11 March 2022

Australian Energy Regulator

GPO Box 520
Melbourne Vic 3001

By email: incentivereview@aer.gov.au

Discussion Paper – Review of incentive schemes for networks

CitiPower, Powercor and United Energy welcome the opportunity to respond to the Australian Energy Regulator's (AER) Discussion Paper – Review of incentive schemes for networks (the discussion paper).

We agree with the AER's view that the efficiency benefit sharing scheme (EBSS) is working well to incentive efficient investment and the service target performance incentive scheme (STPIS) is generally fit-for-purpose and delivering positive outcomes for customers.

We understand the AER's primary concern is whether the capital expenditure sharing scheme (CESS) is achieving the intended objectives of incentivising efficient network investment. Specifically, the AER raises concern that network businesses may be over-forecasting their capital expenditure needs and deferring projects to future regulatory periods. The AER is therefore considering potential amendments to the CESS, which may include amending the sharing ratio or applying a tiered sharing ratio to individual network businesses, based on threshold measures of historical expenditure and forecasts.

Our submission outlines why the CESS is operating effectively to incentive efficient investment and why amendments to the scheme are not required at this time, including:

- the CESS is incentivising network businesses to seek capital efficiencies and has resulted in material consumer benefits. HoustonKemp analysis calculates consumers have benefited at least $13.4 billion because of the three main AER incentive schemes including the CESS, EBSS and the reliability component of the STPIS. The CESS has delivered $2.9 billion of these customer benefits reflecting an average saving per customer of $269
- there is insufficient evidence from one regulatory period, where allowances were set up to ten years ago, to demonstrate a systemic over-forecasting problem, particularly when the observed period occurred during a significant time of industry restructuring and innovation
- the AER has already increased its scrutiny over expenditure forecasts through the previous round of regulatory reviews and has recently introduced the Better Resets Handbook, which places additional stakeholder scrutiny over forecasts. The AER should reasonably expect to observe expenditure outcomes more closely aligned to forecasts over the next and subsequent round of regulatory determinations
- the AER already has extensive information gathering powers, both through the annual regulatory reporting requirements and the information request process during a regulatory determination. The AER has demonstrated its ability to effectively use these powers through its decision to adjust Powercor's CESS carryover allowance in the 2021-2026 regulatory determination
- it is necessary to retain the current sharing ratio on the CESS to maintain a balanced incentive framework. This is because operating expenditure is subject to additional incentives under the AER's benchmarking analysis and commercial profitability drivers

40 Market Street
Melbourne VIC Australia
T (03) 9683 4444
F (03) 9683 4499

CitiPower Pty Ltd
ABN 76 064 651 056
General Enquiries 1300 301 101
www.citipower.com.au

Powercor Australia Ltd
ABN 89 064 651 109
General Enquiries 13 22 06
www.powercor.com.au

United Energy Distribution Pty Ltd
ABN 70 064 651 029
General Enquiries 13 22 09
www.ue.com.au

- maintaining the current CESS sharing ratio is needed to sufficiently motivate management to keep driving efficiency savings once the easy gains have been delivered, particularly as driving greater efficiency savings requires even more innovation, risk, and investment from the business.

Should the AER remain concerned with the current operation of the CESS, we would recommend:

- reconsidering the merits of adjustments to the CESS after observing a second period of outcomes, particularly given the change in the AER's assessment approach at the previous round of resets and the introduction of the Better Resets Handbook
- reviewing the current regulatory reporting requirements in schedule 1 of the RIN and assessing if these remain fit for purpose for the AER and stakeholders to understand the key drivers of deviations between actual and forecast
- engaging with networks more regularly to openly discuss expenditure trends relative to allowances, to gain a better understanding of efficiency drivers over time and outside of the formal regulatory determination process.

We are very concerned by the suggestions posed in the discussion paper to introduce a tiered sharing ratio for the CESS, because:

- the proposed individual application of CESS sharing ratios may punish high-performing networks, who have delivered material capital expenditure efficiencies in the past and have invested time, resources, and management attention to deliver these for the long-term benefit of customers
- a tiered incentive application will lead to adverse market impacts and network behaviour by creating an effective cap on underspending where networks will be incentivised to scale back on efficiencies to avoid triggering the threshold.

To justify any amendments to the CESS, the AER must:

- first evidence that CESS outcomes are primarily due to issues with the expenditure forecasts and these issues are not being resolved through both the AER's greater scrutiny over expenditure forecasts and effective information gathering powers and the introduction of the Better Resets Handbook
- second be assured that the risks introduced by amending the scheme do not exceed the perceived benefits, such that any amendments are in long-term customer interests in accordance with the National Electricity Objective.

