Seeking better outcomes:

PIAC submission to the AER's Issues Paper –
Expenditure forecast assessment guidelines

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Introduction

The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights;
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from the Trade and Investment, Regional Infrastructure and Services NSW for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

Energy + Water Consumers' Advocacy Program

This program was established at PIAC as the Utilities Consumers' Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Park and Village Service;
- Ethnic Communities Council NSW;
- Rural and remote consumers;
- Retirement Villages Residents Association;
- Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

1. Overview

The Public Interest Advocacy Centre (PIAC) welcomes the opportunity to respond to the *Expenditure Forecast Assessment Guidelines Issues Paper*[1] (Issues Paper) published by the Australian Energy Regulator (AER) as part of its Better Regulation project.

PIAC is hopeful that the Expenditure Forecast Assessment (EFA) Guidelines will, together with the Rate of Return Guidelines and the Expenditure Incentive Guidelines, form a package of regulatory Guidelines that will drive much needed reform of the regulated network revenue assessments in the National Energy Market (NEM).

PIAC's response to the EFA Guidelines below includes:

- general comments about the Guideline process and its ongoing status, as these remain matters of considerable concern;
- high-level comments on the EFA Guideline; and
- response to specific questions raised in the main body of the Issues Paper.

The more detailed questions on benchmarking raised in the Appendices to the Issues Paper may be pursued more directly with the AER.

1.1 Consumer engagement in the process

PIAC is encouraged by the consultative approach taken by the AER to the development of the Guidelines, and more generally, to the network revenue determination processes.

A well managed consultation program that effectively engages all stakeholders will go a long way to addressing some of the criticisms of the previous regime; namely that it lacked transparency and rigour and was not sufficiently focussed on the overarching objective to meet the long term interests of consumers as captured in the National Electricity Objective (NEO).

PIAC acknowledges the consultation program already undertaken by the AER and is committed to working constructively with the AER and other stakeholders so that the Better Regulation process, including the EFA Guidelines, delivers on this objective.

However, as previously indicated in PIAC's response to the Rate of Return Issues Paper,[2] PIAC remains most concerned with the limited resources available to consumer advocacy groups to respond fully to the Better Regulation project.

This concern has only heightened during the first few months of 2013 when the extent and complexity of the issues and associated consultation processes has become more apparent. However, without the full engagement of consumers in all aspects of the process, the impetus for implementing genuine reform that is accepted by all stakeholders will be placed at risk.

Additionally, PIAC considers these risks could be further exacerbated by the current imbalance of resources between consumers and industry, just at a time when the priority is on restoration of the balance between investors' and consumers' interests through a focus on the long-term interests of consumers.[3]

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1 AER, *Expenditure Forecast Assessment Guidelines – Issues Paper,* 2012.

2 Public Interest Advocacy Centre, *Better returns for consumers*, 2013.

3 See for instance the letter from Andrew Reeves, Chairman of the AER, to stakeholders, 10 December 2012, which states: "We are beginning a program of work to deliver an improved regulatory framework focused on the long term interests of electricity consumers."

PIAC acknowledges the AER cannot overcome the resource and information asymmetries that exist between consumers and industry on its own. It is a well-documented dynamic and PIAC commends the AER on its willingness to work with a range of stakeholders to improve opportunities for meaningful consumer engagement to date.

Nevertheless, it is essential that there is no real or perceived risk of industry capture of the reform process arising from these asymmetries in resources.

PIAC, therefore, submits that the AER could assist in overcoming some of the existing imbalances by commissioning independent experts to provide advice, plain language background papers and examples of best practice in other jurisdictions to inform key aspects of the Better Regulation Program.

This would assist consumers greatly in providing constructive and meaningful comment on integral facets of the program. It would also greatly reduce the risk of industry capture of this important process of reform.

Recommendation 1

PIAC recommends that the AER commission a number of background papers and examples of best practice to inform debate about expenditure forecast assessment.

1.2 Non-mandatory nature of the guidelines

A further concern arises from the fact that the new Rules specifically state that the Guidelines are not mandatory on either the AER or the network proposer. [4] PIAC notes, for instance, that this has been highlighted by some of the representatives of the network service providers (NSP) in the very early stages of the consultation processes.

It would be of great concern to other stakeholders if raising the non-mandatory status of the Guidelines at this early stage in the process was a reflection of some lack of commitment to the Guidelines by the NSPs.

