Major Energy Users Inc.

Australian Energy Regulator

Better Regulation Program

Proposed Guidelines for Expenditure Assessment

MEU Comments on the draft guidelines

Submission by

The Major Energy Users Inc

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Preface

Overall, the new guidelines are supported by the Major Energy Users (MEU) as they will increase the ability of the AER to set efficient allowances for opex and capex needed for NSPs to provide their network services. The MEU notes its concerns with the development of and the approach to the guidelines in the following sections.

Whilst the guidelines are an improvement on what applied under previous rules, the MEU considers that further improvement along the lines suggested in this submission should be implemented in the final version of the guidelines. Unless these improvements are implemented, the MEU considers that the AER has lost an opportunity to ensure the guidelines deliver the optimum benefit implied by the requirement of the energy Laws that the focus of the rules and guidelines must be in the long term interests of consumers.

The new rules provide the AER with considerable discretion and the development of these guidelines is intended to provide a structure for the AER to use this discretion it has been granted. Whilst the guidelines as proposed will result in considerable improvement in the ability of the AER to identify efficient expenditures, the MEU has identified a few areas where an even better outcome for consumers will result. The AER is requested to reassess the draft guidelines in light of the MEU concerns raised.

1. Introduction

The Major Energy Users Inc (MEU) welcomes the opportunity to provide comments on the AER draft incentive guidelines (opex and capex) released in August 2013.

The guidelines are being established under the recently approved revised network Rules for gas and electricity. The amended rules recognise that the networks are incentivised to maximise the revenue they are allowed. The expenditure assessment guidelines are being implemented to improve the ability of the AER to set allowed expenditures (opex and capex) at efficient levels. It is stated in other guidelines (especially the guidelines on incentives) that the AER must, in order to optimise the outcome of the other guidelines, establish and implement tools to ensure only efficient levels of expenditure are set as this is an essential precursor for the other guidelines to operate effectively.

Specifically, the incentive guidelines identify that the setting of efficient allowances for capex and opex is key to ensuring the maximum benefit is achieved from the incentives provided to NSPs.

The MEU has noted that NSPs endeavour to "game" the regulator into allowing greater allowances than are efficient when the AER assesses the expenditure allowances. Other than the obvious game of overstating the needed allowance, the other "games" include:

- Building up an allowance for one period to include activities that are not then implemented. In some cases the activity is reintroduced in the subsequent period

- Rather than using benchmark input data, the NSP seeks to recost an activity on a "bottom up" basis, rather than using the costs incurred previously as the basis of the new allowance

- Seeking to implement earlier replacement of assets before their economic lives are over

- Magnifying the expected growths in labour costs, materials costs, network growth and demand/capacity to justify a larger than needed allowance

- For NSPs with a price cap, arguing for consumption growths to be lower than might be the case in order to increase unit prices

If NSPs are permitted to have larger than efficient allowances then the incentive programs will be less effective and will provide an unearned benefit to NSPs

both in terms of their saving within the regulatory period and the bonus awarded under the incentive program.

1.1 An overview of the AER approach

As noted earlier, it is critical for the other guidelines in the suite of guidelines developed under the Better Regulation program that the expenditure guidelines provide a sound starting point for the other guidelines to have full effect (especially the incentive guidelines).

Currently, the AER has been limited by the Rules in developing and enforcing what it considers is the efficient allowance. Whilst the approach to recurrent opex has been based on the revealed cost approach which is a base-step-trend assessment underpinned by an efficiency sharing scheme (the EBSS), other expenditures have been less driven by past performance of the NSP and relied more on individual assessments of cost elements. This has allowed NSPs to "game" the regulator and be allowed larger amounts of expenditure than is probably efficient.

The introduction of benchmarking and development of predictive assessment programs (such as the repex and augex models) to forecast likely network service provider (NSP) needs (which are based on exogenous inputs to the changing nature of the service being provided by the NSPs) will enhance the AER's ability to identify what might be efficient expenditure. At the same time, benchmarking will provide a high level indication as to the relative efficiencies of each NSP.

The MEU has noted that in the past the AER has relied on its technical consultants to provide data on the changing costs to carry out may of the tasks undertaken by the NSPs. This reliance on the datasets held by the technical consultants has created some discord. The decision by the AER to develop its own historical dataset reflecting the costs of various activities that NSPs do undertake is a major step forward and should provide the AER with the ability to not only identify the actually incurred costs for carrying out certain tasks but also provide a guide as to the impacts imposed on each NSP by their unique circumstances, by cross referencing similar tasks each NSP undertakes.

