

22 January 2014

Mr Chris Pattas
General Manager
Network Operations and Development
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Attention: Lawrence Irlam

Dear Chris

AER Draft Category Analysis Regulatory Information Notice (RIN)

Grid Australia lodged a submission on 17 January 2014 in response to the AER's consultation on its draft Category Analysis Regulatory Information Notice (RIN). To further assist the AER in finalising its Category Analysis RIN, Grid Australia has obtained an independent expert opinion from Geoff Swier, Director, Farrier Swier Consulting, which is attached to this letter.

Geoff Swier has substantial national and international regulatory experience, including as a Government policy adviser, as a former member of the AER and as an Associate Commissioner of the ACCC. Grid Australia submits Geoff's opinion to the AER for your consideration, noting in particular the following recommendations and observations:

- The AER should provide a clearer statement of purpose for the Category Analysis RIN.
- The AER should apply a more comprehensive analysis framework, explicit criteria and a consistent approach to materiality, to determine the appropriate scope of the information request.
- The RIN attempts a large amount at the one time. The AER should consider adopting a more targeted approach to implementation.
- Requiring TNSPs to estimate historical information that is not readily available may not provide meaningful information on which the AER can rely, and may damage the integrity of regulatory decision-making.

Given the important matters raised by Geoff, Grid Australia would appreciate the opportunity to work with the AER to finalise the Category Analysis RIN. Grid Australia considers that a joint approach is the best method for ensuring that the RIN appropriately balances the competing objectives of providing better, consistent data to the AER, and also managing the

costs and practical limitations of providing substantial amounts of information within a short timeframe. In this regard, Grid Australia notes that the issue of materiality and the possible evolution of the RIN over time are important matters to consider.

If you have any queries in relation to this submission, please contact Andrew Kingsmill on (02) 9284 3149 in the first instance.

Yours sincerely



for

Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

Encl.

Australian Energy Regulator TNSP Category Analysis RIN Requirements

Geoff Swier, Director, Farrier Swier Consulting

Expert Opinion prepared for Grid Australia

21 January 2014

I. Introduction

Grid Australia¹ has requested an expert opinion as to:

“whether the AER’s information requirements for the Category Analysis Regulatory Information Notice (and associated templates and Explanatory Statement) for transmission is reasonable and proportionate to the issue at hand, both in the context of providing historical data (5-years) in the timeframe and going forward”

The structure of this expert opinion is as follows.

- Key points (Section 2).
- Assessment of the basis for the information requirements of the draft Category Analysis Regulatory Information Notice (CA RIN) (Section 3)
- Assessment of the approach for introducing the CA RIN (Section 4)

Attachment 1 sets out my expertise, experience and background.

¹ Grid Australia represents the owners of Australia’s electricity transmission networks in the National Electricity Market, plus Western Australia.

2. Key points

2.1 The basis for the information requirements of the draft CA RIN

1. The ultimate purpose of the CA RIN is not sufficiently clear or precise; the AER should provide a single statement in the Explanatory Statement and/or the RIN on the ultimate purpose of the CA RIN.
2. I do not consider the scope or nature of the analysis justifying the draft CA RIN information requirements to be sufficiently comprehensive or robust in light of the burden on TNSPs. Specifically:
 - The cost benefit analysis is (by necessity) high level and largely unquantified
 - There is an absence of other supporting analysis or tools to justify the AER's decisions.

Cost benefit analysis should be supplemented by a more comprehensive analysis framework to justify the AER's decisions.

3. I consider the lack of establishing and applying explicit criteria as a basis for the specific information requirements represents a shortfall in the draft CA RIN. In particular, the lack of a holistic, consistent approach to materiality may lead to excessive demand for information and ultimately unnecessary costs to consumers.
 - a) The AER should define explicit criteria for including specific information requirements in the CA RIN, and consistently reference these criteria in designing, implementing and reviewing the RIN.
 - b) The AER should establish a holistic approach to materiality as a design criteria and consistently apply the criteria to all categories.
4. I consider that the draft CA RIN does not explicitly contemplate that the information requirements should evolve. The AER should embed a process for reviewing and amending the CA RIN.

2.2 The approach for implementing the CA RIN

5. I consider that too much is being attempted at once. The AER should consider adopting a targeted approach to implementation.
6. I consider that requiring the TNSP's to estimate historical information, which is not readily available, may not necessarily provide meaningful information on which the AER can rely and may damage the integrity of its decision making. I suggest the AER consider
 - a) allowing a more staged approach to ensure such limitations are able to be better understood
 - b) changes to the RIN requirements for estimated data to enable the AER to better understand the risk of error.