Certainly, PIAC would hope that the detailed consultation processes being undertaken by the AER throughout 2013 means that NSPs' proposals (and the AER's evaluation of them) will be set out within the Guidelines. This would be a far preferable outcome than one where NSP's introduce new models etc., outside the Guidelines and with considerably less consultation than is now occurring.

Moreover, there should be little need to introduce new approaches/models etc. (beyond those set out in the Guidelines.) going forward – particularly when the Guidelines themselves are likely to provide a number of 'acceptable' approaches that could be applied by the network or the AER.

If network proposals do vary from the Guideline framework, then consumers will require networks to provide detailed explanations of why and of how this 'new' approach better satisfies the NEO (or NGO).

Importantly, consumers will also require that an equivalent opportunity be provided by the networks (including resources) for consumers to be engaged in consultations on the alternative

[4] NER cl 6.2.8 (c) & 6A.2.3 (c).

proposals – PIAC would expect no lesser degree of consultation than in the current Guideline consultation approach.

Given that the Guidelines are non-mandatory, PIAC submits that the AER develop a framework or checklist that must be used prior to accepting methodologies that diverge from the Guideline.

This checklist would include a requirement that alternative methodologies have been developed following meaningful consultation with consumers, comply with the principles agreed by all stakeholders and are demonstrably delivering on the long-term interests of consumers.

Recommendation 2

PIAC recommends that the AER develop a framework or checklist that must be used prior to accepting methodologies that diverge from the Guideline.

1.3 Other Risks in the Process

PIAC has also previously highlighted a number of risks in the Better Regulation process that are worth emphasising again as part of the EFA Guideline development.

1.3.1 Seeing the woods, rather than the trees

First, as in the Rate of Return Guideline, there is a risk that in the process of Guideline development the AER and other stakeholders become too focussed on the detail.

The AER recognises this risk indirectly in their statement of principles in the Issues Paper. However, it is a matter that needs constant attention, particularly when examining issues such as benchmarking where the overall objective can be lost in the detail of measurement, data collection and modelling.

PIAC stresses that the purpose of expenditure assessment is ensuring that, overall, the network services are delivered efficiently and in the long-term interests of consumers.

Therefore, the greater focus should be on the overall effectiveness of the regime in driving *aggregate efficiency.* Efficient performance in individual areas of NSPs' services are only important to the extent they are key drivers of the aggregate efficiency in service delivery. This is discussed further in section 2.5.

1.3.2 The exercise of regulatory discretion

The new Rules require the AER to consider a variety of tools in their assessment of the rate of return, and in forecasting expenditure. It is suggested, therefore, that the Rules require the regulator to set out a variety of acceptable approaches (following review) within the Guidelines.

The corollary of this flexibility, however, is that for any particular determination the regulator will need to exercise their discretion more broadly than in the past either in the selection of a particular approach or in combining (weighting) a number of different approaches.

The difficulty PIAC foresees is that the regulator may be exposed to more challenges in their decision making than previously existed when the NER were more specific about the approach to be taken by the regulator and the NSP proposer. Greater judicial intervention would be a perverse outcome from the reform process.

At a minimum therefore, it is essential that the process for selecting the 'menu' of approaches from the Guidelines, whether it relates to rate of return assessments or expenditure assessment and benchmarking, is both transparent and thorough and minimises scope for subsequent judicial challenge through the Australian Competition Tribunal.

Having been through the Guideline process, however, it would again be hoped that all stakeholders feel confidence in the AER exercising its regulatory discretion to act in accordance with the NEO in making any particular determination.

In addition, the Better Regulation program must be accompanied by a parallel reform of the Australian Competition Tribunal (the Tribunal) along the lines set out in the 2012 review of the Limited Merits Review regime sponsored by the Standing Council of Energy and Resources (SCER).[5]

Recommendation 3

PIAC recommends that, given the greater role for regulatory discretion, the AER ensure that the Guideline development process minimises the potential for judicial challenge.

Recommendation 4

PIAC recommends that SCER reform the operation of the Tribunal in line with the recommendations in the Limited Merits Review regime.

1.4 Expenditure Forecast Assessment Guideline

PIAC supports the expenditure forecast assessment program, particularly given the difficulties the AER has had to date in determining efficient and effective operating expenditure (opex) and capital expenditure (capex) proposals by the networks.

