grid australia
BACKBONE OF THE NEM

20 September 2013

Mr Chris Pattas
General Manager – Network Operations and Development
Australian Energy Regulator
GPO Box 520
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Via email: expenditure@aer.gov.au

Dear Chris

Draft Expenditure Forecast Assessment Guideline

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Regulator (AER) on its Draft Expenditure Forecast Assessment Guideline.

For operating expenditure, Grid Australia supports the proposal to rely on revealed costs for setting expenditure forecasts where it is appropriate to do so. This gives proper recognition to the role of incentives in the framework. Grid Australia also supports benchmarking being used predominantly as a filtering tool and not as a determinative tool for setting expenditure allowances. This approach recognises the significant limitations that exist for the application of benchmarking, particularly for TNSPs, and that the robustness and applicability of the AER's foreshadowed economic benchmarking models have not yet been adequately demonstrated.

The key points raised in this submission are as follows:

- For the guideline to achieve its intended purpose, significantly more detail is required on the AER's expected approach to assessing forecast expenditure proposals and the application of related assessment techniques.
- Grid Australia supports a TNSP specific guideline. However, the current guideline does not recognise the necessary differences in approach that exist between transmission and distribution.
- Each of the benchmarking techniques identified by the AER, multilateral total factor productivity (MTFP), data envelopment analysis (DEA), and economic benchmarking are highly unsuitable for application to TNSPs.
- The National Electricity Rules require that the starting point for assessing expenditure forecasts must be a TNSP's revenue proposal. However, the Explanatory Statement and guideline, disproportionately focus on the derivation of the AER's own estimate of efficient costs.

- The implied threshold the AER imposes for itself to reject an expenditure forecast cannot be lower than that required by the Rules; i.e. the AER must accept a proposal that is reasonable having regard to the expenditure criteria and factors.

- Statements in the Explanatory Statement suggest an overly narrow focus on expenditure categories may be applied by the AER. The AER needs to clearly state how it will have regard to the interactions that occur between capital and operating expenditure or categories of expenditure.

- Caution is required to ensure that the application of a productivity factor does not compromise the integrity of the expected rewards under the EBSS or the recovery of efficient costs. Only those efficiencies that are exogenous to the business, and hence do not derive from management effort, should be captured within the productivity factor.

- Adjustments that are made to base year expenditure should be transitioned over the period rather than applied in a single year to ensure there is not undue pressure to achieve reduced expenditure allowances that could compromise reliability of supply.

- Operating expenditure that is not well suited to revealed costs, such as lumpy expenditure, one off costs or where expenditure is efficiently higher than revealed costs, should be subject to a different and fit-for-purpose forecasting approach and a modified EBSS that is consistent with that forecasting approach.

Grid Australia has also provided submissions to the proposed Efficiency Benefits Sharing Scheme and the Capital Expenditure Incentives Guideline. Given these address related matters they should also be considered in conjunction with this submission.

Grid Australia members are also members of the Energy Networks Association (ENA). As such, this submission primarily addresses transmission related matters and should be read in conjunction with the submission provided by the ENA.

This Grid Australia submission is supported by an expert report from NERA Economic Consulting entitled *Holistic Economic Benchmarking – A report prepared for Grid Australia*.

If you would like to discuss any aspect of this submission, please contact Andrew Kingsmill on 02 9284 3149 or alternatively I can be contacted on 08 8404 7983.

Yours sincerely

Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

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BACKBONE OF THE NEM

AER Better Regulation Program

Submission in response to Draft Expenditure Forecast Assessment Guideline

September 2013

Powerlink Queensland | TransGrid | ElectraNet | TRANSEND | SP AusNet

Table of Contents

1. Introduction and summary of key issues

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Regulator (AER) in response to its Draft Expenditure Forecast Assessment Guidelines (EFA Guidelines). As the AER is aware, Grid Australia is the organisation which represents the owners of Australia's electricity transmission networks. The approach taken to assess future expenditure requirements is critical to TNSPs maintaining the efficient delivery of services to customers and the long-term sustainability of network businesses. Therefore, TNSPs have a strong interest in ensuring that the EFA Guideline delivers a positive contribution to the application of economic regulation.

As the 'backbone' of the National Electricity Market (NEM), Grid Australia members seek to work closely with institutions such as the AER to ensure the regulatory framework promotes an efficient and reliable electricity network for electricity consumers. As such, the consultative approach the AER has taken to date for the development of the new guidelines is welcomed.

For operating expenditure, Grid Australia supports the proposal to rely on revealed costs for setting expenditure forecasts where it is appropriate to do so. This gives proper recognition to the role of incentives in the framework. Grid Australia also supports statements that indicate that benchmarking will be used predominantly as a filtering tool and not as a determinative tool for setting expenditure allowances.[1] This approach recognises the significant limitations that exist for the application of benchmarking, particularly for TNSPs, and that the robustness and applicability of the AER's foreshadowed economic benchmarking models have not yet been adequately demonstrated. Grid Australia notes, however, that at times the AER appears to suggest a more determinative role for benchmarking. The guideline needs to be clear, therefore, that its role is limited to a filtering tool.

