15 March 2013

Mr Chris Pattas
General Manager - Network Operations and Development
Australian Energy Regulator
Level 35, The Tower
360 Elizabeth St
Melbourne Victoria 3000
via email: expenditure@aer.gov.au

Dear Chris,

Expenditure Forecast Assessment Guidelines– Issues Paper

SP AusNet welcomes the opportunity to provide this submission in response to the AER's Issues Paper on the Expenditure Forecast Assessment Guidelines.

The Guidelines will form an important component of the framework governing the economic regulation of energy networks as they will articulate the AER's approach to assessing expenditure forecasts in making revenue and price determinations. It is expected that the Guidelines will also set out how the AER's approach to forecast assessment may develop and evolve over time, including potential assessment techniques which may be applied in the future.

This submission sets out SP AusNet's response to the Issues Paper. Our key comments on the AER's proposed assessment techniques are summarised under separate headings below. SP AusNet's answers to the various questions contained in the Issues Paper are provided in the Attachment to this submission. However, it should be noted that at this early stage of the AER's work on the Guidelines, a number of SP AusNet's responses can only be regarded as provisional.

Timeframes under the NER, and implications for the Guidelines

The purpose of the Guidelines is to specify:

- the approach that the AER proposes to use to assess the forecast capital and operating expenditure that forms part of an NSP's revenue or price control proposal; and

- the information the AER requires for the purpose of that assessment.

The Rules state that the AER must consult on, and publish the first version of the Guidelines by November of this year. In view of this challenging timeframe, SP AusNet expects that the further development in the Guidelines may follow the first publication.

SP AusNet is, therefore, supportive of the Guidelines canvassing potential future assessment techniques and the information that may be required to facilitate the development and specification of these future techniques.

It would be valuable for the Guidelines to include, as the AER has already foreshadowed, clear principles that the AER would apply in selecting and applying any new techniques, in order to provide clarity and certainty as to when particular approaches would become 'live.'

While SP AusNet supports the exploration of new and innovative ways to refine and improve regulatory decision-making, SP AusNet shares ENA's view that it is important at this time to clearly distinguish between:

- benchmarking techniques that can be applied in upcoming reviews; and
- "aspirational" economic benchmarking techniques that can, for practical reasons, only be applied during subsequent reviews.

We agree with the ENA that the latter group of techniques should be included in a separate work program that also deals with annual benchmarking reports and regulatory reporting requirements. That work program should have a timetable and resourcing effort that is aligned to the purpose of the annual benchmarking reports.

In making these suggestions, we wish to emphasise that our position is not in any way seeking to delay the application of new and useful approaches to assessing expenditure forecasts. Rather, it is to facilitate the establishment of Guidelines by November that are fit for purpose, whilst allowing a more reasonable timeframe to:

- properly explore and test options in relation to future assessment techniques; and
- formulate the appropriate model designs and specifications to enable the proper application of those techniques.

SP AusNet recognises that the AER intends to publish its first annual benchmarking reports in 2014. A critical precursor to achieving this will be the establishment of the information reporting requirements for the NSPs. Recognising the time constraints, SP AusNet suggests the AER should collect sufficient information to conduct high level benchmarking and comparative analysis in the short term. This would be preferable to specifying an onerous dataset aimed at populating a potential assessment technique which may, or may not, be applied in the future.

SP AusNet considers that simple, yet highly useful and informative data is readily available and can be provided to the AER to allow for the delivery of a benchmarking report in 2014. In the longer term, once the AER has completed its work program examining alternative and new approaches to forecast assessments, it can then design detailed data requirements to support the application of the relevant techniques. That said, we also note that the value of annual benchmarking reports will be enhanced by adopting consistent cost categories and definitions over time. In this regard, we note the need for the AER to work closely with the NSPs on matters such as the definition of cost categories, cost allocation and capitalisation policies, to ensure that consistent, fit-for-purpose information is produced for benchmarking purposes.

The need for transparency and engagement between the AER and NSPs

We consider that the benchmarking analysis should be transparent and replicable by third parties, including NSPs. We agree that data should be readily available to all interested parties, and we welcome the AER's commitment to establishing a public database of such information to assist stakeholders to undertake their own analyses.

The annual benchmarking reports should be as simple as possible, and their production should not entail an inordinate cost or administrative burden on NSPs. SP AusNet appreciates that differences in companies' reporting cycles may create some issues in relation to the production of an annual benchmarking report. However, SP AusNet does not consider that this warrants updating the report outside the annual production process.

We note that the AER is inclined to think that NSPs may seek to strategically present information, rather than to continually engage with the AER. SP AusNet does not share the AER's concerns. Benchmarking processes should be transparent and robust. It would be a major concern if a benchmarking method provided surprises for either the AER or NSPs. We also envisage that benchmarking analysis will lead to constructive and informed discussion between the AER and NSPs. SP AusNet prefers to regard benchmarking as an iterative and interactive process.

Relationship between expenditure assessment techniques and incentives

SP AusNet supports the increased use of benchmarking in expenditure assessments, and welcomes the AER's stated intentions in this regard.

The Issues Paper invites comments on whether the increased use of benchmarking warrants changes to incentive mechanisms such as the EBSS. There appears to be some confusion about whether the increased focus on benchmarking marks the introduction of a different form of regulation.

We do not consider that the use of benchmarking to inform regulatory decision-making in the context the of building block regime (which is mandated by the NER) alters the form of regulation. We acknowledge that where price or revenue controls are set independently of the company's own performance (as would be the case under a "pure" benchmarking or TFP approach), there may be an argument that mechanisms such as the EBSS are less important or even unnecessary. However, the NER does not provide for such a form of regulation, and therefore the question should not arise in relation to the current Guidelines.

In any event, SP AusNet's view is that even if a form of regulation were implemented that disconnected expenditure allowances from the company's own cost performance, it does not necessarily follow that the EBSS would be redundant. The stronger the power of the incentive regime, the greater the likely efficiency gains.

The performance of a new regime should be carefully assessed before making substantial changes to the incentive mechanisms. We note, however, that such issues are well-beyond the scope of the current exercise, which should be focused on implementing the existing regulatory framework.

Applying benchmarking appropriately in a regulatory setting

There are three particular issues that must be taken into account in using benchmarking analysis to assess the forecast expenditure:

- Benchmarking analysis can be prone to error, and care must be taken in drawing conclusions from the analysis.

- NSPs should be provided with appropriate incentives to deliver efficiency improvements and to share in the benefits of delivering these improvements.

- Benchmarking is intended to create winners and losers. It is not appropriate for inefficient companies to be penalised and for more efficient companies to obtain no benefit from superior performance.

The Issues Paper acknowledges that benchmarking methods such as TFP, econometric modelling, data envelopment analysis and stochastic frontier analysis each have their particular advantages, disadvantages, data requirements, levels of sophistication and transparency. It will be important for the AER to inform itself fully of the limitations, in practice, of economic benchmarking approaches – particularly in relation to transmission businesses – and to apply appropriate weight to benchmarking results.

