Guidelines cited above refer to Standards concerning reasonable and limited assurance reports, as well as to a variety of information that the AER may require of a NSP. However, the Guidelines provide no guidance to clarify the circumstances in which:

- The AER would expect an auditor or assurance practitioner to provide:
  - An audit report (for example under ASA 800);
  - A review report (for example under ASRE 2410[82] or ASRE 2405[83]); or
  - A limited assurance report (for example under ASAE 3000); and
- The different levels of assurance would be applied to financial and non–financial information.

The requirement for an auditor's report on capitalisation policies is a case in point. The draft Capital Expenditure Incentive Guidelines do not indicate the nature of the matters relating to the policy on which an auditor may be asked to report, nor of the form or level of assurance that the AER may require.

Also, it may be impractical to expect an auditor to provide an opinion on back cast data over a prolonged period. This is because access to corroborating evidence that an auditor may require, importantly including answers to questions asked of the personnel responsible for the business and/or source data at the time, may no longer exist.

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[81] See, for example, the AER's "Electricity transmission network service provider information guidelines" – paragraph 2.4 on pp 3-4 entitled "Substance over form".

[82] *Review of a Financial Report Performed by the Independent Auditor of the Entity.*

[83] *Review of Historical Financial Information Other than a Financial Report*.

A risk based framework that takes into account other information available to the AER and the inherent risk or materiality of misstatements in setting the level of independent assurance required by the AER, may often be more appropriate and efficient for both the AER and a NSP than a blanket requirement for reasonable assurance in all circumstances.

Responsibilities

A key audit principle is that an auditor is responsible for reporting on information, but is not responsible for the information itself. Otherwise, the auditor would lose independence. This means that an auditor will not report without a NSP's management having first taken formal responsibility for the information being fairly presented or compliant with the financial reporting or compliance framework which forms the basis of the auditor's attestation.

Also, in normal circumstances, an auditor's report once published cannot be reissued, unless exceptionally, the auditor becomes aware of a fundamental error. To do otherwise would undermine confidence in, and hence the purpose of, auditors' reports.

Accordingly, the suggestion on page 74 of Explanatory Statement for the Expenditure Assessment Guidelines that the "*NSP's can subsequently provide Board signoff and changes to the data and audit report (if applicable)"* does not appear workable. An auditor cannot report without a NSP's sign off.

This too places great emphasis on the importance of the AER setting out financial reporting or compliance frameworks for the RINs and RIOs that are relevant, workable and capable of being "signed off" by a NSP's board. An auditor's assurance cannot substitute for such a sign off and, in its absence, an auditor would be unable to express an assurance opinion.

Other matters

In practical terms, guidance on regulatory audit and assurance requirements is required to be set out in accordance with Auditing and Assurance Standards' approaches for:

- Engaging and remunerating an auditor or assurance practitioner;
- Setting and communicating the terms of reference for the audit or assurance report; and
- Establishing the persons to whom the auditor assurance practitioner has formal responsibility for reporting.

These would include providing sufficient notice to allow the auditor to plan and undertake its work to meet both the requirements of Standards and reporting deadlines.

The second point above is particularly important for assurance reports under ASAE 3000 where the scope of work is normally highly specific to each engagement. For example, paragraph 20 of that Standard requires that:

> *The assurance practitioner shall agree on the terms of the assurance engagement with the engaging party, which shall be recorded in writing by the assurance practitioner and forwarded to the engaging party. When the assurance engagement is undertaken pursuant to legislation, the minimum applicable assurance engagement terms shall be those contained in the legislation.*

This also exemplifies where, to implement its requirements, the AER will need to clarify:

- The relationships between the auditor or assurance practitioner, the NSP and the AER; and

- How the terms of reference for the auditor or assurance practitioner would be set, communicated and agreed.

Recommendation 27 - The AER should commit to preparing Regulatory Accounting Guidelines that set out in detail the AER's regulatory accounting and assurance requirements in relation to the provision of historical and forecast financial information by the NSPs, in particular under its RINs and RIOs.

