Consumer
Challenge
Panel

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

Submission to the AER on Review of Incentive Schemes: Options for the Capital Efficiency Sharing Scheme (CESS) – Position Paper

Sub-Panel CCP29

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1. Introduction

The AER established the Consumer Challenge Panel (CCP) in July 2013 as part of its Better Regulation reforms. These reforms aimed to deliver an improved regulatory framework focused on the long-term interests of consumers.

The CCP assists the AER to make better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to the AER to better balance the range of views considered as part of the AER's decisions.[1]

CCP29 is a sub-panel of the AER's Consumer Challenge Panel established by the AER to focus specifically on the AER's review of incentive schemes.[2] The views expressed in this paper are the views of the members of CCP29: David Prins (chair), Dr Ron Ben-David and Professor Andreas Chai.

We have previously responded to a Discussion Paper published by the AER in December 2021, which discussed the various incentive schemes in place. This submission now responds to the AER's Position Paper published in August 2022 which is specifically focused on options for the Capital Efficiency Sharing Scheme (the CESS).

As this submission outlines, the AER is yet to address consumers' key concerns with the CESS or demonstrate how its proposal (in the Position Paper) responds to those concerns. On that basis, CCP29 considers it is unable to respond to the questions posed in the AER's Position Paper (p.16).

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[1] Detailed information on the CCP is available on the AER website at https://www.aer.gov.au/about-us/consumer-challenge-panel

[2] Full information on the AER's review of incentive schemes, including all the papers and submissions mentioned in this submission, can be found on the AER website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-incentive-schemes-for-regulated-networks

2. Consumer concerns with the Capital Efficiency Sharing Scheme

Consumer advocates and past CCP sub-panels have raised concerns about whether the AER's Capital Efficiency Sharing Scheme (the CESS) represents good 'value for money' for consumers. The data presented in the AER's original Discussion Paper (December 2021) and its recent Position Paper (August 2022) show the scheme is generating payments of hundreds of millions of dollars to network businesses over the next few years. These payments represent extractions from consumers.

The AER claims these payments benefit consumers by promoting more efficient capital expenditure by network businesses, thereby avoiding unjustified additions to the regulatory asset base (RAB) and ongoing higher prices. As a representative of the AER stated at a recent public forum (26 August 2022):

"Efficiency is more important than CESS payments."

CCP29 is concerned by this statement and the sentiment it embodies. It sweeps aside all the concerns consumers have raised about the CESS. These concerns are manifold.

First: The AER has not established the true source of the CESS payments that consumers are required to fund. The AER has not established on the balance of probabilities (let alone a higher standard) whether the payments reflect:

- genuine efficiency gains by network businesses that could not have been anticipated during the regulatory reset process;
- capital shifting between regulatory periods (deferrals);
- switching between expenditure types that results in lower ongoing costs for consumers (capex-opex swapping); and/or
- forecast error by the AER when determining the regulatory allowance it provides to network businesses for their capital expenditure.

The evidence cited by the AER in its Discussion Paper and Position Paper relies heavily on conjecture and inference. Such weak arguments do little to instil confidence in the scheme.

Second: The AER's arguments in support of the CESS rely heavily on the assumed efficiency of observed out-turn (or *ex post*) capital expenditure by network businesses. CCP29 accepts there may be some merit in this argument when it comes to repeat expenditure such as replacement or augmentation expenditure. However, as the AER observes, much of the network businesses' capital expenditure is one-off in nature, and so is not readily benchmarked against past revealed expenditure. The AER has proffered no evidence to support its assertion that out-turn capital expenditure is necessarily efficient.

<u>Third:</u> The AER administration of the CESS assumes that observed expenditure entails all relevant information. No assessment is made by the AER attempting to link payments to the quality of delivered services and the efficiency with which those services are delivered. The CESS payments are awarded solely on the basis of inputs (i.e. expenditure). No attempt is made to link those payments to outputs or outcomes – that is, the service benefits consumers receive in return for the money extracted from them. Likewise, no attempt is made to link the CESS payments to network operators' performance, for example, optimising network utilisation. Put simply, the AER has not demonstrated the CESS delivers value for money to consumers. CCP29 encourages the AER to consider what steps it can take to evaluate quantitively how CESS payments have provided an incentive for network businesses to operate more efficiently.

