AER incentives workshop

CCP29

David Prins – Chair (apology)

Professor Andreas Chai

Dr Ron Ben-David

26 August 2022

First...

The CCP did **<u>not</u>** propose reducing the sharing ratio to 20 per cent as the AER claims.

We said the AER needed to take a more focussed approach – particularly in promoting 'honesty' in capex forecasts by networks' in their regulatory proposals (and we provided an example of a mechanism to do that) and more robust assessment of scheme effectiveness.

Our paper on the EBSS described a possible menu approach, not a simplistic reduction.

Second...

We identified fundamental concerns that needed to be addressed:

- What is the source of the CESS payment – efficiency gains, capital shifting (deferrals), switching (capex-opex), forecast error (by AER), gaming (by NSPs)?
- How do we know out-turn expenditure is ‘efficient’?
- The legitimacy of the claimed basis for setting the 30 per cent ratio (ie. in EBSS)
- Assessing the effectiveness of the EBSS and CESS in a more sophisticated way
- How does the AER determine whether a 30 per cent (or other) sharing ratio represents an efficient cost to impose on consumers

The Position paper (August 2022) does not engage with any of these fundamental questions. It confines itself to a couple of ‘quick fixes’.

Let’s step back from the detail for a moment

What is the AER trying to do with the CESS?

➔ Promote efficient investment / capex

Rate of return is set to promote an efficient level of investment.

[1st line of defence against inefficient investment]

Review of regulatory proposals by AER [2nd line of defence]

Ex post reviews of out-turn capex. [3rd line of defence]

Regulatory Investment Tests (RIT-D & RIT-T) [4th line of defence]

Guaranteed Service Level (GSL) Payment schemes [5th line of defence]

Better Resets Handbook sets regulator’s expectations [6th line of defence]

Demand side: DMIS, RPPs+TSS = promote efficient use of… [7th line of defence]

Outcome safeguards: Network Performance Reporting, STPIS [8th line of defence]

So, what exactly is the remaining need for the CESS ?

Only two possible answers…

1) The AER doesn't believe the other EIGHT lines of defence are effective

2) The CESS is fixing a problem that the CESS is itself encouraging.

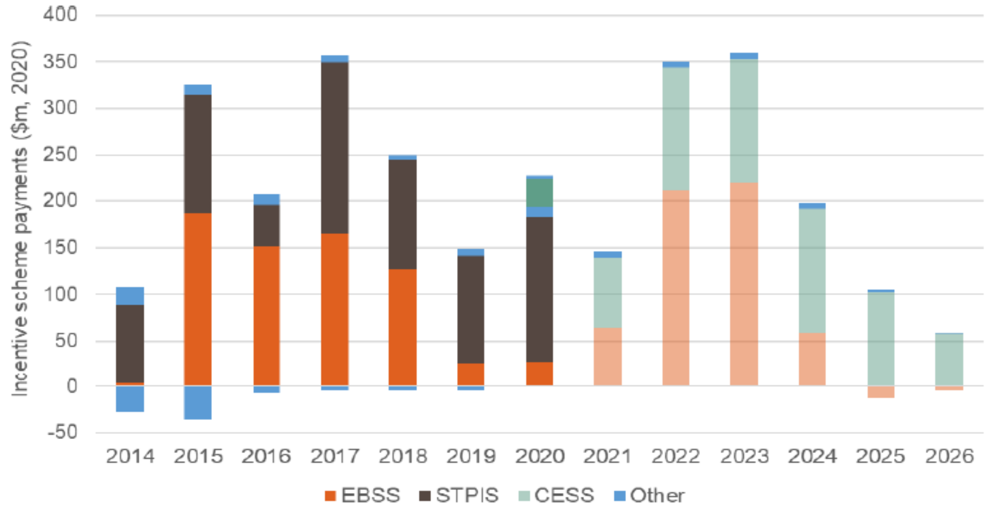
That is:

