17 May 2013

Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

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Dear Mr Roberts

Better Regulation – Expenditure Incentive Guidelines – Issues Paper

Energex Limited (Energex) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Better Regulation Issues Paper (the Issues Paper) on the Expenditure Incentive Guidelines for electricity network service providers (NSPs).

It is important to recognise that any development of additional and/or enhancement of existing incentive schemes that may apply to NSPs, is occurring at a time of unprecedented regulatory and policy change. Last year's Australian Energy Market Commisssion's (AEMC) rule determination on the economic regulation of NSPs provided the AER with an increased capacity to review forecast and actual expenditure, including an ex-post capital expenditure review mechanism. In addition market reviews such as the AEMC's national framework for reliability, including the determination of reliability standards by customers, could have substantial ramifications for drivers and incentives for NSPs' capital expenditure (capex). These significant regulatory developments have coincided with a major state based review in Queensland aimed at reducing expenditure to manage price increases.

Energex understands that the potential design and application of any ex-ante incentive schemes provided for under the National Electricity Rules (NER) may be determined to the extent the AER considers a NSP to be responding to existing incentives. This is likely to be highly problematic for the AER given the extent and timing of these regulatory and policy changes. As such Energex considers any introduction of complex incentive schemes increases the potential for error and perverse outcomes. Accordingly, Energex would recommend a more staged and low powered approach to the introduction of further incentive schemes (including the use of paper trials). In this way the impact of individual regulatory changes can be examined in a pragmatic manner to avoid any potential unintended outcomes.

Energex also notes that no Distribution Network Service Provider (DNSP) has completed its first distribution determination administered by the AER under the NER framework, which limits any judgements that can be made about how a DNSP is likely to respond to the various incentive arrangements created under the NER.

Provided below are some general comments regarding each of the schemes while responses to the specific questions raised in the Issues Paper are

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provided at attachment 1.

Capital Expenditure Sharing Scheme (CESS)

In regards to the AER's proposed capital expenditure sharing scheme (CESS), Energex considers that the AER should carefully consider whether such a scheme is warranted at this time. Energex's view is that DNSPs are sufficiently incentivised to seek efficient expenditure outcomes both through shareholder and stakeholder pressures and the revised regulatory framework, including the application of ex-post capex reviews and the use of actual depreciation.

To the extent the AER develops a CESS, Energex considers that the AER should clearly articulate its criteria for application of the scheme to individual DNSPs as required under clause 6.5.8A(e) of the NER. In particular, the AER needs to take into account the circumstances of the individual DNSP including historical and forecast future performance and its appetite for participating given revenue will be placed at risk under any such scheme. Energex's initial impression is that the AER intends a wholesale application of the CESS. However, to remain consistent with the NER, Energex considers that the AER should clearly articulate in the Expenditure Incentive Guidelines what criteria it intends to apply in determining applicability of the CESS to individual DNSPs.

Notwithstanding the above, Energex considers that any CESS developed by the AER should:

- provide rewards and penalties that are consistent with other incentive schemes applied to DNSPs. Failure to do so increases the potential for perverse outcomes; and
- in principle, provide continuous, symmetric rewards and penalties to facilitate the pursuit of efficient investment.

Changes to opex forecasting

Energex is particularly concerned that the AER appears to be advocating an exogenous approach to forecasting operating expenditure (opex) as a serious alternative to the current revealed cost approach. As indicated by the AER, available evidence does not demonstrate that the existing revealed cost approach is deficient. Furthermore, Energex is not aware that a sufficiently robust exogenous method for determining base opex is currently open to the AER because of deficiencies in the data sets available to the AER. This would be a substantial departure from the current form of incentive regulation. Inherent to the mandated building block approach is that the DNSPs forecast opex costs are the starting point of the AER's assessment. While the NER provide for the AER to consider the most recent annual benchmarking report in determining opex allowances, any substitution must be made with regard to the DNSPs proposed forecasts.

