



## Department of State Development, Business and Innovation

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Mr Andrew Reeves  
Chairman  
Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3001

Dear Mr Reeves,

### **DSDBI Submission to AER - Capital expenditure incentive guideline consultation**

The Victorian Department of State Development, Business and Innovation (DSDBI), as the portfolio agency responsible for the energy market development in Victoria, is pleased to make this submission in response to the Australian Energy Regulator's Capital expenditure incentive guideline consultation.

Any queries in relation to this submission should be directed to Mr Raif Sarcich, Director, National Energy Development by email at [raif.sarcich@dpi.vic.gov.au](mailto:raif.sarcich@dpi.vic.gov.au) or by phone on (03) 9658 4160.

Yours sincerely,

**Mark Feather**

Executive Director, Energy Sector Development Division  
Department of State Development, Business and Innovation

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## **SUBMISSION TO THE AUSTRALIAN ENERGY REGULATOR**

### **BETTER REGULATION – EXPENDITURE INCENTIVES GUIDELINES FOR ELECTRICITY NETWORK SERVICE PROVIDERS**

#### **ISSUES PAPER**

I welcome the opportunity to make this submission to the Australian Energy Regulator (AER) on its Issues Paper on Expenditure Incentives Guidelines for Electricity Network Service Providers (NSPs).

This submission responds to some of the questions in the Issues Paper under the following headings:

- Ex ante measures for capital expenditure
- Ex ante measures for operating expenditure
- Ex post assessment of capital expenditure.

While the Department of State Development, Business and Innovation supports in principle the AER's objective to ensure there is a continuous incentive through the regulatory control period to pursue efficiencies in operating and capital expenditure, there are some concerns with the proposed design of the efficiency sharing schemes which act to not protect the interests of Victorian consumers.

#### **Ex ante measures for capital expenditure**

***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 Department of State Development, Business and Innovation agrees in principle that any capex sharing scheme should provide continuous incentives in each year of a regulatory control period. However, the Department of State Development, Business and Innovation is concerned that the AER does not appear to have adequately addressed the following two key issues associated with the Capital Expenditure Sharing Scheme (CESS):

- the incentive for the NSPs to overforecast capital expenditure, which is discussed under question 2
- the incentive to defer capital expenditure from one regulatory control period to the next.

While the Department of State Development, Business and Innovation supports an objective to have a continuous incentive within a regulatory control period, it is concerned that there is not an objective to have a continuous incentive across regulatory control periods.

The use of the revealed cost approach to forecast operating expenditure and the current design of the Efficiency Benefits Sharing Scheme ensures a continuous incentive across regulatory control periods for operating expenditure.

At the end of 2005 the Essential Services Commission discontinued the previous capex efficiency carryover mechanism, which had a similar design to the CESS and applied to distribution NSPs, due to concerns regarding the incentive to defer capital expenditure from one regulatory control period to the next.

*Reductions in capital expenditure below forecast can be the result of any, or a combination, of: efficiency gains, the deferral of capital expenditure projects between regulatory periods;*



*changes in external expenditure drivers (for example, lower than anticipated peak demand); or overstatement of expenditure requirements when the 2001-05 forecasts were set.*

*In light of these various sources of spending below forecast, it is difficult to isolate whether or not the efficiency carryover mechanism has provided any greater efficiency incentive than that already provided within the five year regulatory review cycle.*

...