Economic benchmarking techniques

SP AusNet supports the holistic approach proposed by the AER, which facilitates the consideration of all available economic benchmarking techniques. SP AusNet favours a flexible approach in the employment of economic benchmarking techniques, which recognises the inherent difficulties and limitations of any benchmarking analysis.

We note however, that much of the focus of Attachment A (economic benchmarking techniques) of the Issues Paper is on detailed matters such as the specification of inputs and outputs that may be used in a multivariate productivity or data envelope analysis. There is much less discussion of econometric models. There is also a sense that the Issues Paper is taking a fixed view in respect of some of these detailed matters.

As explained in the Attachment to this submission, SP AusNet does not consider it appropriate to conclude views on detailed questions (such as the selection of input or output measures) without giving due consideration to the quality of the resulting benchmarking analysis.

In this context we note that econometric modelling employs statistical testing to assess the explanatory powers of the model and the statistical significance of the explanatory variables. It is important that the robustness of any economic benchmarking analysis can be demonstrated if the AER is to rely on the analysis in its assessment of an NSP's expenditure forecasts.

Category analysis

Although SP AusNet is supportive of the AER's focus on improving its category analysis, it is important that the AER's approach remains practical and low cost. In broad terms, the challenge is to balance the level of information sought against its analytical value.

Category analysis can provide a useful tool to enable the regulator and other stakeholders to engage with regulatory proposals and identify areas for further analysis. Issues will inevitably arise when this approach is applied in practice, but these can be minimised by setting out a process that is clear (especially where a transition to new data reporting obligations is required), that draws on experience and best practice.

Given the difficulties in swiftly aligning category definitions across networks, and the likely roll of factors not captured in the analysis it will also be important to ensure that there is an opportunity in the process for network businesses to comment on their performance to provide an extra perspective on the information. For example, in Transmission in Victoria, there is a clear delineation between replacement and augmentation works. In other states where this delineation is less explicit it is likely that some works that would be categorised as replacement in Victoria, get categorised as augmentation (e.g. where they are completed as part of the same project). This information would be important to consider in looking at a comparison of network replacement expenditures.

SP AusNet is concerned that the AER's response to the inevitable and unavoidable differences in cost allocation and capitalisation decisions across businesses is to consider mandating common policies across all companies. While this type of response may appear logical at one level, it is bound to fail in its objective. This is because different cost allocations will arise even if the same policy were applied across all DNSPs, as differences in company practices and interpretations of policy emerge. Furthermore, the cost implications of implementing common policies approach could be significant.

Closing remarks

This response is written primarily from the perspective of distribution networks. SP AusNet refers the AER to the Grid Australia submission, which addresses in further detail those issues that are related specifically to transmission.

We look forward to continuing participation in the development process, and would be happy to meet with the AER at any stage to discuss matters of interest. Please contact Anh Mai, Principal Economist at 03 9695 6627 if you wish to discuss any aspect of this submission further.

Yours Sincerely,

Alistair Parker
Director, Regulation and Network Strategy

Attachment:
SP AusNet's answers to the questions contained in the Issues Paper on the Expenditure Forecast Assessment Guidelines

ATTACHMENT

SP AusNet's answers to questions in the Expenditure Forecast Assessment Guidelines Issues Paper

Scope of current consultation

Question 1: ***Should we anticipate the application of some assessment techniques to gas service providers as part of this consultation?***

As noted by the AER on page 6 of the Issues Paper:

> "The Guidelines will describe the techniques and associated data requirements for our approach to determining efficient capex and opex allowances in accordance with the objectives, criteria and factors in the NER."

Given this, SP AusNet understands that the AER's present consultation activities must remain focussed on producing guidelines that accord with the relevant NER requirements.

However, SP AusNet observes that use of these techniques is clearly applicable to gas businesses, and from a practical perspective may be easier to apply than in electricity (for example, differentiation between deferral and permanent cost saving more straight forward to observe in gas distribution). Indeed, benchmarking techniques have been used and even proposed extensively in State based gas reviews previously (particularly in Victoria). It is, therefore, probable that significant economies of scale and scope could result from considering both industries at once.

We nonetheless concur with the AER's views on the scope of the current consultation exercise. We reiterate our view that the focus of the current exercise should be on producing guidelines that accord with the requirements of the NER.

Question 2: ***Do stakeholders have any preliminary comments on the development of guidelines that will be different for transmission and distribution businesses? Should consultation be separate for these businesses?***

As acknowledged by the AER, much of the Issues Paper is directed towards the assessment techniques it might apply in the distribution sector[1]. However, there are important differences in the characteristics, technologies and functions of transmission and distribution that necessitate the application of different approaches in these two sectors. These differences include the following:

- Capital expenditure in transmission tends to be dominated by large, relatively infrequent discrete projects rather than programs of work (as is generally the case in the distribution sector).

- The nature of environmental factors that impact on costs varies between transmission and distribution.

[1] Ibid, page 13.

- The comparatively small number of TNSPs in different locations and operating environments suggests there will be lower levels of uniformity across the transmission sector, and this creates practical challenges for benchmarking.

It is evident that the AER is aware of these differences, and recognises their implications for assessment techniques[2]:

> "At a broad level, we consider there to be more potential for benchmarking, driver and trend analysis for distribution businesses given they are greater in number and have expenditures that reflect relatively smaller value or higher volume activities and assets than transmission businesses."

It is important for the AER to ensure that these differences are properly recognised in the development of the Guidelines. We therefore suggest that the AER should consult separately on the development of the Guideline for transmission and distribution. This will ensure that the unique characteristics of transmission and distribution are properly recognised in the Guideline.

Question 3: ***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?***

In describing the role of the Guidelines, the Issues Paper states:

> "We would also like to reduce the compliance burden for NSPs by avoiding the duplication of information provided in regulatory proposals. Ideally, the Guidelines and associated RIN templates should cover the information necessary for NSPs to demonstrate efficiency or compliance with capex/opex objectives."

SP AusNet strongly concurs with the AER on these matters. Indeed, we would say that if the Guidelines and the associated RIN templates do not cover the information required to enable an NSP to demonstrate efficiency and compliance with the NER requirements, then the Guidelines would require amendment.

The availability of information that is fit-for-purpose in the context of particular expenditure assessment techniques is dependent on the cost allocation rules applied in producing the information. The inter-dependency between information availability (that is, cost allocation) and assessment techniques must be carefully considered in selecting and specifying the particular assessment techniques that are to be adopted.

The AER has scheduled further meetings and working groups to consider the numerous issues relating to expenditure categories, cost allocation and accounting. Close consultation with the NSPs will be required to ensure that:

- the information requirements can be met by the NSPs at a cost that is proportionate to the overall value of the information to be provided, and

- the information requirements lead to the production of information that is fit for the purpose of applying the expenditure assessment techniques.

