

## Summary of Meeting

### Consumer Reference Group (CRG) Meeting No. 6

**22 August 2013**

*Held at Hotel Stamford in (Sydney Airport) – Corner of Robey Street & O’Riordan Street, Mascot NSW Sydney 2000*

Attendees: Heather l’Anson, Mark Henley, Carly Allen, Dr Si Wei Goo, Belinda Sandilands, Bruce Mountain, Damian Sullivan, David Headberry, Sue Fraser, Bev Hughson, Carolyn Hodge, Graham Mawer, Helen Scott, Katrina Lee, Luke Berry, Peter Strong

AER staff members—Andrew Reeves, Warwick Anderson, Chris Pattas, Tanja Warre, Moston Neck, Arek Gulbenkoglou, Nathan Zhivov, Sarah Ogilvie, Mark McLeish, Adam Petersen, Lawrence Irlam, Kurt Stevens, Elisabeth Vagg, Anna Barker, Dale Johansen

Apologies: Jonathan Pavetto, Matt Helme, Deanna Foong, Janine Rayner, Alexandra Geddes, Tennant Reed

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#### **1 Welcome and opening remarks**

The AER Chairman, Andrew Reeves welcomed and thanked everyone for their attendance at the second CRG face-to-face meeting. In particular, thanking CRG members for their submissions, noting how valuable their input has been in developing the draft documents. The purpose of the meeting was to discuss the draft documents released for consultation and to hear comments and verbal submissions from CRG members, along with providing an opportunity to ask questions and clarify any matters.

AER staff published factsheets outlining the key issues and approaches adopted in each workstream. AER staff also put together (specifically for the CRG) a ‘Reasons for the Decisions’ document.

#### **2 Expenditure Incentives**

The AER’s expenditure Incentive team covered the four key elements of the draft guideline as set out below.

##### **i. capital expenditure sharing scheme (CESS)**

The draft guideline proposes one symmetric CESS to all businesses, with no allowance for exclusions. The CESS involves applying a 30 per cent reward for underspends or penalty for overspends over a cumulative 5 year period. Under ex post review, businesses will bear 100 per cent of the overspend where it is found to be inefficient.

Consumers indicated they would prefer asymmetry incentive arrangements with higher penalties than rewards. The rewards should be set just as high as is required to provide incentives to networks to cut costs. Consumers considered that overspending cannot easily be justified when there are mechanisms such as pass-throughs and contingent projects to cover unforeseen events.

Consumers wanted to see higher penalties for over-spending as they consider high penalties are the best curb on over-spending. They are not confident that ex post reviews are likely to curb over-spending.

Consumers argued that the proposed 30 per cent penalty is too low to curb incentives to over-spend because:

- Where networks' actual rates of return are below the allowed rate of return, a 30 per cent penalty may be less than the additional rate of return on the 70 per cent excess capex that is permitted. As government-owned networks own around 80 per cent of electricity networks and have a lower WACC because their lending costs are less and their tax equivalent payments are returned to the government, this is a significant problem; and
- Under the existing approach, networks bear the costs of financing within the regulatory period, which equates to a penalty of up to 27 per cent for expenditure early in the regulatory period. The incremental penalty of moving to a 30 per cent penalty may therefore be as low as 3 per cent. In addition, the existing penalties have not curbed over-spending.

Consumers considered that there is no fairness, commercial reason, or economic logic in setting penalties the same as rewards. It is typically easier to control overspending than underspending. In competitive markets overspending is borne by the shareholders but underspending (reducing costs) is usually passed onto consumers as this increases market share. These factors favour setting asymmetric incentive arrangements with penalties larger than rewards.

## **ii. Form of depreciation used to roll forward the RAB**

The choice of forecast or actual depreciation to roll forward the RAB can affect capex incentives.

The AER's proposed approach is that depreciation based on forecast capex will be the default except where:

- no CESS applies, or
- there are concerns about persistent overspending or capex inefficiency.

When considering whether to use actual depreciation in either of these circumstances the AER will consider:

- substitutability between opex and capex and the balance of incentives between opex, capex and service
- the substitutability of assets of different asset lives.

AER staff noted that how the RAB is rolled forward is part of the incentive framework therefore would be specified up front. Any available data on overspending or capex inefficiency would be relevant to the choice of whether to use forecast or actual depreciation.

