

14 March 2013

Mr. Chris Pattas
General Manager - Network Operations & Development
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr. Pattas

NSW DNSP Submission on the Forecast Expenditure Assessment Guideline – Issues Paper

The NSW Distribution Network Service Providers; Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) welcome the opportunity to engage with the Australian Energy Regulator (**AER**) in developing the forecast expenditure assessment guideline (**the guideline**). The NSW DNSPs support inclusive, ongoing consultation with all stakeholders to deliver an appropriate outcome.

In accordance with the new rules, the NSW DNSPs understand that benchmarking and modelling will have an enhanced role in the assessment of forecast expenditure to assist the AER in determining the efficient capex and opex allowances.

We expect that the development of this guideline will formalise and clarify the techniques that will be utilised by the AER for their expenditure assessments. A clear understanding of the full expenditure assessment process and any transitional arrangements are of particular importance considering the proximity of the next AER determination to apply to the NSW DNSPs.

Moreover, the NSW DNSPs expect that in light of the historic challenges of benchmarking that the AER will provide some guidance of the longer term vision for refining benchmarking techniques and their application over time. In particular, we consider that the benchmarking of a business's own performance over time should be given greater weighting in the AER's assessment framework as this approach obviates many of the concerns associated with selecting appropriate domestic or international benchmark peers and adequately addresses a business's unique operating characteristics.

High level response to the Forecast Expenditure Assessment Guideline

The NSW DNSPs support the key issues raised in the Energy Networks Association (**ENA**) submission to the AER. The key concern is that the guideline will not provide the required clarity and controls around the assessment of forecasts. The Forecast Expenditure Assessment Guideline Issues Paper (**issues paper**) primarily focuses on the task of developing annual benchmarking reports, considers various economic benchmarking techniques and cost categorisation issues.

This consultation process would benefit from a narrower scope that focuses on the process of assessing expenditure forecasts against the NEL and NER requirements for the upcoming round of network determinations. It is the view of the NSW DNSPs that in order to assess the techniques and associated functional issues contained in the issues paper, the AER must first identify the intended use of these techniques.

The NSW DNSPs support the ENA's view that high level tools have a place in the AER's assessment providing 'reality checks' of the proposed expenditure. It must be recognised however that benchmarking tools have inherent limitations and therefore cannot replace the current incentive framework or a detailed assessment of a Network Service Provider's (NSP's) proposal. This complementary role of benchmarking is supported by the AEMC in its draft determination:

"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 judgments 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."¹

The NSW DNSPs support the ENA's proposal that the AER narrow their focus to developing a guideline that clearly outlines how expenditure will be assessed rather than detailed benchmarking issues. The outcomes of these considerations will define and guide more detailed analysis for the later stages of this review or the separate development of the annual benchmarking report.

Key concerns for the NSW DNSPs

A transitional regulatory proposal will be submitted 31 January 2014 by the NSW DNSPs followed by a full proposal in May 2014. These guidelines will not be finalised until 30 November 2013 and instead be subject to the Framework & Approach stage 2 processes which will not be finalised by 31 January 2014.

The NSW DNSPs note that significant work is underway in preparing forecasts for the upcoming determination. It would be difficult and unlikely that material revisions could be made to meet new reporting requirements. It is also unreasonable to be preparing and submitting expenditure forecasts without a clear understanding of how they will be assessed.

The NSW DNSPs are therefore concerned with the absence of transitional arrangements or a longer-term and balanced vision of implementation and evolution of the guideline over time in the issues paper. The issues paper has a broad focus on areas such as the data specification and gathering exercise needed to employ these techniques. However, there is uncertainty around the following key areas:

- The guideline objectives and how they promote the NEL and NER requirements;
- The full process for the assessment of forecast expenditure by the AER;
- The interaction of this guideline with the incentive framework and other guidelines;

¹ Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 pg. 23, AEMC, 23 August 2012

- How this guideline will apply to transmission NSPs; and
- The implementation process and transitional issues.

