AUSTRALIAN ENERGY REGULATOR – BETTER REGULATION PROGRAM

DRAFT EXENDITURE FORECAST ASSESSMENT GUIDELINES FOR ELECTRICITY TRANSMISSION & DISTRIBUTION

COMMENTS

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# Introduction

The Council of Small Business Australia (COSBOA) supports the need for better regulation in Australia, the Australian Energy Regulator’s (AERs) involvement in this and the efforts of the AER to engage with consumers (and their representatives) in a meaningful way on its Better Regulation Program (BRP). COSBOA also appreciates the opportunity to provide written and other input to the BRP, including through this submission.

This submission responds to the AER’s *Draft Expenditure Forecast Assessment Guidelines for Electricity Transmission and Distribution* and the accompanying *Explanatory Statement* both released in August 2013. We appreciate the considerable thinking, work and effort that have gone into producing these documents.

## About COSBOA and Energy Regulation

COSBOA was founded in 1979 and has a proud history of strong advocacy on small business issues ranging from taxation and workplace relations, through to competition law and retail tenancy. We were created by people who believed that small business needed a voice exclusively representing their interests. Our goals are to:

* Promote and support the development of small businesses in Australia;
* Advocate to advance the interests of small business in Australia, including through policy and regulatory reform; and
* Foster an increased awareness and understanding of the role of small business in Australia amongst elected government and officials, regulators, larger businesses, the media and the general community.

We engage our members and provide opportunities for them to influence outcomes affecting their business, and their industry. We also act as a conduit for information from our members to Government, regulators and other organisations, and vice versa.

Small businesses often do not have the time, resources and expertise required to be alert to the myriad of legislative and regulatory changes that affect them. COSBOA’s efforts are focussed on providing accurate and timely input into decisions which affect small businesses. Our members provide essential input to ensure the quality and relevance of our representation, as well as the substance and the credibility to back it up.

It would be fair to say that energy issues, including the regulation of monopoly network services, are an area containing much detail where small businesses can be significantly affected by decisions they know little about. The recent very large increases in electricity (and more latterly gas) prices would be a case in point.

A list of COSBOA’s members is shown in the Attachment to this submission. As can be seen, they come from a broad range of industries, provide national coverage and are all small business oriented.

## COSBOA’s Involvement in the AER’s Better Regulation Program

COSBOA is taking an active and broad-ranging interest in the AER’s BRP on behalf of Australian small businesses and has secured funding for this from the Consumer Advocacy Panel. The decision by the Panel to provide funding to support our work considerably boosts COSBOA’s ability to participate effectively in the BRP. Our involvement includes written submissions on all areas of the BRP that are important to small business and also participation in the AER’s Consumer Reference Group.

## Structure of This Submission

The following section (2) sets out COSBOA’s views on the expenditure forecasts assessments undertaken by the AER.

Section 3 comments on the approach proposed to be taken by the AER to assessing NSP expenditure forecasts in future determinations and on the associated techniques and principles.

Section 4 discusses issues to do with the interaction of expenditure assessment techniques and the various incentive frameworks for opex, capex, service targets and demand management.

The last section (5), comments on implementation issues.

# COSBOA Views on Expenditure Forecast Assessments

Below we set out COSBOA’s views on the application of expenditure forecast assessments by the AER during energy network regulatory determinations. We have not previously commented on these matters as our involvement in the BRP only commenced after the release of the AER’s Issues Paper and the close of comments on it. To provide some context to our views, we first outline some relevant characteristics of small business.

## Small Business Context

Small business often operates in a highly competitive environment with a need to keep costs under tight control in order to survive. This includes inputs such as electricity and gas. Many small businesses are also involved in export and import competing markets where marginal increases in cost can have a significant impact on sales, employment, and even continued viability. Small business is also reliant on a continuous supply of electricity (or gas) to maintain operations.

As network charges make up around half of the cost of electricity to small businesses, it is important that network prices are kept under control and reflect only the most efficient costs of delivering electricity to small business premises. Similar points can be made about gas transportation.

Seen in this light, the recent large increases in network prices have been most unwelcome for small business and added to the substantial cost and other pressures they face. It is imperative that better regulatory outcomes follow the BRP, especially improved cost control by the NSPs and prices that reflect efficient costs. An important way to achieve this is through the expenditure forecast assessments that form part of AER network regulatory processes.

Small business is also challenged by the complexity of the AER’s processes, including those for its expenditure assessments, and has limited time and resources to become involved in AER network determinations. This being the case, it is important that the AER processes for assessing NSPs’ expenditure proposals is effective, robust and delivers efficient costs to small business, at an appropriate level of reliability. The AER’s process should consider this and make allowance for it. This will help to facilitate increased engagement with small business in future.

## COSBOA’s Position

COSBOA supports the need for effective, robust and transparent expenditure forecasts as an important part of the AER’s determinations for energy networks. A particular focus should be ensuring that NSPs’ costs are set at a level which is commensurate with optimising efficiency in their operations given the need for a reliable supply of energy. This is the best way to ensure that the outcome of expenditure assessments during AER processes actually benefits small business. It is also consistent with the National Electricity (and Gas) Objectives (NEO and NGO respectively) of conferring long term benefits on consumers of electricity and gas. It also supports the need to have regulatory outcomes for these energy monopolies that are consistent with the outcomes that small business would expect to find if it could purchase energy network services in a competitive market, a fundamental objective of effective energy network regulation.