In particular, the AER appears to have felt very constrained in its use of benchmarking tools for assessing network expenditure and has had even more limited capacity to critically scrutinize forecasts for expenditure over the 5 year period. The new Rules should have removed any ambiguity over the AER's rights and obligations to use benchmarking as part of its regulatory tool-kit.

Moreover, the AER (as noted in the Issues Paper) has placed heavy reliance on 'revealed costs' for assessing baseline costs and associated 'step and trend' forecast of costs.[6]

The presumption has been that the regulatory incentive mechanisms would drive a business towards an efficient expenditure frontier.

However, there appears to be no evidence that networks have become more efficient in delivering their regulated services or that they are subject to the same pressures to improve productivity as a competitive market would drive - or as many of the customers they service are subject to.

In PIAC's view therefore, there are a number of reasons for not accepting this presumption, including:

5 Yarrow, G., Tamblyn, J. & Egan, M., *Review of the Limited Merits Review regime,* 2012.

6 'Revealed costs' refers to the actual costs incurred by the NSP in the final years of the previous determination. 'Step and trend' refers to the transition from one regulatory period to another, where there is an initial step change, followed by a smooth trend in the expenditure forecast.

- there has been no efficiency mechanism applied to capex expenditure, with the additional effect that this could distort efficient network expenditure allocations between capex and opex;
- the expenditure efficiency mechanism for opex is relatively weak in terms of its coverage, consistency and the overall impact on network revenue; and
- there are complex relationships between the expenditure incentive regimes and the incentives on the networks to forecast future requirements as accurately as possible – these have not been well documented and potentially also distort the value of using 'revealed costs'.[7]

Despite recognition of the limitations of revealed costs, PIAC considers that this approach will continue to have a place in both capex and opex reviews, particularly while more objective alternatives, such as benchmarking, are being developed.

Development of benchmarking will necessarily occur over a number of determination rounds as data quality and modelling techniques improve over time.

It is essential, however, that the benchmarking process begins now, that it is guided by the long term interests of consumers and the other high level regulatory principles set out National Electricity Law (NEL) and the NER and that all stakeholders recognise and accept that this will be an evolutionary process.

PIAC largely agrees with the AER's approach in which the development of the disaggregated benchmarking (through the category analysis stream) occurs in parallel to the development of aggregate efficiency benchmarking techniques (through the economic benchmarking stream).

This is a practical step forward in the process, enabling early and actionable benchmarking through category analysis. Ultimately, however, the development of high level economic benchmarking may prove to be the more fundamental driver in achieving the NEO and ensuring:

- a 'whole of life perspective'[8] is adopted to assessment of network efficiency;
- network services reflect what consumers want;
- there is an efficient allocation between capital and operating expenditure; and
- Network services are provided at a cost and quality that reasonably replicates those delivered in a sustainable competitive market.

Recommendation 5

PIAC recommends that the AER proceed with the implementation of benchmarking at both the aggregate and disaggregate levels in the next round of determinations, albeit modifying its initial application in revenue assessment to reflect any genuine limitations in the data and models.

7 For example, a network may be incentivised to over-forecast its actual expenditure requirements if the incentive mechanism rewards companies that under-spend the allowed amount. This will be exacerbated in the absence of the regulator implementing effective benchmarking of the base year, and robust forecasting models.

8 AER, above n 1, 18-19.

2. Response to questions

2.1 Implementation of the new assessment framework

Q1: Should we anticipate the application of some assessment techniques to gas service providers as part of this consultation?

Q2: Do stakeholders have any preliminary comments on the development of guidelines that will be different for transmission and distribution businesses?

Q3: How should linkages between expenditure assessment, information collection and storage, cost allocation and incentive arrangements be dealt with in the development of our overall assessment framework?

PIAC understands that the gas service providers will have many different cost drivers and outputs at the disaggregated category level of analysis.

In PIAC's view it is important that the AER focus their current attention primarily on the electricity distribution networks and secondarily on the electricity transmission networks. It is the changes to electricity distribution network revenues that have been the main cause of accelerated energy cost increases for most consumers.

However, the need to develop benchmarks for gas service providers still remains and, when undertaken, the current electricity benchmarking process should inform this development.

In particular, the debates arising in the current process with respect to how and where various benchmarking techniques can be used and the higher level modelling required for economic benchmarking are both relevant to the assessment of expenditures for gas service providers.

PIAC is also encouraged to see that the AER supports the recommendations made by the Productivity Commission to establish a data base to facilitate public access to input data for benchmarking techniques to enable stakeholders to undertake their own analysis.