<u>Fourth:</u> The basis for the 30 per cent sharing ratio is poorly established. This ratio derives from the AER's assertion about the sharing of benefits under its Efficiency Benefits Sharing Scheme (EBSS) for operating expenditure. CCP29's submission responding to the AER's initial Discussion Paper closely examined the sharing arrangements under the EBSS. It also critically evaluated the AER's method for converting that sharing arrangement into a sharing ratio for use in the CESS. On both questions, it found the AER's assumptions wanting. The sharing arrangements under the EBSS lack any theoretical foundation or empirical support. It is an arbitrary arrangement.

The AER's Position Paper excludes for now further consideration of the EBSS and its implied sharing ratio. This means CCP29's concerns about the 30 per cent sharing ratio in the CESS remain extant and unresolved.

<u>Fifth:</u> The regulatory framework (energy laws and rules) reflects a 'regulatory bargain' with consumers, whereby they are promised they will only be required to pay for the efficient cost of the network services they receive. The CESS (like other efficiency schemes) does not reflect the cost of delivering services. The services would continue to be delivered in the absence of the CESS. This self-evidently means the CESS is not a cost that needs to be incurred in the delivery of network services. Given the CESS is not a necessary cost for service delivery, it is not clear how the AER can establish the efficiency of this cost. The AER has not demonstrated CESS payments (including the CESS sharing ratio) reflect an efficient cost to be recovered from consumers under the regulatory framework.

<u>Sixth:</u> Consumer advocates and past CCP sub-panels have expressed concern that the CESS may be rewarding network businesses for the AER's inability to anticipate and forecast capital expenditure requirements with a reasonable degree of accuracy. CESS payments (or penalties) are calculated based on the difference between the AER's capital expenditure allowance and a network's out-turn expenditure during the regulatory period. The AER's Discussion Paper and Position Paper both acknowledge that this means a CESS payment could derive from two root causes – over-estimation by the regulator and/or lower spending by a network business. However, the former is not given a great deal of attention. This lack of attention has been an ongoing concern for consumer advocates.

CESS payments might be justified if they:

- result from lower spending by a network business due to productivity improvements that were *unforeseeable* at the time of the AER's revenue determination; and
- would not have been found without the CESS scheme being in place.

Only in those circumstances would consumers be getting value for money from the CESS. There is little if any evidence to support that any significant proportion of CESS payments is made on this basis.

The AER claims its forecasts are improving. It cites the seemingly narrower gap between its forecasts and out-turn expenditure by network businesses as evidence that regulatory over-estimation is a diminishing limitation in the CESS. The strength of this 'evidence' is doubtful. As the first, second and third concerns noted above make clear, the AER's 'evidence' fails to address questions about the true efficiency of out-turn expenditure. It also fails to rule-out the possibility that network businesses are increasingly seeing the regulatory allowance as a capital budget which they now target – potentially without particular regard to the efficiency of that level of spending.

Seventh: CCP29's submission to the AER's Discussion Paper drew attention to the AER's evidence showing a widening gap between networks' regulatory proposals and the capital allowance approved by the AER. The Position Paper offers no explanation for this widening gap. CCP29 contends the AER's observation is explained by the incentive the CESS provides network businesses to overstate their capital requirements in the hope of upwardly influencing the regulatory allowance, and therefore the payment that they obtain under the CESS (see section 6). Networks may differ in how they respond to this incentive. Clearly, behaviour such as this delivers no benefit to consumers.

Eighth: It is understandable that the network businesses and their peak bodies do not shy away from advocating for amendments to the regulatory framework that serve their financial interests. When viewed in this context, network businesses' enthusiastic support for the CESS (and the EBSS) suggests they view the current incentive schemes as very aligned to their financial interests – irrespective of the schemes' apparent symmetrical risk profiles.

3. CCP29's response to the AER's Discussion Paper (March 2022)

CCP29 identified the above problems in its earlier submission. However, it struck us that the AER was not likely to be open to entertaining the discontinuation or wholesale replacement of the CESS, or any of its other schemes. Our submission therefore focused on:

- the need for networks to account for discrepancies between their allowed revenue (i.e. the AER's capital forecasts) and their out-turn expenditure;
- the type of evidence the AER might collect to address the concerns we identified, and how this evidence might inform the payments to be made to network businesses;
- how the AER might reconsider the design of the EBSS, and therefore how the CESS sharing ratio was derived; and
- modification of the CESS to create an 'anti-gaming' incentive promoting honesty in forecasting by network businesses when submitting their regulatory proposals to the AER.