7. The collection, estimation and auditing of the required information within three months appears challenging and may compromise the quality of certain data. I suggest the AER consider:
 - a) working together with TNSPs and adopting a lenient approach for technical non-compliance with the CA RIN requirements
 - b) deferring requirements for provision of information which is difficult to collect or of more marginal benefit; and
 - c) deferring auditing requirements for historic information.

3. The basis for the information requirements of the draft CA RIN

3.1 Approach

I have been asked whether the CA RIN (and associated templates and Explanatory Statement) for transmission is reasonable and proportionate to the issue at hand.

My approach to answering this question and interpreting “reasonable” and “proportionate” in the context of the CA RIN is outlined below.

I have considered the relevant statutory requirements and principles for best practice regulation.

Statutory requirements

The AER must, in determining the CA RIN requirements, comply with certain provisions in the National Electricity Law (NEL). The AER:

- may issue a RIN if it considers this is reasonably necessary for the performance or exercise of its functions under the NEL or National Electricity Rules (Rules)²
- must have regard “to the matter to be addressed”³
- must “have regard to the likely costs” in complying with information notice or order.⁴

There are also certain procedural requirements. The AER must provide an opportunity for NSPs to be heard before a RIN is served.⁵

² S28F(1) (a) NEL.

³ S28F(2) (a) NEL.

⁴ S 28F(2) (b) NEL.

⁵ S 28 J NEL.

In my view, the drafting of the relevant statutory provisions gives a high level of discretion to the AER on the interpretation of “reasonable” and “proportionate”.

Principles of Best Practice Regulation

I consider that, acting as a good economic regulator, the AER should also be guided by the principles of best practice regulation.

There are a number of sources of best practice regulation, which are broadly similar in their scope and intent. I consider that the following principles⁶ of best practice regulation are particularly relevant to the CA RIN information requirements:

- Adopting the option that generates the greatest net benefit for the community
- Providing effective guidance to regulated parties in order to ensure that the policy intent and expected compliance requirements of the regulation are clear
- Ensuring that regulation remains relevant and effective over time

3.2 Analysis

- 1. The ultimate purpose of the CA RIN is not sufficiently clear or precise; the AER should provide a single statement in the Explanatory Statement and/ or the RIN on the ultimate purpose of the CA RIN.*

I consider there is risk of (1) the AER losing sight of the fundamental purposes of the CA RIN information by not clearly setting out the purpose in the Explanatory Statement; (2) the AER and stakeholders having an inadequate basis for judging the medium and long term success of the CA RINs and (3) there being an unclear basis for undertaking future reviews.

In my view, the *Draft Regulatory Information and Explanatory Statement – draft RINs for expenditure category analysis* has an incomplete discussion of the purpose of the CA RINs. The Explanatory Statement for example states:

The aim of the expenditure data templates contained within these two sets of RINs (referred to collectively as the "category templates / data") is to collect a consistent, standardised time series of expenditure and related drivers or volume measures.

The main use of this information is to conduct trend and benchmarking analysis, which will be supplemented by other information collected at the time of the reset for each NSP, as well as in ad hoc requests leading up to the publication of our new benchmarking reports.⁷

⁶ These principles have been drawn from pg 4, COAG *Best Practice Regulation: A Guide for Ministerial Councils and National Standard Setting Bodies*, October 2007.

⁷ pg 12 Final Expenditure Forecast Assessment Guideline.

This can be compared with the AERs explanation in the *Expenditure Forecast Assessment Guidelines*⁸, which, in my view, has a much clearer and more precise description of the purpose and context of the CA information requirements. For example, in this document the AER states that it intends to use the issues papers step in the determination process to publish a ‘first pass’ assessment, which will indicate its preliminary view on the NSP’s proposal.

This first pass assessment will typically involve high level expenditure assessment (using economic benchmarking and category analysis) and consideration of the NSP’s performance in the most recent annual benchmarking report.

It will enable us to identify and engage with stakeholders on key issues early in the determination process.

Category or driver-based analysis will assist in determining an efficient level of expenditure in a particular category of expenditure. The techniques included in this analysis include benchmarking, modelling and engineering reviews. We can use this analysis to contrast and compare factors influencing expenditure across NSPs.

It is important in my view to keep a focus on the use of category analysis in the ‘first pass’ of analysis, because benchmarking generally suffers from significant limitations and generally cannot be relied on by itself to make a firm conclusion on the efficiency of expenditure. It needs to be used together with other assessment tools including engineering and technical expert reviews.

