CitiPower, Powercor Australia and

SA Power Networks

RESPONSE TO THE EXPENDITURE INCENTIVES GUIDELINES FOR ELECTRICITY NETWORK SERVICE PROVIDERS—ISSUES PAPER

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1 OVERVIEW

CitiPower Pty, Powercor Australia Ltd and SA Power Networks (the **Businesses)** welcome the opportunity to make this submission to the Australian Energy Regulator (**AER**) in relation to its paper entitled "*Better Regulation: Expenditure incentives guidelines for electricity network service providers – Issues Paper" (***Issues Paper**) published in March 2013.

The AER seeks to develop incentive mechanisms for capital expenditure (**capex**) and operating expenditure (**opex**) that:

- incentivises Distribution Network Service Providers (**DNSP**s) to seek efficiency improvements in capex and opex; and
- shares efficiency gains and losses between DNSPs and customers.

The AER proposes three elements to its incentive mechanisms: ex ante capex sharing scheme (**CESS**), ex post measures for efficient capex and the ex ante opex efficiency benefit sharing scheme (**EBSS**). The Businesses set out their views on each of these in turn below.

1.1 Ex ante capex mechanism

The AER identifies two concerns with the current regulatory regime, namely that DNSPs have declining incentives for efficient spending of capex over the regulatory period, and that there has been "overspending" by DNSPs.

To address these concerns, the AER proposes to introduce a CESS which in principle is designed to have the properties of:

- providing a benefit to a DNSP where it spends less than the AER capex allowance, where the DNSP retains 20 to 30 per cent of the underspend and customers obtain the remaining benefit of the underspend;
- providing a penalty to a DNSP where it spends more than the AER capex allowance, where the DNSP is penalised more than 30 per cent of the overspend, and customers fund the remainder;
- providing continuous incentives over the regulatory period, such that the benefit (penalty) for spending less than (more than) the AER allowance is the same irrespective of the year in which it was undertaken; and
- being cumulative, so that the CESS is not sensitive to DNSPs changing the timing of the spending of the capex during a regulatory period.

The Businesses do not support the AER's asymmetry in the proposed CESS where there is a relatively higher penalty for spending above the allowance compared with the benefit from spending less than the allowance. This is for a range of reasons, including that:

- the AER capex allowance is a forecast that is inevitably imperfect;
- the higher penalty will skew behaviour away from spending more than the AER capex allowance, even when that overspend is the efficient level of investment required; and
- DNSPs are not sufficiently protected through the regulatory regime from unforeseen and uncontrollable events.

The Businesses support the introduction of CESS scheme that is continuous, cumulative and does not provide a greater penalty for spending more than the AER allowance compared with the benefit

from spending less than the AER allowance. The Businesses have not had sufficient time to review the proposed CESS model that was distributed by the AER earlier this week for consistency with these principles, but may provide comments in the coming weeks.

1.2 Ex post capex mechanisms

The AER has new powers that enable it to remove capex from the amount that it allows a DNSP to roll-forward into its Regulatory Asset Base (**RAB**) for the next regulatory period, specifically:

- inefficient capex that is above the AER capex allowance;
- inflated related party margins; and
- changes resulting from an amended capitalisation policy.

The Businesses consider that the decision tree must set out the assessment process for not just capex that is above the AER capex allowance but also related party margins and capitalised opex resulting from a change to a NSP's capitalisation policy.

The Businesses are also concerned that the AER has failed to articulate the following:

- whether the decision tree applies to all instances where a DNSP has spent more than the AER capex allowance, or whether it only applies to instances where the DNSP has "significantly" overspent against the allowance;
- interaction of the ex post capex mechanisms with the ex ante mechanisms for both capex and opex; and
- the AER's approach to producing a statement of efficiency of the overall capex proposed to be rolled into the RAB.

1.3 Ex ante opex mechanisms

The AER proposes two ex ante opex incentive schemes:

- where a DNSP's opex allowance is set on the basis of revealed costs, the AER would continue to apply the existing EBSS; and
- where a DNSPs opex allowance is set on the basis of a benchmark, then the AER would apply a new opex scheme.

The Businesses consider that the AER default position should be that the incentive schemes are linked to the revealed costs of the DNSP, except in exceptional circumstances where a DNSP's overall opex is demonstrably inefficient. Furthermore, if the AER is satisfied that the revealed base year in totality is efficient it should not make adjustments to specific opex categories.

