**Matters ENA requests to be covered in the AER 6 June workshop and comments on AER briefing note.**

The ENA welcomes the AER’s constructive dialogue on economic benchmarking techniques (EBTs). Such an approach is essential given:

* + The desirability of having consensus on these techniques and associated models to best ensure their legitimacy and acceptance as a regulatory tool
  + The embryonic state of these models in Australian network regulation and the non-trivial data, specification and environmental control issues that need to be worked through.

In this context the ENA agrees that it is appropriate that the AER has noted that:

*the models are not intended to imply that we are proposing a sudden move to a mechanistic application of these techniques. Rather, they will be used in conjunction with consideration of our existing tools for reviewing expenditure and our refined category analysis.*

To illustrate our understanding of the role EBTs will play in first-pass assessment, the ENA has attached an opex decision tree that steps through the opex assessment exercise that the AER would perform under the rules, and where in this process EBT would apply and in what capacity. We welcome an opportunity to discuss this suggested decision tree with the AER.

Taking the first-pass role of EBT as given, the ENA has identified the following points which we would like to discuss at the 6 June workshop:

* + Schedule for how and when the AER proposes to develop and validate the models from a technical specification perspective (not just the math of a given specification), including using real data
  + Timetable for data request –to enable adequate time for data collection and development of benchmarking models before the first benchmarking report is due on 30 September 2014, the ENA requests that the AER set out a timeframe for the data collection process for the economic benchmarking data. The timeframe should include:
  + When the AER will finalise its data requirements and definitions - the AER should also indicate when it would consult on a draft set of data requirements
  + When the AER will require DNSPs to populate the data
  + The relevant governance arrangements, i.e. is auditing required?
  + When the AER will provide the data publicly.

Assuming the AER will be requesting hind-cast data, the ENA notes that it is likely that some businesses, at least, will not be able to provide all the data requested or provide it in the form, or at the standard of quality and reliability requested. The ENA requests clarification from the AER on how it will account for lack of data from some businesses,

* + How does the AER propose to account for the cost of capital in the models given that forecast costs are a strong function of WACC?
  + To what extent does the AER think historical productivity outcomes are a sustainable predictor of future productivity gains
  + To what extent does the AER think that any of the models under consideration and the required input data are ready for deterministic use in opex rate of change forecasting for the next round of price reviews?
  + Confirm what will be published with the annual benchmarking report, noting that the following should be included as a minimum:
  + Model assumptions
  + Sensitivity to these assumptions
  + Any caveats to the model’s use in practice as identified by the AER’s model validators
  + The nature and extent of judgement to be applied in interpreting the relative efficiency scores. In particular, how judgment will be applied to assumptions on the use of capital (depreciation) and differences in operating environments.

**ATTACHMENT**

**Opex expenditure assessment decision tree – a ‘straw man’**

**PREFACE**

Expenditure assessment necessarily requires the AER to have regard to a number of informants. These broadly include: the business’s regulatory proposal including explanation of variances between actual and forecast expenditure, the results of customer engagement, trend analysis, revealed costs and various levels of benchmarking ranging from holistic economic benchmarking to detailed category level benchmarking metrics.

The AER must be clear about when and how each of these informants will be relied upon to assess an NSP’s opex forecast. Knowing this is important so that the tools can be developed to a level of rigour that is consistent with their intended use (i.e. to ensure the tools and the data collected to inform them both remain fit-for-purpose).

**PRINCIPLE**

Revealed cost remains the default opex assessment method, paired with a base, step trend forecasting approach. If the AER considers that base year expenditure is inefficient and requires adjustment, the adjustment will be informed by the NSP’s proposal and category level analysis and applied to individual categories within the base year.

***Decision tree for assessment of base year expenditure***

1. Benchmarking will be used in the first instance as a high level filter to determine the level of scrutiny that needs to be applied in assessing the efficiency of base year expenditure categories
   * The same range of benchmarking techniques will be applied to each business and the results evaluated
   * It is recognised that every benchmarking technique is prone to error and uncertainty and that only part of any unexplained variance for a business can be attributed to inefficiency
   * Methods that produce results at the extremes—high or low—will not necessarily be accepted as best representing the performance of the business
   * Benchmarking results will not be used deterministically to adjust the base year
   * The decision whether to accept base year expenditure as efficient or to undertake more detailed analysis at the category level will be made on the basis of published criteria such as, for example, the criteria for deciding between different benchmarking methods/results, and the point at which the level of unexplained variance between forecast and benchmark will trigger more detailed analysis.

How benchmarking will be applied in the first instance will be outlined at the Framework and Approach stage of the review on the basis of actual data available at the time. This will provide a preliminary indication to the business as to the level of scrutiny that may be applied at the category level in subsequent stages of the review (as described below).

1. If, as a result of initial filtering (or ‘first pass’), it is determined that category level analysis is required to establish the efficiency of base year expenditure, then a hierarchy of approaches will be applied including category level benchmarking, governance reviews, engineering assessment and bottom up analysis. Category analysis:
   * will progress from high level category assessment to more detailed assessment as warranted
   * will take into account the circumstances of the business and will recognise that, irrespective of the business’s performance at the aggregated level, it will rank better in some categories than in others: no business can be best at everything.
2. The hierarchy of approaches for assessing category level expenditure is:
   * Variance explanation from the business
   * Benchmarking at the category level including benchmarking analysis that may be provided by the business
   * Governance review
   * Engineering/technical assessment
   * Bottom up analysis

Only if inadequacies are found at one stage will the analysis progress to the next. The nature and scope of data that the AER requires to support the analysis will be determined by the level to which the analysis progresses. The default data set required of all NSPs should be constrained to the high level benchmarking and associated comparative metrics at the expenditure category level.

1. The EBSS forms part of the revealed cost framework and as such, if the base year revealed costs are adjusted then the EBSS will be adjusted accordingly so as to avoid a double penalty and preserve continuity of incentives.
2. The process described above is not static—it is expected to evolve over time with experience and in response to changing circumstances.

**THE RATE OF CHANGE**

In setting the rate of change—under the revealed cost base-step-trend method—it is recognised that a business that is close to the performance frontier can only improve sustainably at the rate of change of the frontier. That rate will be less than the rate achievable by a business that is some distance from the frontier. In addition, the average rate of change for the industry will be higher than the rate of change for the frontier to the extent that the average includes businesses that are moving, perhaps rapidly, towards the frontier.[[1]](#footnote-1)

In the event that the process described above leads to an adjustment to revealed base year expenditure, the transition to the new level of expenditure will be accommodated by a glide path rather than a step change.

1. See for example Lawrence, D., Diewert, E., Kain, J*.*; *Productivity–based Regulation of Electricity Networks: The New Zealand Experience; Australian Competition and Consumer Commission 8th Regulatory Conference*, 26 July 2007, pp. 27—28. [↑](#footnote-ref-1)