Submission to the AER on the Draft Capital Expenditure Incentive Guidelines

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About CHOICE

CHOICE exists to unlock the power of consumers. Our vision is for Australians to be the most savvy and active consumers in the world.

As a social enterprise we do this by providing clear information, advice and support on consumer goods and services; by taking action with consumers against bad practice wherever it may exist; and by fearlessly speaking out to promote consumers' interests – ensuring the consumer voice is heard clearly, loudly and cogently in corporations and in governments.

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CHOICE thanks the Australian Energy Regulator (**AER**) for the opportunity to provide a response to the Draft Capital Expenditure Incentives Guidelines (**Guidelines**).

We also thank the AER for its significant efforts in engaging stakeholders including through its Consumer Reference Group as part of the Better Regulation program.

We note that the Guidelines are ultimately aimed at ensuring that consumers pay only for efficient capital expenditure (**capex**) undertaken by electricity network service providers (**NSPs**).[1]

CHOICE believes that the approach set out in the Guidelines does not provide a framework that would deliver outcomes focused on the long term interests of consumers. Specifically, we consider that the Guidelines in the context of the whole regulatory framework will not ensure that the regulated asset base (**RAB**) includes only efficient capex that is recovered from consumers as required by the capital expenditure incentive objective in the National Electricity Rules (**NER**).[2]

'Symmetric' or 'asymmetric' incentives

CHOICE notes that the AER has departed from its initial position in the relevant issues paper, which was for an asymmetric Capital Expenditure Sharing Scheme (**CESS**) with greater penalties than rewards. Instead, the AER is now proposing a 'symmetric' CESS with a reward and penalty of 30 per cent respectively. The AER states that '[i]n recommending a symmetric CESS we have considered the interactions between the CESS, the ex post review and our approach to capex forecasting'[3].

It is our view that the regulatory system when considered as a whole means that a 'symmetric' CESS with a reward and penalty of 30 per cent respectively does not provide sufficient incentives for NSPs to undertake efficient capex. Specifically:

- It is unclear that a penalty of 30 per cent provides a sufficiently strong counterbalance to the benefits of a larger regulated asset base (**RAB**) for NSPs and is strong enough to change the behaviour of NSPs to encourage an efficient and commercial approach.
    - We note that in claiming the 30 per cent penalty is 'symmetric', the AER does not take into account the long-term benefits to the NSP of inclusion of the asset in the RAB. The quantum of this benefit depends on factors such as the life of the asset and the differential between the actual and the allowed cost of capital, but generally means the real impact of the penalty is greatly reduced.

[1] Page 6 of AER Better Regulation Explanatory statement, Draft Capital Expenditure Incentive Guidelines, August 2013.
[2] Page 8 of AER Better Regulation Draft Capital Expenditure Incentive Guidelines August 2013.
[3] Page 8 of AER Better Regulation Explanatory statement, Draft Capital Expenditure Incentive Guidelines, August 2013.

- In addition, where the overspend is efficient, NSPs are able to recover financing costs for the over-expenditure within the regulatory period in which they were incurred, further diminishing the level of the incremental penalty for overspends.

- The regulatory design allows for pass throughs, re-openers and contingent projects, all options that are not available to consumers.

- Information asymmetry is likely to result in capex forecasting being biased upwards (discussed in further detail below).

- The effectiveness of ex post measures in identifying inefficient capex overspends is severely hampered by:

  - the restriction placed upon the AER to 'only take into account information and analysis that the NSP could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure'

  - the length of time between when the relevant expenditure was made and the AER's assessment (up to 7 years)

  - the practical difficulties in identifying inefficient expenditure

  (discussed in further detail below).

Forecast assessments

CHOICE notes that the AER considers that it will be able to address concerns about allowances being biased upwards through its forecasting approach.

We appreciate that the AER has undertaken extensive work with the aim of significantly improving its approach to expenditure assessment. Notwithstanding this, we consider that the AER will be unlikely to accurately predict efficient expenditure requirements with the result that forecasts are likely to be biased upwards due to:

- the information barriers that it faces when assessing the reasonableness of NSP proposals

- the limitations that it has in rejecting a NSP proposal[4].

In addition, we note that the AER is required to provide NSPs with 'a reasonable opportunity to recover at least the efficient costs the operator incurs'.[5]

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[4] 'Under the NER the AER is not "at large" in being able to reject the NSP's proposal and replace it with its own since it must accept a reasonable proposal. Nonetheless, the AER should determine what is reasonable based on all of the material and submissions before it.', page vii of AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, Sydney.