Accordingly, Energex considers that any exogenous approach (such as benchmarking) should have a limited role in forecasting at this time:

- benchmarking has not been sufficiently developed by the AER to be a robust base for forecasting purposes (including due to the absence of appropriate data sets); and
- the use of benchmarking should be confined to a top-down check of forecasts to assist the AER in assessing opex forecasts not as a means to establish base expenditure.

On this basis, Energex's responses to the AER's issues in relation to the efficiency benefit sharing scheme (EBSS) are not to be considered an endorsement of an exogenous forecasting approach in any way.

Ex-post capex review

The AER's proposed approach to ex-post capex reviews appears inconsistent with the NER. Specifically, S6.2.2A (c) of the NER restricts the AER to excluding only inefficient capital expenditure from the RAB where aggregate actual capex is above the forecast allowance; that is there has been an overspend over the whole five year regulatory control period. Accordingly, contrary to the process outlined by the AER in section 5.5 of the Issues Paper, the trigger for determining whether an ex-post assessment of prudency and efficiency is required is the existence of an aggregate overspend relative to approved forecast expenditure at the time of the relevant distribution determination.

Energex considers that, to the extent an overspend is identified, the AER should rely on a staged approach to determine the prudency and efficiency of the expenditure. This process should place the onus on the DNSP to explain and substantiate any capex overspend. In addition, given the serious implications of a detailed ex-post review, including asset stranding risk that is not compensated under the Weighted Average Cost of Capital, Energex considers that the AER should conduct a "first-pass" assessment of the capex overspend to determine if a detailed engineering review of expenditure is required. Energex considers that the AER should also provide guidance on the process it intends to apply in excluding the value of any identified inefficient expenditure from the regulatory asset base (RAB).

Finally, the Energy Networks Association (ENA) will be making a submission on behalf of its members next week. As a member of the ENA, Energex has contributed to the ENA submission and provides support to the submission. If you have any questions in relation to Energex's submission please contact Leigh Henderson, Network Regulatory Economist on (07) 3664 4118.

Yours sincerely

Kevin Kehl
Executive General Manager
Customer and Corporate Relations

Energex Limited

Response to AER's Expenditure Incentive Guideline – Issues Paper

17 May 2013

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Attachment 1 - Response to AER questions

Ex-Ante Measures for Capital Expenditure

Question 1 Do stakeholders agree with the issues that we have identified about declining incentives for efficient capex? Are there any other issues that could arise from declining incentives for efficient capex? If so, what are these?

Energex agrees, in theory, that under the current arrangements, efficient capex incentives decline over the regulatory period. However, evidence presented by the AER regarding capex spends in excess of forecast is not conclusive about the strength of this declining efficiency incentive. Moreover, as identified by the AER on page 12 of the Issues Paper, there has been limited analysis undertaken of the drivers of spending in excess of forecast that have occurred, including the efficiency or otherwise of that spending.

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.

Energex agrees with the AER that, to the extent a sharing scheme is developed, it should be continuous. This position is justified on the basis that non-continuous incentives can adversely affect decision making with respect to capex. For example, they may encourage a DNSP to front-load investment or to defer capex projects across regulatory periods.

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.

Energex considers that the key issue in the design of penalties and rewards is that these should be consistent with other incentive schemes (e.g. EBSS and service target performance incentive scheme (STPIS)) to facilitate unbiased decision making.

Energex does not agree with the AER that any associated reward should be reduced to address perceived concerns regarding reduced service levels. Energex considers that service quality issues are adequately addressed through jurisdictional obligations (e.g. minimum service standards) and the STPIS.

Energex considers that, to the extent the AER identifies perceived issues associated with a DNSP's performance (e.g. reduction in service quality) these should not be addressed through capex rewards/penalties. Rather, these issues should be addressed directly through changes to the assessment and incentives associated with the individual activity e.g. service quality.

Energex also notes the AER suggests that a DNSP can sacrifice service levels in the future to earn higher rewards from the CESS. While such an approach is possible, it assumes that service quality outcomes can be easily manipulated. The reality is that service quality for a distribution network typically involves a complicated mix of related expenditures and can be affected by a range of issues, most importantly weather. It is therefore extremely difficult (and unlikely) for a DNSP to manipulate service quality outcomes with sufficient precision to engineer increased rewards from a CESS.