2. I do not consider the scope or nature of the analysis justifying the draft CA RIN information requirements to be sufficiently comprehensive or robust in light of the burden on TNSP’s. Specifically:

- a. *The cost benefit analysis (by necessity) is high level and largely unquantified*
- b. *There is an absence of other supporting analysis or tools to justify the AER’s decisions.*

⁸ The AER also states that category analysis will have other benefits through improving the regulatory process for all stakeholders by:

- producing savings in administrative, legal and consultancy costs for the AER, NSPs and other stakeholders. The AER considers that increased transparency and consistency in regulatory process will reduce the costs of all parties associated with legal scrutiny, with potentially fewer and/or more limited appeals
- streamlining data collection and compliance processes
- reducing the ambiguity around the reason the AER requires certain information to assess regulatory proposals
- better informing users about matters which may affect their interests, thus enabling them to better engage and further their own interests through the regulatory process.

It may also be beneficial from regulatory efficiency perspective to set these benefits in the CA Explanatory Statement so that over time the AER can review if these benefits are actually being achieved.

Cost benefit analysis should be supplemented by a more comprehensive analysis framework to justify the AER's decisions.

As set out in the statement of reasons, the AER has justified the draft CA RIN requirements on the basis of high level but (necessarily) unquantified cost benefit analysis. In this context, cost benefit analysis involves judgment and it is difficult or impossible to reduce the analysis to quantifiable outputs which are sufficiently robust and credible on their own to underpin the AER's decisions.

Given the acknowledged significant burden the information requirements imposes on TNSPs and the public interests of stakeholders in the information requirements, in my view the cost benefit analysis should be supplemented by a more comprehensive and structured framework to justify the AER's decisions. This is discussed further below.

3. *I consider the lack of establishing and applying explicit criteria as a basis for the specific information requirements represents a shortfall in the draft CA RIN. In particular, the lack of a holistic consistent approach to materiality may lead to excessive demand for information and ultimately unnecessary costs to consumers.*
 - a. *The AER should define explicit criteria for including specific information requirements in the CA RIN, and consistently reference these criteria in designing, implementing and reviewing the RIN.*
 - b. *The AER should establish a holistic approach to materiality as a design criteria and consistently apply it to all categories.*

My reading of the Explanatory Statement indicates that the AER has implicitly, and to some extent, taken into account a number of what can be termed "design criteria" to guide its draft decision on the information requirements in the CA RINs. However, these criteria are not explicit or applied consistently; therefore arguably this may result in some disproportionate/unreasonable information requirements.

In my view, in its final explanatory statement, the AER should formally set out the design criteria it has adopted for determining the CA RIN information requirements.

These design criteria would take into account the statutory requirements noted above, and in particular would address relevant principles of best practice regulation.

The reasons for this include: avoiding gaps and inconsistencies in the design of the regime and instrument; enhancing consistency across different categories of data; and (as above) enhancing transparency to support future assessments of the success of the regime and to facilitate reviews.

The following two examples illustrate these points.

- materiality criteria have been established for determining the level of data disaggregation for some (but not all) information requirements⁹
- the reason for collecting some data is to populate models (in particular the repex¹⁰ model) which will be used amongst other things to generate alternative forecasts.¹¹ If the modelling analysis is deemed not to be useful, then the rationale for the data requirement may no longer hold.

These are discussed below.

Materiality

The draft CA RIN establishes materiality thresholds for augex expenditure that define the level above which disaggregated data is required. While the exact level of the threshold can be debated, the concept of a materiality threshold is sound - it reflects the “proportionality” principles of best practice regulation, and is consistent with best practice in similar areas (such as statutory accounting audits).

There is no analogous materiality threshold for aggregation of data for non-network capex. For example, a very high level of disaggregation is required for reporting of motor vehicle costs regardless of materiality.

In my view, it would be more consistent with best practice regulation for the regime design¹² to establish an overall approach to materiality and apply this on a reasonably consistent basis across all proposed categories of information. Following this approach, for example, this would lead to question about the benefits for such high levels of disaggregation of motor vehicle costs.

Assumption that repex modelling will be beneficial

The AER makes it clear that one purpose of collecting replacement cost data is to enable application of repex modelling techniques¹³ to help assess the efficiency of capital expenditure.

I understand that it is an open question as to whether repex modelling of TNSPs will produce sufficiently useful and credible results to justify such modelling on an ongoing

⁹ For example information on repex project data for substations and lines include a materiality threshold of \$5 million of total cumulative expenditure.

¹⁰ The AER may potentially also undertake augex modelling in future.

