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Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
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By email: incentives@aer.gov.au

Dear Mr Roberts

We are pleased to provide this response to the Issues Paper entitled *Expenditure incentives guidelines for electricity network service providers* (the issues paper) which the Australian Energy Regulator (**AER**) has published as part of its Better Regulation program.

Jemena has contributed to and supports the ENA's submission in response to the issues paper. Accordingly this submission focuses on aspects of the consultation that are of further particular interest to Jemena—it does not respond to all matters and questions raised in the issues paper.

Context

As a result of the rule changes finalised by the AEMC in late 2012, the AER:

1. has guided discretion to develop and apply a capital expenditure sharing scheme (**CESS**) (National Electricity Rules (**NER**), s. 6.5.8A)
2. has guided discretion to determine whether the RAB roll-forward calculation is to be based on forecast or actual depreciation (NER, schedule S6.2.2B).
3. must consult on and publish Capital Expenditure Incentive Guidelines (NER, s. 6.4A) in addition to the efficiency benefits sharing scheme (**EBSS**) already required for opex (NER, s. 6.5.8).

The form of the CESS and EBSS, and the decision made on depreciation in the RAB roll-forward calculation, will define the incentives that an electricity NSP faces and will play a significant role in determining the amounts that an NSP actually spends during a regulatory period.

However the changes relating to incentives were only one aspect of the rule changes. The changes also provide the AER with a number of new and changed "tools" which will affect the way that it assesses and sets opex and capex allowances:

1. It is now clear that, if the AER is not satisfied that a proposal meets the requirements of the NER, it is not constrained to varying the proposal only to the extent necessary to enable it to be approved in accordance with the NER (NER s. 6.12.3(f) has been deleted).
2. The role of benchmarking has been clarified, although it is still just one of a number of factors that the AER must have regard to when assessing a proposal.

3. The AER may designate part of an NSP's proposed capital expenditure as relating to one or more contingent projects subject to defined trigger events and materiality thresholds.
4. Capex reopener provisions are now available to DNSPs.

These changes will affect, directly or indirectly, how the AER assesses an NSP's regulatory proposal and hence the components and aggregate of the building block revenue requirement ultimately determined for the NSP. For opex, the AER has foreshadowed an intention to depart from the established "revealed cost" approach to setting opex allowances where it considers that a business has not responded to cost efficiency incentives. The alternative "exogenous" approach will be informed by benchmarking. The AER also foreshadows greater use of benchmarking in the assessment of capex proposals. In addition, the AER may be inclined to place greater reliance on contingent projects and capex reopeners now that those mechanisms are available for DNSPs.

It appears likely that the aggregate building block revenue requirement determined under the amended rules will be less than it would have been under the rules before they were amended, so that targets against which incentive mechanisms will apply will be more demanding than they would have been.

Finally, under the amended rules, the AER must now undertake an ex post prudency review of capex and may disallow capex in excess of the ex ante forecast that is assessed to be imprudent or inefficient. The mere threat of this review will have an immediate effect on NSPs' capex decisions. The longer term implications of ex post reviews will depend on how the AER exercises this new power. Having regard to the incentive impact of the existence of ex post capex reviews, Jemena welcomes the AER's stated intention to maintain a primary reliance on the ex ante capex incentive measures, while exercising the ex post powers on an exception basis.

Incentives should be tailored to circumstances

New and changed incentive mechanisms are only one component of the suite of changes that are enabled by the amended rules. Each of those changes on its own has potential to bring about significant changes in NSPs' behaviour. If all of these new and changed powers were deployed aggressively and at once, their effects would be amplified with uncertain and unpredictable consequences that may not be in the long term interests of consumers. Moreover, it would not be possible to differentiate their effects in order to make future incremental refinements.

Given their potential power to affect NSPs' behaviour, especially when deployed in combination, Jemena urges the AER to proceed with caution in exercising each of these new and changed powers.