The Businesses support the retention of the existing EBSS as it has worked well to date, as acknowledged by the AER itself. However, the Businesses suggest a minor modification to the scheme where DNSPs that are found to be approaching the efficiency frontier under robust benchmarking approaches are provided a higher sharing ratio to encourage further pursuit of efficiencies as they are harder and riskier to obtain.

2 EX ANTE CAPEX MEASURES

Overall, the Businesses support the introduction of a CESS that is continuous, cumulative, with limited exclusions and uses actual depreciation. The Businesses do not support the AER's proposed asymmetric scheme which imposes higher penalties for spending above the AER allowance compared with benefits from spending less than the AER allowance.

The AER proposes a CESS to address two concerns it has identified with the current ex ante framework:

1) declining incentives for efficient capex over the regulatory period, which the AER says provides DNSPs with incentives to skew capex towards the end of the regulatory period; and
2) overspending by DNSPs.

This section discusses the Businesses' views on the principles and exclusions relating to the AER's proposed CESS.

2.1 Continuous incentives

To address the declining incentives for efficient capex, the Businesses agree that the scheme should provide continuous incentives. A continuous incentive regime encourages the DNSP to invest when it is economically efficient to do so, rather than defer or advance projects within and across regulatory control periods. In practice, DNSPs are limited in their ability to move significant amounts of capex around given the long lead times for some projects. Therefore, the skewing of expenditure should not be viewed as a significant concern.

2.2 Symmetry

To address the concern with "overspending", the AER proposes an asymmetric scheme. That is, a DNSP is rewarded 20 to 30 per cent for spending below the AER allowance but penalised greater than 30 per cent for spending above the allowance. The Businesses do not agree with the AER's proposed asymmetric CESS that provides a relatively greater penalty for spending above the AER allowance, for the reasons set out below.

Firstly, the AER forecast capex allowance will inevitably be imperfect. This is because the AER allowance is a projection of spending five years into the future, and there are many economic and business factors that will change over that time. Therefore, it would be incorrect for the AER to portray all instances where a DNSP spends below the AER allowance as reflecting an upward bias in the forecast of the DNSP. Similarly, it would be inaccurate to portray all circumstances where a DNSP spends above the AER allowance as reflecting a lack of responsiveness by the DNSP to financial incentives.

Second, spending above the AER forecast is not necessarily inefficient. As circumstances change for a DNSP during the regulatory period, spending above the AER allowance may be both efficient and prudent and therefore be beneficial to consumers. The AER may also draw such a conclusion through its ex post review of capex spend above the allowance, and therefore the application of a harsh penalty via the ex ante CESS scheme would appear inappropriate.

Third, the proposed application of higher penalty for "overspends" through the CESS may result in deferral of efficient capex, leading to degradation of network quality and consequent reductions in

service quality. The greater economic cost to society from under-investment relative to a small over-investment is well understood in regulatory economics.[1]

Fourth, DNSPs are not sufficiently protected from unforseen and uncontrollable events, as very high materiality thresholds apply. For example:

- Cost pass through events: a defined list of events set out in the National Electricity Rules (**NER**) as well as nominated events in individual regulatory decisions. The AER has specified a materiality threshold of one per cent of the smoothed forecast revenue.

  The threshold of one per cent of the smoothed forecast revenue is an extremely high hurdle, and would require a very significant value of the capex project. For example, in the case of SA Power Networks, the capex project value would need to exceed approximately $70 million for it to be a pass-through capex event.

  For another example, Powercor Australia was required to install 179 Single Wire Earth Return Remote Automatic Circuit Recloser devices in high bushfire risk areas as a result of the Victorian Bushfire Royal Commission. This was at a cost of around $8 million but Powercor Australia was unable to apply for pass-through of these costs as it did not satisfy the unduly high materiality threshold.

- Reopening provisions: per clause 6.6.5 of the NER, a DNSP can apply to the AER to revoke or substitute a distribution determination where an event that is beyond the reasonable control of the DNSP has occurred. The materiality threshold is 5 per cent of the value of the RAB in the first year of the control.

  This is also a very high materiality threshold. For example, the opening RABs for both SA Power Networks and Powercor Australia in 2016 are estimated to be around $4 billion, therefore the materiality threshold for a reopening provision is around $200 million.

- Contingency events: per clause 6.6A of the NER, the AER can amend a distribution determination to include capex associated with a contingent project (an event that was considered unlikely to occur during the regulatory period) that is now required following a trigger event. The materiality threshold for a contingency event is $30 million.

  DNSPs would rarely have such large projects, and thus are unlikely to ever reach the high materiality threshold.

