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16 May 2013

Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Dear Mr Roberts

AER Expenditure incentives guideline issues paper

APA Group (APA) welcomes the opportunity to contribute to the development of the Australian Energy Regulator's (AER's) guideline on expenditure incentives for electricity network service providers.

The APA is a major ASX-listed energy infrastructure business, owning and/or operating over \$12 billion of assets. These assets include significant gas transmission and distribution interests, as well as investments in the Murraylink and Directlink electricity interconnectors which operate in the National Electricity Market.

APA acknowledges that the guidelines are required under the National Electricity Rules and as such will only apply in respect of electricity network service providers (NSPs). It is also the case, however, that there is a strong regulatory history of approaches and methodologies such as these also being applied in the gas sector. The AER also stated in its workshop on this issues paper that the principles included in the issues paper are also applicable to gas. APA's comments in this submission are therefore directed at both the electricity and gas sectors.

The accompanying submission discusses each of the incentive schemes, and then the interaction between the incentive schemes and forecasting methodology.

Please contact Alexandra Curran, Regulatory Manager on 02 92750020 if you would like further information on this submission.

Yours sincerely

Peter Bolding
General Manager Regulatory & Strategy



AER Expenditure incentives guideline issues paper

APA Group submission

16 May 2013

APA Group (APA) welcomes the opportunity to participate in the development of the AER's expenditure incentives guideline.

Overarching principles

APA supports the use of well-targeted schemes that incentivise regulated businesses to become more efficient. As such, APA considers that the long term interests of consumers are best met by schemes that:

- successfully target and discourage inefficient behaviour; and
- reward investment in efficiency enhancing innovation.

Where a scheme operates to also discourage efficient behaviour, or sets rewards or penalties for outcomes unrelated to efficiency, then APA does not consider such a scheme would be in the long term interests of consumers.

It is also important to ensure that the schemes do not conflate efficiency with short term cost reductions. Cost reductions may not be efficient if they come at the expense of services that customers value, or lead to the deferral or avoidance of expenditure that means that ultimate costs will be greater. Similarly, cost increases may be efficient if they resource the provision of increased levels of services valued by energy consumers.

APA is concerned that the incentives guideline issues paper is focused on achieving expenditures which are below regulatory allowances. It does not focus on the incentives for efficiency to be provided by the efficiency benefit sharing scheme and the new capital efficiency sharing scheme. The proposals in the issues paper do not provide incentives for expenditure to increase the provision of valued services, or to support the innovation needed for long term efficiency improvement. Nor do those proposals discourage expenditure reductions which are not justified on efficiency grounds.

These issues are discussed in respect of the AER's proposed incentive schemes below.

Capital Efficiency Sharing Scheme

Scheme incentives

APA does not consider that the AER's proposal to introduce a Capital Efficiency Sharing Scheme (CESS) with asymmetric incentives applying increased penalties on overspending strikes an appropriate balance between efficiency and cost reductions.

Efficiency improving investments will not occur where businesses cannot gain even short term benefits from those investments. An asymmetric penalty scheme significantly



increases the investment hurdle for such efficiency improving investments, to the extent that businesses at or close to the efficiency frontier are unlikely to have any scope to strive for harder or riskier efficiency gains. Instead, such a scheme is likely to only act punitively on businesses that have already made significant efficiency gains, and to the benefit of those that still have significant efficiency gains to make. APA does not consider that this outcome would be in the long term interests of consumers.

APA is also concerned that introducing a very high powered incentive scheme on overspending up front may have unexpected and unintended consequences, particularly in relation to its interaction with other schemes such as the service standard incentive scheme. There is a potential for conflict between the proposed operation of the CESS and the service standard incentive scheme in respect of investment intended to improve service performance. Since the CESS is a new scheme, it would seem prudent to introduce a symmetric scheme in the first instance to be able to assess businesses' responses to the incentives and how the scheme interacts with other incentive schemes.

Impact on efficient and inefficient expenditure

The AER's issues paper states that it intends the CESS to apply to capital overspends that it may otherwise consider to be efficient (either through *ex poste* review, the RIT-t/RIT-d, or both). APA does not consider that this is an appropriate outcome as it will operate to discourage efficient investment (that is, investment in the long term interests of consumers) in favour of short term cost savings or cost avoidance.

