Guidelines, models, schemes and service performance incentives for electricity distributors

Response to AER Issues Papers

1 February 2008

1. Overview

Key points

- **In general, the complexity of the transition process should direct the AER toward simple, pragmatic, workable approaches that recognise that the objective of convergence should pursued over the medium term**
- **Early development of a framework of key economic guidelines, models and schemes to inform upcoming regulatory proposals is supported**
- **Key differences exist in the regulatory frameworks for electricity transmission and distribution that have implications for the guidelines, schemes and models**

The Energy Networks Association (ENA) welcomes the opportunity to comment on the AER Issues Papers - *Guidelines, models and schemes for electricity distribution network service providers* and the *Electricity distribution service providers - Service target performance incentive scheme* released by the Australian Energy Regulator (AER) in November 2007.

ENA supports the early development of a framework of key economic guidelines, model and schemes to inform upcoming distribution network regulatory proposals. The complexity of the transition process, however, should direct the AER toward simple, pragmatic, workable approaches that recognise that the objective of convergence is a medium term one.

Key differences exist in the regulatory frameworks for electricity transmission and distribution that have implications for the guidelines, schemes and models. Hence, it is important that the timelines involved in guideline and model development processes are sufficient to provide for incorporation of distribution-specific issues.

The 'framework and approach' stage and 'fit for purpose' provisions in the distribution regulatory model means that distribution determinations are more likely to focus around the specific regulatory proposal and circumstances of previous jurisdictional regulation than under electricity transmission rules. This means that some of the guidelines, schemes and models have scope to be less prescriptive and simply set out potential frameworks for regulatory proposals, rather than being substantive 'sub decision' elements.

Consistency is possible and desirable for investment certainty and transparency over a range of the schemes and models provided the AER recognises distribution-specific issues (for example, picking up different depreciation approaches).

2. Background

The Energy Networks Association is the national representative body for gas and electricity distribution network businesses.

Energy network businesses deliver electricity and gas to over 12 million homes and businesses across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines. These distribution networks are valued at more than $35 billion, and each year energy network businesses undertake capital investment of more than $5 billion in network reinforcement, expansions and extensions.

3. Responses to issues raised on guidelines, models and schemes

3.1 Post tax revenue model

Principles applicable to the PTRM

Overall, the post tax revenue model (PTRM) developed under the AEMC Chapter 6A of the National Electricity Rules (Rules) provides an appropriate basis for the development of a model for distribution. Although, this should not be the only reference for the development of a PTRM for distributors, other provisions which the AER should have regard to in finalising the PTRM include the transitional arrangements for initial distribution determinations as provided for in Chapter 11 of the Rules and the National Electricity Law's revenue and pricing principles[1] which apply where the AER applies its discretion. In the case of the PTRM a particularly important principle is that the model should be consistent with the requirement that a service provider should have a reasonable opportunity to recover at least efficient costs in providing distribution services.

Alternative jurisdiction-specific approaches to the treatment of capital contributions for distribution should be dealt with through each specific reset process rather than through modifying the model to take account of jurisdictional differences.

Treatment of cash flows

ENA supports a pragmatic, simple, transparent and replicable approach to cash flow timing assumptions which should be assessed against set industry 'benchmark' assumptions – the approach adopted in the PTRM in transmission achieves this and refinement in this area during a period of significant change to the treatment of fundamental elements of a service provider's regulatory framework is not supported.

[1] National Electricity Law, Section 7A

3.2 Roll forward model

Provided the model accounts for the availability of actual or regulatory depreciation methodologies to be proposed by a distributor, and transitional roll-forward arrangements are followed (including those provided for in Chapter 11 of the Rules), there does not appear to be a barrier to using the roll forward model adopted in transmission

3.3 Cost allocation guidelines

ENA is disappointed at the policy outcome in the Rules that potentially sees distributors subject to ***two*** cost allocation reporting arrangements that are likely to be largely duplicative in intent though inconsistent in form. The AER has an opportunity to ameliorate the practical impact of this poor outcome through the appropriate exercise of its discretion around cost allocation guideline issues.