[2] Ibid, page 13.

The Issues Paper notes that the application of the assessment techniques envisaged by the AER will necessarily involve an extensive information collection and storage exercise. We suggest that the RIN should be the vehicle for gathering data for annual benchmarking reports and the expenditure assessment techniques. We welcome the AER's commitment to establishing a public database of such information to assist stakeholders undertaking their own analysis[3].

Objectives for expenditure assessment

Question 4: ***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?***

Box 2 sets out the AER's objectives for expenditure assessment as follows[4]:

> "We will seek to expand the assessment techniques available to us in this workstream.
>
> Principally, we consider benchmarking techniques would enable us to make decisions about forecast expenditure that better promote the NEO."

SP AusNet does not agree that the objective should necessarily be to expand the toolkit per se. The objective should be to identify and describe workable and effective techniques that enable the AER to assess the expenditure forecasts put to it by the NSPs against the relevant criteria in the NER. We suggest that the AER's thinking should be re-focussed to align with such an objective.

SP AusNet supports the increased use of benchmarking in expenditure assessments, and welcomes the AER's stated intentions in this regard. However, we consider that it is somewhat premature at this stage of the consultation and development process to identify benchmarking (in a statement of objectives) as the principal technique that would enable the AER to make decisions about forecast expenditure that better promote the national electricity objective.

Question 5: ***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?***

The NER presently mandate the use of a building block approach. Under that approach the price or revenue cap applying to each NSP is set on the basis of a forecast of the efficient costs of that particular NSP over the regulatory control period. Once the control is set, incentives for efficient expenditure are provided by the operation of the following features:

- The NSP's allowed prices or revenues vary in accordance with the applicable control, and are unaffected by the NSP's actual expenditure[5]. Therefore, to the extent that the NSP is able to deliver its target outputs at a cost that is below the

[3] Ibid, page 13.
[4] Ibid, page 15.
[5] Ignoring pass-through mechanisms which are designed to enable the NSP to recover changes in costs driven by factors that are beyond the NSP's ability to influence or control.

expenditure forecast used in the setting of the price control, the NSP generates additional shareholder value.

- The EBSS (currently applying to operating expenditure only) provides a continuous incentive for an NSP to reduce expenditure to efficient levels as soon as possible, regardless of the timing of the next revenue or price review. The mechanism does this by allowing for the sharing of efficiency gains made by an NSP between shareholders and customers for a period of five years after the gain was made, regardless of the year in which the efficiency gain was made.

- The STPIS provides incentives for the NSP to maintain service levels, and to improve them where it is economically efficient to do so. The STIPS thereby ensures that cost reductions are not pursued by NSPs at the expense of service standards.

It is important to note that under the building block method, prices / revenues are recalibrated at each periodic review to reflect a forecast of company-specific efficient costs for the forthcoming regulatory period.

This approach differs from a regulatory approach that relies purely on the incentive properties provided by benchmarking. Under a "pure" benchmarking approach, the costs and allowed revenues of a regulated company are de-coupled. Firms able to achieve and sustain above-average levels of efficiency are permitted to sustain above average levels of returns to capital. The incentive under this regime is provided by de-coupling the firm's actual costs from the setting of the expenditure allowance *over successive price control periods*. Such a regime would not be consistent with the current NER.

Under the NER, the task of the AER is to assess the NSP's expenditure forecasts, in the context of the building block regulatory model. Given the incentive properties of that model (noted above), SP AusNet considers that it is reasonable to infer that the costs we achieve and reveal can be taken to reflect efficient costs. We agree with the AER's observation that[6]:

> "Benchmarking would support us in assessing the extent to which NSPs are responding to the incentive framework, thereby reinforcing the revealed cost approach and base, step and trend methods. Where NSPs are not responding to the incentive framework, it may be more appropriate for us to make use of benchmarking techniques in forming a view about the proposed forecast expenditure, with less reliance on the base step and trend approach."

We would observe that the AER's use of benchmarking in this way would be consistent with the Productivity Commission's view that[7]:

> "At this stage aggregate benchmarking models are ill suited to setting regulatory revenue models. However benchmarking is a useful diagnostic tool that can help assess the reasonableness of bottom up proposals."

On the basis of the reasoning set out above, we do not consider that the use of benchmarking to inform regulatory decision-making in the context of a building block regime alters the nature of the regulatory regime as set out in the NER. Therefore, we do

[6] AER Issues Paper, page 16.
[7] Productivity Commission, Electricity Network Regulatory Frameworks Draft Report, October 2012 p269

not consider that the increased use of benchmarking within the building block regime would give rise to any changes in the use application of the incentive mechanisms that have been established within that regime.

Principles for the selection of assessment techniques

Question 6: ***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?***

For ease of reference, the principles set out in Box 3 of the Issues Paper[8] are reproduced below:

Principle 1

Assessment techniques must be relevant to expenditure review task before us. Our expenditure assessment task involves:

1. Assessing forecasts – recognising future events and circumstances that affect expenditure levels

2. Assessing efficiency – noting the need to balance the dual role of the assessment approach in setting immediate price levels and encouraging ongoing expenditure efficiency

Principle 2

All else being equal, our assessment techniques should be based on objective comparative analysis and should use actual or 'realised' data in the first instance and wherever possible. However, in some instances we may find benefit in using a subjective project review.

Principle 3

Additional detail and complexity should not be added to our assessment techniques unless it improves the reliability or accuracy of the assessment of forecasting and comparative analysis beyond the levels of natural variation in exogenous factors that affect changes in expenditure.

Principle 4

If the NSP's current circumstances are reflected in current operations (expenditure, maintenance cycles, asset lives, unit rates, safe working practices etc) then we may apply assessment techniques that examine changes to these circumstances (rather than using assessment techniques that rebuild those circumstances).

[8] AER Issues Paper, page 23.

Principle 5

The assessment techniques should only require expenditure to be distinguished to a level of detail sufficient to:

- identify factors that cause expenditure levels to change over time
- ensure consistency across NSPs and over time, and
- identify uncontrollable factors that influence expenditure and that differ across NSPs.

Subject to the comments set out below, the above principles appear likely to provide reasonable guidance to the AER in its selection of assessment techniques.

Principle 1 seeks to distinguish between the tasks of "assessing forecasts" and "assessing efficiency". We do not consider that such a distinction is necessary.

Under the NER, the AER must accept the expenditure forecasts if it is satisfied that they reasonably reflect the relevant expenditure criteria set out in the NER, which include "the efficient costs of achieving the capital and operating expenditure objectives". It follows that the AER's assessment of an NSP's expenditure forecasts necessarily involves an assessment of efficiency. For the reasons set out in our answer to question 5, we would be concerned if the perceived need to distinguish between "assessing forecasts" and "assessing efficiency" was driven by a view that the increased use of benchmarking somehow altered the incentive properties of the building block regime.

