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

Email: aerinquiry@aer.gov.au

825 Ann Street
Fortitude Valley QLD 4006
PO Box 264
Fortitude Valley QLD 4006

Phone: 07 3851 6000
Fax: 07 3851 6001

www.ergon.com.au

Dear Mr Roberts

SUBMISSION ON THE BETTER REGULATION: EXPENDITURE INCENTIVES GUIDELINES FOR ELECTRICITY NETWORK SERVICE PROVIDERS – ISSUES PAPER

Ergon Energy Corporation Limited, in its capacity as a Distribution Network Service Provider in Queensland, welcomes the opportunity to provide a submission to the Australian Energy Regulator on its *Better Regulation: Expenditure Incentives Guidelines for Electricity Network Service Providers Issues Paper* (Issues Paper).

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact me on (07) 4092 9813.

Yours sincerely

Jenny Doyle
Group Manager Regulatory Affairs

Telephone: (07) 4092 9813
Email: jenny.doyle@ergon.com.au

Encl: Ergon Energy's submission.

Ergon Energy Corporation Limited

Submission on the *Better Regulation: Expenditure Incentive Guidelines for Electricity Network Service Providers Issues Paper*

Australian Energy Regulator

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This submission, which is available for publication, is made by:

Ergon Energy Corporation Limited
PO Box 264
Fortitude Valley
BRISBANE QLD 4006

Enquiries or further communications should be directed to:

Jenny Doyle
Group Manager Regulatory Affairs
Ergon Energy Corporation Limited
Email: jenny.doyle@ergon.com.au
Ph: (07) 4092 9813
Mobile: 0427 156 897

INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its *Better Regulation: Expenditure Incentives Guidelines for Electricity Network Service Providers Issues Paper* (Issues Paper). This submission is provided by Ergon Energy, in its capacity as a Distribution Network Service Provider (DNSP) in Queensland.

Ergon Energy supports any consultative approach aimed at improving the understanding of the AER's expenditure incentive methods. This is particularly important for Ergon Energy at this time. As Ergon Energy is required to submit a regulatory proposal next year, a clear understanding of the process and basis for introducing expenditure incentives is vital to ensure due process.

Ergon Energy shares the concerns of the Energy Networks Association (ENA) that the approach to developing the guidelines isn't delivering the clarity and certainty industry expect it to, and on this basis, Ergon Energy has contributed to, and supports the ENA submission to the AER on the Issues Paper.

In response to the AER's invitation to provide comments on the Issues Paper, Ergon Energy has therefore focused on concerns relating to the benefits and costs of introducing high-powered, untested incentives and a departure from established frameworks. Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AER require.

1. BACKGROUND AND SCOPE

Ergon Energy's broad understanding is that the AER intends to:

- Operate an incentive scheme for capital expenditure (capex) which is based on the current scheme for operating expenditure (opex), in that the penalty for overspend or reward for underspend is the same for each year of the period;
- Introduce a penalty for overspend on capex which will be greater than the reward for underspend;
- Depart from the fundamental tenet of the current penalty/reward scheme for opex, which assumes the business reveals the efficient costs in order to maximise the incentive. Instead the AER will apply penalties/rewards over the period (potentially retrospectively), based on a yet-to-be-determined benchmark; and
- Establish a process for ex post review of capital expenditure.

The fundamental purpose of incentive schemes is to influence behaviour, with the expectation of efficient investment within a given regulatory control period. The current incentive scheme operates in this context and on the assumption that the AER will set a forecast of expenditure that reasonably reflects the efficient forecasts of the Network Service Provider (NSP).

It is worth re-emphasising that there is an inherent and unavoidable level of inaccuracy in any five year forecast set by a regulator. The AER argued successfully for Rule changes to grant it more power to reject excessive cost forecasts[1]. There is no evidence to suggest that the risk of regulatory error is asymmetric – i.e. that the inaccuracy of forecasts is only ever too high. So there is a very high likelihood that the underlying inputs the AER determined in setting the forecast are inaccurate. The possibility of out-turn inputs being lower that the AER's forecast is just as likely as it being higher than forecast.

Incentive frameworks are also imperfect and subject to regulatory error as they are attempting to influence behaviour in response to forecasts set by the AER. Ergon Energy is therefore concerned that the approach taken by the AER regarding incentives is disproportionate to the issues surrounding the current incentive mechanism, especially when other changes to the regulatory framework are taken into account.

