Expenditure Forecast Assessment Guidelines Working Group meeting No. 17

Summary of meeting – 6 June 2013

Economic benchmarking applications

On 6 June 2013, the AER, as part of its Better Regulation package, hosted a working group meeting on the economic benchmarking component of the development of the Expenditure forecast assessment guidelines (the Guidelines).

A full attendee list can be found at Attachment A.

This summary outlines the key topics and themes of the meeting, including views expressed at the meeting, without ascribing particular comments to any one individual or organisation.

1 Introductions

AER staff noted this this was the AER's final scheduled workshop of the AER's consultation on the use of economic benchmarking and the second last workshop of the Guidelines.

In this workshop, AER staff sought feedback from stakeholders on issues relating to the application of economic benchmarking of network service providers (NSPs).

The AER's provided an illustrative example of economic benchmarking of hypothetical NSPs' benchmarked costs, efficiency and rate of change.

The briefing notes and slides used in the presentation are available at: http://www.aer.gov.au/node/20627

2 Major issues for discussion and feedback from the workshop

Weighted average cost of capital

A stakeholder asked if the most recent weighted average cost of capital (WACC) would be used for the whole time series.

AER staff noted that it would be addressing consistency issues with the WACC.

A stakeholder noted that the labour price indices used changed over time but the cost of capital did not.

Economic Insights noted that a capital price index was used for capital inputs and this was the equivalent of the labour price index referred to. It was noted that it would be desirable to have the same WACC across time for each regulatory period.

A stakeholder noted that the forecasts are a strong function of WACC and a slight change could result in a significant change in forecasts relative to the benchmark. Further, the benchmark WACC did not relate to the forecast WACC.

AER staff considered the WACC is the one that is applicable to the business's proposal and the same WACC would be used in calculating both the NSP's forecast total cost and the benchmark total cost.

Model application

A stakeholder asked if the total expenditure model won't be used until more data is available.

AER staff noted that this model will be used with backcast data.

Stakeholders asked if there will be an adjustment for environmental factors and when will they be able to see how environmental factors will be taken into account?

AER staff noted for this illustrative model, environmental factors were not taken into account because the hypothetical NSPs had similar characteristics. Environmental factors will be considered in the testing and validation process and can be modelled using a second stage regression.

A stakeholder asked how the correlation between operating environment factors and efficiency be taken into account. For example if by chance an NSP was affected by a weather variable and the NSP is more efficient, the NSP's efficiency may be attributed to hot weather.

AER staff noted that multicollinearity between explanatory variables was not a problem for efficiency prediction purposes, and raw efficiency scores that may relate to exogenous factors can be adjusted to derive pure efficiency scores in the second-stage regression analysis. This will also be taken into account in the selection of environmental factors which will be part of consultation in the model testing and validation process.

A stakeholder asked why there is a twenty year adjustment period for capital efficiency.

AER staff noted that twenty years was used for illustrative purposes in the model. It was noted that this would be considered further in consultation on economic benchmarking.

AER staff asked what the appropriate time frame would be for long term adjustments.

Stakeholders noted that it would depend on the business and they would not expect a blanket rate.

AER staff noted that at some point assets would be replaced and it was unrealistic to assume an NSP would have no capital efficiency improvements.

Stakeholders also noted that change happens incrementally through tools such as RIT-Ts. Through these tools it is difficult to justify moving to the optimal level of capital because of economic considerations.

AER staff noted that it was not comparing performance against an optimal network and that all comparator NSPs also have long lived assets.

A stakeholder asked if the average productivity gain would be applied as those at the frontier may not be able to achieve the average.

Other stakeholders noted that for NSPs where the average is not appropriate the trend industry average should be removed from the forecast.

AER staff noted that this may depend on the scope for future productivity gains.

A stakeholder raised the observation that the proposed productivity gains include both scale efficiencies and management-led efficiencies. The imposition of management-led efficiencies in an expenditure forecast would mean that these efficiencies may not be rewarded under the EBSS, and a NSP could face a situation where despite management-led efficiency gains it could actually result in a penalty under the EBSS. The stakeholder put the perspective that this is not in line with Rules 6.5.8(b)(3) or 6A.6.5(b)(2). AER staff noted that forecasts should be for efficient costs and NSPs should only be rewarded for greater than forecast efficiency gains.

A stakeholder noted consumers should not bear the costs for inefficient NSPs that are lagging behind.

A stakeholder noted that the model did not appear to be intended for use at the framework and approach stage.

AER staff noted that this will be done at the issues paper stage and were seeking guidance on this view.

