



TransGrid

**TransGrid Revenue Proposal
2018/19 – 2022/23**

Appendix K

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Opex forecast – legal advice



1 Introduction

This advice addresses your questions in relation to:

- (a) prescribed operating expenditure forecast starting point; and
- (b) prescribed operating expenditure forecast and the effect of wage changes.

These questions arise in relation to TransGrid's revenue proposal for the 2018/19 to 2022/23 regulatory control period, which is to be submitted to the Australian Energy Regulator (**AER**) by 31 January 2017.

2 Summary

In relation to each of your questions:

- (a) We consider that there are strong arguments that TransGrid's proposed methodology to determine the starting point for forecast operating expenditure is compliant with the operating expenditure objectives and operating expenditure criteria because it produces an accurate forecast that reasonably reflects a realistic expectation of TransGrid's cost inputs. We do not consider that the AER's methodology achieves these objectives.
- (b) We consider that there are strong arguments that adopting TransGrid's actual labour weighting of 70% to estimate forecast operating expenditure is compliant with the operating expenditure objectives and operating expenditure criteria because it produces an accurate forecast that reasonably reflects a realistic expectation of TransGrid's cost inputs assuming that the efficiency of TransGrid's overall operating expenditure is established.

3 Prescribed operating expenditure forecast starting point

3.1 Background

In its revenue proposal, TransGrid is required to forecast the operating expenditure it requires to provide prescribed transmission services for the next regulatory control period in accordance with the operating expenditure objectives. The AER must then assess this forecast operating expenditure and accept it if it is satisfied that it reasonably reflects the operating expenditure criteria.

The AER's methodology for assessing forecast operating expenditure is set out in the Expenditure Forecast Assessment Guideline published in 2013. This methodology provides for operating expenditure to be forecast from a starting point calculated as follows:

- (a) determine the underspend from the base year (i.e. the difference between the operating expenditure allowance and the operating expenditure incurred in the base year);

- (b) subtract the base year underspend from the operating expenditure allowance in the final year of the current regulatory control period (2017/18); and
- (c) add back any non-recurrent efficiency gains realised in the base year.

We understand that the AER has commented to TransGrid that the methodology for calculating the starting point for forecast operating expenditure was implemented in order to align the estimation of final year expenditure in the current regulatory control period with that of the efficiency benefit sharing scheme (**EBSS**). The accuracy of the forecast was apparently only a secondary factor considered when choosing the methodology.

TransGrid proposes to forecast its operating expenditure using a different methodology. The methodology that TransGrid proposes to use involves a starting point for the next regulatory control period based on revealed expenditure for 2016/17, escalated to the final year of the current regulatory control period in accordance with up-to-date forecasts. We are instructed that TransGrid does not expect to make any 'non-recurrent efficiency gains' in 2016/17.

TransGrid has received advice from Frontier Economics that the forecast starting point that it proposes is more accurate than the AER's starting point. Furthermore, Frontier Economics has advised that it is functionally correct for the EBSS to continue being calculated on the basis of the AER's methodology for final year estimation in the current regulatory control period, without any perverse outcomes or unintended consequences.

You have asked us to consider whether TransGrid's proposed starting point for forecast operating expenditure would better meet the operating expenditure objectives and the operating expenditure criteria.

3.2 Operating expenditure objectives and criteria

The operating expenditure objectives are set out in clause 6A.6.6(a) of the National Electricity Rules (**NER**) as follows:

A Revenue Proposal must include the total forecast operating expenditure for the relevant regulatory control period which the Transmission Network Service Provider considers is required in order to achieve each of the following (the operating expenditure objectives):

- (1) meet or manage the expected demand for prescribed transmission services over that period;*
- (2) comply with all applicable regulatory obligations or requirements associated with the provision of prescribed transmission services;*
- (3) to the extent that there is no applicable regulatory obligation or requirement in relation to:*
 - (i) the quality, reliability or security of supply of prescribed transmission services; or*
 - (ii) the reliability or security of the transmission system through the supply of prescribed transmission services,**to the relevant extent:*
 - (iii) maintain the quality, reliability and security of supply of prescribed transmission services; and*
 - (iv) maintain the reliability and security of the transmission system through the supply of prescribed transmission services; and*
- (4) maintain the safety of the transmission system through the supply of prescribed transmission services.*



The phrase '*is required in order to achieve [the operating expenditure objectives]*' implicitly requires the forecast to be as accurate as possible. Otherwise, the forecast would not represent what TransGrid considers to be required in order to achieve the operating expenditure objectives. The operating expenditure criteria reinforce this by requiring the forecast operating expenditure to reasonably reflect '*a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives*' under clause 6A.6.6(c)(3). That is, the forecast operating expenditure is required to consider what is actually likely to be incurred by TransGrid in the forthcoming regulatory control period.

However, there is no guidance as to the method that must be used to forecast operating expenditure in the NER outside of these general principles. Instead, the AER was required to develop the Expenditure Forecast Assessment Guidelines under clause 6A.5.6 of the NER. These Guidelines set out the AER's approach to forecasting expenditure as described above. The Expenditure Forecast Assessment Guidelines are not binding on the AER (or TransGrid) under clause 6A.2.3(c), but if the AER determines to deviate from the Guidelines, it is required to state its reasons for doing so in TransGrid's final determination.

