AUSTRALIAN ENERGY REGULATOR

First Proposed

Electricity Transmission Network Service Providers

Efficiency Benefit Sharing Scheme

EXPLANATORY STATEMENT AND ISSUES PAPER

January 2007

1 Introduction

The Australian Energy Regulator (AER) is responsible for regulating the revenues of transmission network service providers (TNSPs) in the National Electricity Market in accordance with the National Electricity Rules (NER).

This Explanatory Statement accompanies the First Proposed Efficiency Benefit Sharing Scheme (proposed scheme) and provides the AER's reasons for the proposed scheme. It has been prepared to satisfy the AER's obligations under clauses 11.6.17(c) and 6A.20(b)(2) and (3) of the NER.

The AER has also prepared an Issues Paper, which forms part of this Explanatory Statement, which provides additional information and requests written submissions on specific issues.

2 Rule requirements

Clause 6A.6.5 of the NER requires the AER to publish the Efficiency Benefit Sharing Scheme (the scheme) by 28 September 2007. The scheme must comply with the principles prescribed in the NER at clause 6A.6.5.

Under clause 11.6.17 the AER must also publish a proposed scheme on or before 31 January 2007 that will apply to SP AusNet, VENCorp and ElectraNet for any transmission determination made in 2008. The proposed scheme will form the basis for consultation to develop the scheme that will apply to all other TNSPs in future regulatory periods.

3 The nature and reasons for the proposed scheme

Under the proposed scheme, the incentive to achieve efficiencies is provided by allowing the TNSP to retain, for a fixed period, the difference (negative or positive) between its actual and forecast operating expenditure (opex). Any such difference arising in any year of a regulatory period will be retained by the TNSP and carried forward for five years following the year in which the efficiency gain or loss is incurred.

The efficiency benefit or loss for a particular year is calculated as the difference between the actual and forecast opex amounts as they change from one year to the next. However, the efficiency benefit or loss derived in the first year in which the proposed scheme applies is simply the difference between actual and forecast opex amounts in that year. A numerical example is included at Appendix A of the proposed scheme.

Under clause 6A.6.5(b) of the NER, the AER must have regard to the following when developing and implementing the scheme:

- the need to provide TNSPs with a continuous incentive to reduce operating expenditure, irrespective of the year the efficiency gain or loss is incurred;
- the desirability of both rewarding TNSPs for efficiency gains and penalising TNSPs for efficiency losses; and
- any incentives that TNSPs may have to inappropriately capitalise operating expenditure.

The AER's consideration of these issues is outlined here.

3.1 Constant incentives over time

An ex ante expenditure target, when viewed in isolation, will result in a weakening of incentives as the regulatory period progresses. At each reset, the regulator will re-assess the opex target and in doing so is likely to consider whether there was an under or overspend with respect to targets in the previous regulatory period. In the case of significant efficiency gains with respect to expenditure targets, the regulator will be compelled to pass on these cost savings to network users through lower prices. By implication, lower prices translate into lower expenditure targets for the TNSP, thus the potential gains from achieving cost reductions in the coming regulatory period are reduced. Where a TNSP expects such “clawing back” of efficiency gains by the regulator at each reset, the incentive to outperform targets is weakened, particularly in the latter years of a regulatory period as gains are only retained for a short period of time. The result is a reduced effort in pursuing efficiencies and both the TNSP and network users are worse off as the total gains to be shared are less.

The proposed scheme will allow TNSPs to retain the benefits of their efforts for a specific period of time, and importantly, beyond the next regulatory reset. Therefore, incentives are not truncated by potential claw-backs at the reset and thus are constant over time.

The length of the carry-over period relates to the desired sharing ratio of gains and losses between users and the TNSP. This gain is measured as the net present value of a gain or loss in a particular year, relative to the value of that gain or loss in perpetuity. A five year carry-over period results in a benefit sharing ratio of approximately 50:50 between the TNSP and network users. A ten year carry-over results in a ratio of approximately 70:30 for the TNSP and users respectively. The AER believes that a five year carry-over period provides for a fair sharing of gains and losses between network users and TNSPs.