Advice from MEU members is that competent firms carry out considerable investigation of the costs of activities undertaken by the firm and this information is collected in considerable detail. They advise that unless this collection of data is implemented, analysed and then used to forecast future costs for activities, then they lose an essential ability to control their costs; this then impacts their ability to manage their pricing for their customers to maintain market share.

Senior management in firms use benchmarking data and impacts on product pricing to assess what cost allowances can be used for product supplies. This

market response is a key driver of setting future costs. In a regulated world, the AER has a similar role to that of the market in terms of setting efficient allowances for the NSP so that the impact on prices is controlled to reflect the needs of the market.

The MEU considers that the approaches outlined by the AER in the draft guidelines to provide allowances for opex and capex that are efficient will be a significant improvement in its current practices.

1.2 Access to data

Consumers are aware that their input into regulatory reviews is often marginalised by the paucity of specific data available to them and the considerable aggregation of those costs consumers see of activities undertaken by NSPs.

Under the new guidelines, the AER will be collecting significant additional data from NSPs that allows it to both identify efficient allowances for the NSP that provides the data, but to also use the data collected to benchmark costs across NSPs and to benchmark specific cost elements. The AER is also proposing to develop models to use the data collected and apply the outworkings of these techniques to the setting of future allowances.

However, it is not sufficient that the AER collects the additional data, develops models and calculates appropriate benchmarks. The AER is also seeking improved consumer input into both its and NSP deliberations. The AER has developed a guideline for NSPs to engage better with consumers so that there is greater confidence that the NSP is providing what is seen as needed by consumers. Unless consumers have access to the database developed by the AER to give them confidence about the legitimacy of the input provided by the NSP, then there is a disconnect between what the NSP advises consumers directly and what the NSP is required to provide to the AER. Consumers being able to access the data NSPs provide the AER closes this loop and ensures that the feedback the NSP provides the AER in terms of consumer engagement actually is underpinned by a consistent dataset.

Allowing access to the dataset by others also allows all stakeholders to analyse proposals from NSPs using consistent data. This will provide the AER with better informed stakeholder input into their assessments of NSP proposals.

1.3 Comprehensiveness of the data

The MEU recognises that prior to the development of these guidelines, there was little benchmarking or data provision, its collation and its use. The MEU considers that the AER and its benchmarking consultant have endeavoured to

implement mechanisms that will deliver the outputs needed to deliver the greatest certainty that the assessments of expenditure are efficient.

In particular, the MEU notes that the AER will develop:

- A suite of benchmarking approaches based on certain input and output measures. The MEU considers that over time, the AER will see that some benchmarks are more effective and/or more useful than others in assisting identifying future expenditure needs and that other benchmarks will need refinement in order to provide more useful indicators

- A dataset that provides direct historical costs for certain activities which can be used both laterally (between NSPs for comparison purposes) and longitudinally (for identifying trends for forecasting future expenditure).

The MEU recognises that the data inputs for both activities implicit in the guidelines has been developed after considerable analysis. But despite this deep analysis, the initial development is likely to prove less than optimal for the purposes and more refinement will be needed over time.

The MEU members have identified that the selection of benchmarking inputs and outputs and collection of data most useful to the long term operations of a firm is a continuous process and consistently needs refinement to provide the best outcomes. Essentially, this experience shows that the initially developed approach, whilst providing much of what is needed, is unlikely to be the most useful and effective identification of needs over time. This means that the AER must continually assess the usefulness of the benchmarks and the form of the data collected and to seek refinements in order to deliver the most effective use of the tools available.

Throughout the debate on what information should be collected and how, and what benchmarking should be developed, consumers have been consistently advising that more data than less should be collected. The risk of setting the data collection at too low a level can result in an inadequate dataset. It is always easier to soften a requirement for data provision in the future than to increase the requirement at a later stage

1.4 Conservatism in the allowances

The AER has displayed over time an approach which is overtly conservative, as a little conservatism in the setting of allowances is considered to be in the long term interests of consumers.

The MEU accepts that some conservatism is needed, but recognises that there is no attempt to establish how conservative an overall regulatory allowance actually is. The approach used by the AER is for every element of a reset needs

to be set conservatively. The result of this approach is there is a compounding effect of conservatism throughout a regulatory decision, resulting in a revenue allowance that is much more than is really needed, and imposes less pressure on the NSP to be efficient.

The MEU is of the view that the AER should assess each element without any conservatism and then apply a recognised specifically identified adjustment to provide an overall conservatism.