Finally, the Businesses are not convinced that “overspending” is a major concern with the current ex ante framework. In particular, the AER suggests in Figure C of the Issues Paper that Victorian DNSPs have been “overspending” in the most recent regulatory period. However, the AER also notes that:

> “There are a number of factors that have driven the recent capex increases…it is difficult to draw any strong conclusions from the data. To the extent that capex drivers have been analysed, the

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[1] AER, *Promoting efficient investment – protecting consumers from paying more than necessary*, speech, AEMC Public Forum, 23 November 2011, available from: http://www.aer.gov.au/sites/default/files/as00211_Promoting%20efficient%20investment%20-%20protecting%20consumers%20from%20paying%20more%20than%20necessary.pdf.

conclusions have been varied and tend to point to NSP specific circumstances or characteristics".[2]

Therefore, any spending above the allowance in Victoria might reflect the specific circumstances of some of the DNSPs, and therefore might not reflect a broader problem with the regulatory framework. This is also supported by analysis conducted by the Australian Energy Market Commission (**AEMC**), which noted that it "does not consider that capex incentives in the NER provide an incentive for NSPs to spend more than their allowance".[3]

2.3 Cumulative

The Businesses support the AER's proposal for a cumulative CESS scheme. This is because capex is volatile year-on-year, as planned expenditure may be delayed due to unforeseen events or changes in circumstances. Therefore, a cumulative scheme should remove the impact of a DNSP spending below the AER allowance in one year and then above the allowance in a subsequent year.

Unfortunately the Businesses have not had sufficient time to assess whether or not the AER's proposed CESS model supports the principles of being both cumulative and continuous.

2.4 Exclusions

The Businesses support the removal of capex associated with contingent projects, pass through events and re-openers, as suggested by the AER.[4]

Generally, the Businesses consider that further exclusions from the CESS should be limited to maintain the incentives within the scheme. That said, the Businesses support the AER preparing a defined and agreed list of principles or criteria for identifying other categories of capex for potential exclusion from the CESS. Similar to the EBSS, each DNSP could then make the case to the AER for exclusion of other capex categories against the principles at the time of submitting its Regulatory Proposal.

2.5 Depreciation

The Businesses support the use of actual depreciation given the incentives that it contains in relation to efficient capex. This is because actual depreciation provides the strongest incentive to minimise capex. Furthermore, Economic Insights noted that actual depreciation is the norm for rolling capex into the RAB in the overseas jurisdictions surveyed, which included United Kingdom, United States of America and New Zealand.[5]

The Businesses recognise the main criticism of actual depreciation which is that it provides stronger incentives to minimise capex relative to the allowance for short life assets. This is counter-balanced by the fact that:

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2 AER, *Better Regulation: Expenditure incentives guidelines for electricity network service providers*, Issues Paper, March 2013, page 12.

3 AEMC, *Draft rule determinations: Draft National Electricity amendment (Economic Regulation of Network Service Providers) Rule 2012 and Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, Rule Change, 23 August 2012, page 117.

4 AER, *Better Regulation: Expenditure incentives guidelines for electricity network service providers*, Issues Paper, March 2013, page 19.

5 Economic Insights, *The use of actual or forecast depreciation in energy network regulation*, 31 May 2012, page 33.

- IT and other short lived assets are typically a small percentage of the asset base; and
- there is limited scope to substitute away from "poles and wires" type assets.

Where a CESS is in place, the AER proposes the use of forecast depreciation as the default methodology. The Businesses support the AER's consideration of the use of actual depreciation, with reference to its impact on the:

- substitutability, and the balance of incentives, between opex and capex;
- balance of incentives with service performance schemes; and
- relative incentive for expenditure on assets with differing economic lives.

2.6 Structure of the scheme

The Businesses consider that the methodology for the operation of the CESS should be simple and transparent, to ensure all DNSPs are easily able to understand and respond to the incentives contained within the scheme.

Unfortunately, the Businesses have not had time to fully assess the AER's proposed CESS model which it circulated earlier this week. However, the Businesses have some high level comments based on the model set out in Attachment 3 of the AER Issues Paper.

First, the AER's proposed CESS highlights that a reward for spending below the allowance must not be less than 30 per cent, but the outcome of the model is that:

- $10 spend above the AER allowance in year 1 results in a $5.61 penalty
- $10 spend below the AER allowance in year 1 results in $0.25 penalty, per Figure 1 below.