¹¹ See for example section 4.2.2 of the Explanatory Statement – Draft RIB for expenditure category analysis.

¹² That is, providing effective guidance to regulated parties in order to ensure that the policy intent of the regulation is clear.

¹³ The general data requirements reflected in the draft RIN with respect to repex reflect information necessary to conduct replacement expenditure modelling, and provide for monitoring of replacement volumes across time and NSPs. (Section 5.2.1 Explanatory Statement – Draft RIN for expenditure category analysis)

basis. It may be the case that experience will suggest that traditional engineering review approaches may need to be relied upon.

In my view the Explanatory Statement should, following best practice regulation design, clearly set out the assumptions on which particular information requirements are premised. This will ensure that any doubts about the modelling techniques (for which some data is being collected) can be tested against the assumptions in future reviews of the category analysis regime.

4. I consider that the draft CA RIN does not explicitly contemplate that the information requirements should evolve. The AER should embed a process for reviewing and amending the CA RIN.

The draft CA RIN requirements involve a major change to current practices, and there will be significant learnings. The AER should establish a process for reviewing experience and amending the information requirements to reflect any learnings.

4. The approach for introducing the CA RIN

4.1 Approach

The AER proposes that the TNSPs will be advised of the final CA RIN requirements in late February / early March and must submit audited information by 31 May 2014.

I have considered whether the timeframe and approach to implementation of the CA RIN is reasonable from a practical perspective.

4.2 Analysis

5. I consider that too much is being attempted at once. The AER should consider adopting a targeted approach to implementation.

There has been long standing concern by the TNSPs that too much is being attempted at once. Industry concerns with the consultation process are discussed in section 1.2.2 of the *Explanatory statement - Draft regulatory information notices to collect information for category analysis*. The AER acknowledges that:

It would have been desirable to commence more detailed consultation on category analysis templates at an earlier stage, however, commencing this process in August

was necessitated by having to reach firm positions on the assessment approach, as expressed in the draft Guideline.¹⁴

Despite this it concludes:

..... Overall we made the best use of the limited time available through workshops, bilateral meetings and direct information exchanges and discussions with NSP staff as outlined above. We consider this has enabled us to reach a solid landing on the draft RINs and this should allay NSP concerns.

In my view, the compressed consultation timeframe and the pressures to introduce the new CA RIN requirements, mean that it is arguably more important that the AER take a pragmatic approach to balance the quality and reliability of the new CA RIN data that can be produced at the current time.

The AER should consider adopting a more pragmatic and targeted approach to implementation for the CA Information to be provided on 31 May 2014. This is discussed further below.

6. *I consider that requiring the TNSP's to estimate historical information, which is not readily available may not necessarily provide meaningful information on which the AER can rely and may damage the integrity of its decision making. I suggest the AER consider*
- a. *allowing a more staged approach to ensure such limitations are able to be better understood*
 - b. *changes to the RIN requirements for estimated data to enable the AER to better understand the risk of error.*

The draft CA RIN requires historical information to be collected for the last five regulatory years. I understand that there are cases where the historical information requested is not currently collected at all by TNSPs, or the information currently collected is not in the form required by the AER, and so the CA RIN information would need to be estimated and /or based upon high-level allocation rules (Estimated Information).

The draft RIN requires that where historical information needs to be estimated that the TNSP

explain why an estimate was required, and the basis for the estimate, including the approach used, assumptions made and reasons why the estimate is the TNSP's best estimate.¹⁵

¹⁴ pg 23 Explanatory statement - Draft regulatory information notices to collect information for category analysis.

¹⁵ S1.2)d) (ii) Schedule 2, Draft Regulatory Information Notice

In principle I agree that collection of historical information supports the purposes of the regime, in particular the development of trend analysis, which can be useful in informing planning of a regulatory review. Also, I note that the problem identified by the TNSPs should resolve itself over time as information systems are put in place to collect the required actual information (providing such information is itself useful and meaningful).

I understand that a TNSP could make a valid best estimate but this may still involve risk of error. If there are reasons to believe the estimate may have significant error then the AER ought not to place significant reliance in the estimate in its analysis. In addition, there is sometimes a trade-off between the robustness of the estimate and the cost of preparing it. If it is considered that certain information is sufficiently valuable then it may be worth more investment to obtain a more accurate estimate.

Options for resolving this problem include:

1. Status quo- The TNSPs preparing best estimates for all information as required by the draft RIN.
2. As for 1, but the TNSP explicitly being required to provide commentary on the robustness of the best estimate i.e. the risk that a best estimate could be an error.¹⁶
3. The TNSPs not being required to prepare information for the 31 May 2014 returns where they believe an estimate would be subject to significant error. In this instance, the TNSP should engage in discussions with the AER on how to address the gaps in the information (including whether it is still considered as necessary) and submitting the estimates for the subsequent return period.