The outcome for consumers under the current AER approach is one based on initial allowances which have a conservatism (of an unknown amount) built into the allowance. This means that the chance of an underspend is more likely than an overspend, providing an asymmetric risk for consumers. This asymmetry needs to be adjusted so that there is not conservatism being compounded throughout the regulatory assessment.

1.5 The MEU assessment of the new tools

The MEU notes that the AER has accepted that NSPs will seek to inflate their expected expenditure needs (explanatory statement page 20)

> "However, and as the MEU notes, the NSP has an incentive to prepare its proposal in a manner that allows it to increase its cost allowances. Therefore, we need to test the NSP's proposal robustly. This means we must necessarily conduct our own analysis to assess its reasonableness."

The new Rules and the guideline development is focused on identifying the efficient costs needed to provide the service. The MEU considers that the guidelines provide the AER with a much better chance of ensuring the NSPs are provided efficient allowances, with a reduced scope to obtain a greater allowance than is required.

Despite this desire to implement better techniques to assess allowances, the AER proposes to use its current approach of the revealed cost approach (its base-step-trend) as its prime tool to setting allowances. The new tools are to be used as a check on the basic approach and to advise where deeper analysis and investigation might be needed.

The MEU recognises that the revealed cost approach needs to be used in the short term due to the absence of an adequate dataset, but as the other tools become more refined and there is a better dataset, the MEU considers that the new tools should have greater standing in the analysis and setting of expenditure claims.

A recurring theme through the debates on the new tools to be used has been the view put by the NSPs that all of the NSPs are different and to benchmark

any NSP against others in the NEM will result in distorted outcomes. The MEU can see the logic for making such claims and accepts that there is some validity in them. Equally the MEU considers that by careful selection of the benchmarking inputs and outputs and of the categories used in the development of the dataset, there is considerable commonality of activities that can result in useful comparisons. These can assist in providing a clear indication of what can be achieved by NSPs and the pursuit of NSP efficiency by the AER and consumers.

However, just benchmarking the NEM NSPs against each other can result in the loss of improved efficiency that has occurred in overseas jurisdictions. The MEU considers that the benchmarking must also include a wider set of benchmarking entities than just the NEM NSPs

2. The AER approach and MEU observations

The guidelines address the requirements on TNSPs and DNSPs separately but the differences between the guidelines for TNSPs and DNSPs are so minor as to make them virtually identical. With this in mind, the following MEU comments and observations apply to both the DNSP and the TNSP guidelines.

The guidelines look to implement the revealed cost approach as its basic tool and then use two other approaches to test the revealed cost:

- high level benchmarking using a number of controls, and
- category analyses which look at actual costs for activities and applies these for cost build ups and for use in forecasting models - the augex model for augmentation capex and the repex model for replacement capex.

2.1 The revealed cost approach

The MEU notes that the AER has a preference for the base-step-trend (the revealed cost) approach to forecasting expenditure – especially for opex. The revealed cost approach is also a form of benchmarking (self benchmarking) as it assumes that the costs incurred by the NSP in the base year are efficient and to provide efficient allowances for the future needs only adjustment in this base year cost for changes that have occurred subsequent to the base year and to accommodate forecast changes in input costs (eg network growth, price movements, etc)

The assumption of historic efficiency that underpins the revealed cost approach is supposed to be supported by the incentive for the NSP to reduce its actual costs below the allowance and so assist the NSP get to the efficient frontier of costs. This approach should be successful if the incentives are properly developed and there are no other incentives that drive an alternative outcome. As the MEU has highlighted in its response to the draft incentives guideline, there are a considerable number of in-built incentives in the Rules which will detract from the effectiveness of the headline incentives (the efficiency benefit sharing scheme for opex – the EBSS and the capital expenditure sharing scheme for capex – the CESS) to minimise opex and capex.

In the case of opex the in-built incentives are relatively modest, mainly being based on the assumptions that all NSPs are allowed to be different (and therefore comparisons between each are not appropriate) and that NSPs actually understand their activities well enough that they know when they are really inefficient and have to take actions to become more efficient.

In the case of capex, the in-built incentives detracting from the headline approach are quite significant and include the automatic roll in of capex into the Regulatory Asset Base (RAB) and the easy ability of NSPs to increase the capex through pass through of costs, reopeners and identification of contingent projects. On top of these, is the WACC incentive where, if there is a positive differential between the allowed WACC and the firm's actual WACC, the NSP is incentivised to over invest.

