grid australia
BACKBONE OF THE NEM

20 September 2013

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

Via email: incentives@aer.gov.au

Dear Sebastian

Draft Capital Expenditure Incentive Guideline

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Regulator (AER) on its draft Capital Expenditure Incentive Guideline for Electricity Network Service Providers.

Incentive regulation is a key feature of the regulatory framework for transmission network service providers (TNSPs). Grid Australia's long held view is that ex-ante financial incentives are the best means of promoting efficient expenditure outcomes that promote the National Electricity Objective (NEO). Given this position, Grid Australia supports any initiatives to improve expenditure incentives for network businesses.

This submission is focused on a number of matters where Grid Australia is seeking further clarification on the AER's position and, in some cases, for the AER to reconsider its position.

Grid Australia has also provided submissions to the Expenditure Forecasting Assessment Guideline (EFA Guideline) and the proposed Efficiency Benefits Sharing Scheme (EBSS). Given these address related matters they should also be considered in conjunction with this submission.

If you would like to discuss any aspect of this submission, please contact Andrew Kingsmill on 02 9284 3149 or alternatively I can be contacted on 08 8404 7983.

Yours sincerely

Rainer Korte

Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

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AER Better Regulation Program

Submission in response to Draft Capital Expenditure Incentives Guideline

September 2013

Powerlink Queensland TransGrid ElectraNet TRANSEND SP AusNet

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1. Introduction and summary of key issues

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Regulator in response to its Draft Capital Expenditure Incentives Guideline (CEI Guideline). As the AER is aware, Grid Australia is the organisation which represents the owners of Australia's electricity transmission networks.

Incentive regulation is a key feature of the regulatory framework for transmission network service providers (TNSPs). Grid Australia's long held view is that ex-ante financial incentives are the best means of promoting efficient expenditure outcomes that promote the National Electricity Objective (NEO). Given this position, Grid Australia fully supports the AER's process to improve capital expenditure incentives for network businesses.

Grid Australia supports the AER's proposal to have symmetric rewards and penalties under the Capital Expenditure Sharing Scheme (CESS). A symmetric scheme has the primary benefit of promoting balanced incentives between capital and operating expenditure and service incentives.

Given the importance of certainty and predictability in regulation, Grid Australia requests that the AER clarify, across each of the guidelines that form part of the Better Regulation work program, the process it will take to make, and apply, amendments to the guidelines. It is essential for a well-functioning regulatory framework, and in particular the effectiveness of financial incentives, that NSPs have full knowledge of the scope of the incentive up-front and confidence that the AER will commit to an approach to regulation for the duration of a regulatory period. This means clearly stating that changes to the regulatory approach will only apply on a prospective basis and following a comprehensive, and inclusive, consultation process.

Grid Australia has also provided submissions to the Expenditure Forecasting Assessment Guideline (EFA Guideline) and the proposed Efficiency Benefits Sharing Scheme (EBSS). Given these address related matters they should also be considered in conjunction with this submission.

1.1 Summary of key issues

This submission is focused on a number of matters where Grid Australia is seeking further clarification on the AER's position. In some cases Grid Australia requests the AER to reconsider its position. The key points raised in this submission are as follows.

<u>Ex-ante measures for capital expenditure</u>

- Grid Australia supports the AER's proposal to apply a symmetric CESS and to rely on forecast depreciation rather than to apply actual depreciation to update a NSP's Regulatory Asset Base as an additional incentive mechanism.

- Grid Australia suggests that in its guideline the AER reaffirm its statements from the Issues Paper that it will rely predominantly on ex-ante incentives and will only disallow expenditure ex-post in cases of clear and material inefficiency.

- Deferrals or advancements between regulatory periods under the CESS should be addressed through an adjustment to the carry-over amount rather than to the forecast of expenditure for the subsequent regulatory period.

- The AER should set out its approach to making adjustments under the CESS where expenditure has been disallowed following an ex-post review from years 4 or 5 of the preceding regulatory period.

Ex-post measures for capital expenditure

- Subject to confirming that an ex-post disallowance would only be applied in extreme circumstances, Grid Australia supports the AER's simplification to the process for undertaking these assessments.

- Any capital expenditure that has been disallowed in an ex-post review should be allowed to re-enter the Regulatory Asset Base (RAB)where it is deemed to be efficient at a later time. The AER has recognised this and proposes, where appropriate, to make an ex-ante adjustment to the amount of capital expenditure that is prevented from entering the RAB. However, a better alternative would be a Rule change to allow excluded capital expenditure to re-enter the RAB when it is deemed to be efficient. This Rule change could potentially be co-sponsored by the AER and NSPs. In the meantime, the AER should clearly set out its likely approach to making adjustments to the amount disallowed where the relevant assets are expected to be deemed to be efficient in the future.