The choice of option is interrelated with the challenges created by the short time frames for preparing and auditing the CA RIN information as discussed in the next section.

7. *The collection / estimation and auditing of the required information within three months appears challenging for the TNSPs and may compromise the quality of certain data. I suggest the AER consider:*
 - a. *working together with TNSPs and adopting a lenient approach for technical non-compliance with the CA RIN requirements*

¹⁶ It is not clear to me that

- (a) if the AER is provided with the “basis for the estimate, including the approach used, assumptions made and reasons why the estimate is TNSP’s best estimate ...” that it is necessarily best placed to identify areas where a best estimate is at risk of significant error; and
- (b) this requirement provides sufficiently clear guidance on the TNSP to provide commentary on whether its best estimate might be at risk of significant error.

- b. deferring requirements for provision of information which is difficult to collect or of more marginal benefit; and*
- c. deferring auditing requirements for historic information.*

I carried out a very high level review of the size and scope of the information template. I understand that TNSPs are concerned about the extent of the requirements, and the additional systems and resources that will be required to collect and prepare the information, in particular certain historical information.

In my view the ability of individual TNSPs to provide the information to the expected standard will vary. This will depend on the current information and record keeping systems and their alignment to the new requirements; the institutional knowledge and skill of key staff; the size of the organisation; the availability of spare resources and the extent of preparation work that has already been undertaken. In addition, bedding down the new auditing requirements will take considerable effort and there may be competing resource requirements for finalising and auditing other regulatory reporting obligations and year end accounts.

Therefore, in my judgement it may be unrealistic to expect that the provision of the currently required information by 31 May 2014 will be of consistently high quality and enable the AER to place reliance on any analysis of that information.

The options for addressing this problem include:

1. The AER could work with the TNSPs as far it can, but would reserve its right to proceed with enforcement action for significant non-compliance. This could be termed a threat of enforcement approach.
2. The AER and TNSPs could agree to proceed to complete the information requirements on some agreed best efforts basis which recognises that the information will not be perfect and further work will be required to improve it for the subsequent return period; this may also set out priorities for the required work. This could be termed a “working together approach.” Subject to legal advice, this could be augmented by the AER issuing some form of “no action” letter for technical non-compliance.
3. Both 1 and 2 could additionally include specific deferrals for provision of certain information, in particular historical information which is difficult to collect (see previous section) or which is of more marginal benefit (for example detailed disaggregated information on non-network costs). This could be termed “selective deferral approach.”
 - a) Under this option, the AER may be concerned that it results in unnecessary slippage.
 - b) The TNSPs (both collectively and individually) could address this concern through providing detailed explanation of the challenges in providing certain information and why provision of the information should be deferred; and a specific proposal as to when it would be provided.

4. Both 1 and 2 could include deferrals of implementing auditing requirements for historic information

In my view option 2 probably augmented by options 3 and 4 are most appropriate given the magnitude of the changes required and the short time the TNSPs have to prepare the information and have it audited.

There may be a risk to the AER's reputation as being a fair and reasonable regulator if it pursues compliance actions in such challenging circumstances.

Attachment I. Geoff Swier, Curriculum Vitae

I am a Director of Farrier Swier Consulting a utility consulting firm based in Melbourne. I have an M.Com in Economics. Currently I am also a director of Trustpower (NZ) Ltd and a member of the National Electricity Market Dispute Resolution Panel.

Previously I have been a member of the Australian Energy Regulator and an Associate Commissioner of the Australian Competition and Consumer Commission (ACCC).

I have provided regulatory and policy advice in the energy and water industries in most states of Australia as well as New Zealand. I have also worked in energy sector regulation and reform in Indonesia, Singapore, Philippines and China. I have been appointed to government expert panels to provide policy advice. From late 1993 to 1999, I was the deputy project leader for the Victorian electricity and gas reform process. I subsequently participated in developing and implementing reforms to the Australian national electricity and gas markets.

I have provided number of expert opinions on energy industry regulatory design questions and have been a member of several Dispute Resolution Panels.

Other previous roles include: director of VENCORP (1999-2001), Victorian representative on the National Grid Management Council (1995); policy director for a board established by the New Zealand government to oversee the reform of the New Zealand public hospital system (1992-93), and economic adviser to the New Zealand Minister of State Owned Enterprises (1990) and New Zealand Minister of Finance (1984-87).