AUSTRALIAN ENERGY REGULATOR – BETTER REGULATION PROGRAM & EXPENDITURE INCENTIVES – ISSUES PAPER

COMMENTS

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Introduction

The Council of Small Business Australia (COSBOA) supports the need for better regulation in Australia, the Australian Energy Regulator's (AERs) involvement in this and welcomes the efforts of the AER to engage with consumers (and their representatives) in a meaningful way on its Better Regulation Program (BRP). COSBOA also appreciates the opportunity to provide written and other input to the BRP, including through this submission.

As this is COSBOA's first submission to the BRP, it responds to two things:

- It provides some contextual comments on how COSBOA views the need for better regulation and the AER's BRP; and
- It responds to the AER's Issues Paper entitled, *Expenditure Incentives Guideline for Electricity Network Service Providers* (released in March, 2013).

COSBOA's Involvement in the AER's Better Regulation Program

COSBOA is taking an active and broad-ranging interest in the AER's BRP on behalf of Australian small businesses and has recently secured funding for this from the Consumer Advocacy Panel. The decision by the Panel to provide funding to support our work will considerably boost COSBOA's ability to participate effectively in the BRP. Our involvement will include written submissions on all areas of the BRP that are important to small business and also participation in the AER's Consumer Reference Group. However, this funding has only recently been secured and we are therefore endeavouring to be as timely as we can with submissions but unfortunately some initial ones will inevitably be late, including this one. We apologise for this and seek the AER's forbearance.

Structure of this Submission

The remainder of this submission comments firstly on the context of COSBOA's involvement, its interest in the BRP and its position on what would promote better regulation of network monopolies, including the need for incentives for better regulation of energy network monopolies. It then goes on to comment on specific issues raised by the AER in the context of their Expenditure Incentives Issues Paper.

Context

This section discusses the context of COSBOA's involvement in the AER's BRP, our interest in Better Regulation and our position on incentives to promote better regulation of energy network monopolies, including specifically incentives for control of expenditure by energy networks.

About COSBOA and Energy Regulation

COSBOA was founded in 1979 and has a proud history of strong advocacy on small business issues ranging from taxation and workplace relations, through to competition law and retail tenancy. We were created by people who believed that small business needed a voice exclusively representing their interests. Our goals are to:

- Promote and support the development of small businesses in Australia;
- Advocate to advance the interests of small business in Australia, including through policy change and regulatory reform; and
- Foster an increased awareness and understanding of the role of small business in Australia amongst elected government and officials, regulators, larger businesses, the media and the general community.

We engage our members and provide opportunities for them to influence outcomes affecting their business, and their industry. We act as a conduit for information from our members to Government and other organisations, and vice versa. A key activity for us is to facilitate introductions between member organisations and businesses with relevant customers, suppliers, service providers and regulators.

Small businesses often do not have the time, the resources and the expertise required to be alert to the myriad of legislative and regulatory change that affects them. COSBOA's efforts are focussed on providing accurate and timely input into decisions which will affect small businesses. Our members provide essential input to ensure the quality of our representation, as well as the substance and the credibility to back it up.

It would be fair to say that energy issues, including the regulation of monopoly network services, are an area containing much detail where small businesses can be significantly affected by decisions they know little about, are not able to get involved in themselves. The recent very large increases in electricity (and more latterly gas) prices would be a case in point.

A list of COSBOA's members is shown in the Attachment to this submission. As can be seen they are broad ranging in terms of the industry or scope of their activities, provide national coverage and are all small business oriented. This provides important background to our involvement in the BRP.

COSBOA's Interest in Better Regulation

As mentioned above, a particular and significant reason for COSBOA's interest in better regulation of energy networks is undoubtedly the significant recent increases seen in electricity prices in all parts of Australia and also in gas prices. COSBOA is aware that the majority of these price increases have been because of large price increases in network charges resulting from recent AER regulatory determinations for energy networks – electricity and gas, distribution and transmission. We are also aware that network charges make up a significant

component of the delivered price on energy – around half in most parts of Australia – including for small business. Moreover, we are concerned that shortcomings in network regulation, which have acted to promote regulatory outcomes that grossly favour network businesses over consumers, are a key reason for this, and that much expert analysis of the situation has confirmed these shortcomings.

We strongly support the need to remove the shortcomings in network regulation, especially to ensure fairer and more reasonable price outcomes for energy consumers in future. In fact, it is unreasonable for consumers to continue to pay prices now that reflect past decisions based on these shortcomings and inadequacies, whilst network businesses and their owners, including State Governments, continue to earn unjustified revenue and profits at the expense of energy consumers. Small business in Australia faces a difficult landscape and cannot afford to pay excessive network charges.

Whilst we appreciate that addressing past failures in network regulation and decisions that are now embedded in AER determinations is not the role of the BRP, we nevertheless draw attention to how this impacts on small business and would urge State Governments that still own electricity networks to take steps to unwind some of these excesses in the interests of providing fairer network charges to small business.

Whilst very large increases in energy prices are the main reason for COSBOA's interest in better regulation, it is not the only reason. Our members need access to electricity and gas to run their businesses. For this, they need a secure and reliable supply. They also value good customer service and innovation by energy utilities that benefits customers.

