

20 September 2013

Mr Chris Pattas
General Manager, Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne Victoria 3001

via email: expenditure@aer.gov.au

Dear Chris,

Draft Expenditure Forecast Assessment Guideline for Network Service Providers

SP AusNet welcomes the opportunity to provide this submission in response to the Australian Energy Regulator (AER)'s draft Expenditure Forecast Assessment Guideline. Along with the incentive scheme guidelines, this Guideline is a central element of the AER's better regulation program. In particular, it has the potential to enhance the regulatory framework in terms of providing regulatory certainty, as well as facilitating more effective engagement.

In making this submission, SP AusNet also supports the submissions made by Grid Australia, the Energy Networks Association and the Victorian distribution businesses (the industry submissions) on this guideline. In this submission, SP AusNet raises the following important points:

- The principles that govern the selection and application of assessment techniques should reside in the Guideline, not the explanatory statement.
- The Guidelines should clarify that the AER's role is to assess the NSP's forecasts, rather than develop its own forecasts.
- Further work is required to ensure that the AER's assurance requirements for back cast data are practical.
- The Guideline should indicate a likely revision date.

Each of these matters is addressed in turn.

1. Principles for selecting assessment techniques

The AER explains the purpose of its assessment principles in the following terms:

To determine which techniques to use when we assess expenditure, we may consider the assessment principles outlined in section 4.5.1. These principles also apply equally when assessing the appropriateness of NSPs' forecasting techniques. We have not, however, incorporated the principles into the Guidelines because we consider this is unnecessarily prescriptive. Our position on assessment principles is a departure from our issues paper, which suggested we would select techniques to include in the Guidelines and potentially apply at the F&A stage.¹

However, in deciding not to include assessment principles in the Guidelines, the AER makes the following observations:

We do not agree with the ENA's submission that the Guidelines should explain when and how we will use assessment techniques so NSPs can target their proposals towards meeting relevant regulatory tests in light of our approach. We consider this approach is unnecessarily prescriptive and inconsistent with the AEMC's intent. The intent of the changes to the NER was not to codify exactly when, how and why we will use expenditure assessment techniques. Rather, the AEMC was quite clear that the Guidelines are not intended to limit the AER [...].²

While the AER concludes that it is appropriate to set out its 'best practice' principles in the explanatory statement, it also considers that the principles should be excluded from the Guidelines. The AER sets out its reasoning as follows:

... we need the flexibility to respond to issues stakeholders may raise during determination processes, and to refine our techniques over time. We consider our Guidelines strike the appropriate balance between flexibility and certainty by explaining our approach to assessing expenditure in light of the requirements of the NEL and NER. Accordingly we consider it unnecessary to prescribe in the Guidelines, any principles to follow when deciding to select or to weight certain techniques.³

SP AusNet agrees with the AER that the intention of the Guideline is not to restrict the AER's ability to use additional assessment techniques if it appropriate to do so after reviewing a NSP's proposal. In particular, the AER should be provided with the flexibility to adopt the most appropriate assessment techniques in light of the particular issues arising from the NSP's proposal.

However, in contrast to the AER's position, SP AusNet considers it is important that the principles that the AER intends to apply in selecting and applying assessment techniques are set out in the Guidelines. If this is not the case, stakeholders will not know how the AER intends to approach its assessment task, which is a key objective of the Guideline. In particular, clause 6.4.5(a) of the Rules states that:

¹ AER, Explanatory Statement, Draft Expenditure Forecast Assessment Guideline for electricity transmission and distribution, August 2013, page 5.

² Ibid, pages 54 and 55.

³ Ibid, pages 54 and 55.

The AER must, in accordance with the distribution consultation procedures, develop and publish guidelines (the Expenditure Forecast Assessment Guidelines) that specify the approach the AER proposes to use to assess the forecasts of operating expenditure and capital expenditure that form part of Distribution Network Service Providers' regulatory proposals and the information the AER requires for the purposes of that assessment.⁴

Contrary to the AER's concerns, the inclusion of principles in the Guideline will not bind the AER or limit its flexibility. However, it will provide the benefit of a clearly articulated framework for selecting and applying assessment techniques. The application of such a framework will facilitate better and more consistent regulatory decisions over time. It should also provide the AER with flexibility to select different assessment techniques as the need arises.

SP AusNet is also concerned that the AER's decision to include best practice principles in the explanatory statement but to exclude them from the Guideline has the potential to create confusion and uncertainty across NSPs and other stakeholders. Stakeholders should be able to rely on the Guideline to provide a comprehensive description of the AER's approach to assessing an NSP's forecast expenditure. The effectiveness of the Guideline would be undermined if stakeholders need to consider both the Guideline and the explanatory statement to comprehend the AER's approach.

SP AusNet also notes that the industry submissions have proposed some amendments to these principles. SP AusNet supports these amendments. A threshold issue, however, is that the principles should be included in the Guideline.

2. Clarification that the AER's role is to assess the NSPs' expenditure forecasts

SP AusNet is concerned that, in places, the AER's explanatory statement and Guideline appears to focus on the AER's determination of substitute forecasts, rather than assessing the NSP's forecasts. For example, in the explanatory statement the AER comments that:

Our expected opex forecasting assessment approach will affect NSPs' incentives to pursue efficiency gains. It is therefore appropriate to outline how we will forecast opex in advance of our determinations.

*We prefer to continue using a revealed cost base-step-trend forecast, in tandem with the current EBSS. We can thus perform a non-intrusive assessment of and determination on opex allowances. Our approach relies on the incentive framework to encourage NSPs to achieve continual efficiency gains. Further, it is appropriate for forecasting opex, given its recurrent nature.*⁵

*The CESS will share the rewards/penalties of underspends/overspends of forecast allowances between NSPs and their customers. Our proposed forecasting approach for capex does not rely on a particular method, including any pre-commitment to use base year expenditures. In this way, the CESS (and all capex incentives) is not dependent on our forecasting approach in the same way as opex.*⁶

⁴ An equivalent provision applies to TNSPs in clause 6A.5.6.

