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by email: incentives@aer.gov.au.

Dear Sebastian

Thank you for the opportunity to provide a response to the Draft Capital Expenditure Incentives Guideline.

The incentive design issues covered in this guideline are particularly important to the EUAA's members. We contend that flaws in capex incentives dating back to the AEMC's initial Chapter 6 and 6A Rules account for a large part of the much higher prices and inefficient over-spending by network service providers (NSPs) that users have had to bear.

In this submission we develop our response to the Draft under various headings, which are expressed as choices between competing propositions.

Constant or declining incentives?

We remain of the view that incentive power should decline over the course of the regulatory control period, to reflect greater uncertainty in the forecast level of capital. Such decline reduces the prospect of windfall gains or losses as a result of inaccurate forecasts.

We also continue to believe, on the basis of the evidence we submitted in our submission on the Issues Paper, that there is no compelling evidence in electricity networks of inefficient intra-period or inter-period capex shifting. We recognise nonetheless that there is evidence of this in gas distribution in South Australia, and also that the Essential Services Commission of Victoria was concerned about this in its regulatory controls for distributors in Victoria.

While it would be possible to create declining incentives using the AER's CESS mechanism, we recognize that this would create additional complexity. Simplicity in incentive design is

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important. For this reason we recognise that the detriment attributable to the additional complexity in specifying sharing factors that decline during a regulatory period, may not sufficiently compensate for the benefit of possible reductions in windfall gains or losses that declining incentives would offer.

Forecast or actual depreciation?

The AER has left open the possibility of using actual depreciation to calculate the closing asset base, rather than forecast depreciation. This provides higher-powered incentives if actual expenditure is below forecast expenditure (i.e. the firm captures more of the benefit of under-spending). But it also provides weaker incentives if actual expenditure is above the forecast (i.e. using actual depreciation means that the firm bears less of the detriment if spending exceeds allowances).

On balance we prefer the use of forecast depreciation in combination with a CESS that provides appropriate sharing factors for gains and losses. This is because it provides constant incentives irrespective of asset age (assuming actual WACC equals allowed WACC).

Symmetric or asymmetric incentives?

The AER has expressed a preference for what it refers to as symmetric incentives (i.e. incentives that are intended to ensure the firm shares equally in gains when under-spending allowances as it would in losses when overspending allowances). We disagree with the proposition that the same sharing factor is actually a symmetric incentive. It may appear to be the case, but looking at the regulatory design as a whole we suggest it is not, for the following reasons:

1. The regulatory design allows for the pass-through of additional costs in various circumstances. While in principle NSPs can apply to pass-through cost reductions as well as cost increases, there is no record of NSP's ever proposing pass-through of cost reductions. By contrast there have been numerous pass-through applications resulting in higher charges for users. The pass-through arrangements are therefore asymmetrically to NSP's benefit.
2. The regulatory design for transmission provides for the ability to seek additional expenditure during a regulatory control period on "contingent" projects. Again this is an asymmetric provision.
3. The regulatory design provides for re-openers, which NSPs alone have the ability to apply for. Users can not apply to re-open regulatory decisions.
4. Concerns about under-investment threatening reliability encourages regulators to err on the side of caution (on the basis of the logic that the economic loss from the failure to supply can be expected to be much less than the economic loss attributable to the carrying cost of inefficient over-investment).
5. Information and resource asymmetry (between the NSPs and the AER, and between NSPs and users) is likely to result in regulatory expenditure allowances that unavoidably err on the side of NSPs rather than users.

We are aware of the AER's argument that its effort in developing more accurate expenditure allowances will reduce the prospect of asymmetrically higher expenditure allowances. While we recognise the work that the AER is doing to understand NSP expenditure more deeply, we

suggest it is improbable that the AER (or indeed any regulator) will ever be able to predict efficient expenditure requirements accurately. Indeed it is the inability to do so, that is the reason incentives are so important in encouraging NSPs to discover efficient expenditure.

For these reasons, we suggest that the specification of identical sharing factors for both over and under spend is *apparently* but not *actually* a symmetric incentive. An apparently asymmetric sharing factor (higher sharing factor for over-spend) is needed to compensate for the asymmetries described above.

Should the capex incentive scheme discriminate on the basis of ownership?

The AER has proposed ownership-invariant incentive schemes. Underlying this proposal is the notion that government and privately owned NSPs value financial profits in the same way. We don't think this notion is valid for two reasons:

1. Government-owned NSPs are often required to meet various other non-financial objectives – maximizing pecuniary gains is only one of their objectives. Financial objectives are often in conflict with other objectives their government owners require them to pursue. There can be no doubt about this: the NSPs themselves say this is so.
2. Government-owned NSPs collect debt fee income and income tax equivalents. The sum of these can increase net profits after tax by around 40%. The income from these additional sources means that government-owned NSPs can accept a lower pre-tax return on investment and still achieve the same post-tax return on investment as their privately owned peers.

The AER's cost of capital regulation does not take account of these fundamental differences between private and government-owned NSPs in setting the allowed return. The EUAA has long disagreed with this, but we recognise that the AER does not have the "policy mandate" to address this concern.