Question 4
Do stakeholders agree with our initial position that the penalty for overspending should be greater than 30 per cent? Please give reasons to support your view.

Energex disagrees with the AER's proposal and considers that any penalty for spending in excess of forecast should be symmetrical with corresponding rewards.

The AER identifies a number of perceived issues associated with a DNSPs capex forecasts and the AER's ability to assess expenditure. On this basis, the AER presumes that DNSPs are more likely to exceed their capex allowances than not and this warrants the use of higher penalties for spending in excess of forecast vis-a-vis underspending.

Energex considers that any perceived problems associated with the AER's ex ante assessments of forecast capex should be addressed in the way that they are undertaken (and the recent Rules amendments have given the AER more powers in this regard), not through the capex incentive mechanism. In doing so, the AER risks generating perverse outcomes, including encouraging exaggeration of capex forecasts to mitigate the risk of penalties from spending in excess of forecast (contrary to the AER's intent). Similarly, the use of higher penalties for spending in excess of forecasting has the potential to lead DNSPs to opt against efficient investment decisions to avoid incurring the greater penalty. Energex considers that the AER has not adequately assessed the potential impact of its proposed asymmetric approach.

Further, Energex considers that the loss of income within-period associated with spending in excess of forecast (as a result of forgone WACC return and depreciation) coupled with the application of the ex post prudency and efficiency review provides sufficient disincentive for inefficient spending in excess of forecast. Energex considers that there is no need for the addition of a further asymmetric penalty within the regulatory period.

Energex agrees that the CESS should be based on the aggregate outcome over the full five year regulatory period not annual outcomes given spending priorities can change over the course of regulatory periods. This approach allows DNSPs the flexibility to manage capex as appropriate within the regulatory period.

Question 5
Do stakeholders agree with our initial position that one capital expenditure sharing scheme should apply to all NSPs? Please give reasons to support your view.

Energex agrees with the AER's initial position that one CESS apply to all DNSPs. Notwithstanding this position, the process should allow for DNSPs to propose minor variations to the scheme where individual circumstances dictate. Energex considers that the use of a single scheme will serve to increase certainty at the commencement of the regulatory period.

However, consistent with the Rules, Energex notes that the capex sharing scheme need not be applied to all DNSPs. Section 6.5.8A(e) of the Rules require the circumstances of the DNSP to be taken into account in applying the sharing scheme. Energex suggests that the AER should clearly articulate the criteria for application of the scheme, and the process and timing for making the determination. For example, it may be appropriate to include a discussion of the application of the scheme in the Framework and Approach component of the regulatory process.

As part of determining the application of the scheme to individual DNSPs, Energex considers it will also be important to take into consideration the views of the individual DNSP. Accordingly, the process for determining the application of the CESS should provide for the views of the individual DNSP to be adequately raised and addressed.

In determining the applicability of the CESS to an individual DNSP, Energex proposes that the AER should consider at least the following issues:

- Historical performance for example, whether the DNSP has exceeded its forecast capex during the current regulatory period and, in the case of greater-than-forecast expenditure, whether that over-spend is prudent and efficient;
- Forecast future performance, including:
  - whether capex is forecast to significantly increase in the next period;
  - evidence that the DNSP has identified capex efficiencies that it intends to pursue in the forthcoming regulatory period; and
  - whether the DNSP is likely to be incentivised by the CESS to pursue further efficiencies (given the extent of efficiencies incorporated in forecast capex).

Energex also notes that in determining whether a DNSP is likely to respond to the incentives created under the Rules framework, no DNSPs have yet come to the end of their first distribution determinations administered by the AER.

Question 6
If we were to tailor different schemes for individual NSPs, what criteria should we use to differentiate between NSPs?