- Extrapolating the findings of an ex-post review of one, or a limited number, of projects to exclude other project expenditure would see a penalty imposed on NSPs without clear evidence of inefficiency and should be ruled out by the AER. In addition, given the limited number of projects for transmission, and therefore the transparency of actual outcomes, the need for extrapolation is obviated.

- The AER needs to clearly set out how it will take into account the fact that the review period for an ex-post review is not aligned with the revenue determination period, and therefore, not aligned with the period over which the capital expenditure allowance is provided, and clarify applicable transition arrangements for affected businesses. The AER also needs to set out the circumstances under which capex could be assessed on a year by year basis in its ex-post review, as indicated in the draft guideline.

- The AER should more clearly explain how it anticipates that its ex-post review of capital expenditure will interact with the formal stages of the revenue determination process.

2. Ex-ante measures for capital expenditure

Grid Australia supports the AER's proposal to make improvements to the ex-ante incentives for capital expenditure. In particular, where a CESS is in place Grid Australia supports a symmetric incentive rate.

Grid Australia also supports the AER's proposal that it will only apply actual depreciation to update a NSP's Regulatory Asset Base where there is no CESS in place and that in most cases forecast depreciation will be applied as the default. Noting that the application of actual depreciation for this purpose can increase the power of the incentive, relying on forecast depreciation when a CESS is in place maintains the balance of incentives with operating expenditure and also addresses the problem of different incentive rates applying for assets based on their economic life where actual depreciation is applied.

Further clarification, or potential improvement, in the AER's approach is sought in relation to the following matters:

- The balance between ex-ante and ex-post incentive measures;
- Rewards and penalties for projects that shift between regulatory periods;
- Adjustments to the CESS where expenditure is disallowed from the RAB ex-post; and
- Treatment of expenditure related to the Network Capability Incentive.

2.1 Balance between ex-ante and ex-post incentive measures

In order to avoid distorting ex-ante incentives or imposing unnecessary risks and costs it is vital that the use of the ex-post disallowance measure is limited to those cases where there is clear evidence of material inefficiency.

The AER, in its Issues Paper for the CEI Guideline, was clear that it would rely predominantly on ex-ante incentives to promote efficient investment with ex-post measures used only as a backstop.[1] In its Explanatory Statement the AER acknowledges this previous position. However, while there is a requirement for the guideline to articulate how the capital expenditure measures work together, the AER has chosen not to reaffirm in the draft guideline that ex-ante incentives will be the primary means of promoting efficient investment by NSPs.

In order to reduce regulatory risk, the AER should reaffirm its previous view that ex-ante incentives will be the primary means of promoting efficient capital expenditure

[1] AER, *Better Regulation, Expenditure incentives guidelines for electricity network service providers, Issues Paper*, March 2013, p.38.

with ex-post measures only used in cases where there is evidence of material inefficiency. Further, for the avoidance of doubt, Grid Australia does not consider that reaffirming this position requires a reconsideration of the design of the CESS. It simply ensures that each tool is properly applied to the tasks for which it is suited.

More generally, Grid Australia encourages the AER to give a more complete analysis of how each of the ex-ante and ex-post tools contribute to the achievement of the capital expenditure objective, and in doing so, how the schemes are intended to operate in combination with each other. This will further promote certainty and transparency by articulating how the AER interprets its obligations under the Rules and the National Electricity Law.

2.2 Rewards and penalties for projects that shift between regulatory periods

The AER has correctly identified that an issue with the previous capital expenditure sharing scheme implemented for distribution businesses in Victoria was the treatment of deferrals between periods.[2] Where there are movements in key investment drivers it may be prudent to defer projects from the timing that might have been assumed for expenditure forecasting purposes based on the circumstances. The concern is that under a simple CESS the efficiency gain, and resulting reward to the NSP, when a project is deferred from one regulatory period to the next is higher than the true efficiency gain.

The AER has not recognised, however, that the reverse problem arises where a project is advanced from the next period to the current period. This might occur, for instance, because demand was higher than forecast and the new projects required are not contingent projects. In this case under a simple CESS a larger efficiency loss is calculated than should be the case.

Grid Australia, therefore, encourages the AER to consider the issue of rewards and penalties for projects that shift between regulatory periods in the context of both advancements and deferrals between regulatory periods.

