10 March 2022

Mr Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Sent via email: incentivereview@aer.gov.au

Dear Mr Roberts

Submission to AER review of incentive schemes for networks

SA Power Networks welcomes the opportunity to respond to the AER Discussion Paper on this review (the Discussion Paper). Incentive regulation has been central to how the broader regulatory framework has been driving good consumer outcomes in the National Electricity Market. Since the application of AER incentive schemes, consumers have been materially better off with:

- benefits in the order of $13.4 billion[1] across the NEM; and
- continued improvements in service performance by way of reliability.

We strongly support incentive regulation. Well-designed incentives have real impact on network business priorities. As a business consistently topping AER benchmarks, incentives have been core to aligning our organisation and staff on key focus areas to drive continual innovation, efficiency and improvements in service value over time.

We see no case to change existing incentives. Our submission addresses the Discussion Paper's potential concerns regarding the Capital Expenditure Sharing Scheme (CESS) with our key views being that:

- it is too early to assess trends resulting from the CESS, as it has only applied for one period;
- we see no evidence of the CESS having driven undesired behaviour; and
- any risk of the CESS driving poor outcomes is being effectively addressed via the AER's existing broad discretion, assessment methods, and information gathering powers to decide an efficient capital expenditure (capex) forecast and adjust CESS payments if capex was materially deferred.

The most significant issue appears to be information asymmetry for stakeholders in understanding:

1. how customers benefit from networks responding to incentive regulation;
2. the scope of the AER's existing role; and
3. the drivers that may lead networks to spend less than AER forecasts.

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

Concerns should be directly addressed, and to address information asymmetry our view is that:

- there is scope for improved communication on how the AER conducts assessments and how consumers benefit from incentives – to assist, we engaged, via Energy Networks Australia, consultants HoustonKemp to independently estimate consumer benefits, and we encourage the AER to reference this work in this review and in its regular reporting; and
- there is an important role for networks, in improving the effectiveness of their consumer engagement, on factors that may drive them to achieve spend levels less than AER forecasts – to this end, we support the enabling role that will be played by the strong consumer engagement expectations set in the AER Better Resets Handbook.

Further, we also encourage the AER to consider increasing the ability of the Customer Service Incentive Scheme to drive material change in consumer service experience, and more broadly, how incentive schemes can in future better reflect the service outcomes that networks derive for consumers and communities.

We would be pleased to engage further with the AER as it conducts this review and welcome the transparent and open discussions that AER staff have held with networks thus far.

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

Yours sincerely

Patrick Makinson
Executive General Manager Governance and Regulation

Review of incentive schemes for networks

Submission to AER Discussion Paper

SA Power Networks

Empowering South Australia

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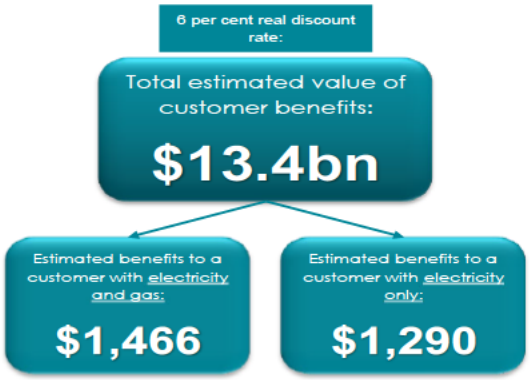
1. Executive summary

SA Power Networks believes strongly that incentive regulation drives efficiency in network service provision to consumers and improved consumer service outcomes over time. Incentives drive our organisation, practices and staff to continuously look for innovation and efficiency, resulting in SA Power Networks consistently topping many AER benchmarks (including total factor productivity).

Incentive regulation has driven material benefits for consumers across the National Electricity Market (NEM) lowering their costs of energy supply and improving the service performance they receive.

