11 March 2022

Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator
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Canberra, ACT, 2601

Email: incentivereview@aer.gov.au

Dear Mr Roberts,

RE: SUBMISSION TO AER REVIEW OF EXPENDITURE INCENTIVE SCHEMES – DISCUSSION PAPER

Origin Energy (Origin) appreciates the opportunity to provide a submission to the Australian Energy Regulator (AER) in relation to the review of expenditure incentive schemes for network service providers (NSPs).

Incentive mechanisms are an important component of the regulatory framework as they encourage NSPs to pursue efficiency improvements. These efficiency improvements provide benefits to consumers in the form of lower prices and/or improved service quality. Origin supports the AER's review of its operating and capital expenditure incentive schemes to ensure these remain fit-for-purpose and are operating as intended.

We consider that the efficiency benefit sharing scheme (EBSS) has been operating largely as intended. Given the reliance on revealed costs, we consider there is reduced scope for gaming under the EBSS, although the prevalence of efficiency payments suggests there is scope for the AER to review its approach to opex forecast assessment and/or the setting of efficiency benchmarks. The capital expenditure sharing scheme (CESS) is relatively new and while there are some emerging trends, it is not clear whether these are attributable to scheme design or other factors. Given the nature of capex and the CESS, we consider there is an increased potential for NSPs to game the scheme. We encourage the AER to continue to monitor outcomes and suggest the AER retain the flexibility to adopt an individualised approach to the application of incentives where warranted.

We are generally supportive of the operation of the EBSS however we have some concerns regarding the frequency of efficiency payments to NSPs. Over time we would expect the efficiency payment to tend toward zero i.e. some regulatory periods the NSPs achieve efficiency targets whilst other they do not. Those networks on the efficiency frontier would presumably have limited scope to achieve efficiencies in excess of the AER's efficiency targets. Similarly, the application of catch-up productivity to those networks inside the efficiency frontier should act to limit the ability of these networks to achieve super-efficiency gains. The ability of NSPs, particularly those on the efficiency frontier, to consistently achieve EBSS payments tends to suggest that the incentive regime may not be operating as intended. We consider that either the AER's assessment of NSPs' opex forecasts is not sufficiently robust and is therefore allowing some "fat" in the forecasts or efficiency targets (including catch-up) are not challenging enough. To the extent this is the case, there will be a bias toward outperformance for the NSPs and, as a result, future EBSS payments.

While we acknowledge the improvement in opex efficiency generated through the scheme, we consider there is merit in reviewing the process and outcomes to ensure that optimal efficiencies are achieved. We encourage further refinement of the economic benchmarking process and the adoption of challenging yet achievable efficiency targets.

Consistent with AER observations we have some concerns with the patterns of underspending and aggregate over-forecasting of capital expenditure.

We note the trend of capex underspend in the early years of the regulatory period and over-spend in the final years. While NSPs are free to adjust the timing of within-period capex, it is not clear whether the incentive scheme is contributing to the skewing of expenditure toward the end of the regulatory period. This may have implications for service delivery during the regulatory period where proposed projects are ultimately not delivered according to the original timetable. We support the AER's proposal to further review the pattern of expenditure and determine whether the design of the CESS is contributing to the uneven expenditure. Where the pattern of expenditure is deemed inefficient, there may be scope to alter the power of incentives or adopt a more flexible approach to the application of the CESS.

In terms of aggregate capex, it is important the AER confirm that the capex underspends during the regulatory period represent genuine efficiencies rather than over-forecasting or the deferral of capex projects that are then reintroduced in the subsequent regulatory period. We find it somewhat counterintuitive that NSPs can underspend against the AER allowance in the current regulatory period and claim these savings as part of the capex incentive scheme; yet request increased expenditure in the next regulatory period.

We agree with the AER that a greater understanding of underspends during a regulatory period is required. In the first instance it is necessary to determine if the underspending reflects over-forecasting and thus requires refinement of the expenditure forecasting assessment process. We acknowledge the recent developments in the AER's expenditure assessment methodology and encourage the AER to continue this process. In addition, we are supportive of increased stakeholder engagement in the development of NSP forecasts.

Having established the robustness of the forecasting process, the onus should be on NSPs to clearly explain any underspend during the regulatory period. Where NSPs indicate that an underspend reflects efficiency improvements, we would expect the NSP to be able to verify how such efficiencies were achieved. This information may help to inform the assessment of capex forecasts in future regulatory periods.

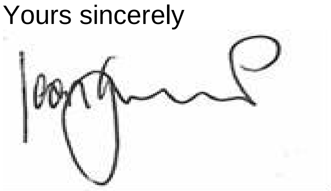
As highlighted by the AER, identification of deferred projects is a critical issue. Where a project is deferred there is potential for the project to be re-scoped by an NSP and incorporated in future expenditure forecasts thus undermining any consumer benefit intended through the CESS. Accordingly, the AER and stakeholders require a thorough understanding of expenditure proposed in the current regulatory period and the intended outcomes/deliverables from this expenditure. It is important to determine whether proposed capex for the next regulatory period could (or should) have been incurred in the current regulatory period and, if so, whether there was an impediment to doing so e.g. resourcing constraints. Decisions to defer expenditure may reflect good business practice in some instances. However, to ensure the effective operation of the CESS, it is critical that deferred projects are identified, and appropriate adjustments made to the incentive scheme or future forecasts.

Ex-post expenditure reviews would assist in understanding the reason for capex underspends and act as a disincentive to inefficient expenditure. However, the nature of distribution network expenditure (multiple, often inter-meshed projects) complicates any ex-post review process. Nevertheless, it may be feasible for the AER to conduct an ex-post review of select larger projects to verify that expenditure processes and systems are appropriate and being effectively applied. Any decision to adopt an ex-post review must incorporate an assessment of the associated costs and benefits. Importantly, the threat of ex-post review may assist in promoting efficient expenditure practices by NSPs.

We acknowledge that the CESS has only been operational for a short period and observations from a single regulatory period are not necessarily indicative of emerging trends. At the same time, the nature of distribution network capex, ongoing information asymmetry and difficulty in assessing expenditure means that NSPs are able to game the CESS. We encourage the AER to continue to closely interrogate capex forecasts and monitor expenditure outcomes to determine if systematic trends are emerging. We agree that the AER should retain the flexibility to apply differing incentives to individual networks depending on an assessment of an NSP's expenditure patterns and response to incentives.

If you have any questions regarding this submission, please contact [redacted] in the first instance at [redacted]

Yours sincerely



Sean Greenup
Group Manager Regulatory Policy
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