The underlying principle set out in the Expenditure Forecast Assessment Guideline for forecasting recurrent expenditure is the principle that the actual costs of the transmission network service provider should be a good indicator of the efficient expenditure required by that provider (at 8, emphasis added):

*For recurrent expenditure, we prefer to use revealed (past actual) costs as the starting point for assessing and determining efficient forecasts. **If a TNSP operated under an effective incentive framework, actual past expenditure should be a good indicator of the efficient expenditure the NSP requires in the future.** The ex-ante incentive regime provides an incentive to improve efficiency (that is, by spending less than the AER's allowance) because TNSPs can retain a portion of cost savings made during the regulatory control period. However, the incentive to spend less than our allowance must not be to the detriment of the quality of the services the TNSP supplies.*

TransGrid's actual costs for the 2017/18 year will not be known when the AER makes its final determination for TransGrid. As a result, the AER has adopted the same methodology for determining base year operating expenditure as that used to estimate operating expenditure in the final year of the regulatory control period for the purpose of calculating carryovers under the EBSS.

This methodology is inconsistent with the underlying principle of the Expenditure Forecast Assessment Guidelines because its starting point is the forecast operating expenditure allowance for the final year of the regulatory control period. This allowance was set in TransGrid's final determination for the current regulatory control period and will therefore be almost four years old when it is used to set the starting point for forecast operating expenditure for the next regulatory control period. It cannot therefore be said that it represents an accurate forecast for the operating expenditure starting point because it does not use the most recent information on actual expenditure available. Because the AER's methodology fails to take into account new information that has become available in the five years since the operating expenditure allowance was determined, the AER's methodology does not reflect a realistic expectation of the cost inputs required to achieve the operating expenditure objectives as required under clause 6A.6.6(c)(3) of the NER.

In contrast, TransGrid's proposed methodology for determining the starting point for forecast operating expenditure is consistent with the principle expressed in the Expenditure Forecast Assessment Guidelines. It uses TransGrid's revealed costs for 2016/17 escalated to 2017/18 using current forecasts. Accordingly, it will deliver a forecast that is realistic and better reflects what is required to achieve the operating expenditure objectives because it uses the most recently available information.

Finally, we do not consider that the EBSS is a relevant consideration when determining the starting point for forecast operating expenditure as suggested by the AER. The EBSS rewards and penalises efficiency gains and losses against forecast operating expenditure allowances; it does not set the allowances. That is, the EBSS uses the operating expenditure allowance and actual expenditure to determine any rewards and benefits. Furthermore, there is no reference to the EBSS in clause 6A.6.6 of the NER, which provides for the determination of operating expenditure allowances, and as advised by Frontier Economics, no reason to expect any perverse outcomes or unintended consequences from adopting a different methodology for determining the starting point for forecast operating expenditure than that adopted to determine the carryover amounts in the EBSS.

4 Prescribed operating expenditure forecast and the effect of wage changes

4.1 Background

The AER has recently adopted a generic weighting of 62% to its wage forecast to calculate the change in operating expenditure resulting from changes in wages. That is, the AER has assumed 62% of an efficient transmission network service provider's operating expenditure is labour costs. In turn, this assumes that all transmission network service providers should have the same proportion of operating costs attributable to labour.

The 62% weighting for labour costs is based on a study by Pacific Economics Group in 2004, which used the regulatory accounts of Victorian electricity and gas distribution businesses. Economic Insights attempted to reassess this weighting in 2009, but only one Victorian distribution network service provider could provide the information necessary to conduct the analysis and the information actually provided was consistent with a 62% weighting. Economic Insights note that the split between the labour component, and the materials and services component of operating expenditure is now more difficult to ascertain given the move to the contracting out of field services.

TransGrid's actual share of operating expenditure that is attributable to labour costs is 70%. It proposes to apply this weighting to its wage forecast to calculate the change in operating expenditure in its revenue proposal. TransGrid has asked us to consider whether its proposed starting point for forecast operating expenditure would better meet the operating expenditure objectives and the operating expenditure criteria.

4.2 Operating expenditure objectives and criteria

For the reasons set out in section 2 above, we consider that the operating expenditure objectives require an accurate forecast to be determined. We do not consider that the 62% weighting recently used by the AER would result in an accurate forecast that would reflect the realistic input costs of TransGrid.

The operating expenditure criteria require the operating expenditure allowance to reasonably reflect a realistic expectation of the cost inputs to achieve the operating expenditure objectives. A realistic expectation of input costs cannot be arrived at without considering TransGrid's actual labour costs and its share of operating expenditure relative to the materials and services component. It is not clear what entity the forecast would reflect a realistic expectation for if TransGrid's labour weighting was not used. In our view, the AER must consider these input costs in order to provide TransGrid with a reasonable opportunity to recover its efficient costs as required by the revenue and

pricing principles in section 7A of the National Electricity Law assuming that the efficiency of TransGrid's overall operating expenditure is established.

Furthermore, we do not consider that the AER should apply the 62% weighting for labour costs to TransGrid in accordance with the NER because:

- (a) The 62% weighting has been derived from studies of electricity and gas distribution businesses. Transmission network service providers are different businesses providing different services. There is no reason to expect that electricity transmission businesses would have the same labour weighting as electricity and gas distribution businesses and we are not aware of any evidence to support this proposition.
- (b) The studies on which the 62% weighting is based are dated (2004 and 2009). There is no reason to expect that the weighting for electricity and gas distribution businesses, let alone transmission network service providers, has remained the same over this time period. In particular, changing costs of labour, and materials and services are likely to have resulted in substitution between labour and, materials and services over time.
- (c) The AER's current approach of adopting a 62% weighting for all businesses is a 'one-size fits all' approach. This assumes that there is only one efficient weighting for the labour component. We are not aware of any evidence to support this. Not only will there be differences between businesses that will affect the trade-off between the labour, and plants and materials components of operating expenditure, but there is also nothing to suggest that different combinations of labour and plants and materials will not be equally efficient.

Accordingly, we consider that there are strong arguments that the AER should not adopt a 62% weighting for TransGrid's labour costs where there is clear evidence that TransGrid's actual weighting is 70% assuming that the efficiency of TransGrid's overall operating expenditure is established.