11 March 2022

Mr Sebastian Roberts
General Manger, Network Expenditure
Australian Energy Regulatory (AER)
GPO Box 3131
Canberra, ACT, 2601

Dear Mr Roberts,

AER DISCUSSION PAPER: REVIEW OF INCENTIVE SCHEMES FOR NETWORKS

Endeavour Energy appreciates the opportunity to provide feedback to the AER's Discussion Paper (the paper) setting out its approach to reviewing the incentive schemes established in the National Electricity Rules (NER). These schemes are critical components of the regulatory framework as they are designed to encourage networks to operate efficiently in the absence of competitive pressures to do so.

The Efficiency Benefit Sharing Scheme (EBSS), the Capital Expenditure Sharing Scheme (CESS) and the Service Target Performance Incentive Scheme (STPIS) are delivering on this objective as demonstrated by the recent trend of network expenditure reductions and service improvements. Not only has this performance delivered financial rewards for several gas and electricity networks including Endeavour Energy, but they have also generated significantly larger benefits for consumers in the form of reduced network prices and better reliability.

Simultaneous improvements in cost and service outcomes indicate the incentives to outperform allowances and targets are well balanced and have been effective in encouraging efficiency seeking behaviours. It also affirms the Australian Energy Market Commission's (AEMC) conclusion that the current regulatory framework provides appropriate incentives for efficient investment decisions.[1] In short, the incentive schemes are working as intended to promote the long-term interests of customers.

Whilst the financial rewards from the schemes which accrue firstly to networks for performance improvements are straightforward to determine, the benefits to customers are delayed and not as discernible. This potentially gives rise to concerns by some stakeholders regarding the size of the rewards paid to networks and whether they reflect real efficiency gains that customers also benefit from.

To provide some context on the total benefits from the incentive schemes, in 2019 Energy Networks Australia (ENA) published a report which estimated that between 2006 and 2018 the EBSS and STPIS had delivered an estimated $6.3 billion of additional benefits to customers.[2] More recent estimates from HoustonKemp (which includes the addition of the CESS) suggest the incentive schemes have delivered at least $13.4 billion of benefits between 2006 and 2020.[3]

The financial rewards earned by Endeavour Energy to date demonstrate that we are responding efficiently to the incentive schemes. Benefits in the form of sustained real cost reductions have and will continue to flow through to our customers as a result of our efficiency gains. These gains have been evidenced by our improvement from the 8th most efficient Distribution Network Service Provider (DNSP) in 2016 to 4th in 2020 per the AER's Multi Total Factor Productivity (MTFP) measure.

Whilst we are committed to keeping costs as low as possible, whether our expenditure reductions and service improvements are sustainable are best tested over time. To the extent they are not, we will accrue penalties that partially offset the rewards earned to date. Our preliminary forecasts indicate that we will spend our entire 2019-24 capex allowance and our opex will increase (from FY20) in the coming years meaning it will become increasingly difficult and unlikely that we will be able to replicate previous performance improvements and rewards.

[1] AEMC, Economic regulatory framework review, 2018 Final report, July 2018, p.35
[2] This estimate increases to $11.2 billion if industry average discount rate is adopted.
[3] This estimate increases to $22.3 billion if industry average discount rate is adopted.

We expect this experience will be shared by several DNSPs as opportunities to address organisational and structural inefficiencies are exhausted. Also, new and uncertain cost pressures as part of facilitating the transformation of the energy sector and improving resilience against increasingly frequent and severe weather events will inhibit the ability of networks to make sustainable cost reductions. This points to incentive scheme penalties becoming more frequent and material payments scarcer over time.

It is important the performance of incentive schemes should also be reviewed over several years as shorter periods may be subject to business specific circumstances or significant exogenous events. Further, the benefits accrued to networks should be viewed in the context of the benefits customers have or will also accrue which are substantively higher. Whilst a counter-factual does not exist to validate these benefits incentive regulation is widely accepted as the optimal regulatory approach and the available evidence suggests the schemes have been effective to date.