We were not in a position to propose definitive solutions in response to these concerns. Nonetheless, within our resources we sought to point out new directions the AER should explore.

4. The AER's Position Paper (August 2022)

The AER's Position Paper only engaged with the least ambitious of CCP29's proposals – namely, the suggestion that network businesses account for any discrepancies between their allowed expenditure and their out-turn expenditure. The AER did not engage with the more fundamental ideas submitted by CCP29. It neither accepted nor rejected the concerns we raised and the improvements we proposed. It either made no reference to those potential improvements, or duly noted them without further consideration of their merits.

The Position Paper proposed two modifications to the CESS.

- Require network businesses to be more transparent about the reasons for differences between actual capital expenditure incurred and the AER's approved forecasts; and
- Introduce a variable sharing ratio with a 30 per cent default rate that may be lowered to 20 per cent, subject to an assessment against certain criteria. Different potential mechanisms for applying the lower rate were described.

While CCP29 suggested changing how the CESS sharing ratio operated, the Position Paper wrongly attributed its proposed 20 per cent sharing ratio to CCP29.

5. CCP29's response to the Position Paper

CCP29 is disappointed with the limited scope of the AER's Position Paper. The CESS is an expensive scheme. It is a scheme created and administered by the AER, but funded by consumers. The AER is accountable for the CESS. The burden of responsibility for demonstrating the benefit of the scheme lies with the AER. It is unsatisfactory that the AER has chosen not to do so, and not to engage directly with the concerns identified in section 2.

In regard to the AER's proposal to require network businesses to be more transparent, we make the following observation.

- We support the proposal, though we note that the additional information is of little (or no) use to consumers unless the AER makes clear, and consults on, how it will use this information to inform the exercise of its regulatory decision-making for the betterment of consumers.

In response to the AER's proposal to adopt a lower (or split) sharing ratio in the CESS, we make the following observations.

- This proposal in the Position Paper does not respond to, or address, any of the consumer concerns outlined in section 2 of this submission.
- While moving away from a one-size-fits-all approach appears to lower risks marginally for consumers having to pay too much for an unspecified benefit, it is not clear what problem this proposal is fixing, or why the AER considers it to be the most appropriate and efficient solution to that problem.
- The proposal does not appear to alter any of the unhelpful incentives created by the current CESS. Network businesses would continue to face no sanction for overstating their capital requirements in their regulatory submissions to the AER.
- The Position Paper provided no information about the assessment criteria the AER would apply when determining the applicable sharing ratio to a network business. These criteria and how they will be applied are central to any assessment of the merits of the AER's proposal. Without this level of detail, the proposal is largely meaningless.

In addition to this missing information from the Position Paper, there are two more fundamental design issues the AER does not appear to have considered. These are:

- The AER has not explained why it is proposing to make 30 per cent the default sharing ratio, with poor proposals being provided with a 20 per cent sharing ratio. Nor has the AER yet suggested how it would distinguish good proposals from poor proposals. It is not at all evident why the AER has proposed this approach rather than the converse – that is, making 20 per cent the default sharing ratio, with great proposals being provided with a 30 per cent sharing ratio. Regulatory experience clearly demonstrates the **evidentiary burden** on the AER would be much greater under the AER's proposed approach rather than under the converse approach.
- The AER does not appear to have recognised the **perverse consequences** of its proposal for a sub-standard expenditure proposal from a network business – that is, because the CESS acts symmetrically, a network with a poor submission would incur a lower penalty if it were subsequently to over-spend its capital allowance. In other words, the proposal in the

Position Paper has the effect of *de-risking* poor proposals from, and poor performance by, network businesses. Such an outcome is of no benefit to anyone other than a poorly performing network business. CCP29 considers this is a flaw in the design of the proposal in the Position Paper. Even if all our other concerns were addressed, this perverse consequence would still need to be rectified. The most likely remedy would require an asymmetric sharing ratio. In other words, consideration should be given to why the CESS provides the same reward for an efficiency saving and the same penalty for an efficiency loss. For a network that overspends its capital allowance, it makes more sense for it to incur a larger share of the overspend, relative to a network that underspends its capital allowance and generates an 'efficiency saving'.

