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Dear Mr Roberts

SUBMISSION ON THE BETTER REGULATION: DRAFT EXPENDITURE INCENTIVES GUIDELINES FOR ELECTRICITY NETWORK SERVICE PROVIDERS

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: Draft Expenditure Incentives Guidelines for Electricity Network Service Providers*.

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

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Group Manager Regulatory Affairs

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Encl: Ergon Energy's submission.

Ergon Energy Corporation Limited

Submission on the *Better Regulation: Draft Capital Expenditure Incentive Guidelines for Electricity Network Service Providers*

Australian Energy Regulator

20 September 2013

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20 September 2013

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

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INTRODUCTION

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

As a member of the Energy Networks Association (ENA), the peak national body for Australia's energy networks, Ergon Energy has contributed to the ENA's submission on the Draft Guidelines and Explanatory Statement and fully supports the issues raised therein. In particular, Ergon Energy is appreciative of the AER's consultative approach to developing the Draft Guidelines, which should facilitate a clearly defined expenditure incentives process within the context of the National Electricity Rules (the Rules). A clear understanding of the process and basis for introducing expenditure incentives is particularly important for Ergon Energy as we work toward submission of our Regulatory Proposal in October 2014.

On this basis, we reiterate our concerns, raised in response to the *Better Regulation: Expenditure Incentives for Electricity Network Service Providers Issues Paper* (the Issues Paper), that the intended approach does not provide the desired level of clarity and certainty. This is particularly evident in relation to the proposed introduction of certain untested incentives; the lack of clarity around any inclusions and exclusions; and the lack of details in relation to how the proposed incentives will operate in the context of other schemes and obligations that apply to Network Service Providers (NSP). In addition to this general observation, Ergon Energy has a number of specific concerns in relation to the Draft Guideline, which are addressed in detail below.

Capital Expenditure Incentive Guidelines

As noted in our response to the Issues Paper, Ergon Energy considers that the primary purpose of an incentive scheme is to influence behaviour that will drive efficient investment within a given regulatory control period. Ergon Energy also notes that incentive frameworks are, by nature imperfect and necessarily subject to regulatory error in their attempt to influence behaviour in response to approved forecasts.

Ergon Energy believes that the current incentive scheme operates in the desired manner, and on this basis we re-emphasise our concerns that the AER's proposed approach to incentives through the Draft Guidelines, is disproportionate to the issues surrounding the current incentive mechanism, especially when analysed in conjunction with other changes to the regulatory framework.

Certainty of application

Ergon Energy notes the Explanatory Statement indicates that the AER may consider applying actual depreciation where a Capital Expenditure Sharing Scheme (CESS) does not apply. As an example, Ergon Energy notes that based on the current drafting, the CESS may not apply:

- For the transitional period for the 2014 group of NSPs; or
- When an ex post adjustment is being made (i.e. application of CESS would result in a double penalty).

Ergon Energy requests that the AER include in the Guideline details of circumstances where this may be the case.

Presumption of gaming

The Draft Guideline and the Explanatory Statement imply that NSPs will routinely game capitalisation changes, as the rule rather than the exception. Ergon Energy does not agree that this is a reasonable presumption for the AER to make. Where such a presumption is made, Ergon Energy is concerned that NSPs could be unreasonably penalised for complying with other requirements such as commercial/accounting system requirements or Accounting Standards in satisfaction of their obligation to produce true and fair financial statements. Ergon Energy considers that it would be unreasonable to require NSPs to choose between compliance with one scheme or standard at the expense of another..

CESS exclusions

Ergon Energy is generally supportive of provisions which permit the AER to make exclusions from the CESS. However, Ergon Energy considers that such provisions should not be overly restrictive and exclusions should not be permitted in advance of submission and perusal by the AER, of a NSP's Regulatory Proposal. Moreover, Ergon Energy considers that as part of the process, NSPs should also have the ability to propose exclusions for consideration by the AER in certain circumstances. In particular, Ergon Energy believes that NSPs should be able to propose the following exclusions:

- Uncontrollable costs;
- 'Neutral incentive' costs (e.g. demand management expenditure); and
- Costs incurred which may otherwise qualify for pass-throughs, but the NSP decides not to pursue it or they fail to pass the materiality threshold.

Ergon Energy recommends that it would be most suitable for this to occur either during a NSP's consultation on its Framework and Approach Paper or as part of its Regulatory Proposal.

Relationship between CESS and ex post reviews

Ergon Energy believes that the introduction of the CESS must be complementary to, and not inconsistent with, existing ex post review processes and incentive schemes, such as the Service Target Performance Incentive Scheme (STPIS) and the Demand Management Incentive Scheme (DMIS).

Ergon Energy agrees with the ENA's suggestion to include drafting in the Guidelines which will allow exclusions to be made from the CESS where a failure to do so would otherwise undermine the operation of other incentives schemes.

In support of this view, Ergon Energy highlights the fact that, unlike other forms of capital expenditure, NSP's funding for reliability and quality improved expenditure is not considered on an ex ante basis; such expenditure is funded via financial rewards under the STPIS, and then rolled in the Regulatory Asset Base (RAB) on an ex post basis. Where such expenditure is not able to be excluded from the CESS, a NSP would be penalised under the CESS for being successful under STPIS, and similarly, under the DMIS.

Related party margins

Ergon Energy notes that the *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution and Transmission* commit the AER to adopting the two stage process for analysing related party margins adopted in the 2013-17 Victorian gas access arrangement review[1]. Ergon Energy believes such an approach is appropriate and supports its use in the assessment of incentivising NSPs. However, we note that the AER has not committed to using this process under the Draft Guidelines. Consistent with the ENA, Ergon Energy recommends that the AER amend the Draft Guidelines to clarify that it will apply the same two-stage approach to assessing related party expenditure under both Guidelines.

