Consumer
Challenge
Panel

Submission to the Australian Energy Regulator (AER)

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Submission to the AER on Review of Incentive Schemes for Regulated Networks: Draft Decision

Sub-Panel CCP29

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1. Introduction

The AER established the Consumer Challenge Panel (CCP) in July 2013 as part of its Better Regulation reforms. These reforms aimed to deliver an improved regulatory framework focused on the long-term interests of consumers.

The CCP assists the AER to make better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to the AER to better balance the range of views considered as part of the AER's decisions.[1]

CCP29 is a sub-panel of the AER's Consumer Challenge Panel established by the AER to focus specifically on the AER's review of incentive schemes for regulated networks.[2] The views expressed in this paper are the views of the members of CCP29: David Prins (chair), Dr Ron Ben-David and Professor Andreas Chai.

We have previously responded to two consultation papers in this AER review:

- The AER's Discussion Paper published in December 2021, which discussed the various incentive schemes in place.
- The AER's Position Paper published in August 2022, which specifically focused on options for the Capital Efficiency Sharing Scheme (the CESS).

This submission now responds to the AER's Draft Decision published in December 2022. It should be considered to be additional to our previous two submissions. We aim this submission to focus on the issues highlighted in the AER Draft Decision for stakeholder input. Therefore, comments made previously that we feel have not been adequately addressed to date are not necessarily repeated in detail here, but are still relevant and of concern to us. Section 3 in this submission summarises our overarching observations, comments and recommendations in this regard, including tables that highlight:

- CCP concerns that were raised in our submission to the AER's Position Paper on the CESS, which was published in August 2022;
- CCP proposals that were raised in our submission to the AER's Discussion Paper on the incentive schemes more broadly, which was published in December 2021; and
- the AER's response now in its Draft Decision to each of these concerns and proposals.

The AER initiated this review largely to address consumers' concerns. The expectation of consumers was that the AER would undertake thorough analysis responding to their concerns, leading to significant readdressing and ultimately reform of the design of incentive schemes. However, this expectation has not materialised. We expect that consumers and their representatives will be disappointed by the Draft Decision.

[1] Detailed information on the CCP is available on the AER website at https://www.aer.gov.au/about-us/consumer-challenge-panel

[2] Full information on the AER's review of incentive schemes, including all the papers and submissions mentioned in this submission, can be found on the AER website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-incentive-schemes-for-regulated-networks

2. Summary of the AER's Draft Decision, on which the AER seeks stakeholder input

2.1. Efficiency Benefit Sharing Scheme (EBSS)

The AER's Draft Decision in regard to the EBSS is to:

- retain the EBSS
- retain the current design of the scheme which allows networks to retain efficiency gains for six years and delivers a sharing ratio (currently around 20:80) that changes as the rate of return parameters change
- improve transparency about opex outcomes.

The AER will also continue to assess the appropriateness of the current 0.75 benchmark comparison as part of its benchmarking development work, and report on outcomes in its annual benchmarking reports.

2.2. Capital Expenditure Sharing Scheme (CESS)

The AER's Draft Decision in regard to the CESS is to:

- vary the CESS to implement the Bright-Line Tiered Test, which will apply:
    - a 30 per cent sharing ratio for any underspend up to 10 per cent of the forecast capital expenditure allowance in the previous regulatory control period
    - a 20 per cent sharing ratio for any underspend that exceeds 10 per cent of the forecast capital expenditure allowance in the previous regulatory control period
    - a 30 per cent sharing ratio for any overspend of the forecast capital expenditure allowance in the previous regulatory control period.
- require an NSP, as part of its regulatory proposal for a forthcoming regulatory control period, to transparently explain the reasons for differences between actual capex incurred and our approved forecast in the then current regulatory control period a proposed forecast for a forthcoming regulatory control period the subject of a regulatory proposal
- determine whether the CESS should be applied to large transmission projects as part of assessing contingent project and regulatory reset proposals.

2.3. Service Target Performance Incentive Scheme (STPIS)

The AER's Draft Decision in regard to STPIS is to:

- retain the distribution STPIS
- retain the service component of the transmission STPIS
- undertake a review of the STPIS MIC starting in the second half of 2023 and completed in time for the next Queensland and South Australian transmission resets
- review the Network Capability Incentive Parameter Action Plan (NCIPAP) as part of the STPIS MIC review.

2.4. Timetable for implementation

The AER's Draft Decision notes that varying the CESS will require amending the AER's Capex Incentive Guideline. The AER seeks views on when the new provisions should commence and specifically whether the revised Capex Incentive Guideline should apply to the upcoming NSW, ACT, NT and Tasmanian resets.