There is a strong case for tailoring the application of the new and changed powers, including the form and parameters of any incentive arrangements, to the circumstances of each NSP. The AER's response should be commensurate with any "problems" that are evident from past performance of a given NSP and should be no more intrusive than is necessary to produce the desired change in that NSP's behaviour. Taking a one-size-fits-all approach to address an isolated problem is likely to have detrimental consequences for businesses that do not exhibit the problem.

Opex incentives—revealed costs and the alternative exogenous approach

In the case of Victorian businesses, they have been subject to incentive based regulation since the mid 1990s. For most of that time up to the present, opex efficiency has been encouraged by the Essential Services Commission's (**ESC**'s) efficiency carryover mechanism (**ECM**) and now the AER's efficiency benefits sharing scheme (**EBSS**) where forecast allowances are based on the well understood and accepted revealed cost approach. There is clear evidence that the businesses have responded to those mechanisms. The Office of the Regulator General (**ORG**) also introduced an ECM for capex for one regulatory period.

The AER has foreshadowed an intention to depart from the established "revealed cost" approach to setting opex allowances where it considers that a business has not responded to cost efficiency incentives. Jemena is particularly concerned about the exposures that the exogenous approach presents for businesses such as Jemena. There are 2 important questions:

- What reliance can be placed on economic benchmarking results to inform decisions about the exogenous approach?
- How should the opex incentive mechanism be structured under the exogenous approach—and in the transition between the revealed cost and exogenous approaches?

Taking these questions in turn:

1. What reliance can be place on economic benchmarking?

   Jemena is very concerned that the AER may place undue weight on economic benchmarking to inform a move from revealed costs to the exogenous approach before there is broad stakeholder acceptance that the results of economic benchmarking are reliable and fit for purpose.

   We have referred in previous submissions to the AEMC's conclusion in its review of total factor productivity (**TFP**) that existing data is not sufficiently reliable to support the immediate introduction of TFP regulation as an alternative to building blocks. The AEMC reached that conclusion in the context of a rule change proposal where TFP would only have been used to set the rate of change of prices. Significantly, the level of prices would have been re-set at each review by reference to revealed costs. It is notable that the consequences of an error in the level of prices would likely be greater than the consequences of the potential error in the estimate of TFP and hence the rate of change of prices.

   If opex allowances are to be set on the basis of exogenous information such as economic benchmarking, that would amount to an adjustment to the level of opex. In Jemena's view this creates a significant exposure if there is any question about the reliability of the exogenous information. Not only is it possible that an incorrect decision will be made to move from revealed costs to the exogenous approach, but the opex allowance set under the exogenous approach may be inadequate, contrary to the revenue and pricing principles (**RPP**).

   Given the current state of development of economic benchmarking, where key issues of model specification and source data are unresolved, that exposure is likely to be at least comparable to the exposure that led that AEMC to conclude that the introduction of TFP regulation should be delayed until a reliable and consistent data set has been assembled and model specifications have been developed and tested.

   The AER must proceed cautiously in applying the results of economic benchmarking in its decision-making, at least in the short to medium term. Premature use of economic benchmarking to inform what are very important decisions, will introduce a significant level of risk and uncertainty for businesses.

2. How should the opex incentive mechanism be structured under the exogenous approach?

   There has been much discussion about the form and operation of an incentive mechanism that might apply under the exogenous approach and in the transition between the revealed cost and exogenous approaches. In Jemena's view the proposed solutions appear unnecessarily complex.

   The current EBSS arrangements are relatively simple and are well understood and accepted by stakeholders. The AER should consider how these existing arrangements can be adapted to the exogenous approach rather than develop new and potentially complex structures. It seems that one way of accomplishing this may be to manage the difference between the revealed cost and exogenous approaches through an adjustment to the base year while preserving the other features of the current EBSS.

Symmetry is important

An incentive mechanism should be designed to encourage, and certainly not discourage, efficient expenditure. The allowance is only a forecast of efficient costs and, like any forecast, it is necessarily imperfect. In particular, when it comes to the later years of a regulatory period, the forecast for those years is based on information and projections that can be as much as 7 years old. Moreover, it will rarely be a consensus forecast—most often it will be determined and imposed by the AER.

Ideally incentives should operate around an assessment of what the efficient level of expenditure should have been at the time the expenditure was made, taking into account circumstances as they were at that time.