We therefore welcome the AER's finding that networks are responding appropriately to the constant incentive to reduce opex. With respect to the CESS, we note the AER has raised concerns with the timing of capex within periods (particularly early period underspends) and the risk of inefficient capex being included in allowances resulting in windfall gains to networks.

As noted above, we caution against drawing any definitive conclusions on the CESS given most networks have only been subject to it for a solitary full regulatory period. We also caution against relying on within period capex timing to evaluate a network's response to the CESS. This is because the CESS is primarily designed to incentivise capex reductions rather than incentivise capex that is timed in accordance with the allowance. Instead, the CESS neutralises the financing impacts of capex timing differences to enable networks to flexibly manage and respond to a variety of factors which impact spending decisions as contemplated by the regulatory framework.

Given this, we consider it is premature to change the strength of the financial incentives in response to how a network is perceived to be responding to individual schemes. This could unintentionally create an imbalance in the existing incentives. For instance, a reduced CESS reward could create a bias towards opex savings which would be rewarded more than the penalty from any offsetting capex increase (ignoring the temporary impact of market factors on the EBSS sharing ratio).

Whilst the AER has the flexibility to alter the sharing ratio (or application of the CESS entirely) on a case-by-case basis it is important that this discretion is exercised cautiously in order to balance accuracy with the regulatory stability and predictability that is central to the effectiveness of incentive regulation. It may only be warranted where the AER is not able to validate the sources of outperformance for the prevailing regulatory control period and/or the extent to which deferrals have occurred following an information gathering exercise.

We would expect this to be a rare occurrence given there are considerable safeguards in the broader regulatory framework that mitigate the risk of inefficient capex amounts or deferrals being included in allowances and rewarded by the CESS. The AER has several guidance notes, the Better Resets Handbook expectations, substantive information gathering powers and a robust ability to scrutinise and determine an efficient capex allowance and/or monitor spending trends. We consider these measures are effective and appropriate and they will be further enhanced over time as the CESS incentivises networks to pursue (and reveal) further efficiencies and improvements to the AER and stakeholders.

We support the ENA's submission to the paper which is underpinned by the aforementioned analysis by HoustonKemp. Our views on key issues discussed in the paper are included in Attachment A. To discuss our submission further please contact [redacted] Manager Regulatory Transformation and Policy at Endeavour Energy on [redacted]

Yours sincerely,

Colin Crisafulli
Head of Network Regulation

Attachment A – Endeavour Energy's feedback to key focus areas

Increased capex later in a regulatory period can be driven by operational and organisational needs that have been appropriately prioritised over optimising CESS performance and expectations.

The paper draws on recent capex patterns to highlight potential areas of concern with the CESS. One of these patterns is the propensity for networks to underspend their capex allowance early in the period and overspend later in the period. This conflicts with expectation that the CESS would lead to smoother spending patterns.

In our view, reviewing within period capex spending patterns provides limited insights into whether a network is responding efficiently to the CESS and should be interpreted with caution. The CESS provides networks a continuous, time invariant incentive to spend less than the total period capex allowance as distinct from promoting a stable annual capex profile.

Regarding the latter, it is worth noting that DNSPs have the flexibility to prioritise expenditure programs over the course of the regulatory control period. This discretion can result in expenditure to vary from forecasts and limits any meaningful conclusions about an individual networks' performance from a single year 'snapshot'. Rather, inferences about a network's expenditure performance are more accurate and informative when reviewed over the length of a regulatory period.

Capex variability within a regulatory period does not point to a failing of the CESS but rather can be explained by networks responding flexibly and efficiently to a combination of endogenous and exogenous factors. To the extent that urgent and unforeseen events arise that require new projects to be undertaken, networks typically bear the cost of this forecasting risk noting outside of the cost-pass through and contingent projects mechanisms (which are both subject to materiality thresholds), there is no mechanism to adjust capex forecasts and the CESS for expenditure that falls into the efficient capital expenditure bucket.[4]

Inferences about a network's response to the CESS require these factors to be considered. In Endeavour Energy's case, capex variability in recent years has been driven by a number of factors (in no particular order):