Having said that, COSBOA remains concerned that this has not been the experience of small business following the first round of AER network determinations, which have resulted in unacceptably large increases in network charges. A key objective of future expenditure assessments by the AER needs to be that excessive network charges are a thing of the past. We therefore welcome the AER’s recognition of the shortcomings of its past assessment approaches and its desire to improve these.

COSBOA believes that the approach to expenditure forecast assessments outlined in the Draft Guidelines provide a reasonable start. Naturally, it will be important that the AER ensures that the final Guidelines also reflect this and that it administers them in such a way as to ensure actual outcomes are consistent with this and support the NEO (NGO).

We also recognise (and support) that consumers should be more active in AER determinations in future. Whist there are certain reforms underway, or in prospect, to support this, we believe that the involvement of consumers and their representatives will remain crucial. COSBOA is keen to play a part in this so that the involvement of small business is elevated.

# AER’s Approach to Future Expenditure Assessments

This section provides COSBOA’s comments on the AER’s approach to future expenditure assessments as outlined in the Draft Guidelines.

## General Approach

COSBOA supports the general approach to expenditure assessments outlined in the Draft Guidelines and Explanatory Statement. We also support that the AER will apply a range of techniques to this assessments, including the use of its own estimates and that it intends to collect and apply a range of more consistent data. We particularly value and strongly support the need to benchmark the performance of NSPs and apply the results to help determine the efficient level of expenditures for NSPs. This technique has been absent from past AER expenditure assessments and, we believe, has contributed to a lack of cost control by NSPs and excessive network prices.

We note the AER’s intension to use, for recurrent expenditure:

“revealed (past actual) costs as the starting point for determining efficient forecasts. If a NSP 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 reduce expenditure because NSPs can retain a portion of cost savings (that is, by spending less than the AER's allowance) made during the regulatory control period.” (Explanatory Statement, p. 22.)

Whist this might be an appropriate as a statement of principal, in practice, reliance on revealed costs by the AER in the past has been a contributor to the excessive expenditure allowances provided to the NSPs. We remain concerned that continued reliance on this approach will allow NSPs to continue to inflate their future expenditures. This makes the application of incentive frameworks such as the Efficiency Benefit Sharing Scheme (EBSS) for opex and the Capital Efficiency Sharing Scheme (CESS) for capex more problematic, with consumers still having to pay network charges that reflect inefficient costs. For this reason, we strongly support that the AER will, in future, also apply a range of techniques, especially economic benchmarking, to determine if revealed costs are efficient. We believe that, in doing so, it needs to place significant weight on the outcomes of these.

We also note the AER’s intension to rely on revealed costs to a greater extent for non-recurrent capex and to normalise for work volumes and examine per unit costs, including through benchmarking but, if necessary, to undertake a more involved assessment, including the review of projects and programs. We believe that this should provide a starting point for non-recurrent capex given the additional issues that can emerge through ‘lumpiness’. However, we would still encourage the AER to undertake and rely on, as far as possible, benchmarking techniques.

Some stakeholders have sought a transition period in which to make necessary efficiency savings, should it be necessary to significantly reduce capex or opex. The AER has disagreed with such proposals and COSBOA endorses the AER’s position. As the Explanatory Statement says:

“If the prudent and efficient allowance to achieve the objectives is significantly lower than actual past expenditure, a prudent operator would take the necessary action to improve its efficiency. That is, mirroring what would be expected under competitive market conditions, we would expect NSPs (including their shareholders) to wear the cost of any inefficiency rather than passing this onto consumers through inefficient or inflated prices.” (p. 23)

In this context we again mention that it is widely recognised and accepted that allowances provided to NSPs in past AER Determinations have been demonstrably inflated (inefficient) and it would be unacceptable to small business that this should continue, including through providing NSPs with transition arrangements.

The Explanatory Statement recalls that some “past regulatory proposals posited that a prudent operator would apply a premium above efficient costs to balance risk.” (p. 25) and rejects this approach, noting that NSPs, not consumers, are best placed to manage such risks. We strongly agree with the AER on this and that it appropriately reflects its regulatory obligations.

Turning to related party margins, we have a deal of sympathy with comments in submissions that the AER’s process is not sufficient to guarantee consumers will only pay for efficient costs as a result of such transactions. In particular, we share the concerns that tenders and tender processes can contain flaws and omissions which provide an opening to inflate costs. The AER’s response is that it believes that the contract price provides a good proxy for the competitive market price, but that it will “conduct further examination” if it believes that the tender process was deficient. The problem with this is that it may not be apparent to the AER that the tender price was not a good proxy or that there were deficiencies. This being the case, COSBOA would prefer that the AER further investigated the scope to apply benchmarking techniques to related party margins.

