10 May 2013

Mr Chris Pattas
General Manager Network Operations and Development
Australian Energy Regulator
GPO Box 520
MELBOURNE Vic 3001

Dear Mr Pattas

Response to expenditure incentives guidelines issues paper

ActewAGL Distribution welcomes the opportunity to provide this submission in response to the AER's issues paper on Expenditure incentives guidelines for electricity network service providers (the issues paper) released in March 2013 as part of the AER's Better Regulation program.

ActewAGL Distribution is a member of the Energy Networks Association (ENA) and fully supports the ENA's comprehensive submission in response to the issues paper.

The issues paper canvasses substantial changes to the incentives currently existing in the regulatory regime under the National Electricity Rules (NER), including:

- A new continuous incentive scheme capital expenditure—*Capital expenditure sharing scheme* or CESS—which is asymmetric in its application. It penalises expenditure outcomes in excess of the regulatory allowance to a greater extent than it rewards equivalent under-expenditure
- Potential adjustments to the existing efficiency benefit sharing scheme (EBSS) for operating expenditure, including, in some cases, substitution by the AER of revealed costs with exogenous benchmarks.

The paper also proposes:

- The use of forecast depreciation for incrementing the regulatory asset base (except where no CESS applies where actual depreciation would be used)
- Retaining an approximate 30/70 sharing ratio for opex decreases below/increases above forecast even where a revealed cost approach is not used
- A staged approach to ex post review of capital expenditure now required under the National Electricity Rules (NER).

ActewAGL Distribution supports the development of effective incentive mechanisms that align the interests of Network Service Providers (NSPs) with electricity consumers, serve to reduce the detail required in assessing expenditure forecasts, and promote certainty and predictability of the regulatory regime. ActewAGL is opposed to any measure or measures in combination that would result in revenue penalties inconsistent with the revenue and pricing principles in the NER. The AER provides no reason why penalties should be asymmetric. This seems to be based only on the assumption that NSPs need to be punished for exceeding the allowance even though forecasts underlying the allowances are necessarily based on imperfect information about future needs of the network.

ActewAGL Distribution, in common with the AER, favours a revealed cost approach to expenditure determination. Forecasts of expenditure are inevitably imperfect and should not form the basis for judging whether expenditure is efficient. Given the costs involved in detailed reviews of proposals, it is clarity and continuity of incentives over time that provides, as required by the National Electricity Objective, the best outcomes in the long term interest of consumers.

The AER's proposed approach understates the ability of well designed ex ante incentives to optimise expenditure over time in the long term interest of consumers. To do so requires that the incentives be well understood, that they be consistently applied and that there is confidence that they will not be subject to change after expenditure decisions have been made.

ActewAGL Distribution endorses the principles-based approach to incentive scheme design and application advocated by the ENA. This stipulates, in alignment with the National Electricity Objective, Revenue and pricing principles and capital expenditure incentive objective of the Law and Rules:

- the ability of an NSP to earn a commercially appropriate rate of return on all efficient investment to meet obligations to owners and lenders
- there should be incentives to prudently manage capital and operating costs that encourage the NSP to implement productive and dynamic efficiencies and to pass on efficiency gains to consumers over time
- to be effective the operation of incentive mechanisms and the power and form of incentives must be known to be business in advance
- that schemes should provide neutral incentives that are symmetrical and continuous so as not to distort expenditure decisions such that the NSP faces the optimal incentive to spend at the appropriate time
- the ability of an NSP to adjust expenditure to changing circumstances over the regulatory period to deal with changing costs, new information and requirements, and forecasting error.

Ex ante opex incentives and proposed adjustments to existing EBSS

ActewAGL Distribution is in its initial period of application of an EBSS to opex for both its ACT electricity network (from 2009-10) and its ACT, Queanbeyan and Palerang gas network (from 2010-11). The business recognises the continuous incentives under the scheme to optimise operating expenditure throughout the regulatory period, including the need to carefully assess expenditure increases. Realised expenditure can vary from forecasts for many reasons including unforeseen changes in the costs of inputs, changed requirements and emerging circumstances. Through the continuity engendered by the carryover of incremental changes in operating expenditure, the EBSS as it stands provides the incentive both to continually reduce costs to gain a share of benefits of doing so and equally to constantly avoid unnecessary increases in costs due to the cost penalty incurred. However the potential opportunity for incurring costs in anticipation of longer term benefits, for example, through business restructuring or key system improvements—sources of dynamic efficiency—should not be underestimated. The incentive to undertake such major but periodic initiatives should not be undermined by departing ex post from the regulatory compact on revealed costs.

Ex ante capex scheme

ActewAGL Distribution considers that there is a case for a properly designed capital expenditure incentive. This would address the inherent incentive for sub-optimal deferral of expenditure of capital projects and assist in their optimal timing (given that there can be a window over which such projects can feasibly take place). A capital incentive scheme would, as well, complement the EBSS by addressing potential distortions in choices between capital and operating expenditure solutions.

However, in its proposal for an asymmetric CESS, the AER appears to be advocating a punitive approach to spending in excess of the regulatory allowance. Introducing asymmetric incentives will inevitably distort spending decisions whenever NSPs are operating beyond expenditure allowances promoting inefficient investment decisions, such as deferral to future periods, to the potential detriment of the long term interests of consumers. While there are existing mechanisms such as cost pass through that can be used for mitigating the risk of unanticipated expenditure, these are quite limited and restricted to externally imposed events. The recently introduced contingent project regime for distributors applies a threshold of $30m which is too high to be of much practical use to smaller NSPs such as ActewAGL.

It should be noted that extensive examination by the AEMC during its consideration of the Regulation of Network Service Providers rule change proposals failed to find any evidence of systematic inefficient above forecast expenditure that might warrant such asymmetric treatment.

ActewAGL Distribution is supportive of the ENA's proposal that, given the risks inherent in adopting a new incentive scheme design, the AER should give consideration to redrafting its approach to the CESS to more closely match the characteristics of the Capital Expenditure Carryover Mechanism (CECM) scheme that was formerly applied with effective outcomes in Victoria and South Australia. The CECM is, in essence, an EBSS applying to capital expenditure which shares the benefits and costs of lower or higher spending against the allowance by ensuring that the underspend/overspend is retained by the NSP for five years. It differs from the CESS put forward by the AER in the important respect that the CESS calculation mechanism compares actual capex to the allowance, whereas the CECM uses comparison of returns on the investments. Using the latter method lowers the power of the incentive and better equates the incentive across capex and opex.

ActewAGL Distribution also supports the potential for exclusion of particular costs from the application of the CESS, and the approach to this issue advocated by the ENA of requiring the expenditure incentive guideline to set out defined principles for exclusion, and NSPs proposing exclusions that conform to the principles.

Ex post capital expenditure measures

ActewAGL Distribution agrees with AER that the primary focus for promoting efficient expenditure should be on appropriate ex ante investment incentives and that the AER should continue to rely on ex ante capex measures to provide incentives for NSPs to achieve efficient costs.

ActewAGL Distribution welcomes that, in its issues paper, the AER has identified that ex post review of capex now permitted under the NER would be undertaken only with regard to spending significantly over the determined capex allowance.

Given the inherent difficulties involved in assessing expenditure ex post, it is vital that before any capex is assessed the AER have in place adequate protocols to ensure a decision based only of information available to the NSP at the time the decision was made.

Should you require further information in regard to this submission, please contact Mr Chris Bell, Manager Regulatory Affairs on 02 6248 3180.

Yours sincerely

David Graham
Director Regulatory Affairs and Pricing