As above, Energex considers that individual DNSPs should be permitted to propose variations to the general scheme. The onus should be on the DNSP to demonstrate that its circumstances are sufficiently different to warrant variation to the scheme. This may include the power of the incentive that the DNSP considers is appropriate to encourage it to pursue further efficiencies. Energex considers that any differentiation between DNSPs is on the basis of characteristics/performance of the individual DNSP not on the basis of ownership structure.

Question 7
Are there any categories of capex that should not be covered by a capital expenditure sharing scheme? Why?

Energex considers that capex associated with cost pass-throughs, contingent projects and re-openers should be excluded from any CESS. However, given capex can vary for any number of reasons, Energex considers that there should be provision for DNSPs to nominate categories of capex for exclusion on an individual basis, most likely prior to the commencement of the regulatory period. Energex for instance may opt to exclude capex driven by customer connections on the basis this expenditure is uncontrollable and can be readily identified.

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

Energex considers that adjustments may be appropriate where assumptions underpinning capex forecasts change materially during the regulatory period. For example, a material increase in maximum demand compared to forecast may justify an adjustment.

Question 9
Do stakeholders agree with our initial position to apply a continuous asymmetric capex scheme with higher penalties for overspending than rewards for underspending? Please provide reasons.

Energex agrees with the AER that any CESS should be continuous. However, Energex does not agree that the scheme should be asymmetric.

Energex considers that the AER has not presented a compelling case for the use of higher penalties for spending in excess of forecast. In particular, Energex considers that:

- any perceived bias toward spending in excess of forecasts (as proposed by the AER) should be addressed through the ex ante assessment approach not the capex incentive scheme;

- the use of an asymmetric scheme (in particular a higher penalty for spending in excess of forecast) is generally inconsistent with the overseas application of incentive schemes[1]; and

- the use of an asymmetric scheme increases the potential for perverse outcomes and may discourage legitimate efficient investment (for fear of incurring higher penalties).

Energex considers that, in order to facilitate efficient investment decision-making and limit perverse outcomes (between the various incentive schemes), penalties and rewards should be symmetric and consistent with other incentive schemes (EBSS and STPIS).

Question 10 Do stakeholders agree with our initial position that the penalties and rewards for a capex scheme should be included in the guidelines rather than determined as part of a determination? Please provide reasons.

Energex agrees that there should be up-front guidance with respect to potential penalties and rewards. This provides greater certainty to both the AER and DNSPs and allows for greater focus on the ex-ante assessment of capex forecasts throughout the determination process.

Depreciation

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?

Energex agrees that, where a capex sharing scheme is in place, forecast depreciation should be the default, otherwise actual depreciation should be employed.

Question 12 Do stakeholders agree with the factors that we have identified for consideration in determining whether to apply forecast or actual depreciation?

Energex considers that the relevant factors impacting depreciation identified by the AER appear reasonable. Energex would highlight that NSPs typically have an asset base with, on average, a long asset life and a low substitutability between assets of different asset lives.

Ex ante Measures for Operating Expenditure

Energex considers that there may be other reasons that past opex may not be a good indicator of future expenditure and therefore not an appropriate approach to setting base opex. For example, changes in underlying assumptions within the regulatory period or new arrangements going forward (such as reductions in the minimum service standards and

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[1] Ofgem (2013), *Strategy decision for the RIIO-ED1 electricity distribution price control Outputs, incentives and innovation*, March, and Ofgem, (2011), *Decision on strategy for the next transmission price control - RIIO-T1*, March.

reduced network security as has recently occurred in Queensland) may effectively cause a "break" in the opex series. As a result, base opex in a particular year of the current regulatory period may need to be adjusted to be representative of future opex.

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?

Energex considers that there is no compelling reason to change the EBSS as currently applied. It seems premature to be considering significant changes given that Energex has only become subject to an EBSS in the current regulatory period with any sharing of benefits/penalties yet to occur.

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

Energex considers that, at this time, an incentive power of 30 per cent provides an appropriate powered incentive to achieve efficiency gains. However, to the extent that the AER introduces a capex sharing scheme, incentives may need to be altered to ensure consistency between schemes.

Question 15
Are there any circumstances where balancing the opex incentive with the capex and service level incentives may not encourage economic efficiency?