2. AER'S CONCLUSION ON INCENTIVE FRAMEWORKS AND ITS RESPONSE

Most stakeholders agree that incentive frameworks are a vital and important mechanism in the regulatory framework and have been largely effective in operation. Further, most stakeholders would agree that

[1] Andrew Reeves Speech to CEDA energy series part 2 – Regulation, Investment and Energy Prices.

there exists opportunity to improve incentives around capital expenditure as the effectiveness of the incentive declines over the duration of any given regulatory control period.

The area of disagreement surrounds the AER's conclusions drawn in the Issues Paper relating to the impact of the current capital expenditure incentive on DNSP behaviour. The AER asserts that the incentive as it now operates has removed the discipline on DNSPs to spend efficiently, distorts decision making in relation to capex and opex[2] and results in unnecessary peaks and troughs in capex profiles[3].

Ergon Energy is concerned that the AER's perception of the impact is not consistent with what occurs in practice. In support of these assertions, the AER has used analysis from the last completed regulatory control period (i.e. 2005-2010), but refers to recent trends to justify a need for change. Other conclusions are made without sufficient substantiation of their context or applicability, or with the support of selective evidence without acknowledging wider critique of such evidence[4].

From a Queensland and NSW perspective, the AER's analysis refers to a regulatory control period operating under the auspices of a vastly different regulatory regime from the one the AER now proposes to abandon. In both of these states, jurisdictional regulators did not apply the same incentive arrangements and were not subject to the same disciplines as the AER has in setting forecast expenditure. The AER's comparison ignores the significant differences in the context of regimes for approving forecast expenditure and the differing circumstances which resulted in the expenditure profile in those jurisdictions.

In broad terms, Ergon Energy is concerned that the AER has erred in reaching a conclusion that the current incentive arrangements require substantial modification. The AER's proposed guidelines attempt to impose what AER officers describe as "draconian" measures to address these issues. We remain unconvinced that the case has properly been made for the imposition of such measures on businesses and we would ask the AER to reconsider the rationale for its response.

Ergon Energy has welcomed the opportunity for further discussions at workshops with the AER, and regards these interactions as helpful in gaining an understanding of the AER's concerns and why it seeks to impose such substantial modifications to the incentive framework. AER officers noted their preliminary concerns regarding the relative efficiency of some Government-owned businesses. The suite of "draconian" arrangements the AER intends to impose appear to be in response to these concerns.

Where the AER holds substantial concerns with a minority of businesses, Ergon Energy would see more advantage in attempting to deal with those issues via direct business contact. Attempting to reverse-engineer an incentive guideline to meet specific issues with a minority of businesses, creates ambiguity and confusion with stakeholders and, in Ergon Energy's view, does not promote best practice regulation.

3. ENSURING A LINK BETWEEN INCENTIVE AND BEHAVIOUR

Ergon Energy generally agrees with the ENA's perspective that incentive mechanisms should be retained and can be modified. In particular, we would support a move to provide the same power of incentive for capex and opex evenly across the regulatory control period. This would afford DNSPs the ability to have a continuous incentive to achieve efficiencies when they arise and as appropriate, rather than being determined by their position in the five year regulatory control period.

Ergon Energy agrees with the ENA's suggestion that minor modifications to the scheme, such as by increasing the reward/penalty in later years of the regulatory control period, with an application of adjustments reflective of the time value of money, would achieve this purpose. This would ensure that the reward/penalty's effectiveness is the same in each year of the regulatory control period.

Ergon Energy would caution the introduction of stronger incentives, for the following reasons:

[2] AER's *Better Regulation: Expenditure incentives guidelines for electricity network service providers* Issues Paper, March 2013, page 10

[3] Ibid, page 11.

[4] For instance, the AER refers to 1. Productivity Commission, *Electricity Network Regulatory Frameworks, Draft Report,* Canberra, 2012 and 2. Mountain, B.R. *Australia's Rising Electricity Prices and Declining Productivity: the Contribution of its Electricity Distributors, Report for the Energy Users Association of Australia*, Melbourne, 2011 as its main sources to support its conclusions, without reference to objective, legitimate critiques of those sources. This lack of objectivity creates a distinct and unsupported bias.

- Forecast capex is invariably inaccurate – DNSPs do not have the ability to completely assess investment needs and there are inevitably errors implicit in the AER's assessment of regulatory proposals;
- Circumstances change from the time of the determination until the end of the period – this can be because of economic circumstances, cost pressures, changes in demand, new legislation or severe environmental factors;
- Pass through costs represent a limited opportunity – 'uncontrollable factors' cannot be accurately identified and ex post adjustments to revenue have a very high threshold and are event-specific; and
- Ex post reviews can now safeguard customers from inefficient or unnecessary investment.