In both the case of opex and capex, the NSP is incentivised to overstate the need for both opex and capex as this increases the potential for the NSP to increase its profits, both directly and by gaining a benefit through the EBSS/CESS. Overstatement of opex and capex is primarily driven by the NSP having the ability to develop its cost structure using a "bottom up" approach to set the cost for the work to be done and for the costs it expects to incur. It is well recognised in business circles that a bottom up cost approach tends to overstate expenditure needs. In contrast, firms subject to competition identify how much they can afford in terms of opex and capex, based on their expectations of the future sales and the price they can get for their products. This market discipline is not available in the case of regulated monopolies so the AER must impose this otherwise market driven discipline.

Whilst the revealed cost approach has shown a degree of control in relation to opex, its application to capex has been minimal, with analysis of the bottom up development of capex claims being assessed by an independent reviewer on a case by case basis – effectively another bottom up approach. The approach does not look at every element of the capex build up but at selected projects and then the outcomes from these selected projects being extrapolated to all other capex. This leads to debate between the AER and the NSP.

The greatest risk for consumers is where the NSP seeks to address its opex and capex needs using a mix of revealed costs and bottom up assessments – effectively delivering the best of both approaches to the NSP.

The MEU sees that the continued use of the revealed cost approach is a pragmatic decision as the dataset required for more comprehensive benchmarking has not yet been developed. However, the MEU considers that as the dataset does improve and greater reliance can be placed on the information it contains, then there should be a trend away from the revealed cost approach to more use of benchmarking; this forecast change needs to be explicitly stated.

2.2 Testing the base year efficiency

Under the revealed cost approach the base year expenditure provides the basis for forecasting future expenditure.

The AER proposes to set the base year as the second last year of a regulatory period on the assumption that this will reflect the most efficient expenditure, as this was driven by the incentive program. This decision is well known prior to the regulatory reset process and provides an incentive for the NSP to overstate the expenditure in the pre-determined base year.

The AER has attempted to obviate the benefit to the NSP of this ability through making the EBSS continuous (ie operate over consecutive regulatory periods). As the MEU has noted in its response the draft incentive guidelines, the continuous EBSS does not guarantee that overstating the fourth year expenditure does not provide a better outcome.

However, the MEU considers that a greater certainty as to the efficiency of the base year can be assessed by applying the high level benchmarking assessments to each year of the regulatory period and comparing these to the forecast benchmarking that results when setting the allowances for the period. By comparing the actual benchmarks for each year of the regulatory period (including the last year of the previous period) with the forecast benchmarks derived when assessing the future efficiencies of the expenditure allowance for the forecast period, this will provide evidence as to whether the assumption that the base year can be assumed to be efficient.

For example, when testing the base year for efficiency the AER would develop a table comparing the actual benchmarks (ie using actual expenditure)against those the AER had calculated from the forecast allowances derived for the period when the reset revenue was fixed.

Eg revenue/kVA*km	Year 5 past period	Year 1 current period	Year 2 current period	Year 3 current period	Year 4 current period	Year 5 current period
Forecast benchmark calculated at reset						
Actual benchmark achieved						

By assessing the benchmark for each year, this will provide an indication as the relative efficiency of the base year and provide justification for changing the base year to another if the fourth years is seen as inefficient compared to the difference between the forecast and actual benchmarks.

The benefit of assessing the efficiency of the last year of the past period is to provide confidence in the assumption made regarding the incentive scheme's EBSS and the assumptions made about the benefit carry forward from the scheme.

The MEU accepts that although comparisons such as is proposed have limitations, the outcome will assist in supporting the AER approach, or not.

2.3 The "step-trend" changes

Having set the base cost at an efficient level, the AER sets the future costs by adjusting the base cost to reflect changes imposed on NSPs that occur subsequent to when the base cost is set, and for increases expected in the inflation of wages and materials and from the growth of the network.

2.3.1 Step changes

In the past, these step changes have been assessed at a high level and essentially relied on the NSP to aggregate the cost impact on a number of different elements. Usually, the argument as to the inclusion of these costs related to the legitimacy or otherwise of the inclusion of the step change rather than a detailed assessment of the costs claimed.

The AER has identified two basic changes in the assessment of step changes:

- The step changes will be generally assumed to be incorporated in the "trend" aspect of the price setting by using productivity adjustments
- Step changes will only be allowed if the cost impact is likely to be greater than what would normally occur "on average"

The AER has further identified that the historic approach to pricing the effects of step changes needs greater investigation and will implement a more rigorous approach to cost estimation for such step changes.

The MEU supports this new approach as it addresses some very basic concerns that the MEU has identified over many revenue resets in the past

2.3.2 Trend aspects

The MEU has consistently been concerned at the manner used to assess the future trends seen by NSPs - wage inflation, materials inflation and the impact of growth of the network.