The AER is required to undertake an ex post review of capex (if any) that is in excess of the forecast allowance. The corollary must be that expenditure that is not disallowed through ex post review must be efficient. If "allowed" capex after ex post review was still greater than the ex ante forecast, a CESS that imposes penalties on expenditure in excess of forecast would, in effect, be penalising efficient capex. On its face this would be contrary to the RPP which require, among other things, that the NSP be given a reasonable opportunity to recover at least its efficient costs. In principle this penalty is balanced over the long term by the opportunity that the NSP has to benefit through the CESS when it outperforms the ex ante allowance. But, for that balance to be achieved, the ex ante allowance must be unbiased and the incentive scheme must operate symmetrically. The balance would be denied if the CESS was asymmetric.

In Jemena's view, the AER should model its CESS on the ORG's capex ECM in the first instance. That mechanism is simple in its construction and straight forward to administer and has the desirable attributes of being continuous and symmetrical. The mechanism can always be further developed and refined over time if it does not perform as expected.

Exclusions

Ideally incentives should operate around a hind-cast of efficient costs as we have noted above. However, that is clearly not practical and the NER do not require that as an option. Nevertheless, the NER do recognise the principle in that, for example, in an ex post capex review, actual capex is assessed against the ex ante capex allowance after it has been adjusted for any pass-through amounts and the cost of any contingent projects that actually eventuate.

In JEN's view there is likely to be a case for excluding other categories of costs from the operation of the CESS (for capex) and EBSS (for opex). Those categories should be determined ex ante for each NSP on a case by case basis in the framework and approach phase of the price review process. This will provide the NSP with a degree of certainty when framing its regulatory proposal. The principles for exclusion should be that:

- the expenditure is outside the NSP's control e.g. growth or connections-related expenditure where there is a universal connection obligation or
- failure to exclude the costs would distort the intended incentive properties of other parts of the regulatory regime applied to that NSP.

An example of costs in the latter category is expenditure on reliability and quality improvements that is made in response to the incentives provided by the STPIS in Victoria. That expenditure is not forecast on an ex ante basis and so could contribute to total capex exceeding the allowance if not excluded. Given that it is justified on the basis of the STPIS criteria, the expenditure should be excluded when determining whether an ex post review is required and that exclusion step should be included in the AER's staged assessment approach. The expenditure should also be excluded in applying any CESS. If that was not done then penalties for over-expenditure would be over-stated and rewards for under-expenditure would be under-stated, effectively eroding and distorting the STPIS incentives.

Should forecast or actual depreciation be used in the RAB roll-forward calculation?

It is well accepted that, absent a continuous CESS, the use of forecast depreciation in the RAB roll-forward calculation produces an incentive to defer capex within a regulatory period. The incentive is at its maximum in the first year of the period and decreases to zero in the last year of the period. If actual deprecation is used there is an additional incentive, over and above that provided by forecast depreciation, to defer capex within the period so as to maximise the value rolled into the RAB. That incentive is especially strong for short-lived assets. Having said that, businesses have only limited capacity to respond to those incentives:

- a significant proportion of capex for DNSPs is growth-dependent and cannot be re-scheduled
- larger projects cannot be re-scoped, deferred or discontinued economically once committed
- even where timing is discretionary, resource constraints limit the DNSP's ability to defer significant amounts of capex within a period.

Even so, incentives that distort timing decisions are undesirable.

A properly designed continuous CESS in combination with forecast depreciation will eliminate the incentive associated with the use of forecast depreciation—the NSP will be indifferent as to when expenditure occurs in the regulatory period. If actual depreciation was to be used instead of forecast depreciation it would re-introduce the incentive to defer expenditure and unreasonably penalise expenditure on short-lived assets.

In Jemena's view, actual depreciation should only be specified for the RAB roll-forward calculation in exceptional circumstances. Forecast depreciation should be the default.

If you would like to discuss this submission please contact me on 03 8544 9053 or by email at robert.mcmillan@jemena.com.au.

Yours sincerely

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General Manager Regulation