The AER should at the first round of reviews err towards acceptance of distributor proposed methodologies that are based on existing jurisdictional arrangements, and pursue harmonisation following the assumption in each jurisdiction of full regulatory monitoring and enforcement functions.

3.4 Efficiency benefit sharing scheme

Broad approach

Overall the ENA does not consider some of the proposed features of the efficiency benefits sharing scheme (EBSS) to be appropriate.

ENA considers there to be numerous reasons as to why efficiency losses would be an *inappropriate* feature of an EBSS, including:

- If the regulator has set benchmarks based on projected 'efficient' costs then the system potentially embeds a one-way bias inasmuch as the opportunities for efficient underspending must be smaller than the potential for 'over-spending'

- It is inappropriate and overly simplistic to systematically interpret over spending relative to a forecast as a reliable measure of inefficiency

- Negative efficiency carryovers from one period to the next amounts to a double penalty – over-spending in the first instance goes directly to the bottom line. By carrying over an aggregate negative to the next period, a second penalty is applied in that the distributor's revenue allowance is less than the assessed efficient requirement

- Most importantly, ENA considers efficiency losses to be inconsistent with the National Electricity Law objective due to the potential for a distributor to be placed in a position of not having a reasonable opportunity to recover at least the forecast costs of providing network services which would not be in the long term interests of consumers of electricity.

The distribution sector is also concerned that the effective sharing ratio of 30/70 currently in place across jurisdictions and a number of AER/ACCC decisions does not provide the high-powered incentives required to facilitate the next wave of more costly infrastructure and operational investments to secure efficiency gains. ENA considers a reasonable net present value sharing ratio to be 50/50.

The AER has requested comments on whether it is reasonable to require distributors to provide evidence that demonstrates that the operating expenditure incurred in the current regulatory period is related to operational needs as they arise and does not entail instances of 'cost-shifting'.[2]

The Rules provide a detailed set of rules governing the assessment of operating expenditure designed to ensure that the forecast reasonably reflects the expenditure required to meet or manage forecast demand.[3] ENA considers such a requirement to duplicate legal requirements in the Rules, and to be costly and subjective. Requiring a distributor to prove that all their operating expenditure has not involved cost-shifting risks establishing an automatic pre-judgment that cost-shifting has occurred unless a distributor evidences otherwise. This is a highly inappropriate approach for the AER take for operating expenditure and is similarly inappropriate for capital expenditure.

Capital efficiency schemes

ENA supports the opportunity of distributors to be able to put forward capital expenditure efficiency incentives within the remit of the Rules.

It would be inappropriate for a broad AER framework on efficiency mechanisms to unilaterally rule out this option. The choice for distributors to propose such a scheme should take into account the distribution businesses' own assessment of, and willingness to assume, the risk exposures of such a scheme. A capital efficiency scheme could play an important role in certain circumstances in sustaining incentives for non-network solutions to localised constraints.

The AER has requested comments on the application of an EBSS to capital expenditure yield sufficient benefits to consumers to offset the risk of windfall gains and losses. ENA considers this to be misguided question in the context of the relevant Rules. The question is implying that there may be circumstances where a distributor obtains a windfall and the consumers may not sufficiently benefit. This overlooks a basic characteristic of all EBSS which is the sharing ratio between the distributor and consumers. Any gain by a distributor due to capital efficiency would result in a gain to consumers and the larger the efficiency, the larger the benefit to consumers, this approach promotes the National Electricity Law objective. Clause 6.5.8 (c) of the Rules directs the AER to consider benefits to consumers compared to gains and potential penalties to distributors. The concept of these gains being 'windfall' is not a part of this Clause, and ENA considers its introduction is not helpful in this context.