Additionally, such powerful penalties may drive undesirable behaviour from Executives and Boards, as they may be provided with incentives to defer investment to avoid capex over-run. Therefore, legitimate and prudent reasons for investing may be overlooked in order to appropriately respond to the incentives.

Ergon Energy would also strongly caution against any approach to retrospectively adjust incentive parameters. This was mooted at the recent incentive guidelines workshop. However, AER officers could not agree on whether retrospective application was part of the guideline arrangements.

It is important to note that incentive arrangements, as they should, do drive behaviour. Network businesses routinely adopt planning and expenditure strategies with the efficient forecast set by the regulator as their starting point. Nevertheless, the AER appears inclined to retrospectively apply a "new efficient" forecast. Because this forecast is established retrospectively, businesses cannot respond as their expenditure decisions have already been made. They may be penalised for over-expenditure to the forecast and denied the opportunity to respond to the incentive when making their investment and expenditure decisions.

4. THE PROPOSED INCENTIVE ARRANGEMENTS NEED TO BE BETTER EXPLAINED

At this juncture in the development of improvements to incentive based regulation processes under the National Electricity Rules (Rules), Ergon Energy remains concerned about the distinct lack of clarity with regard to the AER's proposed methods. Ergon Energy believes it would assist industry greatly, and would be entirely appropriate if the AER were to set out:

- Specific and detailed criteria to guide DNSPs on how costs are to be treated;
- Specific case studies and examples of how the AER intends to operate the scheme in the context of its assessment of expenditure forecasts; and
- Examples of how these criteria would be useful to clearly define which costs can be nominated.

Ergon Energy also believes the AER's primary focus for the development of ex post measures for capex should include clearly articulated mechanisms for conducting ex post reviews, in order to deliver a process of review which is reasonable, proportionate and understood by stakeholders. With the understanding that each stage will require progressively higher levels of resourcing (both for the regulator and businesses) it is crucial that conditions are clearly defined and well understood.

Equally important in this process is an assessment of the regulatory compliance arrangements that might be needed when applying the scheme. Ergon Energy believes this may inform the scheme's operation. For example, there may be significant regulatory costs in developing reporting arrangements for all possible capex exclusion events. An alternative approach would be providing a further step in the process which would require the AER to assess any over-expenditure on excluded capital items and, if convinced the over-expenditure is explained in these excluded events, to conclude the review at this point.

Ergon Energy's detailed responses to the AER's Issues Paper

Question(s)	Ergon Energy Response
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?	Most stakeholders agree that incentive frameworks are a vital and important mechanism in the regulatory framework and have been largely effective in operation. Further, most stakeholders would agree that there exists opportunity to improve incentives around capital expenditure as the effectiveness of the incentive declines over the duration of any given regulatory control period. The area of disagreement surrounds the AER's conclusions drawn in the Issues Paper relating to the impact of the current capital expenditure incentive on DNSP behaviour. Ergon Energy is concerned that the AER has erred in reaching a conclusion that the current incentive arrangements require substantial modification. The AER's proposed guidelines attempt to impose what AER officers describe as "draconian" measures to address these issues. We remain unconvinced that the case has properly been made for the imposition of such measures on businesses and we would ask the AER to reconsider the rationale for its response.
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.	Ergon Energy regards the AER's proposed response to this issue as disproportionate i.e. in an attempt to temper existing issues with the timing of incentives, the AER appears to favour creating new incentives which substantially increase penalties, rather than correcting and managing existing ones. Ergon Energy agrees that modification to the existing scheme, for the purpose of spreading the incentive more evenly across the regulatory control period would be preferable. Ergon Energy believes this is achievable with only minor changes to the scheme, by increasing the level of penalty/reward in the latter years of the period, with the application of adjustments, reflective of the time value of money.
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. **Question 4** Do stakeholders agree with our initial position that the penalty for overspending should be greater than 30 per cent? Please give	There are significant risks in the approach proposed by the AER. Ergon Energy is concerned that DNSPs may incur significant financial penalty as a percentage of overspend, in spite of no evidence suggesting investment that is not efficient or prudent. Ergon Energy would seek to remind the AER that the current ex post review exists to safeguard customers from unnecessary or imprudent investment. To avoid the significant, asymmetrical penalties suggested, Ergon Energy believes there would be a strong incentive for Executives/Boards to defer necessary investment