Given the importance of certainty and predictability in regulation, Grid Australia requests that the AER clarify, across each of the guidelines that form part of the Better Regulation work program, the process it will take to make, and apply, amendments to the guidelines. It is essential for a well-functioning regulatory framework, and in particular the effectiveness of financial incentives, that NSPs have full knowledge of the scope of the incentive up-front and confidence that the AER will commit to an approach to regulation for the duration of a regulatory period. This means clearly stating that changes to the regulatory approach will only apply on a prospective basis and following a comprehensive, and inclusive, consultation process.

1 AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.43.

Grid Australia has also provided submissions to the proposed Efficiency Benefits Sharing Scheme (proposed EBSS) and the Capital Expenditure Incentives Guideline (CEI Guideline). Given these address related matters they should also be considered in conjunction with this submission.

Grid Australia members are also members of the Energy Networks Association (ENA). As such, this submission primarily addresses transmission related matters and should be read in conjunction with the submission provided by the ENA.

1.1 Summary of key issues

The key points raised in this submission are as follows:

Overarching issues

- For the EFA Guideline to achieve its intended purpose, significantly more detail is required on the AER's expected approach to assessing forecast expenditure proposals and the application of related assessment techniques. Much of the material in the Explanatory Statement would be better promoted into the guideline itself. There is also a need for the AER to set out its approach on some matters that are not presently addressed in either document. Examples of such matters are identified throughout this submission.

- Grid Australia supports a TNSP specific guideline. However, the current guideline does not recognise the necessary differences in approach that exist between transmission and distribution. For example, the limited sample size given the small number of TNSPs in the NEM and their large and lumpy investment profile suggests that specific expert project reviews have a far more significant role than for distribution. A TNSP specific guideline provides an opportunity for this to be set out in a transparent manner.

- Each of the benchmarking techniques identified by the AER, multilateral total factor productivity (MTFP), data envelopment analysis (DEA), and economic benchmarking are highly unsuitable for application to TNSPs. This is because it is not possible to develop a meaningful data set for these techniques with the limited number of TNSPs in the NEM, or to establish valid statistical confidence intervals in the benchmarking results. The TNSP specific guideline should expressly acknowledge these limitations, recognising that a principled assessment of the techniques would see them ruled out for application to TNSPs.

Approach to assessing expenditure forecasts

- The National Electricity Rules (Rules) require that the starting point for assessing expenditure forecasts must be a TNSP's revenue proposal. The Explanatory Statement and guideline, however, disproportionately focus on the derivation of the AER's own estimate of efficient costs. Both the AER's and the

TNSP's estimate may be reasonable in accordance with the Rules, therefore, the task for the AER is to demonstrate how it will justify its decisions by reference to the revenue proposal.[2]

- The implied threshold the AER imposes for itself to reject an expenditure forecast cannot be lower than that required by the Rules; i.e. the AER must accept a proposal that is reasonable having regard to the expenditure criteria and factors. Alignment with a statistically derived efficiency frontier or AER derived estimate is not necessary, or consistent with the Rules.

- Statements in the Explanatory Statement suggest an overly narrow focus on expenditure categories may be applied by the AER.[3] The AER needs to clearly state how it will have regard to the interactions that occur between capital and operating expenditure or categories of expenditure.

- Caution is required to ensure that the application of a productivity factor does not compromise the integrity of the expected rewards under the EBSS or the recovery of efficient costs. Only those efficiencies that are exogenous to the business, and hence do not derive from management effort, should be captured within the productivity factor. Consequently, the most appropriate assumption about future productivity growth in operating expenditure would be to seek to capture productivity growth that would arise from realising economies of scale.

- Adjustments that are made to base year expenditure should be transitioned over the period rather than applied in a single year. Doing so will ensure there is not undue pressure to achieve reduced expenditure allowances that could compromise reliability of supply.

- Operating expenditure that is not well suited to revealed costs, such as lumpy expenditure, one off costs or where expenditure is efficiently higher than revealed costs, should be subject to a different and fit-for-purpose forecasting approach and a modified EBSS that is consistent with that forecasting approach.

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2 The requirement that the AER justify its decisions by reference to the revenue proposal was made clear by the AER in its final Determination for the Economic Regulation of Network Services Rule change proposal, see: AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, p.112.

3 AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.123.

2. Scope and objective of the guidelines

It is essential for the successful implementation of the regulatory framework that the AER produce guidelines that strengthen the certainty and transparency of the regulatory process, and in doing so, minimise the overall costs of regulation.[4] The EFA Guideline, as presently drafted, does not provide the level of guidance that is sought by industry and other stakeholders. The current drafting provides little detail on the process the AER will follow and how it will make decisions in the context of its Rule requirements.

Grid Australia encourages the AER to reconsider the scope of the EFA Guideline and the information provided within it. To that end, a first step should be to promote much of the material set out in the Explanatory Statement into the guideline itself. In particular, those sections of the Explanatory Statement that address the principles for choosing between assessment techniques should be promoted into the guideline.

