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11 March 2022

Mr Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: incentivereview@aer.gov.au

Dear Sebastian,

AER Incentives Review – Response to Discussion Paper

AusNet welcomes the opportunity to respond to the AER's Incentive Schemes Discussion Paper. We have long supported strong incentive regulation as delivering lower prices and superior outcomes for customers. We were the first network business to successfully propose a Customer Satisfaction Incentive Scheme in our recent distribution price review; an incentive scheme that rewarded networks for improving customer experience in ways that lead to increases in customer satisfaction.

Except for the Market Impact Component of the transmission STPIS (which should be urgently reviewed as outlined below), evidence suggests the AER's current incentive schemes are working well. as the AER states in its 2021 network performance report: *'..network regulation is improving outcomes for consumers.'*[1] Network expenditure has reduced over recent years and long-term reliability has been improving.

While we welcome this review, any changes to the incentive schemes must be unpinned by a strong case for change. The stability of the framework is critical to provide appropriate investment signals over the long term. At this time, due to the step change in operational conditions on the transmission network given the connection of renewable generation, we only see a need for a material change in the Market Impact Component. We also have some less material suggested improvements for consideration, as set out below.

AusNet responds to incentives

As a commercial business AusNet has a history of strongly responding to regulatory incentives. The various schemes and their relevant strengths are built into our business cases and investments made accordingly. We target outcomes to maximise overall performance (benefiting networks and customers) under the framework.

This can be seen by changes in our investment patterns as new schemes have been introduced over time, or the relative strengths have changed. For example, in the 2011-15 EDPR the service standard incentive was strengthened while the capex efficiency scheme was very weak. Accordingly, we invested in a distribution feeder automation (DFA) program to improve performance outcomes. Importantly customers did not pay for this investment upfront through capex allowances, but only paid (through STPIS) once the benefits had been delivered.

[1] AER, *Electricity Network Performance Report,* September 2021, p.1

Conversely in the 2016-20 EDPR, the service standard incentive was halved (due to the fall in the Value of Customer Reliability) while the capex efficiency incentive was significantly strengthened. During this period a lower level of unfunded reliability-driven capex was invested.

This example illustrates the tangible result changing incentive schemes will have on patterns of investment.

Measuring customer benefits

Incentive payments made to networks at the time of their five yearly determinations are the most visible aspect of incentive scheme benefits that flow to customers or networks. These payments, which may be large, can attract concern from consumer advocates, despite the benefit to consumers of these schemes far exceeding the payments to networks by design. For example, under the CESS networks receive 30% of the benefit of any saving while consumers receive 70%. To make the benefits delivered to consumers of these incentive payments clearer and more transparent, we recommend that the AER begins reporting the estimated benefit to consumers of the incentive schemes applying in the previous regulatory period, in each of its determinations.

It is also important to understand that incentives can be symmetric but result in asymmetric outcomes. Incentive schemes should be – and are – symmetric; that is, a network should lose the same from a decline in performance under the scheme as they would gain if their performance improved by the same amount. However, a well-designed incentive scheme does not need to result in penalties to the same degree that it results in rewards. Where a network is responding to an incentive and demonstrating continuous improvement it is appropriate that the network is rewarded, so it can share the benefit of its improvement with customers.

Expenditure incentive schemes

The current expenditure incentive arrangements have delivered significant consumer benefits since their inception and remain fit for purpose. As demonstrated in analysis prepared by Houston Kemp for ENA[2], in response to the incentives provided by the EBSS and CESS, networks have generally been able to underspend their efficient allowances through a combination of efficiency improvements and prudent investment decisions. This demonstrates the effectiveness of incentive regulation which, have resulted in customer benefits estimated at $13.4 billion, with the CESS accounting for $2.7 billion of these benefits despite the relatively short time since its introduction, and the EBSS accounting for $7.2 billion.

Importance of Consumer Engagement in Informing Expenditure Forecasts

An important part of the regulatory framework that has evolved since the Better Regulation program in 2013 is the strong involvement of consumers in regulatory determination processes. The AER's Better Reset Handbook has confirmed the AER's strong expectations when it comes to networks seeking, and acting on, meaningful consumer views in developing regulatory proposals.

As expenditure allowances set by the AER are the baseline for the expenditure incentive schemes there is a strong link between the effectiveness of the regulatory determination process in setting ex-ante efficient allowances and the effectiveness of incentive schemes to drive genuine efficiency improvements.

[2] Houston Kemp, *Consumer benefits resulting from the AER's incentive schemes – A report for Energy Networks Australia*, 8 March 2022

Our experience in the NewReg process was that thorough up-front consumer scrutiny of forecasts is more likely to lead to expenditure allowances the AER can accept as efficient. The prospect of AER acceptance provides a powerful operational and reputational incentive for networks to engage openly and early on the drivers of their expenditure forecasts, in particular areas where increases are being sought relative to historical spending levels. In the NewReg process, we made several adjustments to our expenditure forecasts, prior to lodgement of our Regulatory Proposal, to reflect the views of the Customer Forum. These included the deferral of several zone substation rebuild projects and reducing the scope of several projects to prioritise cost savings.[3] We also absorbed several step changes (e.g., some ICT Cloud costs) and aspects of our forecast that the Customer Forum considered were in our control (i.e. Guaranteed Service Level (GSL) payments for late appointments).