We strongly encourage the AER to open a review of outcome-based incentives schemes which provide an essential and highly effective counterbalance to expenditure incentives.

We would also support a targeted review of the STPIS to consider whether the calculation of the major event day (MED) thresholds should be amended to exclude the effects of severe weather events.

Should you have any queries please do not hesitate to contact me on [redacted]

[redacted]

Yours sincerely,

Megan Willcox
Head of Regulatory Performance and Analysis
CitiPower, Powercor and United Energy

1 There is insufficient evidence of the problem to justify scheme amendments

1.1 Further evidence is needed to demonstrate over-forecasting is a driver of CESS outcomes

The AER's primary concern is that network businesses may be over-forecasting their capital expenditure needs and deferring projects to future regulatory periods. To address this perceived problem, the AER is considering incremental amendments to the CESS, which they note may include amending the CESS sharing ratio or applying a tiered incentive rate application to individual networks, based on historical performance.

We note the AER's concerns come from analysis on aggregated network trends with a pattern of underspending in the last regulatory period followed by an increase in the forecast for the current period. However, we note this initial pattern is equally consistent with networks efficiently responding to the CESS by driving efficiency savings early to deliver savings for customers, followed by increases in forecasts reflecting the changing demands being placed on networks. Notably the industry experienced a period of acquisition and consolidation in the last regulatory period, as well as unanticipated growth in solar and energy efficiency which materially impacted energy demand. It is difficult to draw legitimate conclusions regarding the effectiveness of the CESS from one regulatory period which reflected a time of significant transition.

We also note that the incentives were materially different prior to 2016 when CESS and forecast depreciation were introduced. Prior to these, businesses were under the actual depreciation approach and there was no adjustment for deferrals. Therefore, relevant data for AER consideration should be from 2016 onwards and given the short time framework, there is insufficient data to conclude a systematic issue with CESS.

Further, looking more globally at incentive regimes, UK distribution networks have underspent by a greater amount compared to Australian distribution networks. As such, the Australian underspend is in line with underspending in a comparable jurisdiction.

Given reasonable alternative explanations for the AER's observed patterns, and the short period over which it has observed the pattern, further evidence and analysis should be conducted to better understand the issues.

1.2 The AER has materially increased scrutiny of expenditure forecasts which will be reflected in future CESS outcomes

Regulatory allowances set in the more recent round of determinations have been subject to a greater degree of scrutiny by the AER. The AER has applied increased scrutiny through both the application of its expenditure level assessment tools, the introduction of expenditure category level guidance notes, an extensive bottom-up review on each expenditure category, additional external expert reviews and workshops, and an extensive information request process. The AER is yet to see the impact of the increase scrutiny on CESS outcomes. The combination of increased scrutiny and reduced merger and acquisition activity would suggest the AER can expect actual spend to align with allowances more clearly through the next round of regulatory determinations.

Further scrutiny will also be applied to expenditure forecasts in the next round of regulatory determinations with the introduction of the Better Resets Handbook which further uplifts expectations in relation to earlier and deeper engagement with AER and customer stakeholders through-out the development of the proposal.

We therefore encourage the AER to allow more time to see the effect of the changes in its assessment approaches and the introduction of the Better Reset's Handbook before amending what are well functioning incentive arrangements.

1.3 The AER has extensive information gathering powers and demonstrated ability to adjust the CESS

The annual regulatory information notices (RINs) require networks to provide explanation of material deviations between forecast allowance and actual spend by category level (Annual RIN schedule 1) and the AER regularly follows up with additional questions on material variances between forecasts and outturn expenditure and customer outcomes.

Further, the AER already has wide-ranging powers to issue questions and information requests to networks during the regulatory determination process if it needs to better understand spend and decisions. Our regulatory determination process involved responding to over 2,500 separate AER questions on our expenditure forecasts. Given the AER retains the discretion to reject a networks regulatory proposal if it is not satisfied with the information it receives, the burden of proof is on networks to provide sufficient information to satisfy the AER.

The AER has demonstrated the effectiveness of its information gathering powers and its ability to make CESS adjustments in Powercor's 2021-2026 regulatory determination. The AER successfully applied a CESS adjustment of $51 million (nominal). We therefore encourage the AER to review the existing reporting requirements to understand whether they are fit-for-purpose to understand the key drivers of deviations between forecasts and outturn prior to introducing additional reporting requirements on networks.