Our members operate in competitive markets, be they domestic or internationally focused. They are also burdened by the regulations that are increasingly imposed upon them and the AER may be aware of the vocal concerns that small business has been expressing about this. Whilst most of these are in the form of regulatory requirements imposed on small business themselves, some are more indirect. One of these is the imposition of higher energy prices on small business due to network regulation. This is just as important to COSBOA members as regulation that impacts directly on them – it is a cost to small business and impacts on its competitiveness. Small business faces some particularly difficult hurdles in overcoming regulatory costs and burdens. For example, it experiences difficulty in passing on cost increases and is less able to do so than large businesses. It also buys inputs from, supplies goods and services to and competes with large organisations, which can place small companies in a cost-price squeeze. The recent large increases in energy prices are an important contributor to the commercial inequality faced by small business.

Better regulation at all levels is therefore fundamental to small business and we are keen to ensure that this is recognised and acted upon in the AER's BRP.

COSBOA's Position on Promoting Better Regulation

COSBOA believes that it is strongly in the interests of small business to have better regulation of energy networks. The main reasons for this were outlined in the previous section.

The National Electricity and Gas Objectives are important touchstones for better regulation and clearly focused on protecting the long term interests of consumers of electricity and gas. However, for them to do this effectively, they need to be supported by rules and a network regulatory framework that is consistent with them and they need to be adhered to by bodies set up under the national energy laws. Past outcomes, especially with respect to rapidly rising network prices, strongly suggest that his has not always been the case.

We note that energy networks enjoy a privileged position in the Australian economy because they are all monopolies in regions where they operate. It is therefore entirely appropriate that they should be regulated to ensure that they do not abuse or misuse their absolute monopoly power. This is in contrast to small businesses which operate in competition with other firms, often in a fierce way and which face intense pressure to keep their costs down, including from customers and suppliers in larger firms.

Energy networks also transport an important input to small business – electricity and gas. It is important for the BRP to keep in mind that energy is a cost of doing business and that small business finds it difficult to pass on increases in the cost of energy.

This being the case, we strongly support the original intent of economic regulation of energy networks in Australia, which was to use incentives to promote efficient operations of energy networks so as to mimic the outcomes that energy consumers would get if network services were provided in a competitive environment. Of course, regulation is never perfect and cannot provide outcomes that exactly match a competitive market, but the real objective should be to come as close to this as possible and to keep striving to improve outcomes over time. We believe that this is fundamental to better regulation, including through the BRP.

Based on outcomes to date, we remain a long way short of this objective. In fact, it seems to COSBOA as though we may have even gone backwards and lost sight of the objective in the current round of regulatory determinations. Some correction seems likely through the actions of individual State Governments, the Australian Energy Market Commission's (AEMC) changes to the national electricity and gas rules, the recommendations of the Yarrow Panel to reform the merits review mechanism, the Productivity Commission's inquiry into energy networks, and the actions of the Council of Australian Governments (COAG) and the Standing Council on Energy and Resources (SCER), though the latter are yet to respond to the Yarrow Panel's recommendations and the PC's final report is yet to be released. The number of reviews and the breadth of the reforms emerging from them is testament to the malaise that has crept into energy network regulation.

The extent of concerns expressed about the outcomes of network regulation, especially rapidly rising prices, by the COAG, SCER and individual governments is instructive. The desire of Governments to see energy network regulation deliver better outcomes to consumers, especially better price outcomes, is manifest.

It is therefore vital that the AER's BRP, which translates the outcomes of a number of these reviews into regulatory guidelines, especially the AEMC's rules changes, reflect the need for substantially better regulation that delivers substantially better outcomes to energy consumers.

From what we have observed so far, the AER is embracing this challenge in the BRP, and we welcome and support this. The AER's establishment of a sound, open and consultative process for consideration of the issues, its selection of work streams and consideration of their inter-relationships, its involvement of consumers and the networks, its diligence in preparing papers and other inputs, and presenting complex issues in ways that are clearly intended to help their understanding are all worthy of mention. For the BRP to succeed, the AER needs to continue along this course.

Naturally, better regulation is not just a matter of the BRP being a success. The BRP is aimed at only one element of the regulatory matrix for energy networks, the development of a framework to be applied by the regulator, as important as that is. However, COSBOA recognises that better regulation also involves a range of other elements, all of which fit together to ensure optimal outcomes for consumers. This includes:

- Ownership of the networks, with continued public ownership especially under the spotlight.
- The functions of Federal and State Governments and the AEMC in setting the boundaries for regulation.
- State Government jurisdiction over important elements of regulation, including reliability, safety, other technical and planning issues.
- The workings of the merits review process for AER regulatory determinations.
- COAG, SCER and individual government monitoring of regulatory outcomes and how they impact on consumers, with an eye to further reform where and when necessary.
- The way in which the AER administers the framework and makes its determinations, noting that it will have more discretion in how they do so in future.

The willingness of the Consumers Advocacy Panel to support consumer involvement in the BRP should also be mentioned. This support has allowed for better resources and more informed input from consumers; and broadened that input to include large consumers, low income consumers and now small business.