2.1 The role of guidelines in economic regulation

The regulatory framework consists of legislation which guides the overall objectives of the framework, and Rules which specify the methodology for the determination of revenue caps. Guidelines sit underneath these instruments. They outline how the regulator intends to exercise its discretion in accordance with the Rules and the Law.

The role of guidelines in the context of economic regulation is to:

- Ensure that the regulator objectively considers the approach it is going to take to exercise its discretion, including the evaluation of alternative approaches
- Provide consistency, predictability, and transparency about the approach that will be taken, and
- Potentially reduce the risks of regulatory error by seeking to have regulated businesses, customers and the regulator 'on the same page' when it comes to the communication of proposals and the regulatory approach to assessing those proposals.

Grid Australia contends that the AEMC's intention for the development of the guidelines will be lost if the above objectives are not achieved by the AER through this process. Specifically, the AEMC was clear when making the Economic Regulation of Network Service Providers Rule that the role of early engagement between NSPs and the AER, including the development of guidelines, was to

[4] The importance of these objectives in the regulatory framework was noted by the AEMC recently in the Rule change that led to the requirement for the EFA Guideline, see: AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, p.114.

streamline the regulatory process. This, however, can only be achieved by the AER clearly setting out its intended approach in advance:[5]

> *The Commission views the early engagement with NSPs, as well as broader industry engagement in developing the guidelines, as beneficial. It will potentially save time and effort for both parties once the regulatory process has commenced.*

2.1.1 Deciding on the contents and scope of the guideline

Guidelines will only be useful to businesses, customers, and the regulator itself where they provide more information and guidance than is provided for in Rules or legislation. It is Grid Australia's view that this is best achieved by the AER setting out in the guideline the approach it is minded to take when assessing expenditure forecasts. Specifically, Grid Australia requests the AER to clearly set out its approach on the following matters:

- The process it will follow, including intended outcomes at each of the different formal stages of consultation
- The questions it will ask
- The information it will look for to make its decisions
- The assessment techniques it might apply at each stage and the criteria for choosing between various techniques, and
- The principles it will apply when exercising its discretion, including those it will apply when deciding to depart from the guidelines.

The AER has made comment on many of these matters in its Explanatory Statement. However, by not promoting this material to the guideline the transparency, certainty and effectiveness of the regulatory framework is substantially diminished. In the first instance, this is because the Explanatory Statement is not a document that is explicitly referenced in the Rules. Therefore, there can be no expectation that stakeholders will seek it out for guidance in the future. Further, because the Explanatory Statement addresses a wide variety of matters, such as comments from submissions and the comparison of alternative approaches, it is very difficult to draw out those sections of the Explanatory Statement that relate directly to the AER's preferred approach on different matters.

If the AER is concerned about maintaining appropriate discretion and flexibility in its approach, the promotion of elements of the Explanatory Statement into the guideline would not compromise this. The Rules are clear that the AER is not bound by its guidelines and can depart from them when the circumstances warrant such a

[5] AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, p.110.

departure and the AER outlines its reasons for doing so. Where it is not practical to set out a 'minded to' position the AER should set out the factors it will have regard to in making decisions. This approach allows for flexibility while delivering a necessary level of certainty and predictability.

Explaining the application of the guideline in determinations, or at least variations from it, should not be viewed by the AER as a burden. It is simply the application of good regulation. Undertaking this process makes it clear to all stakeholders that the AER has carefully considered its approach and has applied consistent criteria for decision making.

3. Assessment matters relating to transmission

Grid Australia fully supports the AER's decision to produce a TNSP specific guideline. This approach allows for the differences in technology and functions that exist between transmission and distribution to be reflected in the guideline. Grid Australia is concerned to ensure, however, that the AER provides a TNSP specific guideline that is fit-for-purpose and as such improves the framework for economic regulation.

The current TNSP EFA Guideline provides little guidance of specific relevance to TNSPs, for example, with regard to the AER's approach to the matters set out in Section 2.1.1 above. This shortcoming provides little confidence to industry that the AER recognises, and has taken into account, the fundamental differences between transmission and distribution that warrant a separate approach to be taken to assessing forecast expenditure proposals. Such fundamental differences have been identified in earlier submissions to this process.

Indeed, the AER correctly acknowledges in several places in its Explanatory Statement that a different approach to assessing forecast expenditure is required for transmission. This includes, for instance, that detailed reviews of projects are likely to continue to be necessary for TNSPs.[6]

While consistency in approach should be sought where possible, Grid Australia urges the AER to develop the TNSP guideline independently of the distribution guideline. This should be based on the AER's existing approach to transmission; noting improvements can, and should, be made to the approach over time.

3.1 Application of economic benchmarking to TNSPs

As indicated above, Grid Australia supports the AER's statements that it intends to use benchmarking primarily as a filtering tool to identify areas for further detailed investigation. In some instances, however, the AER appears to indicate a more

[6] AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.10.

determinative role for benchmarking.[7] Further, the AER does not appear to have given sufficient attention to the limitations of benchmarking, particularly in the context of TNSPs.

