AER 'Better Regulation'

Capital Expenditure Incentive Guidelines and Efficiency Benefit Sharing Scheme

Submission on Draft Guidelines and associated Explanatory Statements

20 September 2013

The Energy Networks Association (**ENA**) is pleased to have this opportunity to respond to the Australian Energy Regulator's (**AER**) draft capital expenditure incentive guidelines (**draft Capex Incentive Guidelines**) and efficiency benefit sharing scheme (**EBSS**) for electricity distribution and transmission and the associated explanatory statements. The ENA appreciates the open and interactive approach adopted by the AER in this consultation. The ENA supports consultation that supplements written submission with face-to-face stakeholder workshops.

Key messages

The Capex Incentive Guidelines and the EBSS are critical elements of the economic regulatory framework for electricity Network Service Providers (**NSP**). In order to do this effectively, the ENA considers that it is important that the draft Capex Incentive Guidelines be amended to:

- Allow exclusions in both the Capital Efficiency Sharing Scheme (**CESS**) and the EBSS;
- Explain how it will assess what constitutes a "significant overspend" under the CESS;
- Clarify the nature of, and process for, the AER undertaking its Stage 1 ex post review of capex; and
- Apply the same two-stage approach to assess related party expenditure as it applied for the 2013-17 Victorian gas access arrangement review.

Recommendations

The ENA recommends that the AER makes the following amendments to the draft Capex Incentive Guidelines, the EBSS and the associated Explanatory Statements:

Recommendation 1 - The AER should allow exclusions from the CESS and the EBSS for uncontrollable costs;

Recommendation 2 - The AER should also allow NSPs to apply for pass through events to be added to the AER allowance for the purpose of calculating carryover amounts, even if it chooses (for its own internal purposes) not to recover such costs from end consumers;

Recommendation 3 - Enable a NSP to explain why it has changed its capitalisation policy. The AER should only exclude newly capitalised expenditure from the regulatory asset base if it considers that there are no legitimate reasons for the policy change and it concludes that the NSP's intention was purely to gain from capex-opex substitution;

Recommendation 4 - Commit the AER to preparing Regulatory Accounting Guidelines that set out in detail the AER's regulatory accounting and assurance requirements in relation to the provision of historic and forecast financial information by the NSPs, in particular under its Regulatory Information Notice (**RINs**) and Regulatory Information Order (**RIOs**);

Recommendation 5 - Clarify that it will apply the same two-stage approach to assessing related party expenditure as it applied for the 2013-17 Victorian gas access arrangement review and which it has committed to under the draft Expenditure Forecast Assessment Guidelines;

Recommendation 6 - Acknowledge that NSPs will only be required to provide information about "contractor's actual costs" where they can reasonably access that information given their legal relationship with the contractor;

Recommendation 7 - Align the Capex Incentive Guidelines and the AER's Roll Forward Model to ensure that they treat overspends in a consistent manner;

Recommendation 8 - Provide more detail about the nature of, and process for, the AER undertaking its Stage 1 ex post review of capex;

Recommendation 9 - Clarify the circumstances that the AER can foresee when a CESS may not apply to a NSP, and therefore when the AER may apply actual, rather than forecast, depreciation; and

Recommendation 10 - Include a clear statement that it will only specify terms for incentive schemes on an ex ante basis at the time of its final determination and will not make changes to them during the course of a regulatory control period.

Recommendation 11 - The EBSS and CESS should align the regulatory control period with the application of the schemes if the regulatory control period is longer than five years.

Attachment 1 provides a detailed discussion of these issues.

Closing

The ENA appreciates the work that the AER has put into the draft Capex Incentive Guidelines and Explanatory Statement and the opportunity for the ENA to continue to contribute to their development. We would be pleased to discuss our submission with the AER as it finalises these documents.