We also note that improved forecasting by the AER through use of benchmarking while welcome is likely to be limited in its applicability until the AER has sufficient data available to track changes in efficiency over time.

In these circumstances, CHOICE believes it is unrealistic for the AER to rely extensively on improved forecast assessments as a means to address concerns about allowances being biased upwards. We therefore consider that a stronger penalty under a CESS is required to mitigate the biased allowances.

Ex post review

CHOICE notes that the AER considers that the threat of ex post measures will minimise inefficient capex overspends by NSPs.

We believe that in practice, identifying inefficient overspend is likely to be extremely difficult with the legal requirement that the AER 'only take into account information and analysis that the NSP could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure'.

We also note that while ex post review is utilised in the United States, the regulatory system involves a high degree of asset-specificity and controls with much shorter duration. These differences mean that ex post review in Australia is a very different proposition to that in the United States as it is much harder to identify where the inefficiency has occurred.

The above issues are likely to be exacerbated by the time lag between when the relevant expenditure was made and the AER's subsequent assessment, which could be up to 7 years.

As such, we do not consider that the AER is correct in assuming that the ability to exclude capex from the RAB enables a weaker penalty for overspending in an assymetric CESS.

Incentives across capex, opex and service

It is not clear why the AER considers that a 'symmetric' CESS with a reward and penalty of 30 per cent is needed to 'balance' incentives across capex, operating expenditure (**opex**) and service.[6] CHOICE does not believe that a 'balance' would incentivise NSPs to engage in efficient expenditure.

In relation to the interaction between capex and opex, it appears that historically there has been a strong incentive for NSPs to capitalise opex in the absence of a CESS given the financial benefits of a larger RAB over the long term.

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[5] Page 18 of AER Better Regulation Explanatory statement, Draft Capital Expenditure Incentive Guidelines, August 2013.

[6] Page 8 of AER Better Regulation Explanatory statement, Draft Capital Expenditure Incentive Guidelines, August 2013.

However, it is not clear that in circumstances where there is an ‘asymmetric’ CESS with a higher powered penalty than reward that this would provide additional incentive for NSPs to capitalise opex. That is, an additional incentive above that which appears to have existed historically.

For example, it is not clear that a CESS with a reward of 30 per cent and a penalty of 70 per cent alongside an Efficiency Benefit Sharing Scheme (**EBSS**) with a reward and penalty of 30 per cent respectively would provide additional incentive for NSPs to capitalise opex. Indeed, given that an overspend in capex would result in a penalty, it is our view that this would provide a bigger disincentive to capitalise opex.

In addition, where there is an ‘asymmetric’ CESS with a higher powered penalty than reward, NSPs are not likely to convert capex to opex as this means the investment could not be rolled over into the RAB. We also note that the AER is able to make an adjustment to the RAB to account for capitalised opex[7].

Similarly, there does not appear to be a strong case for ensuring that incentives are the same across capex and service to promote efficient NSP expenditure.

Recommendations

- We recommend that the AER adopt an asymmetric CESS with a higher powered penalty than reward. For example, a penalty of 70 per cent and a reward of 30 per cent. We note that for those NSPs that do not overspend, the level of penalty under a CESS is irrelevant.

- We recommend that the AER in determining the penalty value under a CESS conduct further investigation on the interaction between the value of the penalty (a) against the benefit to the NSP of the growth in the RAB, and (b) the incremental incentive this places on NSPs to engage in an efficient and commercial approach.

- We recommend that the AER reconsider the weight it is placing on ex post review in relation to its ability to minimise inefficient capex overspends given (a) the legal restrictions imposed in exercising this tool, (b) the practical problems involved in identifying specific inefficient investments and (c) the length of time between when the relevant expenditure was made and the AER’s subsequent assessment (up to 7 years).

- We recommend that the AER place greater emphasis on the constraints on its ability to accurately estimate efficient expenditure requirements given:

    - information barriers;

    - legal constraints on its ability to reject NSP proposals; and

[7] Page 39 of AER Better Regulation Explanatory statement, Draft Capital Expenditure Incentive Guidelines, August 2013.

- restrictions on the applicability of benchmarking until there is sufficient data available.

- We recommend that the AER conduct further work on the interactions between the capex, opex and service incentive schemes in order to better understand how differences in the relationships affect the incentives on NSPs to spend efficiently.