The AER has indicated that it will rely mainly on MTFP, DEA and econometric approaches for its economic benchmarking. Grid Australia does not consider that any of these approaches are suitable for application to TNSPs at this time. As noted in the accompanying report on economic benchmarking prepared by NERA for Grid Australia, the small number of TNSPs in the NEM, and the consequent small sample size available for benchmarking applications, is a threshold issue with respect to the application of benchmarking to TNSPs.

The NERA report particularly highlights the impact of small sample sizes on each of the economic benchmarking approaches proposed by the AER, stating:[8]

> The insufficiency of sample size affects all three of the benchmarking techniques that the AER is proposing to use, ie, regression analysis, MTFP and DEA:
>
> - In the case of the proposed regression analysis, the small sample size raises concerns in relation to the statistical reliability of the analysis. The greater the number of explanatory variables included in the analysis, the larger is the sample size required in order to find a significant relationship. In general, the larger the sample size, the more reliable is the regression analysis.
>
> - In relation to MTFP analysis, the AER intends to combine its MTFP approach with regression analysis, in order to take account of the different environmental factors affecting NSPs. The reliability of such regression results would again be adversely affected by the small sample size. This difficulty is recognised in the report by Economic Insights accompanying the AER Draft Expenditure Forecast Assessment Guidelines. In particular, Economic Insights states that the ability to adjust benchmarking results for multiple operating environment factors will be constrained by the number of observations available, and that several years of data may be required to support any regression based environmental adjustments, particularly for TNSPs.
>
> - Finally, DEA is also likely to be less appropriate for small samples. DEA effectively gives companies 'the benefit of the doubt' in that it assigns an efficiency score of 1.0 (perfectly efficient) to a firm unless there exists a linear combination of other firms that are found to be more efficient. Where there are few observations compared to the number of outputs and environmental variables, and there is significant variation in those variables between companies, DEA may erroneously find many inefficient companies to be efficient. DEA is more likely to give accurate efficiency scores when the sample size is larger. This

[7] AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.35

[8] NERA, *Holistic Economic Benchmarking - A report prepared for Grid Australia*, 20 September 2013, pp.9-10.

> point has been previously noted by the ACCC, leading it to conclude that DEA methods are more effective the larger the number of observations in the sample.

Grid Australia notes that this view from NERA is consistent with the AEMC's previous findings on the application of TFP approaches to transmission businesses:[9]

> It appears unlikely that it would be appropriate to implement a TFP methodology for the electricity and gas transmission sectors because of the small number of service providers, the lumpiness of capital expenditure and difficulties in measuring outputs. It is, however, important to improve data collection within the electricity and gas transmission sectors to allow these issues to be tested more fully.

3.1.1 Having regard to the individual circumstances of the network

Grid Australia considers it is important for the AER to reaffirm in its guideline that it will have regard to the individual circumstances of the network when undertaking its assessment of revenue proposals; including how it intends such circumstances to be taken into account.

The AER correctly notes in its Explanatory Statement that the AEMC removed the requirement for it to consider the circumstances of the particular NSP when determining the costs a prudent operator would incur to meet the expenditure objectives. The AEMC was very clear in doing so, however, this did not remove the requirement for the AER to have regard to the circumstances of the network in making a decision on capital and operating expenditure allowances.[10]

Grid Australia notes also that during the *Economic Regulation of Network Service Providers* rule change the AER was clear that it agreed with Grid Australia's interpretation of how the individual circumstances of a network should be considered as part of the assessment of a revenue proposal. Indeed, as indicated in the quote below, the AER even positively cited a Grid Australia submission on this matter:[11]

> The Direction Papers seeks views on when circumstances of the business should be taken into account during benchmarking. The AER considers that the circumstances of the businesses which should be taken into account when benchmarking are well established; at a high level, factors which are exogenous to the business should be taken into account, endogenous factors should not. (We note that there are likely to be exceptions to these rules which the AER would assess on its merits.) The AER agrees with Grid Australia's position:

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9 AEMC, *Review into the use of total factor productivity for the determination of prices and revenues, Final Report*, 30 June 2011, pp 9-10.

10 AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, p 107.

11 AER, *Submission, AEMC Directions Paper, Economic regulation of Network Service Providers*, April 2012, p.9.

> [W]hen used properly, benchmarking may be effective as a comparative tool to draw inferences about the efficiency of proposed expenditure levels from observed outcomes for similar businesses. Grid Australia also agrees that it is not appropriate for benchmarking to have regard to internal circumstances of a business.
>
> For instance, it would not be appropriate to consider the effect of previous managerial decisions on the capacity for a business to raise capital. However, benchmarking, when properly applied, should have regard to the starting base for businesses and to the exogenous factors that may impact differently across businesses. These include factors such as customer density, local topography and the network that is in place at the time that expenditure forecasts are made (including the age of relevant assets). If benchmarking did not have regard to these factors it would pose an unacceptable risk that a business may not be able to earn sufficient revenue to meet its costs. Therefore, while Grid Australia agrees that the requirement to have regard to the individual circumstances of the business may limit the AER's ability to apply benchmarking properly, the extent to which this is a problem depends on how broad an interpretation is taken of the "individual circumstances of a business.