COSBOA's Position on the Use of Incentives in Promoting Better Regulation

Incentives are fundamental to any firm and what they respond to at the commercial level, though there may be other incentives besides pure profit maximisation. For firms operating in an open market subject to some competition or the treat of it, the competitive setting will provide strong signals or incentives to keep prices (and costs) as low as possible, provide the best service possible, and be responsive to consumer demands. Firms that do not match up will have to lift their game or else they will fall by the wayside. This process of creative destruction is fundamental to any competitive market.

Firms operating in monopoly environments do not face the same incentives. They seek to maximise profit (or achieve some hybrid of profit and other objectives) but do so in a way that results in higher prices and less service than in a competitive market. This applies especially to firms that enjoy natural or statutory monopoly status, as energy networks do. This is a fundamental reason why they are regulated.

Picking up on the well known flaws in past attempts to regulate monopoly utilities, especially in the United States (US), and on attempts to overcome this in the United Kingdom (UK) at the time that their electricity utilities were privatised, Australia adopted a similar means of regulating energy networks. Essentially, this regulatory model dispensed with failed cost-of-service regulation as practiced in the US and instead used incentives intended to improve productivity, and drive costs and returns down to efficient levels over time, with benefits to consumers. A key aim was to provide similar outcomes to a competitive market.

As mentioned above, this worked well in Australia for a while but has gone badly awry in recent years as regulation transferred from individual jurisdictions to a national regime. In the process of this transfer, the rules for regulation shifted their balance dramatically from one where the regulators had the ability to assess the needs of both consumers and the networks, to one where the needs of the networks were given primacy, especially in the name of the need for continued (and more) investment. Costs blew out of control as the incentive structures referred to above broke down and were replaced by other ones which allowed the networks to argue for (and get) large increases in expenditures and inflated rates of return. State Governments, the AEMC and the networks themselves were major supporters of this change. The inevitable (and obvious) consequence was a blow out in network prices to the long term detriment of consumers (contrary to the National Electricity and Gas Objectives). Several detailed and official reviews have come to this view, which greatly concerns COSBOA because of the detriment it has imposed on small business.

Moreover, there is a good deal of evidence supporting the view that State Government owned energy networks have been particularly adept at influencing and exploiting this regulatory structure. They have benefitted disproportionately and at the expense of their customers. This is leading to questions about whether the regulation being applied to these businesses, which assumes they face the same incentives as private sector networks (i.e., treats them as though they were privately owned) is inappropriately applied to them(noting that the regulatory fabric being applied was intended for privatised utilities in the UK).

COSBOA is very concerned about this and that it not continue to inflict damage on consumers under the BRP. We would encourage the AER to closely consider this matter as part of the BRP which should not seek to apply a common regulatory structure to both privately and publicly owned energy networks where this will not meet the National Electricity Objective.

This experience highlights the importance of incentives in network regulation. Even more importantly, it highlights the need for these incentives to be applied in a way that disciplines the excesses of monopolies. Incentives need to be used to force them to minimise costs, seek more productive ways to provide their services, invest at efficient levels, outperform a target regulated rate of return that reflects their cost of funds and (low) risk profile, and provide a level of service that consumers are willing to pay for, whilst sharing the gains they make with consumers. That is to say, the incentives need to support the objectives of incentive-based regulation not the objectives of the regulated businesses, as has been the case in Australia in recent years.

COSBOA strongly supports the need to for such incentives and for the AER to build more of them into the BRP, noting that the AER has strong support to do this from COAG, SCER, individual governments, energy consumers and their representatives. There has never been a better time for the AER to use this support to ensure that the BRP delivers much better outcomes for consumers in future.

The incentive structures that the AER puts into place in framing its guidelines and how it applies these in its determinations will be key to this.

Expenditure Incentives

As mentioned above, the control of costs, making them more efficient and keeping them that way and using cost efficiencies to increase the productivity of energy networks is an important task of network regulation. The incentives applied are the key to achieving better outcomes in future. This applies both to capital expenditure (capex) and operating expenses (opex).

COSBOA particularly supports:

- The rigorous application of benchmarking techniques to both future capex and opex to help ensure that costs are efficient, and/or continue to move in that direction, including for the less efficient network businesses. We recognise that the initial application of benchmarking involves some challenges but note that it is a strong tool for delivering better regulatory outcomes to consumers and that the initial application does not need to be perfect. It is more important to make a start, albeit one that is soundly based.
- Less reliance on current approaches to forecasting capex (‘ground up’ type approaches) and opex (the so-called ‘base, step, trend’ approach) given the poor outcomes that these have delivered to date.
- The use of measures that contain incentive powers that balance the needs of consumers and the networks in ways that support the National Electricity and Gas Objectives, and the need for regulatory

outcomes to, as far as possible, mimic those that consumers would get if the market for network services were competitive.

- The continued application of an Efficiency Benefits Sharing Scheme (EBSS) for opex, but one that should be reformed and improved to deliver better outcomes.
- The application of a Capital Expenditure Sharing Scheme (CESS) to both transmission and distribution networks.
- A preference for the application of *ex ante* approaches to capex and opex, with limited *ex post* assessments of capex.
- A preference for the use of forecast depreciation unless there are clear reasons to use actual depreciation.
- Taking account of the inter-relationships that exist between expenditure incentives, expenditure assessments, choices between capex and opex, setting of the rate of return, the return of capital (depreciation) and service levels.

