



Jemena Limited

Submission to the AER's review of incentive schemes for networks discussion paper



An appropriate citation for this paper is:

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Table of contents

Abbreviations	iv
1. Response to the discussion paper.....	1
1.1 Transparency of outcomes	2
1.2 Balance of rewards and penalties.....	2
1.3 Linking incentives with performance	4
1.4 A case for change: listening to customers	6
2. Response summary.....	7

Abbreviations

AER	Australian Energy Regulator
capex	capital expenditure
CESS	Capital Expenditure Sharing Scheme
DNSPs	distribution networks service providers
EBSS	Efficiency Benefit Sharing Scheme
ENA	Energy Networks Australia
JEN	Jemena Electricity Networks
JGN	Jemena Gas Networks
NEO	National Electricity Objective
NER	National Electricity Rules
NSP	network service provider
NSPs	network service providers
opex	operating expenditure

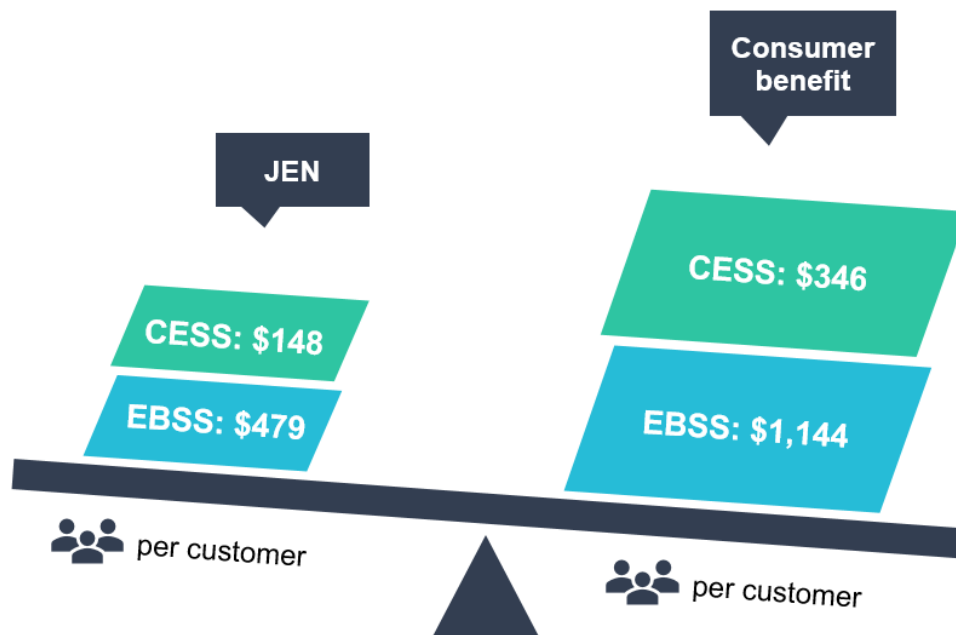
1. Response to the discussion paper

Jemena welcomes the opportunity to respond to the Australian Energy Regulator's (**AER**) review of incentive schemes for networks discussion paper (**discussion paper**). We support the AER's engagement and consultation on incentive schemes that apply to network service providers (**NSPs**). Reviewing these incentive schemes—in consultation with stakeholders—ensures the AER is well placed to make decisions in the long-term interests of consumers and provide certainty to NSPs on how the AER will assess future regulatory proposals.

Overall, the AER's discussion paper outlines that the current regulatory framework is improving outcomes for consumers. The AER's 2021 performance report highlights revenue and expenditure reductions and service reliability and productivity improvements since 2014.¹ In a study for Energy Networks Australia (**ENA**), Houston Kemp also found that consumers have benefited significantly from the efficiency benefit sharing scheme (**EBSS**) and capital expenditure sharing scheme (**CESS**).