We possess some remaining concerns about the AER’s proposed approach to real price escalators:

* The Explanatory Statement refers to “strong competition from related industries (such as the mining sector) resulted in strong labour price growth in many states.” (p. 29) This may have had an impact in some states but can also be used to exaggerate the extent of labour price growth or to avoid tougher labour cost bargaining. For example, we understand that competition for labour faced by NSPs from the mining sector is not as strong or direct as is sometimes claimed. NSPs can also offer other employment advantages such as stability and being close to family that the mining sector cannot. The main point being that the AER needs to question such propositions and seek evidence if they are used to justify higher labour costs. If they are true, the recent slowdown in mining sector construction and activity will presumably also lead to a slowdown in labour costs.
* In relation to material costs, there is mention in the Explanatory Statement of these having escalated due to the mining boom. NSPs also mentioned the ability to purchase materials on the basis of large, long-term contracts, we well as, exposure to currency and other fluctuations, and the Energy Networks Association (ENA) that “inputs used by the NSPs are often industry specific, so prices can diverge [presumably up or down] from the input prices of other industries.” (p. 30, our parenthesis). Of course, consumers would expect NSPs to negotiate contracts the prices which are as low as possible. COSBOA notes that not all factors at play in materials contracts would operate to push prices up, though this is often the impression NSPs seem to convey. For example, the ability to negotiate large, long term contracts presumably provides some scope to negotiate prices down and currency fluctuations can operate in both directions and should be prudently managed to take advantage of favourable circumstances when they exist. The main point here is that the AER cannot take such things at face value. It must require the NSPs to provide robust evidence of their proposals and undertake its own assessments, including through the use of benchmarks.
* We are concerned that, in the past, it has been relatively common for NSPs to argue for step changes in expenditure whilst there have been few examples of step change reductions. Of course, there is very little incentive for NSPs to identify and propose reductions. The AER proposes a highly deterministic approach to justifying step changes. Whilst we do not absolutely oppose this, at least in the absence of a better alternative, we remain sceptical as to how well this will work in practice. We therefore believe that it will be important for the AER to continue to investigate better alternatives that provide for more robust assessment of step changes. In saying this, we do acknowledge that the two changes the AER propose to make to its current approach, i.e., compensating for incremental (and presumably decremental) changes in opex through lower (higher) productivity and requiring NSPs to justify step changes through reference to core expenditure categories, should help to allay some of our concerns.
* It also concerns COSBOA that the AER’s approach to step changes does little to provide a path to identifying step change reductions in expenditure. We urge the AER to consider this before finalising the Guidelines. It is important to the NEO (NGO) and the credibility of the regulatory process that there should be symmetry and fairness about expenditure changes.

## Opex Approach

The AER is proposing to continue to use its existing revealed cost approach to opex assessments though application of the ‘base-step-trend’ technique. The Explanatory Statement says that:

“… if a NSP has operated under an effective incentive framework, and sought to maximise its profits, the actual opex incurred in a base year is a good indicator of the efficient opex required.” (p. 34)

We do not share the AER’s faith in the ability of this approach to provide consumers with an efficient level of opex. The approach is far too susceptible to gaming and trade-offs by NSPs; and the AER is placed at an enormous information disadvantage. The poor regulatory outcomes felt by consumers in recent years attest to this, with large increases in opex across-the-board.

We therefore very much welcome the AER’s intension to “test this, and if we determine that a NSP's revealed costs are not efficient, we will adjust them to remove the inefficient costs.” (Explanatory Statement, p. 34) The real proof and what ultimately matters to consumers, however, will be in how well the AER is able to do so, in terms of the techniques it uses, how they are applied and its ability to make (and sustain) determinations reflecting such decisions.

We note that the AER intends to apply all its assessment techniques in deciding on the level of the base year opex allowance for the next regulatory period. We support this approach but highlight, in particular, the importance of applying economic benchmarking techniques to ensure an efficient level of opex. Consumers must be confident that these costs are efficient and the natural monopoly character of energy networks means that robust benchmarking is one of the few assurances they can have that this is the case.

COSBOA supports that the AER include productivity change as a variable in its forecasts of future opex, initially through firm specific productivity and in the ‘rate of change’ it applies to the base year opex over the regulatory period, but to ultimately develop a single measure through econometric modelling. We are concerned that productivity change has not been a feature of past AER determinations and that this has contributed to higher network charges and a lack of confidence by consumers in the regulatory process. Nevertheless, the application of a fixed rate of productivity change over the regulatory period will not work in the interests of consumers, with them being denied access to within period productivity benefits, especially where NSPs are materially inefficient.

The Explanatory Statement outlines the AER’s proposed approach to decomposing productivity into ‘catch up’ and ‘frontier shifts’ and seeks comment on this. We have examined the AER’s proposed technique and believe it represents a reasonable starting point for the next regulatory period.

We agree with the AER’s approach to step changes in opex in relation to the rate of change forecasting approach set out in the Explanatory Guidelines. However, we have some concerns about the AER’s comment that “forecast opex should provide sufficient expenditure to comply with all applicable regulatory obligations or requirements.” (p. 37) Our concern is that this leaves unclear that all such costs should themselves be efficient and determined as such by the AER. We also note the difficulties raised by stakeholders of determining the productivity impact of past regulatory obligation changes, whilst agreeing with the AER that this needs to be determined to ensure that opex is not overstated.

