Incentives Review: CESS Workshop

Why the CESS should be abolished

David Havyatt – Public Forum, 26 August 2022

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What is incentive regulation?

- The objective of incentive regulation is to mimic the processes of competition. The alternative – rate of return regulation – has as its objective the implementation of the outcome in theoretical competitive markets that price equals cost.
- The (Laffont and Tirole) theory of incentive regulation is based on the regulator having incomplete information about the regulated entities cost type and cost reduction effort. While it is sometimes described as being about revealing the cost type, this isn't the objective. Its goal is eliciting the social welfare maximising amount of effort.
- A generalised version of incentive regulation is described in four elements:
  - Multiyear rate plans (MRP). Set prices, price caps, or revenue for a predetermined regulatory period.
  - Attrition-relief mechanisms (ARMs). Automatically adjust rates (or revenue) for changing business conditions such as inflation and external productivity (as in CPI-X)
  - Efficiency-sharing mechanisms (ESMs). Specify how a utility's efficiency improvement rewards should be distributed between the utility and its customers.
  - Performance-incentive mechanisms (PIMs). Reward specific outcome achievements.
- The "incentive regulation" mechanism is the MRP plus ARM – the ESMs (EBSS and CESS) are about sharing the rewards of the incentive.

What does efficient mean?

- Efficient in this context primarily refers to productive efficiency, generating the output at the least cost.
- The cost in this context is total cost not components of cost.
- The efficiency characteristics of PBR as applied to energy networks are determined by the mechanism for selecting the MRP prices and the ARMs (how X is selected).
- Two observations on the EBSS
  - The mechanism would be unnecessary if for the base year the AER used the average of the five preceding years rather than the fourth year (Biggar 2004)
  - The 30% sharing ratio is accidental and mythical. It is a consequence of a five year length of the regulatory control period, is artificially calculated by assuming a 6% real WACC and assumes that consumers get benefits to infinity.
- Are we interested in efficient capex – i.e, only spending as much capex as we need in one period – or in efficient investment, and operation and use of the network (the NEO/NGO)?.

Let’s consider a simple example

- Assume a network has a usage profile of only two levels, low for half the day and high for the other half of the day. Further assume that the network is fully utilised at the high period, and that over the next regulatory control period the peak will increase by 10%.
- A focus on efficient capex asks how cheaply can I expand capacity, a focus on efficient capital utilisation asks how can I shift 10% of the high period load to the low period load (e.g. by changing tariff structures and facilitating the connection of community batteries – the feed in tariff needs to be complex in that it is high in the low load period unless the consumer is exporting to a local community battery in which case it is low).
- Even if we accept the need for the capex, the current regime rewards the network for convincing the AER that the project will cost more than it actually does. There is no evidence that what is achieved is efficient.
- There is equally no reason why the consequence of variance from allowance should be symmetric.
- The CESS is a piece of “jiggery-pokery” designed to turn an already flawed incentive into one with a higher payout modelled on the arbitrary and mythical 30%.

Solution

- Just like the EBSS case part of the problem here lies in the AER's approach to determining revenue allowances. The AER should not be identifying a list of approved capital projects, it should choose some other method (possibly benchmarking based) for determining an *ex ante* capital expenditure for calculating the revenue allowance.
- The incentive for the network to outperform on capital efficiency should be specified as an outcome incentive – e.g. improvement of the ratio of total energy consumed to total capital employed (valued at current price of initial purchase to take away depreciation timing issues).
- The CESS was introduced as a means to reward the network for efficient capital expenditure to avoid the risk of the network artificially/inefficiently favouring capex over opex. However, we know from the theory of rate of return regulation that where the allowed rate of return is greater than the actual cost of capital (and you have a profit maximising management) then the business will overinvest (the AJ-effect).
- The correct solution is to set the allowed rate of return below the cost of capital, and design incentives that are asymmetrically biased to pay out (as ours already are).
- In competitive markets businesses are rewarded for what they do, not what they own. That is the discipline we need to introduce.

What is to be done?

- Abolish the CESS now – there is no need to increase the reward for a business that can convince the AER to give a greater allowance than the actual cost of the project.
- Revise the expenditure assessment guidelines to move to a parametrised capex allowance for setting allowed revenue, while maintaining the *ex ante* approval process so that businesses have clarity about what they will be allowed to add to the RAB *ex post.*
- Develop a framework for incentives for capital efficiency, while allowing details of the design of specific incentives to be subject to agreement with consumers in agreeing the revenue proposal.