- Apart from designing financial incentives to reward network businesses for capital expenditure underspending (and penalise overspending), CCP29 suggests the AER may wish to consider how to communicate the findings of its expenditure and performance audits with the key stakeholders of the network businesses more effectively. The AER should also consider communicating its findings directly with the network businesses' boards and other key stakeholders (e.g. investors). Such non-pecuniary incentives would target the network businesses' public reputation with key stakeholders. The practice of "regulatory shaming" is increasingly used in the US, and could prove a more effective deterrence against capital overspending (see Yadin 2019, Johnson 2020).[3]
- Additional forms of deterrence that the AER may wish to consider employing for network businesses that consistently deviate between forecast and actual capital expenditure for unexplained reasons could include the AER undertaking more intensive audits of capital expenditure for these operators. These could act as deterrence for network businesses that are considering artificially inflating their capital expenditure to take advantage of CESS payments.

In summary, CCP29 considers that the proposal outlined in the AER's Position Paper has not addressed consumers' fundamental concerns with the CESS. The proposal lacks the necessary foundations or elegance of design required to address these concerns. CCP29 urges the AER to return to the drawing-board, and first re-define the problem it is seeking to solve with the CESS. We begin this necessary discussion in the following section.

[3] Yadin, Sharon (2019). Regulatory Shaming. Environmental Law, vol. 49, no. 2, 2019, pp. 407–51.
Johnson, Matthew S. (2020) *Regulation by Shaming: Deterrence Effects of Publicizing Violations of Workplace Safety and Health Laws*. American Economic Review, 110 (6): 1866-1904.

6. Stepping back from the detail

The AER needs to consider carefully three core questions before deciding whether the CESS is required, and if so, what modifications should be made to the scheme. These questions relate to:

(i) the role of such a scheme within the broader context of the regulatory frameworks governing network businesses in the national electricity and gas markets;
(ii) the AER's assumptions about the role of "management effort" in the operation of a network; and
(iii) whether the CESS is creating the problem that it claims to fix.

We address these three matters in turn.

(i) The broader regulatory framework

The regulatory framework administered by the AER is typically described as an "incentive-based framework". That is, each element of the framework is designed to create incentives for networks to operate and invest efficiently – as opposed to "cost of service" regulation which seeks to compensate networks for their reasonable costs.

With regards to promoting efficient capital expenditure, CCP29 has identified eight lines of defence against inefficient expenditure. There may be more. The eight lines include (in no particular order):

1. The AER invests extensive effort in deriving the regulated rate of return that will promote an efficient level of investment. The current review of the rate of return will have taken 2½ years by the time it concludes later this year.

2. A large number of AER staff (as well as consultants) review every regulated network's expenditure proposal at a fine level of detail, with the objective of excluding any expenditure deemed to be inefficient.

3. At the end (or near the end) of a regulatory control period, the AER can conduct *ex post* reviews of capital expenditure by the networks that it regulates, to ensure that the expenditure was efficient and prudent. Inefficient expenditure can be excluded from the Regulated Asset Base (the RAB).

4. Elsewhere in the overall regulatory framework, the AER administers Regulatory Investment Tests for transmission and distribution capital expenditure (RIT-T and RIT-D, respectively), to ensure that the nature and level of investment is efficient.

5. Guaranteed Service Level (GSL) payment schemes are implemented with the intent of incentivising networks to avoid investing in inefficient infrastructure given their service obligations.

6. More recently, the AER has published its *Better Resets Handbook*, which outlines its expectations about how networks should determine and demonstrate the efficient level of expenditure required to meet the service outcomes expected by their consumers.

7. Surrounding these expenditure checks and balances, the AER administers various monitoring and outcome measures designed to identify (and disincentivise) inefficient expenditure – for example, the Service Target Performance Incentive Scheme (STPIS), and detailed annual performance reporting for all the networks it regulates.

8. The AER administers a range of demand side mechanisms, to ensure there is no demand-side requirement for inefficient investment – for example, the Demand Management Incentive Scheme (DMIS), and tariff structures intended to promote efficient use of the network (by requiring networks to adhere to the Revenue and Pricing Principles (RPP) and submit Tariff Structure Statements (TSS) for regulatory approval).

These eight lines of defence demand considerable commitment of resources by the AER and networks. Each line has been designed to promote efficient investment, and/or dissuade inefficient investment by networks. What work is left for the CESS to do is far from obvious.