> The AER supports taking into account reasonable differences, other than efficiency, which influence firms' cost outcomes. Indeed, in addition to the drafting of the Rules, limited access to comparable data has constrained the AER's ability to apply benchmarking during the reset process. These issues are discussed in detail in the appendices to several of our decision documents (see for example Appendix I of the Victorian DNSPs final decision document). The AER's work to overcome these deficiencies is described in our response to the Productivity Commission's Enquiry into Electricity Network Regulation.

Grid Australia urges the AER to restate in the guideline its intention with respect to the individual circumstances of the network that is reflected in the quote above.

3.2 Application of other techniques to TNSPs

The draft explanatory statement and guideline propose a number of techniques, in addition to economic benchmarking, that the AER proposes to apply to TNSPs. These are:

- category analysis
- methodology review
- governance and policy review
- predictive modelling
- trend analysis
- cost benefit analysis

- detailed project review (including engineering review)

During earlier consultation on this work stream, Grid Australia provided a 'straw man' guideline to the AER that evaluates the merits and application of each of these techniques to TNSPs, for both total expenditure assessments and category based assessments.[12]

Grid Australia refers the AER to the 'straw man' guideline for advice on the techniques Grid Australia considers are fit for purpose for assessing TNSPs' expenditure forecasts and the circumstances in which they may be used, and those techniques it is concerned are not currently fit for purpose. This reflects the feedback provided in workshops with the AER in earlier consultation.

3.3 Establishment of a 'price book' of project costs

In the Explanatory Statement the AER notes the following with respect to the development of a 'price book' of project costs:

> During consultation we discussed the prospect of developing a "price book" of project cost components for benchmarking transmission capex projects. This was considered relevant given the heterogeneity of such large projects, although the cost of more specific asset components may be more consistent and amenable to comparison. We typically ask our consultants to examine this level of detail in transmission capex assessments, but we see benefit in collecting and assessing this information ourselves. The Australian Energy Market Operator (AEMO) has already begun collating information that might be useful for this purpose. We will continue to liaise with AEMO and TSNPs regarding the usefulness of this information.[13]

It is unclear to Grid Australia why the AER considers it is appropriate for it to provide to AEMO the unit cost information that it has received from TNSPs to develop and maintain its own price book of project cost components. The AER's proposal raises two issues:

- First, there is a preliminary issue of whether the AER can provide the unit cost information to AEMO for AEMO's use in developing a "price book". Grid Australia does not consider that the information disclosure provisions in the National Electricity Law allow for the provision of unit costs that comprise all or part of the estimating databases of TNSPs to be provided to AEMO.

- Second, even if it is within the AER's powers to disclose the information to AEMO, a question arises as to whether it is within AEMO's statutory functions to use that information to develop and maintain a "price book".

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12 This is available on the AER's web site at http://www.aer.gov.au/node/20627.

13 AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.46

Turning to the first issue, section 44AAF of the *Competition and Consumer Act 2010* (Cth) (**CCA**) provides that the AER must take all reasonable measures to protect from unauthorised disclosure information that is obtained in compulsion in the exercise of its powers.[14] Section 44AAF sets out a number of persons or bodies to whom disclosure of information is an authorised use and disclosure, which includes AEMO. The section goes on to provide that a person or body to whom information is disclosed may use the information for any purpose connected with the performance of the functions, or the exercise of the powers, of the body and that the AER may impose conditions to be complied with in relation to the information that has been disclosed to it.

Grid Australia submits that as the development and maintenance by AEMO of a price book of project cost components comprising information that the AER has obtained from TNSPs does not come within AEMO's statutory functions, the AER may be acting beyond its powers if it was to disclose the relevant information to AEMO. AEMO's powers are set out in Section 49 of the National Electricity Law. Collating and maintaining a price book of unit costs (that the AER would then use to assess the capital expenditure forecasts of TNSPs) does not appear to come within AEMO's functions and powers, even when taking into account the functions conferred on AEMO under the National Electricity Law and Rules.

Turning to the second issue, if the reason behind giving AEMO access to the information is so AEMO can check the reasonableness of proposals given to it as part of AEMO's role in contracting for augmentations of the Victorian transmission network, as was advised to Grid Australia at a meeting with the AER and AEMO on 13 June 2013, Grid Australia submits that the disclosure of such information would not be for a legitimate purpose. The disclosure and use of the information for this purpose would provide AEMO with highly specific market sensitive information that is not otherwise publically available to entities who procure capital works.

