20 September 2013

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
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energex
positive energy

Dear Mr Pattas

**Better Regulation - Draft Expenditure Forecast Assessment Guideline for Electricity Distributors.**

Energex Limited (Energex) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Better Regulation Draft Expenditure Forecast Assessment Guideline for Electricity Distributors (the Draft Guideline).

Energex has a number of concerns regarding the Draft Guideline:

- Energex considers that the purpose of the Draft Guideline is to set out the AER's proposed approach to assessing Distribution Network Service Providers' (DNSPs') expenditure forecasts. However, in a number of instances, the Draft Guideline appears to prescribe the forecasting approach a DNSP should use;
- in Energex's view, the Draft Guideline (and Explanatory Statement) places an over-reliance on benchmarking as a potential means of assessing DNSPs' expenditure forecasts and as the basis to substitute replacement values;
- given the suite of available assessment techniques, Energex considers that the Draft Guideline would benefit from the inclusion of further detail concerning the circumstances under which the AER will apply a particular assessment approach (or combination of approaches);
- Energex considers that the AER's existing incentive-based assessment approach with its resultant revealed costs represents the most effective way of deriving base opex; and
- Energex is concerned that the data requirements set out in the Draft Guideline will be difficult to fulfil and that, where data is able to be provided, there is a significant risk that it will not necessarily be comparable over time or across DNSPs. As a result, Energex considers that the data may not be sufficiently robust to be used to underpin the AER's proposed benchmarking assessments at this point in time.

Each of these issues is discussed further below.

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*Purpose of the Guidelines*

Clause 6.4.5 of the National Electricity Rules (*the Rules*) stipulate that the Expenditure Forecast Assessment Guideline should specify the approach the AER proposes to use to assess the capital and operating expenditure forecasts that form part of the regulatory proposals submitted by DNSPs and its associated information requirements.

Energex considers, however, that the Draft Guideline as currently drafted extends beyond the AER's assessment role into establishing requirements for a DNSP's forecasting methodologies. For example, the Draft Guideline:

- identifies the "base-step-trend" approach as the AER's preferred approach to forecasting opex;
- seeks to pre-emptively determine an opex productivity adjustment; and
- limits the types of step changes that can be proposed by DNSPs.

Energex considers that the inclusion of such prescribed or pre-determined forecasting approaches in the Draft Guideline is inappropriate and effectively extends the scope of the Guideline beyond its intended purpose. The National Electricity Law (NEL) and *the Rules* set out the requirements associated with a DNSP's expenditure forecasts. Provided a DNSP's forecasts comply with these requirements, we consider the role of the Guideline is to set out the AER's approach to assessing the forecasts as they are presented.

Hence, Energex seeks clarification regarding the AER's interpretation of Clause 6.9.1 of *the Rules* such that this provision allows the AER to request that a DNSP re-submit its regulatory proposal if it does not comply with the Guideline.[1]

*Over-reliance on benchmarking*

Energex considers that the Draft Guideline (and Explanatory Statement) places a primary and undue reliance on benchmarking as a potential assessment approach, as well as the means of determining substitute expenditure forecasts. For example, the Explanatory Statement notes that:

> *...if we find a material and unjustified difference between revealed costs and our assessment of efficient costs, we will depart from revealed costs in favour of benchmark costs.*[2]

While Energex accepts that benchmarking is an appropriate assessment technique for the AER to apply, given current data limitations, benchmarking should be confined to providing a high-level reasonableness check of a DNSP's aggregate and/or category-level expenditure forecasts. The AER already undertakes benchmarking of this nature and Energex is open to improvements in the way it is undertaken.

The difficulties associated with the development of benchmarking tools are well established (and previously accepted by the AER). For example, as noted by the Productivity Commission[3], ACCC and AER[4], there is no consensus among either

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1 AER, 2013, Draft Expenditure Forecast Assessment Guideline for Electricity Distribution, August, p.4.

2 AER, 2013, Explanatory Statement - Draft Expenditure Forecast Assessment Guidelines for electricity transmission and distribution, August.

3 Productivity Commission, 2012, Draft Report, Electricity Network Regulatory Frameworks, October.

4 ACCC/AER, 2012, Working Paper 6, Benchmarking Opex and Capex in Energy Networks, May.

academics or energy regulators on the appropriate methods or variables to be included in benchmarking analysis.

Data collected from DNSPs and applied in any benchmarking analysis needs to be consistent across DNSPs and across time, and must be of high quality and absent of errors. The Productivity Commission[5] and AEMC[6] have previously indicated that the AER does not currently have a robust and consistent data set to undertake economic benchmarking. Energex does not consider that the 10 year 'backcasting' exercise the AER is proposing as part of the development of the Expenditure Forecast Assessment Guideline will addresses these data issues.

Energex notes that the AER acknowledges the limitations of the benchmarking techniques and the potential difficulties in collecting the necessary data and ensuring data quality. The AER indicates in the Explanatory Statement that it intends to address these issues through testing and validation of benchmarking techniques and extensive stakeholder engagement to ensure data requirements can be achieved.

However, while Energex accepts that the AER proposes to address the benchmarking deficiencies over time, Energex has serious reservations whether benchmarking techniques (including data) will be sufficiently robust to be used in the manner proposed by the AER, particularly to potentially establish substitute expenditure forecasts, in time for the next round of distribution determinations.