Energy Networks Association Limited. Level 1, 110 Giles Street Kingston ACT 2604. ABN 75 106 735 406
T +61 2 6272 1555 . **F** +61 2 6272 1555 . **W** www.ena.asn.au

Attachment 1 – Detailed Discussion of Specific Issues

A. CESS and EBSS exclusions unduly constrained

In its submission on the Issues Paper, the ENA argued that the Capex Incentive Guidelines should set out defined principles for identifying potential CESS exclusions. The ENA proposed certain exclusions to the AER that meet those principles.

In its Explanatory Statement, the AER rejected the ENA's suggestion and indicated that it is "proposing not to allow for any exclusion from the CESS".[1]

Uncontrollable costs

The ENA is concerned that the inclusion of uncontrollable costs could unfairly disadvantage NSPs if they are retained in the CESS. Uncontrollable costs refer to those costs where a NSP can demonstrate on an *ex ante* basis that it may be required to incur expenditure over the regulatory control period that is outside of its control and as such, difficult to predict. If a NSP cannot exclude these costs then it may be penalised under the CESS and EBSS.

The ENA considers that it would be unduly restrictive for the AER to disallow exclusions and to pre-judge what a NSP should have a right to propose in their Expenditure Forecasting Methodologies, their submissions on the AER's Framework and Approach (**F&A**) paper and their Regulatory / Revenue Proposals. Therefore, the Capex Incentive Guidelines and the EBSS should include an explicit provision to enable NSPs to propose other exclusions to the AER through the regulatory process.

Other incentive regimes

The ENA notes that the Service Target Performance Incentive Scheme (**STPIS**) and the CESS provide competing incentives for investment in reliability improvements given that the STPIS provides incentives to improve reliability while the CESS discourages spending more than the AER capex allowance. In this way, including STPIS related expenditure in the CESS diminishes the incentives for NSPs to pursue reliability improvements.

Calculation of the carryover

The AER has made clear that it proposes that capex or opex associated with contingent projects, pass through events and re-openers be added to the original AER allowance for the purposes of the CESS or EBSS, so that NSPs have the opportunity to try and obtain efficiencies against those cost categories.

While supporting this approach, the ENA considers that the AER should also take into account costs where a NSP would qualify for a cost pass-through under the National Electricity Rules (**NER**) but, for its own internal purposes, the NSP decides that it does not want to pass-through these costs to end consumers. An example of such an event is the recent tropical cyclone Oswald where NSPs incurred significant expense in rectifying the network.

If a NSP cannot exclude these costs then it may be penalised under the CESS and EBSS for costs that it may legitimately incur but which are not allowed for in the AER's expenditure allowance. For this reason, the ENA considers that a NSP should be able to apply to the AER for a pass through event solely for the purposes of reducing the penalty associated with an overspend under the CESS or EBSS even if it does not intend to recover the costs of the event from end consumers.

[1] AER, *Explanatory Statement - Draft Capital Expenditure Incentive Guidelines*, August 2013, p 74.

Recommendation 1 - The AER should allow exclusions from the CESS and the EBSS for uncontrollable costs.

Recommendation 2 - The AER should also allow NSPs to apply for pass through events to be added to the AER allowance for the purpose of calculating carryover amounts, even if it chooses (for its own internal purposes) not to recover such costs from end consumers.

These amendments should be reflected into section 3 of the draft Capex Incentive Guidelines and section 2 of the EBSS which deal with the application of the two schemes.

B. The AER should not presume that NSPs change their capitalisation policy without legitimate reasons

The Draft Capex Incentive Guidelines state that:

> *Where the AER identifies that opex has been capitalised as a result of a change to the NSP's capitalisation policy (where the incentives for capex and opex are not balanced), the corresponding expenditure will be excluded from the RAB. For the purposes of calculating the payment due under the opex efficiency benefit sharing scheme (EBSS), this expenditure will count as opex.*[2]

The decision tree and related discussion in both the draft Capex Incentive Guidelines[3] and the Explanatory Statement[4] make it clear that the AER does not intend considering the reasons why a NSP has changed its capitalisation policy. The AER will simply exclude capex from the Regulatory Asset Base (**RAB**) that has resulted from a change in policy in the event that incentives under the CESS and EBSS are not balanced.