3.2 Desirability of providing rewards and penalties

The underperformance of efficiency benchmarks can give rise to negative carry-over amounts. While the AER recognises that it may be equally important to reward efficiency and penalise inefficiency, there may be circumstances where the application of large negative carry-over amounts may affect a TNSP’s ability to provide efficient services in subsequent periods. The proposed scheme states that the AER will use its discretion in applying negative carry-over amounts.

3.3 Interaction between opex and capital expenditure incentives

TNSPs may have some scope to respond to incentives through their capitalisation policies and by substituting expenditures between opex and capital expenditure (capex).

To determine whether these actions are inappropriate responses to the incentive framework, the AER may consider:

- whether a TNSP’s capitalisation policy has changed and why
- what impact this has on regulated revenues
- the relative effort required to achieve incremental savings in opex and capex
- the effects on network services of substituting one type of expenditure for another, including changes in maintenance or asset replacement policies.

4 Consultation process

The AER anticipates that it will engage in the following consultation process:

- publish the proposed scheme, this Explanatory Statement and additional material inviting written submissions
- consider comments received on the proposed scheme by 1 May 2007
- publish the final scheme in September 2007.

5 Invitation for written submissions

Interested parties are invited to make written submissions to the AER on the proposed scheme, having regard to the issues outlined in the attached Issues Paper. The requirements for submission are outlined in the Issues Paper.

ATTACHMENT:

ISSUES PAPER

FIRST PROPOSED EFFICIENCY BENEFIT SHARING SCHEME

1 Introduction

This Issues Paper accompanies the Explanatory Statement and provides an overview of the key concepts contained in the proposed scheme.

2 Development of the scheme

The Australian Competition and Consumer Commission (ACCC) released its *Statement of principles for the regulation of transmission revenues* (SRP) in 2004. The AER adopted the existing scheme as part of its compendium of regulatory guidelines.

The AER has developed the proposed scheme by making adjustments to allow for recent amendments to the NER. Broadly, the proposed scheme departs from the existing scheme by:

- adopting the new terminology used in the NER
- providing a numerical example of how the proposed scheme operates
- removing references to specific types of operating expenditure (opex)
- providing for the exclusion of changes in opex associated with pass through events from the calculation of efficiency gains and losses, and other events at the AER's discretion.

3 Specific issues for comment

An earlier version of the proposed scheme was circulated to SP AusNet, ElectraNet and VENCorp being businesses facing regulatory determinations in 2008 for their comments. A number of issues were raised by those businesses and have been addressed in the first proposed scheme. Issues upon which the AER now seeks wider comment are:

- negative carry-over amounts
- timeframe for carry-overs
- categories of opex excluded from the scheme
- separate identification of carry-over amounts.

3.1 Negative carry-over amounts

3.1.1 Issue raised

The businesses believe that the AER should not apply any negative carry-over amounts arising from efficiency losses as this would reduce efficient opex allowances in subsequent regulatory periods. This they claimed would affect a TNSP's ability to recover efficient costs and reduce its regulated rates of return, thus creating a risk that sections 16(2)(a) and (c) of the NEL would be breached.

3.1.2 The AER's position

The AER makes the following points in response:

- Clause 6A.6.5(b)(2) of the NER requires the AER to have regard to the desirability of penalising TNSPs as well as rewarding them. This is consistent with section 16(2)(b) of the NEL, which requires the AER to provide effective incentives to promote economic efficiency in the provision of services.
- Any carry-over amounts from one year are combined with others and the net amount is smeared over several years in the following regulatory period, reducing the effect of a decrement arising from any particular year. The negative effect of a decrement in one year can be negated by a more efficient performance in later years.
- Where there is a series of consecutive decrements (resulting in a net negative carry-over amount), operating expenditures are combined with four other building blocks, meaning the overall revenue permitted may still be above the cost of service.
- Section 16(2)(a) of the NEL does not establish a floor under a TNSP's revenue. It requires the AER to provide the TNSP with a "reasonable opportunity" to recover the efficient costs of complying with regulatory obligations. This opportunity will be provided through this scheme and the revenue cap.

However, at the present time, the AER has drafted the proposed scheme to provide it discretion in applying negative carry-over amounts to allow it to consider these issues on a case-by-case basis.