3. Overarching observations, comments and recommendations

Our overall view is that the AER's Draft Decision gives some minor concessions to consumers, but does not address many of the fundamental concerns with the schemes which we and the previous CCP have highlighted.

We have consistently been of the view that the AER's review of incentive schemes was an opportunity for significant reform. Our submission in March 2022 identified some genuine reform opportunities for the EBSS (menu approach) and CESS (anti-gaming incentive scheme). The subsequent papers from the AER have not engaged with these reform opportunities (other than noting that we proposed them).

While the AER's Draft Decision lists some of the concerns that we and earlier CCPs have previously raised, it does not then respond to them. Nor does it carefully evaluate how the very limited proposals in the Draft Decision will substantively address the concerns that have been raised by this CCP and its predecessor. Tables 1 and 2 below in this submission summarise respectively our previously raised consumer concerns and proposals, with the AER's responses in each case.

The two tables highlight that the AER has not attended to consumers' concerns and proposals, despite initiating this review in December 2021 with the following observation and commitment.[3]

> *Emerging questions raised by customer and community groups included the size of the incentive rewards to networks and whether the incentive schemes are providing value for money.*
>
> *Our review provides us with an opportunity to consider in further detail the issues raised by stakeholders and reflect on the experience in applying the incentive schemes.*

Table 1: CCP concerns raised in its submission to the Position Paper on the CESS, and the AER's Draft Decision responses

The numbering in this table reflects the numbering "First", "Second", "Third", etc. in section 2 – *Consumer concerns with the Capital Efficiency Sharing Scheme* – in our submission to the AER's Position Paper on the CESS.

CCP concerns raised in its submission to the AER's Position Paper on the CESS	AER response in its Draft Decision
1. The AER has not rigorously established precisely what the CESS payments are supposed to fund. Capex reductions can be achieved in various ways, including switches between capex and opex, and forecast error.	The AER acknowledges that it is difficult to ascertain whether capex underspend represents genuine efficiency gains. It continues to assert that CESS payments are efficient, without offering robust evidence that this is in fact the case. The AER maintains that forecast errors are declining.
2. The AER has provided no evidence that actual one-off capex levels are more efficient (lower) due to CESS payments.	The AER accepts that CESS rewards for underspends that are not genuine efficiency gains outweigh the benefits to consumers from incentives that the CESS provides for NSPs to incur efficient capex. The AER's proposed remedy is that forecast error should be reduced.

[3] AER (December 2021) *Review of incentive schemes for networks discussion paper*, pp.8 & 9, respectively

CCP concerns raised in its submission to the AER's Position Paper on the CESS	AER response in its Draft Decision
3. The AER has not assessed how capex under the CESS has delivered actual better outcomes for consumers (as defined by the NEO).	The AER has not commented on how it judges that CESS payments represent efficient expenditures.
4. The basis for the sharing ratio is poorly established. It derives from the AER's assertion about the sharing of benefits under the EBSS. The AER has not provided any theoretical foundation or empirical support for the sharing arrangement under the EBSS.	The AER proposes to vary the CESS to implement the Bright-Line Tiered Test. The AER has not addressed the concern raised here by CCP.
5. The AER has provided no evidence that CESS payments represent an efficient cost that can be passed on to consumers under the rules.	The AER has not addressed this concern.
6. The AER has not ruled out the possibility that networks are 'gaming' their forecasts in order to inflate their revenue (operating and capital) allowances by the AER.	The AER maintains that forecasts are improving over time.
7. The AER has not explained the widening gap between networks' regulatory proposals and the capital allowance approved by the AER.	The AER states that the gap is narrowing despite the graphical data it presents.
8. The AER should be wary of the networks' enthusiastic support for the CESS (and the EBSS).	The AER uncritically refers to the Houston Kemp reports as demonstrating the benefits of the efficiency schemes, and does not seem to be concerned about the networks' enthusiastic support.

Table 2: CCP proposals raised in its submission to the Discussion Paper, and the AER's Draft Decision responses

The unnumbered entries in this table reflect the recommendations that we included in the Executive Summary of our submission to the AER's Discussion Paper.

CCP proposals raised in its submission to the AER's Discussion Paper	AER response in its Draft Decision
Businesses should provide a credible narrative to explain deviations between their forecast and actual expenditures.	The AER proposes to implement this suggestion, though it has not explained how the narrative will inform its own decision-making (page 34).
The AER should assess whether CESS improves outcomes for consumers.	The Draft Decision again asserts that the CESS has been successful in providing incentives to NSPs (page 19).
The AER should examine changes to the CESS so that it rewards (penalises) accurate (inaccurate) capex estimates submitted by networks.	AER has given no apparent regard to this proposal. The minimal changes to the CESS it proposes will have negligible bearing on addressing consumers' concerns about the CESS.