Question(s)	Ergon Energy Response
reasons to support your view.	where they may be a risk of capex over-run, which will result in a significant detriment to customers over the longer term.
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.	Ergon Energy believes that a single scheme is preferable to provide certainty in advance of the commencement of regulatory determination processes. Further, Ergon Energy believes there is merit in including an explicit provision allowing the proposal of variations to the application of the scheme as part of regulatory proposals, with the AER afforded power to accept or reject these variations.
Question 6 If we were to tailor different schemes for individual NSPs, what criteria should we use to differentiate between NSPs?	Ergon Energy would request that the AER consider the wide range of reasons that may relate to individual circumstances when a DNSP requests a variation from the application of the scheme. It may not be possible to develop an exhaustive list of variations. However, Ergon Energy would suggest as a starting point, the following: • Previous capex history; • Inherent volatility of cost structures; • Financial solvency and liquidity.
Question 7 Are there any categories of capex that should not be covered by a capital expenditure sharing scheme? Why?	Ergon Energy's general concern is that uncontrollable cost categories are not able to describe all circumstances which may result in over/under spend as compared to the allowance.
Question 8 When, if at all, might it be appropriate to make adjustments to a type of capex before applying a CESS? Why?	Ergon Energy would like to reiterate the broad range of factors which constitute variations to allowances, which are often unable to be separated from one another. As such, it will be difficult to isolate separate items or events which would individually account for a variation from a forecast.
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.	Ergon Energy believes incentives should remain consistent. This would provide a level-playing field and consistent base point from which to decide whether to pursue efficiency opportunities, rather than reacting to considerations in the context of over-underspending the regulatory allowance.
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.	In the interests of regulatory certainty, Ergon Energy believes the AER should provide guidance on the penalties in advance of the introduction of any alternative scheme. DNSPs need to be able to assess risk exposure and make prudent decisions with regard to financing agreements or other arrangements and planning requirements with an ample and reasonable lead time.
Question 11	Whilst Ergon Energy reiterates its preference for maintenance of the existing

Question(s)	Ergon Energy Response
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?	arrangements, should a CESS scheme be introduced, it would be recommended that forecast depreciation be used as a default for rolling forward the asset base. Use of actual depreciation would exacerbate the level of financial penalty.
Question 12 Do stakeholders agree with the factors that we have identified for consideration in determining whether to apply forecast or actual depreciation?	Provided only forecast depreciation was used to roll forward the asset base, Ergon Energy would broadly support further consideration of the factors identified.
Ex ante measures for operating expenditure	
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?	To date, the EBSS has encouraged DNSPs to reveal their underlying efficient costs, and has proven effective by reducing the costs associated with opex assessment. Ergon Energy supports the continued use of a revealed cost approach to forecast opex, and believes it would be prudent to retain the current opex EBSS, as it is symmetrical and provides a continuous incentive.
Question 14 Does an incentive power of 30 per cent provide a sufficient incentive to achieve efficiency gains?	Ergon Energy is not convinced that the EBSS as currently designed automatically generates a 30:70 sharing outcome. Nor was it ever intended to. The scheme was initially designed to incentivise DNSPs expenditure within the period. It was further developed to apply a continuous incentive irrespective of the year in which the expenditure was incurred. Regulators have traditionally asserted that the outcome of the incentive was a sharing of penalties and rewards where the continuity of the scheme was maintained. Ergon Energy would caution the assertion that the aim of the scheme was to provide a 30 per cent incentive for DNSPs.
Question 15 Are there any circumstances where balancing the opex incentive with the capex and service level incentives may not encourage economic efficiency?	Ergon Energy believes all schemes should be symmetrical and provide continuous incentives over the regulatory control period. As opex, capex and service level schemes are invariably connected, Ergon Energy believes the AER's approach to all schemes must be balanced, so that incentives are not distorted, or so that changes in one scheme do not create perverse or unintended outcomes in another.
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?	Where the EBSS is continuous, it remains indifferent to the timing of the generation of that efficiency. As such, Ergon Energy agrees that the incentive should be provided on this basis.