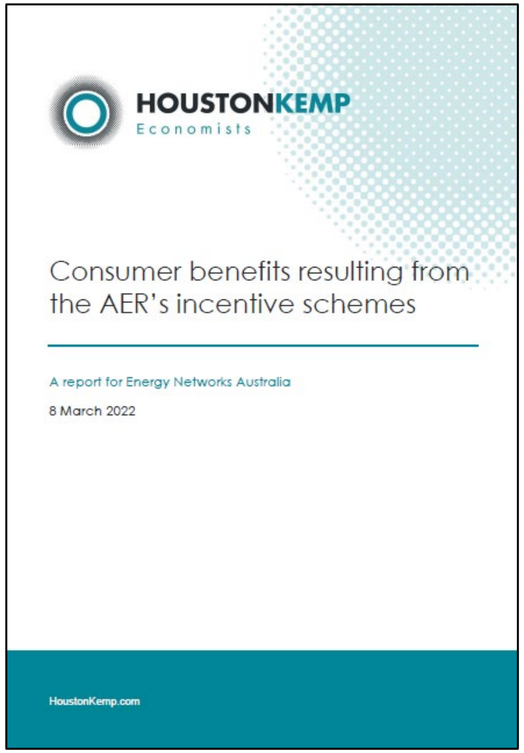
Networks know very well how much they are going to spend in a regulatory period (given all of the above defences) but ***the CESS*** creates an incentive for overstate to over-state their capital requirements because ***the CESS*** then rewards them if they successfully influences the regulator's capital allowance.

The networks have clearly figured they've hit the jackpot with this scheme (and others).

So, of course, the networks are going to be highly complimentary of the scheme.

Figure 7 Incentive scheme revenues — electricity distribution





That is: Given networks know broadly how much they are going to spend anyway (given the eight lines of defence), the CESS is money for jam – they just need to talk up their capex requirements.

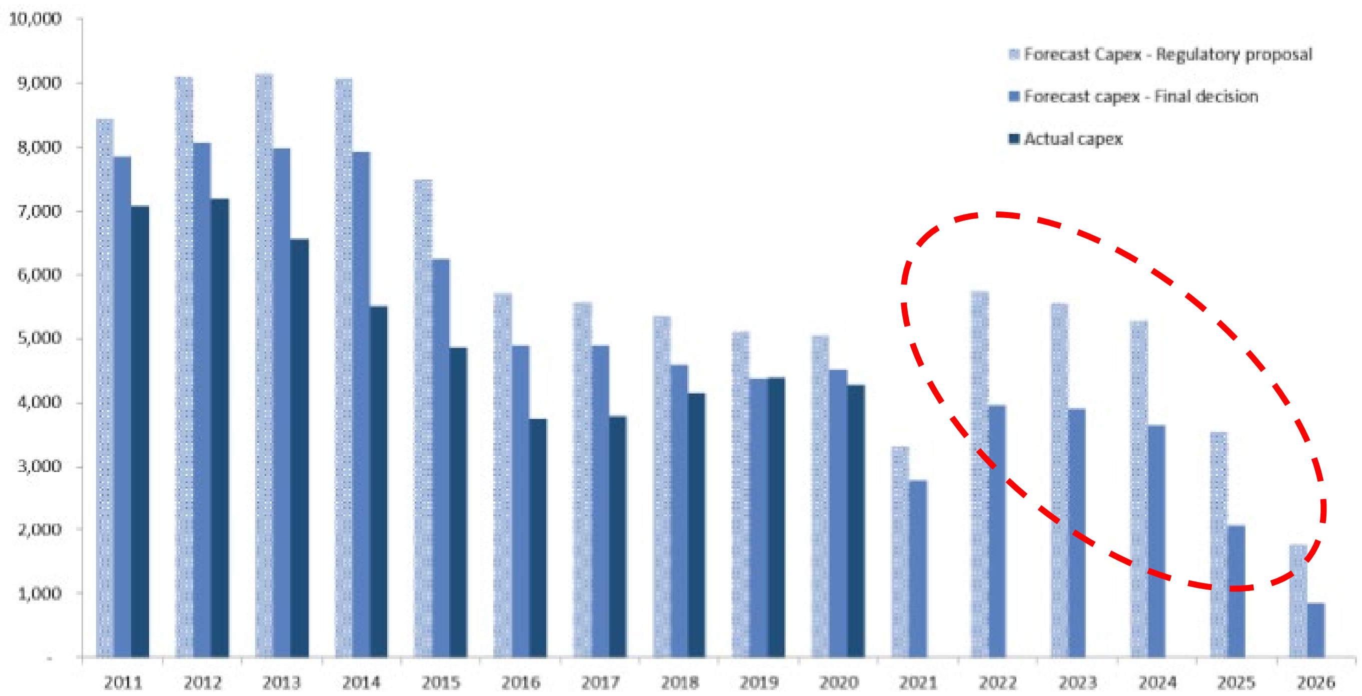
But the AER has even described the CESS's fundamental problem