*However, where capital expenditure underspends arise from unsustainable rates of investment deferral (or inaccurate forecasts), customers are at risk of potentially funding efficiency carryover rewards on efficiencies that are not sustainable (or not genuine efficiencies). Where efficiencies are not sustainable (or have not occurred in the first place) customers will not benefit from lower prices arising from the sharing of efficiency benefits through the efficiency carryover mechanism and regulatory review. This differs from operating and maintenance expenditure where the incremental calculation of the efficiency carryover amounts and the clear translation of revealed costs into the next period forecasts ensure that customers only reward sustained efficiencies and that customers share in efficiency benefits via lower prices.*

*Deferral of capital expenditure can be efficient, in which case customers benefit through a lower regulatory asset base which reduces the return required to be funded through prices over time. However, in contrast to operating expenditure, the benefits to customers are not as readily realisable. For example, where capital expenditure is included in the expenditure forecasts, but deferred to the next period, customers benefit through a reduced regulatory asset base but may pay for that benefit more than once where they also pay for a reward under the efficiency carryover.*

*Further, where expenditure is less likely to be recurrent as is the case with many types of capital expenditure, the relationship between revealed expenditure and future capital expenditure is more difficult to establish. Therefore the additional value that the efficiency carryover mechanism provides in estimating efficient future expenditures is less tangible. This reduces the benefit to customers from the application of the mechanism.<sup>1</sup>*

The former Department of Primary Industries made a submission to the Australian Energy Market Commission's (AEMC's) Directions Paper on rule changes requested by the AER in relation to the economic regulation of network services<sup>2</sup> which indicated that these concerns would need to be addressed if a CESS were to be introduced.

Notwithstanding, these concerns have not been addressed in the AER's Issues Paper. The Department of State Development, Business and Innovation request that the AER provide assurance to Victorian consumers that the CESS will be designed in such a way that it does not reward NSPs for capex underspends during one regulatory control period and then include the capex for that same project in the expenditure allowance for the next regulatory control period.

The Issues Paper includes a plot of the over or underspends in capex in each year of a regulatory control period. The figure does not include the data for the Victorian DNSPs as "a capex efficiency carryover mechanism applied at the time". A capex efficiency carryover mechanism, similar to the CESS, applied during the first regulatory control period (2002 -2005) but did not apply during the second regulatory control period (2006 – 2010), contrary to the note under the figure in the Issues Paper.

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<sup>1</sup> Essential Services Commission, *Electricity Distribution Price Review 2006-10; Final Decision Volume 1, Statement of Purpose and Reasons*, October 2005, pages 431-432

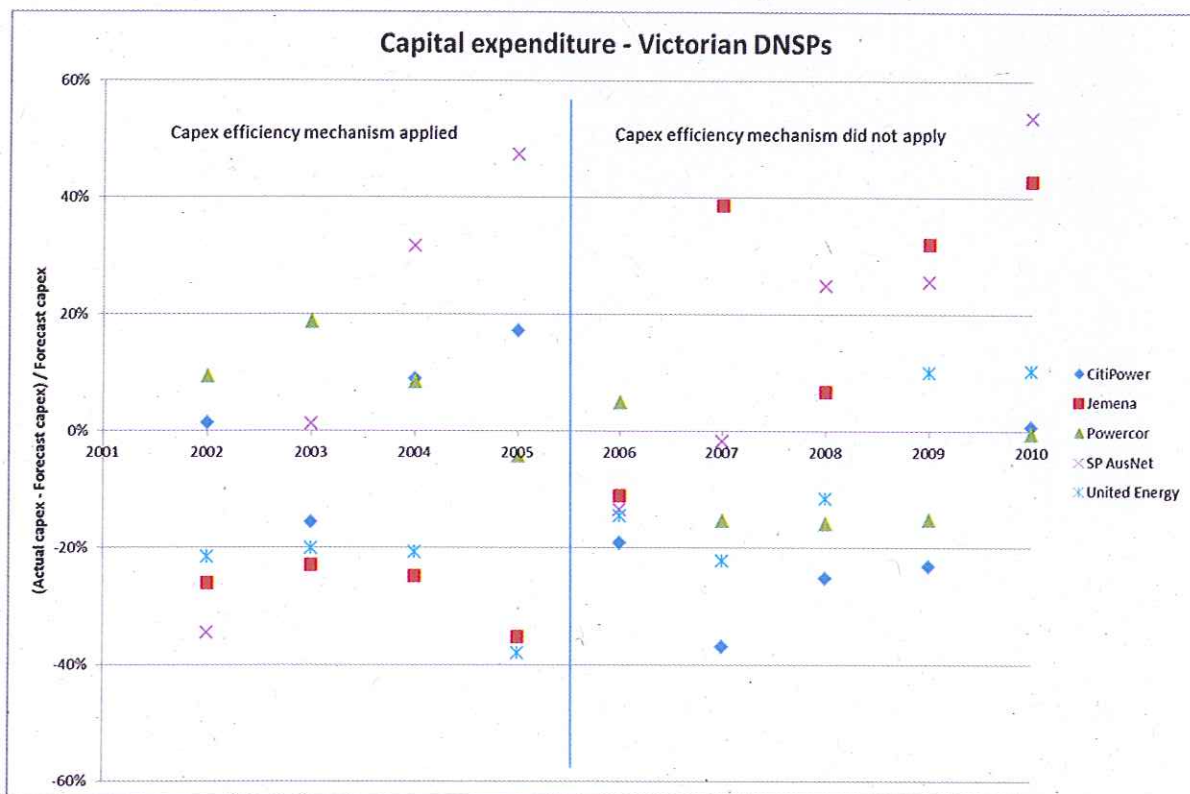
<sup>2</sup> Available at <http://www.aemc.gov.au/Media/docs/Victorian-Department-of-Primary-Industries-Victorian-DPI-9602ab50-5f96-497e-8b43-b559cb80e3e6-0.PDF>