Under the NER, the purpose of the Guidelines is to specify the approach that the AER proposes to use to assess the forecasts of capital and operating expenditure that form part of an NSP's regulatory or revenue proposal, and to specify the information the AER requires for the purpose of that assessment. Accordingly, the principles used by the AER in its selection of assessment techniques should be applied in preparing the guidelines themselves, as well as at the regulatory review stage. The guidelines should provide a clear decision framework explaining:

- the basis on which expenditure assessments will be undertaken;
- the technique(s) that will be applied in those assessments; and
- the basis on which particular assessment techniques are selected to be applied in each particular circumstance.

Principle 2 should explicitly state a requirement for the AER's assessment techniques to be replicable by third parties (including NSPs).

Principle 3 should explicitly commit the AER to not pursuing techniques that would place an inordinate cost or administrative burden on NSPs to collate and provide the required data. In this context, we draw the AER's attention to COAG's guidance on best practice regulation, which states[9]:

[9] Council of Australian Governments, Best Practice Regulation: A Guide for Ministerial Councils and National Standard Setting Bodies, October 2007, page 6.

> "Proportionality involves ensuring that government action does not 'overreach', or extend beyond addressing a specific problem or achieving the identified objective. The scope or nature of government action should be commensurate with the magnitude of a problem, its impacts, or the level of risk without action. *The principle of proportionality applies equally to the implementation of regulation, including the development of frameworks for ensuring compliance.*"

Expenditure assessment techniques

Question 7: ***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?***

Section 4.2 of the Issues Paper describes the principal techniques that have to date been adopted for the purpose of assessing expenditure forecasts. In view of the purpose of the Guidelines (as set out in the NER) it would be appropriate for the Guidelines to set out the AER's approach to applying each technique.

As noted in section 4.2 of Issues Paper, there are benefits and shortcomings associated with each of the techniques, and some techniques provide more useful information than others in relation to certain categories of expenditure or activities. As noted in our answer to question 6, it would therefore be helpful if the Guidelines were to set out how the AER will select the particular approaches it proposes to apply to each subset or category of expenditure.

The ENA submission provides helpful commentary on the benefits and shortcomings of the various techniques identified in the Issues Paper. We concur with the ENA's comments on these matters.

Proposals for further work

Question 8: ***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?***

SP AusNet is supportive of the AER's general approach of attempting to derive quantitative relationships between expenditures and drivers. We note the description (on page 29 of the Issues Paper) of the prior work of the AER in this area and comparisons to Ofgem's approach:

> "Our analysis has also been informed by work currently being undertaken by Ofgem in preparation for its next price control determination for electricity distribution as well as its recent determinations in gas distribution. A key element of Ofgem's cost assessment framework is to apply regression analysis to panel data (i.e. for multiple businesses over several years) of categories of expenditure and scale variables to benchmark efficient expenditure on a per unit basis…
>
> We note that the amount of information collected by Ofgem in performing this task is significantly more than we have collected in our RIN templates to date, and reflects the evolution of an approach over many rounds of price determinations. In particular, considerable effort has gone into identifying volume drivers and expenditure category definitions with NSPs over many years and is still in refinement."

As already noted in our answer to question 2, the AER's general approach of attempting to derive quantitative relationships between expenditures and drivers is likely to be more applicable to the distribution sector. It will be important for the AER to progress its work in this area having regard to the different characteristics of the transmission and distribution sectors.

The issues identified by the AER on page 30 of the Issues Paper strongly reinforce the need for the AER to work closely with the NSPs on matters such as cost allocation and capitalisation policies, to ensure that the Guidelines lead to the production of consistent, fit-for-purpose information.

Question 9: ***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?***

On the question of disaggregation of data for analytical purposes, the Issues Paper states[10]:

> "Overall we anticipate that relationships between volume drivers and expenditures will be more robustly measured for low value, high volume type works which are recurrent in nature. Choosing categories at higher levels of aggregation, with combined volume drivers, may also assist where differences at more detailed levels of aggregation are averaged out."

We agree with these observations.

The Issues Paper also states[11]:

> "Category based assessment will need to consider network expenditure in total. Benchmarking assessments that only determine expenditures at the category level will, when aggregated, reflect an artificial and unrealistic benchmark NSP. Basing the expenditure assessment initially on total expenditure also promotes benchmarking across DNSPs because it ensures that it is the total cost of addressing a particular need that is being compared. Differences in capitalisation, cost allocation and outsourcing across DNSPs are less likely to distort the benchmarking analysis."

We strongly concur that the summation of disaggregated partial performance indicators will lead to the derivation of unrealistic aggregate benchmarks.

The extent to which lower levels of aggregation lead to more robust benchmarking is an open question, and it depends on the availability of reliable, sufficiently abundant and consistent data across NSPs. As the AER has recognised, ensuring consistency of data across the NSPs within the different sectors (namely, transmission and distribution) is critical to producing robust analysis. These considerations point to the need for the AER to work closely with the NSPs on the definition of expenditure categories to ensure that the category definitions facilitate meaningful and valid comparisons across NSPs.

As noted in our answer to question 3, it will also be particularly important to ensure that disaggregated analysis does not lead to new information gathering and recording

[10] Ibid, page 30.
[11] Ibid.

requirements on NSPs that cannot be met cost-effectively through existing business systems.

Question 10: ***Do stakeholders agree that economic benchmarking will be an important adjunct to more detailed expenditure assessments?***

As already noted, it will be important for the AER to have regard to the different characteristics of the transmission and distribution sectors when developing its expenditure assessment techniques, including any economic benchmarking techniques.

The AEMC's recent review of total factor productivity (TFP)[12] examined in detail the potential for the use of one such technique in the determination of prices and revenues for NSPs. In a submission to that review, SP AusNet noted that[13]:

> "For transmission networks, TFP-based regulation cannot properly capture genuine differences in the levels of productivity of individual companies. Transmission is highly capital intensive, with investment in large-scale long-lived assets occurring in lumpy increments. These characteristics can distort measures of productivity for extended periods. Furthermore, 'output' is notoriously difficult to define with respect to electricity transmission, and therefore it is very difficult to be confident that measures of productivity will reflect actual performance. Given these considerations and the inherent characteristics of the electricity transmission sector, application of TFP regulation would create significant uncertainty for the sector."

In addition, as also noted in our response to question 2, there are significant differences across the TNSPs in terms of their operating environments and network topologies, and there is a limited number of TNSPs. These considerations will limit the ability to control statistically for the exogenous factors that differ across TNSPs.

Having said that, SP AusNet agrees that the economic benchmarking techniques identified by the AER certainly have the potential to complement category-based analysis by:

- providing an overall and higher-level test of relative efficiency;
- facilitating benchmarking which may not be possible as part of the category analysis; and
- cross-checking or reinforcing findings that are made through other types of analysis.