- Investment uncertainties: Planning assumptions are made several years in advance for the purpose of setting an allowance. The actual requirements will invariably differ from these forecasts and networks must respond to revealed requirements.
- COVID-19: Forecasting risk has been further exacerbated by COVID-19 which has impacted our ability to carry out BAU activities (such as being restricted to emergency works, creating an uncertain environment and procurement delays) and impacted the level of developments, connections and demand across our network.
- Natural disasters: similar to the above, we were forced to prioritise our resources to responding to the unprecedented 'Black Summer' bushfires, floods and major storms.
- Organisational changes: refocussing our strategic objectives and reviewing and improving our asset management framework (in response to AER and EMCa feedback during the 2019-24 proposal process) may have delayed investment in the early part of the 2019-24 period.
- Efficiency programs: we are in the process of implementing an ICT efficiency program and a targeted efficiency project was also undertaken in FY20. However, it will not be known whether these savings are fully realised or more importantly sustainable until later in the period.
- Accounting adjustments: the were some large provision movements during FY20 that may have a one-off impact on our opex due to Accounting Standards. It is important to note that opex for EBSS and forecasting purposes and the capex used for roll-forward purposes are all adjusted for movements in provisions to neutralise this impact from a customer perspective.

[4] Noting under the CESS 'unexpected capex' can only be considered where the AER is assessing whether a capex deferral has occurred (i.e. as the potential cause or offset of a deferral).

Essentially, the CESS (and EBSS) is designed to ensure there is no benefit to underspending capex early in a period and overspending late in a period. However, it is worth noting the ex-post review period covers a differing period[5] to a regulatory control period which may also distort a networks capex timing decisions. Also, whilst Endeavour Energy's revised capex was accepted for the current regulatory control period we note other networks may face challenges early in a period reassessing and reprioritising investments following a substituted AER allowance.

There are effective safeguards which prevent networks over-forecasting expenditure to earn incentive scheme rewards.

As highlighted in the paper, some stakeholders have raised concerns that the incentive schemes incentivise networks to overestimate future expenditure forecasts and defer projects between regulatory periods. A lack of transparency behind the reasons underpinning the underspending of allowances has also raised suspicions that rewards have been paid for reasons other than genuine efficiency gains.

To clarify, any incentive by networks to over-estimate forecasts predates the introduction of the EBSS and CESS. The purpose of these schemes is to provide networks a constant and time invariant incentive to outperform its allowance. By encouraging improving performance these schemes in turn help inform future expenditure allowances. However, there are several other aspects of the regulatory framework that also support the AER's ability to set prudent and efficient allowances which must also be considered.

In theory, over-forecasting would make it easier for networks to underspend a generous rather than efficient allowances and in turn receive a larger financial reward (or smaller penalty) from the EBSS and/or CESS. However, in practice these opportunities are limited as there are substantial information gathering requirements, consultative and engagement processes and safeguards within the regulatory framework that encourage both networks to minimise their expenditure forecasts and the AER to set allowances no more than efficiently required to satisfy the opex and capex objectives and criteria prescribed in the NER.

Since the Better Regulation reforms, the AER has continued to improve its expenditure assessment techniques and capabilities to ensure that expenditure allowances reflect the efficient amount required to provide network services valued by customers. Enhanced information gathering powers and an increase in the quantity and quality of financial and operational information and data disclosed by networks to the AER has facilitated this improvement. This has significantly reduced information asymmetries that were previously barriers to the AER determining an efficient expenditure forecast which has resulted in a gradual convergence between actual expenditures and allowances, most notably capex.

Operating Expenditure

Specifically for opex, the AER has refined its benchmarking tools and its application to make more accurate and informed assessments of base year opex efficiency. Since 2019, the AER has also applied a positive productivity factor which adjusts (reduces) opex forecasts for expected efficiency improvement trends which, in contrast to the EBSS sharing ratio, ensures customers receive 100% of these benefits. More recently, the AER's review into the impact of different capitalisation practices looks to improve the comparability of network benchmarking performance.