Investment above a regulatory allowance can be made for a number of reasons. In most cases, investment is required and the fact that it is above a given regulatory allowance is more of a reflection on the adequacy of the allowance (and the information available at the time it was set) than the efficiency or prudence of the investment.

There are many uncertainties faced by businesses and regulators in setting regulatory allowances, but the most relevant of these (for this purpose) relate to demand and cost forecasting risks. Minor changes in economic conditions, as well as international financial events and decisions, can impact both domestic demand and the cost of procuring goods and services. Currently, regulated businesses bear all forecasting risk within the period, however this is considered appropriate as forecasting risk can operate symmetrically – the chance that a business gains from forecasting risk is balanced against the risk that it will suffer losses.

The AER's proposed approach under the CESS, however, places a significantly greater penalty on the business for downside compared to upside risk arising from inaccurate forecasts. APA does not consider that it is appropriate to impose this additional penalty without differentiating between expenditure above the regulatory allowance that is efficient and unavoidable, and expenditure that is not efficient or could have been avoided.

The AER seeks to address this issue in part by referring to other mechanisms that can alleviate these risks for businesses such as reopeners, cost pass through provisions and contingent project mechanisms.

APA does not consider that the AER's conclusion that businesses have ample opportunities to protect against unforeseen costs is accurate. While regulated businesses do have access to cost pass through mechanisms, and electricity network businesses now have access to the recently introduced contingent project mechanism, these mechanisms do not



protect against many drivers of higher costs such as higher than forecast material or labour costs, increased peak demand, or growth in connections that is greater than forecast. In particular in respect to changes in demand, it does not appear in the long term interests of consumers to penalise businesses for meeting regulatory obligations to connect customers and to ensure reliable supply.

Application of scheme

APA considers that there are key differences in the type and size of individual investments in the transmission sector (gas and electricity) that may warrant a more limited scheme applying in that sector.

In particular, customer-driven transmission-level extensions and expansions typically evolve as major users develop their own plans and facilities, and can have very short lead times for transmission businesses. In these circumstances, mechanisms such as contingent projects may not be in place. These projects can be very large; however it is efficient and in the long term interests of consumers for the projects to proceed. It is therefore important that transmission businesses are not penalised through an incentive scheme for responding to customer needs which have not been forecast.

Even where a project is known, customer driven extensions and expansions are highly dependent on customer needs. An individual customer's requirements can vary considerably over time, with anticipated connection capacities being either increased or decreased, in response to external and uncontrollable events such as international commodity prices (for example in relation to gas pipeline projects for the resources sector).

Such changes in customer needs are not related to the service provider's efficiency, and therefore rewarding or penalising service providers for such changes through an incentive regime would not be targeting efficient or inefficient behaviour of the service provider.

Efficiency Benefit Sharing Scheme

APA considers that the current EBSS, like the proposed CESS, is not sufficiently targeted to discourage inefficient behaviour. Instead, the scheme operates to incentivise businesses to remain within expenditure allowances, without sufficient attention to whether this represents an efficient outcome for customers.

APA considers that the current EBSS places too much emphasis on the forecast expenditure allowance, meaning that very minor deviations from that forecast can lead to penalties and rewards for the business. It is not rationale to assume that all movements in costs calculated with reference to a forecast made up to 6 years earlier are related to changes in efficiency. Instead, some allowance or recognition must be made for the uncertainty of forecasts before rewards or penalties are paid. To address this issue, the AER could introduce deadbands for movements in costs, within which the business would receive no reward or penalty.

As noted by the AER, the current EBSS offers a symmetrical 30% reward or penalty for operating expenditure under/over spends. APA does not consider that allowing a business to retain only 30% of any efficiency improvement provides sufficient return to the business for harder or riskier efficiency initiatives. This sharing ratio also places an effective cap on the scope of any efficiency improving investment, placing more expensive and higher (long term) yielding efficiency gains out of the reach of both businesses and customers. To



address this issue, the AER could apply improved incentives for efficiency gains, allowing for larger and more significant investments in future efficiencies to be made.