The Better Reset Handbook has many similar features to the NewReg process. Enhanced consumer engagement is acting as another 'tool' to assess the efficiency of networks' forecasts. The strength of this tool will likely grow as the Better Reset Handbook is implemented. This is also likely to address stakeholder concerns regarding over-forecasting.

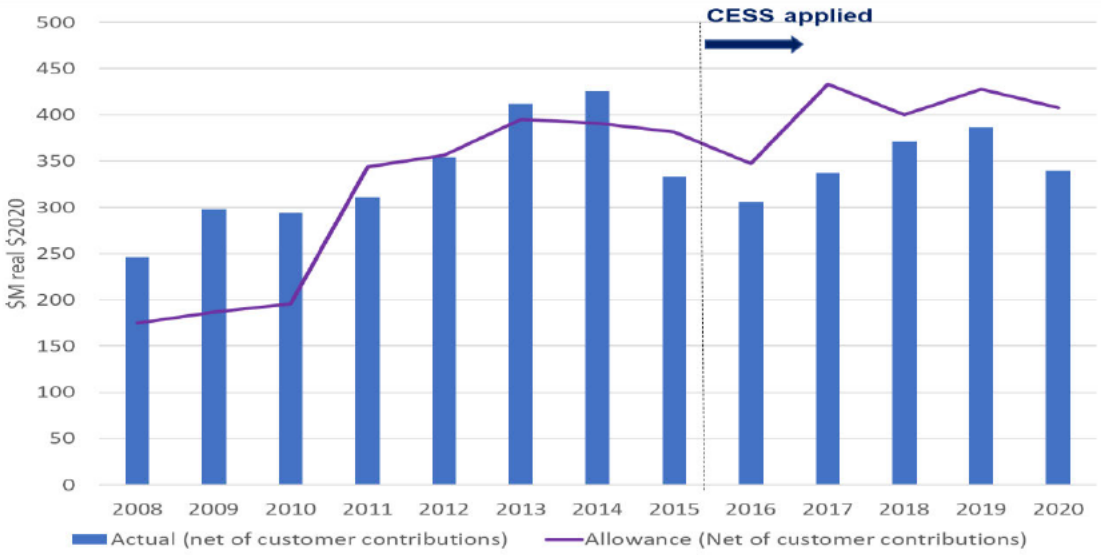
Capital Efficiency Sharing Scheme

As described above, AusNet responds to incentives, including the CESS, by building sharing ratios into business cases, which typically assess a range of capital and operating operations to identify the most efficient solution to addressing an identified network need. All else equal, a stronger incentive will elicit a larger response (in terms of identifying and delivering the lowest cost capital solutions) than a weaker incentive and, therefore, provide greater benefits to consumers in the long run.

AusNet's track record of responding to the CESS is demonstrated by the charts below, which show that since the CESS's first application in 2016 for our electricity distribution network and 2017-18 for our electricity transmission network, AusNet has underspent its capex allowances by 15% and 13%, respectively. In contrast, for the periods prior to the CESS's application, actual expenditure was 2% below (distribution) and 4% below (transmission) each network's respective capex allowances. While these impacts are driven by several factors including the strength of the STPIS in place at the time (see STPIS section below), the CESS has had powerful effects on actual expenditure patterns and, consequently, the substantial long-term benefits consumers are receiving due to more constrained RAB growth.

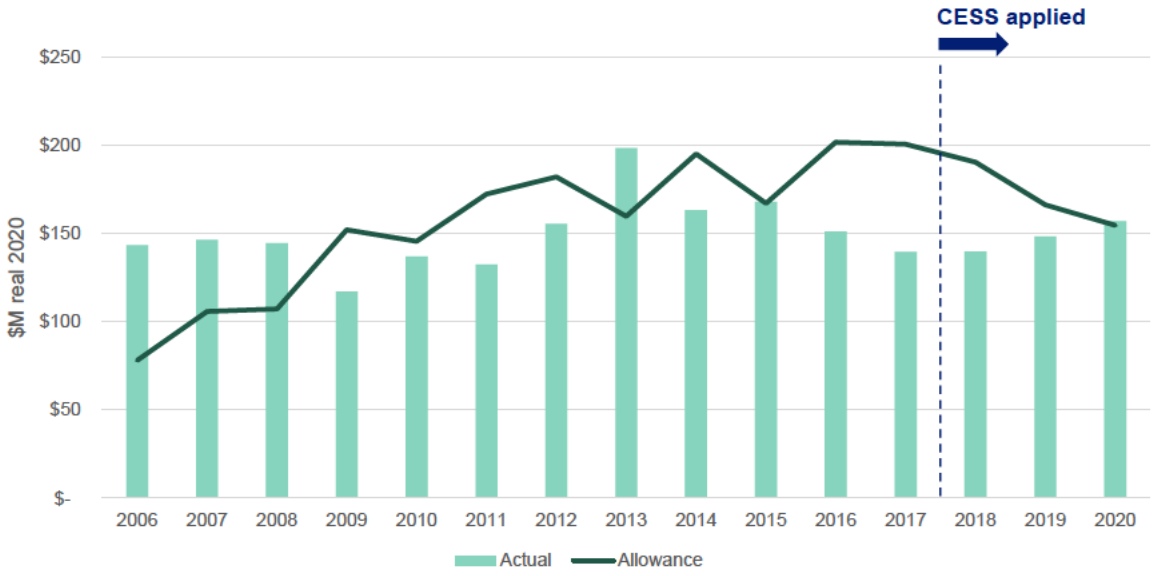
[3] AusNet Services, Electricity Distribution Price Review 2022-26, Part III, p. 71