The conclusion drawn from the plot is a tendency for DNSPs to spend more in the later years of a regulatory control period in the absence of a CESS.

A similar plot the over or underspends in capex is provided below for the Victorian DNSPs. This plot illustrates that, other than 2010, there is no tendency for the DNSPs to either overspend or underspend, with or without a capex efficiency carryover mechanism, and no tendency for the DNSPs to consistently overspend more during the later years of the regulatory control period in the absence of a CESS or similar scheme.

The consistent overspend in 2010 is inconsistent with the pattern in any other year. It is difficult to conclude from this information that the overspend is due solely to the absence of a capex efficiency carryover mechanism in that year, particularly given the circumstances in the summer of 2008/09 (high temperatures, higher demand for electricity, and catastrophic bushfires).



Source: AER, Victorian Electricity Distribution Network Service Providers, Annual Performance Report 2010, Appendix B<sup>3</sup>

**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.**

If the NSPs are able to secure a higher capital expenditure forecast than they would in the absence of a CESS, then the benefits to the NSPs under the CESS will be greater than the theoretical 30% benefit that is proposed. The benefits to customers of the CESS will thereby be reduced. While this has been identified as a risk, there is insufficient assurance provided that the risk will be addressed in the design of the CESS.

<sup>3</sup> The 2008 report has been referred to for CitiPower's actual expenditure in 2002, 2003 and 2004 as the data in the 2010 report is wrong.

***Question 8: When, if at all, might it appropriate to make adjustments to a type of capex before applying a CESS? Why?***

Consistent with the design of the Efficiency Benefits Sharing Scheme (EBSS), the Department of State Development, Business and Innovation is of the view that there should be some adjustments for differences in growth assumptions prior to the application of the CESS. There should also be some consideration as to whether there should be some adjustment based on labour and material indices.

***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?***

The Department of State Development, Business and Innovation supports the use of forecast depreciation as the default option for rolling forward the asset base, rather than actual depreciation. As has been noted in previous submissions to the Australian Energy Market Commission in its assessment of the AER's network regulation rule change proposals, the Department of State Development, Business and Innovation considers that privately owned Victorian network businesses have strong incentives to over-forecast capex to secure higher regulatory allowances. They then have an incentive to profit from this behaviour by under-spending. The Department of State Development, Business and Innovation considers that forecast depreciation has a dis-incentive effect on over-forecasting of capex and therefore supports the use of forecast depreciation for the Victorian network businesses.

