20 September 2013

Mr. Chris Pattas
General Manager – Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Pattas

RE: Response to draft capex incentives guidelines and proposed changes to the EBSS

Ausgrid, Endeavour Energy and Essential Energy ('the NSW DNSPs') appreciate the opportunity to respond to the AER's draft guidelines for capital expenditure incentives schemes and proposed changes to the Efficiency Benefit Sharing Scheme (EBSS) guidelines. We refer the AER to the comments in the Energy Network Association (ENA) submission and support the positions put forward.

Our submission is focused on high level comments with the draft guidelines including:

- We support the direction of the new Capital Efficiency Sharing Scheme (CESS) including the symmetrical and proportionate design of the scheme.

- We seek clarity on the calculation mechanism in the CESS including whether the reward / penalty may inadvertently result in price shocks to our customers or cash flow shortfalls for a DNSP. We also request the AER to provide a worked example to show that the level of incentive for the EBSS is equal to the CESS, so that we are not penalised for efficient capex-opex substitutions during the period.

- We consider that the AER's CESS and EBSS should allow DNSPs to nominate uncontrollable cost categories as part of a regulatory proposal as this would avoid windfall gains or losses arising from factors outside the control of the DNSP. Further, we believe that excluding such items would limit customers' exposure to price shocks arising from the operation of the schemes.

- We seek clarity from the AER on statements which suggest it may exclude certain cost categories from the EBSS when a 'revealed costs' method is not used to set the allowance. We consider that only uncontrollable costs should be excluded from the operation of the EBSS, rather than excluding categories based on the AER's assessment approach. In this respect, we consider that the AER should give significant weight to the actual costs revealed by a DNSP in response to incentive schemes when making a decision under the criteria and factors in the Rules. Other measures may provide guidance as to the forecast rate of change over the forthcoming regulatory period. More detailed comments on this matter are provided in the NSW DNSPs' response to the AER's Forecast Expenditure Assessment draft guidelines.

- We support the AER's approach to transitional arrangements whereby the CESS would not apply to the NSW DNSPs for the 2014-15 regulatory year. We would like to consult further with the AER on the issue of the transitional arrangements for the EBSS as part of discussions on Stage 2 of the Framework and Approach paper.

Support draft incentive scheme for capex

We support the direction of the AER's draft guidelines for capex incentives. We consider that the proposed CESS has appropriate design features including a symmetric sharing ratio. In terms of the penalty or reward, we consider that a ratio of 30 per cent would provide a proportionate penalty or reward structure.

We also support the AER's process for undertaking ex-post reviews. In particular, we recognise that the AER has amended its initial position to ensure there is no duplicative penalty under the CESS if capex has already been excluded from the asset base.

Clarity on calculation mechanism in the CESS

Our initial modelling suggests that the outcome of the AER's model for the CESS would result in a sharing ratio of 30 per cent, in accordance with the principles of the scheme. However, our analysis shows that there are two potential issues with the application of the CESS.

- The penalty or reward occurs in the early years of investment, while the compensating loss or gain is received by customers in the longer term. We question whether the timing of the penalty or reward would lead to unintended cash flow issues or price shocks for our customers. In any case, we acknowledge that smoothing the penalty or reward over longer periods may lead to added complexity.

- The manner in which a penalty or reward is calculated is functionally different between the CESS (calculated using absolute cost variances) compared to the EBSS (calculated using marginal cost variances). We seek clarity from the AER that a DNSP would gain the same relative reward from a reduction in capex and opex. This is an important matter for the NSW DNSPs in pursuing efficiencies from capex-opex substitutions over the period.

  For example, with better information we may be able to implement an opex information technology (IT) solution such as cloud computing rather than purchasing new IT capital equipment and may be able to provide a lower cost solution when considering the lease or purchase of vehicles or property. Overall, this substitution may lead to a saving for our customers if the incentives are both transparent and neutral for capex and opex.

Uncontrollable costs for the CESS and EBSS

We are concerned that the proposed CESS and EBSS only exclude a limited range of cost categories such as pass through amounts and contingent projects from the operation of the schemes. We consider this may lead to 'windfall' rewards or penalties arising from factors outside the control of the DNSP.