Figure 1: Actual capex vs allowance, AusNet electricity distribution network



Source: AER 2021 network performance report, AusNet Services

Figure 2: Actual capex vs allowance, AusNet electricity transmission network



Source: AER 2021 network performance report

Note: 2020 actual capex excludes $44M of capitalised leased

Our historic capex outperformance reflects genuine efficiency improvements, including ongoing improvements in asset management capabilities, increased outsourcing and more effective contract management. The most significant drivers of AusNet's historical underspending relative to approved allowances include:

- **Risk-based asset management.** AusNet is a leader in risk-based, data-driven asset management that aims to maintain network risk at the lowest long-term cost. In combination with our economic, risk-based asset planning methodology, the integration of data from across our

various asset management systems and the use of advanced analytics (e.g., such as machine learning algorithms that automatically calculate asset-by asset health based on all system available information and historical asset failure data for key asset class at the subcomponent level) allows us to:

  - Bring more data into models and, therefore, continuously improve accuracy of the probability of asset failure models;
  - Use systematic data-driven decision-making algorithms to optimise all inspections, maintenance and replacement actions;
  - Achieve greater granularity with our quantified risk assessments to refine the optimal timing of replacement, compared to traditional engineering methods; and
  - Establish a common operating platform and single source of truth that allows asset risks to be reviewed more frequently and guide asset management decisions during a regulatory period.

- **Outsourced delivery model.** AusNet utilises a competitive outsourced model for the safe and efficient delivery of its capital works program, comprising separate design and construction panels established in 2018 and 2019, respectively. By consolidating our contractors whilst retaining competitive tension and utilising robust KPI frameworks that encourage innovation and value driven solutions, this approach drives significant capital efficiencies across our portfolio.
- **Effective contract management and procurement processes.** All panel contracts are underpinned by a contract management framework that provides comprehensive performance incentives in respect of cost, safety, risk, compliance, customer experience, reliability and capacity building. The delivery framework is coupled with the business' strategic material sourcing capability that unlocks greater value via competition between suppliers and strives to establish long-term relationships that harness innovation.

Project Deferrals

In relation to the deferral of expenditures, we routinely re-assess and reprioritise our capital program to ensure we are meeting our obligations in relation to network reliability, safety and security at the lowest cost to customers. As a result, projects may be deferred due to a range of factors that impact the economic evaluations that determine optimal project timing, which is carried out prior to business case approval and project commencement. These factors include, for example, changes in location-specific forecast demand, reassessment of asset condition and site conditions, and changes in the VCR. Where it is no longer economic to deliver a project in line with the timing reflected in expenditure allowances, deferral is an efficient decision that is in the long-term interests of customers. More recently, and while a transient factor, supply chain disruptions caused by COVID-19 have impacted the ability of networks to maintain delivery timeframes for some projects. We also note that deferrals – such as those caused by an inability to obtain project approvals – increase network risk and may impact reliability so, for a network, a CESS benefit may be offset other consequences such as a STPIS penalty, for example.

Equally, projects may be advanced in response to changes in circumstances. For example, during the 2017-22 transmission regulatory period, the timing of several major asset replacement projects at Loy Yang Power Station, Hazelwood Power Station and Heywood Terminal Station were brought forward due to the unexpected closure of Hazelwood Power Station in 2017, which increased the criticality of assets at these locations. In our electricity distribution network we brought forward unfunded major projects at Seymour, Bairnsdale and Kinglake zone substations to align with the timing of funded REFCL augmentation projects to lower overall costs to customers. To be robust, any examination of the differences between actual and forecast capital expenditure should (and

does) take account of the net effects of both project deferment and advancement. In this context, we agree with the AER that:[4]

> "*Networks may need to undertake programs or projects that they did not anticipate during the reset. Networks also may not need to complete some of the programs or projects proposed if circumstances change. We consider that a prudent and efficient network would consider the changing environment throughout the regulatory control period and make decisions accordingly*'"

Under the current CESS, the AER can (and routinely does) request detailed information on deferrals as part of the reset process and has adjusted CESS payouts for material deferrals it has found. Indeed, we offered $14m of capex deferrals to be removed from our CESS payment our recent EDPR, which the AER accepted. The current arrangements include the necessary safeguards to ensure customers are funding no more than efficient costs.