In the ENA's view, this is an unreasonable approach as it presumes that the only reason why a NSP would change its capitalisation policy is to gain from capex-opex substitution. This fails to recognise that there may be quite legitimate reasons for a NSP changing its capitalisation policy that is unrelated to the economic regulatory framework. For example, such changes could result from:

- Commercial and accounting system imperatives; or
- Requirements of Accounting Standards to provide true and fair financial statements.

The AER could unreasonably penalise a NSP if it excludes expenditure from the RAB that has been capitalised for legitimate reasons.

Recommendation 3 - The AER should amend the Capex Incentive Guidelines to enable a NSP to explain why it has changed its capitalisation policy. The AER should only exclude newly capitalised expenditure from the RAB if it considers that there are no legitimate reasons for the policy change and it concludes that the NSP's intention was purely to gain from capex-opex substitution.

This amendment should be reflected into section 5 of the draft Capex Incentive Guidelines which deals with the application of the ex post measures.

[2] AER, *Draft Capital Expenditure Incentive Guidelines*, August 2013, p19.

[3] *Ibid.*

[4] AER, *Explanatory Statement - Draft Capital Expenditure Incentive Guidelines*, August 2013, p 35.

C. Expenditure and capitalisation policy audit and sign-off obligations

Section 28M(e) of the National Electricity Law (**NEL**) provides that the AER may require a NSP to have the information audited that it provides under a RIN or RIO.

The draft Capital Expenditure Incentive Guidelines provides that:

> *The AER may also require the NSP to provide details of its capitalisation of expenditure as part of the annual Regulatory Information Notice/Regulatory Information Order process, including a statement of its capitalisation policy with auditor's sign-off.*[5]

The ENA is concerned that the AER will seek audit requirements for the respective regulatory information requests which are neither workable nor achievable.

The ENA seeks guidance regarding how the AER will obtain assurance regarding the relationships between the AER's assurance requirements and the regulatory framework that governs the provision of audit and assurance reports in Australia. This guidance should:

- Indicate that the AER intends to rely on the existing regulatory framework for the appointment of auditors and the conduct of their work and not to introduce unnecessary additional or alternative requirements;
- Provide clear guidance, which might be through a Regulatory Accounting Guideline that details the basis on which the AER expects RINs, RIOs and other regulatory information to be prepared and presented. This is necessary to allow a NSP to report and to enable an auditor to opine on that report; and
- Clarify how the AER will set the terms of reference and form of report required of auditors.

For further discussion on this matter, please see the ENA's response to the draft Expenditure Forecast Assessment Guidelines.

Recommendation 4 - The AER should commit to preparing Regulatory Accounting Guidelines that set out in detail the AER's regulatory accounting and assurance requirements in relation to the provision of financial information by the NSPs, in particular under its RINs and RIOs.

This amendment should be reflected into section 5 of the draft Capex Incentive Guidelines which deals with the application of the ex post measures.

D. Treatment of related party expenditure

The draft Expenditure Forecast Assessment Guidelines commit the AER to adopting the two-stage process for assessing NSPs' related party contracts and margins that it used in the 2013-17 Victorian gas access arrangement reviews (**GAAR**).[6] The ENA supports this two-stage approach as an appropriate basis for the AER assessing NSPs' forecast related party expenditure.

However, the draft Capex Incentive Guidelines do not commit to using this accepted two-stage approach for ex post reviews of related party expenditure. The difference between the two

[5] AER, *Draft Capital Expenditure Incentive Guideline*, August 2013, p 19.

[6] *Ibid.*, page 26.

