9 September 2022

Mr Sebastian Roberts
Network Expenditure
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Sent via email: incentivesreview@aer.gov.au

Dear Mr Roberts

Submission on options for the Capital Expenditure Sharing Scheme

SA Power Networks welcomes the opportunity to comment on the AER Position Paper on its 'Review of incentive schemes: options for the Capital Expenditure Sharing Scheme (CESS)'. This submission provides additional perspectives to those set out in Energy Networks Australia's submission which we support.

Incentive regulation has driven material benefits for consumers across the National Electricity Market (circa $13.4 billion),[1] lowering costs of energy supply and improving service performance. We strongly support incentives for networks to take efficient risks to innovate and improve the efficiency in services. Incentives are particularly relevant now while networks are altering practices and investments to support customer services moving to more distributed energy and electrification.

We are concerned that incentives may be weakened when the issues that changes seek to address have not been clearly articulated, and where they have been, appear to be focused on isolated situations of extreme underspends.

Consequently, our views on the Positions Paper are that:

- we are pleased that the AER has narrowed this review to the CESS and finding that the CESS should be retained having driven efficiencies for customers;
- we support improving information transparency on drivers of underspends, particularly through better and more customised engagement by networks with consumers;
- we see no evidence of a case to introduce a variable incentive rate to address 'regulatory proposals of concern', as the AER has broad existing powers to action on potential material capital expenditure (capex) deferrals and a significant and only recently expanded assessment tool-kit to determine an efficient capex forecast;
- any variable incentive rate option should be assessed against objective criteria to balance the need for strong incentives, to reward genuine efficiency, and provide predictability and simplicity;
- of the options the Positions Paper proposed, our view is that the 'Bright line #2 (tiered incentive rate)' presents the least risk to the promotion of efficient customer outcomes, providing that a suitable threshold is applied to set the tier over which incentives are reduced. We wish to work with the AER on developing a suitable approach, should it demonstrate that change is in fact

1 HoustonKemp, *Consumer benefits resulting from the AER's incentive schemes – A report for Energy Networks Australia*, 8 March 2022.

needed. Our preliminary view is that the proposed 10 percent threshold is set too low, and a more appropriate threshold would be in the order of 15 percent.

If you have any queries or require further information in relation to our submission, please contact [redacted]

Yours sincerely

[redacted]

Patrick Makinson
Executive General Manager Governance and Regulation

1. The case for a variable incentive rate has not been made

Assessing the reasonableness of capex forecasts and CESS payments to networks

The CESS is integral to how the incentive regulation framework has materially benefitted consumers. We welcome the AER's position that the CESS should remain as there is strong evidence that the CESS has worked well in providing incentives for networks to incur efficient capital expenditure, and that it should retain its current 30 percent sharing ratio for efficiencies that networks derive.

However, we are concerned with the suggestion that changing the CESS, by introducing a variable incentive rate, is needed to address 'regulatory proposals of concern'. We see no case for change noting:

- there is insufficient evidence from one regulatory period of actuals to demonstrate any systemic problem of over-forecasting of capital expenditures;
- available data actually demonstrates that capex has lowered over time and that the difference between regulatory allowances and actual capex spent has already been narrowing significantly;
- checks and balances already exist to counter the risk of networks being rewarded for deferrals:
    - the AER has broad information gathering powers and discretion to assess the drivers of CESS payments and has actively used this discretion to approve CESS payments for some networks while materially reducing CESS payments for other networks;[2]
    - as the CESS Guideline requires deferrals to be accounted for, several networks have themselves adjusted their CESS payments for deferrals into their forecast periods;
- the AER has a significant tool-kit of assessment methods to assess the reasonableness of a network's proposed capex forecast and address concerns it may have with that proposal:
    - AER scrutiny of proposals has increased significantly through the last round of regulatory reviews, which also generally relied more on historic / revealed capex; and
    - multiple guidelines now underpin the AER's more detailed assessments, many recently introduced with results still to play out. This is especially the case with the Better Resets Handbook which will profoundly guide subsequent network proposals, setting expectations for: more involvement by consumers in forming a proposal, and for a proposal's reasonableness to be judged in the context of revealed capex.[3]

Further, we observe that very few parties other than networks have submitted to this review[4], raising further doubt on the existence of a problem to be solved, and the suggested significant concerns that stakeholders have with the CESS. This also hampers our ability to engage on whether there are potential solutions that do not need to weaken current incentives which have worked for consumers in practice.