The revealed cost approach means that a network's actual expenditure is used more directly to inform opex forecasts than capex. If networks were actively inflating their opex forecasts, an increase in base year opex would be observed. Encouragingly, the AER has found no systematic evidence to suggest networks are inflating base year opex which indicates the EBSS and the AER's benchmarking

[5] The most recent five years of actual expenditure data at the time of the AER's draft decision (i.e. the final two years of the preceding regulatory control period and the first three years of the prevailing regulatory control period.

assessments are working together effectively to provide constant incentives to reduce opex to efficient levels.

An additional deterrent to over-forecasting opex is the risk of the AER making a downward efficiency adjustment to base year opex. As recently evidenced in Jemena's 2021-26 draft opex determination, the AER has this ability if its benchmarking analysis suggests that opex in the base year is not suitably efficient to inform next period opex forecasts.

It can be difficult for a network to determine ahead of time whether the AER will apply an adjustment and where this is considered a reasonable possibility (especially if it is unknown whether and how the AER might alter its assessment approach), networks will be incentivised to minimise base year opex or alternatively, as in the case of Jemena's revised proposal, adjust opex forecasts to include savings not reflected in the base year. It is worth noting that spending below an allowance in the base year does not preclude the AER making an efficiency adjustment.

A related risk is the possibility of the AER not applying the EBSS where a base year adjustment is applied (and CESS where they consider a network has not responded efficiently). Although this would further incentivise networks to reduce their base year opex, we consider suspending the EBSS and/or CESS in these circumstances is counter-productive as it would not promote the efficiency seeking behaviour from networks that ultimately deliver significantly larger benefits to customers.

Capital Expenditure

As capex is inherently more variable than opex, the AER principally relies on its statistical repex model and detailed supporting documentation and analysis (typically project assessments, cost-benefit analysis and overarching investment plans and strategies) when undertaking capex assessments. Coupled with RIN data, the inputs and assumptions underpinning capex proposals is subject to intense scrutiny by the AER, the CCP as well as various consumer and stakeholder groups and expert consultants engaged by the AER.

More recently, the AER has provided additional guidance to assist networks prepare the capex forecast for a range of capex categories. In a broad sense, this guidance outlines the AER expectations of what it considers constitutes a well justified proposal and clarifies its assessment approach. The Better Reset Handbook also provides a pathway for networks to access a more streamlined determination process which is designed to incentivise networks to more closely involve consumers and consider their views in developing forecasts.

When considered holistically, the strict conditions and criteria which a network's capex forecast must adhere (largely set out in the NER), improved network information transparency, extensive and rigorous capex assessment undertaken by the AER, clearer and stringent expectations on 'justifiable' capex and new incentives to adopt a more consumer-centric approach to developing capex forecasts all work in unison to limit the risk of networks inflating their capex proposals.

On the issue of deferrals, we note that the CESS can be adjusted so that short-term deferrals from one period to the next do not result in a CESS benefit for 'double dipping'. We support this approach and consider it should be used in circumstances where the deferral is driven by exogenous factors rather than efficiency improvements or demand management solutions implemented by a network.

A key issue in utilising this feature of the CESS is determining whether short-term deferrals have occurred and the specific projects driving them. At a high level, a significant capex underspend (at the total or category level) followed by a material proposed increase would be an obvious trigger for investigation. We consider a review should be triggered by category level movements and/or the extent to which outputs have been achieved over the course of a period. Whilst project level information is available (and can be improved) there is likely to be a high degree of variation at this level.

On project level information, capex forecasts are typically accompanied by significant and detailed supporting information regarding a network's forward program of capital projects. Whilst the AER does not determine which programs or projects should be undertaken when setting an allowance, they are provided with sufficient transparency to determine whether the proposed costs of a project or program has previously been provided for. Where additional information is required, the AER has significant information gathering powers to help determine whether an adjustment to the CESS is required and the value of the adjustment.

This has enabled the CESS to be adjusted by the AER to the tune of approximately $200m for a handful of identified project deferrals across several determinations following its first period of application. The vast majority of these deferred projects and related CESS adjustments were proactively identified and proposed by networks ahead of the AER decisions.