Houston Kemp's report highlights that consumers are benefiting from incentive schemes much more than NSPs.² For example, Jemena Electricity Networks' (**JEN**) customers have paid \$627 per customer for incentive schemes (\$479 for the EBSS between 2006 and 2020 and \$148 for the CESS between 2016 and 2020) in return for \$1490 per customer in long-term savings (shown in Figure 1-1 below).³

Figure 1-1: Benefits delivered by incentive schemes (\$ per customer)



The discussion paper acknowledges that these trends suggest that NSPs have pursued efficient expenditure while maintaining service reliability, indicating that the current regulatory framework appropriately balances incentives.⁴ We agree with this characterisation and consider that the current incentive schemes are fit-for-purpose. Box 1 in section 2 outlines a summary of our responses to each consultation topic.

¹ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 23.

² Houston Kemp, *Consumer benefits resulting from the AER's incentive schemes*, February 2022, p. 1-3.

³ JEN's consumer benefits (in net present value terms) are calculated over the entire period when the EBSS and CESS have applied (EBSS: 2006-2020, CESS: 2016-2020) using the same method as described in Houston Kemp's report for ENA (*Consumer benefits resulting from the AER's incentive schemes*), based on a 6% real discount rate in real 2020 dollars.

⁴ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 26.

1.1 Transparency of outcomes

The discussion paper outlines that the AER heard from stakeholders there is a lack of transparency about how incentive scheme rewards and penalties advance the interests of consumers. For capex, several stakeholders considered there is a lack of transparency regarding whether underspends were due to genuine efficiency gains, a combination of happenstance, poor or over-forecasting or the inability to obtain project approvals.⁵

The discussion paper outlines that greater transparency and reporting of underspend drivers will help address these concerns and provide stakeholders with greater confidence in forecasts, and this should be balanced with an appropriate amount of regulatory burden and costs.⁶ We agree that transparency is very important across all aspects of an NSP's price reset because it improves stakeholder engagement and uplifts capabilities. We provided this transparency in JEN's proposal for the 2021-26 regulatory control period (**regulatory period**). Our initial proposal highlighted the primary drivers of JEN's capital expenditure (**capex**) underspend in the 2016-20 regulatory period compared with the AER's allowance:

- lower than forecast activity volumes and achieving delivery and scope efficiencies for replacement expenditure
- lower than expected demand growth, reducing the need for demand-driven augmentation expenditure.⁷

The AER's draft decision was satisfied with JEN's CESS revenue increment and the explanations for JEN's historical capex and underspend compared with the AER's allowance. The draft decision also noted that JEN's small amount of capex deferral was not material and had been sufficiently transparent. The AER noted that stakeholder concerns were less applicable to JEN for these reasons.⁸

This recent experience demonstrates that the existing regulatory framework and assessment approach provides sufficient transparency for stakeholders regarding incentive scheme outcomes. This experience also struck an appropriate balance between addressing stakeholder concerns and the amount of regulatory burden and cost. To address the root concerns, we recommend that NSPs complete a similar template and follow a similar approach as undertaken by JEN to help address any future transparency concerns.

Finally, a lack of transparency is not a sufficient reason to change how the incentive schemes operate. The discussion paper considers that transparency concerns can be addressed by changing how the CESS operates. However, changing the CESS without proper visibility to ensure an effective design could exacerbate perceived transparency concerns. Further, the AER has substantial information-gathering powers to collect data and—barring any confidentiality requirements that the AER can amend—access more information and make this transparent. Using this approach can address any transparency concerns.

1.2 Balance of rewards and penalties

The discussion paper expresses concerns that the EBSS and CESS do not currently provide equal rewards and penalties due to the reduction in the rate of return over recent years impacting the EBSS sharing ratio. The discussion paper considers the possibility of changing the CESS sharing ratio based on the time value of money to ensure the EBSS and CESS provide equal rewards to NSPs.⁹ When the EBSS was developed, the AER calculated a sharing ratio between NSPs and consumers of 30:70.¹⁰ NSPs retain the benefits of operating expenditure (**opex**) efficiency gains for six years and pass the benefits of lower opex to consumers from the seventh year onwards with a 6% real discount rate in the long term. The CESS was designed to be consistent with the sharing of opex efficiency gains under the EBSS. However, the calculation method differs from the EBSS by setting a fixed NSP incentive sharing ratio of 30%.¹¹

⁵ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 8.

