ActewAGL
for you

15 March 2013

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

Dear Mr Pattas,

Response to Expenditure forecast assessment guidelines issues paper

ActewAGL Distribution welcomes the opportunity to provide this submission in response to the AER's Expenditure forecast assessment guidelines issues paper.[1]

ActewAGL Distribution is a member of the Energy Networks Association (ENA) and has contributed to and supports the ENA's comprehensive submission in response to the AER's issues paper. In particular, ActewAGL Distribution supports the ENA's proposal that the AER refocus its work on delivering guidelines that clearly set out the AER's intended approach for assessing expenditure forecasts at the next review.

ActewAGL Distribution shares the ENA's concern that many of the matters raised in the issues paper have little relevance to establishing expenditure assessment guidelines to be applied by the AER from the next round of regulatory determinations. Of particular note is the significant portion of the paper focused on the complexities of various benchmarking techniques that may or may not be applied in future regulatory decisions. This discussion provides little guidance to DNSPs on how the AER might assess expenditure forecasts at the upcoming review, which makes commenting on the issues paper a difficult task.

Notwithstanding this, ActewAGL Distribution has the following comments to make in relation to the development of expenditure forecast assessment guidelines.

Benchmarking as a diagnostic tool

ActewAGL Distribution does not support the use of benchmarking techniques to mechanistically set expenditure allowances. Rather, we support the view of industry, international experts and the Productivity Commission, that benchmarking is a useful 'tool' or 'filter' to be used to identify significant variations between businesses, or particular anomalies in expenditure proposals that require greater scrutiny. In other words, benchmarking should be used to support, rather than drive regulatory decisions.

In this regard, ActewAGL Distribution notes the Productivity Commission's suggestion that *"over the longer run, there may be scope for a larger role for benchmarking in determining regulatory*

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[1] AER, 2012, *Better Regulation: Expenditure forecast assessment guidelines for electricity distribution and transmission – Issues Paper*, December.

Importantly, any benchmarking exercise undertaken by the AER must take into account the individual circumstances of network service providers (NSPs). ActewAGL Distribution strongly supports 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."*[3]

The AER has identified the many difficulties associated with economic benchmarking in the energy industry. There is only a small number of NSPs, each NSP captures data differently in their accounting systems and all are subject to exogenous circumstances that are unique to their situation. Given these constraints, benchmarking should only be used as a high-level, diagnostic check on the reasonableness of forecasts developed under a bottom up or revealed cost approach until such time as a technique is proven and can reliably be used as a basis for regulatory decisions.

Compliance costs

ActewAGL is generally supportive of the AER's proposed principles for the selection of assessment techniques. In particular, we would endorse Principle 3 in the issues paper, which requires that:

> *"...additional detail and complexity should not be added to the assessment techniques unless it improves the reliability or accuracy of the assessment..."*[4]

The AER should be required to demonstrate that there is a net benefit in introducing new, costly information gathering requirements.

The importance of making sure the costs of regulation do not outweigh the benefits has been clearly established by the Australian Government's Office of Best Practice Regulation. In its handbook on 'best practice regulation making,' it has stated:

> *"Determining whether regulation meets the dual goals of effectiveness and efficiency requires a structured approach to policy development that systematically evaluates costs and benefits."*[5]

ActewAGL Distribution notes the already substantial work load associated with completing regulatory information notices (RIN)s, and considers that there would be significant additional compliance costs from having to submit information, particularly at a disaggregated level, for the AER's benchmarking activities. To reduce this as much as possible, it will be important for the AER to maintain consistency between benchmarking and RIN requirements. Duplication between benchmarking, annual RIN and regulatory proposal RIN requirements should also be avoided.

The issue of increasing compliance costs has also been raised by the Productivity Commission. ActewAGL Distribution supports the Commission's draft recommendation that;

> *"The AER should periodically examine its detailed benchmarking methodologies and processes to assess their compliance costs for businesses and the costs for the AER. It should compare these costs with the likely benefits when determining the appropriate frequency and type of detailed benchmarking."*[6]

Benchmarking and Incentive regulation

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[3] Productivity Commission, 2012, p.278
[4] AER, 2012, p.23.
[5] Australian Government, 2010, Best Practice Regulation Handbook, June, p. 4.
[6] Productivity Commission, 2012, p.300

ActewAGL Distribution is very concerned by the AER's suggestion that as it progressively increases the use of benchmarking to form a view about proposed expenditure, one of the consequences will be that the AER will be *"less reliant on the revealed costs of an individual NSP in assessing and making adjustments to its forecast expenditure."*[7] Indeed, the AER has questioned whether, once benchmarks are established, the application of the revealed cost approach combined with the existing Efficiency Benefit Sharing Scheme (EBSS) should be retained.

This position contradicts the AER's Final Decision on the EBSS in which the AER stated that in the presence of information asymmetry, *"it is preferable to apply a light-handed approach to regulation, while providing a system of broad financial incentives to induce the firm to operate efficiently."*[8] Furthermore:

> *"The AER considers that a regulatory regime that relies on providing efficiency incentives to DNSPs is preferable to an approach which attempts to micro manage their business decisions."*[9]

It is also completely contrary to the National Electricity Rules (NER) that provide for incentive mechanisms to incentivise NSPs to maximise value for both the NSP and customers, by continuing to focus on and reveal efficient costs. The newly revised rules published in November 2012 even seek to extend the reach of incentive mechanisms to capital expenditure through the development of capital expenditure incentive guidelines.

ActewAGL Distribution strongly believes that incentive based regulation remains a superior method for NSPs to continue to seek and reveal efficiencies in their operations. Any move away from the incentive framework would be inconsistent with the NER, and well outside the scope of this consultation process.

<u>Cost allocation</u>

ActewAGL Distribution strongly disagrees with the AER's proposal to employ a cost allocation method that is neutral to the allocation of indirect costs and requires NSPs to allocate all costs to various drivers.[10] This arbitrary approach to cost allocation is inappropriate for a multi-utility organisation like ActewAGL that ensures corporate costs are allocated appropriately between its electricity network, gas network, water and retail operations. It is also inconsistent with the AER's statement elsewhere in the issues paper that:

> *"Any costs shared between a DNSP and other related businesses (such as staff shared between the electricity and gas distributors under one company) should be allocated to reflects its contribution to the production of the DNSP's outputs."*[11]

Since it was first approved by the AER in 2008, ActewAGL Distribution's cost allocation method was recently revised to improve the accuracy of cost allocation across business divisions, and submitted to the AER for approval in December 2012. Where indirect corporate costs cannot be directly attributed to projects, ActewAGL applies an 'indirect driver' to allocate costs. This driver has been developed after taking advice from external consultants, and allocates corporate costs across the organisation in a way that reflects each division's consumption of corporate services, and is consistent with accounting standard principles.

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[7] AER, 2012, p.35

[8] AER, 2008, *Electricity distribution network service providers Efficiency benefit sharing scheme: Final Decision*, June, p.3.

[9] AER, 2008, p.3.

[10] AER, 2012, p.119

[11] Ibid, p.62

ActewAGL Distribution does not support the AER mandating a standardised approach to cost allocation for the purposes of regulatory reporting. This would require ActewAGL Distribution to maintain a separate set of regulatory accounts resulting in duplication of effort and further compliance costs.

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

Yours sincerely,

David Graham
Director Regulatory Affairs and Pricing