This is an important step towards ensuring ongoing transparency in the process and to holding network service providers more accountable for their investment decisions and general operating expenditure.

Having said that, however, the issues about what data could be legitimately considered 'commercially confidential' become even more critical given public access to input data. The potential for a public access data base should therefore inform the development of the Guidelines on confidentiality (et al), while on the other hand, should not become a reason for not proactively addressing the current issues around the excessive redacting of data in the determination process. A careful balancing of interests by the AER will be required.

2.2 Objectives for expenditure forecast assessment

Q4: Have we appropriately characterised the role of benchmarking in expenditure assessments, and set an appropriate objective in expanding and formalising our approach in consultation with stakeholders?

Q5: Do stakeholders have views on the use of revealed costs and the reliance on incentive mechanisms and how this should change with the increased reliance on benchmarking to assess expenditure allowances?

As stated by the AER, the current framework under Chapters 6 and 6A of the NER promote the implementation of an incentive framework that (simplistically) rewards NSP's for outperforming the expenditure allowances set by the regulator.

While PIAC supports this approach in principle, its effectiveness in promoting achievement of the NEO by meeting the long-term interests of consumers rests very strongly on the reasonableness of the forecasts of future capital and operating expenditures – as provided by the NSP or by the AER.

For example, if the final approved forecasts are in fact above the reasonable expenditure requirements, then NSP's are rewarded under the incentive mechanisms while they may not, in fact, be improving their performance.

PIAC understands that, to date, the AER has relied heavily on the 'revealed cost' approach (or its variation, the 'step and trend' approach) on the assumption that the incentive mechanism would itself have provided a driver to reduce historical costs.

However, given the outcomes over the past round of regulatory determinations in a number of jurisdictions, PIAC firmly believes that the revealed cost approach is not sufficient to illuminate efficient costs for either the base year or the forecast years.

Specifically, PIAC does not consider that the previous determinations had sufficient rigour in assessment of operating and capital costs, nor the incentive mechanisms have sufficient range or strength,[9] for the regulator to assume that the last years of the current determinations provide a starting point for the determinations from 2014 on.

In addition, the incentive mechanism itself provides an incentive for NSPs to over-forecast their expenditure requirements in their revenue proposals leaving the onus on the regulator to establish the unreasonableness of the forecasts, and in the alternate, the reasonableness of the regulator's forecasts.

Moreover, while the 'step and trend' analysis can provide some insights, it is difficult to see how the approach will, on its own, turn around the decline in productivity of the networks and drive the improvements in productivity that are essential for the long term interests of consumers. As the AER notes, the NER puts the process of *improvement* in cost and quality at the heart of the regulatory compact with the monopoly providers.[10]

In PIAC's view it is essential that both aggregated and disaggregated benchmarking techniques are expanded and effectively and immediately implemented.

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9 That is, the incentive mechanism did not include capital expenditure ('range'), and only a relatively small proportion of total revenue was at risk ('strength').

10 AER, above n 1, 18 – refers to NER clauses 6.5.6 (e)(8), 6.5.7(e)(8), 6A.6.6(e)(8) and 6A.6.7(e)(8).

To this extent, PIAC supports the AER's proposals on benchmark development. PIAC also urges the AER to progress these developments as soon as possible so that future determinations can build on an efficient base line and a set a clear pathway to achieving further improvements in the cost and quality of the NSP's services over time.

2.3 Use of principles for selection of assessment techniques

Q6: Are there any other principles that you think that should be added to this list? Should we include principles that guide the selection of the assessment techniques to be applied in the framework and approach stage, from the list of appropriate techniques (that will be) outlined in the Guideline? If so, do you think that the principles outlined here provide appropriate guidance on technique selection?

Given the multiplicity of techniques that can be applied by the regulator to benchmark network performance, PIAC supports the use of explicit principles to inform the process of selecting the most appropriate of these techniques.

However, PIAC has previously emphasised the need to also *explicitly* frame the principles in the context of the NEO, and specifically, the obligation to regulate network revenue in the long-term interests of consumers with respect to cost, quality reliability etc. [11]

PIAC would seek to ensure that this is also captured in the current Expenditure Guideline principles.