CCP proposals raised in its submission to the AER's Discussion Paper	AER response in its Draft Decision
The AER should conduct international benchmarking.	As the AER refines its benchmarking techniques, there may be a case to revise the 75 per cent target, so that benchmarking is applied at a point closer to the efficiency frontier. The AER will consider this further and report on it in future benchmarking reports.
The AER should conduct studies to assess economies of scope in outcome measures targeted in benchmarking exercises.	This was not addressed by AER.
The AER should examine changes to the EBSS to ensure networks are rewarded for genuine efficiency gains. CCP proposed a menu-based approach to the EBSS.	The AER has given no regard to this proposal, and proposes to make no changes to the EBSS addressing consumer concerns.
The AER should use high efficiency factors for EBSS forecasting.	The AER will continue to review its benchmarking techniques there may be a case to revise the 75 per cent target so that benchmarking is applied at a point closer to the efficiency frontier.
The AER should improve forecasting of capital expenditure.	The AER will consider this further, and report on it in future benchmarking reports.
The AER should rebalance STPIS to ensure a great emphasis on deterrents	The AER's Draft Decision is to retain the distribution STPIS in its current form.

Recommendations

CCP29 makes the following recommendations in response to the proposals outlined in the Draft Decision. In its Final Decision, the AER should:

- Adjust (reduce) the EBSS so that the sharing arrangements under the two schemes remains aligned following its proposed amendment to the CESS.
- Better explain how the AER will use the narrative, and how it will respond to an inadequate narrative.
- Outline the criteria that it will apply when assessing whether a TNSP is provided access to an incentive scheme.
- Fully and directly explain how its proposal responds to the concerns raised by consumers, the previous CCP and the current CCP.

4. Efficiency Benefit Sharing Scheme (EBSS)

The AER's Draft Decision is to leave the EBSS unchanged.

The Draft Decision sets out some of the issues raised in our previous submissions and in other consumer-focused submissions, but in our view does not engage with them fully.

We suggest that the AER should consider revising the EBSS sharing arrangements so that they more closely approximate the proposed new sharing arrangements for the CESS (which imply a lower sharing ratio), as set out in Draft Decision.

Are the efficiency gains generated by the EBSS statistically significant?

The AER consider that the EBSS has successfully driven opex efficiency gains (page 11 in the Draft Decision). As part of this, Figure 1 in the Draft Decision compares actual and forecast operating expenditure. This figure highlights that actual opex has been below forecast opex for the last three years (2018-2020 inclusive). In reality, the forecast opex is always a probability distribution defined over a range of possible opex values between some upper and lower bound within which the actual operating forecast lies.

It is therefore important to highlight the $\alpha = 5\%$ per cent confidence bounds around the annual forecast opex value. This would allow the reader to discern whether the actual opex fell within or below the confidence bounds.

If the actual opex fell below the lower confidence bound in a given year, this would help support AER's argument that the EBSS is effective. However, if the actual opex fell above the lower confidence bound, this conclusion is hard to accept. As it stands, with no published confidence bound, this claim stands currently without any statistically valid evidence. The AER should apply widely accepted econometric methods to test whether they support its claims.

5. Capital Expenditure Sharing Scheme (CESS)

5.1. Proposed changes to the CESS sharing ratio

The proposed change to the CESS sharing ratio is intended to reduce the burden on consumers when networks underspend compared to the capital allowance provided in the AER's final determination. We support that intention, and in our view the proposed asymmetry between the treatment of under- and overspends is a positive, albeit modest, development for consumers.

The AER also claims that the proposed change to the CESS sharing ratio will reduce the incentive for networks to overstate the capital requirements.

> *The tiered rate proposed will reduce incentives for NSPs to overstate their expenditure requirements by reducing CESS payments (compared to the current CESS) when outperformance is high. This increases the likelihood that NSPs will provide realistic and efficient forecasts as part of a regulatory proposal, and in turn reduces the risk of forecast error and underspending that reflects non-genuine efficiency gains. (p.26)*

We are concerned that this might not be the case. In our view, there is an alternative (and in our view more likely) outcome that the AER has not considered. Our concern is that the proposed change to the CESS sharing ratio might increase the incentive for the networks to attempt to influence the AER's capex forecast by overstating their capital requirements in their regulatory proposals (i.e. in order to earn the same expected payment as previously under the CESS).