Access to contractors' actual costs

Ergon Energy does not believe NSPs should be required to provide information on behalf of other parties; both as a matter of principle, and on the basis NSPs will not have access to contractors' actual costs, particularly where the nature of the relationship does not allow the NSP to exercise any control over information.

Inconsistency between CESS and Roll Forward Model (RFM)

Ergon Energy suggests that, in the interests of providing certainty for the operation of incentives schemes and other processes, the AER should clarify in the Guidelines how the CESS and the AER's RFM will interact. In the absence of such clarity, Ergon Energy is concerned that the CESS and RFM may not be aligned so as to recognise capital expenditure overspend. In this regard, Ergon Energy agrees with the ENA, that the Guidelines should make clear that the RFM should include any overspend in the RAB at the start of the next regulatory control period. As cited by the ENA, this will ensure that where any CESS penalty is to apply, it will start to apply at the same time the NSP begins to earn a return on, and of, the assets which are subject to the overspend, and that no return of assets will apply to the assets that relate to the overspend before the start of the next regulatory control period.

[1] AER, *Explanatory Statement – Draft Capital Expenditure Forecast Guidelines*, page 26.

Ex post reviews – discretion / uncertainty

Ergon Energy recognises and acknowledges the efforts of the AER to clarify issues raised in response to the Issues Paper, through the drafting of the proposed process for ex post reviews. In particular, Ergon Energy supports the simplified drafting that has been included in the Draft Guidelines. However, Ergon Energy would appreciate additional clarification in relation to how and when the AER will make decisions to progress to the application of Stage 2 of the process.

Clarify when CESS does not apply

Ergon Energy seeks clarification from the AER in relation to an apparent inconsistency between clause 6.4A(c) of the Rules, which states that there must be an Capital Expenditure Incentive Guideline in force at all times after the date on which the AER publishes its first Capital Expenditure Incentives Guideline, and the Explanatory Statement, which refers to circumstances where the CESS may not apply (for instance when applying actual depreciation).[2] It is not clear from the Draft Guidelines, when the AER considers that there may not be a CESS that applies to a NSP. On this basis, Ergon Energy suggests that to assist NSPs to better understand the incentive regime, the Guidelines should clarify the circumstances in which the AER can foresee when a CESS may not apply to a NSP.

Interaction between the CESS, EBSS and Expenditure Forecast Assessment Guidelines

It appears that the AER proposes only minor changes to the incentive scheme for operating expenditure. Ergon Energy's is particularly concerned about the interaction of this incentive scheme with significant changes to the AER's assessment of operating expenditure forecasts being proposed through the *Draft Expenditure Forecast Assessment Guideline for Electricity Distribution and Transmission*. In particular, Ergon Energy is concerned that apparent gaps in the interaction of these two methodologies will result in NSPs being unable to recover efficient costs.

Ergon Energy notes that in recent Determinations the AER has resisted the inclusion of capital costs incurred for the purpose of improving efficiencies within the business, on the basis that NSPs will recover these costs through the incentive mechanism that applies.

Under the proposed new regime, the Draft Guidelines assume a level of benchmark efficient expenditure and productivity adjustments over time. Ergon Energy is concerned that NSPs who have not already invested in expenditure to deliver future efficiencies may be penalised either for the investments to deliver efficient future outcomes, or for the expenditure above the efficient benchmark. Moreover, NSPs may also be penalised to the extent that productivity improvements for the benchmark efficient business incorporate a mix of investments not common to other businesses.. In this regard, Ergon Energy requests that the AER give due consideration to the interaction of these methodologies, to ensure the achievement of an appropriate balance between the long term interests of customers and a NSP's ability to recover its efficient costs.

Incentive arrangements should not apply to transitional determinations where the AER substitutes a NSPs revealed cost

Ergon Energy notes that a carry forward incentive mechanism creates a very high powered penalty where:

1. NSPs have been required to submit proposals with insufficient time to assess the basis on which the AER has determined its efficiency with reference to benchmarking reports;
2. The NSP can demonstrate that it has responded to the incentive applying at the beginning of the regulatory control period by spending within the efficient allowance set or by reconciling actual expenditure with reference to the efficient allowance set;
3. Despite this, the AER substitutes the DNSP's revealed cost with a lower amount on the basis of benchmarking; and
4. The AER determines a forecast with reference to this lower amount on the assumption that the revealed cost was inefficient.

In this situation, Ergon Energy believes that a NSP would be subject to a higher than reasonable penalty as a consequence of being insufficiently informed of concerns over efficiency in advance of making decisions on its expenditure and submitting its Regulatory Proposal to the Regulator. Ergon Energy is concerned that

[2] AER, *Explanatory Statement – Draft Capital Expenditure Incentive Guidelines*, August 2013, page 13.

the Draft Guidelines make a presumption of inefficiency when there are differences between revealed costs and benchmark costs. Moreover, Ergon Energy is concerned about the prospect of a NSP not being provided with the opportunity to understand the basis of the benchmark outputs and findings in order to respond appropriately.

Timing Issues

To ensure certainty of process for NSPs and the maintenance of a static baseline for comparison Ergon Energy does not consider that it is appropriate for the AER to make changes to incentives schemes during the course of a NSP's regulatory control period. In fact Ergon Energy believes such a course of action will undermine the integrity of incentives schemes generally, and limit the extent to which NSPs can rely on the signals they receive.