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

**Proposed Efficiency Benefit Sharing Scheme**

Grid Australia welcomes the opportunity to provide this submission to the Australian Energy Regulator (AER) on its proposed Efficiency Benefit Sharing Scheme (EBSS) 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.

The key points raised in this submission are as follows:

- The current EBSS works well and includes an appropriate level of guidance for the application of the scheme. Removing detail from the scheme, as has been proposed by the AER, will only serve to erode its quality and the current level of confidence provided by the scheme.

- Caution is required to ensure that the application of the proposed pre-emptive productivity factor to operating expenditure forecasts does not compromise the integrity of the expected rewards under the EBSS or the recovery of efficient costs. Only those efficiencies that are exogenous to the business, and therefore do not derive from management effort, should be captured within the productivity factor.

- Operating expenditure categories that are not well suited to the revealed cost forecasting technique, such as lumpy cost items, uncontrollable costs or costs that are efficiently higher than revealed costs should be subject to a different forecasting approach and therefore a different application of the EBSS that is consistent with how those items were forecast.

- While it is appropriate for the AER to make adjustments to base year values where it has evidence of material inefficiency, making this adjustment can lead to an NSP incurring a penalty under the EBSS of greater than 100 per cent of the deemed inefficiency. This, in turn, can compromise the ability for an NSP to recover at least the efficient costs of providing network services.

Grid Australia has also provided submissions to the Expenditure Forecast Assessment Guideline and the Capital Expenditure Incentives Guideline. Given these address related matters they should be considered in conjunction with this submission.

This submission is supported by an expert report from Incenta Economic Consulting entitled *Advice on certain issues in relation to the Draft Expenditure Forecast Assessment and Efficiency Benefit Sharing Scheme Guidelines*.

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**

# AER Better Regulation Program

## Submission in response to Proposed Efficiency Benefits Sharing Scheme

September 2013

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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 (AER) in response to its Proposed Efficiency Benefits Sharing Scheme (EBSS). 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 NSPs. 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). Specifically, Grid Australia supports the application of continuous and symmetrical incentives for operating expenditure, in conjunction with applying the revealed cost approach as the basis for setting expenditure forecasts where it is appropriate to do so. Given this position, Grid Australia is fully supportive of the AER's proposal to maintain the application of an EBSS to network businesses.

Grid Australia supports the AER's decision to move away from the proposal to apply different forms of EBSS depending on the approach the AER chooses to take for setting forecast operating expenditure. The previous proposal would have inappropriately, and retrospectively, limited the expected payoffs for an NSP where it is outperforming expenditure forecasts.

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 Forecast Assessment Guideline (EFA Guideline) and the Capital Expenditure Incentives Guideline (CEI Guideline). Given these address related matters they should also be considered in conjunction with this submission.

<u>Summary of key issues</u>

The key points raised in this submission are as follows:

- The current EBSS works well and includes an appropriate level of guidance for the application of the scheme. Removing detail from the scheme, as has been proposed by the AER, will only serve to erode its quality and the current level of confidence provided by the scheme. Grid Australia is particularly concerned about the broad, and unbound, discretion included in the proposed EBSS with respect to exclusions. This proposed change opens up the prospect for discretionary ex-post adjustments to be made that would considerably increase uncertainty and regulatory risk.

- Caution is required to ensure that the application of the proposed pre-emptive productivity factor to operating expenditure forecasts does not compromise the integrity of the expected rewards under the EBSS or the recovery of efficient costs. Only those efficiencies that are exogenous to the business, and therefore do not derive from management effort, should be captured within the productivity factor. This can be achieved by limiting the productivity growth that is captured in the productivity factor to that arising from realising economies of scale.

- Operating expenditure categories that are not well suited to the revealed cost forecasting technique, such as lumpy cost items, uncontrollable costs or costs that are efficiently higher than revealed costs should be subject to a different forecasting approach and therefore a different application of the EBSS that is consistent with how those items were forecast. Modifying the forecasting approach and EBSS in an ex-ante decision is preferable to applying a forecasting technique that is artificially constrained merely to maintain consistency with the standard EBSS or adjusting forecasts in a subsequent regulatory control period.

- While it is appropriate for the AER to make adjustments to base year values where it has evidence of material inefficiency, making this adjustment can lead to an NSP incurring a penalty under the EBSS of greater than 100 per cent of the deemed inefficiency. This, in turn, can compromise the ability for an NSP to recover at least the efficient costs of providing network services. Grid Australia is willing to work with the AER to develop a solution to this deficiency.