2.2.1 Addressing incentive issues from projects shifting between regulatory periods

The AER has proposed that the issue of deferrals be addressed through its approach to expenditure forecasting.[3] That is, where it identifies that a project that was provided for in the previous period has been deferred into the next period it will not provide an additional allowance for that project.

2 AER, *Better Regulation, Explanatory statement, Draft Capital Expenditure Incentives Guidelines*, August 2013, p.22.

3 AER, *Better Regulation, Explanatory statement, Draft Capital Expenditure Incentives Guidelines*, August 2013, p.22.

In the first instance, Grid Australia agrees that, at least in the context of TNSPs with large and lumpy projects, project scrutiny is a suitable approach to identify when material advancements and deferrals have occurred. The AER is also correct that its proposed solution will address the incentive issue for deferrals between regulatory periods. However, excluding deferred projects from the expenditure forecast does not address the issue of project advancements identified above. In addition, there are a number of other concerns that arise because the forecast for capital expenditure would not include all of the expenditure that is actually required for the period, which include that:

- It will diminish the transparency of the expenditure requirements of the businesses over the period, and complicate both internal business and external regulatory reporting requirements;
- It may inappropriately lead to the capital expenditure forecast being overly focused on projects rather than an overall allowance; and
- There is the potential for inconsistency with the requirements of the Rules and the Revenue and Pricing Principles.

Grid Australia considers that an alternative and simpler approach would be to adjust the measured efficiency gain where a material project deferral or advancement is identified. That is, to substitute the full cost of the project (which is the efficiency gain if a project is avoided permanently) with the gain that arises from deferring the project – and to include the new project in the next period's capital expenditure forecast. This alternative approach is a mathematically equivalent solution to the one proposed by the AER.

However, in addition to resolving reporting and transparency issues and potential inconsistency with the Rules and Revenue and Pricing Principles, this approach would also have the benefit of making advancements of projects more straightforward to address.

As a simple example, assume that a $10 million project is deferred from year 4 in one period to year 2 in the next (at which time the project will cost $10.5 million, in real terms). The appropriate treatment in this case would be to adjust the year four efficiency gain down from $10 million to the present value of the new cost, discounted back to year four. The outcome is represented in the calculation below:

$$= 10 - \frac{10.5}{(1 + 7.5\%)^3} = \$1.55 \text{ million, assuming a 7.5 per cent real, pre tax WACC)}$$

Grid Australia also considers it is prudent for the AER to clarify in its guideline that the adjustment for advancements or deferrals will apply only for material projects where the materiality threshold is defined in advance. This is to ensure that the administrative costs of making the adjustment do not outweigh its benefits. This approach is also consistent with the current version of the EBSS for targets to be revised retrospectively in the event of a material trigger (for example, actual demand outside of a particular range). Grid Australia notes that projects with probabilistic expenditure profiles would also need to be treated appropriately, and an approach defined in advance.

2.3 Adjustments where expenditure is disallowed ex-post

The AER has indicated that it will make adjustments to the CESS where an ex-post review results in capital expenditure being excluded from the RAB.[4] Grid Australia agrees that this adjustment is necessary to ensure that rewards and penalties are commensurate with the efficiencies or inefficiencies in capital expenditure.[5]

As noted by the AER, a different adjustment is needed depending on the period to which the capital expenditure relates. The Rules require that the period for review is the first three years of the current period and years 4 and 5 of the preceding period. Expenditure incurred in years 4 and 5 of the preceding period would have already been rolled into the RAB by the time of the ex-post review. Where this expenditure is subsequently removed from the RAB the AER has indicated it will need to make a further adjustment to take account of the time value of money for the period the capital expenditure was included in the RAB.

It is important for the promotion of certainty, transparency and predictability that the AER set out in advance the approach it intends to take for the disallowance of expenditure from the preceding period. Therefore, the AER should set out the formula it intends to apply, including the WACC that would be applied for the adjustment, as well as the timing and process by which such adjustments would impact revenues. Setting out its approach in advance avoids any perception that the AER will make opportunistic choices at the time that it disallows capital expenditure from the RAB.

2.4 Treatment of expenditure related to the Network Capability Incentive

To preserve the fair sharing of efficiency improvements, capital expenditure incurred on approved initiatives under the Network Capability Component of the Service Target Performance Incentive Scheme for TNSPs should be explicitly excluded from the CESS. This is because this expenditure, and the associated allowance, is separate to the approved ex-ante allowances.

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4 AER, *Better Regulation, Explanatory statement, Draft Capital Expenditure Incentives Guidelines*, August 2013, p.35.