Therefore, potential or claimed concerns with the incentive framework must be carefully considered and evidenced. We see no case for change, and caution against prematurely undermining capital expenditure (capex) incentives, when these have only applied in one regulatory period providing insufficient time to observe any concerning behaviour trend, nor the full effect of all reforms made to the AER's ever-increasing forecast assessment tool-kit.

Figure 1: Total consumer benefits (Present Value, 30 June 2020): EBSS, CESS, DNSP STPIS (reliability)



Source: HoustonKemp, Consumer benefits report, 2022

The most significant issue to address appears to be information asymmetry for stakeholders, in relation to:

1. how and how much consumers benefit from incentives;
2. current AER discretion and powers to assess forecasts and incentive payments claimed; and
3. the drivers of networks' claimed efficiencies over time.

Our submission focusses on the following matters:

- consumers have materially benefited from incentives and the existing incentive schemes have worked as intended;
- the need for strong incentives remains relevant, to encourage further and potentially significant network service innovation, in traditional and new aspects of service;
- the case for changing the Capital Expenditure Sharing Scheme (CESS) has not been made, with no clear evidence of a problem. Focusing on the main concerns noted by the AER, we submit that:
    - there is no observable trend that the CESS is driving incorrect behaviour;
    - the AER has effective discretion and information gathering powers to adjust CESS payments if there have been material capex deferrals. However, better communication and engagement to consumers is needed by the AER and networks to address information asymmetry - noting the difficulty of stakeholders understanding how the AER conducts its assessments, and the drivers that lead networks to spending less than AER forecasts;
    - AER assessment tools are already effective in mitigating forecasting risk, and we observe an increasing link between revealed capex and forecast setting;
    - there is no evidence nor practical feasibility for perverse behaviour resulting from current differences between the network incentive sharing ratios between capex and opex;
    - applying the CESS on a bespoke and tiered basis varying by distributor, presents real risks of driving perverse behaviour, and punishing networks that have driven their organisations the hardest to achieve efficiencies; and
    - we urge progress in considering the role and design of service incentives for export services, and the potential to increase the relevance of the Customer Service Incentive Scheme.

2. Incentive regulation has been delivering for consumers

Incentive regulation has been at the core of the network regulatory framework administered by the AER and by Australian jurisdictional regulators prior to the AER. The incentives in this framework were designed by the AER and networks responded to these directions to find efficiency and improve service over time.

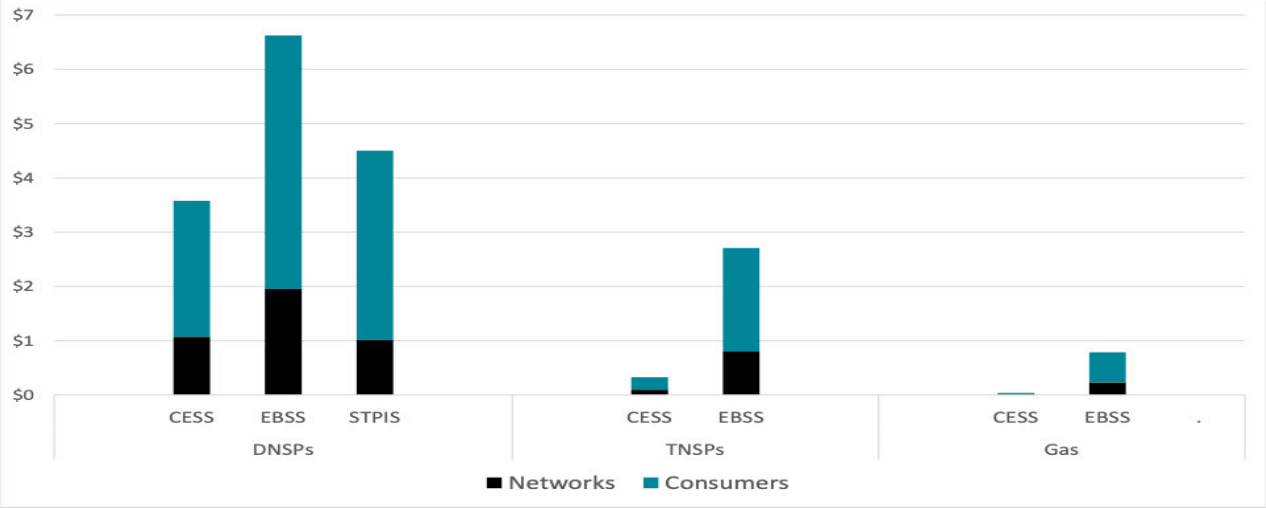
In our view, the Discussion Paper has presented an overly negative view on incentive regulation by focusing on the size of incentive payments to networks, rather than more fully explaining to stakeholders, the benefits that consumers have and will continue to receive from networks responding to AER incentives.