## 2. Avoiding retrospective adjustments to incentives

The AER has chosen to review the design of the EBSS in conjunction with the requirements that it develop an EFA Guideline and a CEI Guideline. Grid Australia agrees that it is important for all elements of the framework to work well together and revisions should be considered where these are justified by changes to the approach for expenditure forecasting or capital expenditure incentives. However, the AER should avoid making any unnecessary changes to the scheme so that it does not deteriorate what has been a successful scheme to date.

Noting the AER has indicated that it considers that the EBSS has been successful and is working well to date, Grid Australia is concerned that apparently minor changes to the scheme, as well as removal of detailed guidance from the scheme, will be detrimental to the operation of the scheme and the framework overall.

Indeed, many of the changes the AER proposes only serve to reduce the level of transparency and predictability of the scheme. This outcome is counter to the intention of the AEMC for guidelines when it made its determination on the Economic Regulation of Network Service Providers Rule change.[1] This was that through early engagement, including through guidelines, a robust framework could be developed that provides confidence to NSPs and stakeholders.

As an example, the AER has chosen not to set out what exclusions might apply to the scheme. The proposed scheme has left open the option for the AER to identify and apply exclusions, at its own discretion, that are additional to those identified ex-ante in the revenue determination.[2] The consequence is that the AER can make any additional adjustments or exclusions it wishes to, and apply these on a retrospective basis without the agreement of the relevant NSP. This potential for an ex-post adjustment to be made without any advance guidance on how or when this adjustment might be made demonstrates an inappropriate exercise of discretion, and as such, a considerable increase in uncertainty and regulatory risk for TNSPs compared to the existing approach.

Grid Australia urges the AER to limit changes to the scheme to only those that are required or beneficial in the context of other framework changes. In particular, the AER should seek to maintain the level of detailed guidance that exists in the current scheme. Helpful prescription that is included in the current scheme that should be retained includes:

- A propose and respond approach to amendments to the scheme or to adjustments and exclusions
- Detail on adjustments and exclusions to forecast operating expenditure allowances for the purposes of calculating carryover amounts, established ex-ante in a revenue determination,[3] and
- Accommodation for the prospect of regulatory control periods of longer than five years.

## 3. Productivity factor and the EBSS

The AER has indicated that it intends to develop a single productivity forecast using econometric modelling of the operating expenditure function.

1 See: AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper,* 29 November 2012, p.110.

2 AER, *Electricity Network Service Providers, Proposed Efficiency Benefits Sharing Scheme,* August 2013, p.7.

3 More specifically, the AER should clearly state that expenditure related to schemes such as the Network Capability Incentive in the Service Target Performance Incentive Scheme, where a separate allowance to the standard revenue allowance is provided to fund activities, are excluded from the EBSS.

Grid Australia recognises that it is reasonable to factor expected productivity improvements into forecasts, but only where adjustments are constrained to those factors that are exogenous to the business and do not include efficiency improvements that arise through management effort. Grid Australia considers that this can be achieved by limiting the productivity growth in the productivity factor to those that would arise from realising economies of scale.

This is vital because imposing a pre-emptive productivity factor that is not constrained in this way would compromise the incentive properties of the EBSS, or the expectation of a recovery of the efficient costs of supply.

The productivity factor can compromise the integrity of the EBSS by removing the prospect for NSPs to be rewarded for management induced gains. This could occur through the AER pre-empting potential gains that are speculative (for example, based on past performance) and/or that come at some risk or cost to the business.

Grid Australia would also be concerned if the AER were to apply the productivity factor as an alternative, and less transparent, means of shifting away from the use of revealed costs. The AER can provide confidence to the sector that a fair share of management induced efficiency gains will be retained under the EBSS by setting out more clearly in the EFA Guideline its likely approach to the development of the proposed productivity factor and ensuring its application is appropriately limited.

Limiting the assumed productivity growth to that which would arise from realising economies of scale would ensure that NSPs are provided with appropriate rewards where management effort is devoted and costs are incurred for efficiency improvement programs. The benefits of these efficiency gains would then be passed on to customers in the future through the use of the new “revealed costs”. It would also ensure that gains that are a product of capital projects are excluded (which is an appropriate outcome given these gains have come at the cost of incurring additional capital expenditure, part of the justification for which, would have been the offsetting reward for the operating expenditure efficiency gains).