In other words, while the proposed change could potentially reduce the cost of the scheme to consumers (one of the concerns consumers have had with the CESS), it will not reduce the incentive on networks to overstate expenditure requirements in the pursuit of higher payments under the CESS (this being the main concern consumers have expressed about networks receiving payments that do not reflect genuine efficiency gains). It is for this reason that we continue to believe that the CESS needs more ambitious reform to penalise networks who seek to 'game' the scheme.

5.2. Separate approach of applying the CESS to transmission resets

The AER proposes to consider whether it applies the CESS to TNSPs on a case-by-cases basis.

> *For large transmission investments our proposed approach is to consider whether the CESS is fit for purpose on a case-by-case basis in the context of our consideration of such investments in regulatory reset proposals and contingent project proposals. (p.7)*

Given the large one-off transmission investments expected under the ISP, this approach seems appropriate. In addition, in the interests of full disclosure to consumers, the AER should publish (as part of this review) the eligibility criteria that it would use when assessing whether the CESS is made available to a TNSP.

5.3. Timing of capital expenditure in a regulatory period

One of the key concerns to which the AER drew considerable attention in its original discussion paper was networks' persistent tendency to postpone capital expenditure to later in the regulatory period – despite the AER's expectations that the CESS was designed to avoid this behaviour.

The Draft Decision does not address this matter. If the AER considers that this is no longer a concern and that it does not have to be addressed in the design of the CESS, stakeholders should be informed why this is the case, and given the opportunity to respond to the AER's view.

5.4. Proposed increase in reporting / transparency

The Draft Decision proposes to require networks to provide increased detail explaining:

- the reasons for any differences between actual capex incurred and the AER's approved forecasts; and
- how actual capex outcomes in one regulatory control period relate to any proposed forecasts in a regulatory proposal for the following regulatory control period (see section 5 of the Draft Decision).

As the Draft Decision notes, this proposal is in line with the CCP's suggestion in an earlier submission. In our earlier submission, our recommendation was partly motivated by networks continuing to delay capital expenditure to later in the regulatory period. It would be helpful if the AER could confirm whether it considers that this increased reporting and transparency will address:

- the propensity of the networks to postpone capital expenditure to later in the regulatory period; and
- the CCP's previously stated expectation that networks' narratives would be required to explain delayed capital expenditure to later in the regulatory period.

We expect that in creating the regulatory requirement to provide a narrative addressing certain matters, there will be a corresponding sanction for networks failing to provide the required narrative at a suitable standard (i.e. understandable by consumers).

In our submission in response to the AER's Position Paper, we wrote:

> *We support the proposal, though we note that the additional information is of little (or no) use to consumers unless the AER makes clear, and consults on, how it will use this information to inform the exercise of its regulatory decision-making for the betterment of consumers. (p.9)*

The Draft Decision still offers no apparent insight on how the AER would use the additional information (narrative) from networks to inform its regulatory decision-making. We request that the AER should provide this important insight to stakeholders.

5.5. Comments on the effectiveness of the CESS

The AER has taken the position that CESS rewards are efficient in the sense that the benefits to the consumers of capital expenditure underspending outweigh the costs of CESS. The AER acknowledges that this judgement depends on the AER's ability to make accurate capital expenditure forecasts, which the AER argues have become more accurate (page 24).

While the AER is to be acknowledged for making efforts to improve the accuracy of its forecasts, we contend that the proposed position still creates a relatively low-risk environment for NSPs to overspend their capital allowance in real time, as long as this overspend is below the AER's forecast levels of capital expenditure that was set at the beginning of the regulatory period.

The AER's forecast is calculated at one point in time, and covers the duration of the regulatory control period. Hence the forecast level of capex and the NSP's capital allowance is effectively fixed for the duration of the regulatory control period. As long as the NSP's capex is below forecast levels, it will be rewarded with its share of CESS payments.

In a dynamic market environment, exogenous market conditions can easily impact how easily underspend can be delivered by NSPs. A key driver of capex is actual demand growth, which can vary substantially from forecast demand growth, as recent history has shown. For example, between 2004 and 2008, Regulatory Asset Bases tripled in value, partially due to by forecasts of demand growth that turned out to be erroneous (Simshauser and Akimov 2019).

In competitive markets, firms faced with unexpected softening demand fully bear the investment risk associated with capex expenditure, and have to write down their assets. However, in the case of NSPs, actual demand growth that is below forecast levels will lead NSPs to earn CESS rewards more easily, since the NSP's capital allowance is fixed for the duration of the regulatory period. Under these conditions, CESS payments do not reflect genuine underspends and savings for consumers.

In this way, the CESS does not cope well in market conditions where changes in demand are volatile and unexpected. Given the large number of technological innovations and energy transition impacting the NEM, periods of substantial uncertainty in demand forecasts are likely to continue for some time into the future.