This amendment should be reflected into a new section of the Guidelines and section 6 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

J. Transitional arrangements

Transitioning from previous to new assessment techniques

In its Explanatory Statement, the AER provides the following view about its approach to assessing NSPs' expenditure forecasts:

> *Our general approach is not significantly different from what we applied in the past.*[84]

This submission highlights that the Guidelines do contemplate departing from the AER's previous practice in some key ways. This particularly arises from the AER's intention to increase its reliance on economic and category level benchmarking for assessment purposes. This benchmarking will be based on information that the AER will request from all NSPs through RINs and RIOs that will start to be submitted in the next six months.

ENA members have repeatedly raised formal and informal concerns to the AER about the unknown quality of the dataset upon which this benchmarking would rely, particularly in the next round of resets. The ENA is concerned to ensure that:

- The AER applies the assessment principles and the proposed weighting factors to determine what weight should be given to benchmarking (and other assessment) techniques in the coming five years;
- The AER's application of the benchmarking techniques affords NSPs due process; and
- The AER's approach does not introduce greater risks of downwardly biased regulatory decisions given the power of the incentive arrangements and the impacts on the industry benchmark.

Each of these matters is discussed further below.

Premature use of unproven assessment tools

The AER appears to acknowledge that its benchmarking techniques will need to be refined over the medium term and that the outcomes of these techniques are likely to be imprecise before that time. For example, the AER states in the Explanatory Statement that:

> *We intend to give ourselves the ability use all of our techniques when we assess expenditure and refine them over time.*[85]

[84] AER, *Explanatory Statement - Draft Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2013, p 22.

The AER's proposed approach introduces significant uncertainty about the benchmarking techniques that it will, and will not use, particularly in the next round of resets. In order to address this uncertainty, the ENA considers that the AER should amend the draft Guidelines to make clear that it will only apply benchmarking (and other assessment) techniques if they clearly satisfy the assessment principles in section B. The AER should also apply the proposed weighting factors in deciding the weight to be given to these techniques.

It is important that the AER is disciplined in ensuring that its benchmarking reflects the assessment principles. If its benchmarking does not reflect and promote these principles then the benchmarking should not be applied in setting NSPs' forecast expenditure.

The ENA notes that its proposal to have a five year review of the Guidelines will provide a formal means to review the use of benchmarking following the next round of resets.

Recommendation 28 - The AER should apply the assessment principles and the weighting factors to determine what weight should be given in the resets over the coming five years to benchmarking (and other assessment) techniques that rely on unreliable data.

This amendment should be reflected into sections 3 to 5 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

<u>Need for due process to enable correct interpretation of outcomes</u>

In the Explanatory Statement, the AER acknowledges that:

> *. . .NSPs submitting regulatory proposals in May 2014 will do so without full visibility of our new techniques. We recognise this creates a potential disadvantage as these NSPs will not be able to modify their proposals for the AER's assessment approach.*[86]

The ENA notes that this disadvantage will extend to the Queensland and South Australian DNSPs who also submit proposals in 2014, recognising that the AER's first Annual Benchmarking report is not due to be released until September 2014.

The effectiveness of benchmarking is improved when the techniques and data are accepted by stakeholders as promoting the assessment principles, in particular those relating to accuracy, reliability, robustness and fitness-for-purpose. Achieving consensus on these matters will take some time and the sudden application of techniques and data that don't exhibit these principles could erode, rather than promote, the legitimacy of the regulatory regime. A data gathering process of the kind recommended by the AEMC in its "Review Into the Use of Total Factor Productivity for the Determination of Prices and Revenues" is better aligned with promoting these principles, given the data would be collected for the relevant purpose in real time, not backcast. The ENA's extensive concerns about the use of backcast economic benchmarking data are detailed in section G above.

Before applying any new benchmarking techniques, the ENA considers that it is important that NSPs are given adequate time to understand and explain differences in results. There may be perfectly good reasons for variances to a benchmark other than inefficiency, which NSPs should be given a reasonable opportunity to explain to the AER. This is particularly the case when there is considerable uncertainty around the quality of the information being used in the analysis.

