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Dear Mr. Roberts

Submission to the AER Better Regulation Program – Draft *Capital Expenditure Incentive* Guidelines

Thank you for the opportunity to provide comments to the AER draft *Capital Expenditure Incentive Guidelines.*

ACCI welcomes and fully supports the initiative of the AER's *Better Regulation Program* to promote greater efficiency in network spending and thus is supportive of the new capital expenditure sharing scheme (CESS). ACCI is very concerned that electricity prices have increased by more than 70 per cent in real term since June 2007, partly attributable to increases in network charges. ACCI wants to see future network charges that reflect efficient costs and protect the long term interests of energy consumers. The AER's *Better Regulation Program* and the future implementation of its results will have an important influence on ensuring a fair and efficient energy costs for all energy users.

Bearing this in mind, ACCI does not support the proposed symmetric CESS in the draft guidelines, which provides a 30 per cent reward to network businesses for underspend and a 30 per cent penalty for overspend. ACCI would prefer an asymmetric CESS as proposed in the AER issues paper that provides a lower reward for underspend and a higher penalty for overspend. We believe that a direct and asymmetric incentive mechanism is likely to be more effective in curbing capex overspends by the networks than would reliance on an ex-post assessment. In addition, we are not fully convinced by the reasons put forward by the AER on the changes of approach in the draft guidelines and the accompanied explanatory statement.

ACCI argues that a stronger ex-ante incentive measure will be more effective to constraint businesses from overspend. The proposed 30 per cent penalty is too low to curb incentives to overspend, particularly the state-owned businesses, which own around 75 per cent of distribution assets in the NEM.

State-owned businesses have an easier access to finance in comparison to private businesses, particularly since the global finance crisis. As such, state-owned businesses face a lower actual weighted average cost of capital (WACC) than the regulated WACC that weakens the penalty of overspending. If the gap is large enough, it is profitable for businesses to overspend. The best way to overcome this would be to apply an ex-ante penalty to their capex that matches this differential through an asymmetric approach. Ex-post assessments cannot achieve this as effectively in practice, given their reliance on the regulator being able to match the networks in terms of knowledge, information and resources.

The Productivity Commission has reported some evidence that above-allowance capital expenditure differed between state-owned and private networks. Capex and opex for Victorian distribution networks were generally below both regulatory allowances and network forecasts between 1996 and 2006; while all of the New South Wales distribution networks had exceeded their capex allowance between 1999 and 2004. We understand that the situation has deteriorated further since then. A previous AER study has found that the above-allowance in New South Wales and Queensland accounted for roughly 25 per cent of the subsequent price increases. In addition, previous studies have shown that the aggregate productivity outcomes of the state-owned network businesses are poorer than their privately-owned counterparts.

Thus, ACCI argues for an asymmetric CESS, which provides a stronger penalty for capex overspends that are commensurate with the objective of avoiding inefficient capex, and a lower reward for underspend.

ACCI is concerned that the proposed 30 per cent symmetric CESS relies heavily on the improved methods of expenditure forecast assessment. ACCI is not confident that improvements in AER's expenditure forecast assessment will be able to fully address the ongoing user concerns on generous capital allowances for network businesses. Given the inherent difficulties in forecasting due to incomplete information, the regulator will always tend to err on the side of caution and have an upward bias in the expenditure allowance determination. We are also not convinced that the application of a symmetric penalty and the risk of an ex-post assessment of actual capex overspends, along with the application of benchmarking will be sufficient to avoid inefficient capex in the future.

Moreover, our concerns are heightened, as there are no discussion in either the draft guideline or explanatory statement as to why the 30 per cent penalty/reward is proposed and if any evidence or studies have shown that the proposed 30 per cent penalty would encourage behavioral change in network businesses.

ACCI supports the ex-post review in principal; however, we are concerned about its implementation and its effectiveness in constraining businesses from overspending its capex allowance. We fear that the AER will always tend to take a conservative approach to any ex-post assessments and that this will bias them against any inefficient overspending. Moreover, the ex-post review can only be undertaken after the end of the next regulatory control period. For example, the first full ex-post capex review can only be conducted when the AER undertake the regulatory determination for the regulatory control period commencing 1 July 2019 for the capex incurred during the regulatory control period from 1 July 2015 to 30 June 2017.

As such, consumers will not see the benefits of capex exclusion from the regulatory asset base (RAB) if network businesses overspends were deemed inefficient during the 2015–17 regulatory control period, until at least 1 July 2019. This delay is not acceptable to energy users. In addition, ACCI is concerned about the time, information and resources involved for the AER to prove that business have overspent over the previous regulatory period, given businesses have more resources and knowledge compared to the regulator and consumers. Thus, ACCI argues that more weight should be given to ex-ante incentive measures to deter businesses from inefficient overspend than those measures proposed in the draft guideline.

Should you wish to discuss this matter further, please do not hesitate to contact myself (greg.evans@acci.asn.au) or Dr Siwei Goo, Senior Policy Adviser (siwei.goo@acci.asn.au) at (02) 6273 2311.

Thank you.

Yours sincerely,

Greg Evans
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