Similar to firms operating in perfectly competitive markets that bear full investments risks and have to factor in the possibility of downturns in demand and write downs in stranded assets when making capital expenditure decisions, we argue that NSPs should also bear some of these risks associated with volatile demand. This could be addressed in introducing additional cases in which capex can be excluded from the RAB as part of the ex-post review process (page 15 of the capital expenditure incentive guideline).

In addition, the CCP proposes that the AER should consider excluding some portion of capex from the RAB when the capex spend does not reasonably reflect actual demand growth (rather than forecast demand growth). For example, if actual demand growth was 10 per cent below forecast demand growth, the AER could introduce a penalty factor to exclude 10 per cent of the capex from the RAB as part of the ex-post review. In this way, the AER can ensure that NSPs bear some of the investment risk associated with volatile market conditions. This would effectively incentivise NSP managers to take into account volatile demand conditions when making capex decisions. Moreover, the AER should consider further refining the CESS such that total efficiency gains are reduced when actual demand growth is below forecast demand growth.

6. Service Target Performance Incentive Scheme (STPIS)

Our submission to the AER's Position Paper on options for the CESS did not comment on STPIS, because that was not the subject of the Position Paper. Our outstanding comments on STPIS were made on the AER's previous Discussion Paper, where we discussed STPIS in section 7 of that submission.

6.1. Our previous comments regarding service performance for electricity distribution

In regard to electricity distribution, we made the following important consumer-focused comments:

> *We note that incentive payments under STPIS correlate with improved service reliability, but this does not prove that the incentive schemes are working at least cost or most efficiently for consumers. There may be less costly mechanisms for ensuring improved service reliability.*
>
> *We suggest that the nature of the STPIS should evolve as the scheme matures so that it is more evenly balanced between payments and penalties – eventually shifting to a largely penalty based scheme reflecting a consumer-centric focus on providing high quality services (i.e. in accordance with service standards).*

We provided a recommendation:

> *The AER should begin a rebalancing of STPIS so that it is less reliant on incentive payments (for example, by halving the dollar value of the payment mechanism), and more reliant on deterrents for failing to meet services standards (for example, by doubling the dollar value of the penalty mechanism).*

6.2. Our previous comments regarding service performance for electricity transmission

In regard to electricity transmission, we noted what the AER was and was not proposing to do, without further comment or recommendation. In particular we noted that the AER was proposing to address transmission network service provider concerns about the market impact component of the STPIS within revenue determinations.

6.3. The AER's Draft Decision in regard to STPIS and our views on that

As summarised in section 2.3 above, the AER's Draft Decision in regard to STPIS is to:

- retain the distribution STPIS
- retain the service component of the transmission STPIS
- undertake a review of the STPIS MIC starting in the second half of 2023 and completed in time for the next Queensland and South Australian transmission resets
- review the Network Capability Incentive Parameter Action Plan (NCIPAP) as part of the STPIS MIC review.

6.4. Our views on the AER's Draft Decision in regard to STPIS

In section 1 of the Draft Decision, the AER states:

> *The STPIS has been in place since 2008. We now have data to assess the effectiveness of the schemes and whether there is scope for improvement.*

We note that the AER asserts for example in section 4.3 of the Draft Decision:

> *Over time the STPIS has contributed to improvements in the number and duration of distribution outages with the scheme. Between 2006 and 2020, the average number of interruptions per customer per year declined by 0.68, or 38 per cent. Similarly, between 2006 and 2020, the average duration of outages reduced by 26 minutes or 18 per cent.*

It is unclear to what extent the STPIS contributed to improvements in the number and duration of distribution outages or other improvements, as against other factors and improved technology and working methods that one would have expected an efficient network to take on even in the absence of an incentive scheme.

We believe that there may be more opportunity for the AER to assess the effectiveness of the schemes and whether there is scope for improvement.

While the AER has noted our previous recommendations regarding **service performance for electricity distribution**, its Draft Decision does not propose to progress them now. Nor has the AER provided rationale as to why our recommendations are inappropriate or cannot or shouldn't be analysed further. We therefore leave them on the table for the AER to consider at a future date even if they are not analysed further for implementation in this review.

We support the AER's proposed actions regarding **service performance for electricity transmission**. We comment that notwithstanding that the TNSPs are the key proposers of review of components of the STPIS in regard to electricity transmission, the review must as always focus on the long-term interests of consumers in accord with the NEO, and the process of review should facilitate consumer participation and engagement, with appropriate weight being given to consumer submissions.

7. Timetable for implementation

We have no comment to make on the timetable for implementation.