Grid Australia recognises that the AER has made some comments in its Explanatory Paper for the EFA Guideline in relation to each of the matters raised above that suggest a prudent approach will be taken. However, these sentiments are not reflected in the guideline and the explanatory statement provides no detail on the AER’s proposed approach, leaving open the possibility of arbitrary or opportunistic application of the proposed productivity factor.

NSPs can have little confidence that the factors set out for consideration in the Explanatory Statement will actually be taken into account by the AER when developing and applying its productivity factor. Therefore, the AER is strongly encouraged to promote the issues it has identified in the EFA Explanatory statement into the guideline and provide additional assurance to NSPs that potential gains under the EBSS will not be inappropriately removed through applying the proposed productivity factor.

## 4. Other adjustments to base year costs

As discussed in the Grid Australia submission to the Draft EFA Guideline, there are a number of circumstances where it may not be reasonable to rely on revealed costs combined with an exogenous productivity assumption and limited step change for assessing expenditure requirements or setting expenditure forecasts. These include, for example, operational refurbishment and other asset works, which have individual cost estimates and tend to be lumpy in a similar way to capital expenditure, rather than behaving as recurrent costs.

Grid Australia understands that the AER is hesitant to make adjustments to revealed costs or to take account of a wider range of factors when setting the trend and step inputs, except where there are examples and evidence of material inefficiency. This is due to concerns about the requirements for consistency between the method of forecasting and the efficiency gains that are ascribed to the NSP in the EBSS.

Grid Australia considers that while preserving the integrity of incentive schemes is important, it is equally important to ensure NSPs are provided with the capacity to earn a revenue stream that compensates them for at least the efficient costs of supply. Therefore, Grid Australia is proposing that in those circumstances where revealed costs would not be appropriate that adjustments be made to the forecasting approach as well as the application of the EBSS. Forecasting this expenditure separately, and excluding it from the EBSS or applying a modified EBSS that is consistent with the forecasting method, will ensure that efficient cost recovery is maintained without compromising the integrity of the incentive schemes.

In the case of operational refurbishment and other asset works, a portfolio based forecast based on individual cost estimates together with an EBSS that is suited to non-recurrent costs, perhaps of a similar design to the Capital Expenditure Sharing Scheme (CESS), may be suitable.

## 5. Penalty imposed where base year values are adjusted down by the AER

Grid Australia accepts that in the unlikely circumstance where there is clear evidence of material inefficiency that it is appropriate for the AER to make adjustments to the base year values. This ensures that the price customers pay for electricity network services reflects the efficient costs of supply. It is important, however, for the AER to also be cognisant of the interrelationship between the EBSS and the forecasts of operating expenditure.

In particular, the potential exists for part of the efficiency adjustment to already be provided implicitly under the EBSS, and hence for “double counting” to occur – and consequently for an NSP to be exposed to more than 100 per cent of the efficiency gap – if the base year is simply adjusted by the deemed inefficiency.

Incenta Economic Consulting, in the report attached to this submission, addresses this issue in depth, and has identified that even under conservative assumptions, the penalty incurred by the NSP in this circumstance could be up to 117 per cent of the deemed inefficiency. Incurring a penalty of greater than 100 per cent would compromise the ability for NSPs to recover at least the efficient costs of providing network services, and is an outcome that the AER has recognised as unreasonable in the context of the capital expenditure incentive scheme where an ex-post disallowance is made.

There are two options that the AER could implement to limit the penalty imposed for deemed inefficiency to a maximum of 100 per cent. The first is to provide a mechanism, established in advance in the EBSS guideline, to adjust the penalty incurred by the NSP. The second is for the AER to take into consideration the effect an adjustment will have on the penalty incurred by the business under the EBSS and factor this into the adjustment made to the expenditure forecast. Grid Australia considers that limiting the total penalty to a maximum of 100 per cent is consistent with, and therefore a requirement of, the operating expenditure factors. Specifically, that the AER have regard to whether the operating expenditure forecast is consistent with any incentive schemes that apply to TNSPs.[4]

Grid Australia is willing to work with the AER to further develop the potential solutions to this issue.

[4] NER, clause 6A.6.6(e)(8).