In addition, the enhanced consumer engagement encouraged by the Better Resets Handbook offers an additional incentive for networks to provide greater transparency on the drivers of underspends. Given the stakeholder concerns that have been expressed regarding the effects of deferred expenditure on CESS rewards, in seeking consumer support for regulatory proposals networks face a strong incentive to engage on this issue, such as presenting information comparing proposed and historical expenditure and clarifying where material deferral may have occurred. We consider this process will encourage the desired level of transparency in respect of the drivers of underspending, consistent with the AER's expectation that networks "provide well justified reasons for any material CESS benefit that have been explained to customer groups."[5]

We do not support increased reporting, including through RINs, on the drivers of capex underspending (or overspending). The cost of regulatory reporting is ultimately borne by customers and has been increasing significantly. The benefits of any additional requirements need to be balanced with cost. There are a range of practical difficulties in identifying drivers of under or overspending, due to the myriad factors that can impact actual project costs and timing. These factors would make addressing prescriptive reporting requirements of this nature a highly manual and time-consuming process. As per above as the AER already access this information during reset processes, the incremental benefits of additional reporting will be limited.

In addition, this detailed reporting appears to be at odds with the AER's capex assessment which targets an efficient overall allowance rather than decisions on individual projects.

We consider that any remaining concerns about over-forecasting should be addressed by review of the AER's expenditure assessment approach and techniques, i.e. addressing the root cause of the issue; rather than adjusting the existing expenditure incentives that have delivered very material consumer benefits. As explained in the AER's discussion paper, since the Better Regulation reforms in 2013, an extensive suite of capex assessment techniques and forecasting tools has been developed, including an enhanced repex model, an Asset Replacement Industry Note and an ICT Guidance Note. These tools are routinely used to assess and, where necessary, adjust networks' expenditure proposals. Furthermore, the incentive properties of the CESS provide greater confidence that historical expenditure levels are likely to reflect efficient, revealed costs for expenditures of recurrent nature, such as replacement programs.

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[4] AER, *Review of incentive schemes for networks – Discussion Paper*, December 2021, p.59
[5] AER, *Review of incentive schemes for networks – Discussion Paper*, December 2021, p.59

Flexible CESS

We do not support the flexible application of the CESS outlined in the discussion paper, which the AER suggests may address concerns around information asymmetry, over-forecasting and whether capital expenditure incentive outcomes are commensurate with genuine efficiency gains. It is not clear how bespoke application of the CESS would provide better incentives and drive more efficient behaviour than existing arrangements. In contrast, introducing "menu-based" regulation has historically been avoided by the AER and would create undesirable investment uncertainty and regulatory risk over the long term. It would create perverse incentives: to avoid being deemed to have 'over-forecast' thereby attracting a lower incentive strength at the next reset, a network spending below their allowed capex would have an incentive to spend additional capex even where inefficient and retain the strong incentive rate.

It is also not clear in which circumstances (and to which networks) lower or higher incentive strength would be applied to encourage more desirable behaviour. Where there are concerns about the balance of capital and operating incentives, seeking to align these incentives through bespoke application of the CESS is unlikely to result in balanced sharing ratios over the long-term, due to fluctuations in the rate of return that will invariably occur, impacting the EBSS sharing ratio. Caution should also be taken when considering bespoke application of the CESS, given its relatively short period of application, lack of evidence that change is required (and indeed evidence that the currently regulatory framework is improving customer outcomes), and the possibility that changes to existing settings will give rise to unintended consequences, such as increased investment uncertainty and foregone capex efficiency improvements.

We encourage the AER to clarify the circumstances in which it considers bespoke CESS application may offer benefits, to provide stakeholders with the ability to better understand its potential advantages and disadvantages.

For the above reasons, we do not consider the current CESS should be modified. Modifying the CESS' incentive properties should only be done where there is a clear case for change and there is not. Instead, change places at risk the material benefits future consumers may enjoy, given networks' demonstrated track record of driving capex efficiencies in response to the scheme's existing settings.

Efficiency Benefit Sharing Scheme

We agree with the AER that the EBSS provides a continuous incentive to reduce opex, is fit-for-purpose and does not require material modification. It has driven aggregate opex reductions in recent years which has benefited customers through lower prices. Networks have responded to the EBSS incentives by underspending efficient opex allowances through productivity improvements and efficiency gains. This has resulted in customer benefits estimated at $7.15 billion, and network benefits of $3.0 billion.

In combination with benchmarking, there are strong incentives in the regulatory framework for networks to reduce opex. AusNet has been able to generate opex savings in recent years by maintaining a culture of continuous improvement and implementing a range of cost saving initiatives, including back-office outsourcing arrangements, contractor consolidation, automation and digitisation, aerial inspection technology, and risk-based asset management.

We are however extremely concerned about the current performance of the AER's economic benchmarking approach. While this does provide strong incentives to networks to perform well, both to gain reputational benefits and to avoid opex allowance reductions in regulatory determinations, we do not have confidence in the current methodology nor the results it is producing. As raised in our

submission to the AER's current capitalisation review, we support a holistic and thorough review of the AER's benchmarking methodology, to consider evidence-based changes to improve its accuracy. Specific issues of concern for AusNet include:

- Treatment of capitalisation differences – while this is the subject of a current consultation, we are concerned that the proposed adjustment methodology was not supported by evidence as adjusting for differences in capitalisation.
- Underdevelopment of the Operating Environment Factors (OEF) framework – attention is needed outside of regulatory determination processes to advance the OEFs framework, particularly in relation to vegetation management, but this review should encompass all OEFs as several are underdeveloped.
- Treatment of Guaranteed Service Levy (GSL) opex – GSLs are a re-distribution of funds between customers to recognise those who are poorest served. We suggest they are included as both an input and an output into the benchmarking, rather than the current approach whereby they are treated as an input but their benefit to customers who receive them is not recognised.
- Cost pass throughs – opex associated with pass throughs, particularly those arising from one-off events like natural disasters, should not be included in the benchmarking as they have no bearing on a networks' underlying efficiency.