As recognised by the AER[14], methods such as TFP, econometric modelling, data envelopment analysis and stochastic frontier analysis each have their particular advantages, disadvantages, data requirements, levels of sophistication and transparency. It is therefore important for the AER to inform itself fully of the limitations of economic benchmarking approaches – particularly in relation to transmission businesses – and to apply appropriate weight to benchmarking results.

Expenditure assessment process

[12] AEMC, Review into the use of total factor productivity for the determination of prices and revenues: Final Report, July 2011.
[13] SP AusNet, Submission on AEMC's Review of Total Factor Productivity Preliminary Findings Paper, 22 February 2010.
[14] Issues Paper, page 31.

Question 11: ***Do stakeholders agree that the first-pass process described above is a useful and appropriate application of expenditure assessment techniques?***

SP AusNet understands that the principal purpose of the first-pass assessment methodology is to:

- provide stakeholders with the AER's initial views on forecast expenditure at the issues paper stage in the regulatory determination process; and
- assist in streamlining the assessment of opex and capex, and facilitate a more targeted use of engineering consultants.

SP AusNet supports both of these objectives. It will be important, however, that the first pass assessment does not pre-judge the outcome of the Draft or Final Decisions. If the assessment is genuinely a 'first pass', then the basis of the assessment must be explained fully so that all stakeholders understand how and why the Draft and Final Decisions may differ materially from this provisional assessment. This is particularly important in relation to listed companies, where the market and investors need to understand the nature of first pass assessments.

Expenditure incentive schemes and their application

Question 12: ***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?***

Our answer to question 5 addresses these matters in part. In addition, we note that the Issues Paper[15] understates on the role of the EBSS in commenting that:

> "The need to use a carryover mechanism to counteract the incentive for NSPs to shift operating expenditure to the base year will decrease. This is because we will be less reliant on the revealed costs of an individual NSP in assessing and making adjustments to its forecast expenditure."

As noted in the answer to question 5, a far more significant role of the EBSS is to provide constant incentives to the NSP to deliver efficiency improvements throughout the regulatory period, and to provide for a 'fair sharing' of efficiency gains between the company and customers.

A question arises as to whether the use of benchmarking to set expenditure allowances makes the incentive properties of the EBSS redundant. It is conceivable that this may be the case where expenditure benchmarks are set independently of the company's own performance. However, the NER do not provide for this form of regulation, and therefore the question should not arise in relation to the current expenditure guidelines.

In any event, SP AusNet's view is that even if a form of regulation were implemented that disconnected the expenditure allowance from the company's own cost performance, it

[15] Ibid, page 35.

does not necessarily follow that the EBSS should be disbanded. The stronger the power of the incentive regime, the greater the likely efficiency gains. It would be important to assess the outcomes of a new regime before making substantial changes to the existing incentive mechanisms. As already noted, however, these issues are beyond the scope of the current exercise, which should be focused on implementing the regulatory framework as set down in the NER.

The guideline, benchmarking reports and determinations

Question 13: ***Do stakeholders have any comments on how best to manage the interrelationships between the guidelines, F&A processes, determinations and annual benchmarking reports?***

SP AusNet does not consider that there are any particular issues of concern regarding the interrelationships between the Guidelines, F&A processes, determinations and annual benchmarking reports. The AER's Issues Paper appears to suggest that these components of the regulatory process ought to be amended in response to information provided by NSPs.

For example, the AER appears to be concerned that timing issues mean that the Guidelines cannot change in response to an NSP's submission on its forecasting methodology. SP AusNet does not agree. It is important that the AER's regulatory approach is stable and predictable over time. Therefore, SP AusNet questions whether it is necessary to fine-tune or tweak the regulatory approach in response to information submitted by NSPs.

On a related matter, the AER expresses concern that NSPs may seek to strategically present information only at the time of their individual revenue determinations, rather than continually engage with the AER on these matters. The AER suggests a possible solution may be to release benchmarking results only after stakeholders have exhausted the opportunity to present arguments and information from an "in-principle" perspective.

SP AusNet does not share the AER's concerns. Benchmarking processes should be transparent and robust. It would be a major concern if a benchmarking method provided surprises for either the AER or NSPs. It is also likely that benchmarking analysis would lead to constructive and informed discussion between the AER and NSPs. SP AusNet prefers to regard benchmarking as an iterative and interactive process.

Question 14: ***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?***

SP AusNet would expect the application of techniques to be refined over time as new data becomes available. It is not clear that there should be any consistency issues arising from the assessment techniques and data reporting. It is important that both processes are transparent and not subject to frequent and unpredictable changes.

Question 15: ***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?***

Please see the response to question 13 above. It is unclear why the Guidelines should be linked to the NSP's obligation to notify the AER of its forecasting method in the manner suggested by the question. The same comment applies to the F&A process. The NER establish the linkages between the various regulatory processes, and it is not clear why new linkages should (or could) be established through the Expenditure Forecast Assessment Guidelines.

Detailed timing and transitional issues

Question 16: ***Keeping in mind the preference to use up to date and nationally consistent data in all benchmarking analysis, what would be the best time to issue RIN templates? Would these need to be for all NSPs? How frequently should we do this?***

Clause 6.27 of the NER makes it clear that the AER is required to produce an annual benchmarking report in respect of DNSPs. Clause 6A.31 contains a similar provision in respect of TNSPs. The AER is required to take account of the latest annual benchmarking report in assessing the expenditure forecasts. SP AusNet appreciates that differences in companies' reporting cycles may create some issues in relation to the production of an annual benchmarking report. However, SP AusNet does not consider that this warrants updating the report outside the annual production process.

As part of the price or revenue determination process, it is reasonable to expect the relevant NSPs to provide comment on the implications of the annual benchmarking report, and to provide further analysis and data if they wish. By the same token, the AER may also wish to augment the analysis in the annual benchmarking report to the extent that this assists in assessing the expenditure forecasts. However, SP AusNet does not consider it necessary for the AER to update its benchmarking report for the purposes of each determination, nor is it necessary to seek additional data for this purpose.

The value of the annual benchmarking reports will be enhanced by adopting consistent cost categories and definitions over time. In this regard, it would not be helpful to 'tweak' the benchmarking report for purpose of addressing each determination.

Question 17: ***Should we try and limit the collection and analysis of benchmarking data to annual benchmarking reports? Alternatively, should we focus our effort on benchmarking analysis at each draft and final decision stage, with less attention to annual benchmarking reports?***

Please see the response to question 16 above. The annual benchmarking report should inform the determination process as envisaged by the NER.

Question 18: ***Are there alternative, more flexible means to gather data for benchmarking purposes in annual reports and in determinations, such as requests outside the NEL provisions?***

It is essential that the AER does not add to the regulatory burden by increasing its information requests, either in terms of content or frequency. As already noted, the value of the annual benchmarking report over time will be enhanced if few changes are made to cost categories and definitions.