⁵ Ibid, page 59.

⁶ Ibid, page 59.

In addition, the draft Expenditure Forecast Assessment Guideline also uses language that suggests the AER's role is to set the forecast expenditure:

*The AER's general approach to assessing total forecast opex will not be significantly different from our past approach. However, we intend to use a broader range of assessment techniques and collect consistent data to aid us with our assessment. We prefer a 'base-step-trend' approach to forecasting most opex categories. However, when appropriate, we may forecast some opex categories using other forecasting techniques, such as an efficient benchmark amount.*⁷

The above drafting raises concerns as to whether the AER has appropriately scoped the Expenditure Forecast Assessment Guideline. In this regard, however, SP AusNet notes that section 3.3 of the explanatory statement recognises that the task of setting substitute forecasts only arises if the AER determines that the NSP's forecasts do not comply with the Rules requirements:

*If we are satisfied that a NSP's total capex or total opex forecast reasonably reflects the expenditure criteria, we must accept the forecast. If we are not satisfied, we must not accept the forecast. In this case, we must estimate the total forecast that we are satisfied reasonably reflects the expenditure criteria.*⁸

SP AusNet welcomes the point made in section 3.3 above, and considers it should be reflected in the Guideline because it is essential that the AER not confuse the task of assessing the NSP's expenditure forecasts with the task of setting a substitute forecast. The AEMC's Rule Determination made it clear that the scope of the Expenditure Forecast Assessment Guideline is focused solely on the first task, and not the second.

*The NSP's proposal is necessarily the starting point for the AER to determine a capital expenditure or operating expenditure allowance, as the NSP has the most experience in how its network should be run. Under the NER the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own since it must accept a reasonable proposal.*⁹

SP AusNet would welcome drafting changes to the Guideline and the explanatory statement to clarify that the Guideline is concerned with the AER's assessment of each NSP's forecast of expenditure requirements against the criteria in the Rules, rather than how NSPs should forecast expenditure to facilitate the AER's development of a substitute forecast. In this regard, SP AusNet notes that the industry submissions provide suggested drafting amendments for the AER's consideration.

⁷ AER, Draft Expenditure Forecast Assessment Guideline for Electricity Transmission, August 2013, page 15.

⁸ AER, Explanatory Statement, Draft Expenditure Forecast Assessment Guideline for electricity transmission and distribution, August 2013, page 20.

⁹ AEMC, Rule Determination – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, November 2012, pvii.

3. Back cast data verification requirements

The AER's explanatory statement recognises that NSPs raised concerns about providing back cast data. The concerns arise because internal data may be suitable for NSP business needs, but it may not have been audited or likely to pass audit if provided to the AER in the back-cast form required. In response to these concerns, the AER comments that:

We have considered the concerns of NSPs and the ENA. However, the information we are seeking will ultimately impact electricity prices, so it should be of a high quality and reliable. The Australian Government has endorsed us using economic benchmarking techniques and ensuring we are able to access the information to do so, and we intend to collect the data we need. While it may not be a simple task to provide reliable back cast data, we expect NSPs to commit to allocating the requisite resources to ensure back casting is conducted properly.

We acknowledge that our new reporting requirements differ in some respects from the past but it is a priority for us to gather robust data that is consistent across the NEM. Therefore, we will require back cast data to be independently audited. It is acceptable for NSPs to make assumptions or exercise judgment to comply with our data requirements. However, NSPs must be transparent about the assumptions and processes they use. We will require auditors to review compliance with our framework.¹⁰

SP AusNet fully supports the AER's view that the data employed for benchmarking purposes must be robust. The question remains, however, whether auditing back cast data is a practical approach. SP AusNet's view is that it should be possible to provide the AER with sufficient assurances regarding the quality of the data without requiring an audit. SP AusNet would welcome further dialogue with the AER on this matter, in conjunction with the other Victorian distributors.

4. The Guideline should indicate a likely revision date

The AER explains that the Rules require the AER to publish the Expenditure Forecast Assessment Guideline by 29 November 2013, and thereafter, a guideline must be in force at all times. The AER also comments that:

We do not need to develop Guidelines as part of every review.¹¹

SP AusNet agrees with the AER's observation that the Guideline should not be revisited for each regulatory determination. In particular, it is important that stakeholders and investors have confidence that the regulatory framework is stable and not subject to change at each regulatory determination.

By the same token, it would be valuable to stakeholders if the AER provided an indication of when the Guideline may be subject to revision. For example, it may be instructive to build up experience in the application of the Guideline over a number of reviews prior to making any amendments to the Guideline. A planned review of the Guideline would enable the AER and stakeholders to log their experiences and take a balanced view on how the Guideline may be improved. It will also promote a more stable and predictable regulatory regime.

¹⁰ Ibid, page 74.

¹¹ Ibid, page 2.

SP AusNet would welcome the AER's consideration of when the Expenditure Forecast Assessment Guideline should be amended, and whether it would be beneficial to all stakeholders to commit to a timetabled review. SP AusNet notes that a review in 5 years from now would allow for a full round of price reviews to be completed before the next revision. It would also allow the AER to update its position in the Guideline on the usefulness of various assessment techniques as it builds experience in testing and applying them.

SP AusNet would be pleased to address any queries you may have in relation to this submission. Please do not hesitate to contact Anh Mai, Principal Economist on (03) 9695 6627 if you wish to do so.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'Tom Hallam', written in a cursive style.

Tom Hallam
Manager Economic Regulation