We consider these matters higher priority than reviewing the expenditure incentive schemes and request they are urgently addressed by the AER.

Strength of the EBSS

We support strong expenditure incentives and consider the 30:70 benefit sharing split between networks and consumers as an appropriate balance. Indeed, as noted above and established in Houston Kemp's report for the ENA, these high-powered incentives have delivered very material benefits for consumers.

As the Discussion Paper notes, the EBSS sharing ratio depends on financial market conditions; that is, it varies with the rate of return. Currently its benefit sharing split is estimated to be 18:82; that is, networks have a weaker incentive to reduce opex than in the past. We do not consider this is desirable, and ideally the EBSS sharing ratio would be invariant to the rate of return and fixed to deliver the 30:70 benefit sharing split as was decided at the time of its inception and has been demonstrated to deliver material consumer benefits. This would also have the benefit of aligning to the CESS benefit sharing ratio, which is fixed at 30:70.

However, we note that over the long-term as market rates change the EBSS sharing ratio may return to 30:70, and in some periods could provide even stronger incentives. We also recognise the practical considerations in re-designing the EBSS to deliver this fixed sharing ratio.

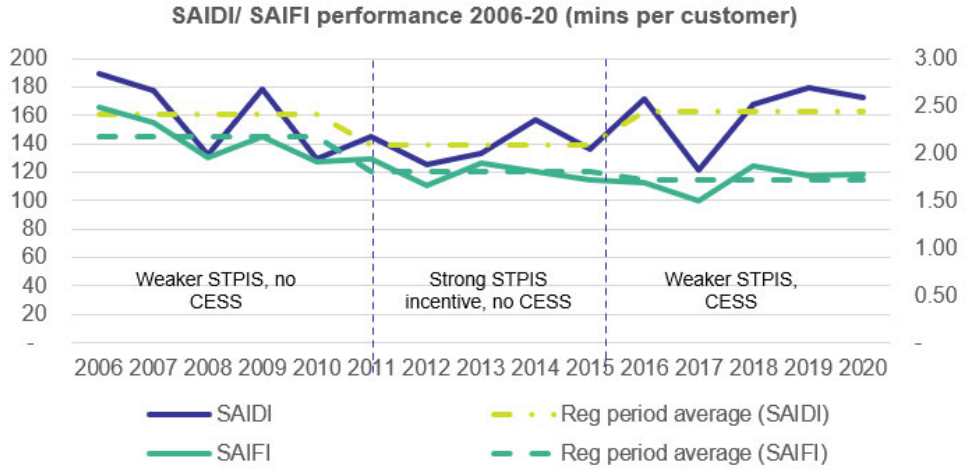
Reliability Incentive Schemes

Distribution STPIS

The STPIS is another scheme that has consistently performed over time, has an economic link to the reliability customers value through the use of the VCR in setting incentive rates.

As mentioned earlier, AusNet has invested heavily in reliability improvements where these investments have been economic under the incentives provided by the scheme. This has resulted in material improvements in reliability over time, although in 2018-20 an increase in frequency of moderate weather events has resulted in a slight deterioration in SAIDI performance.

Our historical STPIS performance is shown in the chart below. This shows that the strong STPIS with no CESS in 2011-15 drove step improvements in reliability, while under a weaker STPIS and a CESS, reliability has been generally maintained. The incentive schemes have driven AusNet to focus more heavily on capital efficiencies (put downwards pressure on prices) rather than on reliability improvements since 2015.



Source – AER operational performance data 2006-20. Data is net of exclusions.

Improvement Opportunities – STPIS

We note the current major gap in the STPIS – the lack of recognition of export services networks provide – has been addressed by the AEMC's recent Access and Pricing Rule Change with the introduction of requirements to provide incentives for DNSPs to provide efficient levels of capacity for embedded generation units. The AER is currently reviewing the incentive arrangements for distribution businesses to provide export services. After the AER's report is published by 31 December 2022, this may trigger a review of the STPIS. We support the addition of an export services incentive into the STPIS to incentivise improved services to customers using distributed energy resources and other new technologies.

Three additional proposed changes as follows:

- **Recognise the reliability benefits provided by Virtual Power Plants (VPPs).** We support paying a contestable service provider for the provision of reliability improvement services to customers with relatively poor reliability using behind-the-meter energy storage and smart control. Networks should have an incentive to fund lowest cost, reliability services for customers where these are economic, regardless of whether these are provided in front of, or behind, the meter given customers are likely to value these services equally. Without recognition of the reliability benefits of this service through the STPIS, contestable service providers cannot fully monetise the value of the behind-the-meter service for customers.
  We consider that the current STPIS reporting can incorporate the reliability benefits of this behind-the-meter service. We have discussed this potential arrangement with the AER in recent months and are currently resolving whether networks can re-designate its network boundary to behind the meter by procuring a third party to provide back-up supply to a customer. If the AER concludes it is no permitted under the current STPIS, as it relates to DER, we suggest it is considered by the AER as part of its review of the incentive arrangements following the DER Access and Pricing rule change. This arrangement would enable more efficient reliability outcomes and greater customer participation incentives.