In determining whether forecast depreciation is used to roll forward the asset base, the AER should consider the range of incentives for the NSP to be efficient, not just whether there is a capex sharing scheme in place. That is, the default option of using forecast depreciation to roll forward the asset base should apply in all circumstances and not only where there is a capex sharing scheme in place.

**Ex ante measures for operating expenditure**

***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?***

Figure 4.1 in the Issues Paper plots the relationship between actual and forecast opex over a single regulatory control period. On page 26 of the Issues Paper, the AER states that "given the short time the EBSSs have been in place, there is relatively limited available data to measure how effective the current EBSSs have been".

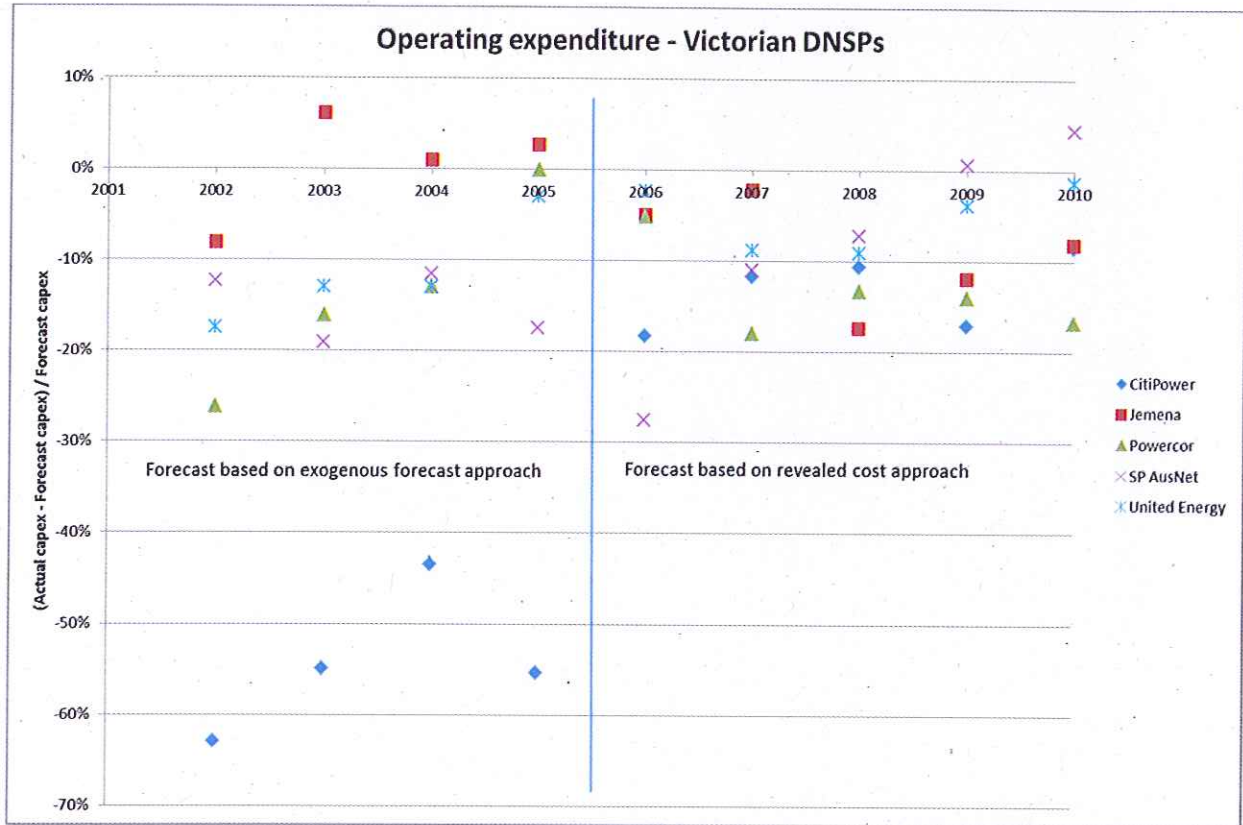
A scheme similar to the EBSS has applied to the Victorian DNSPs since 2001. There is therefore data over more than two regulatory control periods on which to draw. The figure below is similar to Figure 4.1 but plots the data over the first two regulatory control periods in which an efficiency carryover mechanism was applied to operating expenditure. In the first regulatory control period the operating expenditure forecasts were determined using an exogenous forecasting approach and in the second regulatory control period the operating expenditure forecasts were determined using a revealed cost approach.