In particular, the MEU has consistently been critical of the AER approaches for forecasting a number of key aspects of the trend elements. For example:

- Attempts are made at forecasting "real" cost impacts. This requires assessing the nominal impact and then applying a general forecast inflation to deflate the nominal forecast to a real forecast. This introduces compounding of errors and conservatism.

- The AER needs to assess the accuracy of forecasts against what actually occurs in order to determine the degree of error that the various forecasts have inherently
- NSPs have determined the weightings of the various elements of materials forecasts that apply at each reset, and this allows the NSPs to bias the weightings to reduce the influence of elements where lower price increases are expected and to increase the weightings where higher prices are expected. One approach often used is where the NSP assumes that general inflation will be greater than the forecast price change of specific elements (wage or material), effectively preventing the symmetry of price increase/decreases to be passed onto consumers. The use of a standard set of weightings would prevent the NSPs from "gaming" the escalation provisions.
- NSPs use the fact they have entered into an enterprise agreement with their labour and seek to use the EBA to set the wage growth estimate for the trend. Using an EBA as the basis for wage growth removes from the NSP the need to negotiate the lowest wage increase arrangement and passes the risk onto consumers. Imposition of general wage rate growth should be used to as the adjustor of wage movements, not the EBA.
- Replacement capex should result in lower opex yet there is little recognition of this in opex allowances.
- Opex is mainly related to the increase in numbers of assets or extensions to the networks, yet the growth of opex is claimed in relation to other elements (eg RAB, or capex) which do not reflect the actual increase in work that is required.

The MEU notes that some, but not all, of these concerns have been addressed in the new guidelines.

However to overcome the basic concern that consumers are overpaying for using forecast data rather than actual inflation costs, the MEU has consistently recommended the AER develop its own inflation adjustment rather than apply the general consumer price index change. This approach of a "Utilities Inflation Index" would obviate the need to forecast these increments and require consumers to only pay for actual changes.

The reason given for not applying such an approach has been that consumers expect only to see stability in their annual price adjustments within a period. The move to annual updating of debt costs will remove some of this stability and therefore the main reason for not implementing a "Utilities Inflation Index" disappears.

2.4 Productivity adjustment

Historically the AER has used a productivity adjusted labour index as the basis for adjusting the forecast expenditure from the base year. In the most recent completed reset review, the AER used an unadjusted labour index and separately applied a productivity adjustment for the forecast allowance.

The proposed approach appears to follow a similar pattern, with productivity being set as a specific adjustment, although calculated in a different way. The MEU accepts that this approach has merit as long as there is pressure to increase productivity. Whilst varying year on year, there is clear evidence that productivity nationally increases over the long term and the NSPs should be exposed to this pressure.

The MEU is concerned that the new approach to productivity adjustment will be NSP specific. This will not impose on inefficient NSPs the pressure to increase productivity. Using a Total Factor Productivity (TFP) change from the performance of the most efficient businesses will impose a lesser drive for productivity improvement on inefficient NSPs than is needed. The AER approach assumes that each NSP is operating at the efficient frontier yet, pragmatically, this assumption is flawed because it is unlikely that all are operating at this point.

The MEU considers that the AER needs to more comprehensively develop its approach to productivity adjustments. Rather than assume that an NSP is at the efficient frontier, assessing the efficiency of the base year as proposed above could provide a better indication as to the validity of the assumption.

2.5 Cost benefit analysis

The AER rightly identifies that all expenditure must be prudent. In the past, prudency has been equated with efficiency and the AER rightly points out that this is not entirely correct - a prudent investment might not be efficient.

The networks are required to carry out a Regulatory Investment Test.(RIT) to demonstrate that an investment it intends to make is efficient and prudent. Prudency implies that investment is required to ensure an improved outcome for consumers, but efficiency identifies if there is a net benefit - that the benefits of the investment more than offset its costs.

The MEU considers that there is a need to tie in the RIT to the actual costs incurred to ensure that there has not been inefficient investment made. The AER should require, as a matter of course, that when an NSP prepares a RIT for a project and that project proceeds, the NSP must report to the AER the actual costs of the project compared to the RIT allowance and to advise on any cost variances (and reasons) at the time the project is complete. This would

provide the AER with both a clear track record of an NSP's actual RIT development performance as well as the basis for any ex post investigation as to inefficient investment.

2.6 Transmission cost estimation risk factors

The AER expounds considerably on the cost estimation risks faced by TNSPs and proposes to allow the TNSPs some latitude in assessing the cost estimation risk allowance. The MEU has some concerns regarding this.