- **Planned outages** – The inclusion of planned outages in the STPIS has been considered from time-to-time over the last couple of decades. The lasting impact of the COVID-19 lockdowns over the last two years is that more customers are working from home during the day. This means planned outages, which often occur during the day, can cause more customer disruption than previously. In addition, the electrification of the gas and transport sectors over the next few decades means that customers will become more reliant on electricity. It is therefore an opportune time to re-assess the customer benefits of an incentive for planned outages. Ideally the regulatory framework would have the flexibility for an incentive on planned outages to be applied as part of a regulatory determination if supported by customer engagement through the reset process. This cannot be dealt with through the small-scale incentive scheme given the limited revenue at risk under the small-scale incentive scheme provisions, so the STPIS is a more appropriate scheme for this parameter to form part of.

- **Catastrophic events –** Major Event Days (MEDs) are excluded from the calculation of our STPIS rewards/penalties. However, a question mark remains over whether catastrophic events should be included or excluded from the calculation of MED thresholds that determine whether an event is or isn't a MED. The AER currently calculates MED thresholds based on *all* historical outages from the most recent five-year period, including catastrophic events. This can lead to a problem that the Institute of Electrical and Electronics Engineers' (IEEE) 1366-2012 standard provides a discussion on. The IEEE standard said that the inclusion of catastrophic events, in the calculation of reliability indices could cause a shift of the average of the data set and increase the standard deviation, and therefore cause a relatively minor upward shift in the resulting reliability metric trends. This means that the inclusion of rare and large events (catastrophic events) could artificially increase average SAIDI and its standard deviation and lead to a MED threshold that is artificially high. The impact of an artificially high MED threshold is that it could result in the under-identification of MED exclusions. This means more outages are counted towards our performance indices, leading to artificially under-performing indices. This is an unreasonable outcome as it would penalise us for catastrophic events that are clearly rare and considered outliers, even when compared to other large events. It will also artificially increase future SAIDI targets, which means bonuses may be rewarded despite no improvement in underlying performance.

  IEEE standard also states that is not possible to universally identify catastrophic events and recommended that the identification of catastrophic events should be determined on a case-by-case basis:

  … identification and processing of catastrophic events for reliability purposes should be determined on an individual company basis by regulators and utilities since no objective method has been devised that can be applied universally to achieve acceptable results.

  As a result, the STPIS Guideline should align with the IEEE 1366-2012 standard and provide some guidance on the treatment of catastrophic events.

  Additionally, we note that the current STPIS Guideline refers to the older and out-of-date IEEE standard (IEEE 1366-2003). It is our view that this must be an error because:

  - The current IEEE 1366-2012 standard was released 6 years prior to the STPIS Guideline' 2018 amendment and thus the Guideline should have referred to the current IEEE 1366-2012 standard.
  - The definition of 'IEEE Guide' in the AER's Distribution Reliability Measures Guideline refers to the current IEEE 1366-2012 standard.
  - Adopting the current IEEE 1366-2012 standard is consistent with how we report reliability metrics in accordance with the AER's Distribution Reliability Measures Guideline.

As a result, the STPIS Guideline should be updated to refer to the current IEEE 1366-2012 standard (or whatever is current at the time of the updated Guideline).

Transmission STPIS – Market Impact Component

Across all the regulated incentive schemes the highest priority scheme for review is the Market Impact Component of the Transmission STPIS. The MIC provides an incentive for transmission networks to manage outages to minimise impacts on wholesale market prices. These impacts can be extremely material – many times the maximum bonus a network is eligible to receive.

The MIC has delivered significant customer benefits since its introduction in 2009. However, due to the step change in operational challenges on the transmission network since the component was last reviewed in 2015, it is no longer fit for purpose.

AusNet has raised the need for a review of this parameter with the AER since 2017. We strongly support a continuation of this incentive to ensure customers continue to receive the material benefits incentivised by this scheme.

To illustrate why the MIC is no longer fit-for-purpose, between 2018 and 2020, net of the Dispatch Intervals (DIs) counted under the MIC associated with the collapse of transmission towers near Cressy in early 2020, recorded DIs have averaged around 38,034 per annum, compared to a target of 1,245.

We consider that the high and growing number of DIs recorded makes the current MIC increasing unworkable because:

- The 7-year historic average with no wide-ranging exclusions cannot be reasonably used to set forward targets for the scheme as they will likely woefully underestimate the number of DIS caused in the new period
- An alternative reasonable forecast accounting for predicted growth cannot be used because it is not possible to accurately forecast DIs due to the fundamental changes occurring in an operating environment under a renewables transition that is leading the world and is still not fully understood.

While the AER has clarified that some of the issues AusNet raised in its recent transmission reset qualify as exclusions under the MIC, not all our concerns were able to be addressed given the limitations of the current MIC which does not reflect today's environment.