## Capex Approach

COSBOA notes the AER’s intension to adopt the same basic approach to assessing forecast capex for NSPs as it has in the past but that it will rely on a broader range of assessment techniques. We further note the AER’s view that improved and standardised data will make its capex forecasting processes more efficient, more effective and simpler.

Given the significant role that capex plays in AER revenue determinations and its rapid rate of increase in the last round of determinations by the AER, we strongly endorse the need to strengthen capex assessment processes to ensure that capex costs are efficient, that capex delivers an appropriate level of reliability and that it is assessed in a transparent manner, which consumers can understand.

Therefore, we especially support the AER’s intension to apply a requirement for greater economic justification, to use economic benchmarking and to introduce a CESS. Each of these should help to strengthen the assessment of capex proposals provided they are introduced and administered in an effective, robust and transparent manner by the AER.

COSBOA also notes the AER’s view that capex should be split into four high level categories, namely, replacement capex (repex), augmentation capex (augex), connection and customer driven works, and non-network capex, as it considers these have distinct unit cost and volume drivers. The AER also proposes to go beyond this to a lower subcategory level to enable a more refined assessment of the prudence and efficiency of future capex. Based on the fact that capex has seen unjustified, explosive growth in recent years, especially for state-owned NSPs, we believe that it is vital for the AER to be better able to control it in future.

However, we do have some concerns about the proposed approach, including its detailed and intrusive nature at the lower level, with a significant level of regulatory compliance involved. We are also somewhat concerned that the AER has not always been clear about why it has formed a view that the benefits of applying its approach and collecting the necessary data will outweigh the costs. This will also increase complexity for consumers and make the approach more difficult to understand. Nevertheless, we are prepared to accept, for the time being, the AER’s judgement on these matters. However, the AER should be prepared to review the performance of the approach and make adjustments if necessary.

Whilst all businesses, including individual NSPs, are different in some respects, they also have similarities and display similar cost drivers. We therefore do not share the concerns of some NSPs that differences could detract from the AER’s approach.

The AER proposes to avoid ‘cherry picking’ between capex and opex and intends to consider these trade-offs when examining category level expenditure. However, it is not clear to us how the AER will do this effectively?

The Explanatory Statement discusses the cost estimation risk factors that are typically contained in a Transmission Network service Provider’s (TNSP) capex proposals and the AER’s objective to standardise the way these are assessed. We understand that additional uncertainties can be involved in estimating costs for TNSP projects and that this raises difficulties for TNSP capex assessments. COSBOA supports the standardisation objective and notes the importance of the following:

* The need for TNSPs to identify and quantify both upside and downside risks but that the AER may have difficulty in achieving this given the relative lack of incentive for TNSP to report the former. It is not clear how the AER intends to ensure this beyond its “requirement” on TNSPs to do so and its application of a CESS? We also note that it would be undesirable for the AER to rely on information taken from past (inefficient) capex proposals.
* The need to limit the extent to which “optimism bias or strategic misrepresentation” can form part of a TNSP’s proposal. We acknowledge that the introduction of a CESS will assist with this but the power of its incentive will be important in determining to what extent and this may be weaker for state-owned TNSPs. We note Ergon’s comments that uncertainty may contribute to an element of bias in project costs. We do not share JEN’s view that bias would be precluded by the implications of making false declarations given that the falsehood in such bias would be difficult to prove and may, in fact, be consistent with a duty to shareholders. Given this, we believe that the AER needs to be mindful of such ‘errors’ in capex proposals.

Considering the above, COSBOA is of the view that it will be important for the AER to find more objective and verifiable ways to deal with TNSP cost estimation risks. The application of a meaningful CESS may help but the application of benchmarking techniques will still be necessary to limit such risks. We therefore read with interest the possibility of developing a “price book” of project cost components for benchmarking TNSP capex projects and AEMO’s possible involvement (Explanatory Statement, p. 46). We encourage the AER and AEMO to pursue this further.

## Expenditure Assessments for Gas

The Draft Guidelines relate only to electricity transmission and distribution. However, they also have significant applicability to gas pipelines regulated by the AER and COSBOA would be keen to see them extended to regulated gas networks as soon as possible. We urge the AER to commence such as process. We note that submissions to the Issues Paper supported this and that one NSP expressed the view that the techniques used in expenditure assessments for electricity would be easier to apply to gas. From a consumers’ point of view, the same benefits would apply from their application to gas, i.e., greater certainty of efficient costs, prices that reflect this, improved transparency and greater engagement in regulation.

# Assessment Techniques

We support the AER’s intension to move away from detailed techniques such as project reviews and towards the application of higher level techniques. We also support its approach of applying a ‘first pass assessment’, based on the latter, before resorting to more detailed approaches if required. We particularly support the application of economic benchmarking techniques during the first pass and beyond.

## Economic Benchmarking

COSBOA believes that benchmarking is an important and powerful tool in economic regulation, given that energy networks are natural monopolies and consumers have no way of switching provider. They must therefore rely on regulation to establish efficient costs (and prices). We therefore very much welcome the AER’s proposed wide application of benchmarking in expenditure assessments in its future determinations. We also support the use of benchmarking for annual reporting.

We have noted the AER’s intension to determine which techniques to apply at the time of determinations rather than specify this in its Guidelines. We agree with this.