5 Clause 6A.6.5(c)(2) of the Rules.

3. Ex-post measures for capital expenditure

As indicated above, it is important for the effectiveness of the regulatory framework as a whole that the AER relies predominantly on ex-ante measures to promote efficient investment. The role for ex-post measures is to 'fill the gap' where ex-ante incentive schemes have not operated as intended and where there is clear evidence of material inefficiency in the circumstances.

Grid Australia supports the AER's proposed simplification of its process for reviewing expenditure ex-post. Under this approach more detailed analysis is only undertaken once an initial review identifies significant concerns about the efficiency of expenditure in excess of the expenditure forecast.

Grid Australia also supports the AER's proposal with respect to whether an adjustment is made to the RAB for expenditure that has been capitalised in a manner that is not consistent with the approved capitalisation policy. The AER's approach appears to be pragmatic and demonstrates the advantages of balanced incentives between capital and operating expenditure. Further, Grid Australia also supports the AER's approach to assessing related party margins, subject to it ensuring consistency with the approach in the EFA Guideline as raised in the ENA submission to the CEI Guideline.

As with the approach to ex-ante capital expenditure incentives, Grid Australia has identified a number of specific matters to address regarding the approach to the ex-post review of capital expenditure. These relate to:

- The re-inclusion of capital expenditure into the RAB;
- The extrapolation of the findings of ex-post reviews;
- The approach to the review of capital expenditure across multiple regulatory periods; and
- Procedural arrangements for conducting the ex-post reviews.

3.1 Re-inclusion of capital expenditure into the RAB

The AER has taken the view that while it would be appropriate to include previously disallowed capital expenditure into the RAB once deemed to be efficient, the Rules currently prevent it from doing so.[6] The AER proposes that instead it will take into account the likelihood that capital expenditure will be deemed as efficient at a later point when deciding the amount of capital expenditure to disallow from entering the RAB. Grid Australia considers that this is a second best solution compared to a

6 AER, *Better Regulation, Explanatory statement, Draft Capital Expenditure Incentives Guidelines*, August 2013, p.38.

change in the Rules. However, in the absence of a change to the Rules, and in the interests of transparency, the AER should specify in the guideline its likely approach on this matter.

It is clearly important that customers do not pay for inefficient network investments. However, it is equally important that customers pay for those assets and services they do use and benefit from. For this reason, it is important that a robust solution is identified to the treatment of disallowed capital expenditure that is expected to, or is subsequently deemed as efficient.

The AER's proposal to make an ex-ante adjustment to the amount of capital expenditure that is prevented from entering the RAB is clearly a preferable solution to no adjustment being made at all. However, by its nature this approach is likely to be highly imprecise. It would require the AER to make an assessment in advance of when, and how much, of the capital expenditure will be deemed as efficient in the future.

Given TNSPs and the AER agree on the principle that disallowed expenditure should be added to the RAB where it is deemed as efficient at a later point, a possible alternative solution would be for a Rule change to be submitted to the AEMC; potentially co-sponsored by the AER and NSPs. The proposal would make an adjustment to the roll-forward provisions for the RAB so that previously disallowed capital expenditure could be included in the RAB at the time that the relevant assets are assessed as being efficient, inclusive of all other associated building-block costs.

While Grid Australia considers that it is likely that such a rule change proposal could be processed well before it needed to be applied, it is nevertheless prudent for the AER to set out its likely approach in the absence of a Rule change on this matter.

In its guideline the AER should set out how it intends to undertake its ex-ante assessment of when assets are expected to become assessed as being efficient in the future and how this will impact on the amounts of expenditure that it disallows up-front. Grid Australia notes in this context that the societal cost from a project being constructed at a different time is the financing cost over the period of difference rather than the full cost of the project. Setting out this process in advance can provide a better assurance to customers that they will pay for the efficient costs of service provision and that NSPs will be compensated for the efficient costs they incur.

3.2 Extrapolation of the findings of ex-post reviews

In response to a comment in the Grid Australia submission to the Issues Paper, the AER has indicated that it considers it is appropriate for it to retain the discretion to extrapolate the findings of an ex-post assessment of a single project, or limited number of projects, across an entire capital expenditure program.[7] This approach, however, would impose substantial risks onto NSPs. As such, the AER is strongly encouraged to reconsider its view on this matter.

Given the uncertainty and risks associated with an ex-post review, which have been previously acknowledged by the AER[8], a high threshold should apply before expenditure is disallowed from entering the RAB.

The AER's position to retain the discretion to extrapolate the findings of an ex-post assessment of a single or limited number of projects raises the possibility of the AER imposing a penalty on a NSP even where there is no clear evidence of material inefficiency. The evidentiary burden on the AER would be substantially reduced and a degree of arbitrariness would be introduced into decision making. Extrapolating findings of material inefficiency is particularly unnecessary in the case of transmission given the relatively few major projects that are undertaken over a regulatory period.