Whilst this does not appear to be a material issue at this stage, improvements could be made such as better explaining capex variations either as part of annual reporting requirements and/or Better Resets Handbook engagement. The latter in particular could be a focus area so that customers are provided a clearer understanding of the value the incentive scheme has generated for them.

A flexible approach to applying incentive scheme rewards and benefits must be mindful of the importance of providing regulatory certainty and a balanced incentive framework.

The paper discusses the possibility of tailoring incentive schemes according to a how an individual network has responded to incentives. This is within the AER's remit of ensuring the CESS achieves its objective of incentivising efficient capex. It is also akin to the more well-defined process for suspending the application of the EBSS where a benchmark approach is instead used to set the opex allowance.

However, the necessary conditions to trigger a bespoke approach for the CESS are less clear. It is worth noting that the CESS is distinct from the EBSS in that it is contained to each regulatory period. The EBSS is directly linked to 'revealing' the efficient level of opex that is then used as part of the base-step-trend approach to setting future opex allowances. Unlike opex, capex is less recurrent and therefore a 'revealed' level of capex efficiency within one period does not necessarily translate into future periods. The CESS was introduced to correct the declining incentives for efficient capex over a regulatory control period.

As such, the primary value of the EBSS is realised through the lower future opex allowances and the primary value of the CESS is a lower RAB. This means that a capex underspend in one period does not necessarily mean the next period will start from this point. Instead, there may be changing circumstances (licence conditions, growth forecasts, asset condition, etc) that require a different forecast level of spend.

However, we accept it remains a reasonable starting point for the AER to test and understand the reasons for any changes and whether the current period reflects an efficient outcome. We therefore support the approach contemplated in the AER's Better Resets Handbook to assessing capex which indicates a focus on period to period variations to guide the AER's review .

We therefore stress the importance of establishing a clear process or circumstances under which a bespoke CESS arrangement is triggered. As aforementioned, we would suggest this is where other avenues have been exhausted to determine the source of outperformance and the potential for between period deferrals. If the AER is not provided sufficient information to confidently determine this then it may be appropriate to modify or suspend the application of the CESS.

This assessment should be mindful of the complex and varied reasons which could influence a network's historical and forecast capex – both between years and regulatory periods. We caution against any presumption that a network proposing capex increases after a period of underspending and accruing a CESS reward should be considered as being unresponsive (or inefficiently so) to the CESS by default.

A balance must be achieved that does not involve a line-by-line assessment of capex projects that is contrary to the AER's regulatory task of setting a revenue allowance (rather than acting as a technical regulator) and which provides customers confidence that they are receiving value for money. The AER must also be mindful of not disincentivising networks from pursuing capex efficiencies and instead spending at the allowance to avoid the administrative burden of a CESS deferral assessment.

Whilst the AER can decide to not apply or suspend the EBSS, the CESS offers the AER the added flexibility to apply the scheme but vary the sharing ratio. It would be worth understanding whether the AER wishes to delineate between circumstances that warrant the suspension of the scheme entirely versus varying the sharing ratio.

Similarly to the decision to apply the scheme itself we would caution against regular (or even infrequent) variations to the sharing ratio, particular given the CESS has not been in operation for a long period of time. The importance of symmetric rewards and penalties is that it encourages networks to make efficient trade-offs between different types of expenditure and between service levels and costs. Balanced and symmetrical incentives between the CESS and EBSS in particular encourages efficient substitution between capex and opex. Where a change is made that would reward a network less for capex reductions than for opex reductions (or vice versa), an inefficient capex bias could develop.

This tendency was noted by the New Zealand Commerce Commission:[6]

> *In DPP2* (Default price-quality path) *there was a significant differential between the incentive rates applying to opex and capex, and this asymmetric treatment of opex and capex savings may contribute to a capex bias. This may have distorted decisions such as whether to consider non-wire (opex) solutions. Reducing or removing this differential will reduce this distortion.*

The AEMC did not find any conclusive evidence that the investment decisions of Australian networks exhibited a bias towards capex under the current regulatory framework.[7] It is also worth noting that the suspension or dilution of the existing sharing ratio could expose customers to the risk of expenditure increases or prove insufficient to combat the information asymmetry the exists between regulated networks and the AER and stakeholders.