This figure illustrates that the opex underspends were significantly higher during the first regulatory control period than during the second regulatory control period. This implies that either the potential efficiencies were substantially realised during the first regulatory control period and/or the forecasts were more reasonable during the second regulatory control period by using the revealed cost approach rather than an exogenous forecast approach.

The longer time series of data reinforces the AER's conclusion that the year 4 opex does not appear to be consistently disproportionately high across the DNSPs.



In 2004, the year 4 data was analysed in detail by the Essential Services Commission as part of the 2006-10 revenue determination for the distribution NSPs and adjustments were made as required. The Department of State Development, Business and Innovation would urge the AER to ensure that it undertakes an appropriate analysis of the NSPs' regulatory accounts so that adjustments are made as required to ensure that the year 4 data is appropriate for the purposes of the revealed cost approach.



Source: AER, Victorian Electricity Distribution Network Service Providers, Annual Performance Report 2010, Appendix B

**Question 14: Does an incentive power of 30 per cent provide a sufficient incentive to achieve efficiency gains?**

Section 4.4 of the Issues Paper states that the “preference is that all NSPs will face the same incentive power regardless of whether the opex forecasting approach relies on revealed costs, exogenous data or a combination of both”.

It is unclear from the information provided in the Issues Paper as to whether the AER will use a revealed cost approach when the operating forecast resulting from a revealed cost approach is less than using an exogenous forecast approach. If it uses an exogenous forecasting approach which results in a higher operating expenditure forecast than under the revealed cost approach, there is the potential for a NSP to be rewarded under the EBSS for efficiency gains for which it has been previously rewarded.

The AER states that no adjustments for changes in capitalisation policy would be required if capex and opex incentives are matched. However, this would only occur when there is no deferral of activity from one regulatory control period to the next and/or a revealed cost approach is adopted for forecasting operating expenditure.

***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 Department of State Development, Business and Innovation is of the view that costs that have been forecast using a revealed cost approach should not be excluded from the EBSS.

***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 Department of State Development, Business and Innovation is of the view that there should be some consideration as to whether there should be some ex post adjustment of opex forecasts based on the labour and material indices that were used in developing the opex forecast.

#### **Ex post assessment of capital expenditure**

***Question 24: Do stakeholders agree with having a staged approach to the ex post review?***

The ex post assessment provides a strong incentive to over forecast capital expenditure so that the allowance is higher than it would otherwise be and the probability of overspending relative to the allowance is reduced.

Figure 5.1 in the Issues Paper indicates that the AER will consider any underspending by the NSP in stage 1 of the proposed ex post assessment approach, but it is unclear from the diagram what actions will be taken by the AER where underspending has occurred.

In stage 2 of the proposed ex post assessment approach, the AER considers only the regulatory incentive to not overspend, that is, whether the NSP is subject to a CESS. The Department of State Development, Business and Innovation is of the view that the AER should consider the full range of incentives for an NSP to not overspend (for example, access to capital financing).

Where a project is assessed for prudence and efficiency, that assessment for prudence and efficiency should be based on the information available at that time and not with the benefit of hindsight. For example, the investment should be assessed based on the demand forecasts at the time the investment decision was made rather than actual demand.