[2] AER Issues Paper *Guidelines, models and schemes for electricity distribution network service providers*, November 2007, Section 2.4.10, p.28

[3] National Electricity Rules, Clause 6.5.6

Further to the above question, the AER is asking whether forecasts and/or actuals be adjusted *ex post* to reduce the risk of windfall gains and losses to acceptable levels. If the AER does pursue the conclusion that large gains/losses are inappropriate, the approach of altering the terms of an EBSS after it has been agreed to and relied on discredits the purpose, credibility and incentive properties of the scheme. The approach would effectively result in an EBSS 'regulatory contract' being made at the commencement of a regulatory period with the AER having the capacity to change the terms of this contract after the event.

Distribution losses

ENA agrees that persuasive evidence is required that distribution losses are greater than a level that is economically efficient before moving to design mitigation incentives.

Distribution network planning decisions already seek to manage losses at one of the most relevant points of distributor control – the design phase. ENA considers that due to the number of factors contributing to line losses outside of the distributor's control an efficiency scheme may not be warranted when the risk, costs and exclusion details are fully considered.

Given the complexity already inherent in new national arrangements, with potentially duplicative cost allocation obligations, information requirements, GSL and service standard schemes the objective for this untested area should be simplicity. ENA considers the IPART approach of recognising the economic value of distribution loss management investments in the regulated asset base, this approach provides certainty for investments in loss management.

By way of general comment, ENA encourages the AER to proceed cautiously with the implementation of new schemes. This is because, not only are distributors making significant business adjustments in applying the new Rules in preparing their Regulatory Proposals (forecasts, allocations, applying new principles and criteria), they are also having to balance the potential risks and rewards of new schemes. Overall, the new and untested elements of the regulatory regime mean that there may be unexpected and unintended outcomes that will need to be worked through. ENA therefore believes that in the initial stages, there needs to be conservatism, flexibility and interim approaches to schemes (such as low powered risks and rewards, paper trials etc).

4. Service target performance incentive schemes

4.1 Proposed guiding principles and objectives

ENA supports the development of a national Service Target Performance Incentive Scheme (STPIS) designed to reward or penalise a distributor for its network performance relative to a series of service targets. The service targets and measures themselves should cater for a distributor's unique characteristics, including its operating environment, past performance and existing service obligations.

The ENA has prepared a set of guiding principles for the appropriate development of service target performance schemes. These are described in the **Information Box** overleaf.

Information Box - ENA Design Principles for Service Target Performance Schemes

- ***Clear objectives (i.e. related the specific elements of service that are to be measured) that are consistent over time***
- ***Simplicity***
- ***Cost-effectiveness***
- ***Focused on distributors' individual performance improvements, and not used for the purpose of comparing disparate network configurations against each other***
- ***Ensuring common national incentives to improve performance***
- ***Avoiding multiple layer of service quality performance schemes and muted incentives***
- ***Convergence as a medium term goal***

ENA believes that development of an effective STPIS requires a clear statement by the AER of the scheme's objective. This should be relative to the range of existing network performance improvement mechanisms with which distributors are required to comply under the NER and by virtue of jurisdictional legislation and licence obligations. For example, a STPIS that focuses on particular measures will result in a particular network performance response from distributors. If the measures were different (or are changed between regulatory periods), there would be a different network performance response from distributors, and hence a different outcome for customers. This is why ENA believes the AER ought to be clear as to what objective is sought, in order that the STPIS can then be tailored to delivering that objective.

ENA considers a common approach within a national framework to service target performance should be a 10-15 year medium term objective of convergence. During this transitional phase it is essential that any duplication is minimised, if not avoided. A critical design issue of existing jurisdictional systems has been ensuring the scheme is simple and cost effective. Transition arrangements should recognise this.

ENA believes that it would be unduly onerous, from an implementation, monitoring and compliance perspective, to require distributors to operate under concurrent (and potentially conflicting) national and state based schemes. We also believe that the Australian Energy Markets Agreement's Annexure 2 provides supporting guidance about the intention that customer service performance standards should be a national function and linked to economic regulation. There therefore needs to be co-ordination between the national and jurisdictional bodies to ensure an appropriately funded and workable arrangement is achieved.