One of our outstanding concerns is that the scheme remains anti-competitive. This is a concern that we have raised since before the 2015 review, but due to the increasing number of contestable works across the NEM, it is imperative that this is addressed. Specifically, the scheme sets out that post-commissioning O&M outages on AusNet's contestably owned assets will be included in AusNet's MIC count, whereas if the contestable assets were not owned by AusNet these same outages would not be captured by the MIC. This unduly disadvantages AusNet's contestable business as it faces an additional cost compared to its competitors.

We have had extensive discussions with customer advocates and AER staff on this topic during our TRR and received a lot of support for a review of the scheme. We strongly disagree with the AER's rationale that:

- The increased counts will signal to a TNSP to change its network management or undertake capital works to address network congestion. The magnitude of the increased counts is so material that changes to network management is highly unlikely to improve performance to the extent required for the MIC's incentive to be maintained. Capital works to address the widespread issues discussed above would also need to be extremely material (e.g. an ISP

project – the investment need is not driven by loss of MIC incentive revenue). In addition, in Victoria AusNet is not the transmission planner and so has no control over network upgrades.

- There is a need to wait until the following processes to conclude as they could affect the MIC's design: the Energy Security Board's post-2025 Market Design, AEMC's Investigation into system strength frameworks in the NEM, the outcomes of the Coordination of Generation and Transmission Investment review, and the general implementation of actionable projects under AEMO's integrated system plan.
  While there are a number of related reforms some of these are expected to be ongoing for many years. Transmission access reform has been debated over several decades and due to its complexity is it unlikely to be resolved in the short-term. In the meantime a flawed MIC scheme continues to apply to networks, generating sub-optimal outcomes for consumers. We note that the AEMC's system strength frameworks review is complete.

The Discussion Paper notes that in the meantime, individual issues can be addressed in determinations. However, while many issues were able to be clarified in our recent TRR, some issues could not be resolved due to the wording of the current MIC and its explanatory statement. That is, although some of the modifications we proposed were desirable, the AER could not ultimately apply these changes.

The parameter setting arrangements for the Loss of Supply Event frequency parameters – part of the Service Component of the STPIS – should also be reviewed. Specifically, the system minutes thresholds used to report events are hard coded into the STPIS. Instead, these should be decided as part of a determination to provide flexibility, especially where networks are approaching frontier performance under this parameter. For example, we often record zero events exceeding 0.30 system minutes; to avoid problems associated with having a potential target of zero events in future, there may be a case to change this system minutes threshold instead.

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We look forward to engaging in the remainder of this review. Please contact me on [redacted] with any questions in relation to this submission.

Sincerely,

Charlotte Eddy
General Manager Regulatory Strategy and Policy
AusNet Services

Attachment – Response to AER's Questions

Key priorities

1. Have we captured the key stakeholder issues?

Yes.

2. Do you agree with our intention to prioritise a review of the expenditure incentive schemes and customer outcomes?

No. While we do not oppose a review of the expenditure incentive schemes, the Market Impact Component of the transmission STPIS is the incentive scheme that needs the most urgent attention. This is due to the step change in operational conditions on the transmission network due to the increased uptake of renewables. AusNet has been requesting a review of this parameter since 2017.

3. What deliverables should we prioritise as part of this review?

We suggest the following deliverables should be prioritised:

- A modified Market Impact Component of the transmission STPIS which is fit-for-purpose.
- Endorsement of an evidence base that demonstrates the benefits the expenditure schemes have delivered for customers. A starting point could be Houston Kemp's report for the ENA.
- A means to improve the transparency of the benefits being delivered for customers on an ongoing basis, for example reporting these benefits as part of a revenue determination process.

Proposed focus areas

4. Do you agree with our key areas of focus? Our proposed key focus areas are:
• Better information and monitoring of incentive schemes costs and outcomes over time.
• The interaction between incentive schemes and forecasting.
• The balance of incentive scheme rewards and penalties.
• Linking incentive schemes to network service provider performance.

We support these focus areas, and suggest adding:

'Whether the scheme is fit for purpose in the current environment'

It is important that this assessment is made as the external environment and operating conditions change over time – due to, for example, the energy transition. All incentive schemes should work adequately in the current environment.

5. Are there other key issues we should consider as part of this review?

Other than reviewing the Market Impact Component as a priority, the AER could consider whether there are any gaps in the incentive framework – that is, whether there are additional desirable consumer outcomes that could be appropriately promoted through an incentive scheme. Examples include extending the distribution STPIS to planned outages and extending the STPIS to recognise the benefits of behind-the-meter solutions that enable customers to avoid outages.

Overview of incentive regulation

6. Do stakeholders agree that the incentive framework is improving outcomes for customers of electricity services?

Yes. The current expenditure efficiency sharing schemes have driven material consumer benefits, as demonstrated by the Houston Kemp report for the ENA.

7. Is the size of incentive payments appropriate and commensurate with the outcomes being provided to customers?

Yes – it is 30:70. A lower strength of incentive would result in lower long-run customer savings given networks respond based on the strength of the incentive power in place.

Key components of incentive schemes

8. Does the current approach to financial incentives remain appropriate?

Yes. The current approach has driven good outcomes for customers. Unless there is a problem with one of the incentive schemes that is demonstrated by evidence, it is risky to change an approach which is currently delivering material customer benefits.

