Ms Anne Sastro
Analyst
Australian Energy Regulator
Level 19, 175 Pitt Street
Sydney NSW 2000

22 May 2013

Email: incentives@aer.gov.au

Dear Ms Sastro

INTERACTION BETWEEN THE EBSS AND OPEX FORECASTS

CitiPower, Powercor Australia and SA Power Networks (the **Businesses**) welcome the opportunity to respond to the Australian Energy Regulator (**AER**) paper regarding the relationship between the basis for forecasting the operating expenditure (**opex**) allowance and the opex incentive scheme applied to Distribution Network Service Providers (**DNSP**s).

The Businesses consider that:

- the use of revealed costs should be the default mechanisms for expenditure assessment;
- profit maximising businesses will always respond positively to the efficiency benefit sharing scheme (**EBSS**);
- the use of benchmarking to set the operating expenditure allowance should only be used in extraordinary circumstances where there is overwhelming evidence that a DNSP is not responding to the incentives contained within the EBSS;
- the data limitations associated with the AER's first annual benchmarking report mean that it will not be able to provide sufficiently robust evidence as to whether or not a DNSP is responding to the EBSS incentives, and
- the publication of the AER's first annual benchmarking report is therefore not critical to the timing of the AER's position on the cost basis used in setting a DNSP's operating expenditure allowance.

The Businesses have set out their responses to the questions posed by the AER in its paper dated 6 May 2013 in the attachment to this letter.

The Businesses would be pleased to discuss any aspect of this submission with the AER. Please contact Elizabeth Carlile on 03 9683 4886 or ecarlile@powercor.com.au.

Regards

Brent Cleeve
MANAGER REGULATION
CitiPower and Powercor Australia

Wayne Lissner
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ATTACHMENT Responses to AER's questions

Question 1

In the interests of providing certainty on matters to be raised during a determination process, should the AER decide whether to accept or potentially adjust base year opex at the Framework and Approach stage? In considering this question, we note that:

a. new data to inform the decision to accept or adjust the base year may arise at any time after the Framework and Approach

b. in managing this uncertainty, NSPs may prepare their submissions in anticipation of addressing issues in base year opex regardless of the Framework and Approach position

c. NSPs will be required to provide various historical data, including for benchmarking techniques, as part of annual performance/ benchmarking reports, even in the event the AER considers the revealed cost approach and base year are appropriate for particular NSPs

d. Data and analysis forming part of the most recent performance/ benchmarking report would likely form the basis for the "stage one" assessment of base year opex.

The Businesses support the AER's preference for using the revealed cost approach when forecasting opex. The Businesses agree that where the DNSP's opex allowance is set on the basis of revealed costs, the AER should continue to apply the existing EBSS.

An efficient DNSP will always respond positively to the EBSS. The success of incentive schemes such as the EBSS is in fact predicated on the basis that DNSPs have a strong profit motive. There is strong empirical evidence that privately-owned businesses have over time consistently and positively responded to incentives to reduce costs, whether the schemes were implemented by the AER or previous jurisdictional regulators. This has been acknowledged previously by the AER in the Victorian and South Australian Final Decisions.

No compelling case has been identified as to why a change to the EBSS is needed for privately-owned businesses. Further the uncertainty created by the threat of augmenting or substituting the EBSS undermines its effectiveness.

<u>AER assessment process and timing</u>

Clause 6.8.1(b) of the National Electricity Rules (**NER**) requires the AER to outline in its Framework and Approach (**F&A**) paper its proposed approach to the application of the:

- EBSS; and
- expenditure forecast assessment guideline.

That said, the AER notes that the F&A paper is not binding and the AER may depart from the position outlined if there are good reasons to do so.

Where the AER proposes to set the opex allowance on revealed costs, then it will outline in the F&A paper that it will apply the existing EBSS to the DNSP.

However, where the AER considers that a DNSP is not responding to the incentive to reduce opex to an efficient level, then it may determine that the revealed cost approach is not appropriate. To make this assessment, the AER proposes to:

- undertake benchmarking at a high level, as well as disaggregated category assessments, on the base year;
- consider using a different base year if concerns are identified in the initial base year chosen; and
- seek further information from the DNSP to inform the need to make adjustments to base year expenditure.

Where the DNSP's opex allowance is not set on the basis of revealed costs, for example where the AER makes adjustments to the base year, then it would apply a different opex incentive scheme. The AER would need to specify this in the F&A paper.

For CitiPower and Powercor Australia, the AER must publish the F&A paper on 31 October 2014. This is after the publication by the AER of its first annual benchmarking report, which is scheduled for 30 September 2014.

The AER's staff preferred approach is to set out whether it intends to use the revealed costs of the DNSP in its Issues Paper. This appears to be intended to address the timing issue that arises in South Australia and other jurisdictions where the AER is required to publish the F&A paper prior to its publication of the first benchmarking report.

Under clause 11.60.3(b)(3) of the NER, the AER is not required to publish Issues Papers for DNSPs in Victoria, Queensland and South Australia. As the AER has not addressed the transitional issues in its paper, it is unclear what the AER's preferred approach and timing would be for these jurisdictions.

In the interest of providing certainty to DNSPs on matters to be raised during a determination process, the Businesses supports the AER setting out at the F&A stage whether or not it intends to accept the base year opex of the DNSP, or potentially adjust opex and apply a different incentive scheme. This would afford the Businesses natural justice by providing sufficient time to prepare a response to the F&A paper and enable the Regulatory Proposal to be prepared with a clear understanding of how it will be treated by the AER.