Question 19: ***Should we be considering the alignment of regulatory years and of regulatory control periods for transmission and distribution NSPs to overcome some of these challenges? If so, should regulatory years reflect the Australian financial year? How would the alignment of regulatory control periods be best achieved?***

SP AusNet considers that the AER is overstating the problems that arise from the different reporting arrangements across NSPs. We do not support the AER requiring companies to vary their reporting cycles for the purposes of producing the annual benchmarking report. It is unlikely to have a material impact on the benchmark analysis if some company data relates to calendar years and other data relate to financial years. Furthermore, it is unlikely to be material if some companies provide an estimate for the latest year's data and others provide actual data.

SP AusNet notes that it is more important to focus on aligning cost categories and definitions, rather than being concerned with differences in reporting cycles, which are likely to be immaterial in terms of the benchmarking outcomes.

Question 20: ***We are interested in your views on the holistic approach to the selection and establishing reporting requirements for economic benchmarking techniques.***

SP AusNet concurs with the AER's view that it is appropriate to adopt an holistic approach to assessing efficiency through benchmarking techniques. It is reiterated that transmission network service providers are much less conducive to benchmarking analysis than electricity distribution businesses.

Question 21: ***Have we identified all the relevant economic benchmarking techniques and, if not, are there other economic benchmarking techniques that should be considered?***

The AER's list is a comprehensive summary of the most relevant economic benchmarking techniques.

Question 22: ***We are interested in your views on how economic benchmarking techniques should be applied in our decision making process regarding expenditure. Specifically, we are interested in your views on:***

- ***using these techniques to assist us to form a view on the efficiency of base expenditure and expenditure forecasts***
- ***measurement of the likely pace at which productivity improvements may be made over a regulatory control period.***

It is reasonable for the AER to have regard to the benchmarking analysis to address questions of efficiency in relation to the expenditure forecasts. This is consistent with the NER, which state that the AER must have regard to the annual benchmarking reports in assessing the expenditure forecasts.

However, benchmarking has its limitations and three particular considerations must be taken into account in using benchmarking analysis to assess the forecast expenditure:

- Benchmarking can be prone to error, and therefore care must be taken in drawing conclusions from the analysis.

- NSPs must be provided with appropriate incentives to deliver efficiency improvements and to share in the benefits of delivering these improvements.

- Benchmarking should create winners and losers. It is not appropriate for inefficient companies to be penalised and for more efficient companies to obtain no benefit from superior performance.

From a regulatory perspective, SP AusNet would not endorse the AER employing benchmarking to determine whether actual expenditure is efficient, unless the ex post prudency review provisions for capital expenditure have been triggered. The regulatory framework does not provide for reviews of historic expenditure. However, the analysis may be relevant for assessing the efficiency of expenditure forecasts.

SP AusNet also notes that using benchmarking to assess capital expenditure is more problematic than operating expenditure. The problem arises primarily because capital expenditure is driven by factors that have varying impacts over time and across companies, such as asset age and condition; reliability standards; and the costs of complying with safety cases.

Question 23: ***Should the AER separate DNSPs into groups for the purposes of economic benchmarking? If so, how should the groupings be determined?***

It may be appropriate to separate DNSPs into groups. However, this is an empirical question that would need to be tested through the benchmarking analysis. It would be wrong to commence from the premise that DNSPs should be separated into different groups. In addition, the use of dummy variables may be a more effective alternative in accounting for the differences between urban and rural DNSPs.

Question 24: ***Are our criteria for selecting inputs appropriate? Are there any additional criteria that should be added?***

SP AusNet notes that econometric modelling does not necessarily equate inputs and outputs in the manner described in the Issues Paper. Instead, the approach seeks to explain an NSP's costs by reference to various explanatory variables or cost drivers, which are not necessarily the same as inputs. For example, numbers of customers may be an important explanatory variable, but cannot be said to be an input.

In relation to the criteria for selecting inputs, SP AusNet notes the following description in the Issues Paper is open to various interpretations: "Inputs, and the sub-components of inputs, should be mutually exclusive and collectively exhaustive." As models generally seek to provide a simplified version of reality, SP AusNet questions whether it is appropriate to include a criterion that the inputs should be 'exhaustive'.

Question 25: ***Are the "assets" and "operate and maintain" variables appropriate for economic benchmarking?***

The Issues Paper explains that DNSPs require two fundamental types of inputs in order to provide distribution services:

- assets (the assets variable); and

- activities to operate and maintain assets and the business more generally (the operate and maintain variable).

The AER notes that these two input variables are broadly consistent with the input variables used in previous benchmarking studies, although there is considerable debate in the literature on how to measure capital inputs for economic benchmarking.

SP AusNet agrees that these input variables are relevant to any benchmarking study. However, the challenge in successfully benchmarking performance is to examine the respective inputs and outputs in a meaningful way, given the sometimes significant difference in operating conditions across companies. It is therefore not possible to commit to a particular approach to inputs or outputs without understanding the overall approach and the results of the benchmarking analysis.

We note, for example, that the efficacy of an econometric model would be determined by conducting statistical tests on its reported results. Changes to the choice of explanatory variables may subsequently be made, providing that the model remained grounded in economic theory. Similarly, SP AusNet would expect the AER to determine the most appropriate benchmarking approaches in light of the results obtained.

Question 26: ***What indices can we use to derive price and quantity information for the operate and maintain variable for economic benchmarking?***

As explained in answer to question 25, it is not appropriate to commit to a particular approach to indexation without understanding the particular benchmarking proposal. The discussion on page 64 of the Issues Paper comments that:

> "Labour quantity can also be measured as the labour cost (derived from opex data) deflated by an appropriate labour price index, which may reflect many inter-business differences, such as skill composition and wage rates."

SP AusNet notes that it would be easier to use the number of FTE employees as an input. However, it is not clear whether such an approach would be meaningful as it would ignore differences in labour mix, and would also ignore differences in organisation structure including the extent to which services are contracted out.

Question 27: ***Is the one-hoss shay assumption appropriate for the measurement of capital services provided by individual distribution system assets?***

The assumption that an asset provides a constant level of service over its lifetime – and by implication requires a constant level of maintenance and condition monitoring – is false. It may, however, be a reasonable working assumption for a particular type of economic benchmarking. SP AusNet cannot agree, however, that it is appropriate to commit to a particular form of depreciation in the absence of reviewing the outputs from the benchmarking study.

For example, it would be expected that maintenance costs would increase as the weighted average remaining life of the asset base declines. It would not be appropriate to commit to a benchmarking approach that ignored this potentially important cost driver.