2 The AER's expenditure incentive schemes are delivering on intended purpose and are well balanced

2.1 Customers are benefiting through long-term savings

Efficiency savings achieved under the expenditure incentives reflect long term savings for customers, resulting in lower network tariffs over time for customers. HoustonKemp analysis demonstrates consumers have benefited by at least $13.5 billion because of the three main AER incentive schemes including the EBSS, CESS and the reliability component of the STPIS. CESS has delivered $2.9 billion of these customer benefits reflecting an average saving per customer of $269.

Under the CESS, spending less than a given capital expenditure allowance is unambiguously efficient and in consumers long term interests, provided quality standards continue to be met. The CESS is a functional tool which ensures networks have continuous incentives to deliver savings as early as efficient and every dollar saved or deferred is of benefit to customers.

We agree with the AER that the EBSS is fit for purpose and operating as intended by incentivising efficient operating expenditure and delivering benefits to consumers. The EBBS provides a constant incentive to reduce operating expenditure and recent inclusion of a positive productivity factor guarantees that customers receive 100% of the expected improvement in productivity over the regulatory control period.

2.2 The incentives schemes encourage management to really push to seek efficiencies

In the 2016-2020 regulatory period, much of our efficiency savings were delivered through a holistic overhaul of our resource partner contracting arrangements, merging our CitiPower, Powercor and United Energy corporate operations, and extensive investment in automating processes and systems across the organisations. Notably, many of these initiatives have not yet been adopted by other networks and therefore customers have not yet received the benefits. To continue to drive innovation to seek out more efficiency savings, we must work harder and take on greater risk, which requires management to be adequately incentivised.

As a result of our persistent commitment to delivering efficient cost saving for our customer, our electricity tariffs are one of the lowest across the National Electricity Market (NEM), while we continue to deliver the most reliable networks. These outcomes are a result of significant management effort to seek genuine efficiencies in response to the current effective incentive arrangements.

We urge the AER to take a long-term view of the efficiency's networks are delivering for customers. Placing trust in the effectiveness of the incentive regime will ensure the best outcomes for customers over the long term.

3 AER suggested amendments to the CESS are likely to have perverse impacts

3.1 The CESS sharing ratio should remain to ensure continued incentivises to seek efficiencies

The current incentive framework drives networks to seek efficiencies for customers. However, it becomes increasingly challenging to drive efficiencies over time once the 'quick wins' have been realised and therefore greater management focus and effort is required to take on higher risk, higher cost investment and innovations necessary to deliver greater efficiencies. Therefore, a strong incentive over time is required to continue incentivising networks to meaningfully invest and innovate in evolutions that will drive transformational shifts in operational process and deliver permanent savings for customers.

We are concerned that a lesser incentive to seek efficiencies under a lower CESS sharing ratio will lead to management being less willing to put in the discretionary effort needed to continue to deliver more savings for customers, as there is insufficiency reward or certainty over the reward in doing so. This will ultimately lead to poorer customer outcomes over the long-term.

3.2 The incentive framework is balanced with the current CESS sharing ratio

The AER notes in its discussion paper that the EBSS and CESS are not providing *equal* rewards and penalties and the AER questions whether this imbalance distorts decision-making.

The AER's objective however should be for a balanced **incentive framework**, as opposed to focusing on a balanced sharing ratio. The current incentive framework between operating and capital expenditure is balanced with a stronger sharing ratio on the CESS. This is because operating expenditure is also subject to additional incentives, including the AER's benchmarking which has a real reputational effect, as well as commercial profitability drivers – this is because operating expenditure savings deliver higher profit outcomes compared with equivalent capital expenditure savings in any given year. Therefore, to ensure the overall incentive framework is balanced, it is imperative that the current CESS sharing ratio remains.

3.3 The AER's potential tiered incentive will punish high-performing networks and introduce distorted network behaviour

The AER proposes to address its concern of over-forecasting by varying the incentive rate by network based on past performance under the CESS. We understand the AER is considering identifying these networks after observing a pattern of underspending followed by higher forecasts.

It is unclear how the AER's proposed amendments address the AER's perceived problem of over-forecasting. Notably, it is unclear how the AER will determine which networks have delivered saving through genuine efficiency gains or through over-forecasting. It is also unclear how the scheme would be applied if the AER determined there was a genuine need for an expenditure uplift in the next period. Indeed, it is likely that networks that drove the greatest efficiencies in the latest period will have no residual capacity to absorb cost increases required to deliver new capabilities required to address a transiting energy market.