We comment in more detail on the above issues in the next section.

Comments on Issues Raised in the AER's Expenditure Incentives Issues Paper

This section provides COSBOA's comments on the main issues for small business raised on the AER Expenditure Incentives Issues Paper. It also takes into account other submissions made in response to this paper, especially those from other consumer representatives.

Ex Ante Capex

This part of our response considers Section 3 of the AER's Issues Paper and Questions 1 to 12.

COSBOA supports the development of a Capital Expenditure Sharing Scheme (CESS) by the AER, but this must be shown to work in the interests of electricity consumers and to provide an incentive to network businesses for efficient capex and to sustain this over time.

Declining incentives

We respond below to the three issues raised by the AER.

- *Lack of discipline over capex in year five (last year of regulatory period)*

We generally concur with the AER that this could be a problem in terms of the regulatory settings and note the information provided to support this. We also note the AER's comment that, "if a NSP's [Network Service Provider] WACC is consistently lower than the regulated WACC, the NSP could benefit from overinvesting in the latter years of a regulatory control period." (Issues Paper, p. 15) It particularly concerns us that there is significant evidence to support the view the government owned NSPs have WACCs that are well below those set under regulation and that this has not yet been recognised in the Rules to set WACCs. This then needs to be fully considered in the AER's development of guidelines and a CESS. Small business consumers in these jurisdictions do not wish to be subject to excessive capex, which will flow through into excessive network prices.

- *Distorting choices between capex and opex*

We agree that differing incentives for capex and opex could distort choices between the two and that this could result in reclassifications or changes in policy. This could have undesirable consequences, including less efficient outcomes for consumers. The AER is therefore seeking to put in place incentives which reflect this. We agree that this should be an aim of the regulator, although we also believe that it needs to balance this with other issues, e.g., the need to provide incentives so that the overall level of capex remains efficient.

- *Less efficient capex if skewed towards the end of the regulatory period*

The AER mentions that this could lead an NSP to use more contractors, enter into less cost effective contracts (due to it being under time constraints), or lose some of the economies of scope that result from larger contracts. We do not disagree with this assessment, but make the point that though these issues may be stronger at the end of the regulatory cycle, they are not limited to the end of the cycle and could come into play at any time.

The AER also refers to Productivity Commission (PC) data to support the view that capex has, in fact, been skewed toward the end of the regulatory cycle. As other submissions have pointed out, it is somewhat spurious to rely on this data to support a conclusion that declining incentives have promoted widespread capex deferral. For example, the data relates to only one regulatory period, only to distributors (not transmission) and is not appropriately weighted (to allow for differences in size).

We also note that the AER does not have to rely entirely on the power of the capex incentive to deal with concerns about declining incentives. It could also:

- Alter its approach to setting the regulatory WACC to reflect any concerns.
- Reflect the concern in setting the return of capital (depreciation).
- Reflect the concern in its approach to *ex post* capex.
- Reflect any concerns it has in the determination of intra-period capex.

It would be useful to have a more detailed consideration of the relative benefits and costs of the different alternatives.

Protecting consumers

We strongly endorse the AER's comment that there are "concerns that the current regulatory regime does not provide sufficient protection for consumers against electricity price rises that are caused by inefficient overspending on capex." (Issues Paper, p. 18) As the AER notes, capex allowances and actual expenditures have increased significantly in recent years and this has contributed (COSBOA would say in a major way) to electricity price increases. A solution is clearly needed to this problem and it is critical for the AER to play its part in developing it.

The Issues Paper notes that there has been overspending of capex by Distribution NSP (DNSPs) in both New South Wales and Queensland but also comments that "this trend does not appear to have persisted in the current regulatory control period. Indeed, there has been more overspending in Victoria … ." (Issues Paper, p. 18) It then goes on to say that:

> *"Without undertaking further analysis on the underlying capex drivers for each NSP, it is difficult to draw any strong conclusions from the data. To the extent that capex drivers have been analysed, the conclusions have been varied and tend to point to NSP specific circumstances or characteristics." (Issues Paper, p. 18)*

This is of concern to us. First, bearing in mind that these are States with government-owned NSPs, it seems highly likely that, to the extent that there has been a moderation in capex, it reflects a response to public and political concern about very high electricity price rises, greater public and political scrutiny of the NSP's expenditures and a concern that capex reflects past (much higher) forecasts in demand than is actually the case. We also note that the data in Attachment 2 to the Issues Paper, show that actual capex has continued on a steeply upward path, at least in New South Wales, notwithstanding that the gap between actual and allowed has narrowed. Moreover, it is possible that the Victorian trend reflects more the distorted incentives that have crept into regulatory determinations under the earlier AER determinations, which all related to government owned NSP? We believe that it is important for the AER to analyse these matters in greater depth to improve everyone's understanding of them in the interests of ensuring its guideline and any CESS is as well informed as it can be, and to ensure that the interests of consumers are protected.