⁶ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 12-14.

⁷ JEN, *2021–26 electricity distribution price review regulatory proposal, Attachment 05-02*, January 2020, pp. 1-12.

⁸ AER, *Draft decision, Jemena distribution determination, Attachment 9*, September 2020, p. 7.

⁹ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 33-35.

¹⁰ AER, *Efficiency benefit sharing scheme*, November 2013.

¹¹ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 34-35.

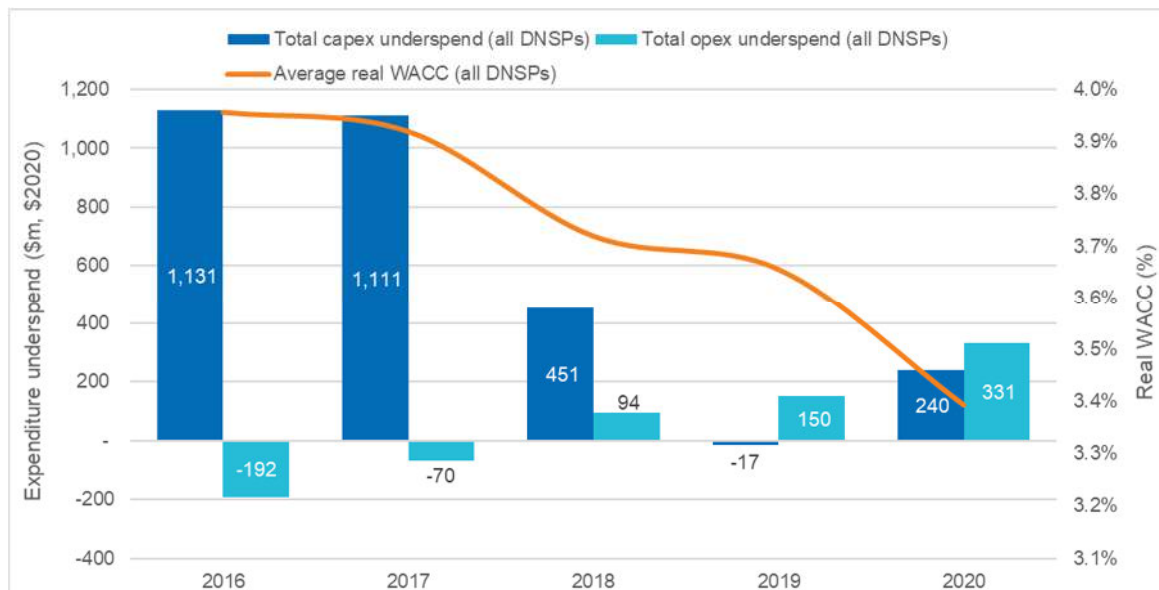
The discussion paper argues that the EBSS sharing ratio for NSPs reduces below 30% when the real rate of return reduces below 6%. In particular, the AER noted that the real regulated rate of return over the past five years has lowered to around 3%, implying an NSP sharing ratio of 15% under the EBSS. This reduction in the EBSS sharing ratio implies that the CESS would become more attractive than the EBSS.¹² However, the rate of return assumption used to calculate the EBSS sharing ratio reflects the long-term expected return. Therefore, it is incorrect to assume that the long-term expected EBSS sharing ratio reduces with short-term reductions in the rate of return and that the low rate over recent years would be the perpetual rate into the future.

In addition, the actual sharing ratio of the EBSS varies with the outturn rate of return each year and could be above or below 30% in different years. However, NSPs make investment decisions in advance of knowing the outturn sharing ratios of EBSS. An NSP’s expectations of their rewards over the long term are unlikely to change if the outturn sharing ratio is higher or lower than the expected 30% due to short-term interest rate movements. Therefore, the CESS sharing ratio should not be adjusted, as this would cause the incentive schemes to become unbalanced.