In particular, PIAC notes that the AER itself has referred in the Issues Paper to the need to take a long-term perspective on the expenditure proposals, saying:

> The concept of efficiency contained in the NEO and the revenue and pricing principles reflects a longer-term perspective, addressing the interests of consumers and the implications of investment requirements over the long term. **In this context we will be assessing expenditure proposals from a whole of life perspective**, with the NSPs expected to provide evidence that they have considered investment and operational decisions over this timeframe.[12] (PIAC emphasis)

PIAC strongly supports the AER's views expressed above with respect to analysis of expenditure proposals. However, this also means that the benchmarking tools need to be compatible with a longer term perspective and are not just undertaking analysis of short term efficiency opportunities.[13]

For example, the benchmarking techniques with a longer term assessment focus are better able to assess the efficiency of expenditure allocation between opex (usually short term benefit) and capex (longer term benefit).

Given its importance, PIAC therefore recommends that the requirement to provide a *longer term perspective* on efficiency is *also captured* in the principles espoused by AER for evaluating relevant benchmarking techniques.

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[11] PIAC, above n 2, 8.
[12] AER, above n 1, 18-19.
[13] PIAC notes that this issue is also considered in some detail in AER, above n 1, 58-59.

In addition to the need to capture the overall objectives (as expressed in the NEO and the NEL) and the requirement to provide a longer term perspective (above), PIAC would make the following comments on the 5 principles listed in the Issues Paper:

- PIAC agrees with Principle 1 that the assessment technique must be relevant to the task and also agrees with the distinction made by the AER between the two tasks of assessing efficiency and assessing forecasting from a practical perspective, although the two are linked.
- PIAC supports Principles 2, 3 and 5 whose collective effect is to focus on objective comparison using actual or 'realised' data, and to limit the level of detail and complexity of the analysis; and
- PIAC agrees in general with Principle 4, which states that for certain variables (e.g. regulatory compliance requirements) there should be a focus on the *change* to these variables, rather than 'rebuilding' those circumstances.

Providing sensible limits on the detail of the analysis as per Principles 3 and 5, provides some comfort to PIAC that the AER will not find itself trapped into debates on relatively unimportant parameters, and can therefore focus its attention on the overall performance of the business across both capex and opex.

Recommendation 6

PIAC recommends that the AER include in its principles for evaluating benchmark techniques that the technique(s) is consistent with providing a longer-term perspective on efficiency.

2.4 Expenditure assessment techniques

Q7: Are there any assessment techniques that should be considered as forming part of the guidelines? What are the relative benefits and shortcomings of each of the approaches and how could the latter be addressed?

In considering the assessment techniques set out by the AER in Section 4.7 of the Issues Paper, PIAC notes that they vary in both the level of disaggregation of the business and the extent of both data collection and modelling required to support the benchmarking analysis.

At this stage, PIAC considers it valuable to retain the option for using all of the techniques set out in the Issues Paper, albeit with a concurrent review of their strengths and weaknesses (which will, in turn, inform the selection of the appropriate technique at a given time, and/or for a given determination).

As a general principle to follow in the implementation of the various techniques, PIAC also seeks consideration of the following:

- where detailed analysis is chosen (such as engineering analysis), the AER should establish priorities in terms of the relative cost of the service element on the one hand and its impact on the quality of the service and its relevance to consumers' long term interests on the other hand;
- the opportunities for using robust data sampling techniques to assess the cost and quality of a particular network's historical services delivery;
- the AER apply considerably more rigour to the examination of expenditure forecasts that are significantly above previous expenditures. There may be legitimate reasons for such

changes, but these need to be justified by appropriate analysis and investigation of whether alternatives have been considered[14]; and
- the techniques selected should also reflect the previous performance of the NSP in providing reliable forecasts of expenditure requirements. For example, if an NSP has previously had a record of over-forecasting requirements then the default presumption should be that they will be subject to more intrusive techniques in the next determination.

PIAC considers that this approach will provide an additional incentive mechanism for NSPs to provide accurate forecasts of expenditure requirements, the 'reward' being that the AER can utilise less intrusive (and costly) techniques in future determinations. Ofgem, for instance, has adopted such an approach to encourage improved planning and service delivery by NSPs:

> Our initial assessment (of the DNOs' plans) will inform our view on how much regulatory scrutiny each plan requires and whether any company has submitted a plan of sufficient quality for us to be able to conclude its price control settlement early (ie to be 'fast-tracked').[15]

2.5 Proposals for Further Work

Q8: Do stakeholders agree with our general approach of attempting to derive quantitative relationships between expenditures and drivers? Are there better, more cost effective alternatives to assessing disaggregated expenditures?