A stakeholder asked if it was possible to have a forecast that was too low.

AER staff noted that asset health is looked at to see if there is sufficient expenditure and leading indicators can assist in this assessment.

Stakeholders noted that process would make incentives more complicated.

Opex model

A stakeholder asked how productivity has been calculated for opex.

AER staff noted that this method is the same as the Economic Insights methodology prepared for SP AusNet and uses forecasts of the NSP's future output changes and operating environment changes.

A stakeholder noted that there may have been issues in the use of labour price changes for the SP AusNet gas decision. AER staff noted that the approach adopted had been consistent with the framework proposed by Economic Insights.

Economic Insights noted that adopting a consistent opex partial productivity index for historical and forecast data is the appropriate method and preferable to macro-based adjustments to the labour price index.

AER staff noted that the wage price index (WPI) was used for consistency with the underlying data used in the model.

Stakeholders noted that a list of variables that affect opex specifically can be provided.

Data and testing

A stakeholder asked if these statistical methods are more efficient than current expenditure review methods.

AER staff noted that having these results will be helpful to get a high level view of efficiency in assessing expenditure proposals.

A stakeholder noted that if its planning was considered prudent but the TFP analysis indicated that it was 20% inefficient what would they have to do and would the error margin around the results be 20%?

AER staff noted that there was imprecision in all assessment methodologies and an understanding of the error was required. If there are reports on efficient expenditure from other assessment processes such as RIT-Ts, these cannot be ignored and show that the future may be significantly different to the past.

A stakeholder noted that ultimately consumers are paying for the cost of collecting data that may not be used if the weight applied to economic benchmarking was low.

AER staff noted that it was important to take into account the data available and the robustness of the models in applying economic benchmarking.

A stakeholder asked how difficult operating environment conditions would be taken into account and, to the extent that it is quantifiable in a chart, this should be used rather than editorial notes when presenting economic benchmarking results.

Stakeholders noted that internal data may be suitable for planning but it may not have been audited and that an auditing requirement may present a difficult high data quality hurdle for backcasting. Stakeholders also noted that to obtain Director sign off on the quality of the data may impact on the length of time required to fulfil the AER's data requirements.

AER staff noted that there may be different requirements for backcast data compared to ongoing data requirements.

A stakeholder noted that imperfect data can still be useable. Another stakeholder noted that using poor quality data would undermine the quality of the benchmarking analysis and therefore the reliability and confidence in the benchmarking results which would to some degree be relied upon by the AER in the revenue determination process.

Stakeholders noted that there were concerns about obtaining physical data and that it would be helpful if this data wasn't to be submitted at the same time as the RIN.

AER staff noted that ideally data would be provided early next year however at this stage the exact timing for the data is uncertain.

AER staff noted that it intended to release data requirements before the draft guidelines and the next template would reflect workshop feedback.

A stakeholder asked if data testing for NSW would occur at the same time and if it would include a projection.

AER staff noted that it would be good to estimate a projected TFP at the regulatory proposal stage and that the AER would try to complete the testing and validation process prior to the lodgement of these proposals.

Stakeholders noted that before the first economic benchmarking report is published, the data validation process should be consulted on to allow for peer review.

AER staff noted the importance for all stakeholders to get the data set and asked if there was likely to be any confidentiality issues.

Stakeholders noted that there did not appear to be any and expressed a preference for all data used in economic benchmarking to be available to all stakeholders.

Attachment A: Attendee list

Melbourne office

Name	Organisation
Andrew Kingsmill	TransGrid
Anh Mai	SP AusNet
Bill Jackson	ElectraNet
Bruce Mountain	CME
Damien O'Connor	SA Power Networks
Guy Mutasa	Energex
Jeff Balchin	Incenta Economic Consulting
Jennifer Harris	Powerlink Queensland
Jeremy Rothfield	United Energy & Multinet Gas
Leigh Mayne	Aurora Energy Pty Ltd
Megan Willcox	CitiPower and Powercor Australia
Michael Seddon	Transend Networks
Peter Bucki	Envestra
Robert McMillan	Jemena
Denis Lawrence	Economic Insights
Toby Holder	AER
Lawrence Irlam	AER
Jason King	AER
Su Wu	AER
Andrew Ley	AER
Mark McLeish	AER
Kevin Cheung	AER
Anthony Seipolt	AER

Sydney office

Name	Organisation
Mark Hillsdon	Essential Energy
Matt Cooper	Ausgrid
Oliver Skelding	Ergon Energy
Warwick Tudehope	Jemena
Matt Le Cornu	AER