The focus should be on an electricity distributor being able to propose a framework that complies with existing jurisdictional arrangements that will remain binding, and move

on a path towards a *more* nationally consistent approach. The way forward is to provide a framework over time for increasing consistency without seeking to set out a prescriptive single approach that will be inappropriate due to differing network characteristics and the types of schemes in force currently.

However, differing levels or layers of a more consistent national approach are likely to be appropriate even over the medium term depending on the nature of performance that the community wishes to focus on.

4.2 Types of service performance incentive schemes

Ultimately a national s-factor and GSL scheme may be warranted, provided the risks imposed by such a system are well-understood, as well as recognised and accounted for in the price review processes.

The AER has stated that it would like views on the overall design of a national s-factor scheme. One important consideration for the s-factor scheme is whether it should be symmetrical or not. ENA does not consider it appropriate that the service performance incentive scheme contain penalties for under performance. ENA considers penalties associated with under delivery of service target performance to be inconsistent with the National Electricity Law objective due to the potential for a distributor to earn less revenue than is assessed as being necessary in a forward looking way as being required to safely and reliably deliver distribution services. This potential is not in the long-term interests of consumers of electricity, for the reasons described above in relation to the EBSS.

In addition, there needs to be significant care that where both an s-factor scheme and a GSL scheme apply, distributors do not incur double penalties for the same events as this will create an imbalanced service incentive scheme. To avoid this, it is necessary to prevent overlapping events between the two schemes as applied to penalties. Overlap can occur even though the s-factor and GSL schemes have different objectives.

The AER has also invited views on whether the value to customers of having both types of schemes is sufficient compared to the additional costs associated with having to implement and administer multiple schemes. ENA's view is that the cost-effectiveness of a scheme is an essential criterion in determining the appropriateness of the scheme. The service incentive scheme should not result in significant cost increases by imposing an undue administrative burden on distributors.

In considering any service incentive scheme, it is essential that the AER consider current jurisdictional arrangements to determine whether it is practical, credible and cost-effective to shift from the distributor's current position to the proposed service incentive scheme. In particular the AER should ensure that distributors are not exposed to one off losses caused by changes to an existing scheme. This can easily occur due to the volatility inherent in network performance caused by uncontrollable variables such as weather. When this natural volatility in performance is combined with a sudden change in the incentive properties of the scheme, unintended outcomes can occur.

The AER has stated that it would like views on whether the AER should distinguish between planned and unplanned interruptions. ENA considers it important to

distinguish between planned and unplanned outages. Planned outages are required for the maintenance of the networks and construction activities, by creating an incentive/penalty to reduce all outages, whether they are planned or unplanned, the scheme would be creating an incentive/penalty to prevent and/or reduce planned outages that are either unavoidable or a function of network improvement initiatives. A core component of the National Electricity Law objective is to ensure efficient operation with respect to safety and security of supply of electricity.

ENA considers in this context that creating a penalty to reduce unavoidable outages is inconsistent with the National Electricity Law objective. The safety and security of networks should be paramount, and this imperative should not be undermined by design features of any future s-factor scheme. It is also reasonable to suggest that customers value reductions in unplanned interruptions more than planned interruptions as they are better able to mitigate the disruption caused by planned outages where they have prior warning. Planned outages should be excluded from the s-factor schemes.

ENA considers it important that appropriate exclusions are built into the service incentive scheme. The current exclusion criteria for transmission businesses is an appropriate approach for distributors, this criteria is based on *force majeure* events which are defined within the service target performance incentive scheme for transmission businesses. This qualitative approach ensures that the distributor is not penalised for events that are not reasonably foreseeable by the distributor. The ENA also considers a quantitative approach to be potentially appropriate in combination with a qualitative approach.

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