As this is a complex aspect of regulation, networks via Energy Networks Australia (ENA) commissioned a report by consultants HoustonKemp, to help address information asymmetry for stakeholders in understanding the consumer benefits from AER incentives.[1] We encourage the AER to consider how such information might be best disseminated in this review and in its future regular reporting.

In more fully explaining incentive regulation, we believe it is important to indicate that:

- the fact that networks have received material payments in reward for finding ways of spending less than regulatory allowances, means that the framework has worked as intended. That is, networks have responded to the AER's directions, and there have been material benefits for consumers – payments to networks are only made if consumers benefit;
- consumers have benefited from lower network operating costs, lower than expected network investments and improved reliability, locking-in substantial gains for consumers today and into the future in terms of lower prices and improved network reliability;[2]
- HoustonKemp's report estimates that the total benefits attributable to AER incentive schemes is $18.6 billion (PV 2020), with consumers retaining $13.4 billion (PV, 2020) and networks receiving $5.2 billion (PV 2020). This $13.4 billion represents the net gain to consumers after any incentive payments to networks and translates into gains for the average consumer with both an electricity and gas service of $1,466, and $1,290 for the average consumer with an electricity-only service; and
- benefits to consumers have materially outweighed the payments to networks.

Figure 2: Total benefits (PV, 30 June 2020, $billion) of EBSS, CESS & distribution STPIS (reliability)



Source: HoustonKemp, Consumer benefits report, 2022

[1] All details on the approach to calculating these consumer benefits are set out in the HoustonKemp report. HoustonKemp, *Consumer benefits resulting from the AER's incentive schemes – A report for ENA*, 8 March 2022. Figures displayed in this submission are in Present Value (PV) terms, and use a 6 percent discount rate.

[2] As outlined in the Discussion Paper, consumers have experienced fewer and shorter outages over time, despite reductions in network revenues and actual expenditure, suggesting that networks have been able to pursue efficient expenditure while maintaining service reliability. AER, *Discussion Paper – Review of incentive schemes for networks*, December 2021, pp.25-26.

3. Incentives remain relevant for innovation in service delivery

In questioning the size of incentive payments that networks should access in reward for attaining efficiency for consumers, the Discussion Paper created a perception that we have reached an equilibrium point in the need for network service innovation – that is, that strong efficiency incentives are now less relevant.

In our view, having strong incentives to attain efficiency in network service delivery through innovation not only remains relevant but is increasing in relevance, as networks need to adapt to various consumer-led and technology enabled changes in services. This is noting that:

- even in traditional areas of expenditure such as replacement and augmentation of assets used to provide energy consumption services, there remains great potential for innovation, including for example, in how networks use technology to:
    - identify and assess service risk (in a monetised way) posed by asset condition and use this information to optimise, prioritise and automate business and in-field decision making;
    - manage employee safety, finding ways of removing people from dangerous work; and
    - minimise bushfire safety and outage inconvenience impacts;
- customers and third parties are wanting networks to evolve in how they interact with them, via more digital and data interfaces to, for example, better communicate outage information and attendance times, and to access data to optimise their consumption / export decisions;
- networks also need to innovate in delivering export service levels aligning to customer expectations, now an explicit requirement of network planning. For example, networks in coming years must find:
    - methods to gain visibility of their low voltage networks to understand hosting capacity;
    - optimal combinations of network and non-network options to maximise hosting capacity;
    - new approaches to maximise the value of customers' Distributed Energy Resources (DER), such as interacting with customers' devices in real-time, to manage congestion flexibly / efficiently and to offer flexible services targeted to customer desires; and
- new capabilities are needed to action directions that might be sent by the Australian Energy Market Operator, jurisdictional governments and technical regulators, to manage broader system security.