Interaction between incentive schemes and forecasting methodologies

The AER's issues paper discusses the operation of the EBSS under exogenous forecasting approaches. As exogenous forecasting techniques can potentially be used with both the CESS and EBSS, APA discusses the interaction between incentive schemes and forecasting methodologies in this section in relation to both schemes.

Use of exogenous data to set regulatory allowances

APA has significant concerns over the AER's intention to use exogenous data to set regulatory allowances where it considers that the business's revealed or forecast costs are inefficient. Exogenous data can, at best, indicate that a forecast may include estimates of inefficient costs. Without further analysis, it cannot indicate the extent of the inefficiency and, in the circumstances of the business, what the efficient costs might be.

The AER has provided no detail as to the principles and thresholds it will apply, in particular the confidence level it will need, in order to determine that it is appropriate to use exogenous data in place of a business's forecast. Given the impact that using exogenous data will have on the application and power of the incentive scheme, guidance on this matter is critical to give businesses certainty over the AER's assessment approach, as well as the forecasting technique and incentive scheme the AER will apply.

Discussion in relation to the development of benchmark data has made passing reference to the need to take forecasting error into account when determining whether to substitute benchmark costs for a business's expenditure allowance.¹ Adequately recognising forecasting error is important as there will be significant confidence intervals associated with any benchmark data, and the AER must have regard to these confidence intervals before determining that a business is in fact inefficient compared to benchmark data.²

The problem with data accuracy is multiplied, however, where the data are used to determine rewards and penalties under an incentive scheme. This is because the margin of error associated with the substituted benchmark data is combined with the margin of error associated with forecast data, which it itself can have significant confidence intervals, particularly in the later years of a forecast. The risk is that these errors combined create an incentive scheme that determines rewards and penalties for outcomes that are in no way related to a business's efficiency.

This risk must be taken into account by the AER when determining to apply benchmark data under an incentive scheme, and the power of incentives under that scheme. APA considers that there is a far greater risk that a business will not have the opportunity to recover its efficient costs under a combined exogenous benchmark and incentive scheme approach, particularly if penalties from the previous operation of the scheme start to compound.

¹ Australian Energy Regulator 2013, *Better regulation – Expenditure forecast assessment guidelines for electricity distribution and transmission: Issues paper*, p 31

² APA considers that the specific circumstances of the business should be the key determinant of whether a business is efficient, rather than a comparison to benchmark data



Incentives under scheme

The AER proposes that the EBSS would operate to give the same incentives under both the revealed cost and exogenous techniques, by ensuring that there is a 70:30 split of efficiency gains and losses between customers and businesses.

APA is concerned, however, that the AER's use of exogenous data is more likely to lead to penalties than rewards under the scheme, and that those penalties will be far greater than those that would apply using a revealed cost approach. This is because of the AER's stated intention to use exogenous data only where it assesses that a business is inefficient; that is, exogenous data will only be substituted in forecasts where they lead to lower forecasts than the business's revealed or forecast costs.

Because exogenous data will only be used to reduce expenditure allowances below revealed or forecast costs, the business will need to achieve far greater cost reductions, in a very short amount of time, before it can hope to achieve any efficiency rewards (or at least stop incurring large penalties). It is therefore not correct to state as the AER has done that the power of incentives under the revealed cost and the exogenous forecast approaches are the same.

APA considers that speedy reductions in expenditure made by a business to meet inadequate regulatory allowances are more likely to be in the nature of short term cost cutting than longer term efficiency savings. Short term expenditure reductions may lead to longer term cost increases, whereas efficiency savings deliver genuine benefits to customers and ought to be preferred by the regulator.

Application of productivity adjustments with incentive schemes

The AER has stated in respect to its expenditure forecasting workstream that it intends to apply a benchmark productivity adjustment to business forecasts, and for this productivity adjustment to operate in addition to any incentive scheme.

APA is concerned that the application of a productivity adjustment to forecast costs in addition to an incentive scheme, will disproportionately disadvantage the most efficient businesses, and make it far more likely that the more efficient firms will face penalties under the scheme. This would be a perverse outcome that the AER should seek to avoid.