Energex considers it essential that the AER balances opex, capex and service level incentive schemes in order to limit perverse outcomes. Accordingly, all schemes should be symmetric and provide continuous incentive over the regulatory period.

Energex also notes its concern that the incentive framework under Chapter 6 is becoming increasingly complicated, and suggests there is much to be said for simplicity in approach where possible and for the AER not to attempt to pursue false precision in the incentives being created.

Question 16
Do stakeholders agree the EBSSs should provide a continuous incentive in each year of a regulatory control period? Are there any circumstances where a continuous incentive may not encourage economic efficiency?

Energex agrees that the EBSS should provide a continuous incentive in each year of the regulatory period.

Question 17
Do stakeholders agree the EBSS rewards and penalties should be symmetrical, regardless of the forecasting approach?

Energex agrees that the EBSS rewards and penalties should be symmetrical in order to encourage efficient expenditure decisions.

Question 18
Should uncontrollable costs be excluded from the operation of the EBSSs?

Energex agrees that uncontrollable costs be excluded from the operation of the EBSS. Failure to do so would expose DNSPs to windfall gains and/or losses. Energex notes that there is a considerable precedent in the AER's past distribution determinations with regard to uncontrollable costs being excluded from the EBSS.

Question 19
Should the approach to addressing uncontrollable costs differ depending on the forecasting approach?

While Energex rejects the use of an exogenous forecasting approach, uncontrollable costs (as identified above) should be excluded from any future efficiency assessment.

Question 20
Are there any other reasons to exclude costs from the operation of the EBSSs?

Energex considers that an adverse exogenous 'event' which is material from a DNSP's perspective but which fails to satisfy the AER's definition of materiality for a cost pass-through, should be excluded under the EBSS.

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?

Energex notes that some events that occur within a regulatory period are not necessarily discrete (such as legislated changes to minimum service standards). As a result, it is difficult to reconcile resultant changes in actual expenditure with forecast expenditure. For example, while the reduction in actual expenditure resulting from a reduction in minimum service standards is expected to be directly observable, it is likely to be difficult to determine the appropriate reduction to corresponding forecast expenditure.

Consequently, Energex considers that, rather than define specific costs for exclusion, the AER should provide clear criteria for exclusion, including discussion of the expected treatment for excluded costs.

Question 22
Should all excluded cost categories be determined prior to the commencement of the regulatory control period in which the scheme applies?

As discussed above, Energex considers that the AER should define the criteria for exclusion and the associated process for applying exclusions (including how forecast expenditure will be adjusted), rather than define excluded cost categories. Energex considers that the criteria and process for exclusion should be determined prior to the commencement of the regulatory period.

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?

As explained above, Energex considers that there may be circumstances or events within the regulatory period that may not have been foreseen at the commencement (for example, changes in minimum service standards or network security standards). As such, Energex considers that increased flexibility is necessary to ensure that forecast and actual outcomes are compared on a like-for-like basis.

Ex post Measures for Capital Expenditure

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

Energex agrees that a staged approach is appropriate but, only where an aggregate actual capex overspend (as per the Rules) has first been identified. Section S6.2.2A of the Rules indicates that the AER is restricted to excluding only inefficient capital expenditure from the RAB where aggregate actual capex is above the forecast allowance i.e. an overspend (subject to capitalisation and related party adjustments), where, S6.2.2A(c) states that:

The overspending requirement is satisfied where the sum of all capital expenditure incurred during the review period exceeds the sum of:

(1) the forecast capital expenditure accepted or substituted by the AER for the review period as such forecast capital expenditure has been adjusted in accordance with clauses 6.6.5(f) and 6.6A.2(h); and

(2) any capital expenditure that is recovered by way of such part of an approved pass through amount as is permitted to be passed through to Distribution Network Users during the review period less any capital expenditure that is included in a negative pass through amount that is required to be passed through to Distribution Network Users during the review period.