[85] *Ibid.*, p 53.

[86] *Ibid.*, p 72.

The AER should be especially cautious in applying new information requirements and interpretations of efficiency to those NSPs that will be assessed first in the next round of resets. This is particularly the case where the NSP has previously adopted a different forecasting approach to that which the AER proposes to apply itself. The AER should be mindful of the sheer volume of information that these NSPs will need to prepare at one time, given that they will need to provide backcast information at the same time as preparing their expenditure forecasts.

Recommendation 29 - The AER should ensure that the Guidelines afford all NSPs due process in the application of benchmarking techniques, including those NSPs who will be assessed first in the next round of resets.

This amendment should be reflected into sections 3 to 5 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

Avoiding greater consequences of regulatory error

The AER's proposed approach introduces greater potential consequences of regulatory error given the power of the incentive arrangements and the impacts on the industry benchmark. This will particularly be the case in the transition from the current expenditure allowances to the AER's new approach.

The AER's approach introduces greater potential consequences of regulatory error. There is a particular risk if the AER intends to replace a NSP's forecast that has been determined on the basis of revealed costs with an allowance that has been determined on the basis of a new, untested approach to benchmarking.

The incentives in the regulatory framework are strong and provide clear signals for a NSP to spend less than its allowance. A high-powered incentive combined with an inefficiently low forecast could force NSPs to make inefficient expenditure decisions that are not in the long term interests of consumers. This is particularly the case where the AER sets an allowance based on a benchmark.

Recommendation 30 - The AER should ensure the Guidelines require it to weigh up the unintended consequences of any decision to substitute a forecast based on a benchmark, including the fact that this substituted forecast could be set inefficiently low. The AER should also have regard for the strong incentives on NSPs not to spend above a substituted forecast and the impact on the long term interests of consumers if a forecast is set inefficiently low.

This amendment should be reflected into sections 3 to 5 of the Guidelines and section 4 of the Explanatory Statement that deal with the AER's assessment approach, with consequential changes made elsewhere.

Attachment 2 – Proposed wording of assessment principles and weighting factors for inclusion in Expenditure Forecast Assessment Guidelines

Assessment principles

Accuracy and reliability

Data are accurate when they are fairly stated for their intended purpose. Historical data are accurate when they reflect the records that they are purported to represent and those records fairly describe the data being quantified. As with historical data, the accuracy of forecast data can only be verified after the event. It is, nevertheless, possible to form a view on whether forecast data have been prepared appropriately on the basis of reasonable assumptions and in accordance with a stated method. No data can be described as accurate in isolation from clear knowledge of what they are supposed to represent and how they are supposed to be prepared and presented. These reference points are necessary before it is possible for anyone to form a view about whether (forecast or historic) data are accurate.

Data are reliable when they are unbiased and free from material error having regard for their intended purpose and any assumptions that may be made about them.

A technique is accurate when it produces unbiased results having regard for its intended purpose.

A technique is reliable when its results can be replicated by independently applying the input data. A reliable technique should produce stable results when a small change is made to the data, model specification or model assumptions. The results produced by a reliable technique should be broadly consistent with those that have been (or would be) produced by alternative, comparable techniques and should be justifiable in the light of other data. In this way, the results of a technique should be capable of being independently verified.

Data and techniques may require testing and calibration to be satisfied of their accuracy and reliability.

Robustness

Robust techniques remain valid under different assumptions, parameters and underlying conditions. They must be complete having regard for their intended purpose. A technique that is lacking in some material respect cannot be robust.

Data are robust when they are fairly described and presented (including by disclosing relevant assumptions) and they are fit for their intended purpose. Robust data should not be lacking in any material respect. The quality of the robustness of any data is not independent of their intended purpose. Data can therefore be robust for one purpose but not for another. It must therefore be clear what data are to be used for in order to form a view about whether they are robust for that purpose. Data used for benchmarking purposes must be complete in order to be robust (subject to the exclusion of outliers). In this regard, data may also only be robust where it is of sufficient depth such that analysis of it provides meaningful results.