Q9: Do stakeholders have any in-principle comments about the level of expenditure disaggregation given our expectation that lower levels of aggregation e.g. by asset type, are likely to be conducive to more robust benchmarking and other quantitative analysis?

PIAC strongly supports the AER's proposed approach of deriving quantitative relationships between expenditure categories and drivers.

For instance, the last round of determinations has been characterised by NSPs proposing very significant additional costs in response to growth in peak demand, network replacement (due to 'aging' network assets) and higher regulated reliability standards.

While it is acknowledged that these factors may be important drivers of 'above trend' expenditures, there is a need for a much clearer understanding of what the relationship is – for a 1% growth in peak demand, what is the expected growth in augmentation expenditure; and for a 10% growth in average age of an asset age, what is the expected replacement expenditure? Is this a straight-line relationship or a different functional form?[16]

Similarly, there are many discussions about the relationships between scale (whether geographical, consumer numbers, volumes etc.) and efficient costs. However, these relationships have not been quantified and it is important that they are investigated.

PIAC notes here that this also raises the questions of ownership structures and how this may influence scale effects.

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14 PIAC notes here the AER's review of Aurora Energy's proposal for 2012-2017, where significant cost savings were made following detailed review of particular new expenditure items.

15 Ofgem, *Strategy decision for the RIIO-ED1 electricity distribution price control,* 4 March 2013, 6. A detailed description of the 'proportionate treatment' regulatory approach is set out in section 6 of the Ofgem report.

16 AER, above n 1, 74.

For example, a number of the Victorian electricity NSPs are quite small, but when aggregated at the entity level, they are substantially larger. Which size is the relevant variable for (say) CitiPower – is it the number of customers in CitiPower or is it CitiPower plus PowerCor – when it comes to assessing parameters such as efficient connection costs?

Statistical analysis, sampling and detailed engineering investigation may provide some insights into these relationships, as might Ofgem's regression analysis approach to capex, opex and totex (total operating expenditure) at a higher level.[17]

While acknowledging that Ofgem's approach places greater demands on information provision, it is worth undertaking some preliminary investigation of the opportunities to test these models – or some simplified version of these - in the Australian context.[18]

With respect to Question 9 in particular, PIAC would be concerned if the inference in the question is that the more disaggregated the expenditure category, the greater the robustness of the benchmarking. This may be the case in some instances, but there will be others where a greater level of aggregation will result in more robust benchmarking by averaging out errors (as identified by the AER on page 30 of the Issues Paper).

At a minimum, PIAC suggests that it is the combination of both disaggregated analysis of some key expenditure components and aggregated analysis that is the key to a robust process.

Q10: Do stakeholders agree that economic benchmarking will be an important adjunct to more detailed expenditure assessments?

PIAC considers that the progressive introduction of economic benchmarking is essential to the process of economic regulation.

Economic benchmarking both complements and informs the more detailed expenditure assessments. As the AER has noted in the Issues Paper (at page 29), the capex, opex and totex analysis can be used to 'supplement' the category based assessments and to 'capture whole business efficiency'.

Moreover, it is to the benefit of all parties that aggregate assessments become progressively more significant as part of the overall determination by the regulator.

Driving improvements in the 'whole business efficiency' is the end-goal of economic regulation, leaving each business to achieve this in the way that best suits their circumstances within the regulatory service level standards. This provides more flexibility for the network business as the network can choose to have (for example) above average expenditure in one area, offset by less expenditure in others to achieve the most efficient mix for that business.[19]

17 A description of these techniques is provided in a number of Ofgem papers, for instance, Ofgem, *Strategy consultation for the RIIO-ED1 electricity distribution price control: Tools for cost assessment,* 2012, 13-21.

18 Given the more restricted data available, such investigation would need to be exploratory and not form part of a determination directly until at least there is more confidence in the data.

19 This is analogous to the AEMC's assessment that it is the 'level' rather than the specific contents of the approved expenditure allowances that underpin the incentive properties of the regulatory regime in the NEM. AEMC, *Rule determination: Rule change; Economic Regulation of network service providers and price and revenue regulation of gas services*, 2012, 93. Cited in AER, above n 1, 15.

2.6 Expenditure Assessment Process

Q11: Do stakeholders agree that that the first-pass process described above is a useful and appropriate application of expenditure assessment techniques?