In circumstances where AEMO procures services from the same suppliers as TNSPs or from TNSPs themselves, the AER's proposal to provide AEMO with the unit costs of TNSPs provides AEMO with commercial information that would not typically be available to a participant in the market. The consequence of this could be that AEMO could unduly focus on the information it has on unit costs at the expense of other legitimate, but perhaps less transparent, costs that form part of a tender price. In other words, the disclosure of the unit cost information could unreasonably and adversely affect the lawful business, commercial and financial affairs of TNSPs.

In the event that the AER determines that it is open to it to disclose the unit cost information of TNSPs to AEMO, the AER should, pursuant to section 44AAF(5) of the CCA, impose conditions to be complied with in relation to the disclosure of that information. Such conditions should include:

[14] Section 18 of the National Electricity Law provides that section 44AAF of the Competition and Consumer Act 2010 (Cth) (CCA) has effect for the purposes of the National Electricity Law.

- that the information may only be used for the purposes of compiling and maintaining a price book of unit costs which AEMO is to provide to the AER;
- the information may not be used for the purposes of the procurement of any services by AEMO (for example: contracting for augmentation of the declared shared network);
- the information is to be "ring fenced" such that any AEMO staff that are involved in the procurement of capital works do not have access to that information.

4. Approach to assessing expenditure forecasts

There are a number of aspects of the AER's proposed approach to assessing forecast expenditure proposals that Grid Australia considers could be improved either in terms of the guidance given for the likely approach or the approach itself. These are:

- The considerations given to the requirements of the Rules and the NEL when undertaking assessments of forecast expenditure proposals
- The apparent focus on categories of expenditure, particularly for operating expenditure
- The application of the proposed single productivity measure, and
- The approach to applying adjustments to categories of operating expenditure.

4.1 Requirements of the Rules and the NEL

The Rules require the AER to decide whether a revenue proposal is prudent and efficient having regard to the expenditure objectives and factors in the Rules. This means that the AER is required to start with a TNSP's proposal and decide whether the proposed forward looking costs reflect what an efficient and prudent business is likely to incur in order to meet its regulatory obligations. In doing so, the AER is required to have regard to the revenue and pricing principles, which include a requirement that NSPs are afforded the opportunity to earn at least the efficient costs of supply. If the AER finds that the revenue proposal reasonably reflects the expenditure criteria, having regard to the expenditure factors, it is required to accept the proposal.

Rather than focusing on the AER's approach to assessing the revenue proposal before it, much of the Explanatory Statement and draft guideline is focused on the AER's approach to deriving its own estimate of efficient and prudent costs. If the AER is overly focused on developing its own estimate there is a considerable risk that TNSPs are not afforded the due process that is required by the Rules. This in turn

may put at risk the opportunity for TNSPs to recover at least the efficient costs of supply.

Grid Australia strongly encourages the AER to set out its approach to expenditure forecasting within the context of the Rules requirement that the revenue proposal is the starting point for the AER's assessment. Setting this out in the guideline will allow for improved communication to stakeholders that the primary role of the AER is to decide whether to accept a revenue proposal as being reasonable and that this does not require that the revenue proposal exactly match the AER's estimate; noting that both may be reasonable in the context of the expenditure criteria and factors.

Further, given the focus on the AER's own estimate, there is very little clarity on the approach the AER will take for assessing bottom up forecasts. These might include zero base costs or significant step changes. Where these form part of a revenue proposal the AER is required to determine whether or not they are reasonable, having regard to the expenditure criteria and factors. As such, the AER is encouraged to more clearly set out how it intends to assess such costs as part of making a revenue determination.

For the avoidance of doubt on this matter, the AEMC reaffirmed through the recent *Economic Regulation of Network Service Providers* rule change that the starting point for the AER's assessment remains the revenue proposal of the business and that the AER should justify its conclusions with respect to it. The implication being that the proposal of the business must remain at the forefront of the AER's assessment and decision making:[15]

> *In clarifying the AER's powers, the Commission has confirmed its overall approach to capital expenditure and operating expenditure allowances. The NSP's proposal is necessarily the starting point for the AER to determine a capital expenditure or operating expenditure allowance, as the NSP has the most experience in how its network should be run. Under the NER the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own since it must accept a reasonable proposal. Nonetheless, the AER should determine what is reasonable based on all of the material and submissions before it.*

4.1.1 Threshold for rejecting a forecast

In the context of operating expenditure, the AER indicates in parts of its Explanatory Statement that it will reject revenue proposals as not reasonably reflecting the expenditure criteria where it identifies examples of material inefficiency.[16] Grid Australia considers that this is the appropriate threshold to apply. It recognises the inherent imprecision of assessing forecast expenditure and also the requirement that

[15] AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, p.vii.

[16] AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.60.

NSPs be afforded the opportunity to recover at least the efficient costs of the services they supply.

In other parts of the Explanatory Statement, however, the AER appears to indicate that its own estimate will be the threshold for rejection, or that the threshold might be a statistically estimated efficiency frontier.[17] Grid Australia considers that this approach would imply a hurdle that is different from what is required by the Rules and the Revenue and Pricing Principles.