[W]e have observed a growing disparity between initial proposals from networks and our final decisions recently.

…this difference has been more pronounced in recent capital expenditure allowances for the regulatory periods covering 2021 to 2026.

The scheme is incentivising networks to inflate their capex asks (in the hope of upwardly influencing the AER's capex forecast and therefore future CESS payments).

Figure 21 Difference between proposed capital expenditure and AER final decision



The CESS is the problem the CESS is trying to fix.

Discussion Paper (Dec 2021) p.56-57

Despite seeming to realise there is something fundamentally wrong with the CESS, all the Position Paper proposes to do is:

- require NSPs to be more transparent about the reasons for differences between actual capex incurred and the AER's approved forecasts

Fine. It can't hurt – but how will the AER use this information in pursuit of better consumer outcomes?

- introduce a variable sharing ratio with a 30 per cent default rate that may be lowered to 20 per cent (to be assessed against certain criteria)

It's marginally better than simplistically allowing 30 per cent, but…

- What problem is it fixing? It stills encourages and rewards gaming
- What about the fundamental problems identified above?
- What are the assessment criteria?
- Why not make 20 per cent the default and reward great proposals?

One final observation about the proposal …

The proposal to apply a 30 per cent default rate and lower it to 20 per cent for sub-standard regulatory proposals has the **<u>perverse</u>** consequence of ***lowering the penalty*** that poorly performing networks (with poor regulatory proposals) would incur if they over-spend their capex allowance.

ie. it ***derisks*** poor proposals and poor performance

This is the 'honesty' adjustment – which lowers the *effective* sharing ratio when a network's claimed capex requirement is higher than its actual expenditure.

CCP submission (March 2022)

Proposed a scheme that sought to tackle all these problems with the CESS – by adding to CESS a mechanism that rewards honesty and penalises dishonesty in regulatory proposals from networks.

This is the 'regular' CESS

$$Y = \alpha\,({}^{A}/_{F})(R - A) \quad \text{when } A < F$$

$$Y = \alpha\,(R - A) \quad \text{when } A \geq \text{F}$$

where: Y = payment or penalty

α = fixed sharing ratio (currently 0.3)

A = out-turn (**A**ctual) capex

R = **R**egulated capital allowance

F = network's **F**orecast capital requirements

For the avoidance of doubt, the CCP is not suggesting this is the one and only solution to the shortcomings of the CESS. We are demonstrating, however, that there are far more innovative ways to design the CESS so consumers are paying for something meaningful.

Conclusion

The position paper does not engage with the real, fundamental questions about the CESS (or other schemes).

It's not at all clear what problem the CESS is fixing (ie. eight lines of defence for efficient capex)

The CESS is fixing a problem that the CESS is creating – at great expense to consumers & money for jam for NSPs

The modifications proposed in the position paper don't address the fundamental questions.

The proposed variable sharing ratio has a perverse consequence for underperforming networks.

CCP submission

- identified an alternative approach that addresses the fundamental issues with the CESS by incentivising honesty in regulatory proposals from networks (and a menu approach to the EBSS).
- outlined mechanisms to assess the effectiveness of the scheme(s).

AER incentives workshop

CCP29

David Prins – Chair (apology)

Professor Andreas Chai

Dr Ron Ben-David

26 August 2022