Further, NSPs’ capex and opex spending is not solely driven by incentives. NSPs have ongoing obligations to ensure that they meet the opex and capex objectives defined in the National Electricity Rules (NER). These include maintaining the safety, reliability and security of supply of the network. NSPs are also subject to changes in non-discretionary accounting standards, cost allocation methodologies and capitalisation policies that do not allow for the simple substitution of capex and opex to benefit from incentive scheme outcomes. These binary obligations have a stronger influence on NSPs’ expenditure choices than incentive schemes.

If the EBSS sharing ratio did decline below 30% when the prevailing rate of return is lower, NSPs would underspend more capex than opex to benefit from the higher CESS rewards. However, distribution networks service providers’ (DNSPs) opex and capex underspends have moved in the opposite direction between 2016 and 2020 (when both the EBSS and CESS have applied). As shown in Figure 1-2 below, DNSPs’ capex underspends reduced when the prevailing rate of return declined in recent years. In addition, DNSPs’ opex underspends were higher than capex underspends in 2019 and 2020 when the prevailing rate of return was at its lowest level. Therefore, there is no evidence suggesting that the incentive rewards are biased towards the CESS under current economic conditions with a low short-term rate of return.

Figure 1-2: The overall opex and capex underspend against allowances and average real WACC for all DNSPs



Source: AER network performance report, DNSP final revenue determinations

NSPs’ capital investments typically have long economic lifespans of 30 to 50 years or longer. Maintaining the stability and certainty of the incentives framework will help promote efficient investment in these long-lived network

¹² AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 34-35.

assets. Introducing frequent changes to the CESS, which has only been operating for five years for JEN and one year for Jemena Gas Networks (**JGN**), creates uncertainty in the framework and undermines the credibility of the incentive regime that could affect NSPs' incentives to make efficient long-term investments and operational decisions in the future. Therefore, adjusting the CESS sharing ratio at intervals similar to the time of each determination—based on the assumed EBSS sharing ratio using the prevailing rate of return—will potentially unbalance the EBSS and CESS. The current rewards and penalties provided under the EBSS and CESS are balanced and remain fit-for-purpose over the long term.

1.3 Linking incentives with performance

Identifying drivers of high expenditure forecasts and underspends

The discussion paper conflates 'over-forecasting' with capex forecasts that are higher than an NSP's actual revealed capex in a preceding regulatory period. There are many legitimate reasons why an expenditure forecast may increase above actual expenditure from one period to the next, such as changes in regulatory obligations and increases in forecast demand. We encourage the AER to not characterise all of these instances as 'over-forecasting'. The AER acknowledges that circumstances can reasonably change and NSPs may need to spend more or less than initially forecast to maintain the safety and reliability of the network and that the incentive schemes share these changes between networks and consumers.¹³

In addition, capex is less recurrent than opex and the AER's assessment of forecast capex is linked to an underlying requirement and less dependent on historical revealed capex. Therefore, it is important to understand the key drivers when NSPs underspend capex allowances and propose higher capex forecasts in subsequent regulatory periods. Reducing incentives for higher capex forecasts or material underspends—by lowering the incentive rewards that NSPs are entitled to without understanding these underlying drivers—creates an imbalance in the incentive regime. Below we highlight two examples where understanding and further context are important:

- An NSP may have underspent its augex forecast during a particular regulatory period due to changes in demand drivers and underlying market conditions. However, a new regulatory obligation, such as REFCL requirements, may result in a significant increase in the NSP's forecast later in the regulatory period or the subsequent regulatory period.
- For customer connection driven capex—which is largely outside NSPs' control—historical underspends could be driven by lower than forecast demand. However, increased population growth and new housing developments could drive a higher capex forecast in the subsequent regulatory period. We expand on this in more detail in section 1.4 below.