The AER also discusses whether government owned NSP respond as sharply to financial incentives as privately-owned ones and refers to several "theoretical reasons" why they may not. We believe that the AER has not acknowledged sufficiently the significant body of empirical work done on this matter by various sources including the PC, the Review of Limited Merits Review, the Garnaut Review Update, the Grattan Institute, consultants and in learned journals, which strongly supports the conclusion of poorer outcomes for consumers from government –owned NSPs. This is an important point and has clear implications for the AER's BRP, including the expenditure incentives guideline.

CESS

We support the aim that a CESS should reward NSPs for underspending and penalise them for overspending. We are also supportive of benefits from underspending being shared with consumers, but are less attracted to consumers being penalised for NSP overspending, especially where that overspending is inefficient.[1] We note that the AEMC's Rules on the development of a CESS provide significant discretion for the AER in whether to develop such a scheme and how to go about it. The AER needs to exercise this discretion carefully, especially in ensuring that it meets the National Electricity Objectives.

Continuity

The AER's preferred position is to have a CESS that provides a continuous incentive over the regulatory period. Whilst we agree that the use of a continuous incentive would help to deal with the sorts of issues raised in the Issues Paper in terms of declining incentives, our earlier comments raised some questions about the importance of these issues and/or the need for them to be dealt with solely through a CESS. We also questioned the use of the same incentives for private and government owned NSPs, given the much stronger incentive for the latter to spend capex (the cost of which is carried by consumers). We also raised some questions about the data presented by the AER in Attachment 2 and the inferences that can be drawn from it. We therefore suggest that the AER further investigate the pluses and minuses of a CESS based on continuous incentives.

Power of the incentive

The Issues Paper discusses the two-sided nature of the power of the incentive in a CESS, i.e., that it reward underspending and penalise overspending, as well as the sharing of these rewards and penalties between NSPs and consumers.

COSBOA agrees that NSPs should be encouraged to spend less than their capex allowance if this is efficient and notes that consumers will be future beneficiaries of this (eg more efficient capex, lower RAB, lower prices).

The AER proposes to limit the reward to NSPs for underspending to 20 to 30 per cent. It provides two reasons:

- To minimise the scope for the NSP to limit capex with a resulting deterioration in service levels. We support that the CESS should not diminish service levels, provided these levels have themselves been set in a robust and transparent manner which reflects consumer preferences and willingness-to-pay. We note also the AER's comment that the separate scheme for service levels, the Service Target Performance Incentive Scheme (STPSS), involves a lag with capex and that the present value of the incentive between the reward for underspending and service improvements should be equal.

[1] If the overspending relates to matters that are outside the control of the NSP, such as exogenous cost increases, this would be less of a concern, although care is needed to ensure that all such costs are genuinely outside the NSP's control.

- To limit the scope for the NSP to capitalise opex or switch between opex and capex. It notes that the power of the incentive for opex is 30 percent. We can see logic in the AER's position in relation to a capex incentive of around 30 per cent as far as private NSP are concerned. However, we have a serious concern that this will not be sufficient for government owned NSPs and suggest that the AER consider this further and the need for a stronger incentive for them. In raising this, we note the difficulty that if they are given a more powerful incentive this would allow them to capture a greater share of the benefits from underspending

The AER's initial proposal is that the penalty for overspending of capex should be "greater than 30 per cent". We respond below to the AER's reasons for proposing this and its preferred approach.

- *NSPs are able to spend within their allowance in most circumstances*

We agree with the AER that this is the case and provides a reason to have a higher penalty for capex overspends than underspends. We also note that the AEMC recognised this and suggested that there was an argument that no capex overspend be rolled into the RAB.

- *Asymmetries in setting capex allowances*

We concur with the AER's comments that they are more reliant on the NSPs own data and information in setting capex and so face more formidable asymmetries in setting capex allowances. We also note the comment that this could lead to more generous capex allowances and that the underspending could reflect this, whereas any overspending is more likely to reflect inefficiencies.

- *NSPs respond differently to the incentives*

We believe that NSPs do respond differently to financial incentives and that government-owned NSPs, in particular, do not have the same incentive to lower capex to efficient levels. Rather they have a greater incentive to expend capex. This places consumers in these jurisdictions at greater risk of prices that reflect these inefficiencies.

- *Targeted use of* ex post *assessments to correct overspending*

We sympathise with the AER's view that *ex ante* provisions should provide the primary means of ensuring improvements in capex efficiency but that *ex post* assessments can provide additional safeguards for consumers. We comment further on the latter below.

- *NSPs are protected by other mechanisms*

We agree that NSPs receive additional protection from the downside risks of not spending more capex through mechanisms such as cost pass through applications, re-openers and contingent projects, should they have a justified need for additional capex. We also note that these are all upside mechanisms and that NSP face very limited downside risks of adjustments. Even though these exist, in practice, they are unlikely to be invoked.

- *What should the penalty be?*

We agree with the AER that the penalty for overspending should be more than the reward for underspending. However, the AER says only that the penalty for overspending should be more than 30 per cent not what its actual level should be. We believe that the AER needs to specify the amount that it has in mind and why, and consult with stakeholders on this. Presumably it is intending to do so at a later stage.