Guidelines is that, for an outsourced arrangement that is not competitively tendered (and that therefore fails the presumption threshold), the AER states:

- Under the draft Expenditure Forecast Assessment Guidelines, it would undertake a separate assessment to determine whether related party costs are efficient using a clear set of criteria[7]; whereas

- Under the draft Capex Incentive Guidelines, it would:

> *allow the contractor's actual costs to be rolled into the RAB. A 'margin' will only be permitted where the service provider is able to establish the efficiency and prudency of such a margin against legitimate economic reasons for the inclusion of the margin (and its quantum).*[8]

The draft Capex Incentive Guidelines therefore provide no avenue for including the full related party costs where the presumption threshold has not been met. However, the AER has provided no rationale for assessing forecast and actual related party expenditure differently between the two Guidelines. The ENA believes that the AER's two-stage approach should be applied for both assessments. This approach is clear, well accepted by stakeholders and will allow the consistent treatment of all related party expenditure. In applying this approach, the AER should recognise that NSPs have clear requirements under the Corporations Law to look after the interests of all of its shareholders equally. It would be a contravention of this Law for a NSP to treat a related party in a preferential manner if the effect would be to disadvantage other shareholders by imposing higher costs on the business.

Recommendation 5 - The AER should amend the Capex Incentive Guidelines to clarify that it will apply the same two-stage approach to assessing related party expenditure as it applied for the 2013-17 Victorian gas access arrangements and which it has committed to under the draft Expenditure Forecast Assessment Guidelines.

This amendment should be reflected into section 5 of the draft Capex Incentive Guidelines that deals with the application of the ex post measures.

E. Access to contractors' actual costs

As noted above, where the presumption threshold has not been met, the draft Capex Incentive Guidelines would base the related party expenditure to be included in a NSP's RAB on "contractor's actual costs".[9]

If this approach is applied, the AER should be aware that a NSP would not be in a position to provide contractors' actual costs if there is no relationship of control between the NSP and the related party – this is because the NSP would not have any right of access to this information. This is consistent with the principle that NSPs should not be required to provide information for other parties.

This issue would be overcome if the AER applies the same two-stage approach to assessing related party expenditure in the draft Capex Incentive Guidelines as it has committed to under the Expenditure Forecast Assessment Guidelines.

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[7] AER, *Draft Capital Expenditure Incentive Guidelines*, August 2013, pp 27-28.

[8] Ibid., p 20.

[9] AER, *Draft Capital Expenditure Incentive Guidelines*, August 2013, p 20.

Recommendation 6 - Should the AER continue to refer in the Capex Incentive Guidelines to "contractor's actual costs" then it should acknowledge that NSPs will only be required to provide this information where they can reasonably access the information.

This amendment should be reflected into section 5 of the draft Capex Incentive Guidelines that deals with the application of the ex post measures.

F. Alignment of the CESS and the Roll Forward Model

It is not clear from the draft Capex Incentive Guidelines whether the CESS and the AER's Roll Forward Model (**RFM**) are aligned in the way in which they recognise overspent capital expenditure.

The Capex Incentive Guidelines should make clear that the RFM should include an overspend in the RAB at the start of the next regulatory control period. In this way:

- The CESS penalty will start to apply at the same time as the NSP starts to earn a return on, and of, the assets that relate to the overspend; and
- No return of assets (i.e. depreciation) should apply to the assets that relate to the overspend before the start of the next regulatory control period.

Recommendation 7 - The AER should amend the Capex Incentive Guidelines and the RFM to ensure that they treat overspends in a consistent manner.

This amendment should be reflected into section 3 of the draft Capex Incentive Guidelines that deals with the application of the CESS.

G. Clarify basis for applying Stage 2 of ex post reviews

The ENA supports the simplification that the AER has made in its draft Capex Incentive Guidelines from its Issues Paper to introduce a two stage process for undertaking ex post reviews, involving a preliminary assessment in the first stage and, if required, a detailed assessment in the second stage.

However, the Capex Incentive Guidelines provide very limited information about the basis on which the AER will undertake its first stage assessment. In the ENA's view, the Capex Incentive Guidelines should detail:

- The basis on which the AER will undertake its assessment, including the types of matters it will consider in forming a view about what constitutes a "significant overspend";
- The process and timing for the AER's assessment;
- How the AER will engage with NSPs in undertaking its assessment, including the information that it will seek from NSPs in order to understand the nature of, and reasons for, the overspend; and
- The techniques that it will use to undertake its assessment.

