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10 May 2013

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Dear Sir

Issues Paper: Expenditure Incentives Guidelines for Electricity Network Service Providers

Thank-you for the opportunity to provide input to the *Expenditure Incentives Guidelines for Electricity Network Service Providers* Issues Paper, released in March 2013 (the "Issues Paper").

Aurora Energy Pty Ltd, ABN 85 082 464 622 (Aurora) is an incorporated, State Government owned fully integrated energy and network business, with complementary activities in telecommunications and energy-related technologies. Aurora provides electricity generation, retail and distribution services to more than 270,000 customers in the Tasmanian jurisdiction. In this document, reference to Aurora should be taken as reference to Aurora in its capacity as the provider of distribution network services licensed by the Regulator under the Electricity Supply Industry Act 1995.

Aurora agrees with the AER's intentions to minimise price increases to customers. As a State Government owned essential service provider in a jurisdiction with a large proportion of customers that qualify as vulnerable, Aurora is keenly aware of the effect of electricity pricing on its customers. To this end, Aurora has implemented, with the approval of its shareholders, a strategy of providing its services to meet customer needs at the lowest sustainable cost. This strategy underpinned the capital expenditure and operating and maintenance expenditure forecasts made by Aurora's during the distribution determination process for the current regulatory control period, with a resulting stabilisation of expenditure requirements.

Additionally, the Tasmanian Electricity Supply Industry is undergoing a reform following a State Government initiated review. Of relevance to the current issue, the State Government owned distribution and transmission businesses are to be combined, with the new businesses being required to meet the following policy objectives:

- lowest sustainable electricity bills;
- long-term safe, secure and reliable supplies of electricity;
- maximise the value of Tasmania's low carbon advantage and the brand benefits of clean Tasmanian electricity; and
- financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

Aurora is concerned that the operation of an incentive scheme on top of these objectives, may in fact result in some perverse customer outcomes.

The current incentive scheme for operating and maintenance expenditure (the Efficiency Benefits Sharing Scheme, as articulated in *Distribution Network Service Providers Efficiency Benefit Sharing Scheme* published by the AER in June 2008) is intended to reward or penalise the entity depending upon that entity's performance against a given expenditure target. The Issues Paper does not seem to indicate that this aspect of the Efficiency Benefits Sharing Scheme is intended to be changed. The Issues Paper also indicates that the operation of a Capital Expenditure Sharing Scheme will be similar and provide a reward or penalty for the entity's performance against a given expenditure target.

The reward or penalty in the Efficiency Benefits Sharing Scheme is in the form of an ability to collect more revenue at some time in the future, the penalty being a reduction in the allowable revenue. It is assumed that the Capital Expenditure Sharing Scheme will operate in a similar fashion, although the Issues Paper is not clear on this point.

From a customer perspective, the reward equates to a rise in the price of a service because the service provider was able to restrict its expenditure. Aurora does not consider this to be a good customer outcome. Aurora's customers would expect the price of a service to fall, or at least stabilise, if a service provider was able to restrict its expenditure.

From a business perspective, the penalty is an incremental decrease in the allowable revenue that has been determined by the regulator, by definition, to be efficient. That is, the penalty will result in the entity being permitted to collect less than the efficient level of revenue. This seems to be contrary to the revenue and pricing principles articulated in section 7A of the National Electricity Law. Further, a reduced revenue allowance may result in:

- reduced profits, with commensurate reduction returns to shareholders which, in Aurora's case is the State Government, with the ultimate cost again being borne by Aurora's customer base, albeit indirectly this time;

- reduced operating and maintenance expenditure, which will, in turn, feed into the operation of the Efficiency Benefits Sharing Scheme; or

- increased borrowings to cover the revenue shortfall, the cost of which will again be borne by the customer.

Aurora considers that none of these are good customer outcomes.

The Issues Paper considers the extent to which incentive schemes actually drive NSP behaviour. Aurora understands, in the first instance, that economic theory assumes that an entity will respond to financial incentive. In the event that this assumption is not met, any subsequent conclusions drawn from the theory should be closely re-examined. As noted above, Aurora's strategy, centres around minimising the effects of its operations upon its customers. These requirements are contrary to the premise that businesses require incentive to provide efficient outcomes. Both the Issues Paper and the Issues Paper for the Expenditure Forecast Assessment Guideline also question the responsiveness of NSPs to financial incentives.

The Issues Paper raises some concerns about the status of forecast expenditure. The National Electricity Rules (clause 6.12.1) provide that the AER must, as part of making a distribution determination, either accept a forecast of capital expenditure or operating and maintenance expenditure made by a distributor, or make a substitute estimate of efficient expenditure for one or both of those categories of expenditure; an analogous provision for transmission determinations is contained within clause 6A.14.1 of the National Electricity Rules. Aurora notes that, while the determination so made by the AER is final, it is a determination of a forecast or estimate. The Issues Paper (and the current Efficiency Benefits Sharing Scheme) takes a conceptual step from considering that the determination is of a forecast of efficient expenditure to considering that the determination is of the efficient expenditure.