CCP29 is concerned that the AER's insistence on maintaining the CESS reveals that questions hang over the efficacy of the regulatory framework. That is, despite the extensive effort that the AER invests in all of the mechanisms (eight lines of defence) listed above, its insistence on the need for a CESS indicates that it has little or questionable faith in the efficacy of those mechanisms (individually and collectively) to promote efficient levels of investment. If this is indeed the case, then profound questions must be asked about the merits of the entire regulatory framework, and the underlying beliefs and principles which motivate it.

When examined within the context of the overall regulatory framework, the need for, the role of, and the benefit delivered by the CESS, are far from obvious. Its only obvious feature is that it is a costly scheme funded by consumers.

(ii) The role of management effort

At the public forum on 26 August 2022, participants discussed the importance of the CESS in driving management effort in pursuing efficiencies in capital expenditure. The central point of contention is the assumptions made in the CESS about the balance between *ex ante* versus *ex post* management effort in pursuing capital efficiencies.

The CESS focuses exclusively on rewarding *ex post* management effort – that is, management identifying efficiencies after the regulator has determined the allowed capital expenditure. CCP29 is concerned that this approach overlooks the management effort that must go into identifying the efficient level of capital expenditure before a network business submits its regulatory proposal.

A board's fiduciary duties means it is responsible for identifying and properly costing the investment needed to manage the risks it faces over a relevant time horizon (such as an upcoming regulatory control period). In other words, CCP29 considers that a network business must have a 'better than reasonable' estimate of its true capital requirements at the time of submitting its regulatory proposals to the AER. The CESS plays no role in influencing how a board and management determine this estimated capital requirement.

Of course, this does not mean that a network business will voluntarily reveal its true capital requirement to the regulator. But it does mean that the appropriate baseline for CESS payments should be this internally estimated capital requirement, because it is the best available estimate. It is for this reason that CCP29's submission to the Discussion Paper focused on identifying a mechanism to encourage network businesses to reveal their internally estimated capital requirements.

(iii) The CESS is the problem that the CESS is trying to fix

There is no obvious reason why a network would want to advise the regulator of its true capital requirements. The CESS ensures that this is the case.

Ex ante knowledge of a business' capital requirements is propriety and commercial knowledge that the regulatory framework expects networks to make public. It is not at all clear why anyone believes they would do so willingly. The regulatory framework offers no benefit to networks from revealing this information. Worse still, the CESS rewards businesses that overstate their capital requirement, and by doing so they succeed in upwardly influencing the AER's capital forecast.

When viewed in its totality, the CESS can be seen to add to networks' *ex ante* incentives to conceal their propriety knowledge about their efficient capital requirements, and then it incentivises them to reveal *ex post* that information, in order to earn a reward under the CESS. Alternatively stated, the CESS is trying to overcome the very conduct that it encourages. It does so wholly at consumers' expense.

The CESS modifications described in CCP29's submission to the AER's Discussion Paper demonstrated that it is possible to reward networks for revealing *ex ante* their efficient capital requirements (i.e. in their regulatory proposals). Unfortunately, this type of thinking about improving the CESS was given short shrift by the AER.

7. Conclusion and next steps

The AER's proposed modifications to the CESS have some merit insofar as they may have some theoretical potential to reduce the scheme's cost burden on consumers. Nonetheless, the benefits consumers receive in return for that impost, and the efficient determinants of that impost, remain as obscure as ever. The only certainty about the CESS is that the AER obliges consumers to fund it.

The forecasting of capital expenditure allowances involves an information game between networks and regulators. Consumers simply pay for the spectacle. Rather than countervailing against networks' commercial inclination to conceal their true capital requirements, the CESS supercharges their incentives to do so. The CESS handsomely rewards networks that successfully persuade the AER to adopt capital forecasts greater than their true capital requirements.

The legitimacy of a regulatory scheme whose benefits are so poorly specified, and unverifiable, surely invites deep reconsideration. A scheme that promotes and rewards perverse conduct *demands* deep regulatory reflection. Unfortunately, the AER's Position Paper has not been informed by the deep questioning and reflection that the CESS demands.

CCP29 urges the AER to step back from the Position Paper and use the months ahead to examine critically and frankly reassess the merits of the CESS. Perhaps it is not possible to overcome all of the scheme's shortcomings, but it is certainly possible to overcome some of them – as our previous submission to this review demonstrated. CCP29 is ready to work with the AER to ensure its incentive schemes are operating in, and for, the long-term interests of consumers.