Question(s)	Ergon Energy Response
Question 17 Do stakeholders agree the EBSS rewards and penalties should be symmetrical, regardless of the forecasting approach?	Ergon Energy agrees that the rewards and penalties should be symmetrical.
Question 18 Should uncontrollable costs be excluded from the operation of the EBSSs?	These costs are currently excluded from both the base and carry-over year, with each being defined at the time of each DNSP Distribution Determination. Ergon Energy believes the current arrangements provide certainty and therefore does not regard changes as necessary.
Question 19 Should the approach to addressing uncontrollable costs differ depending on the forecasting approach?	Ergon Energy does not believe that costs beyond the control of DNSPs should be considered in efficiency assessment processes.
Question 20 Are there any other reasons to exclude costs from the operation of the EBSSs?	
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?	Ergon Energy believes it would be appropriate for the AER to set out the criteria to guide which costs should be nominated by the NSP as 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?	In the interests of maintaining regulatory certainty, Ergon Energy believes all excluded cost categories should be set out in the regulatory determination prior to the commencement of the regulatory control period in which the EBSS scheme applies.
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?	Ergon Energy considers that the current level of flexibility with regard to how the opex forecasts are adjusted should be maintained in the EBSS.
Ex post measures for capital expenditure	
Question 24 Do stakeholders agree with having a staged approach to the ex post review?	Ergon Energy agrees that a staged and clearly outlined approach to ex post reviews is the most advantageous to all stakeholders, ensuring a more robust review process which can be delivered in a way which is efficient, proportionate and transparent.
Question 25 Are the issues that the AER proposes to consider as part of the ex	Ergon Energy's response to this question refers to the individual Stages 1-4 as outlined in Figure 5.1 of the Issues Paper:

Question(s)	Ergon Energy Response
post review appropriate?	**Step 1 – Actual performance** In making a determination for expenditure allowances, the AER needs to take account of the level of uncertainty associated with cost forecasts. At this stage the AER's inquiry should be cognisant of any ex post assessment of actual performance. **Step 2 - Incentives** Ergon Energy believes it is important for the AER to provide clarity regarding when and on what basis particular thresholds will be met. As NSPs require clarity on these issues in advance of commitments to expenditure being made, the absence of certainty and with the possibility of an unfavourable ex post review, the impact on efficient investment could be severe. Ergon Energy considers the inclusion of examples or case studies indicating likely scenarios for the triggering of ex post reviews would assist NSPs with their understanding of the AERs intended application of these incentives. **Step 3 – Project management** Ergon Energy is unsure why thresholds from Stage 2 (overspending concerns/service standard concerns) are reiterated in Stage 3. Ergon Energy is concerned that the effect of this repetition is that where a DNSP might not be subject to a CESS in one circumstance, they are naturally subject to a detailed review of projects. Ergon Energy believes this may limit the AER's flexibility to be satisfied by other evidence provided by DNSPs that their processes are best-practice. **Step 4 – Detailed review of capex** Ergon Energy would request that this step is clarified to ensure the no hindsight rule is applied. Without clarity on the intended interpretation and application of this rule, the DNSP would not have sufficient information to in turn, demonstrate prudent and efficient investment decision making. Additionally, Ergon Energy is concerned that the Issues Paper alludes to the ex post analysis 'using a similar methodology to how it undertakes this analysis ex ante'; these are processes which commence at fundamentally different points.
Question 26 Are there any other factors that the AER should consider in conducting an ex post review?	Ergon Energy recommends that Steps 1-4 should be implemented to be consistent with the 'no hindsight' rule in the Rules. Additionally, in ex post reviews, Ergon Energy would support the AERs' consideration of significant changes in:

Question(s)	Ergon Energy Response
	○ Costs; ○ Demand levels; and ○ Regulatory obligations impacting on capital project planning or delivery.
Question 27 Are there any additional factors that we should consider before excluding an amount of an overspend from a NSP's RAB?	Ergon Energy recommends the AER take into account the following when applying s6.2.2A: • Revenue and pricing principles and the reasonable opportunity to recover efficient costs; and • Capital Expenditure Criteria (s6.5.7(c)). Ergon Energy believes that consideration should be given to the level of uncertainty assumed at the time of the setting of the expenditure allowances, when conducting an ex post review, and the materiality thresholds applied to cost pass throughs.
Question 28 Do you think our approach for the assessment of related party margins is reasonable? What other approaches may be appropriate?	Ergon Energy has no specific comment.
Question 29 Do you think our approach for the assessment of capitalisation requirements is reasonable? What other approach may be appropriate?	Ergon Energy believes the proposed approach is broadly reasonable. Ergon Energy understands that all DNSPs would have a reasonably consistent approach in applying accounting standards to expenditure including when expenditure is capitalised. However, there are differences in capitalisation rates and a change to standardise an approach may be complicated and inappropriate.