We note that some other submissions have also pointed out that the effective penalty for government-owned NSPs, given they face a much lower actual than regulated WACC, should reflect this, i.e., that the penalty should be set much higher. We have a good deal of sympathy with this view and believe that the AER needs to consider it closely.

- *Should consumers share in the penalty?*

We have a serious concern that the penalty side of a CESS should not allow NSPs to avoid taking responsibility for making sound decisions about capex. We note that in competitive markets, consumers are less likely to share in the penalty for bad decisions on capex. Shareholders are more likely to have to take on this responsibility whilst still having to share any underspends with consumers. COSBOA's view is that the AER needs to consider how this principle can be adequately reflected in the CESS. Adequacy of the proposed asymmetry between rewards and penalties is one means of reflecting this.

- *Should there be differences in schemes for different NSPs?*

Given our previous comments about the differences in incentives faced by government owned NSPs, we believe that they should face more powerful incentives on underspends and overspends. The extent of this should be subject to further AER investigations. We do not believe that there is a strong enough case for differentiating between Transmission NSP (TNSPs) and NSP.

- *Should any capex be excluded?*

Prima facie, we do not believe that any elements of capex should be excluded from a CESS. While the AER is proposing to exclude pass-throughs, reopeners and contingent projects, presumably on the basis that they are uncertain and difficult to forecast, on the other hand there are already significant means of dealing with uncertainty in these elements and excluding them could distort what type of capex is favoured by an NSP. The downside risks of excluding these items seem to outweigh any problems of including them.

- *Should penalties and rewards be included in the guidelines?*

COSBOA believes that the AER needs to set out clearly in the guideline what its approach to the CESS and the setting of rewards and penalties will be, so as to provide as much clarity as possible to consumers and NSPs. If it is confident about the specific values of the power of the incentive it will be applying, it should include these in the guideline. However, it may wish to leave some room for flexibility in determinations given complexities regarding differences between NSP and asset lives. It should also set out that the CESS will form part of a suite of interdependent measures, also involving benchmarking of capex proposals, *ex post* review mechanisms, return of capital and service performance.

Treatment of Depreciation

In the absence of a strong and robust CESS, COSBOA would favour the use of actual depreciation to provide a discipline on overspending of capex by NSPs. However, assuming that the AER proceeds with a CESS and this provides a strong and robust scheme that adequately reflects the interests of electricity consumers, we would not object to the application of forecast depreciation by the AER. However, we also agree with the AER's position that it should leave open the option of applying actual depreciation based on the following provisos:

- If there is no CESS in place (or such a scheme proves to be not sufficiently effective).
- The NSP's past performance shows evidence of persistent overspending.
- There is evidence of significant expenditure shifting.
- The service performance of the NSP is not meeting the requirements of the regime.

Ex Ante Opex

This section responds to Section 4 of the Issues Paper and answers Questions 13 to 23.

Opex Approaches & EBSS

COSBOA accepts that the AER's current approach to setting opex for NSP has some useful aspects and has provided some protection to consumers from strategic behaviour by NSPs by:

- Avoiding some of the risk that NSPs will increase expenditure in the base year used for setting opex (usually the fourth year of the regulatory cycle) in order to increase their future opex;
- Providing NSPs with an incentive to continue to pursue reductions in opex throughout and across regulatory periods; and
- By allowing consumers to share in the benefits of lower opex.

Nevertheless, we also have concerns about the current approach:

- The revealed cost approach to establishing the base for future opex has flaws. It relies on the assumption that past opex is efficient (ie low cost), and that it is recurrent and relatively stable. It should not be implicitly assumed that the opex base of an NSP is efficient purely on the basis of past behaviour when this might not be the case, especially when what is efficient has never been measured and when the only point of reference is the costs of the NSP under review.[2] This could be the equivalent of 'looking in the rear view mirror to drive forwards'. It could become a self-fulfilling prophecy for entrenching and perpetuating inefficient costs, which consumers will pay for. The only effective way to overcome this is to undertake external 'tops down' benchmarking or some other process involving an exogenous point of reference. It is important that the AER do this in future. This could be in combination with the revealed cost approach.

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[2] The Issues Paper refers to data on past opex for several NSPs and draws the conclusions that "there is limited empirical evidence to suggest year 4 opex is disproportionately high" (p. 39). We note that this only provides data for a limited number of NSP and that all except one are privately owned. Whilst we appreciate that data limitations are due to there being only some NSPs with an EBSS in place and having completed a regulatory control period, these limitations suggest that few, or limited, conclusions should be drawn from the data. We also note that, notwithstanding the AER's view above, which appears to be based on the 'Total', or average, line in Figure 4.1, looking beyond this suggests that there is some evidence for the current EBSS not having worked fully as expectated. For example, Electranet, UE, Citipower, and Powercor appear to have shown significantly lower differences between (rising) actual and forecast at least in the second half of the periods shown, whilst Powerlink, the only government owned NSP in the sample, has persistently spent more than it was allowed with the difference tending to increase over the control period.