CRG members noted that it would be good to further understand how the CESS, different forms of depreciation and the ex post review all interact. The Chairman noted a couple of examples would help explain how it works and the implications. Tanja Warre noted the AER could hold a subgroup meeting to go over a working model in more detail if this would be useful.

### **iii. Ex-post review statement of efficiency using**

The ex-post review of efficiency has two purposes:

- Statement of efficiency
- Whether to exclude inefficient capex from the RAB

There are two stage process for the ex post review.

Stage 1 will consider a number of factors including:

- whether the NSP has overspent
- whether the overspend is significant
- the NSP's history of capital expenditure
- how the NSP's capex compares with similar NSPs.

If the AER has concerns after undertaking this high level assessment, it will progress its review to stage 2.

Stage 2 will be a more detailed assessment of the NSP's capex including an assessment of the NSP's planning and management processes and an assessment of the efficiency of capex undertaken by the NSP given the relevant drivers. This will include engineering reviews and other detailed analysis.

- To the extent that inefficient overspends are identified in stage 2, these will not be rolled into the NSP's RAB.

Consumers have concerns around the accuracy of the data making ex-post work over a 5 year period. Consumers consider ex post reviews are a discipline on over-spending. However, they have not played a significant role in disciplining behaviour in the past so in practice they are only likely to be effective in very clear cases of over-spending.

Consumers stated that the US has a system of ex post reviews, but in the US capex is granted on a project-by-project basis. It is much easier in the US under that system to determine in an ex post review whether the spending for a particular project was inefficient

Consumers noted that ex post reviews will not start before 2019 at the earliest, and historically, when they have applied, they have not played a significant role in reducing over-expenditure. In practice it is difficult to demonstrate during an ex post review that expenditure was unjustified when this requires evaluation of the information available to the network at the time the expenditure was undertaken.

Consumers also highlighted that it would occur across two regulatory periods, that is, the first three years of the most recent determination, and the last two years of the previous determination to that. Assessing the efficiency of expenditure across two regulatory periods made it even more difficult and problematic, particularly given that the efficiency had to be assessed against the information available to the network at the time. Assessing efficiency over two regulatory periods meant considering it in the light of two different regulatory decisions, with different forecasts and different rate of returns.

#### **iv. Opex EBSS**

The AER has conducted a review of the current EBSS, and proposes to largely retain the existing scheme.

The only changes proposed that would affect how the EBSS operates are changes to the allowed adjustments and exclusions.

### **3 Expenditure Forecast Assessment**

AER staff outlined the key components of the expenditure forecast assessment guideline:

- The guideline is an improvement on existing methods including repex and base step trend approach
- The repex model has been developed after intensive consultation
- Separate guidelines for TNSPs and DNSPs
- The guideline provides a balance between prescription and flexibility, the AER can tailor to individual companies if need be rather than have it too detailed.
- The AER's assessments would be affected by the setting of service standards, noting the current AEMC's review of how they are set. In general, the AER does consider historical performance information and the costs involved.
- Data requirements were likely to give rise to confidentiality claims, to be governed under the AER's Confidentiality guideline, and in consultation with network businesses
- The guideline affirms the AER's preference to rely on revealed costs when setting opex allowances, while allowing the AER to scrutinise the efficiency of base year expenditures.

Consumers questioned the scope of further workshops and their potential attendance. AER staff noted that there would be a general workshop on 2 September discussing initial reactions to the guidelines and would be useful for consumer representatives to attend. Further meetings were anticipated between AER staff and network businesses solely on data requirements where consumers were unlikely to gain much value.

Consumers asked whether the guideline would apply to the transitional year for the upcoming resets. Staff indicated this was not the case, although there would be some scrutiny of ex ante forecasts that would be subject to a "true-up".

Consumers considered the comparator set for benchmarking should be broadened to include overseas networks. This has the advantage of comparing networks to international best practice. If there are any inefficiencies common among Australian networks then international comparators will reveal these inefficiencies. The AER is hoping to broaden the range of comparatives to include international jurisdictions however the current priority is developing a robust dataset for businesses in the NEM.

Consumers stated it is critical that networks should be benchmarked to the performance of the most efficient firm and not the average firm.