Changing incentive schemes based on past behaviour

In addressing stakeholder concerns on capex forecasting, the AER proposes to apply different incentive arrangements—including the incentive rates and symmetry—to different NSPs at each regulatory determination according to their past performances and whether they are appropriately responding to incentives.¹⁴ The discussion paper states:

When the AEMC made the rule change that required the AER to establish the CESS, it contemplated that the AER could tailor incentive scheme rewards and penalties to service providers based on their historical spending behaviour and how they are responding to incentives. We consider that it may be appropriate for incentive schemes to be flexible and responsive to NSP performance and views on whether they are appropriately responding to incentives.¹⁵

Specifically, the AEMC proposed to provide stronger incentives for NSPs that historically spend above allowances and weaker incentives for NSPs who are considered to inefficiently defer capex into future periods.¹⁶ We do not agree that the AER should be able to apply different incentive arrangements—including the incentive rates and

¹³ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 31.

¹⁴ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 38.

¹⁵ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 15.

¹⁶ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 32-38.

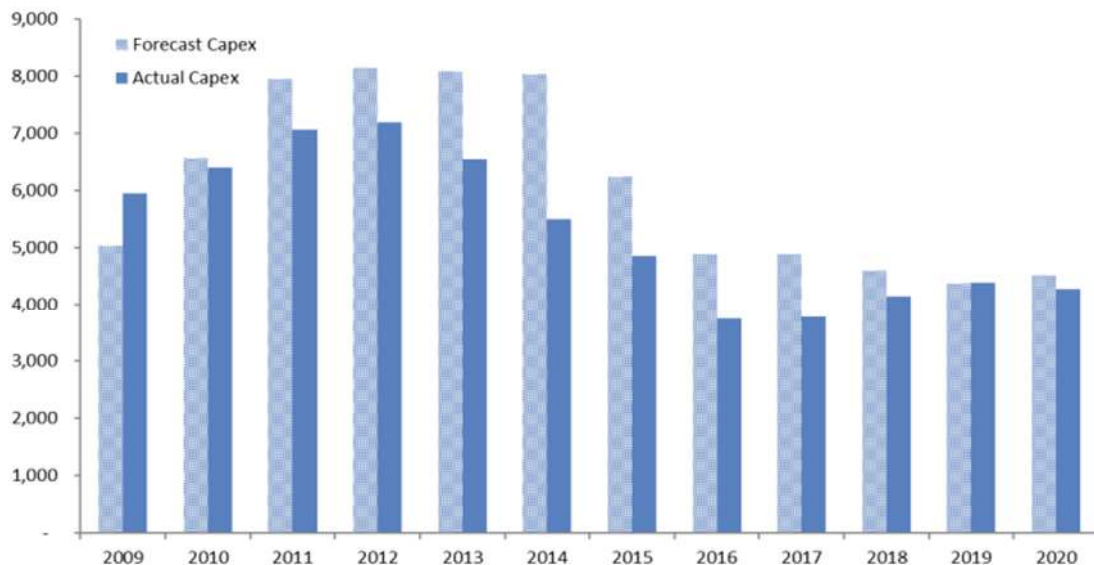
symmetry—to different NSPs at each regulatory determination according to their past performances. As noted in section 1.2 above, the schemes were designed with a long-term view in mind and adjusting the operation of the schemes across regulatory periods may cause imbalance. This long-term view is also consistent with the NEO. To address the accuracy and transparency of capex forecasts or perceived ‘over-forecasting’ concerns, we recommend that the AER continues to improve forecasting techniques rather than changing the way the existing incentive schemes operate.

Improving forecasting techniques

The discussion paper notes that the AER’s capex forecasting techniques have improved over time, resulting in reductions in approved capex forecasts in more recent regulatory periods.¹⁷ To demonstrate this, the AER presents the forecast and actual capex for all electricity DNSPs between 2009 and 2020. This is shown in Figure 1-3 below, which highlights:

- Since the introduction of the CESS in 2015, the AER’s approved capex forecasts have reduced significantly. We agree that forecasting techniques have significantly improved over time, including the development of standardised forecasting approaches, assessment techniques and additional guidance notes to assist DNSPs to prepare capex forecasts. These tools have enabled NSPs and the AER to forecast capex more accurately in more recent determinations.¹⁸
- The difference between the AER’s allowances and NSPs’ actual capex between 2016 and 2020—when the CESS applied—is much smaller than before the CESS was introduced. The underspends observed between 2016 and 2020 are more likely to reflect NSPs achieving efficiencies rather than forecasting errors compared with previous periods.