PIAC considers that the first-pass process proposed by the AER is a useful adjunct to the regulatory determination cycle. Its benefits include:

- allowing the AER to focus on particular areas that are problematic in the NSP's submission.
- providing an incentive to the NSP to forecast their requirements more accurately as they will benefit from a less intrusive process; and
- other stakeholders, including governments and consumers, will get early access to objective and transparent comparative performance data that, in turn, will provide an opportunity to proactively query their NSP on the past performance and proposals before the draft determination stage.

PIAC would particularly stress the importance of the last benefit listed above, which was not specifically identified in the Issues Paper.

It has been a constant theme in recent reviews of network regulation that the regulatory processes to date have not adequately engaged consumers. On the other hand, the cost and technical skills that are required to be effectively engaged in the current processes are a daunting challenge for consumers.

The first-pass assessment—properly communicated to consumers—will enable a direct and early engagement by consumers on parameters that are more readily accessible, such as comparative costs for particular activities.

As noted above, consumers themselves can immediately and, importantly, before the draft determination stage, query the NSP as to why its performance (at either disaggregated or aggregated levels) lags behind the benchmarks.

2.7 Expenditure Incentive Schemes and their Application

Q12: Do stakeholders have any views on the relationship between the assessment tools that we have identified, and our existing incentive schemes? Given the interrelationship between the two, and that our incentive schemes are to be revised over 2013, what processes should we follow to ensure there are appropriate incentives on NSPs to make efficiency gains, while at the same time implementing appropriate expenditure assessment techniques?

To the extent that various investigations have identified declines in both total and partial factor productivity levels in the NSPs over the last 3-5 years,[20] PIAC is sceptical that the current efficiency benefit sharing schemes (EBSS) arrangements have achieved their stated objectives across all the jurisdictions in the NEM.

While a number of factors may have contributed to this productivity decline, nevertheless it is of major concern to both small and large consumers and must be aggressively addressed by regulators in the long-term interests of consumers.

[20] See for example, Productivity Commission, *Electricity networks regulatory framework – Draft report,* 2012, 219.

It is hoped therefore that the proposed 2013 review of the existing opex incentive mechanism, and the development of a new capex incentive scheme, will enable the regulator to address this issue of productivity decline more effectively in the next round of determinations.

It is also important to consider, as part of this review, the 'strength' of any incentive scheme. That is, how much of the network's revenue is at risk from below par performance and, in the alternate, what additional profits can be (justifiably) made by improved performance against the forecast?

PIAC would expect that over time, the strength of any incentive scheme would increase.

If this is not the case, and/or the incentive arrangements continue to be vulnerable to 'gaming', then perhaps the regulator can consider a more direct approach by setting an overall efficiency improvement target (e.g. 10% reduction in costs to connect customers over a 5 year determination period) based primarily on the outcomes of the economic benchmarking analysis. It would be then up to the network to determine how they achieve this within the regulatory performance requirements (that is, service quality would have to be closely monitored in parallel)

Beyond PIAC's concern with the apparent flaws and gaps in the current incentive arrangements, PIAC does understand that incentive schemes can lead to perverse outcomes and that there are complex relationships between forecasting, benchmarking and incentive schemes.

However, PIAC would also note that there appears to be a further relationship between these factors and the cost of capital differential (i.e. the differences between the 'allowed' and 'actual' capital expenditure). Where the allowed cost of capital exceeds the 'actual' there may be an incentive to spend more than the allowed amount even with an efficiency scheme in place, depending on the relative 'rewards' from the incentive scheme and the rate of return amounts.

Whether the recent changes to the Rules which allow the regulator to investigate historical capital expenditure efficiency (when this exceeds the regulated capex allowance)[21] will sufficiently address this issue, or whether the cost of capital approach must be also considered alongside the incentive schemes, is worthy of further investigation.

Recommendation 7

PIAC recommends that when developing the capex and opex incentive scheme, the AER adopts a long term perspective with progressively more revenue at risk under the incentive scheme arrangements.

2.8 Implementation Issues

Q13: Do stakeholders have any comments on how best to manage the interrelationships between the guidelines, F&A processes, determinations and annual benchmarking reports?

Q14: How would it be best to maintain a degree of consistency in assessment techniques and associated data reporting while at the same time allowing improvements in techniques?

[21] NER sch. 6.2.2(a)

Q15: Are there any ways the expenditure assessment process, including in preparing NSP forecasts, could be improved by linking the Guidelines, the F&A process and the NSP's obligation to notify us of its forecasting methods?