Accordingly, the only trigger for determining whether an ex post assessment of prudency and efficiency is required is the existence of an overspend relative to forecast. That is, whether actual capital expenditure incurred during the review period is greater than allowed expenditure (adjusted accordingly). Where actual capital expenditure is less than or equal to allowed expenditure, no prudency and efficiency review can be undertaken by the AER.

However, the AER appears to suggest (Section 5.5 of the Issues Paper) that the determination of an overspend is a much more involved process than the simple trigger set out in the Rules. Consistent with the Rules, Energex considers that the determination of an overspend is a simple objective exercise – "is actual capex in the review period greater than the allowance?"

Once this condition has been satisfied, the AER can then conduct an assessment to determine if a review is required and if the overspend is prudent and efficient. As per the Rules, Energex notes that if a review were conducted (and inefficiencies identified), only that amount equal to the overspend could be excluded from the RAB.

Question 25
Are the issues that the AER proposes to consider as part of the ex post review appropriate?

Energex does not agree with a number of issues proposed by the AER. In particular, as noted above, Energex considers that the first stage of the process must be a simple identification of an overspend. In addition, the AER's references to 'service declines' as a relevant consideration in the ex post capex review process is inappropriate (e.g. "If the AER is reasonably satisfied that the NSP has not overspent, or that any underspending has not caused service standards to decline (including future expected service standards) the ex post assessment would not have to progress past this [first] stage."). The only relevant consideration in the first instance is the existence of an overspend as defined by the Rules.

Energex also considers that any prudency and efficiency review of past capex is a complicated and potentially costly exercise and should not be taken lightly. As such, Energex considers that it is necessary, in the first instance, for the AER to determine whether a review is warranted. Only then should a detailed (engineering) review be undertaken. To facilitate the review, Energex considers that the AER's process (Figure 5.1) should be replaced with the following staged process consistent with Rules requirements:

Stage 1
Determine whether an overspend (as defined by Section S6.2.2A of the Rules) has occurred.

No overspend = no review required

Yes = proceed to Stage 2

Stage 2
Determine whether the overspend is material

Not material = no further action required

Yes = proceed to Stage 3

Stage 3
Identify the areas of overspend compared to approved forecasts and the associated key drivers. The onus should be on the DNSP to justify/explain any overspend.

Proceed to Stage 4

Stage 4
The AER to assess whether it considers the overspend represents inefficient expenditure. This may involve the AER determining whether there are any corresponding offsets or uncontrollable events that may mitigate the overspend and whether the DNSP has a history of overspending etc.

AER considers that overspend is not inefficient = no further action required

AER considers the overspend inefficient = proceed to Stage 5

Stage 5
Conduct an engineering review of the expenditure (<u>not</u> a sample). The onus should be on the DNSP to identify the cause of the overspend and demonstrate to the consultant that the overspend is efficient.

Engineer concludes that overspend is not inefficient = no further action required

Engineer considers the overspend inefficient

AER may exclude inefficient capex from RAB

Question 26
Are there any other factors that the AER should consider in conducting an ex post review?

As above.

Question 27
Are there any additional factors that we should consider before excluding an amount of an overspend from a NSP's RAB?

Energex considers that the factors identified by the AER are reasonable.

Energex suggests that the AER should also provide guidance on the process it intends to apply in adjusting for any identified inefficient overspend. Most importantly, how will the value of the RAB be adjusted to account for the deemed overspend, which will relate to a specific asset class or classes (with different asset lives) and will have been added to the RAB and rolled forward from the point of its commissioning.

Question 28
Do you think our approach for the assessment of related party margins is reasonable? What other approaches may be appropriate?

Energex considers that the AER's approach to the assessment of related party margins appears reasonable.

As discussed above, to the extent an expenditure reduction is identified, the AER should discuss how that reduction will be applied in the next regulatory period.

Question 29
Do you think our approach for the assessment of capitalisation requirements is reasonable? What other approach may be appropriate?

Energex considers that the AER's approach to the assessment of capitalisation requirements appears reasonable.

As discussed above, to the extent an expenditure reduction is identified, the AER should discuss how that reduction will be applied in the next regulatory period.