Q1.	*Would the carry-over of efficiency losses be inconsistent with the AER's requirement to provide TNSPs a reasonable opportunity to recover efficient costs, and to make allowance for the value of transmission network assets under section 16(2) of the NEL?*
Q2.	*Would the prospect of not penalising TNSPs for inefficiencies reduce the incentives of the benefit sharing scheme?*
Q3.	*Should the scheme allow the AER to use its discretion when applying large positive carry-over amounts and consider the resulting impact on network users?*

3.2 Timeframe for carry-overs

3.2.1 Issue raised

The five year carry-over period may not be consistent with the length of a TNSP's own regulatory period and it was questioned if the carry-over period can be greater than five years.

3.2.2 AER's position

The length of the carry-over period relates to the desired sharing ratio of gains and losses between users and the TNSP, and not the length of the regulatory period. This ratio is the NPV of the particular gain or loss for the specific number of years, relative to the NPV of the gain or loss in perpetuity. A five year carry-over period results in a benefit sharing ratio of approximately 50:50 between the TNSP and the users. A ten year carry-over results in a ratio of approximately 70:30 for the TNSP and users respectively. In addition to considering whether this is a "fair" sharing of gains and losses between TNSPs and network users, the length of the carry-over period may also correspond to the time taken for competition to erode any efficiency gains made by a particular business in a competitive market.

The length of the carry-over period was examined in the preparation of the SRP and the 50:50 ratio settled upon at that time. There has been no material change of circumstances since the release of the SRP and the approach outlined has not been given opportunity to be comprehensively tested in practice since that time. The AER does not, therefore, see any need to revisit the benefit sharing ratio in publishing the proposed scheme.

Q4.	*Is the five year carry-over period and the resulting 50:50 sharing of gains/losses appropriate?*

3.3 Certain categories of opex should be excluded from the proposed scheme

3.3.1 Issue raised

The businesses proposed that the scheme specify that changes in certain opex categories should not be regarded as efficiency gains or losses as they may be uncontrollable by the TNSP.

3.3.2 AER's position

The proposed scheme states that the AER will not recognise changes in costs associated with pass through events. The treatment of these expenditure amounts under the NER, including the process by which they are recognised, is intended to reflect that these amounts are not subject to the control of the TNSP. The AER believes that the intention of the efficiency benefit sharing scheme is to reward and penalise a TNSP for controllable expenditures, thus pass through amounts should be excluded from the calculation. The AER will use its discretion in excluding changes in expenditure that are argued to be outside a TNSP's control where these are not dealt with under the pass through provisions of the NER.

Q5.	*Should the scheme define what events and associated cost increases/decreases are to be excluded from the calculation of efficiency gains and losses?*
Q6.	*What are the processes and considerations by which the AER should determine whether the impact of a certain event is excluded from the calculation of efficiency gains and losses?*
Q7.	*Is the proposed approach consistent with relevant aspects of the regulatory regime, such as pass through provisions, reopening provisions and the forward looking nature of the ex ante incentive framework?*

3.4 Separate identification of carry-over amounts

3.4.1 Issue raised

The businesses requested that the AER identify carry-over amounts separately from opex targets in order to avoid confusion when comparing actual and target expenditures.

3.4.2 AER's position

The AER will ensure that amounts associated with the proposed scheme will be identified separately in the reporting of expenditures.

4 Issues for comment

Interested parties are invited to make written submissions to the AER on the proposed scheme and provide any comments in response to the following:

Q1. Would the carry-over of efficiency losses be inconsistent with the AER's requirement to provide TNSPs a reasonable opportunity to recover efficient costs, and to make allowance for the value of transmission network assets under section 16(2) of the NEL?

Q2. Would the prospect of not penalising TNSPs for past inefficiencies reduce the incentives of the benefit sharing scheme?

Q3. Should the scheme allow the AER to use its discretion when applying large positive carry-over amounts and consider the resulting impact on network users?

Q4. Is the five year carry-over period and the resulting 50:50 sharing of gains/losses appropriate?

Q5. Should the scheme define what events and associated cost increases/decreases are to be excluded from the calculation of efficiency gains and losses?

Q6. What are the processes and considerations by which the AER should determine whether the impact of a certain event is excluded from the calculation of efficiency gains and losses?

Q7. Is the proposed approach consistent with relevant aspects of the regulatory regime, such as pass through provisions, reopening provisions and the forward looking nature of the ex ante incentive framework?

Any submissions should be received by close of business 1 May 2007 and should be addressed to:

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