Capital Expenditure Sharing Scheme

		Year 1	Year 2	Year 3	Year 4	Year 5
Inputs						
Under / (over) spend		$10	$0	$0	$0	$0
WACC	10.0%					
Sharing of underspends	30%					
Sharing of overspends	70%					
Cash impact at year end		$10.00	$10.00	$10.00	$10.00	$10.00
Return on under/(over) spend			$1.00	$1.00	$1.00	$1.00
Discount factor		1.46	1.33	1.21	1.10	1.00
Brought forward capex	$14.64					
DNSP share	$4.39					
Within period benefit / (cost)	$4.64					
Reward / (penalty)	**-$0.25**					

Figure 1 Example of a $10 spend below the AER allowance in its model

The Businesses understand why the proposed CESS model shows this outcome, however the illogical application of a penalty as a consequence of a DNSP spending less than the AER allowance is best avoided. Therefore, the Businesses consider that the DNSP benefit share for spending less than the AER allowance should not be less than 30 per cent.

Second, the AER CESS model should:

- set out how it intends to address issues of tax and tax depreciation;
- consider the time period to which it applies, given that the actual capex in the fifth year will not be known at the time of the regulatory determination; and

- set out how and where the reward or penalty will be applied in the subsequent regulatory period.

The Businesses have not had sufficient time to review the proposed CESS model that was distributed by the AER earlier this week for consistency with the principles set out in the AER Issues Paper, but may provide comments at a later date.

3 EX POST CAPEX MEASURES

The AER has new ex post measures associated with efficient capex, which include:

- a new requirement for the AER to undertake an ex post review of capex entering the RAB;
- the ability for the AER to remove capex which it considers problematic from entering the RAB, in particular:
  - i) inefficient capex above allowance;
  - ii) inflated related party margins; and
  - iii) changes resulting from an amended capitalisation policy.

To provide greater certainty to DNSPs, the Businesses consider that the AER must set out a decision tree which covers its approach to all aspects of capex that can be excluded from the RAB, and not just capex above the AER allowance. The Businesses also consider that the AER must provide greater clarity on the interaction of the ex post mechanisms with the CESS and EBSS. The Businesses set out their comments below.

3.1 Capex above the AER allowance

To determine whether or not to exclude capex from the RAB that is above the AER allowance, the AER sets out in Figure 5.1 of the Issues Paper its filtering process to determine whether or not capex above the AER allowance is efficient.

It is not clear whether the decision tree in Figure 5.1 is for the AER to assess all instances where a DNSP has spent more than the AER capex allowance, or whether it only applies to instances where the DNSP has "significantly" overspent against the allowance. This is because the AER indicated at the public forum[6] that the purpose of the ex post capex measures is to target "significant" overspends. If it is the latter situation then the Businesses consider that the AER must provide greater clarity on how it would define "significant", as this would be an important factor for any DNSP in deciding whether or not to undertake efficient capex that is over the AER allowance. That is, the lack of clarity on this point may have a chilling impact on efficient investment.

Furthermore, the lack of clarity about the application of the ex post capex mechanism may give rise to DNSPs approaching the AER for pre-approval of expenditure above the allowance during a regulatory period. In effect, this might result in a mini price review for each individual capex project.

In relation to the decision tree, the Businesses consider that the AER should:

- make clear that the first question is whether or not the business has overspent;
- make clear whether this spending above the AER allowance is by category, or in aggregate (although the Businesses assume that it refers to aggregate spend);
- specify what the threshold is for "minor" concerns per stages 2 and 3 of the diagram, (e.g. quantum by value or percentage);
- provide greater clarity on the criteria for the prudency and efficiency test by which the engineers engaged by the AER will assess the capex projects per stage 4 of the diagram, (e.g. regarding optimisation testing); and

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[6] Held at the Melbourne Airport PARKROYAL Hotel, 29 April 2013.

- make clear that its assessment reflects the "no hindsight rule", given that the NER requires that the AER only take into consideration information and analysis that the DNSP could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capex.[7]

The Businesses consider that DNSPs must be entitled to a fair hearing in circumstances where the removal of capex is proposed. Therefore, the AER should also set out the process by which it would engage with the DNSP at each stage of its assessment.

The Businesses note that not all capex that is disallowed from the RAB should be excluded in perpetuity. Capex that is removed from the RAB may, at a later stage, become efficient. For example, this situation may arise where capex is spent on inefficient additional capacity, but the additional capacity eventually becomes required. Therefore the AER must outline the process for its potential re-inclusion into the RAB, including:

- where the capex becomes efficient part way through a regulatory period; and
- where the capex becomes efficient in the next regulatory period, how a DNSP could re-propose the capex in its Regulatory Proposal given that it would not be aware of whether or not the AER has excluded that capex from entering the RAB via its ex post review process.