The conceptual step from "forecast" to "actual", leads to consideration of the nature of over-expenditure, being expenditure in excess of that determined by the AER. The assumption is that expenditure in excess of the determined allowance is primarily due to behaviour of the entity being regulated. An alternative unconsidered in the Issues Paper is that the forecast was wrong. Such a possibility was noted by the Tasmanian jurisdictional Regulator in making the final jurisdictional distribution determination for Aurora:[1]

> The Regulator has noted concerns about the effectiveness and the equity of a benefit-sharing scheme that is dependent on forecasts of costs many years in advance. Any error in forecast is magnified by a benefit-sharing scheme that carries forward, for a number of years, the benefit or burden arising from under-runs or over-runs, whether they arise from genuine efficiency gains, from exogenous factors or from forecasting errors. The risk of error increases with the extended time.

The Issues Paper discusses briefly the operation of the Efficiency Benefits Sharing Scheme and Capital Expenditure Sharing Scheme when the AER uses an estimate of efficient capital expenditure or operating and maintenance expenditure in place of the forecast(s) proposed by the NSP. Aurora considers the issue is not how the schemes operate when the forecasts are set through benchmarking, rather the issue is whether or not an efficiency scheme should operate at all when the forecast is made by the AER.

With regards to application of the scheme, operational and maintenance expenditure is relatively stable, with large variations usually created by events that can be excluded. Capital expenditure, on the other hand, is inherently "lumpy" in nature, in that a small number of projects can account for a large proportion of the forecast expenditure. Changes in the timing of capital expenditure can result in a significantly changed profile against which "performance" is measured, leading to a scenario where a business is penalised for taking appropriate action. For example, Aurora planned to construct infrastructure in 2012-13 to accommodate demand growth on Hobart's eastern shore. This work has been deferred because the actual demand growth did not warrant construction in this financial year. Under a Capital Expenditure Sharing Scheme, however, such a deferral may result in a "win" in the current year, but a "loss" in the year in which the deferred project is completed, neither of which is appropriate.

Capital expenditure resulting from unforeseen and unforeseeable events may also result in an actual expenditure profile that is quite different from that set during the distribution determination, up to six years before the event. By way of example, the significant bushfires in southern Tasmania resulted in a large capital expenditure investment to renew destroyed infrastructure. Consistent with its strategy of minimising customer costs, Aurora has chosen to re-prioritise its capital expenditure program to accommodate the capital expenditure associated with the bushfires rather than to apply for a pass-through which would result in

[1] *Investigation of Prices for Electricity Distribution Services and Retail Tariffs on Mainland Tasmania Draft Report and Proposed Maximum Prices*, published by the Office of the Tasmanian Energy Regulator in July 2007, page 188

increased prices to customers. This re-prioritisation, by necessity, will result in a change to the profile of capital expenditure required in future years which, under a poorly designed Capital Expenditure Sharing Scheme could potentially result in a penalty, albeit for exhibiting the behaviour required.

The need for an expenditure incentive scheme is also raised by the Issues Paper. Aurora recognises that the AER is required under the NER to develop an Efficiency Benefits Sharing Scheme and a Capital Expenditure Sharing Scheme. The form of the schemes, however, are not dictated. Aurora suggests that the forms of the two scheme need not be as that currently applied in the shape of the Efficiency Benefits Sharing Scheme or as suggested in the Issues Paper in relation to the Capital Expenditure Sharing Scheme. By way of illustration, Aurora refers to the AER's approach to the demand management incentive schemes applied during the first round of distribution determinations, the application of which were also mandated under the NER.

On this basis, given the AER is required to develop a capital expenditure scheme under the NER, Aurora's preference is for an ex post assessment of capital expenditure. Aurora considers the AER's approach proposed in chapter 5 of the Issues Paper to be workable. In making its distribution determination, the AER approves an annual capital expenditure figure. Ascertaining which aspect of the NSP's capital program has resulted in the forecast being exceeded, and whether that aspect is a result of inefficient investment, will require a complete evaluation of the entire capital expenditure program. In consequence, a high level assessment is encouraged, with detailed assessment subject to materiality considerations: a complete detailed "bottom up" assessment will not be a trivial exercise. Aurora notes that the essence of an ex post review will be that the NSP must justify, after the event, why the forecast made before the event was not accurate. This will be rendered more difficult if the forecast used in the determination was made by the AER and not based upon information provided by the NSP: the issue of the nature and status of the forecast discussed above is relevant here.

Aurora wishes to emphasise that its strategic objectives align with those of the AER in relation to operating with the lowest sustainable capital expenditure. Aurora is concerned, however that the best practical approach to monitoring and reviewing capital expenditure be implemented. It is highly desirable that , NSPs are provided with sufficient flexibility to alter their capital expenditure profiles and projects to react to changing conditions and meet their obligations relating to the connection and supply of customers.

If you have any questions, please address them to the contact noted above.

Yours faithfully

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