Unlike when expenditure forecasts are rejected in circumstances of material inefficiency, setting the threshold at a 'best estimate' derived by the AER or a statistically derived efficiency frontier, would not properly recognise the imprecision of forecasting expenditure requirements or the limitations of the techniques that are applied when making assessments of these forecasts. The consequence is that this approach would impose considerable unmanageable risks onto TNSPs. In doing so it would threaten the opportunity for a TNSP to earn sufficient revenue to provide transmission services in the long term interests of consumers and recover its efficient costs.

In the context of operating expenditure, the AER raises the prospect in the context of its proposed EBSS that a business could be outperforming its expenditure forecast but nevertheless been deemed as inefficient and have an adjustment made to its expenditure forecast for the next regulatory period.[18] Grid Australia considers that making an adjustment in this circumstance would be inconsistent with the regulatory contract that exists between the regulator and the NSP. In other words, there is a clear assumption in the application of the EBSS that expenditure that occurs below the expenditure forecast is deemed to be an efficiency improvement. As such, to make further adjustments to revealed costs in this case would be inconsistent with the expected application of the regulatory framework and would also reduce the power of the incentive.

The AER's proposed approach to making adjustments where NSPs are already outperforming benchmarks also highlights the potential for the inappropriate use of benchmarking and the risks that this can impose on NSPs. This is because benchmarking is a highly indirect tool for assessing efficiency and may not have sufficient regard to the circumstances of the network. Instead, the AER should rely on expert analysis and reviews of governance and processes undertaken by NSPs in determining whether or not they are responding to incentives.

Grid Australia considers that the AER should clarify its intention on this matter in the guideline. Specifically, the AER should articulate how it interprets the requirements of

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17 AER, *Better Regulation, Explanatory statement, Draft EFA Guideline for electricity transmission and distribution*, August 2013, p.59.

18 AER, *Better Regulation, Explanatory statement, Proposed Efficiency Benefits Sharing Scheme, August* 2013, p.25.

the Rules and revenue and pricing principles; including how it interprets material inefficiency in the context of operating expenditure. In doing so, it should clarify how it will take into account the inherent inaccuracy of forecasts and the limitations of assessment techniques. In order to maintain consistency with the Rules and Revenue and Pricing Principles, Grid Australia considers that this requires the AER to recognise in the guideline that reasonable estimates of expenditure requirements can differ and as such there is no requirement for a revenue proposal to exactly match, or better, the AER estimate or what will be an imprecise efficiency frontier for that proposal to be accepted.

4.2 Focus on expenditure categories

The AER has indicated that a particular focus of its analysis will be on categories of expenditure. Grid Australia acknowledges that it is prudent to have regard to categories of expenditure. Doing so can give the AER confidence that expenditure proposals reasonably reflect the expenditure criteria of the Rules.

It is important, however, that the AER not unduly focus on outcomes or information gathering at the category level. Applying this narrow approach can mean that important interactions between types, or categories, of expenditure are not given due regard. For instance, at times NSPs might spend more on one category of expenditure in order to reduce costs in another. Focusing too heavily on categories of expenditure may create the perception that an NSP is not efficient in that category when in fact additional expenditure has been incurred to reduce costs in other categories. It may also create a perverse incentive for NSPs to focus too narrowly on outcomes at a category level at the expense of overall efficiency.

4.3 Productivity measure

The AER has indicated that forecast productivity changes will be incorporated into an annual ‘rate of change’ that will be applied to base operating expenditure. The AER indicates that this will represent its best estimate of the shift in the productivity frontier.

Grid Australia accepts it is appropriate for operating expenditure forecasts to include adjustments to account for expected productivity improvements, but it is important that these are constrained to only those factors that are exogenous to the business and do not include efficiency improvements that arise through management effort. Grid Australia considers that this can be achieved by limiting productivity growth in the productivity factor to those gains that would arise from realising economies of scale.

Focusing only on productivity growth that would arise from realising economies of scale would mean that the extent of productivity gain that is pre-empted is limited to the gains that an efficient firm could achieve outside of those efficiency gains that are endogenous to the business. There are two ancillary benefits, from a forecast

expenditure assessment perspective, from limiting the breadth of the adjustment made for productivity gains:

- It allows for estimates of expected productivity growth from realising economies of scale that are provided by econometric models to be cross checked against engineering bottom-up models, and

- The productivity trend that is estimated would not be affected by the cost impacts of new obligations on NSPs. Therefore, the AER's concerns about 'double counting' for the cost of new obligations if step changes include all such obligations would be avoided.