To the extent benchmarking techniques do not accurately reflect a DNSP's network characteristics, cost drivers and cost structure, there is potential for a DNSP's future revenue requirement to be significantly underestimated. Given the potential adverse consequences of regulatory error associated with any mis-application of benchmarking assessments, Energex proposes that benchmarking be confined to high-level assessments for the upcoming distribution determinations.

*Use of different forecast assessment approaches*

The Draft Guideline sets out a range of forecast assessment approaches available to the AER and indicates that the choice of assessment approaches (or combination of approaches) is likely to vary depending on the particular circumstances.

While Energex understands that the AER may be required to exercise its discretion in the selection of a particular assessment approach or in combining (weighting) a number of different approaches, Energex considers that the Guideline should clearly articulate:

- the individual assessment approaches that will be used and describe how each will be applied, including the data required and the models or methods that will be employed; and
- the circumstances under which the assessment approach will be used and what weight it would be given.

Further, given the potential for the exercise of discretion, Energex considers that the Guideline would benefit, at a minimum, from the inclusion of principles to apply in choosing expenditure assessment approaches. Accordingly, Energex suggests that

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5 Productivity Commission Draft Report, 2012, Electricity Network Regulatory Frameworks, October.

6 AEMC, 2011, Review into the use of total factor productivity for the determination of prices and revenues, June.

assessment principles similar to those outlined in the Explanatory Statement be incorporated in the Guidelines.

Energex considers that, provided they are sufficiently high-level, the inclusion of principles in the Guidelines will not inhibit the AER's flexibility to choose an assessment approach. Rather, it would assist DNSPs in understanding the AER's relevant considerations in applying individual assessment techniques or choosing between assessment techniques.

*Operating expenditure assessment*

While the Guideline indicates that the AER's preferred approach to determining base opex is the revealed cost method, the accompanying Explanatory Statement suggests that DNSPs are not responding to expenditure incentives and as a consequence revealed costs may not be efficient. Where this is the case, the AER suggest that base year opex may need to be determined on an alternative basis (eg via benchmarking).

Alternative methods of determining efficient base opex (such as benchmarking) are typically dependent on the quality of the underpinning data to ensure that the unique characteristics of the individual DNSP are adequately incorporated in the analysis. As discussed in the previous benchmarking section, this is likely to be a difficult task, both in terms of capturing comparable data and in accurately reflecting differences across businesses, particularly if the task is undertaken in too hurried a manner.

Energex considers that an incentive-based approach represents the most effective way of deriving base opex. Further, under this approach, the resultant opex costs are more likely to accurately reflect the unique characteristics of the individual DNSP than alternative approaches.

Consequently, Energex proposes that the AER should determine base opex on the basis of revealed costs and, where it considers these costs may not be efficient, focus its efforts on improving the associated incentive mechanisms rather than abandon the revealed cost approach in favour of potentially inferior approaches.

*Information requirements*

The Draft Guideline sets out the information required by the AER to facilitate its expenditure assessments, including a 10 year "backcast" data set. The accompanying Explanatory Statement highlights the importance of obtaining high quality, reliable data for the AER's assessment process.

While the data requirements are extensive, the AER expects DNSPs to provide all the requested data. Where data are unavailable, the AER expects DNSPs to make assumptions or exercise judgement in order to compile the required data set, as well as gain an auditor's 'sign off' for this data.

Given the potential uses of the required data by the AER, including determining whether or not revealed costs should be applied as the basis for expenditure forecasts, it is essential that the data is of the highest quality.
Energex has a number of concerns with the AER's data requirements, most notably:

- Energex considers that, to facilitate comparisons over time and between DNSPs, it is essential that the AER develop Regulatory Accounting Guidelines that set out in detail the AER's regulatory accounting and

assurance requirements in relation to the provision of historic and forecast financial information, in particular, under its RINs and RIOs;

- Energex anticipates significant difficulties associated with the provision of backcast data, including the fact that some data has not been previously collected or reported. The AER's requirement for all data to be provided means that some data will require estimation. Such an approach is likely to significantly undermine data quality and consistency, particularly if each DNSP were to apply different assumptions in deriving its historical estimates. This may require the AER to specify a standard approach to the derivation of individual data items where estimates may be required;
- Given the importance of the data (including the potential to impact future revenue), Energex considers that all data, both financial and non-financial, provided for the purpose of benchmarking must be audited against a clearly defined standard. Energex is concerned that a significant amount of the proposed historical data will be particularly difficult to provide to an auditable standard. Further, where it is necessary for Energex to estimate information, we would not expect that an auditor would be able to attest to the appropriateness of the assumption underpinning the estimate. Thus any audit is effectively rendered irrelevant in the context of providing comparable data across DNSPs.

Energex notes that where it is not able to gain an unqualified audit opinion on the 'backcast' data, it will not be able to obtain Directors' sign-off and, as a consequence, will be unable to provide the associated data in the way the AER requires in the Draft Guideline.

Finally, The Energy Networks Association (ENA) will be making a submission on behalf of its members. As a member of the ENA, Energex supports the ENA's submission.

If you have any questions about this request, please contact Nicola Roscoe, Revenue Strategy Manager - Network on 07 3664 5891.

Yours sincerely

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