Addressing these matters will help to determine the trigger point to activate stage two.

Recommendation 8 - The AER should amend the Capex Incentive Guidelines to provide more detail about the nature of, and process for, undertaking its Stage 1 ex post review of capex.

This amendment should be reflected into section 5 of the draft Capex Incentive Guidelines that deals with the application of the ex post measures.

H. Clarify when CESS may not apply

Clause 6.4A(c) of the NER provides that:

> *There must be Capital Expenditure Incentive Guidelines in force at all times after the date on which the AER first publishes the Capital Expenditure Incentive Guidelines under these Rules.*

The Explanatory Statement indicates that:

> *We recommended that forecast depreciation will be the default approach for rolling forward the RAB except where a CESS does not apply or where there is persistent overspending by a NSP.*[10]

Elsewhere in the Explanatory Statement, the AER states that:

> ......*where a CESS does not apply" is one of the "two circumstances in which we would consider applying actual depreciation.*[11]

It is not clear from the AER's proposed draft Capex Incentive Guidelines when it considers that there may not be a CESS that applies to a NSP.

Recommendation 9 - The AER should clarify in the Capex Incentive Guidelines the circumstances that the AER can foresee when a CESS may not apply to a NSP, and therefore when the AER may apply actual, rather than forecast, depreciation.

This amendment should be reflected into section 4 of the draft Capex Incentive Guidelines that deals with the application of the ex post measures.

I. Do not change incentives during a regulatory control period

The ENA is concerned about the AER making changes during the course of a NSP's regulatory control period to features of its approved incentive schemes.

An example is the AER's "Draft Decision - Service Target Performance Incentive Scheme for TNSPs - Early application of version 4"[12]. In this instance, the AER is proposing the early application of the new Version 4 of the STPIS to Murraylink, Powerlink and ElectraNet during their current regulatory control periods.

Changes of this kind have the effect of undermining the incentives that a scheme should be seeking to promote by creating uncertainty and by sending confused signals to NSPs. If NSPs are not certain that the benefits of the scheme will be honoured it inherently weakens the strength of the incentive. This may arise, for example, if a change in the scheme means that a NSP will not receive the benefits that it has invested in to procure.

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[10] AER, *Explanatory Statement - Draft Capital Expenditure Incentive Guidelines*, August 2013, p 13.

[11] *Ibid.*, page 32.

[12] Available at http://www.aer.gov.au/sites/default/files/AER%20draft%20decision%20-%20early%20application%20of%20STPIS%20ver.4.pdf

Stability and prospective certainty about the application of an approved incentive scheme is vital to engendering confidence amongst NSPs in the scheme and to encouraging them to respond appropriately to the incentives it is intended to promote.

Recommendation 10 - The AER should include a clear statement in the Capex Incentive Guidelines that it will only specify terms for incentive schemes on an ex ante basis at the time of its final determination and will not make changes to them during the course of a regulatory control period.

This amendment should be reflected into section 1 of the draft Capex Incentive Guidelines that deals with the nature of the Guidelines.

J. <u>Implications of regulatory control period being longer than 5 years</u>

The EBSS is framed in terms of a five year regulatory control period. It provides NSPs with six years of benefits from a marginal efficiency gain, regardless of when the gain was made, and six years of costs from a marginal efficiency loss, regardless of when the loss was made. In a similar way, the CESS is framed in terms of a five year regulatory control period.

The EBSS and CESS do not contemplate how it applies when the regulatory control period is longer than five years.

Recommendation 11 - The EBSS and CESS should align the regulatory control period with the application of the schemes if the regulatory control period is longer than five years.

This amendment should be reflected into section 2 of the EBSS that deals with the application of the EBSS and section 3 of the Capital Expenditure Incentive Guidelines that deals with the CESS.