As discussed further in the Grid Australia submission on the Draft EBSS Guideline, including factors other than scale efficiency into a productivity adjustment factor risks eroding the integrity of the expected rewards under an EBSS. Specifically, that submission identifies that, in addition to cases where the productivity factor captures efficiency improvements that are endogenous to the business, the integrity of the EBSS would also be compromised if the AER were to apply the productivity factor:

- As an alternative, and less transparent, means of shifting away from the use of revealed costs, and

- To project efficiency gains that are greater than an efficient firm could make, that are speculative in their nature or that can only be made from undertaking capital expenditure and whose inclusion in the operating expenditure forecast would be inconsistent with the remainder of the proposal.[19]

4.4 Smoothing of adjustments

The AER has indicated that if it finds that a business' revealed operating costs are materially inefficient, and an adjustment is made to the forecast on this basis, that it will not smooth the adjustment over the regulatory control period. Instead, the adjustment will be made in full at the commencement of the regulatory control period. Grid Australia considers that the AER should reconsider this position and allow for adjustments to be made over a period longer than a single year.

Grid Australia recognises that if the AER did have sufficient evidence to substantiate an adjustment to expenditure forecasts that it is understandable for customers to want the full adjustment to be made as soon as possible. However, customers also value a

[19] Where a capital expenditure project is accepted that is expected to generate productivity gains in operating activities, the AER has stated that the savings in operating expenditure will be factored into the step change. In this case, if the assumed productivity growth also includes the capital-induced savings, then those savings will be double counted. Conversely, if capital expenditure is required to achieve certain productivity improvements in operating activities, but that capital expenditure is not allowed, then the NSP will not have a reasonable opportunity to recover its efficient costs if capital-induced productivity growth is factored into the forecast of operating expenditure.

safe and reliable supply of electricity. It is Grid Australia's view that an immediate and substantial cut to forecast expenditure would threaten the ability for a TNSP to provide a safe and reliable network, as it may not allow the TNSP sufficient opportunity to make the necessary transformational change to improve productivity.

There are a number of practical and serious challenges associated with making substantial and immediate cuts to expenditure; these include:

- Identifying, in the first instance, where and how to implement cuts without compromising supply reliability or the safety of employees and electricity consumers
- The implementation lags once areas for cuts are identified, and
- Restrictions in breaking contracts with third party suppliers.

In addition, and as demonstrated further in Grid Australia's submission to the proposed EBSS and also in more detail in the Incenta Economic Consulting Expert Report attached to that submission, large one off adjustments to the revealed cost outcome may lead to NSPs bearing more than 100 per cent of the deemed inefficiency. Grid Australia considers it is imperative for the AER to ensure that the application of the EBSS in this circumstance does not lead to a penalty in excess of 100 per cent.

4.5 Other adjustments to base year costs

As is also discussed in Grid Australia's submission to the proposed EBSS, there are a number of circumstances where it may not be reasonable to rely on revealed costs combined with an exogenous productivity assumption and limited step change for assessing expenditure requirements or setting expenditure forecasts. This can include categories of expenditure such as operational refurbishment projects or asset works that are lumpy in nature, and therefore may experience large variations from year to year, or where there are costs that have arisen that are legitimately higher in the next period than what has been incurred efficiently in the past.[20]

The AER has indicated, however, that its strong preference is to not make adjustments to revealed costs for setting expenditure forecasts, except where it identifies material inefficiency. Grid Australia understands that the AER is concerned that NSPs could be rewarded for efficiency gains that are illusory and so not passed on to customers if it commits to making adjustments to base year values for setting expenditure forecasts.

[20] Grid Australia acknowledges in this context that a revised forecasting and EBSS approach is expected to be most relevant in those circumstances where NSPs would not have already gained through a reduction in expenditure under the EBSS.

It is agreed that there can be consequences for the rewards and penalties faced by NSPs where adjustments are made to revealed costs for setting expenditure forecasts. It is further agreed that it is important to preserve the integrity of the incentives framework. However, it is equally important to ensure that forecast operating expenditure includes the total operating expenditure that is required to achieve the operating expenditure objectives.

Grid Australia proposes that in those circumstances where revealed costs would not be appropriate, that adjustments be made to the forecasting approach as well as the application of the EBSS. Forecasting this expenditure separately, and applying a modified EBSS that is consistent with the forecasting method, will ensure that efficient cost recovery is maintained without compromising the integrity of the incentive schemes. This is explored further in Grid Australia's submission on the proposed EBSS.

4.6 Approach to forecasts of debt and equity raising costs

Grid Australia notes that in the rate of return guideline consultation paper, the AER indicated it was considering changing from the well-established practice of treating debt and equity raising costs as operating expenditure items to one where the costs were 'rolled in' to the rate of return.

Grid Australia notes that an earlier Energy Networks Association submission to the rate of return guideline process (with which Grid Australia agreed) stated that the current practice should be retained and provided updated debt raising cost benchmarks. The draft rate of return guideline was silent on this issue and discussions with AER staff suggest that it is not the regulators intention to address it in the final rate of return guideline. Grid Australia submits that debt and equity raising costs should continue to be treated as operating expenditure items and, to the extent that this issue is addressed in the final expenditure forecast assessment guideline, that:

- the AER take into consideration the material already supplied in response to the rate of return consultation paper; and
- should the AER adopt a different treatment, that the regulator provide additional time for Grid Australia to respond given that it would be the first time stakeholders would have to address the matter as a formal AER position.