20 September 2013

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

Dear Mr Pattas

Response to AER Draft Expenditure Forecast Assessment Guidelines

ActewAGL Distribution welcomes the opportunity to provide this submission in response to the AER's Draft Expenditure Forecast Assessment Guidelines[1] and associated explanatory statement. ActewAGL Distribution is a member of the Energy Networks Association (ENA) and supports the ENA's submission on the draft guidelines. In addition, ActewAGL Distribution wishes to make the following key points.

Application of the guidelines

The AER's assessment of the reasonableness of a Network Service Provider's (NSP's) expenditure forecasts is a key step in ensuring that the National Electricity Objective (NEO), that of promoting efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system, is being achieved.

The role of the guidelines is to set out the approach the AER proposes to use to assess the forecasts submitted by NSPs in their regulatory proposals, and the information the AER requires in order to undertake that assessment. The test to be applied to an NSP's forecasts is set out in the National Electricity Rules (NER), that is whether the NSP's forecasts reasonably reflect the operating and capital expenditure objectives. However the way the draft guideline and explanatory statement are written suggests that the AER is seeking to impose a different test on NSPs' expenditure forecasts.

The AER states in the explanatory statement that:

> *If a DNSP's total capex or opex forecast is (or components of these forecasts are) greater than estimates we develop using our assessment techniques and there is no satisfactory explanation for this difference, we will form the view that the DNSP's estimate does not reasonably reflect the expenditure criteria. In this case, we will amend the DNSP's forecast or substitute our own estimate that reasonably reflects the expenditure criteria*[2]

[1] AER, 2013, *Better Regulation: Draft Expenditure Forecast Assessment Guidelines*, 9 August.

[2] ES, p.7

Under the statement above, the AER seeks to replace the test in the NER with its own test – namely whether the NSP's forecasts are higher or lower than the AER's estimate with higher forecasts forming sufficient reason for rejecting an NSP's forecasts. The AER's formulation clearly shifts the burden of proof onto an NSP to explain why its proposal differs from the AER's benchmark.

ActewAGL Distribution strongly supports the ENA's proposal that the guidelines and explanatory statement be amended to clarify how the assessment principles, assessment techniques and the information requirements will each be used by the AER to assess whether the NSP's forecasts reflect the expenditure criteria set out in the NER.

ActewAGL Distribution is also concerned that the guidelines as they currently stand do not provide adequate detail on how the AER proposes to assess a NSP's expenditure forecasts as required by clause 6.4.5 of the NER. Rather, the guidelines and the explanatory statement currently list a suite of potential assessment techniques that may or may not be applied by the AER. ActewAGL Distribution considers that the AER must clarify in the guidelines and explanatory statement the process it intends to follow in assessing expenditure forecasts, and endorses the list of amendments proposed by the ENA in its response to the draft guidelines.[3]

NSP proposal must be procedural starting point

ActewAGL Distribution shares the ENA's concern that if the draft guidelines are applied in their current form then the NSP's forecasts will simply function as a 'check' on the AER's alternative forecast formed using benchmarking techniques rather than a thorough assessment of the requirements for the appropriate safe and reliable operation of the network put forward in its regulatory proposal. The AER's role is to conduct a detailed assessment of the NSP's proposal. This role is supported by the AEMC in its final rule determination when it stated:

> *The NSP's proposal is necessarily the procedural starting point for the AER to determine a capex or opex allowance. The NSP has the most experience in how a network should be run, as well as holding all of the data on past performance of its network, and is therefore in the best position to make judgements about what expenditure will be required in the future. Indeed the NSP's proposal will in most cases be the most significant input into the AER's decision.*[4]

ActewAGL Distribution endorses the ENA's proposal that the guidelines and explanatory statement be amended to be consistent with the AEMC's final rule determination and that, in particular, to remain consistent with the clear intent of the rules that the NSP's proposal will be the procedural starting point for the AER to determine an expenditure allowance, and that the NSP's proposal will, in most cases, be the most significant input into the AER's decision.

Focus on 'minimum' cost

In the explanatory statement, the AER states that the regulatory framework under which it operates aims to align with the NEO and the revenue and pricing principles by setting NSP revenue allowances "at the minimum cost required to provide the level of service consumers expect."[5] ActewAGL

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[3] ENA, Submission on Draft Guidelines and Explanatory Statement, p9.

[4] AEMC, 2012, p.111

[5] AER, 2013, Explanatory Statement – Draft Expenditure Forecast Assessment Guidelines for electricity transmission and distribution, August, p. 24

Distribution believes this interpretation to be inconsistent with section 7A (2) of the National Electricity Law which provides that "a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs....". Furthermore, under this interpretation there could be the potential for the AER to cherry pick amongst assessment techniques to achieve its minimum cost intentions.

ActewAGL Distribution therefore endorses the ENA's proposal that the AER remove references in the draft guidelines and explanatory statement to the AER determining revenues based on 'minimum costs.' Rather, the guidelines and explanatory statement should refer to 'efficient costs' and 'the reasonableness of a NSP's proposal' when assessed against the expenditure objectives. Furthermore, the AER should amend the guidelines and explanatory statement to make clear the intended use and limitations of techniques, and their place among the full suite of assessment techniques in providing a consensus outcome to reduce the risk or perception of preferential selection of the results of a particular assessment technique.