The Businesses consider that, as a minimum, these arrangements should afford DNSPs equivalent capital protections to those provided under the speculative investment amount provisions of the National Gas Rules – namely allowance for accrued financing costs on the assets when they are subsequently deemed used and useful.

3.2 Interplay of ex post review of underspend with ex post review of overspend

The AER has noted that it has a new requirement to undertake an ex post review of capex entering the RAB. That is, the AER must complete a statement of efficiency per clause 6.12.2(b) of the NER for DNSPs. This requirement applies to capex both above and below the AER allowance.

The AER has failed to set out its process for considering the efficiency of capex below the allowance to assist in preparing the efficiency statement. The AER should include in its decision tree diagram the process by which it will assess such capex.

3.3 Related party margins and change of capitalisation policy

The AER powers relating to its ability to exclude capex from the RAB also cover inefficient related party margins and opex that has been capitalised due to a change in capitalisation approach. The AER decision tree diagram must also set out its process for the consideration of these issues.

3.4 Interplay of ex ante and ex post capex measures

The AER must set out how the ex post capex mechanisms inter-relate with the ex ante mechanisms, in particular:

- how capex that is excluded from RAB roll forward is also removed from the CESS, to remove the risk of a DNSP incurring a double penalty;
- how capex that is removed from the RAB roll forward on the basis that it is an inflated related party margin is also removed from the CESS; and

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[7] Per clause S6.2.2A(h) of the NER.

- how capex that is excluded from the RAB roll-forward on the basis of a change in capitalisation policy is also removed from the EBSS.

The Businesses request the AER set out the process and methodology, including example calculations, for each of the above matters.

4 EX ANTE OPEX MEASURES

The AER Issues Paper proposes two ex ante opex incentive schemes:

- where a DNSP's opex allowance is set on the basis of revealed costs, the AER would continue to apply the existing EBSS; and
- where a DNSPs opex allowance is set on the basis of a benchmark, then the AER would apply a new opex scheme.

The AER considers that the EBSS has worked well to date,[8] and therefore the Businesses support maintaining the existing EBSS, but with minor modifications. In particular, the Businesses consider that a higher sharing ratio should be provided to DNSPs that are approaching the efficiency frontier under robust benchmarking approaches.

4.1 Higher rewards for efficient firms

The current EBSS mechanism shares the benefits and costs of opex efficiency improvements between the DNSP and customers by ensuring that any incremental under or over spending is retained by the DNSP for a period of 5 years. The sharing ratio is currently symmetric, with around 30 per cent of the benefit or cost retained by the DNSP, with the remainder held by customers.[9]

Where the AER has a sufficiently robust data set and methodology to ascertain the identity of DNSPs approaching the efficiency frontier, the Businesses support increasing the benefit sharing ratio for those DNSPs approaching that frontier. This is because a 30:70 benefit sharing ratio provides a relatively weak incentive for frontier DNSPs to strive for further efficiencies, and therefore a higher incentive should be provided.

Efficiencies become increasingly hard and risky to implement as a DNSP approaches the efficiency frontier. As the industry matures, the scope for large and cost effective efficiency gains diminishes. That is, the DNSP has already achieved the efficiencies associated with “low hanging fruit”, and thus must undertake a higher degree of risk to obtain further efficiencies.

As efficiencies become harder to realise, customers benefit from leaving a greater share with the businesses. That is, all customers' benefit, as the improved benchmark would then be applied to all DNSPs resulting in benefits for all customers and not just those of the efficiency frontier DNSP.

Therefore, the AER must consider strengthening the incentives for DNSPs approaching the efficiency frontier to obtain efficiencies, such as by using a multiplier scheme or a longer carry-over period. The AER has previously dismissed this concept where an incentive scheme was only applied to opex on the basis that it may distort the resource allocation decisions of a DNSP between opex and capex.[10] As the AER is now proposing to introduce a capex sharing scheme, it is appropriate that the EBSS is now amended to provide a greater share of the benefits to DNSPs approaching the efficiency frontier.

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[8] AER, *Better Regulation: Expenditure incentives guidelines for electricity network service providers*, Issues Paper, March 2013, page vii.

[9] Note that the exact sharing ratio depends on the Weighted Average Cost of Capital used in the calculation.

[10] AER, *Electricity distribution network service providers: Efficiency benefit sharing scheme*, Final decision, June 2008, page 17.