- It has meant that consumers have had to share in the costs of opex overruns by the NSP when it is not clear that the NSP has been required to take sufficient responsibility for its actions in relation to opex overruns. We again draw the analogy with business, including SMEs, who have no choice but to absorb opex overruns if they wish to stay in business.
- In a similar vein, the basis for the current 30:70 sharing ratio for the EBSS is not clear from the Issues Paper. It would be helpful if the AER could explain this further.

In summary, at this stage we remain unconvinced that the current revealed cost approach to setting allowed opex and the current EBSS are working as well as suggested in the Issues Paper. We therefore believe that the AER needs to look more closely at performance and outcomes for both before deciding that "only some changes should be considered." We also have a strong view that the AER needs to proceed beyond its current approach and commence benchmarking of future opex. This is already provided for in the NER and we are pleased to see that the AEMC and PC support it, and the AER intends to do so.

Our strong view is that benchmarking should be applied universally and always form part of the process of establishing the efficient level of opex for any NSP. This is the only way consumers can feel assured that the opex base and future direction are efficient. In this regard, we note the following comments from the Issues Paper:

> *"Where we utilise these techniques [exogenous forecasting] in the future to forecast most of a NSP's opex allowance, rather rely on the actual opex incurred by the NSP, the NSP will have limited ability to influence its future opex allowance. (p. 40)*

…

> *"Under exogenous forecasting approaches, without an EBSS, a NSP will have a very strong incentive to reduce its opex." (Ibid.)*

…

> *" As its actual opex has no influence on its future opex, there is not the same incentive to increase actual opex in the penultimate year of the current regulatory control period as would be if we used our current opex forecasting approach without an EBSS." (Ibid.)*

We favour the use of exogenous forecasting/benchmarking with a predilection towards allowing the NSP to retain all the benefits/bear all the costs of differences between allowed and actual opex. Consumers would benefit from more efficient opex, and know with more certainty that the base opex is more efficient (and is being driven down even more) and they would see increased benefits over time (possibly exceeding those under the existing EBSS). By the same token, they would bear none of the risks of opex exceeding the forecast. We would welcome further consideration of and comment on this from the AER.

However, we recognise that the application of benchmarking may need to evolve and improve over time, so that there is a case for retaining an EBSS (at least initially). We are also mindful that there are linkages between the approach to opex, NSP decisions to use opex or capex and the service incentive scheme.

EBSS Design Aspects

If the EBSS is retained, we would welcome further comment from the AER on the reasons for the current 30:70 sharing split, the reasons for retaining it and why a future EBSS should remain symmetric.

Power of the opex incentive

In relation to the split, the AER believe that the current arrangement is suitable for future applications (regardless of what method is used to determine opex) because those data they have referred to show that "where opex incentive schemes have been in place for a whole regulatory control period there is no systematic empirical evidence that illustrates opex of NSPs is excessively high in year 4 compared to earlier years in the regulatory control period." (Issues Paper, p. 38) However, we have some questions about this, which we raised earlier.

COSBOA note and agree with the AER's view that the power of the incentive is a "balancing act" and there needs to be an appropriate balance between the need to encourage NSPs to find efficiencies and sharing these gains with consumers. The AER go on to conclude that the 30:70 split provides this balance but there is little evidence provided to support this. In the absence of this, it is difficult for us to conclude unequivocally that the existing split for benefit sharing should be supported, although it has about the right intuitive feel.

Symmetry

In relation to sharing overruns we take a somewhat contrary view. COSBOA's *prima facie* position is that the justification for consumers sharing in opex overruns has not been sufficiently established. The Issues Paper says that all the opex forecasting error should not be borne by the NSPs. We contrast this to the difficulty that small business has in getting its customers to share in cost overruns associated with such errors. We do not believe that it has been satisfactorily established that the EBSS should be symmetric, or at least that a symmetric 30:70 split should apply. We would appreciate further consideration on this by the AER.

Variation with opex approach

We can find no compelling reason why the incentive faced should vary depending on whether a revealed cost or exogenous approach is used. Under an exogenous approach, such as benchmarking, we believe it is appropriate that less efficient NSPs should only receive benefits if they deliver opex lower than the benchmarks et for them (noting that this could be set so as to encourage NSPs to trend towards the efficiency frontier). For less efficient NSPs, it is appropriate that their benchmark reflect their greater need for efficiency improvements.

Balance with capex incentive

COSBOA supports the comments regarding the need and reasons for favouring a balance in the incentives for opex and capex. We also note some of the consequences of not doing this, including favouring one type of expenditure over another, reduced incentives for efficiency, inefficient investments and distorting the use of non-network options. Whilst we therefore favour a balance being sought, we note that this may require the balancing of competing objectives. For instance, in the previous section we argued for a more powerful set of capex incentives for government owned NSP. We believe the reasons to do this are compelling, but it may require some adjustment to the EBSS if any distortions are created in relation to decisions on capex and opex.

Opex incentives and service levels

COSBOA appreciates the nature of the problem which the Issues Paper raises regarding the need to balance incentives for opex with those for service levels. It would not be in the interests of our constituents for NSPs to distort their choices between opex and service levels if the value to consumers diminished as a result. We also note that the current sharing ratio for service incentives is about the same as for opex.