These questions (and the following questions 16 - 19) highlight the complications facing the AER in the implementation of benchmarking particularly in the context of both the history of jurisdictional based regulation and performance reporting and the staggered timing of regulatory determinations.

PIAC acknowledges these issues, some of which are clearly transitional and some more substantive.

However, PIAC would be most concerned if these difficulties led to undue delays in the implementation of an effective suite of benchmarking tools, albeit PIAC recognises that their use would need to be qualified somewhat in the next determination round.

The questions raised by the AER (above) also highlight that all parties must accept that the process is an evolutionary one not a revolutionary one and, therefore, also accept the need for both an ongoing, protracted dialogue amongst stakeholders and for progressive changes to both data requirements and models.

What is essential to this developmental process is that it is a controlled change process and that the directions of change and modelling enhancements are clearly signalled well in advance of their actual implementation.

PIAC considers that while this may constrain the rapid adoption of 'new approaches', the relative benefits of predictability and transparency outweigh this consideration. In any case, 'new approaches' should be subject to considerably more public and regulatory scrutiny than would be captured in the course of any one determination process.

Consumers should not be faced with a scenario where there is less opportunity for critical consultations on new methodologies than is available under the Better Regulation program. This will only undermine the validity of the current process.

Further, PIAC believes that any network claims regarding implementation costs or other factors hindering the implementation of new data reporting requirements (*particularly when these have been clearly signalled in advance of the regulatory determination*) should be subject to very robust scrutiny by the regulator.

NSPs have generally been granted significant cost allowances associated with non-system information technology (IT) expenditures in their most recent determinations. This should have provided the NSPs with the opportunity to develop comprehensive management and regulatory reporting systems that can also be more readily adapted to provide any new requirements for data.

For example, in the most recent Victorian distribution networks determination (2010-2015), the AER allowed a total of some $463M for non-system IT expenditure, including: Citipower and PowerCor received approval for some $150m new capital investment in non-network IT. Jemena and United Energy received a total of $170M and SP Ausnet received some $143M.[22]

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[22] AER, *Victorian electricity distribution network service providers, Distribution Determination 2011-2015, Final Decision – appendices,* October 2010 Appendix P.6, 710 -738. Table P.94. This does not account for any changes that have been made following appeals by the NSPs to the Tribunal.

This is new capital expenditure and is significantly higher than previous allowed and actual expenditure on non-system IT. It is also additional to the network control and supervisory control and data acquisition (SCADA) capital expenditure allowances and to the allowed Advanced Interval Meter IT capital expenditure.[23]

It would be surprising if such investment did not at least facilitate a relatively low cost response to any future enhanced regulatory reporting requirements.

3. Conclusion: Seeking Better Outcomes

PIAC's strong view is that the previous regulatory regime has failed to achieve an appropriate balance between the interests of shareholders and the interests of consumers.

The expenditure forecast assessment review, together with improvements in the rate of return and incentive frameworks that can be expected under the Better Regulation program, provides a 'one-off' opportunity to address this imbalance,

PIAC acknowledges the complexity of the task facing the AER in developing new Guidelines for assessing the operating and capital expenditure proposals by the NSPs. PIAC also accepts that that the development of a comprehensive and balanced benchmarking regime is an evolutionary process.

Nevertheless it is a task that must be commenced now in order to provide a foundation for regulatory decision making in the next round of electricity network determinations. In this context it is pleasing to see that the benchmarking process will assess overall efficiency as well as the efficiency of individual expenditure categories. Over time, this will provide a stronger regulatory framework for driving productivity improvement in the provision of network services for the long term benefit of all consumers.

PIAC supports the comprehensive program of consultation on the Guidelines that is being undertaken by the AER, although PIAC also notes its concern with the imbalance of resources, which may limit the ability of consumers to participate fully in the program designed to serve their long-term interests. PIAC has therefore suggested various ways the AER could address this issue.

This consultation and greater transparency in the process is particularly important given that the revised NER provides for the AER to exercise a higher level of regulatory discretion than before.

It is hoped and expected that, as a result of this extensive consultation process, all stakeholders accept the Guidelines as the basis for network regulation over the next few years. Given the extent of the process currently under way, it would be difficult for consumers to accept a second period of disputation and judicial appeals, such as that which occurred in the first regulatory period under the AER.

23 Advanced Interval Meter IT expenditures by the NSPs are approved by the AER under a separate regulatory determination.