Figure 1-3: Forecast and actual capital expenditure – all electricity distribution



Source: AER network performance report

Overall, improvements in forecasting techniques and the development of standardised forecasting approaches have reduced forecasting errors in determinations since 2015. Further improving forecasting techniques, developing standardised models and improving existing guidance to NSPs have addressed concerns regarding ‘over-forecasting’. The AER has also published a draft Better Resets Handbook that provides guidance and requirements on DNSPs’ capex forecasts that can help to further improve the accuracy of capex forecasts in future price resets. We support the AER’s greater customer-centric approach in future regulatory processes and believe this will also address perceived concerns regarding ‘over-forecasting’.

¹⁷ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 52-54.

¹⁸ AER, *Review of incentive schemes for networks discussion paper*, December 2021, p. 52.

1.4 A case for change: listening to customers

During JGN's customer engagement for its 2020-25 access arrangement, we received strong and consistent stakeholder support for the CESS to only apply to things within our control.¹⁹ Stakeholders considered that connections capex should be excluded from the CESS because this category was driven by market forces for both volumes and unit rates. Reflecting this stakeholder feedback, JGN proposed excluding connections capex from the CESS in its 2020-25 access arrangement, which the AER accepted in its final decision.²⁰ With this customer feedback in mind, one change the AER could consider is excluding connections capex from the CESS.

The purpose of the CESS is to incentivise capex savings under which NSPs have control. However, connections capex is demand-driven and outside the control of NSPs. Consistent with the principle of balance—as noted above—this potential change to the CESS would align with the approach in the EBSS, which only considers controllable opex savings.

¹⁹ JGN, *Access arrangement proposal, Attachment 7.11 incentive schemes*, June 2019, p. iv.

²⁰ JGN, *Access arrangement proposal, Attachment 7.11 incentive schemes*, June 2019, p. 14.

2. Response summary

Box 1 – Summary of responses to each consultation topic

Section 1.1 – Transparency of outcomes

- Transparency is very important across all aspects of an NSP's price reset because it improves stakeholder engagement and uplifts capabilities.
- The existing regulatory framework, assessment approaches and the Better Resets Handbook can provide sufficient transparency for stakeholders regarding incentive scheme outcomes (see JEN's CESS assessment during its 2021-26 price reset).

Section 1.2 – Balance of rewards and penalties

- The rate of return assumption used in the EBSS sharing ratio calculation reflects the long-term expected return. Therefore, it is incorrect to assume that the low rate over recent years would be the perpetual rate into the future.
- There is no evidence suggesting that the incentive rewards are biased towards the CESS under current economic conditions with a low short-term rate of return. Therefore, it is inappropriate to adjust the CESS sharing ratio at the time of each determination based on the assumed EBSS sharing ratio, using the prevailing rate of return as the perpetual discount rate.

Section 1.3 – Linking incentives with performance

- It is important to understand the key drivers when NSPs underspend capex allowances and propose higher capex forecasts in subsequent regulatory periods. It would be inappropriate to penalise higher capex forecasts or material underspends by lowering the incentive rewards that NSPs are entitled to without understanding the underlying drivers.
- Perverse incentives are likely to be created if the AER can tailor incentive schemes to individual NSPs. Adjusting incentive schemes based on NSPs' past performances will introduce unwanted incentives and discourage NSPs from pursuing efficiencies.
- Further improving forecasting techniques, developing standardised models and improving existing guidance to NSPs will address concerns regarding 'over-forecasting'.

Section 1.4 – A case for change: listening to customers

- Based on customer feedback during JGN's customer engagement for the 2020-25 access arrangement, we encourage the AER to consider if excluding connections capex from the CESS would deliver better long-term outcomes for customers.
- Connections capex is demand-driven and mostly outside the control of NSPs. Importantly, other mechanisms within the connections process ensure expenditure is prudent and efficient.