Transparency

Transparency is a matter that is relevant to the selection of assessment techniques. There are a number of elements to transparency, including:

- The application of the technique – it should be clear how a particular technique is applied, including that it can be replicated by third parties; and

- The data used by the technique – it should be clear what data is being used. Any data that the AER uses to support its decision making should be made available to persons that may be affected by the decision.

Typically, transparency requires data to be made available to persons who will be affected by a particular decision, although some data, and the results of some techniques, may be confidential to individual NSPs. Furthermore, NSPs can only provide data that are available to them. NSP will not be expected to provide data relating to another NSP or to explain material differences between their respective costs (particularly, when an NSP does not have access to the other NSP's cost information).

If the AER indicates in a framework and approach paper that it will use a particular technique, but after employing that technique decides that it will not use it to prepare a NSP's expenditure forecast, then the AER will disclose this (and the outcome of applying the techniques that are no longer being relied upon) and will give detailed reasons for its decision in its Draft or Final Determinations (as relevant).

Fitness for purpose

The individual circumstances of each determination will be the starting point for identifying what assessment techniques are available and, of those, which will be appropriate to use. If a particular technique will not materially contribute to the AER's assessment of whether forecast capital and operating expenditure amounts reasonably reflect the operating or capital expenditure criteria, perhaps because the technique is unable to adequately take into account the individual circumstances of the service provider or there is insufficient data for the results to be statistically reliable, the technique will not be "fit for purpose" and should not be used as part of the AER's assessment.

The data and techniques will be chosen by reference to their ability to contribute to the AER's assessment of whether forecast operating and capital expenditure amounts reasonably reflect the operating and capital expenditure criteria. An assessment technique is likely to contribute to the AER's assessment if it:

- Can be applied in a manner that has regard for the NSP's individual circumstances – the nature of the data and technique should be adapted to the specific circumstances of the Regulatory / Revenue Proposal;

- Can be applied in a manner that accounts for matters outside of the NSP's control – this should be addressed both in applying the technique and in using the results that it produces; and

- Is accurate, reliable and robust (as discussed in the other principles); and

- Is tried and tested – this means that, in the case of techniques (as opposed to data), they reflect a sound theoretical foundation and be proven to work in a similar regulatory setting.

The fitness for purpose principle should also consider concepts of proportionality. For example:

- Relatively more time and effort should be spent on the relatively more material expenditure items in a Regulatory / Revenue Proposal; and

- The AER will consider the effect of the regulatory burden on NSPs when it makes its data requests and justify its information requests accordingly.

Consistency and predictability

There are three key dimensions to “consistency and predictability”.

First, the same techniques should be applied in similar circumstances. This logically follows as if the AER has found that a particular technique does assist it in undertaking an assessment of whether a forecast amount reasonably reflects the expenditure criteria, that technique should be applied in similar circumstances.

Secondly, a technique should be applied in such a way that it will produce accurate and reliable results over time.

Thirdly, a technique should be adopted if it produces consensus results that generally accord with the results that are produced by other techniques. Where a technique produces outlier results then it should generally not be relied upon to inform decision making. Equally, the AER should avoid cherry-picking the results of the assessment technique that gives the “minimum cost” outcome.

Weighting of techniques

It is possible that several techniques could be used to assess an expenditure category so that there is a need to weight the reliance placed on each technique. The AER will take the following weighting factors into account for this purpose:

- Acceptance – techniques that have broader demonstrated regulatory acceptance and proven effectiveness should be weighted relatively more heavily than alternative techniques;

- Technique limitations – techniques that have few limitations in terms of their accuracy, reliability and robustness should be weighted relatively more heavily than alternative techniques;