We are concerned the proposed approach creates incentive distortions which risk undermining the effectiveness of incentive-based regulation:

- First, the proposed individual application of CESS sharing ratios risks punishing high-performing networks that have invested effort and resource to drive efficiency savings for customer benefit. Networks that have delivered material capital expenditure efficiencies in the past have invested time, resources, and management attention to deliver these.
- Second, a weaker incentive for more efficient networks will dilute incentives at the point in time which they need to be strong to deliver even better customer outcomes. Delivering more efficiency savings in future periods becomes increasingly challenging as the 'quick wins' have already been achieved. This means that management require a strong consistent incentive over time to continue to meaningful search and invest in

more innovative business evolutions that will drive shifts in operations which deliver additional long-term savings.

- Third, a tiered incentive will also lead to adverse market impacts and perverse network behaviour by creating an effective cap on underspending where networks will be incentivised to scale back on efficiencies to avoid triggering the threshold. On the other hand, it also could create an incentive for networks to purposefully overspend to trigger the threshold if the network expects to overspend in the next regulatory period. In this case, networks will be incentivised to trigger the threshold to decrease the penalty they incur in the following period.

We would encourage the AER to closely consider the risks of distorting incentive arrangements and not to introduce such distortions without clear evidence of a problem with the CESS, which cannot otherwise be addressed through the AER's increased scrutiny over expenditure forecasts.

4 Our proposed way forward to address the AER concerns

4.1 The AER's solution does not address their identified concerns

It is unclear how the AER's proposed incremental amendments to the CESS clearly address the AER's perceived over-forecasting problem. To the extent that a reduced incentive rate or tiered incentive mechanism does bind and alter behaviour, it may result in networks achieving fewer genuine efficiencies. Alternative mechanisms exist that more directly target the AER's concern of networks over forecasting. We expand on our suggestions below.

4.2 Wait to see how effective the increased scrutiny and Handbook have been

We understand the AER's primary concern is the magnitude of the incentive rewards received in the previous round of regulatory determinations which reflected allowances set five years prior. However, allowances set in the more recent round of determinations have been subject to a greater degree of scrutiny by the AER and further scrutiny will be applied in the next round of regulatory determinations through the uplift in customer and informed stakeholder engagement through-out the development of the proposal. In recognition of the growing role of stakeholder engagement we are also intending to communicate with our Customer Advisory Panel (CAP) on annual spending against allowances.

We urge the AER to allow more time to see the effect of the change in its assessment approaches and the introduction of the Better Reset's Handbook before changing the incentive arrangements.

4.3 Trust in your information gathering powers and review if they are fit for purpose

The annual regulatory information notices (RINs) require networks to provide explanation of material deviations between forecast allowance and actual spend (Annual RIN schedule 1). Further, the AER already has wide ranging powers to issue questions and information requests to networks during the regulatory determination process if it needs to better understand spend and decisions. We encourage the AER to review the existing reporting requirements to understand whether they are fit-for-purpose prior to introducing additional requirements on networks.

The AER has also demonstrated that it does not face impediments in applying CESS adjustments where it considers there has been a material capital expenditure deferral. For example, the AER did not face an evidence burden in making its decision to apply a CESS adjustment to Powercor in relation to poles and therefore there is no demonstrated need to further amend the criteria for making CESS adjustments. We encourage the AER to utilise and target these powers when faced with a particular concern about a network's spend, rather than consider standardised reporting requirements or amendments to the scheme.

4.4 Focus on increasing outcome-based incentives to better balance expenditure incentives

We encourage the AER to ensure there is sufficient incentives on driving innovation and long-term efficiency. The need to incentivise innovation is particularly important as we transition to a new energy future and the development of new energy services and markets. A key challenge for the AER is to incentivise networks to manage the Energy Security Board's post 2025 NEM reform.

We commend the AER's introduction of the customer service incentive scheme (CSIS) where customer outcomes are the focus. Outcome-based incentives like the STPIS and the CSIS are essential for delivering customer outcomes and counter-balancing the expenditure incentives. We encourage the AER to undertake a review to increase the incentives for outcomes-based incentives which reflect services and outcomes our customer values. For example, we encourage the AER to consider increasing the revenue at risk on the CSIS and providing flexibility for new incentives to deliver DSO functionality and more non-network solutions. The increased focus on outcome-based incentives will both assist with incentivising networks to manage the Energy Security Board's post 2025 NEM reform and counter balance the incentive on expenditure incentives.

5 Review STPIS in context of changing operating environment

Our operating environment is changing with severe weather events having more impact on our customers lived experience. While we agree with the AER that the STPIS is generally fit-for-purpose and is delivering positive outcomes for customers, we encourage the AER to undertake targeted review of the STPIS to consider whether the calculation of the major event day (MED) thresholds should be amended to exclude the effects of severe weather events, consistent with the IEEE 4.15 Beta catastrophic exclusion method.