These issues must be addressed to enable the NSW DNSPs (and others) to prepare their regulatory proposals for upcoming determinations with proper context and understanding of how they will be assessed by the AER. The NSW DNSPs are particularly concerned with the AER's proposed implementation approach to the guidelines in the immediate future:

"Most techniques that are likely to form part of our first Guidelines will be untested, particularly with nationally consistent data. Even those that are relatively stable will inevitably require some refinement in the future. This could be at the time of the draft and final determinations, during F&A processes or in periodic revisions to the Guidelines."²

It would be inappropriate for expenditure allowances to be set in the upcoming NSW determination by reliance on incomplete, untested and underdeveloped tools. The complexity and challenges of benchmarking mean the AER would benefit from adopting an incremental evolutionary process to its introduction rather than exposing itself and NSPs to the risks of a major change in approach (both now and at any point where the guideline is revised). The current timeline is ambitious and does not appear to heed lessons learnt in Australia or even internationally, even when the issues paper notes:

"the amount of information collected by Ofgem in performing this task is significantly more than we have collected in our RIN templates to date, and reflects the evolution of an approach over many rounds of price determinations. In particular, considerable effort has gone into identifying volume drivers and expenditure category definitions with NSPs over many years and is still in refinement."³

It is highly unlikely that the AER will be in a position to conduct a robust and accurate assessment of our expenditure with these techniques given the proximity of the NSW determination process. The NSW DNSPs believe that the determination process is not an appropriate avenue for developing and refining the assessment techniques in the first instance. A premature application may result in inconsistent application of techniques between NSPs and irregular or suboptimal outcomes.

It is suggested that, until enough observable data is gathered and the techniques are proven to be accurate, these techniques should either not apply or be given reduced consideration as a result of their immaturity. The guideline should describe the criteria that the AER intends to apply in determining the role that particular assessment techniques area are intended to have in the assessment of NSP forecasts. This will ensure that the degree of maturity and proven robustness of individual techniques is a key determinant of the role that they may play in assessing or modifying an NSP's forecast expenditure.

The NSW DNSPs also support the ENA position that this process would benefit from a separate consideration of some benchmarking issues. The issues paper deals with several

² Better Regulation – Expenditure forecast assessment guidelines issues paper pg. 36, AER, December 2012

³ Better Regulation – Expenditure forecast assessment guidelines issues paper pg. 29, AER, December 2012

complex benchmarking issues better suited to the development of the annual benchmarking report (ABR). As the first ABR is not due until September 2014, long term benchmarking issues should not be dealt with in developing this guideline. Rather, the guideline should prioritise clarifying the entire assessment process and how the relevant techniques will be applied in upcoming network determinations.

Key messages of the ENA submission

The NSW DNSPs support the ENA submission. Some of the key positions that the NSW DNSPs would like to take the opportunity to emphasise are set out below in relation to the overarching topic areas set out above:

1. A guideline should provide proper justification, consideration of issues and functional clarity;
2. The interaction of these guidelines with efficiency outcomes and incentive arrangements must be considered;
3. The role of benchmarking and its associated challenges require deeper consideration and possible separation from this process; and
4. The proposed approach needs to be revised to include transitional arrangements which recognise the present immaturity of benchmarking techniques and ensure a consultative and measured approach is adopted.

The issues paper is focused on the data specification and gathering exercise needed to employ these techniques. However, as noted by the ENA, this guideline should focus on:

- Explaining how forecasts are to be assessed against the Rules and the NEL;
- Benchmarking techniques that can be applied in the upcoming reviews (rather than aspirational techniques to be applied in later reviews);
- How the cost/benefit analysis for introducing new obligations to support new assessment methods will be carried out;
- RIN/RIO implications;
- The determination process, including the role and scope of first pass assessments; and
- Links with other guidelines.

As noted by the ENA the appropriate methods for assessing expenditure forecasts cannot be developed independently of the incentive arrangements. Given the different circumstances facing NSPs and the cyclic nature of capital, the NSW DNSPs do not support a long term objective of potentially moving away from the revealed cost approach. The current incentive arrangements provide a strong and ongoing incentive to improve efficiency and there is no evidence to suggest otherwise.

The NSW DNSPs also support the ENA position that benchmarking is not suitable for setting efficient levels of expenditure. It is understood that there may be a benefit in adopting a suite of tools that includes benchmarking. However there are a number of limitations with these models that do not enable 'like for like' comparisons, leading to a high degree of prediction error. In the absence of any evidence to the contrary, detailed engineering analysis based on industry expertise remains the optimal assessment technique.

It also is important to ensure that the benefits of providing data will outweigh the associated resources, limitations and costs for NSPs. The NSW DNSPs support the ENA suggestion that an iterative data collection, analysis and consultative approach is adopted to draw on the industry expertise necessary to address these issues. It is suggested that the benchmarking techniques are developed in a controlled manner or built up over time via the ABRs.

The NSW DNSPs support the ENA position that this process would benefit from a separate consideration of the benchmarking issues and transitional arrangements. A premature approach may result in inconsistent application of techniques between NSPs and irregular outcomes. Therefore a reduced role for particular techniques in the upcoming determinations may be appropriate.

If you would like to discuss this matter further, please contact Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249-3120 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely,



Vince Graham
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