For example, Ofwat in the UK currently provides enhanced incentives to the companies at the efficiency frontier. These companies receive an additional benefit of 50 per cent of the outperformance on opex allowance, i.e. 1.5 multiplier. The incentive mechanism was introduced for the 2005 to 2009 price review, [11] and in its 2009 price review Ofwat noted that its "relative efficiency analysis suggest that the leading companies have continued to improve their efficiency, and that the gap between the most and the least efficient companies remain similar to that the last price review". [12]

4.2 Benchmarking

The Businesses consider that for a profit maximising DNSP it will always respond positively to the EBSS. This fact has been demonstrated by the Businesses expenditure profile, with CitiPower and Powercor Australia approaching their fourth regulatory review, and SA Power Networks approaching its third review.

The Businesses understand that the AER is considering an alternative approach to the EBSS if it is not satisfied the DNSP has been responding to the current incentives. If the AER is not satisfied the DNSP has been responding to the EBSS it will base the DNSP's opex allowance on an industry benchmark. Under such an approach the DNSP would be subject to an opex incentive scheme with a fixed sharing ratio i.e. the DNSP will receive 30 per cent of the Net Present Value (**NPV**) of the difference between actual opex and the forecast opex, with customers receiving the remaining share of the benefits or costs, as applicable.

The Businesses consider that only where there is overwhelming evidence that the DNSP has not been responding to the EBSS, should the AER consider making adjustments to the DNSP's proposed opex forecast. Furthermore, only under an extreme scenario would it be appropriate for the AER to completely ignore the DNSP's proposed opex forecast and base the entire opex allowance on an industry benchmark.

It is vital that the AER sets out its proposed criteria to determine whether or not the DNSP will have its opex allowance forecast based on revealed cost or an industry benchmark. This is a key element of uncertainty in the AER's proposed regime, and it will be important for DNSPs to understand how they are likely to be treated.

If the AER intends that the more efficient firms will have their opex allowance set using revealed costs, and the less efficient using benchmarking, then setting the benchmark at the 75th percentile of all DNSPs is unlikely to be a realistic or achievable target. To enable those DNSPs to respond to the incentives of the opex allowance target, the AER may wish to consider using the 25th or 50th percentile as the benchmark target given that it should only be utilised in exceptional circumstances.

Benchmarking will significantly alter the distribution of efficiency gains or losses, given that the benchmark will be set independently of the actual historical costs of the DNSP. The AER recognises

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[11] Ofwat, *Future water and sewerage charges 2005-10, Final determinations*, 2004, pages 140-162. Available from: http://www.ofwat.gov.uk/pricereview/pr04/det_pr_fd04.pdf

[12] Ofwat, *Future water and sewerage charges 2010-15: Final determinations*, November 2009, page 108. Available from: http://www.ofwat.gov.uk/pricereview/pr09phase3/prs_web_pr09fd

this by noting “the total benefits that a NSP receives will depend on how its opex compares to the new benchmark”.[13]

The use of exogenous forecasting potentially undermines the symmetry of the sharing ratio as well as certainty for the DNSP as to the actual sharing ratio. This uncertainty may manifest itself in a dilution (or concentration) of the incentives potentially distorting investment decisions.

Given that DNSPs will not be aware of the relative position of their cost profile to the benchmark, transitional arrangements or glide paths should be established to smooth the impact of the change in cost base. This is particularly important given that the use of exogenous factors has not yet been tried or tested, therefore there is a genuine risk that the AER benchmark opex may be unsustainably low.

The Businesses consider that the AER must not penalise a DNSP twice through the use of benchmarking. That is, if the DNSP fails to lower its actual costs to the level of the benchmark then it will be penalised:

i) through being unable to recover its incurred costs; and

ii) through the use of a EBSS type scheme for overspending relative to its allowance.

To remove the potential for a double penalty, the AER may consider substituting the benchmark into the actual amount spent in the “revealed cost” year to drive a carry-over benefit, prior to the imposing the benchmarked opex in the subsequent regulatory period.

It is unclear how a DNSP that has its allowance set under a revealed cost approach but is subsequently reassigned an exogenous benchmarking approach (or vice versa) will be impacted under the EBSS. The Businesses seek the AER to provide clarity on this matter.

4.3 Excluded costs

The current EBSS allows DNSPs to propose a range of cost categories for exclusion, which may be justified as uncontrollable costs. The Businesses consider that the exclusion of nominated uncontrollable costs is appropriate, and that the EBSS Guideline should be clear that such costs can be excluded on this basis. However, the current guidelines suggest that a cost category should not be excluded if the cost relates to an ongoing business activity, and the Businesses do not consider this to be an appropriate criterion in assessing whether or not the cost is uncontrollable.[14]

The Businesses consider that the approach to excluded costs should be the same irrespective of which approach is used by the AER in setting the revenue allowance.