Improving transparency for stakeholders and the AER

As per our submission to the earlier Discussion Paper, it appears that a key issue at the core of this review is in fact one of information asymmetry and transparency, and if so, this should be directly and proportionality addressed. To this end, in our view:

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2 Examples are detailed in our submission to the earlier Discussion paper. SAPN, *Submission to AER review of incentive schemes for networks*, 10 March 2022, p.6.

3 That is, networks must identify and justify the benefits for customers in any proposed divergences between what they actually spend and what they forecast requiring.

4 This AER review seeks to respond to apparent significant concerns by consumer groups in relation to incentives.

- for the AER, it is hard to offer improvements without knowing the problem. For our 2020-25 Proposal, we counted seven rounds of information provision on underspends.[5] With further guidance, we could work with the AER on improvements, balancing transparency while avoiding descending into line-by-line micro-management; and
- for stakeholders, networks can improve how they engage to explain drivers of material divergences of actual spends from allowances. The Better Resets Handbook set a clear expectation for this. We see value in networks customising their engagement, rather than adding more information reporting templates that are unlikely to be used outside the AER. This topic is already a feature of SA Power Networks ongoing and Regulatory Proposal engagement, and is something we will improve and customise further together with our Customer Advisory Board.

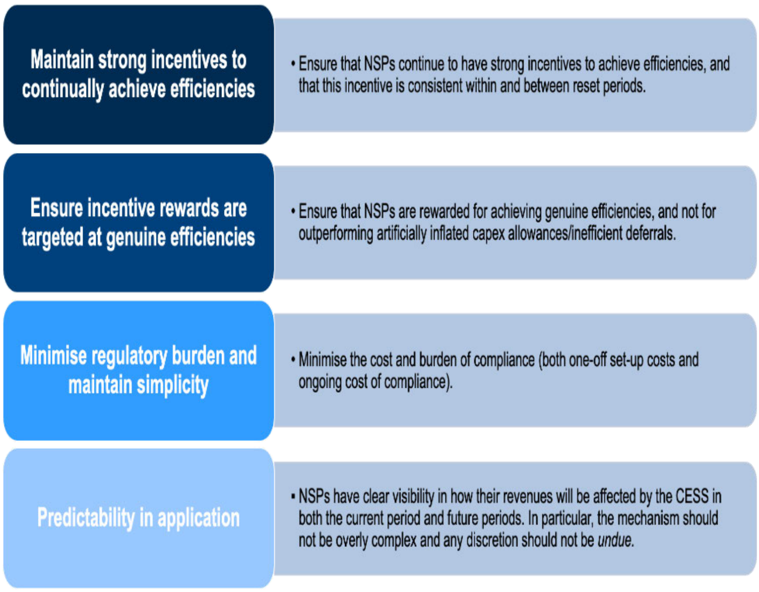
2. Considerations in evaluating potentially variable incentive rates

We see no case to change the CESS. Further, a variable incentive rate risks weakening and confusing signals that currently drive managerial effort to take risks, innovate and drive efficiency. This is also problematic when networks are needing to alter planning / operating practices, and capital investments in response to consumer-led changes toward distributed energy and greater electrification.

Assessment principles

To minimise the risk posed by potentially variable incentive rates, these options should be assessed against clear criteria. We encourage the AER to consider the criteria discussed in Energy Networks Australia's submission, replicated below in Figure 1.

