3 March 2023

Australian Energy Regulator

GPO Box 520
Melbourne Vic 3001

By email: incentivereview@aer.gov.au

Draft Decision – Review of incentive schemes for networks

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

We agree with the AER's draft decision to keep the efficiency benefit sharing scheme (EBSS) and the service target performance incentive scheme (STPIS) for distribution networks unchanged given the schemes are working well and delivering positive outcomes for customers. The AER's draft decision is also to vary the capital efficiency sharing scheme (CESS) to introduce information transparency requirements and to apply a tiered arrangement (Bright-Line Tiered Test).

As raised in our previous submissions, we believe the core issue at hand is an information asymmetry between networks, stakeholders, and the AER regarding the drivers of CESS outcomes. As such, we support the AER's draft decision to introduce information transparency measures on the explanations of the drivers of a network's actual capital expenditure (capex) incurred and the approved forecasts. We strongly believe that the customer concerns raised during the previous resets questioning CESS benefits (which is the basis for the AER's review) could be genuinely addressed by this recommendation. In recognition of this position, we have initiated a project to better track our actual spending relative to regulatory allowances at both a category level and for marquee projects in the regulatory reset. We intend to communicate the outcomes with our Customer Advisory Panel (CAP), the AER and other stakeholders annually following preparation of the regulatory information notices (RINs). Importantly, this presentation will be accessible for a broad audience and will include an explanatory narrative.

We also agree that of all the options considered by the AER, the Bright-Line Tiered Test presents the least risk in terms of introducing perverse incentives, regulatory discretion and unintended consequences that are not in customers' long-term interests. Compared with the other proposed options to amend the CESS, Bright-Line Tiered Test provides a transparent, objective, and neutral scheme which is equally applicable to all networks in all circumstances. This option continues to incentivise networks to seek efficiency savings, albeit at a diminishing incentive rate.

We do, however, raise concern with the proposed asymmetric design of the Bright-Line Tiered Test. We are not convinced of the AER's hypothesis that by applying the Bright-Line Tiered Test asymmetrically it has the effect of providing an **offset to potential asymmetry in the forecasting error.** This hypothesis is made on the assumption that all capex forecasts are already inflated and thus firms should bear a larger portion of any overspending, relative to underspending. In the context of the energy transition, there is no reasonable basis to consider the risk of over-forecasting to be greater than the risk of under-forecasting. Given government policies are currently lagging their emissions targets, there is real risk government policies are accelerated during the regulatory period, requiring materially more network investment than forecast.

The AER already has an existing ex-post mechanism which allows them to consider the efficiency and prudency of any capital overspend and decide to exclude inefficient capex from a networks regulatory asset base (RAB).

Pairing this ex-post mechanism with an increase in the relative penalty for overspending for networks may introduce perverse incentives compounding the original perceived concerns of an incentive to over-forecast. This response follows the economic theory of firms rationally aiming for a high forecast as a hedge against overspending since overspending is now more costly. We believe the existing ex-post mechanism more directly and sufficiently addresses the issue of potential inefficient networks as opposed to an asymmetric CESS.

It could also be argued that for the same reasons the AER believes they lack trust in the forecasts when underspending of more than 10 per cent occurs, the same logic can be applied to networks overspending. When a business overspends by more than 10 per cent it is likely something material has changed in terms of circumstances (for example, forecasting assumptions, macro environment).

We recommend the AER reconsider the design of the proposed scheme to provide symmetric tiered incentives, meaning the penalties imposed on the networks for cost increases will mirror the rewards provided under the schemes. In any case, the AER should provide more economic analysis on the decision to move away from a symmetric CESS.

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

Yours sincerely,

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