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[13] AER, *Better Regulation: Expenditure incentives guidelines for electricity network service providers*, Issues Paper, March 2013, page 30.

[14] Per AER, *Electricity distribution network service providers: Efficiency benefit sharing scheme*, Final decision, June 2008, Appendix E, page 6.

5 RESPONSES TO AER QUESTIONS

Question 1
Do stakeholders agree with the issues that we have identified about declining incentives for efficient capex? Are there any other issues that could arise from declining incentives for efficient capex? If so, what are these?

Subject to the comments in section 2.1, the Businesses agree with the issues that the AER has identified about the declining incentives for efficient capex.

Question 2
Do stakeholders support our initial view that any capex sharing scheme should provide continuous incentives in each year of a regulatory control period? Please give reasons to support your view.

The Businesses agree that a capex sharing scheme should provide continuous incentives in each year of the regulatory period, and thus the scheme would be indifferent to timing of generation of efficiency.

Question 3
Do stakeholders support our initial view that any capex sharing scheme should provide a reward for underspending of between 20 and 30 per cent? Please give reasons to support your view.

The Businesses consider that the reward for spending below the AER capex allowance should not be lower than the EBSS. For example, if the reward for underspending is 30 per cent for opex and 20 per cent for capex, then DNSPs will have an incentive to shift spending from opex to capex. This is reinforced by the illogical outcome of the AER's proposed CESS — see section 2.6.

Question 4
Do stakeholders agree with our initial position that the penalty for overspending should be greater than 30 per cent? Please give reasons to support your view.

The Businesses do not support the AER's proposed asymmetric CESS scheme involving a higher penalty for spend above the AER allowance. Please see section 2.2.

Question 5
Do stakeholders agree with our initial position that one capital expenditure sharing scheme should apply to all NSPs? Please give reasons to support your view.

The Businesses agree that a single scheme should apply to all DNSPs, however a higher sharing ratio is appropriate for DNSPs approaching the frontier, as set out in section 4.1.

Question 6

If we were to tailor different schemes for individual NSPs, what criteria should we use to differentiate between NSPs?

The Businesses have no response to this question.

Question 7

Are there any categories of capex that should not be covered by a capital expenditure sharing scheme? Why?

Please see section 2.4 above.

Question 8

When, if at all, might it be appropriate to make adjustments to a type of capex before applying a CESS? Why?

Please see section 2.4 above.

Question 9

Do stakeholders agree with our initial position to apply a continuous asymmetric capex scheme with higher penalties for overspending than rewards for underspending? Please provide reasons.

The Businesses do not support the AER's proposed asymmetric CESS scheme involving a higher penalty for spend above the AER allowance. Please see section 2.2 above.

Question 10

Do stakeholders agree with our initial position that the penalties and rewards for a capex scheme should be included in the guidelines rather than determined as part of a determination? Please provide reasons.

The Businesses agree with the AER that including the incentives in the Guidelines will provide DNSPs with a greater level of certainty than incentives being determined through the determination process.

The Businesses also believe that the Guideline should be sufficiently flexible to allow the frontier performance DNSPs to receive a higher incentive.

Question 11

Do stakeholders agree that forecast depreciation should be the default form of depreciation used to roll forward the RAB except where there is no capex sharing scheme in place or where there is persistent overspending by a NSP?

Please see section 2.5.

Question 12

Do stakeholders agree with the factors that we have identified for consideration in determining whether to apply forecast or actual depreciation?

The Businesses consider that it would be more helpful if the AER provided a decision tree regarding the use of actual depreciation, rather than just a list of factors that it will consider.

Question 13

If we continue to use a revealed cost approach to forecast opex, should the same EBSSs remain largely in place, or are more significant changes required?

A key feature of the regulatory framework is the reliance on incentives to drive efficient behaviour. The EBSS is an important part of this incentive-based framework. The Businesses support the continuing use of a revealed cost approach to forecast opex, and therefore consider that the AER should retain the current opex EBSS. As explained by the AER, the EBSS has been designed to complement the revealed cost opex forecasting approach.

The Businesses agree with the AER's preliminary assessment that where the EBSS has been in place it is operating as intended providing long term benefits to customers. That is, it has resulted in NSPs revealing their underlying efficient costs and thus has proven effective and reduced the cost of opex assessment.