9. Are the current levels of financial rewards and penalties appropriate?
• Should the rewards and penalty rates be lower or higher?
• Should the relative rewards and penalties under the EBSS and CESS be fixed, or should it vary with the time value of money?

We support the 30:70 sharing ratios under the schemes. Ideally the 30% ratio should be fixed in both schemes, not just the CESS. However, we recognise the practical limitations with re-designing the EBSS to give effect to this.

10. Is the balance of incentives between the schemes important?
• Are there circumstances where different rewards and penalties between operating and capital expenditure appropriate?
• How should financial incentives be considered taking into account potential non-financial incentives on network service providers?

Generally, it is desirable to have balance in the sharing ratios across the schemes. We note that an increase in market rates will strengthen the EBSS sharing ratio, which will move this towards alignment with the CESS sharing ratio. Therefore, the current imbalance may not persist.

Non-financial incentives are also relevant to consider – as outlined above benchmarking provides a very strong incentive for networks to minimise opex.

The absence of any evidence of a problem with the current financial and non-financial incentive frameworks suggests the current arrangements are working well.

11.To what extent is expenditure forecasting a concern for stakeholders?

N/a.

12. To what extent would providing greater flexibility in the approach to applying incentive schemes address stakeholder concerns about the incentives on network service providers to over-forecast?

We oppose this approach for the reasons set out in the main submission. It will be impossible for the AER to definitively establish whether any underspending is due to a network 'over-forecasting' at the time of the determination. Modifying the CESS to respond to something on this basis introduces undue uncertainty into the regime.

Instead, any perceptions of over-forecasting should be addressed directly through enhancing the AER's forecasting techniques if required.

Operating expenditure outcomes and incentives

13. Has the EBSS provided the right incentives in terms of promoting continuous efficiency gains in operating expenditure?

Yes.

14. Is the current level of rewards and penalties under the EBSS appropriate? What considerations should be given when determining the EBSS carryovers, including the length of carryover period?

The EBSS has delivered material benefits to customers. Ideally, the sharing ratio would be fixed in the scheme and not vary with the market rates, similar to the CESS. However, we note the practical complexities associated with amending the scheme to achieve this.

15. The EBSS assumes that only base year operating expenditure is used to inform forecast operating expenditure. How does our use of economic benchmarking to assess the efficiency of base year operating expenditure affect the incentive to reduce operating expenditure? Should the EBSS be amended to reflect this?

There is no need to amend the EBSS due to the application of economic benchmarking to assess the efficiency of base year operating expenditure only. The current approach is working well, there is no evidence this change would lead to better outcomes for consumers. The economic benchmarking assessment of the base year provides an additional incentive to find efficiency improvements in this year for networks that perform relatively poorly in the benchmarking, the EBSS provides a strong incentive for these improvements to be sustained.

16. Should there be any other adjustments to the EBSS?

See above.

Capital expenditure outcomes and incentives

17. Has the CESS provided the right balance of incentives in terms of promoting continuous efficiency gains, efficient timing of investments (including efficient deferrals) and good capital expenditure forecasts?

Yes, the CESS has promoted continuous efficiency gains and efficient timing of investments (including efficient deferrals). This works in tandem with other parts of the regulatory framework, such as the AER's capex assessment tools and the focus on customer engagement, which will become even sharper under the AER's Better Resets Handbook.

18. Is the current level of rewards and penalties under the CESS appropriate? Is a fixed level of 30 per cent still appropriate, or should be it changed? What considerations should be made to the appropriate level?

The current level remains appropriate, in the absence of evidence that it is too high or too low.

19. Should the application of the CESS, and its rewards and penalties, change for individual networks where there are concerns about expenditure over-forecasting?

See above.

20. Should there be any other adjustments to the CESS and capital expenditure incentive guideline?

The AER should consider building into the CESS the flexibility to exclude capex which would qualify for a pass through in some circumstances. Under the current approach, a cost pass through application is required to be submitted and assessed, even if the revenue impact of the application is relatively low because it is heavily weighted towards capex. It may be a better outcome for networks, the AER and customers if the future CESS outcome were able to be adjusted to remove this capex from expenditure for CESS purposes instead of networks needing to lodge, and the AER needing to assess, a resource intensive pass-through application. Customers would also benefit as networks may opt to forego the near-term pass-through revenue impact. Note this would only be possible in some circumstances, such as where the cost pass through expenditure was relatively low value.

Service performance outcomes and incentives

21. Do you agree with our proposal not to review the service performance component of the STPIS at this time?

While the distribution STPIS is working well, we have outlined three suggested improvements above.

22. Do you agree that there is appropriate flexibility across the STPIS and the customer service incentive scheme to ensure that customer preferences can be reflected in service performance incentives over time?

As outlined above it is timely to consider adding a planned outage parameter into the distribution STPIS, which may be applied when supported by customer engagement during a reset process.

23. Do you agree with our proposal to address transmission network service provider concerns about the market impact component of the STPIS within revenue determinations?

No. while we appreciate the approach the AER took in clarifying the application of exclusions in our TRR, there will still issues that were unable to be resolved under the current scheme.