However, we would expect the AER to at least apply multilateral total factor productivity (MTFP), data envelopment analysis (DEA) and econometric benchmarking. We are particularly keen to see the AER apply ‘top down’ benchmarking for both opex and capex. We believe that this offers a powerful means of ensuring that NSP costs are efficient and better match the needs of their consumers. We further note that the recent Productivity Commission (PC) report on energy networks strongly supported using benchmarking in network regulation.

We acknowledge that benchmarking will not be perfect to begin with but the AER will be able to improve on its use over time. Even so, the lack of perfection (in techniques and data) should not become an impediment to benchmarking. Even less than perfect benchmarks can still be used to ensure the NSPs operate with efficient costs. We also point out the other techniques used by the AER are less than perfect and have flaws. This has not prevented their use, notwithstanding that they offer consumers less certainty about the efficiency of NSPs than benchmarking.

As the AER says in the Explanatory Paper:

“… benchmarking should create further incentives for NSPs to achieve efficiencies, and importantly, for customers not to be paying for inefficiency. This may be particularly useful when NSPs do not respond to the current regulatory regime's financial incentives.” (p. 46)

We would therefore strongly encourage the AER to use benchmarking as widely as possible and to ensure that it plays a major role in setting both allowed opex and capex, and to go well beyond minimum use “to target further assessments”. We believe that a minimalist approach would not be consistent with the NEO (NGO).

The AER does not propose to set the benchmark level of efficiency until it has undertaken testing and validation of data. We recognise the reasons for the AER’s position on this, but suggest that the minimum level would need to be around the top quartile of the revealed frontier for benchmarking to have a meaningful impact on NSP performance and to benefit consumers. There are also strong reasons for going further than this to either the actual revealed frontier or by adopting the PC’s recommendation of a yardstick approach (i.e., choosing a firm close to the frontier).

The Explanatory Statement comments that:

“ENA noted some of its members have been subject to incentive regulation for more than 15 years, making large efficiency gains in the process and moving towards the efficiency frontier. For many of these businesses, large step changes in efficiency will not be possible, with only gradual year-on-year improvements being realistic. We [the AER] expect relatively efficient NSPs to be technically efficient and agree it is not appropriate to expect them to achieve further technical efficiencies. However, they should be able to achieve technical change in line with the rest of the industry.” (p. 87, our parenthesis)

COSBOA does not agree with these comments. It is presumptuous to say that NSPs have made large efficiency gains merely because they have been subject to ‘incentive regulation’ for more than 15 years. It is widely accepted (supported by PC and other analysis) that economic regulation of energy networks has fundamental flaws and that costs are not efficient. In fact, we would go so far as to say that many NSPs have shown a greater propensity to increase costs and become less efficient. It is therefore wrong for the AER to suggest that some NSPs cannot improve their technical efficiency. On the contrary, we would expect that most NSPs would have substantial scope for further efficiency improvements (and cost reductions) and should be strongly encouraged through regulation to achieve these as this is consistent with the NEO and expenditure objectives.

We are not convinced about the wisdom of the AER’s proposed use of “loss of supply events” and “aggregate unplanned outage duration” as outputs. We are also concerned about the use of the Value of Customer Reliability (VCR) to value reliability outputs. VCR is uncertain and susceptible to large variation, which may undermine the reliability of and confidence in the benchmarking results.

The use of system capacity over actual demand as an output is not supported by COSBOA. Consumers benefit from the least possible capacity to provide reliable supply. There is now significant evidence of excess capacity in NEM networks due to a combination of excessive demand forecasts approved in AER determinations but falling actual demand. Not accounting for actualdemand in the specification of outputs risks that inefficient over-spending is not reflected in the benchmark efficiency assessment. Consumers are already paying for these inefficiencies and an approach which perpetuates excess capacity would lack credibility among them.

We also note that NSPs have opposed the use of system capacity on the grounds that it is not objectively measurable.

Alternatives would include:

* The use of rolling peak demand, say over 3-5 years, which would smooth any volatility and remove AER concerns about access to a sufficiently long time series.
* Adjusting system capacity for *actual* asset utilization as proposed by Citipower, PowerCor and SA Power Networks.

System capacity could then be used in sensitivity analysis.

Grid Australia raised a number of concerns regarding the applicability of economic benchmarking to TNSPs, *viz*, lumpy investments, greater importance of environmental factors, factors specific to individual TNSPs, the small number of TNPSs and limited application of benchmarking by regulators. No doubt each of these factors has some validity, but its importance can also be exaggerated and does not present an insurmountable problem. Moreover, there are also similarities and a homogeneity about the operations of TNSPs which make them amenable to benchmarking, e.g., they produce similar outputs, have similar inputs (especially at the aggregated level), would be subject to similar environmental variables and it is possible to introduce control variables. COSBOA therefore believes that the AER must push forward with the benchmarking of TNSPs.