Question 28: ***Does the 'portfolio effect' apply to populations of distribution assets? Assuming the one-hoss shay assumption is appropriate for individual assets, does the portfolio effect negate the one-hoss shay assumption when using populations of assets in economic benchmarking?***

Please refer to the answer to question 27. SP AusNet agrees with the observation in the Issues Paper that the portfolio effect of different asset lives may affect the validity of the one-hoss shay assumption. It is not appropriate to make a decision *a priori* that the portfolio issue should be ignored. The better approach – which is consistent with the AER's view that it should adopt an holistic approach to economic benchmarking – is to test the portfolio effect empirically by examining different benchmarking approaches and their results.

Question 29: ***If the one-hoss shay assumption does not appropriately describe the deterioration profile of DNSP assets, which deterioration profile is most appropriate?***

Please refer to our answers to questions 27 and 28. For the reasons already provided, SP AusNet does not support a particular deterioration profile.

Question 30: ***Should we measure asset quantities using physical or value based methods?***

Both approaches may be valid, but the gross replacement value of the asset base provides a valid representation of the long term capital costs paid for by customers. For this reason alone, it does not seem appropriate to prefer a physical measure of the capital base. However, as explained in our earlier answers, SP AusNet does not consider it appropriate to select a particular measurement method on an *a priori* basis.

Question 31: ***Assuming the one-hoss shay assumption is appropriate for individual distribution assets, would the existence of the portfolio effect render the use of physical measures of capital quantities inappropriate for economic benchmarking?***

Please refer to our previous answers. SP AusNet considers that different approaches should be tested by conducting alternative benchmarking approaches.

Question 32: ***How should we derive the value of a DNSP's capital stock for the purpose of determining quantity of assets?***

Please refer to our answer to question 30.

Question 33: ***What index should be used to inflate historical asset prices into real terms?***

Conceptually, it is inappropriate to regard one company as more efficient than another because its assets are older and were purchased at a time when asset prices were substantially lower. On this basis, a reasonable approach is to calculate the current replacement cost of the asset base. If current asset prices are employed, there is no need to employ an index to inflate historic asset prices.

Question 34: ***Is RAB depreciation an appropriate measure of the annual contribution of capital to the provision of outputs?***

RAB depreciation may be affected by the changes in asset prices over time, in addition to the assumed remaining life of the asset as noted in the Issues Paper. However, RAB depreciation is likely to be a useful starting point for measuring the annual capital input.

Question 35: ***What prices should be used to weigh assets and the activities involved in operating and maintaining those assets?***

The annual cost of the physical assets includes both depreciation and a reasonable rate of return. In terms of the costs of procuring an asset, as already noted, SP AusNet does not consider that efficiency measures should be influenced by the impact of price changes over time. Having said that, a source of cost difference between companies is the effectiveness of their procurement policies and their efficiency in project management. It would not be appropriate to adopt a benchmarking approach that disregarded these important differences.

This is a complex issue that is best resolved by testing a range of different benchmarking approaches.

Question 36: ***Do the prices of inputs materially differ across jurisdictions within Australia, or could the AER use the same prices as weights for inputs across jurisdictions?***

Please refer to our answer to question 35.

Question 37: ***Are our criteria for selecting outputs appropriate? Are there any additional criteria that should be considered?***

SP AusNet considers the output criteria to be reasonable.

Question 38: ***If customer numbers are used as an output for economic benchmarking, should these customer numbers be separated into different classes? If so what are the relevant customer classes for the purpose of economic benchmarking?***

It is reasonable to consider 'numbers of customers served' to be an output for a DNSP. It may be appropriate to distinguish between categories of customers, although the added complexity of doing so needs to be weighed against the improved explanatory powers of the resulting analysis.

Question 39: ***Have we identified all the relevant outputs? Which combination of outputs should we use in economic benchmarking?***

From a first pass assessment, SP AusNet considers outputs should reflect the outputs of building block regulation (functional outputs), rather than billing, as this is more reflective of business cost drivers. Of the outputs canvassed in the AER's papers, customer numbers, forecast maximum demand and reliability are the most relevant outputs because:

- customer numbers are a sound indicator of the magnitude of service provided directly to customers, and is often used as a proxy for the quantity of output;

- forecast peak demand, as approved in regulatory determinations, is what businesses are required to provide sufficient capacity for. As such, it drives investment planning and decision-making, and forms a basis for regulated revenues. In contrast, actual peak demand is not relevant as this is outside the control of the business and is not a driver of revenues; and

- reliability is the level of service which customers experience and is therefore a crucial part of the service provided directly to customers.

However, as previously explained, SP AusNet does not consider it appropriate to conclude which output measures should be adopted without giving due consideration to the results of the benchmarking analysis. It is important that the choice of benchmarking approach – including the selection of input and output measures – is informed by testing of the analysis. As already noted, econometric modelling employs statistical testing to assess the explanatory powers of the model and the statistical significance of the explanatory variables. It is important that the robustness of any benchmarking analysis can be demonstrated if the AER is to rely on the analysis in its assessment of an NSP's expenditure forecasts.

Question 40: ***Despite multiple studies using volume of energy delivered as an output, we are not convinced that this is appropriate. What are stakeholder's views on the use of energy delivered as an output?***

While SP AusNet would not dismiss volume of energy delivered as an output at this early stage of the AER's process, it is clearly less relevant than the outputs discussed at question 39. Further, volume of energy delivered may be a useful explanatory variable, even if it is not regarded as an output in a technical sense.

Question 41: ***It would appear that much network expenditure is ultimately intended to maintain the reliable supply of electricity. This might include the management of peak demand, network capacity and investment to ensure that networks are secure. Given this, is it appropriate to use measures of reliability as an output variable?***

Reliability is an important output variable, as it is something which customers value which is reflected in the NER capex and opex objectives. While there are practical challenges in expressing reliability as outputs in benchmarking functions, it is worthwhile trying to overcome these challenges given the importance of reliability as an output. However, as noted in relation to our answer to question 39, it is difficult to adopt a firm position on output variables without understanding their impact on the benchmarking outcomes.

Question 42: ***Are our criteria for selecting environmental variables appropriate?***

The criteria include the following comment:

> "Where there is correlation, the primary driver of costs should be selected. Higher line length might reflect a lower customer density, so perhaps customer density should be selected as the environmental variable because it may be considered to have a more direct influence on costs."

SP AusNet is not convinced that it is necessary to adopt the primary driver of costs where there is a correlation with another environmental variable. In particular, it is unclear how the primary cost driver would be identified without conducting some form of benchmarking or econometric analysis. It follows that the better approach is to be flexible in the selection of environmental variables. SP AusNet does not consider it necessary to agree selection criteria at this early stage of the AER's process.

Question 43: ***Have we identified all the relevant environmental variables?***

SP AusNet notes that the AER has proposed the following list of potential environmental variables:

- measures of load such as load factor, peak demand and system loading
- size of service area
- number of customers
- density measures such as customer density, consumption density and peak demand density
- various climate measures
- asset measures such as percentage of underground cables and asset age

SP AusNet notes that this list is likely to cause confusion. Ordinarily, environmental variables would be matters that are exogenous to the industry, but nevertheless affect its cost or service performance. For example, topology or weather would be examples of environmental variables. SP AusNet would not regard variables that are endogenous to the industry – such as number of customers or peak demand – to be regarded as environmental factors. These variables are endogenous because they are inextricably linked to the services provided by the companies, and the prices charged for those services.