That said, the Businesses are concerned about the AER's reliance on the first benchmarking report in determining whether or not the DNSP is responding to the EBSS, for the reasons set out below.

AER reliance on benchmarking report

First, the AER's reliance on the first annual benchmarking report in determining whether or not a DNSP is responding to incentives to reduce opex is not appropriate given that the report:

- will provide a single snapshot of relative efficiencies, and not a time series of reports indicating trends;
- may be based on a year in which an abnormal level of expenditure was necessary and efficient for at least one DNSP;
- is likely to be based on inconsistent and poor quality data; and
- based on techniques that in their infancy are largely experimental. For example, the initial results may highlight the need to undertake further normalisation adjustments to take into account other differences in operating conditions or further investigation being required into the comparability of certain information provided by the DNSPs.

Second, the AER proposal to adjust the base year opex of a DNSP in setting its forecast opex allowance should only be undertaken in the extraordinary scenario where there is an overwhelming range of evidence that the DNSP has not been responding to the incentive to reduce opex – a one-off benchmarking report is not sufficient evidence for the AER to reach such a conclusion.

Third, the AER has stated that economic benchmarking will not be applied in a deterministic manner to set revenue allowances in the upcoming round of regulatory reviews.

Fourth, the practical timing difficulties associated with the publication of the SA Power Networks F&A paper prior to the AER's first benchmarking report indicate that it is premature for the AER to utilise the benchmarking report in the determination of SA Power Networks' opex allowance.

Finally, there is only one month between the AER releasing its first annual benchmarking report and the submission of SA Power Networks' Regulatory Proposal. Given the likely absence of an Issues Paper under the transitional arrangements, it is unclear when and how the AER would consider the results of the first annual benchmarking report and then communicate whether or not it intends to forecast opex based on revealed costs. The AER would need to provide a reasonable period of time after deciding whether it would accept base year opex to ensure that a DNSP did not need to rewrite its Regulatory Proposal.

Therefore, the AER should not utilise the benchmarking reports in determining whether or not SA Power Networks is responding to incentives to reduce opex, and should only be used as an indicator to guide the AER in relation to further areas of inquiry in relation to CitiPower and Powercor Australia.

Question 2

What are the risks and other practical implications of the AER attempting to determine the effectiveness of the opex incentive framework by reference to an NSP's performance, which may be the result of other incentives or exogenous factors?

The AER notes that it is difficult to determine whether an DNSP is responding to the EBSS incentive to reduce opex. Where there is an indication that a DNSP is not responding to the EBSS, this may reflect the other competing objectives of the DNSP.

The Businesses agree that there is significant risk and practical difficulty in assessing whether or not a DNSP is responding to the EBSS incentive to reduce opex. For example, the current political debate concerning electricity prices may motivate some DNSPs to reduce costs. This cost reduction however may prove unsustainable in the medium to longer term. Similarly major legislative/regulatory changes may also impact on opex such as the Victorian Bushfire Royal Commission. These issues highlight that the AER will need to carefully examine the specific circumstances of individual DNSPs when forming any judgements. A stand-alone mechanical application of benchmarking will never be appropriate.

Over time, if the DNSP is not responding to the incentives to reduce opex and there is a change in the other factors influencing the DNSP's behaviour, then this will likely become visible to the AER through the opex contained its Regulatory Information Notice (**RIN**) submissions.

Question 3

Should the AER consider placing a higher threshold on making adjustments to the base year and departing from the current revealed cost framework? (How) could this be accommodated in the staged assessment process outlined above? For example, should the AER base its decision on several years of identified inefficiencies or upon a certain quantum of inefficiency?

The Businesses consider that the revealed cost framework is the default mechanism for expenditure assessment and other techniques such as benchmarking and trend analysis should only be used as an indicator to guide the AER in relation to further areas of inquiry to establish the appropriate forecast of efficient expenditure.

The AER should only make adjustments to the base year in the extraordinary scenario where there is an overwhelming range of evidence that the DNSP is not responding to the incentives to reduce opex.

The extraordinary scenario where the AER proposes to make adjustments to the base year in forecasting the opex allowance should be based on clear evidence over several years of identified inefficiencies combined with a clear trend indicating that the DNSP is not responding to incentives to reduce opex.

If the AER disagrees that adjustments to the base year should only be made in the extreme scenario, the Businesses urge the AER to steer away from making adjustments to specific categories if the revealed base year is in the 'ball park' of an efficient range.

In building evidence on whether or not an DNSP is responding to the EBSS, the Businesses consider that benchmarking should be used in the 'first pass' as a high level filter to identify any areas of concern.

If as a result of the 'first pass' assessment the AER identifies areas of concern, the Businesses propose the following approaches:

- benchmarking;

- variance explanation from the DNSP;
- governance review;
- engineering/technical assessment; and
- bottom up analysis.

The Businesses considers that only if inadequacies are found at one stage should the analysis progress to the next stage.

The AER should not cherry pick the outcomes of each of the approaches and the DNSPs' internal forecast. A standard benchmarking approach should be used across all DNSPs.

The Businesses believe that the proposed approach recognises that every benchmarking technique is prone to error and uncertainty and that only part of any unexplained variance for a DNSP can be attributed to inefficiency.

Question 4

Are there preferable alternatives to addressing material inefficiencies in an NSP's base year expenditure to simply adjusting the expenditure of that year (prior to applying step and trend changes)? For example, are there circumstances where it would be appropriate for opex allowances to reflect the progressive removal of inefficiencies over several years?

The Businesses do not support the AER utilising benchmarking rather than the revealed costs in setting the forecast opex allowance except in extraordinary cases.