Whilst the MEU accepts that there are increased risks when there is a limited historic data base to develop costs and the longer the lead time before a project is completed, the MEU considers that this risk is overstated by NSPs.

Firstly, for significant projects, the TNSP is required to prepare a Regulatory Investment Test (RIT) to identify the most efficient approach to providing for the identified need. It is on the basis of the RIT that a project is identified as providing a net benefit (or not) and whether it should proceed. The costings used to identify the net benefit of each approach should be the basis for the actual allowance used for the project when it proceeds. To use any other cost makes the development of the RIT pointless.

Secondly, if a TNSP does not have the data in-house on which to develop an accurate capital cost for a project, then it could (and should) seek input from an entity that does have access to better data on which to make a sound cost element.

Thirdly, contingent risks (such as the AER identified "...unforseen weather impacts, industrial action, safety, planning approval, design development...") are not unique to TNSPs yet the impact of these risks is carried by any capital development and there are known techniques that are used to make adjustments for them. To allow TNSPs greater freedom in capital cost estimates for such exogenous impacts is not warranted. In fact many construction contractors provide pricing for projects that do not allow any ability to later vary costs for such exogenous impacts and provide fixed price contracts for capital projects. If this can be done in a competitive environment, then TNSPs should be able to estimate costs just as accurately.

Fourthly, the AER proposed to allow the TNSP to identify any residual risk (presumably with the ability to include an allowance for this) to be included in the cost build up. Again there is no substantiation for providing for such an allowance.

MEU members are just as capital intensive as TNSPs yet they are required to operate within the budget for capital projects where the budget is set on the basis of how the expenditure will enable the firm to provide service to its customers more efficiently. The RIT is the TNSP equivalent of the justification a

firm in competition has to develop its project budget. In a competitive environment, if the project budget is too high, the project will not proceed but if the project exceeds its budget, the staff involved commonly lose their jobs! NSPs should be accountable to the AER for keeping within the RIT established budget for capital works.

The MEU considers that the AER process proposed is too lax and has the potential for TNSPs to propose solutions that appear to be efficient when assessed by the RIT but then allows the TNSP to spend more than was the cost used to provide the preferred solution by the RIT.

2.7 The use of predictive models

The MEU notes that the AER intends to make greater use of predictive models (such as the repex and augex models). The MEU recognises the inherent risks of using such models as a definitive tools for setting allowances, but also recognises that the models will provide a good indication as to what level of expenditure is appropriate.

The MEU is strongly supportive of the use of such models and encourages the widest possible use for such predictive tools.

2.8 International benchmarking is needed

The major drawback of using the revealed cost as the basic approach is that it does not necessarily lead to NSPs being the most efficient. In fact, it embeds historic practices and does not force the NSP to seek more widely new ways for carrying out activities and, by implementing such new ways, reduce the costs to consumers.

Whilst the proposed benchmarking and use of datasets to identify lower costs incurred by other NEM NSPs should lead to continuous improvement across the NEM, the approach does not result in the step changes that might occur should international best practice be used as the basis for setting allowances. Whilst the MEU considers the AER has introduced tools that will provide a better outcome for consumers than the current tool kit, international benchmarking would result in a better outcome for consumers.

While the MEU notes that there is an intention to seek benchmarks from a wider set of comparators, the MEU notes that the focus of the proposed benchmarking and category analysis is essentially in relation to observed financial outcomes and costs. As international benchmarks are in other currencies, there is difficulty in translating overseas costs into $A as there is continued relative movement between currencies and this movement reduces the effectiveness of cross border benchmarks.

In contrast, if the benchmarks are not cost related then translation is much more appropriate and useful. On this basis the MEU considers that as well as the cost related benchmarks, the AER should seek to identify other benchmarks that can reflect overseas practices without introducing the problem of exchange rates