Question 44: ***Which combination of environmental variables should we use in economic benchmarking?***

From a first pass assessment, customer density and climate are the environmental variables more relevant to benchmarking. Both can be significant drivers of costs and are outside of the control of the DNSP. However, as noted in our answer to question 39 and other previous questions, this is an empirical question that would need to be tested through the benchmarking analysis.

Expenditure categorisation

Question 45: ***Do you agree with this list of expenditure drivers? Are there any others that should be added?***

SP AusNet agrees with the list of expenditure drivers, noting that they relate to DNSPs. SP AusNet also supports the observations noted in the ENA submission, which raise some important issues of practical application.

Question 46: ***To what extent do you think the expenditure drivers are correlated with each other? Given this level of correlation, should we examine the impact on expenditure of each one, or can this list be consolidated?***

SP AusNet does not expect the expenditure drivers to be strongly correlated with one another.

Details of driver based assessments

For questions 47-63 SP AusNet refers the AER to ENA's submission.

There are a number of practical difficulties that are involved in some types of detailed category analysis. This does not imply that to attempt such analysis will be of no use. However, there is a need to identify the value of the information, and where that value is uncertain or incremental to ensure the costs imposed to complete the analysis is commensurate. This could be done by relaxing the assurances required around the data at the disaggregated level, or the level of consistency of definitions initially required, and by setting out a process to achieve convergence over time.

As a general observation, however, SP AusNet is concerned that the AER's approach should not create excessive reporting costs and definitional issues for DNSPs. The challenge is to balance the level of information sought against its analytical value. The inevitable differences in the way that companies allocate costs may distort the results of the AER's category analysis and, as a consequence, lead to errors in regulatory determination.

In this regard, it will be important to focus on the intended use of highly disaggregated category analysis within the regulatory determination. If there is an intent to apply it mechanistically (e.g. substituting costs from one network business to another), it will be important to be precise in category definitions. However, if it is used as a screening tool, with further techniques and analysis then employed, definitional issues are less material.

At this stage, SP AusNet questions whether the AER has the balance right. In particular, the AER's approach is at risk of becoming overly complex and costly to implement.

Other issues in category based assessment

Question 64: ***How material do you think are changes in input prices on overall expenditure levels? What forecasting and modelling approaches do you think can reliably account for the impact of input price changes on expenditure without introducing overly burdensome reporting requirements?***

SP AusNet's view is that input prices are important factors in a regulatory determination. Changes in the costs of materials and labour are likely to be pro-cyclical as economic growth affects demand and input prices. Exchange rates are subject to significant volatility, which may also affect input prices. SP AusNet considers it appropriate that these issues are addressed in each price determination, especially as economic conditions have been subject to rapid change in recent years. Nonetheless, it would be appropriate for the AER to provide more guidance on the approach, or range of approaches, that it prefers.

Question 65: ***What categorisation of different inputs do you think provides a sufficient understanding of both how input prices may change over time, as well as how input prices may vary across geographical locations?***

SP AusNet regards the AER's current approach to these issues as appropriate.

Question 66: ***Do you consider optimism bias and/or strategic misrepresentation to be a material issue in the cost estimation for non-routine projects? Do you consider downward biases in cost estimation to materially outweigh regulatory incentives to over-estimate expenditure? To what extent do you consider there to be a consistent downwards bias in initial project cost estimates?***

SP AusNet refers the AER to Grid Australia's response to this question. In addition, it should be noted that the questions raised here are empirical ones that need to be considered as part of a revenue or price control determination. As a general principle, asymmetric risk does arise in relation to capital projects. The question of the appropriate magnitude of the cost estimation risk factor and the efficiency of the forecast capital expenditure are matters that need to be examined in each determination. Furthermore, the AER has examined these matters comprehensively in recent determinations.

Question 67: ***What should be our approach to cost estimation risk factors and addressing potential asymmetric estimation risk? Would techniques such as reference class forecasting be beneficial? How would any techniques to address asymmetric cost estimation risk interact with potential incentive schemes (for either opex or capex)?***

Please refer to our answer to question 66.

Question 68: ***Do you think our established approach to assessing debt and equity raising costs remains appropriate? What modifications or alternative techniques would you suggest?***

SP AusNet refers the AER to ENA's response to this question. It is appropriate that this issue be dealt with through the AER's WACC guideline review.

Question 69: ***Do stakeholders have any in-principle views on how demand forecasts should be derived and assessed?***

The AER's Issues Paper has summarised the demand forecasting issues well.

In relation to transmission, SP AusNet notes that demand forecasts play a very limited role in its revenue determinations, as augmentations to the shared network are a matter for AEMO.

Question 70: ***Do you think that the network segments outlined above provide a useful demarcation of the expenditure incurred to address various expenditure drivers? Do you think that there are significant cost differences in building, repairing, or replacing network assets based on region in which the work is being done? What alternative asset type demarcations would be more appropriate?***

SP AusNet refers the AER to ENA's response to this question.

Question 71: ***For the purposes of comparative analysis of various expenditure categories, do have any views on how to best control for difference in approaches to cost allocation, capitalisation and outsourcing?***

As already noted, SP AusNet's view is that it is more difficult to control for these differences if the analysis is highly disaggregated. The AER's analytical approach should recognise that benchmarking analysis in inherently difficult partly because companies legitimately adopt different approaches to cost allocation, capitalisation and outsourcing. While the AER may take seeks to align reported information, care must be taken not to determine matters that are properly the domain of the companies. For example, AER should not determine a company's capitalisation or cost allocation decisions providing that these decisions accord with the Rules requirements.

The appropriate response to the inevitable and unavoidable differences between companies is to cast the benchmarking analysis at a level that does not rely on perfect consistency in approach.

Question 72: ***Do you think our conceptual framework for the assessment of related party contracts is reasonable? What other techniques may be appropriate? Should we apply the same conceptual framework when assessing the efficiency of related party margins on an ex post basis?***

SP AusNet notes that the AER's conceptual framework is well understood. SP AusNet agrees with the AER's observation that benchmarking of particular cost categories may provide assistance in assessing margins included in related party contracts.

Question 73: ***Do you think our conceptual framework for assessing self-insurance is appropriate? What other techniques may be appropriate?***

SP AusNet believes the current conceptual framework for assessing self-insurance is appropriate.

Question 74: ***Do stakeholders have any in principle views on how benchmarks should be derived and applied?***

As already noted, SP AusNet supports the AER's proposed holistic approach, which should facilitate a consideration of all available economic benchmarking techniques.