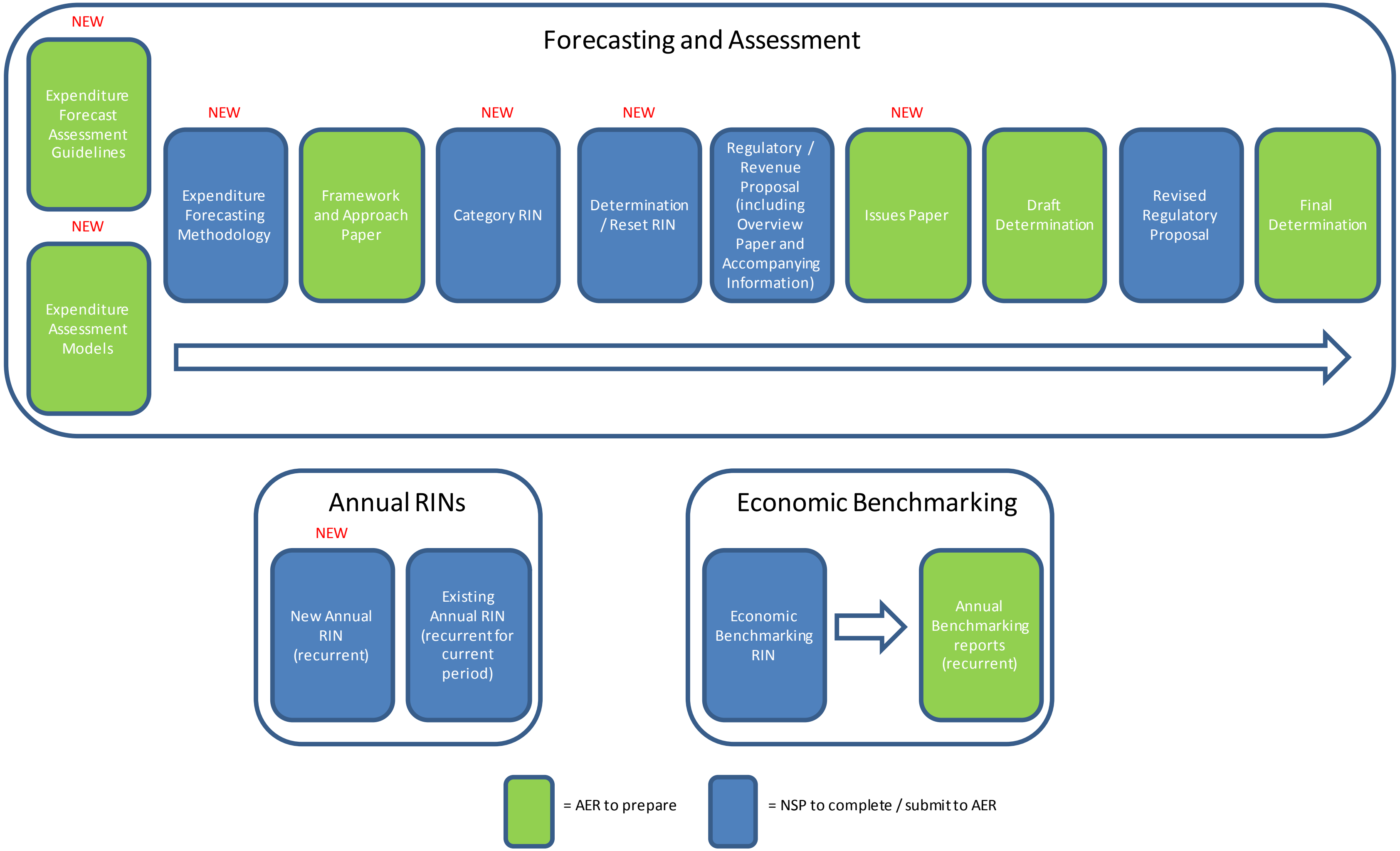
- Data limitations – techniques that uses data that have few limitations in terms of their accuracy, reliability and robustness should be weighted relatively more heavily than alternative techniques that have greater data limitations;

- Corroboration – techniques whose results can be corroborated with the results of other techniques should be weighted relatively more heavily than alternative techniques;

- Accommodating NSPs’ differences – techniques that can accommodate differences in NSPs’ circumstances should be weighted relatively more heavily than alternative techniques; and

- Accommodating exogenous events – techniques that can accommodate the effects of matters outside of an NSP’s control should be weighted relatively more heavily than alternative techniques.