Consistent with the PC report, we also support the extension of benchmarking to include international comparisons as soon as possible. This will provide even more meaningful insights into the efficiency of our NSPs and produce more robust results. We recognise that there may be data and other issues to overcome but believe that the AER needs to investigate this matter further and undertake discussions with overseas energy regulators on it. We welcome the AER’s comment that:

“We consider international collaboration of economic benchmarking to be an appropriate long term goal and our economic benchmarking should not be limited to a comparison of Australian NSPs.” (Explanatory Statement, p. 119)

However, we believe that the AER should treat this with greater urgency than as a “long term goal” given the benefits it can provide. An appropriate goal may be to have such benchmarking operational by at least the end of the forthcoming round of regulatory determinations.

## Other Techniques

The Draft Guidelines and Explanatory Statement outline a range of other techniques the AER may use in its expenditure assessments. We comment on these below.

We have limited faith in the ability of methodology reviews, and governance and policy reviews to determine efficient expenditure by NSPs. Such reviews are about processes which may or may not be followed exactly and may or may not impact on NSPs’ expenditure decisions. We agree with the ENA that “past governance and policy reviews appear to have had little influence on past final decisions.” (Explanatory Statement, p. 49)

Whist we do not object to the AER having such reviews in its ‘regulatory armoury’, we believe that such techniques should not be relied upon to set allowed expenditures and should be only be used if necessary (e.g., they can add something to the AER’s decisions).

COSBOA considers that predictive modelling could be included in the range of techniques available to the AER to assess efficient expenditures but notes the limitations often inherent in such models. Their use may therefore be of narrower value and we support the AER’s consideration of this before making using such models.

We acknowledge the potential usefulness of trend analysis in helping to determine efficient costs for expenditures where divers are similar to historical trends. It should be included in the available techniques but used according to fitness-for-purpose and should support not supplant other, more powerful techniques.

The Explanatory Statement also supports the use of cost-benefit analysis to help determine efficient costs. We recognise the cost-benefit analysis can help to establish efficiency and prudency, particularly of projects. However, it is also prone to limitations and can be data/resource intensive. In the end, this technique should perhaps be used sparingly, e.g., where other techniques have failed and it can add to gaps in the AER’s assessment, or where detailed assessments of projects are justified. As we understand it, this is what the AER intends.

Finally, the AER has raised its intension to continue to undertake detailed project reviews for a sample of projects. COSBOA doubts that such reviews can prove as useful in determining efficiency as other assessment techniques available to the AER. In this regard, the AER’s intension to “to target detailed project and engineering reviews and use these when other assessment techniques may be lacking” would seem to be appropriate. (Explanatory Statement, p 53)

## Category Analysis

COSBOA also supports the use of aggregated category benchmarks and their continued improvement such as through capturing the effects of scale and density on NSP expenditures. These are covered in the following sections.

### Augmentation Capex

In relation to augmentation capex (augex), we support the use of modelling techniques to help establish an efficient and prudent level of augex. NSP augex can contribute over half of capex and this attests to its importance to consumers. We also recognise and favour the use of the model for (or to assist with) point of comparison, benchmarking, filtering and adjustment purposes.

As mentioned earlier, benchmarking against actual peak demand is preferable to benchmarking against network capacity. Comparing the two indicates the amount of “spare” capacity available for use, which is essential when assessing augmentation capex. The AER should therefore ensure that this metric is used in its assessments.

COSBOA believes that, in the past, NSPs have opted for network solutions to augex that may not have always been the most efficient option. The AER itself has found this when assessing augex proposals with issues such as limited consideration of options, cultural barriers, use of unreasonable assumptions and misstatement of planning assumptions apparent. We therefore endorse the AER’s paying close attention to how seriously NSPs have considered non-network solutions given that their use can help to avoid capex. However, the AER will need to develop robust ways to do this and align incentives if it is to become a more significant option for NSPs.

We consider that the AER’s approach to recognising the differences in application of the model to TNSPs is reasonable and support its application to TNSPs.

The Augex model should be run annually and the results published so that forecast versus actual variances can be tracked and analysed, including by consumers.

### Demand Forecasts

Demand forecasts are an important component of AER network determinations and underlie a number of key parameters, including the allowances for augex. COSBOA is concerned that, in the past, these forecasts have not been as accurate as they could have been and have generally overstated actual demand. This is most likely because NSPs have an incentive to over-built their networks, because of the need to connect all new customers, the need to deliver conservatively set reliability standards and as they benefit financially from capex overspends. The latter two are of particular concern. The AER therefore has our strong support for improve the forecasting of demand, including the application of guiding principles, and the use of ‘top down’ and ‘bottom up’ forecasts.

We also believe that the AER needs to be mindful of the incentives NSPs face in providing demand forecasts and develop its own forecasts which correct for any upward bias. COSBOA fully supports the AER’s desire to have all information associated with models used to forecast demand, including model specifications and assumptions, made public. The development of improved transmission level forecasts by AEMO is important and provides an independent source of demand forecasts for the AER and its current development of distribution level forecasts could do the same at this level. The use of both is supported by COSBOA.