APA urges the AER to reconsider whether it is appropriate to apply productivity adjustments in addition to the operation of an incentive scheme. While in principle businesses operating in a competitive market only keep efficiency gains made 'ahead of the pack', APA queries whether the AER could ever have sufficient certainty over its benchmark data to determine average efficiency gains.

To do so it would need to be able to distinguish between true productivity improvements made by businesses and other movement in costs and activities. It would also need to ensure that its measure of the average efficiency gain was not driven by one or a very few businesses making 'above average' gains.

Without this certainty, the AER risks not providing businesses with the opportunity to recover efficient costs, particularly for those businesses that have already made all its low cost efficiency gains. A more prudent approach would rely on the operation of the incentive scheme alone to provide adequate incentives to businesses to pursue efficiency gains.



Exclusions under the scheme

The AER has stated that where exogenous benchmark data is used to set a forecast, then an alternative form of the EBSS will apply that calculates a sharing ratio for expenditure under- and over-runs by a set formula. APA has a key concern that the AER has not provided sufficient detail or guidance as to how it will substitute benchmark data, and how this will influence the operation of the EBSS.

While it appears clear that the AER's exogenous EBSS will apply in circumstances where all of a business's forecast costs are based on exogenous data, it is not clear what scheme will apply, and how that scheme will apply, where only part of a business's forecast expenditure is substituted with exogenous data.

Should the revealed cost incentive scheme remain in place where there is partial substitution of expenditure, then businesses will face much higher incentive rates in respect of substituted expenditure than is intended under the scheme – this is recognised by the AER itself in its issues paper. It is therefore important that where the revealed cost EBSS applies, expenditure that is subject to exogenous forecasting techniques is excluded from the operation of the incentive scheme.

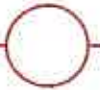
Application of scheme

The AER's issues paper and workshop discussion raised the possibility that the AER will decide to adjust forecasts for the purposes of calculating rewards and penalties where it considers that the business is not efficient or has not responded to incentives.

APA does not consider that a business can adequately respond to an incentive that it cannot quantify. The threat of *ex poste* adjustment to forecasts would mean that businesses could no longer calculate the net value of efficiency improving expenditure; the outcome would be that businesses would no longer make such investments. A further outcome from this approach could be that where a business does make an investment to improve longer term efficiency, the increased expenditure associated with that investment could lead the AER to deem expenditure to be out of step with benchmarks and apply adjusted forecasts *ex poste*, thereby increasing penalties associated with that expenditure and erasing the benefits for the business through the scheme. Again, no investment will be made in these circumstances.

The AER has also made no suggestion that it will look at total expenditure when making assessments as to whether a business is responding to incentives. This is important as investments in capital expenditure can lead to operating expenditure reductions and vice versa. As a result, the AER may be assessing a business as not responding to operating expenditure incentives and applying an additional penalty on that business where it is in fact making capital efficiency improving investments. This should be a key concern to the AER as it is just this type of efficiency gain that the incentive schemes are intended to support and incentivise.

APA urges the AER to reconsider the incentive outcomes following from *ex poste* adjustments to forecasts that are not set out at the start of the regulatory period.



Forecast versus actual depreciation

The AER's discussion on using forecast or actual depreciation is highly influenced by its views on overspending. As such, the AER has not acknowledged the influence that using forecast depreciation has on incentives to underspend regulatory allowances. This is shown by the following statement by the AER in the issues paper, which appears to be equating efficient capital expenditure with lower expenditure:

Actual depreciation provides stronger incentives for efficient capex than does forecast depreciation.³

APA considers that the AER should focus on incentivising efficient expenditure rather than focusing on overspending, and take a balanced approach to determining whether to accept a business's proposal to use either forecast or actual depreciation. This would involve not focusing solely on overspending, and ensuring that the depreciation approach is not used to further increase already significant penalties under the CESS.

³ Australian Energy Regulator 2013, *Better regulation – Expenditure incentives guidelines for electricity network service providers: Issues paper*, March, p 21