On the latter, the AER's ongoing clarification and refinement of its reporting and assessment requirements, along with improving customer engagement practices also effectively mitigate the risk of over-forecasting. These improvements were foreshadowed by the AER when the merits of a symmetrical CESS was originally considered:[8]

> *We also noted that that our forecasting approach for capex will improve through new measures and techniques we develop through the Expenditure Forecast Assessment Guideline. For this reason we considered that concerns about generous allowances are likely to decline in the future, so it would be more appropriate to apply a symmetric rather than an asymmetric CESS.*

And:

> *Information asymmetry is always a challenge when assessing regulatory proposals. In developing our guideline as part of the Better Regulation program we have carefully considered what additional measures are required to address this challenge. We consider the developments we have made to our forecasting toolkit, along with the AEMC's rule changes*

[6] Commerce Commission NZ, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision, Reasons paper, Nov. 2019, p.270

[7] AEMC, Economic regulatory framework review, 2018 Final report, July 2018, p.vii

[8] AER, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, Explanatory statement, Nov. 2013, p.23-25.

and development of greater internal expertise will reduce the risks that forecasts will be systematically biased upwards in the future.

It was for these reasons, inter alia, that a symmetrical sharing ratio was set when the CESS was established. Since its introduction there has been a significant dilution of the EBSS sharing ratio (in the favour of customers) as a result of regulated rates of return falling below the assumed 6%.

In theory, this movement could result in a capex bias but per the pre and post CESS analysis included in the HoustonKemp report it can be observed that capex underspending in the post-CESS period have not increased as the WACC, and therefore the EBSS sharing ratio, has declined. This may be due to the impact of the ex-post review on investment decisions or a range of business specific or exogenous factors driving behaviour. Without being able to draw any firm conclusions from the data it would be premature to make any adjustment to the sharing ratio for the movement in the EBSS sharing ratio at this stage.

Given this, and the improvements to the AER's predicated improvements in its forecasting approach, it is unlikely adjustments will be required at the individual network level. We recommend a clear criteria is established to outline where the CESS would remain in place but the sharing ratio would be amended.

In our view, this decision is even more complex then deciding whether the apply (or not apply) the scheme at all. It would essentially be limited to circumstances wherein the AER was only partially confident (in a quantifiable way) in its ability to assess the drivers of current period performance and/or between period deferrals. It also could risk being predicated on assumptions of how responsive networks are to incentive schemes beyond a bona fide level.

If there were to be more bespoke sharing ratios set from a principled perspective we consider a higher rate should apply to networks as they become more efficient. This would be to reflect the increasing challenges of making and sustaining efficiency gains as they approach the efficiency frontier. This accords with the AEMC's view that the AER could apply stronger incentives for networks that traditionally spend more than their allowance and weaker incentives where the AER is concerned about inefficient deferral into future regulatory control periods.[9]

That said, our position remains that there is no clear justification for more bespoke sharing ratios at this stage. Further, efficiency improvements will generally require networks to commit to increasingly significant upfront costs while the timing and quantum of benefits becomes riskier and more uncertain. Consequently, networks require a stable and predictable framework that provides confidence that the rewards anticipated from investments in business improvement will be realised.

We therefore recommend the approach contemplated by the AER in the Better Resets Handbook is adopted. That being; the AER investigate instances of material underspends at the total and/or category level followed by proposed increases for deferrals and to understand whether there has been an inefficient outcome or over-forecasting bias rewarded. In such instances. A CESS suspension or amendment may then be justified where this process cannot reliably support a more targeted solution such as a CESS deferral adjustment or amendment to the proposed forecast. We also support efforts to improve the transparency of incentive schemes more broadly so that customers can access simple and clear information on their value.

[9] AEMC, Economic Regulation of Network Service Providers Rule 2012, Final Rule Determination, Nov. 2012, p. 122.