2.9 Historic and future benchmarking

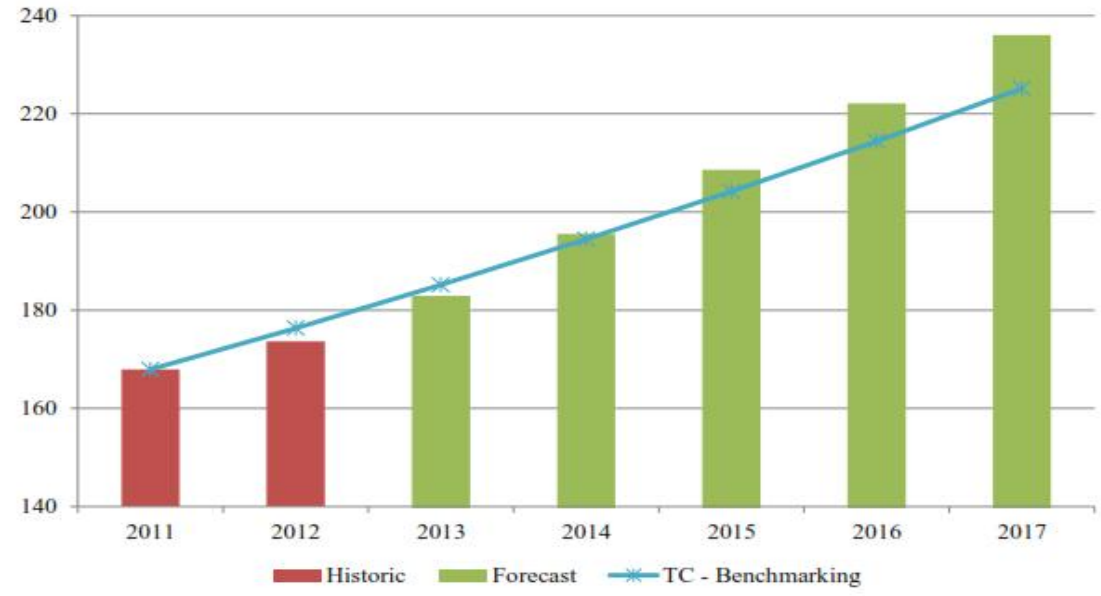
Traditionally, NSPs have provided historic benchmark performance data to prove they are operating efficiently. Usually this historic performance reflects activities some years in the past. What the NSPs have failed to do is to forecast forward to show that their forecast expenditure maintains this level of efficiency or improves on it.

The MEU has consistently been of the view that benchmarking has two very basic roles:

- The show that historic performance was efficient, and
- That this level of efficiency will be maintained or improved upon when using the expenditure forecast for the new regulatory period

The MEU is pleased to see that the AER intends to use its benchmarking to indicate that forecast expenditure will be efficient. This is demonstrated in figure A2 in the explanatory statement

Figure A.2 Comparing Total Cost Forecasts[280]



Under this approach, benchmarking is used to assess the efficiency of the forecast allowances during the rest process for the coming period.

This approach is a significant change and a welcome addition to the benchmarking activities. However, as noted below, this tool loses effectiveness if the forecast peak demand is not used as an output measure for assessing future efficiency.

2.10 Peak demand must be used as an output measure

Whilst the MEU notes that the principle of using forecast benchmarking is to be implemented, the aspect of the nominated outputs then becomes critical.

Consistently consumers have advocated for one of the output measures needs to be actual and forecast peak demand. Both the AER's consultant (Economic Insights) and the AER have espoused a view that the equivalent key output should be capacity of the network, although there is grudging acceptance by the AER that peak demand could be introduced at a later time (explanatory statement page 103)

> "In the long term, we consider some smoothed measure of peak demand should be adopted, in conjunction with an environmental variable that accounts for line lengths and densities. We also consider a 'ratcheted' peak demand (where the peak demand of each asset is summed over a five year period to obtain a rolling peak demand series) could be used. This would require 14 years of data to get the 10 data points necessary for more robust economic benchmarking."

It is the expected peak demand that decides what augmentation that is required to the networks. Whilst the MEU accepts that the historic benchmarking based on actual peak demand will show considerable variation (as actual peak demand varies considerably), the forecast for augmentation capex is based on the expected growth in demand in relation to the capacity already provided. For example, if there is no expected growth in demand during the regulatory period, then the initial view would be that there is no need for any augmentation of the network and no allowance for augmentation capex would be required.

The issue of peak demand (probably the non-coincident peak demand) is a core feature of being able to benchmark forecast allowances. It would be simply wrong to benchmark the forecast allowances on the basis of the system capacity that is likely to be provided over the next regulatory period as this would incentivise the provision of excess capacity. Inclusion of unnecessary excess capacity would result in greater efficiencies.

The MEU considers that the historic data should be based on both capacity and actual non-coincident peak demand. The value of this process is that it provides a strong indication of the spare capacity that is already provided in the network.

Forecast peak demand is a continuation of the series of actual peak demand as can be seen in the AEMO electricity Statement of Opportunities[1]:

Figure 3-8 — New South Wales summer maximum demand projections (medium scenario)

The purpose of showing the peak demand over historical and forecast is to put the forecast into context. In this case, the actual peak demand is unlikely to be exceeded until the end of the next regulatory period. Because of this, the need for augmentation capex in the coming regulatory period in this example would appear to be non-existent because the network has already demonstrated that there is sufficient capacity available.