### Replacement Capex

Replacement capex (repex) is an important component of capex, making up between 30-60 per cent of the latter. It has also been controversial, with consumers in particular (backed by supporting studies), expressing concerns that NSPs have mis-used arguments about the age of their assets to inflate their repex proposals. The AER has also recognised this tendency:

“Past trend analysis suggests NSPs’ repex forecasts systematically overestimate capex. This analysis has shown NSPs spend significantly less than their initial forecast or the repex allowance as part of the determination process. Further we have observed that actual repex follows a gradual increasing trend.” (Explanatory Statement, p. 143)

The development of a repex model by the AER and its application in recent determinations has lead to some improvements in repex assessments, which can help to avoid some of the worst excesses of NSPs overstating their repex requirements. COSBOA supports the use of this model for both DNSPs and TNSPs (modified as needed), combined with techniques such as trend analysis, benchmarking and (where necessary) examination of more detailed information provided by NSPs. We note the AER’s comments about the more limited application of the model to TNSPs and the reasons for this, as well as its discussion of the limitations of the model and its limited application to date. We do not view these as constraints on the broader and more general application of the model. We therefore support that the AER continue to develop and extend the model, including so that it can be used more fully for TNSP determinations. We note that key changes proposed to the model include its wider application, including to TNSPs, and its use for benchmarking.

The Repex model should be run annually and the results published so that forecast versus actual variances can be tracked and analysed, including by consumers.

### Customer-initiated Capex

COSBOA supports the AER’s proposed approach to assessing customer-initiated capex forecasts, in particular the application of techniques such as benchmarking and trend analysis.

### Non-network Capex

COSBOA supports the AER’s proposed approach to assessing non-network capex forecasts, in particular the application of techniques such as benchmarking and trend analysis. However, we recognise that such techniques may be more difficult to apply when forecast expenditures are non-recurrent and could be subject to step changes. The latter is a particular concern as it has been a feature of NSP proposals in the past (e.g. IT expenses) and sometimes proven to be excessive compared to actual outcomes. In such cases, it will be important that the AER ensure that NSPs support their proposals with robust information or else they should not be accepted. Even then, the AER will be at a relative information disadvantage and should consider this risk in its assessments.

### Maintenance and Emergency Response Opex

COSBOA supports the AER’s proposed approach to assessing maintenance and emergency response opex forecasts, which the Explanatory Statement says can account for 55 per cent of opex. We note the AER’s intension to review these items on a more disaggregated basis in future in order to permit benchmarking and trend analysis on unit or average costs.

The AER has also formed a view that the unpredictable nature of emergency response expenditure makes it less amenable to benchmarking and trend analysis. The AER has proposed a list of drivers to enable it to better understand how NSPs forecast these costs. Whilst the AER’s view is understandable and its requests for information reasonable, COSBOA is concerned that this approach will not allow the AER to determine, to any reasonable extent, the efficiency and prudency of NSPs’ proposals. We suggest that the AER considers these risks further during its finalisation of the Guidelines.

Notwithstanding that NSPs sometimes outsource some maintenance activities, we support the AER’s approach that NSPs must nevertheless use their best endeavours to provide the required information (and show they have done this) and ensure it is provided as new contracts are negotiated.

### Vegetation Management

COSBOA notes the AER’s intension to rely on a more disaggregated approach to assessing vegetation management opex in future, including trend analysis and category benchmarking. We generally support this approach noting the limitations in the AER’s knowledge of these costs and the frequent contracting out activities of the NSPs. However, we believe that the AER needs to place the onus on the NSPs to provide all possible information (and use serious endeavours to do so), even if it is incomplete at first, and to improve information collection reasonably quickly.

### Overheads

Noting that these account for around one-third of opex, we support the AER’s approach of examining overheads separately (scaled appropriately) and to benchmark these. We also support full visibility of NSPs’ capitalisation policies.

## Assessment Principles

The Explanatory Statement (section 4.5.1) sets out a number of principles to be applied in expenditure assessments. The AER has indicated that they are broadly similar to the Productivity Commission’s evaluation criteria for benchmarking. COSBOA offers the following comments on these:

* We generally support the list of principles provided as they should support the assessment process, assist consumers to engage in and understand it and help maintain control over detailed information requirements.
* We note that the principles will not form part of the Guidelines but can see no reason why they should not be included in them. This would give stakeholders increased guidance and transparency about how the AER will implement the Guidelines and improve the transparency with which it administers them. We cannot see how inclusion would constraint an ability to refine the Guidelines, the techniques or the AER’s application of them. The AER has itself said that “(t)o determine which techniques to use when we assess expenditure, we may consider the assessment principles” (Explanatory Statement, p. 53).
* As referred to above, COSBOA is concerned to see that the AER does not become overly zealous and unfocused in its pursuit of data and information. The collection of data and information should be limited to that which is necessary and sufficient to establish that NSP expenditures are efficient and prudent according to the NER (NGR). The principles appear to reflect this as they say that:

“We will typically prefer a simpler technique (or one with fewer free parameters) over more complex techniques, if they measure equally against other selection principles. Where possible, we intend to move away from assessment techniques that draw us and stakeholders into unnecessary detail when there are alternative techniques. We reiterate that our role is to assess total capex and opex forecasts. The NER do not require us to assess individual projects. (Explanatory Statement, p. 56)

It will be important for the AER to apply this principle.