For example, actuarial assessments of a liability will often lead to material credits or debits to opex. These adjustments do not relate to the underlying efficiency of the DNSP, but are based on actuarial assessments of future liabilities. If these were to be included in the scheme, a DNSP may receive a large reward or penalty, with customers similarly receiving a large penalty or reward, respectively, without the DNSP having any control of the cost.

Windfall rewards or penalties arising from the inclusion of uncontrollable opex costs would be exacerbated under the following conditions:

- The nature of the cost was asymmetric over the period (that is, a step change up or down) as the EBSS mechanism would calculate an enduring penalty or reward.

- The uncontrollable cost change arose in the 'base year'. There is a risk that the AER would use a revealed cost method to adjust the base year for non-recurrent costs, but at the same time mechanically apply the increment / decrement as part of the EBSS calculation. This would not lead to a fair sharing of losses or benefits under the scheme and could undermine the policy intent of such incentives.

We understand that it may not be practical to identify each type of 'uncontrollable' cost as part of the guidelines. As each DNSP will be different in terms of the types of costs that are beyond its control, we consider that the schemes should allow a DNSP to nominate 'uncontrollable' cost categories as part of a regulatory proposal. In nominating 'uncontrollable' cost categories, the DNSP should have to demonstrate that the nature of the cost is beyond its control.

Concept of excluding costs from the EBSS based on AER assessment approach for opex

The AER's explanatory statement suggests that it would exclude certain cost categories from the operation of the EBSS in situations when it has not used a 'revealed cost' method to set the base year:

> *"For the revised EBSS, we propose a broader criteria that excludes any categories of costs where the exclusion of these costs would better achieve the requirements of clauses 6.5.8 and 6A.6.5 of the NER. When applying this criteria, we propose to exclude any discrete category of costs where we do not expect we will use a revealed cost approach to forecasting these costs at the next regulatory determination."*[1]

We consider such statements highlight concerns we have raised with the AER in our submissions on the draft Forecast Expenditure Assessment guidelines.[2] The AER appears to be catering for a circumstance where forecast opex allowances are based on exogenous benchmarks, rather than using actual costs revealed by a DNSP in response to the existing EBSS. In some respect, the AER seems to recognise that benchmarks may be a 'stretch target' or contain potential forecast errors, and that including such costs in the EBSS may result in a duplicative penalty.

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[1] AER, Explanatory statement for Efficiency Benefit Sharing Scheme, August 2013, p28

[2] Please see the joint submission of NSW DNSPs on the AER draft Forecast Expenditure Assessment guidelines of 20 September 2013.

While we share these concerns with the AER, we note that the issue would not arise if the AER were to determine an opex allowance which gave significant weight to revealed costs when making its assessment under the Rules. Ultimately, the AER's decision should provide for an efficient and prudent forecast allowance, rather than a 'stretch factor' or relying on tools that may give rise to forecasting error. Providing primary weight to the revealed costs to set opex targets would be one way in which the significance of forecast errors could be contained, and the DNSP's allowance would represent a neutral target on which to apply the EBSS as intended.

The NSW DNSPs agree that in certain circumstances some cost categories should be excluded. However, this should be based on whether the nature of the cost is 'uncontrollable' rather than the type of assessment approach used by the AER. To do otherwise would unreasonably complicate the incentive regime, and may lead to perverse outcomes where a DNSP cannot gain a reward under the EBSS despite making inroads into achieving the AER's stretch targets over time.

Transitional issues for NSW DNSPs

We support the AER's position that the new CESS should not apply for actual capex in the first year of our next regulatory proposal. This is appropriate given that we have transitional arrangements in place for setting prices in the 2014-15 financial year.

We also seek confirmation from the AER on the application of the EBSS in the transitional year. We consider that the fundamental principle should be that a DNSP should not be rewarded (penalised) for achieving (not achieving) a target that was unknown at the time of incurring the expense.

If you would like to discuss our submission further, please contact Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249 3120 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely

Vince Graham
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Ausgrid, Endeavour Energy and Essential Energy