By benchmarking on capacity alone, this obvious but critical aspect would not be included as a part of the benchmarking of forward expenditures.

From a consumer perspective, the NSP should only expect to be funded to provide capacity to meet the future needs, not to set a specific capacity. This means that the AER must include a benchmark based on non-coincident peak demand which measures the efficiency of forecast expenditure. To identify the benchmark for the forecast expenditure without testing this against historic non-coincident peak demand reduces the effectiveness of the measure.

[1] This is an extract from the 2012 ESoO

2.11 Interaction with incentive arrangements

The MEU is concerned that the incentive arrangements might not provide the incentives expected by the AER. The MEU has commented on its specific concerns in its response to the incentives guidelines.

In particular, the MEU is very concerned about the underlying incentives in the rules which have the potential to reduce (even overwhelm) the effectiveness of the explicit incentive programs. Whilst the opex incentive program (the EBSS) probably assists in taking opex to the efficient frontier, the MEU is very concerned that the capex incentive program (the CESS) will be effectively overwhelmed by the underlying incentive to overspend provided by the WACC differential.

The MEU therefore considers that a reliance on the explicit incentive programs to provide strong guidance for setting future expenditure needs more careful consideration than the AER has applied in the explanatory statement on expenditure assessments.

2.12 General overview

The AER has expended considerable time on the development of its new approach to assessing expenditure levels. The MEU sees that the AER has implemented a suite of approaches that should result in improved and more efficient allowances being made in regulatory resets.

During the stakeholder meetings to discuss the new AER approach, the MEU noted that one of the main criticisms levelled by NSPs to the proposed changes was that there would be considerable additional costs involved by the NSPs in complying with the new requirements, especially the provision of the additional data.

The MEU does not accept that there will be as much cost involved as is alleged by the NSPs. This MEU view is reinforced by feedback from MEU members who advised that in order for them to be able to control their costs and ensure that their costs are as low as possible, is to generate considerable breakdown of costs across many activities and over a long time frame. This collection of a wide range of input costs over time has considerable value to a firm that is seeking to operate as closely as possible to the efficient frontier. The clear import of their observations is that the NSPs (if they are operating efficiently) should already be collecting the data that the AER is seeking. In principle, this means that the provision of the data to the AER should be a costless exercise.

However, the MEU does accepts that while the data is available, it might not be in the standardised format that the AER requires, so the MEU does see that

there might be some cost for an NSP to generate the data in the format required by the AER to allow it to cross reference between NSPs.

For NSPs to provide the data in the format required should be a relatively simple exercise and the costs involved will far outweigh the benefits to consumers that the data will generate in terms of more setting more efficient expenditure allowances.

3. Comments on the draft Guidelines

The guidelines address TNSPs and DNSPs separately but the differences between the guidelines for TNSPs and DNSPs are minimal and the two are virtually identical. The MEU comments are therefore reflect its concerns across both TNSPs and DNSPs.

The AER assessment of expenditures will still be predicated on the use of a revealed cost approach, but the guidelines look to implement two other basic approaches to benchmarking – high level benchmarking addressing a number of controls and category analyses which look at actual costs for activities for application in cost build ups and use in the predictive models - augex model for (augmentation capex and the repex model for replacement capex.

Although the MEU recognises that the draft guidelines will improve the ability of the AER to assess past performance of NSPs and to integrate this assessment into the revenue reset processes the AER undertakes, the MEU is concerned that there are a number of shortcomings inherent in the draft guidelines as proposed. In the preceding sections, the MEU has attempted to explain its concerns and the impacts on consumers should its concerns not be addressed.

The MEU recognises that the refinements to the revealed cost approach and the addition of the benchmarking and category analysis are intended to implement a more equitable outcome for consumers than has been seen over the past seven years. The MEU considers that the two expenditure assessment guidelines generally reflect the intent of the AER as outlined in the accompanying explanatory statement.

The MEU recognises that during the actual implementation of the guidelines, the AER and stakeholders will identify where further enhancements are required to ensure that the outcomes reflect the intentions espoused in the explanatory statement. The MEU notes that the AER has not identified a specific time at which the guidelines will be reviewed - the AER notes that it may amend or replace the guideline "from time to time".

The MEU considers the AER is wise to be less than definite as to when it might elect to review the guidelines, as the MEU considers that actual implementation will result in more shortcomings being identified than those the MEU has detailed in the preceding sections.