Consumers considered that benchmarking against actual peak demand is just as important (and maybe even more so) than benchmarking against network capacity. Comparing the

two indicates the amount of 'spare' capacity available for use which is essential when assessing augmentation capex.

Consumers stated that the benchmarking guideline does not deal particularly well with related parties. It would be good for the AER to capture this data as well.

Consumers consider it is important to set capex and opex allowances that move networks to the efficiency frontier as soon as possible.

Consumers noted that the AER intends to continue to use revealed costs as the initial assessment of whether opex proposals are reasonable. Under this approach, it is important that all elements of opex be treated in the same way rather than allowing the networks to have opex line items assessed by revealed costs and others to be built from "bottom up". This will ensure that all opex line items are incentivised in the same way.

Consumers generally supported the AER's approach to benchmarking, in particular the templates. Data collected by the AER should be available in both a raw and 'interpreted form' for all to see and not kept confidential. Repex and Augex models should be run annually and reported so that forecast versus actual variances can be tracked.

Consumers are still concerned that the guidelines do not do enough to prevent network from double dipping by claiming the same capex in two or more regulatory periods. The incentive arrangements do not address these concerns.

Consumers questioned the degree of conservatism that may be built into the regulator's decision on expenditure forecasts, and how this related to the incentive arrangements. AER staff noted that the recent policy review of the appeals framework underlined the importance of the AER being able to highlight elements of its decision that were interrelated. Issues around the AER setting symmetric incentive arrangements were discussed, including the impact of contingent projects, pass throughs, and the efficient allocation/ sharing of risk between network businesses and customers.

Consumers noted how this conservatism would have a cumulative effect on the final outcome. That is, if the AER made a conservative decision in each segment of the opex or capex, then the cumulative impact on the overall open/capex allowance would be even more significant. That is, there is a need to consider the overall outcome on opex and capex to ensure that each individual conservative estimate (which perhaps could be 'explained' away at an individual level) does not accumulate into a larger error in the overall outcomes.

#### **4 Shared Assets**

AER staff outlined the key components of the draft shared assets guideline.

Consumers noted that they bore the cost of construction of assets, therefore they should:

- receive the benefits of unregulated revenues earned with regulated assets
- receive an amount equal to revenues less incremental costs less a small mark-up to networks provided as an incentive.

Consumers stated that it is not possible to identify appropriate revenues to share with consumers unless the regulator collects information on the incremental costs of providing the services to third parties. They are therefore in favour of a profit sharing approach, rather than a revenue based approach.

Rather than forecasting third party revenues at the start of the regulatory period, customers proposed they should be examined annually.

Consumers considered that they should not be subsidising telecommunication consumers. Subsidies can be inefficient in providing investment signals.

Consumers consider that a one per cent materiality threshold for triggering sharing unregulated revenues is too high. While the National Electricity Rules' cost pass-through materiality threshold is one per cent, it is not a valid comparison for setting the materiality threshold for sharing unregulated revenues.

One per cent of annual regulated revenue varies significantly in absolute terms across networks given the variations in the size of network revenues. e.g. Jemena's Victorian network revenue is about 10 per cent of that of Ausgrid in NSW.

Using forecasts will give networks strong incentives to understate expected unregulated revenues. Consumers are therefore in favour of ex post corrections, to balance actual revenues and benefits against forecasts.

## **5 Confidentiality**

AER staff noted that the objective of the confidentiality guideline is to strike a balance between sufficient disclosure and transparency to engage with consumers. Our preference is to make as much information as possible available in the public domain. The guideline includes:

- categories of information. The AER would like feedback on whether consumers consider these are useful.
- a detailed list of the type of information that stakeholders should have access to including definitions and examples.
- a process for dealing with confidential information.

Some CRG members proposed a process whereby some consumer advocates could be given access to confidential information where they have signed a confidentiality agreement. A concern with this approach is if some users are allowed to view confidential information there is a lack of equity if others are not allowed to view that same information.

Consumers would like to see some of the detail that currently resides in the explanatory statement incorporated in the guideline, specifically on process, categories of confidential information, public lighting, enforcement, and resolving disagreements.

Consumers need to recognise that some of the information kept confidential would impact consumers if made public.