The implication of reducing the evidentiary burden on the disallowance of capital expenditure is that NSPs may not be afforded the opportunity to recover at least their efficient costs of supply. The considerable risk this imposes on NSPs means that otherwise efficient investment may be discouraged given the uncertainty about whether such costs would be recoverable.

3.3 Approach to review of capital expenditure across multiple regulatory periods

The Rules require that the review period for an ex-post review includes the first three years of the current regulatory control period and last two regulatory years of the previous control period.[9] The fact that a regulatory control period is not reviewed in its entirety, and therefore the review not undertaken in the context of the entire expenditure allowance, means that there is the potential for NSPs to be perceived as more or less efficient than they actually are. While this reinforces the need for a high threshold to apply to the disallowance of capital expenditure, it also means that the AER needs to clarify in its guideline how it will take into account the fact it is only considering part of an entire regulatory control period when undertaking its ex-post review.

A review of capital expenditure ex-post cannot be done on the basis of estimates and must use actual data. At the time of commencing a determination process this means that only the first three years of the current control period can be subject to an ex-post review. In recognition of this the AEMC decided that the review period for an ex-post

7 AER, *Better Regulation, Explanatory statement, Draft Capital Expenditure Incentives Guidelines*, August 2013, p.38.

8 AER, *Rule change proposal, Economic regulation of transmission and distribution network service providers, AER's proposed changes to the National Electricity Rules*, September 2011, pp.43-44.

9 NER, clause S6A.2.2A(a1).

review be these three years plus the final two years of the preceding period; which would not have already been subject to review.

While the approach in the Rules makes sense in the context of the requirement that actual data be available, it creates issues when actually undertaking the assessment. The two main issues are that:

- The regulatory allowance for an NSP is not aligned with the review period for the ex-post review; and
- The need for NSPs to have flexibility over the timing of projects means that it is inappropriate to make an assessment on the basis of annual expenditure allowances.

The issue with the regulatory allowance not being aligned with the review period primarily creates an issue with the assessment of expenditure in the current regulatory control period. Specifically, it is not possible to know at the time the review is undertaken whether the NSP has spent in excess of its expenditure forecast or not. This is because there are still two more years remaining for the period at the time of lodging a Revenue Proposal.

Given the problem identified with the misalignment between the expenditure allowance and the review period there may be a temptation to focus on annual allowances. However, focusing on annual allowances may penalise NSPs that efficiently choose to alter the timing of projects. For instance, a project in the current period may be brought forward from year 4 to year 3. This may cause actual expenditure to exceed the implied expenditure allowance for year 3, and in doing so, trigger the prospect of an ex-post disallowance of expenditure. Assuming it was efficient to bring forward the timing of the investment, it would clearly be inappropriate to expose NSPs to the prospect that the expenditure is disallowed from entering the RAB.

For the assessment of years 4 and 5 of the preceding period the AER will know whether expenditure was above or below expenditure forecasts for that corresponding regulatory period. However, if it chose to only focus on annual expenditure allowances the problems identified above would remain.

<u>Treatment of businesses in transition</u>

ElectraNet and Powerlink have had revenue determinations made prior to the completion of the AER's CEI Guideline and therefore before the finalisation of the approach to the ex-post review. For instance, in the case of ElectraNet, at the commencement of its next revenue determination, a total of only two full regulatory years will have elapsed since the making of the Capital Expenditure Incentives Guideline. To extend the ex-post review to include the current year 2013-14 and two final years of the prior regulatory period would involve a retrospective application of the Guideline and Rules. As such, these businesses would be exposed to different incentives than were in place at the time expenditure decisions were taken. Grid Australia recommends that the AER clarify its approach to undertaking the ex-post review for these businesses and in doing so rule out its retrospective application.

3.4 Procedural arrangements for conducting the ex-post reviews

The AER has indicated that throughout its process for reviewing capital expenditure ex-post it will seek additional information from NSPs, or provide them with opportunities to review and comment on material produced by the AER. Grid Australia agrees it is important that NSPs be provided with the opportunity to review material produced by the AER and provide justification for expenditure decisions where relevant. Given the importance of a potential disallowance of capital expenditure, and in the interests of due process, the AER is encouraged to set out more clearly its intended process, including how it interacts with the formal determination process. This should include the decisions it anticipates it will be making at each stage of the formal process and whether it anticipates any formal consultation to occur outside of the formal revenue determination process.