Figure 1: criteria for assessing incentive scheme changes



Having regard to these criteria, our experience with the current CESS is that:

- incentives have been material enough to drive organisation-wide effort and efficient risk-taking with innovation;
- checks and balances have been applied by the AER to assess that our claimed CESS payment did not arise from material deferrals;
- application and communication has been simple across all levels of our business, from the CEO down to staff in depots – a key requisite in driving an efficiency culture; and
- we have had predictability over time - important as strategies for managing, evolving and improving our service efficiency require long term planning. Indeed some programmes we have run to improve efficiency of our field work optimisation and execution are long term in nature and cross over regulatory periods.

[5] This includes information provided across all stages of the process, from our Draft Plan stage, through the Regulatory Information Notices, Regulatory Proposal and Revised Proposal and multiple rounds of AER information requests. Examples were provided in our submission to the earlier Discussion Paper. SAPN, *Submission to AER review of incentive schemes for networks*, 10 March 2022, p.6.

Options consideration

We refer to the more fulsome revaluation of the AER's options, contained in the Energy Networks Australia submission. Further, Table 1 outlines our additional observations. Our overall views are that:

- while none of the options are preferred, Option 3 – 'bright line test #2 (tiered incentive rate)' poses the least risk to the incentive framework, balancing an apparent AER desire to prevent large underspends, while being simple and sending predictable signals to networks to drive continual efficiency attainment;
- a suitable rationale is needed for setting the threshold in Option 3 over which the incentive rate reduces from 30 percent to 20 percent, as the AER has not set out a rationale for arriving at a 10 percent threshold. The threshold should not be so low that it discourages efficiencies;
- a 10 percent threshold is too low, particularly noting the majority of electricity distributors (9 out of 13) achieved underspends above 10 percent going into the last round of reviews; and
- an appropriate threshold is likely be in the order of 15 percent, preventing cases which appear to have posed the most concern to the AER and stakeholders such as the Consumer Challenge Panel – these appear centred on isolated situations where some networks underspent by 20 percent and above. We question if this review would be occurring were it not for those isolated situations.

Table 1: Assessment of AER variable incentive rate options

AER option	Assessment
1. Principles-based approach	▪ Introduces undue subjectivity on the justification and information considered as 'good quality' by the AER, and on what would be seen as 'good engagement' by networks. Lacks predictability on how managerial efforts and investments in deriving efficiency may be evaluated from one regulatory period to the next. ▪ Increases administrative burden by needing to descend into line-by-line AER auditing of programs, projects and initiatives, including on how these are combined over time.
2. Bright line test #1 (10/10 threshold)	▪ Significantly weakens and confuses incentives for ongoing efficiency attainment, by signaling that if significant efficiencies have been attained in one regulatory period, in the next period there should be less reward and drive to attain further efficiency. ▪ Concerningly suggests an expenditure forecast proposal would be viewed skeptically if it is 10 percent higher than historic spend, regardless of how it aligns its to the capex objectives, factors and criteria in the Rules. This punishes networks that: o applied the most material effort to attain efficiencies in an earlier period; o are more at the forefront of responding to changes in the sector to more distributed generation and electrification, as is the case for SA Power Networks; and o may have greater percentages of network assets installed in a condensed time period relative to peers, and may not have reached a 'steady state' of asset replacement. ▪ Highly complex to work into long-term planning and strategic decision making, and difficult to communicate across all tiers of a network business to send clear signals to guide managerial effort in efficiency attainment.
3. Bright line test #2 (tiered incentive)	▪ Simple to understand and communicate within a network business, and is predictable in its application over time (i.e the parameters are set and known), maintaining signals for ongoing effort to attain efficiency until the tier threshold is hit. ▪ Mitigates against large capex underspends in a simple and pre-determined way.
4. Hybrid: (bright line with reply)	▪ This option would just add the same problems identified above with option 1,