Continuity

We support that the incentives for the EBSS should be continuous so as not to distort the timing of opex expenditure through the scheme, as well as to allow better benchmarking of opex.

Penalty for overspending

COSBOA believes that a strong penalty for overspending opex allowances is appropriate for NSPs. Regardless of how the opex allowance is set – revealed cost or exogenous approach – NSPs should be strongly encouraged to remain within, or preferably seek ways to reduce, their regulatory allowance.

The AER has said that it considers that the penalty for overspending should be shared with consumers given that NSPs face a strong incentive to reduce opex if they bear all costs of overspending opex. We also note the AER's concern that with too strong an incentive, NSPs may seek to reduce service levels along which may not be in consumers' interests. It further believes that a 30 per cent penalty on the total amount of overspend is appropriate, i.e., that consumers would ultimately pay 70 per cent of the penalty.

From COSBOA's perspective, there are strong *a priori* grounds for concern that consumers should be required to pay any of the penalty associated with profligacy or poor decisions on the part of an NSP, whether it is due to poor forecasts or some other reason. Of course, there may be valid reasons for overspending, in which case it may be appropriate for consumers to bear some of the risk. It would be helpful if the AER could provide further information or argument to substantiate the nature of penalties for overspending that consumers would be required to pay and to substantiate a 30:70 split. If consumers are to be asked to pay a share of the penalties they need to understand what it is they are paying for and why.

Referring back to our comments on the penalties for overspending of capex, we agree with the AER that there are differences between capex and opex which could provide a basis for having higher penalties for capex overspend than for opex. However, this should not be taken to mean that we necessarily support a lesser penalty for opex overruns, or that we support symmetric incentives/penalties for opex overruns. As alluded to above, we believe that the AER should investigate the desirability of a stronger penalty for opex as well.

Excluded costs and *ex post* adjustments

The AER points out that certain costs – pass through costs, debt raising costs and "other uncontrollable costs" – have hitherto been excluded from the EBSS. COASBOA is concerned that excluding these costs provides the NSPs with little incentive to control them. Even though they are outside the direct control of the NSPs, it is still important to provide the NSPs with incentives to lower them wherever possible. If they are excluded from the EBSS, any incentive for them to do so is blunted and all the risks associated are transferred to consumers. It would be worth the AER considering this matter further and exploring ways in which these costs can be more tightly controlled through the incentive structure.

The current EBSS also allows for adjustments to opex forecasts used to calculate carryover amounts into the next period that reflect differences between forecast and actual demand growth. We have a concern that this removes part of the incentive for NSPs to produce accurate forecasts, especially as (aside from Victoria) there is a financial reward to NSPs from over-forecasting and forecasts lack independence.

As a general rule, the AER may want to consider the proposition that all opex costs should be included in the EBSS and that the onus is placed on the NSP to show cause as to why particular costs should be excluded. Consistent with other parts of the BRP, the decisions should be based on a set of criteria with the objectives of providing NSPs with incentives to spend efficiently.

Ex Post Consideration of Capex

This section responds to Section 5 of the Issues Paper and to Questions 24 to 29.

COSBOA preference is for the application of *ex ante* measures for capex rather than *ex post* ones. However, we recognise that reliance only on the former, even with the addition of a CESS, may not be sufficient to always create incentives for efficient capex and still allows the NSPs some scope to have inefficient capex included in the RAB, with higher prices for consumers. The Issues Paper lists three reasons for an *ex post* review that are supported by the new Rules, namely:

- Inefficient capex above an NSP's allowance;
- Inflated related party margins; and
- Capitalised opex due to changes in an NSP's capitalisation policy.

We therefore support the application of a limited form of *ex post* capex discipline on the NSPs. In doing so, we recognise the concerns of the NSPs about the application of an *ex post* approach, but believe that these concerns can be minimised by limiting the extent and circumstances in which an *ex post* review is undertaken. We also note that the 'threat' of such a review, even if only used in limited circumstances, can be a powerful signal to NSPs to avoid its application by keeping their capex outside of the parameters for such a review.

The tiered approach outlined in the Issues Paper would limit the scope and application of an *ex post* review, but also allows it to be invoked should an NSP trigger any of the conditions for a review. This threat and the risk that a full review would be an intensive exercise should help to dissuade NSPs from the sort of activity that would trigger a review.

ATTACHMENT: List of COSBOA Members

Australasian Association of Convenience Stores

Australian Booksellers Association

Australian Digital Television Association

Australian Equipment Lessors Association

Australian Hairdressing Council

Australian Human resources Institute

Australian Livestock and Rural Transporter Association

BPW Australia (Australian Federation of Business and Professional Women)

Business Enterprise Centres Australia

CITT (Council of Information Technology & Telecommunications)

Commercial Asset Finance Brokers Association of Australia

Convenience and Mixed Business Association

Fitness Australia

FSV

Independent Retailers Organisation

Institute of Public Accountants

National Financial Services Federation

National Independent Retailers Association

Pharmacy Guild of Australia

Pittwater Business Limited

Real Estate Institute of Australia

Stocktakers Institute of Australia

Tasmanian Small Business Council

University of Western Sydney