Attachment 3 – Regulatory instruments in the forecast assessment process



ENA's understanding of AER's intended role of regulatory instruments in expenditure forecast assessment process

Instrument	NER / NEL requirement	Role in expenditure forecast and assessment
Expenditure forecast assessment guidelines	NER 6.4.5, 6A.5.6	– Detail the approach the AER proposes to use to assess NSPs' expenditure forecasts as submitted in their regulatory / revenue proposals
Expenditure assessment models		– Provide tools that the AER will use to (a) determine NSPs' relative efficiency (b) determine an NSP's expected efficient costs (c) cross-check the results of / identify issues with other assessment techniques (d) undertake sensitivity and scenario analysis
Expenditure forecasting methodology	NER 6.8.1A, 6A.10.1B	– Detail the methodology the NSP proposes to use to prepare its forecasts in its regulatory proposal
Framework and approach paper	NER 6.8.1(b)(2)(viii), 6A.10.1A(b)(5)	– Detail the AER's proposed approach to applying the Guidelines to a NSP under review – Provide an initial view on whether the AER considers a NSP's historical costs are likely to reflect efficient costs
Category RIN	NEL 28F	– Provide historical information by expenditure category to the AER
Determination / Reset RIN	NEL 28F	– Provide "non-standardised" forecast information to AER to support its expenditure analysis as well as some "standardised" forecast data for benchmarking (i.e. outputs, inputs and environmental variables). This will be the primary instrument to collect information for the reset
Regulatory / revenue proposal and accompanying information	NER 6.8.2(c2), 6A.10.1(h) NER Sch 6.1 and 6.8.2(c)(2), Sch 6A.1 and 6A6.6-7	– Provide information to the AER required by the Guidelines as set out in the framework and approach paper – Provide information to the AER about capex and opex required in building block / revenue proposal

Instrument	NER / NEL requirement	Role in expenditure forecast and assessment
Issues paper	NER 6.9.3(b1), 6A.11.3(b1)	– Identify preliminary issues that the AER considers are likely to be relevant to its assessment of expenditure forecast – Publish a first pass assessment using data from the NSP's proposal, including preliminary advice on whether the AER is likely to accept or adjust a NSP's opex base year. This assessment will involve the use of economic and category analysis benchmarking
Draft determination	NER 6.10 and 6.12.1, 6A.12 and 6A.14.1	– Undertake a full expenditure assessment to make a draft decision on whether or not the AER accepts a NSP's expenditure proposal, having regard for the expenditure objectives, criteria and factors. The Draft Determination will include the total capex and total opex forecasts the AER considers comply with the NER and will also detail what information the AER would require from a NSP to alter its decision in the final determination
Revised regulatory / revenue proposal and accompanying information	NER 6.10.3, 6A.12.3	– Provide information to the AER that incorporates or addresses matters raised by the draft determination
Final Determination	NER 6.11 and 6.12.1, 6A.13 and 6A.14.1	– Undertake a full expenditure assessment to make a decision on whether or not the AER accepts a NSP's expenditure proposal, having regard for the expenditure objectives, criteria and factors. The Final Determination will include the total capex and total opex forecasts the AER considers comply with the NER
Existing Annual RIN	NEL 28F	– Provide historic information to the AER presented on the current basis
New Annual RIN	NEL 28F	– Provide historic information to AER presented on a new basis
Economic Benchmarking RIN (one-off)	NEL 28F	– Provide "standardised" historical data (i.e. input, output and environmental information) by benchmarking category
Annual Benchmarking Reports	NER 6.27 and 6A.31	– Provide the AER's view of the NSPs' relative efficiency and on whether a NSP's historical expenditure is likely to reflect efficient costs