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Dear Sebastian,

Ausgrid welcomes the opportunity to comment on the Australian Energy Regulator's (AER) discussion paper reviewing expenditure incentive schemes. Incentive schemes are an important part of the regulatory framework that encourage businesses to improve efficiency and ensures that those benefit of those improvements are shared with customers.

The Energy Networks Australia (ENA) submission, supported by Ausgrid, provides more detail from an industry perspective. This submission outlines the key issues from Ausgrid's perspective, along with some observations regarding the within-period capex profile observed by the AER.

Incentive schemes are working well

Incentive schemes provide a clear incentive to networks to reduce expenditure or improve performance. While other factors affect operational decisions made by networks, the potential for financial rewards is compelling and does influence behaviour. For the expenditure schemes, the efficiency benefit sharing scheme (EBSS) and capital expenditure sharing scheme (CESS), actual expenditure has generally been lower than allowance. For the service target performance incentive scheme (STPIS) both the frequency and duration of unplanned outages have decreased since its implementation.

We understand that it may not be clear to all stakeholders how customers are benefiting from all the schemes because the only dollar value that is visible in regulatory determinations is the reward (or penalty) paid to (or by) network businesses through increased (or decreased) revenue allowances. These amounts have been included in AER performance reports and are very visible to customers. What is not as clear is how the benefits accrue to customers. To help address this, ENA commissioned HoustonKemp (HK) to calculate the benefits of CESS, EBSS and STPIS to customers.

For CESS and EBSS, the analysis assumed the difference between actual expenditure and allowance as the total benefit, which was then broken down between the amount accruing to customers and network businesses in present value terms. There is some conjecture about the allowance being the counterfactual for this calculation due to questions concerning appropriateness of allowances. Our view is that allowances are the only counterfactual that could provide a reasonable estimate because they have been set using comprehensive

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methodologies developed by independent regulators over many years.

The HK analysis shows that customer benefits from the CESS, EBSS and STPIS total around \$13 billion, compared to \$5 billion to networks.¹ This equates to \$1,466 per connection with electricity and gas, and \$1,290 per connection with an electricity service only.² This is a significant benefit to customers since inception of the incentive schemes, and is key evidence that the schemes have been successful in delivering tangible benefits to customers.

Incentive schemes not the only tool to improve efficiency

The AER has a suite of measures it uses, in addition to the incentive schemes, to drive efficiency and ensure the allowances against which the incentive schemes are measured are also efficient.

For opex, this includes benchmarking the base year, and if it is found to be inefficient the EBSS may be removed and a lower, substitute opex allowance put in place. The AER may also impose ongoing productivity factors that assume continuing efficiency which must be reached before any EBSS is triggered.

For capex, the AER uses various tools including the repex model, cost-benefit analysis, category level benchmarking, past performance and statistical tools to reach a decision on the efficient capex allowance. Additional recent enhancements to the process include new assessment guidelines for distributed energy resources and non-network ICT expenditure. The effects of these will not flow through to CESS results until at least another round of resets. While these apply prior to setting allowances, the AER also can conduct an ex-post review of capex to remove inefficient expenditure.

For STPIS, where a network improves its reliability and receives a financial reward, the targets are reset to reflect the higher performance thus the performance is effectively re-based to a higher level without additional cost to the customer. Networks are also required to meet or exceed jurisdictional licence conditions.

These tools complement the incentive schemes through constant examination of costs and forecasts and providing a framework encouraging continuous improvement of allowances and actual expenditure.

Capex spend variations within period are not driven by CESS

In its discussion paper, the AER notes that in the one period that CESS has applied, network businesses tended to underspend capex allowance in the first few years of the regulatory period and many overspent in the last year or two of the period.³ This has raised the question of whether the design of the CESS encourages DNSPs to shift capital expenditure to later in the regulatory period.

It is important to point out that the design of the scheme does not allow for advantage to be gained from changing the timing of capex within the regulatory period. Inclusion of the financing

¹ HoustonKemp, Customer benefits arising from the AER's incentive schemes, 8 March 2022, p 3.

² HoustonKemp, Customer benefits arising from the AER's incentive schemes, 8 March 2022, p 3.

³ AER, Review of incentive schemes for networks discussion paper, December 2021, p56.

benefit adjustment means that an underspend in the early years of a regulatory period has a higher negative adjustment than an underspend later in the period. The reverse is true for overspends.

It is also important to understand that CESS is only one driver among many that feed into delivery of capital programs. Some of these are within the control of a network, some are outside its control. We have provided information to the AER previously explaining the capex profile of Ausgrid's FY14-19 regulatory period, related mainly to the circumstances surrounding the partial lease in 2017. The capex profile in that period was not based on a perceived CESS advantage.

Similarly, the current FY20-24 regulatory period has also seen lower capex in the first two years of the regulatory period, with an expectation that expenditure will increase in the later years. Again, this is unrelated to CESS. Ausgrid's live work pause, COVID-19 and protected industrial action have impacted delivery of capital programs in FY20 and FY21. This is being discussed with the AER and our customer representatives as part of our FY25-29 regulatory determination.

CESS is fit for purpose

In its discussion of the expenditure incentive schemes the AER raised concerns about whether underspending capex allowances reflects genuine efficiency gains or happen for other reasons.⁴ In response it suggests a more flexible approach to the CESS may be warranted, which could include adjusting the strength of financial incentives and/or changing the balance of rewards and penalties separately for each network.

While this option may be open to the AER under the National Electricity Rules, Ausgrid does not believe this would be good regulatory practice. A stable regulatory framework is critically important for the sector. A framework where a business does not know how or to what extent an incentive scheme will apply to it until its regulatory determination, may reduce the incentive to explore and invest in long term efficiencies. The current scheme is simple and transparent and accompanied by a wide range of tools to ensure appropriate allowances are set. Those tools have recently been enhanced (noted above), and we think it appropriate to allow these tools to take effect before considering any changes.

If you have any questions regarding this submission, please contact [REDACTED]

([REDACTED])

Regards,



Alex McPherson
Head of Regulation

⁴ AER, Review of incentive schemes for networks discussion paper, December 2021, p 58.