However, we do consider that the AER has the mandate to address the implications of this in the design of capex incentives. The practical outworking of the fact that government-owned NSPs have an intrinsically lower cost of capital as their privately owned peers, is that in assessing the gains and losses from over-spend and under-spend during the regulatory control period, it is necessary to have regard not just to the effect during the regulatory control period (through the CESS) but also to gains that arise once the depreciated value of the actual expenditure has been rolled into the regulatory asset base. These gains arise because the government-owned NSPs will be discounting future cash flows over the remaining life of the asset at a lower cost of capital than the AER has determined. To calculate the real gain or loss to government-owned NSPs it is therefore necessary to take account of the CESS plus the present value of these gains over the remaining life of the asset.

To quantify this effect we have developed a model, which we have attached to this submission. The model suggests that differences between the allowed and actual cost of capital can have a significant effect on the incentives of government-owned NSPs. For example, we assumed an asset which had a depreciation life of 35 years, an expenditure allowance of $10m in the first year, and actual expenditure of $12m in the first year, and a difference between actual and allowed cost of capital of 120 basis points (an allowed pre-tax real WACC of 5.5% and an actual pre-tax real WACC of 4.2%). The model shows that for the

AER's proposed CESS, the NSP loses $0.63m of the $2.09m overspend (stated as a present value at the start of the next regulatory period). But then the NSP gains $1.43m (stated as a present value at the start of the next regulatory period) because the allowed depreciation and return (based on the higher allowed WACC) is being discounted by the NSP at the lower actual WACC. The sum of the loss during the regulatory period but gain over the remaining life of the asset leaves the NSP ahead by $0.8m. In other words, the effect of the actual WACC being 120 basis points below the allowed WACC means that rather than an NSP bearing $0.63m of a $2.09m loss, it is actually better off my $0.8m.

We recognise that there is some uncertainty about the precise effect. It will depend on the year in which the over or under spend occurs, the life of the asset, and of course on the difference between the actual and allowed WACC. The first of these factors is not significant. The second (life of the asset) is significant for assets that are likely to be full depreciated by the end of the regulatory period (the difference between actual and allowed WACC will make little difference for these assets). The third (the difference between allowed and actual WACC) is also significant. Our working assumption is that the difference is at least about 120 basis points, based on a tax rate of 30% and equity making up 40% of the WACC. In sum therefore, for the vast bulk of NSP assets which are likely to have a depreciation life of at least 30 years, the effect of the difference between allowed and actual WACC will be significant.

There are several ways to deal with this problem. One way would be to set higher sharing factors in the CESS for the government-owned NSPs. However, a higher sharing factor for underspend is unlikely to be necessary (or equitable) since the NSP is already receiving compensation as a result of WACC differentials once the asset is rolled into the RAB. As such, strengthening the incentive on underspend will result in a disproportionate share of the underspend accruing to shareholders.

A second approach would be to apply a higher sharing factor on overspend to both government and privately-owned NSPs. The advantage of this approach is that it avoids the potential difficulties of applying different regimes to private and government NSPs. The EUAA sees no particular problems with this – better to recognise reality than hide from it – but we appreciate that others do not always see it this way.

The disadvantage of this approach is that privately owned NSPs end up with a higher penalty on over-spend than government-owned NSPs do. We recognise that this is not ideal, but the compelling evidence of the outcomes delivered by privately owned NSPs in the NEM is that there is a very low likelihood of privately owned NSPs spending more than their regulatory allowance. As such the fact that they face a higher penalty on over-spend may be of little more than academic interest.

Finally, we need to address the question of the appropriate sharing factor on overspend. Using the attached model, we find that with a 70% sharing factor on overspend (70% borne by the firm, 30% by users) government owned NSPs will no longer derive benefit from over-spending their regulatory allowances. Accordingly our suggestion is for a 30% sharing factor on underspends and 70% on overspend irrespective of NSP ownership.

Ex-post or ex-ante assessment?

The AER has suggested that the threat of ex-post adjustment of overspend strengthens incentives not to overspend regulatory allowances. We are not convinced by this. That the "inefficient dollar" can easily be identified and the shareholder made to bear it is, we suggest, not realistic. Inefficient expenditure is skilled in making itself invisible. Attempts to find it, and then make shareholders bear it, can become little more than invitations to gilt-edged tea parties for lawyers, consultants and lobbyists. Indeed the damage may extend not just to unnecessary transaction costs and red tape, the apparent threat of ex-post adjustments is an invitation to NSPs to claim greater investment risk and thereby demand even higher regulated returns. This will be, of course, highly regrettable.

It is true that ex-post assessment is well entrenched in the U.S., in their utility regulation. However their model is quite different to ours. It entails regulatory controls with a very high degree of asset-specificity and controls with much shorter duration. It is one thing to assess the efficiency of actual expenditure on a specific transformer for which a specific budget was set. It is an altogether different matter to assess the efficiency of expenditure on an aggregate capex budget – typically for several billions of dollars on many different projects over five years. The AER has experience of ex-post assessment in the MetroGrid project – a joint AusGrid and TransGrid project in 2003. This experience should be brought to bear in the AER's consideration of what might realistically be expected from ex-post assessments.

For these reasons, while we recognise that the AER has authority under the Rules to make ex-post assessments, in our opinion it is not convincing to suggest that this will ever be a meaningful or effective element of the AER's regulatory controls. As such reliance on it to act as an effective constraint on expenditure is, we suggest, misplaced.

Finally, we thank you again for the opportunity to provide the views of our Association and its members in this important area.

Yours sincerely

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Chief Executive