# Incentive Frameworks

The Explanatory Statement points out that the application of different assessment techniques can have an impact on the incentives NSPs face to improve their cost efficiency. In particular, the revealed cost approach applied by the AER to date, in combination with the EBSS, gives NSPs an incentive to reduce their opex as they are able to retain the benefits for a period of time before sharing them with their customers. On the other hand, the application of exogenous forecasts, such as benchmarking, blunts this incentive given that the NSP has little ability to influence exogenous forecasts through their actual performance.

COSBOA points out that, even with exogenous forecasts, the application of benefit sharing would still provide an incentive for NSPs to outperform forecasts, as they would retain any savings they make before having to share them with consumers, particularly if expenditures are set on the basis of an efficiency frontier that is less than the most efficient NSP. In fact, as the objective is to improve the efficient costs of an NSP by having it move closer to the frontier, it is appropriate that it be provided with incentives to reach it. In addition, consumers would benefit from the more efficient costs of the NSP.

Moreover, given the problems associated with application of the revealed costs approach and our doubts about whether that technique will actually reveal the efficient costs of the NSP, we have doubts about whether the benefits consumers are sharing in are actually real. As the Explanatory Statement puts it:

“… where a NSP does not respond to incentives, the inaccuracy in the initial forecast may be perpetuated in carryover amounts, as well as in the NSP's expenditures not moving towards their efficient level.” (p. 61)

In any case, the AER’s draft Guidelines on Expenditure Assessments prefer an approach that continues to use revealed costs for opex and recurrent capex, with use of benchmarking to establish the actual efficient base year and forecast costs. This being that case, the extent of any blunting in an efficiency sharing scheme would either not arise or itself be blunted.

In relation to the capex assessment, we note the AER’s view that the CESS will be unaffected by its forecasting approach as it does not rely on historic costs to the same extent. We also note that its comments that the consideration of information on capex deferred, capex incurred versus what was funded, rewards and penalties under the CESS and workload indicators, will prevent undesirable consequences from the CESS such as undesirable deferrals of capex. We further note the comment that the application of replacement capex (repex) and augmentation capex (augex) models “should also help to limit undesirable incentives to engage in inefficient and unsustainable capex savings.” (Explanatory Statement, p. 65)

In relation to the Service Target Performance Incentive Scheme (STPIS), the AER believes that its approach to assessing expenditure forecasts will not affect this and on the basis of the commentary in the Explanatory Statement COSBOA accepts this.

We support the AER’s proposal not to approve expenditure proposals to research demand management and embedded generation given the existence of the Demand Management Innovation Allowance (DMIA). However, we also encourage the AER to develop a new demand management incentive scheme as soon as practicable given the known shortcomings in the current one.

# Implementation

COSBOA supports the implementation timeframe outlined in the Explanatory Statement for data collection and the approach to be used. That said, we believe it is extremely important to the credibility of the AER’s expenditure assessments that:

* Data is collected in a timely and efficient way, including that needed for benchmarking and allowing time for gaps to be filled.
* That there is robust testing and verification of the data, and that this does not become a bottleneck to timely implementation.
* That the AER involves stakeholders in its implementation.

We recognise that not all the data required by the AER may be readily available and that some may not be perfect. The processes and requirements which the AER has set out in the Explanatory Statement to deal with this are generally supported by COSBOA. However, we urge the AER to use all its endeavours to ensure that data issues do not become an impediment to benchmarking NSP expenditures (back cast and forecast) as the application of benchmarking is fundamental to betterment of consumer interests and engagement. We note the AER’s comments that the “NSPs already have data that we intend to use for economic benchmarking.” (Explanatory Statement, p. 73) We also reiterate our earlier comments that it would be preferable to undertake benchmarking with less than perfect data rather than delay its use, so long as the available data is meaningful.

In relation to the availability of data, we endorse the NSP and consumer comments in the Explanatory Statement about the importance of gaining access to benchmarking data to better engage in AER processes, including annual reports, regulatory determinations, and testing and validation. COSBOA would be concerned if significant data for benchmarking – economic and even category analysis – were to be kept confidential. The PC also supported that all benchmarking input data be publicly available given the NSPs are regulated monopolies. We would support the full use of the AER’s powers and authority to avoid data being kept confidential.

Finally, the Explanatory Statement comments that the requirement for the AER to stagger NSP determinations creates some difficulties for obtaining consistent data. Whilst COSBA does not believe that this problem is in any way unsurmountable and can be worked around, it does suggest another reason for a prospective change in the requirement, such that all TNSP and DNSP determinations can be conducted at once.

# ATTACHMENT: List of COSBOA Members

Australasian Association of Convenience Stores

Australian Booksellers Association

Australian Digital Television Association

Australian Equipment Lessors Association

Australian Hairdressing Council

Australian Human Resources Institute

Australian Livestock and Rural Transporter Association

**BPW Australia** (Australian Federation of Business and Professional Women)

Business Enterprise Centres Australia

CITT (Council of Information Technology & Telecommunications)

Commercial Asset Finance Brokers Association of Australia

Convenience and Mixed Business Association

Fitness Australia

FSV

Independent Retailers Organisation

Institute of Public Accountants

National Financial Services Federation

National Independent Retailers Association

Pharmacy Guild of Australia

Pittwater Business Limited

Real Estate Institute of Australia

Stocktakers Institute of Australia

Tasmanian Small Business Council

University of Western Sydney