Individual circumstances of NSPs

ActewAGL Distribution argued strongly in its response to the AER's expenditure forecast assessment issues paper that assessment of efficient costs and reasonableness of forecasts undertaken by the AER must take into account the individual circumstances of NSPs, and referenced the Productivity Commission's view that there may be benefits from aggregate benchmarking, provided that the results "*control to the greatest extent possible, for any significant differences in operating environments of the businesses.*"[6]

ActewAGL Distribution is concerned that the guidelines and the explanatory statement do not go far enough in recognising the importance of taking into account the individual circumstances of NSPs when using benchmarking techniques. While the AEMC in the Final Rule Change Determination removed this specific requirement in the rules, its intention was stated as clarifying the ability of the AER to undertake benchmarking. In doing so, the Commission stressed that the "removal of the individual circumstances clause does not enable the AER to disregard the circumstances of a NSP in making a decision on capex and opex allowances."[7] The Commission further stated that:

> *Under the first expenditure criterion the AER is required to accept the forecast if it reasonably reflects the efficient costs of achieving the opex objectives. These include references to the costs to meet demand, comply with applicable obligations, and maintain quality, reliability and security of supply of services and of the system. These necessarily require an assessment of the individual circumstances of the business in meeting these objectives. So to the extent that different businesses have higher standards, different topographies or climates, for example, these provisions lead the AER to consider a NSP's individual circumstances in making a decision on its efficient costs.*[8]

ActewAGL Distribution strongly endorses the ENA's proposal that the guidelines and explanatory statement be amended to require the AER to consider the individual circumstances of NSPs in assessing their expenditure proposals and, further, for the AER to make explicit how its assessment has done so, thereby giving effect to the first expenditure criterion.

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[6] Productivity Commission, 2012, p.278

[7] AEMC, Rule Change Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, November 2012, p.107.

[8] Ibid

Step changes

In its draft guideline and explanatory statement, the AER seeks to limit the scope of items where step changes can be approved under the AER's preferred base-step-trend forecasting method to instances where there is a clear change in obligations arising from a change in a law or regulation.

It is vital that NSPs have the ability to recover new costs that are in accordance with the expenditure criteria regardless of whether those costs arise from regulatory requirements, or other sources such as changes in acceptable standards or industry good practice. An NSP should have the opportunity to make the case for the reasonableness of such costs in its expenditure forecasts, and to have them considered by the AER.

ActewAGL Distribution supports the ENA's proposal to increase the number of matters in the guidelines that are eligible as step changes, and to allow NSPs to nominate additional step changes as necessary to reflect their efficient cost in their expenditure forecasting methodology and regulatory proposals.

Transitional issues

In its explanatory statement, the AER acknowledges that:

> *NSPs submitting regulatory proposals in May 2014 will do so without full visibility of our new techniques. We recognise this creates a potential disadvantage as these NSPs will not be able to modify their proposals for the AER's assessment approach.*[9]

The AER has also stated that it intends to use all of its techniques when it assesses expenditure forecasts and plans to refine these over time.[10] ActewAGL Distribution is highly concerned at the possibility the AER could apply unrefined, untested and unproven assessment techniques to its regulatory proposal in May 2014, given that potentially unreliable outcomes could be used to test its regulatory proposal, and to set its regulatory allowance.

The first AER annual benchmarking report is not due to be released until September 2014. Given this is the first round of benchmarking undertaken by the AER following the release of the final guidelines in November 2013, there is likely to be a significant discrepancy in the quality and quantity of information provided by NSPs. It will take NSPs and the AER some time to understand and explain differences in information provided and how this may or may not affect benchmarking outcomes.

Until this process of refinement is complete there is the potential for the AER to incorrectly attribute and explain differences in outcomes which may be due to individual circumstances, or information discrepancies. This represents a real disadvantage to those NSPs being assessed by the AER early in the first regulatory round under the new rules.

There is a considerable risk that the AER in applying untested and unrefined assessment techniques in the first round of regulatory determinations will substitute NSP expenditure forecasts based on unreliable benchmarks information.

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[9] ES p.73

[10] ES, p. 78

Regulatory burden

Though prompted by the AER's desire for a lower effort tool for assessing expenditure proposals of NSPs, the assembly of benchmarking data paradoxically creates a significant burden on NSPs which is ultimately borne by electricity consumers. ActewAGL Distribution is concerned at the proliferation of regulatory information requests. Each additional request can involve a significant cost, especially for a relatively small NSP. While recognising the necessity for information and accountability, ActewAGL Distribution considers that a more sustained effort could be made by the AER to reduce these costs through:

- improved integration and coordination of AER requests to ensure there is as little duplication as possible in the requests,
- adopting consistent, agreed definitions for data serving similar purposes,
- removing redundant data requests from information requests, and
- applying data definitions consistent with accepted and meaningful industry use.

In the acknowledged cases where requested data may not be directly available to NSPs, especially where the AER is requiring generation of historical data, ActewAGL Distribution considers that the acceptance of assumptions and allocations, while pragmatic, has the potential to further undermine the reliability and acceptability of benchmarking conclusions.

If you require to discuss any aspect of this submission, please contact Chris Bell, Manager Regulatory Affairs on (02) 6248 3180.

Yours sincerely

David Graham
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