The Businesses consider that the EBSS should provide stronger incentives for those NSPs on the efficiency frontier to continue to push the frontier, as discussed in section 4.1.

Question 14

Does an incentive power of 30 per cent provide a sufficient incentive to achieve efficiency gains?

The AER considers that a power of 30 per cent provides a sufficient incentive for a NSP to make efficiency improvements.[15]

However, a 30:70 benefit sharing ratio provides only weak incentives for frontier network service providers particularly as NSPs will need to bear additional risk to strive for further efficiencies. Therefore, where robust benchmarking is in place, the AER must consider strengthening the incentives for firms approaching the efficiency frontier to obtain efficiencies, such as by using a multiplier scheme, as discussed in section 4.1.

Question 15

Are there any circumstances where balancing the opex incentive with the capex and service level incentives may not encourage economic efficiency?

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15 Australian Energy Regulator, *Better regulation – Expenditure incentives guidelines for electricity network service providers*, Issues Paper, March 2013, page 29.

The opex, capex and service level schemes are all related, such that a change in one scheme impacts the others. Therefore the AER must ensure that its approach to the various schemes is balanced so that a NSP's incentives are not distorted.

The AER should also consider the interplay of the opex, capex and service level incentives with that for demand management or other new incentive schemes.

Question 16

Do stakeholders agree the EBSSs should provide a continuous incentive in each year of a regulatory control period? Are there any circumstances where a continuous incentive may not encourage economic efficiency?

The Businesses agree that the EBSS should be continuous such that it is indifferent to the timing of the generating of that efficiency.

Question 17

Do stakeholders agree the EBSS rewards and penalties should be symmetrical, regardless of the forecasting approach?

Generally, the Businesses agree that the rewards and penalties should be symmetrical. However, higher rewards would be appropriate where higher rewards to encourage DNSPs that are approaching the efficiency frontier to continue to pursue efficiencies.

Question 18

Should uncontrollable costs be excluded from the operation of the EBSSs?

Please see comments in section 4.3.

Furthermore, the uncontrollable costs are excluded from the both the base year and the carry-over, and these costs are defined at the time of the DNSP's determination. This provides certainty to the Businesses, and therefore the Businesses see no reason to change this.

Question 19

Should the approach to addressing uncontrollable costs differ depending on the forecasting approach?

Regardless of the forecasting approach, costs that the DNSP can not control should not be considered in any efficiency assessment process.

Question 20

Are there any other reasons to exclude costs from the operation of the EBSSs?

Where benchmarking rather than revealed costs is used as the basis for forecasting those specific costs in the revenue allowance, it would be appropriate to exclude such costs from the EBSS.

Otherwise, a DNSP may be rewarded/penalised twice if its actual opex is below/above the benchmark opex level.

Question 21

Should the EBSSs define specific costs to be excluded from its operation? If yes, which costs should be excluded from the scheme? If no, should criteria be defined which would guide which costs would be nominated as excluded costs?

The Businesses consider that it would be reasonable for the AER to set out the criteria to guide which costs should be nominated by the DNSP as excluded costs.

Question 22

Should all excluded cost categories be determined prior to the commencement of the regulatory control period in which the scheme applies?

For regulatory certainty, all excluded cost categories should be set out in the regulatory determination prior to the commencement of the regulatory control period in which the EBSS scheme applies.

Question 23

Should the EBSSs provide greater flexibility as to how opex forecasts are adjusted for the purposes of calculating rewards and penalties under the scheme?

The Businesses consider that the current level of flexibility as to how the opex forecasts are adjusted should be maintained in the EBSS.

Question 24

Do stakeholders agree with having a staged approach to the ex post review?

The Businesses agree that a staged approach is appropriate, subject to the comments set out in section 3.

Question 25

Are the issues that the AER proposes to consider as part of the ex post review appropriate?

The issues the AER intends to consider appear broadly appropriate. The Businesses would however stress the importance of the AER actively engaging with the DNSP at each stage of the assessment process.

Question 26

Are there any other factors that the AER should consider in conducting an ex post review?

Please see comments in section 3.

Question 27

Are there any additional factors that we should consider before excluding an amount of an overspend from a NSP's RAB?

Please see comments in section 3.

Question 28

Do you think our approach for the assessment of related party margins is reasonable? What other approaches may be appropriate?

The Businesses consider that the AER should set out a flow diagram outlining its approach to related party margins.

Question 29

Do you think our approach for the assessment of capitalisation requirements is reasonable? What other approach may be appropriate?

The Businesses consider that the AER should set out a flow diagram outlining its approach to the assessment of capitalisation.