Further, at the time of this review, we are still to see progress, such as achieved by OFGEM in the United Kingdom, in considering incentives that focus on the service outputs / outcomes that customers want networks to deliver and that networks have been delivering.[3] It is important that this occurs as:

- customers are and will further receive greater value via the use of network services, particularly as customers use networks to maximise the value of their DER investments, and look to transport electrification to lower their combined costs of energy and fuel;
- the AER's approaches to benchmarking, opex growth forecasting, and Distribution Determinations more broadly have insufficiently recognised the outputs that networks are producing by way of service value (to consider against required cost inputs by networks); and
- while we welcome the introduction of the Customer Service Incentive Scheme (CSIS) for the more limited application to customer experience / interactions with networks, this scheme is currently very low-powered and is unlikely to drive material change in operations.[4]

[3] An example in OFGEM's approaches is that, where firms demonstrate that they are adding value to customers beyond minimum requirements (the "Customer Value Proposition") they can be provided rewards linked to the value they have added for Customers. OFGEM, *RIIO_ED2 Sector Methodology Decision: Annex 2 Keeping bills low for consumers*, 17 December 2020, p.95.

[4] This is noting that the AER has so far chosen to not apply the CSIS in addition to the current STPIS revenue cap, but rather, in replacement of the current telephone answering component within the STPIS.

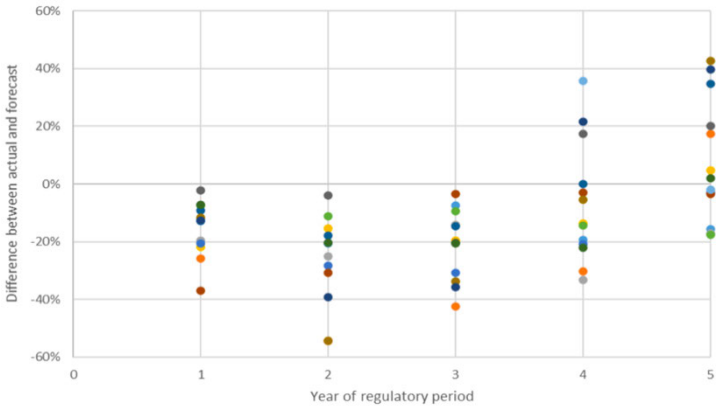
4. Existing capital expenditure incentives do not warrant change

In our view, incentive arrangements applying to capex are working as intended, and there is no clear evidence of a problem warranting change. Below we address key potential concerns raised by the Discussion Paper.

4.1 Do expenditure trends point to the CESS driving perverse behaviour?

The Discussion Paper queried why distributors underspent AER forecasts more in earlier years, and underspent less in later years, of their regulatory periods (seen in Figure 3), and if this points to a concerning trend warranting intervention.

Figure 3: Actual vs forecast capex (1st CESS period) – distributors



Source: AER, Discussion Paper, 2021

In our view, this observation does not indicate failure in the CESS, and performance must be assessed over a longer time period, noting:

- the CESS has only applied for one regulatory period, and it is too soon to observe any trend;
- the fact some distributors in this first period spent less in earlier years is inconsequential – the CESS is designed to be time-invariant, and distributors do not gain more depending on their spend profile;
- the timing of capex spends can be influenced by many factors external to incentives, for example:
    - once an AER Final Decision and the specific initiatives it considered appropriate[5] is known, networks may need time to assess these outcomes, develop work plans, set budgets, purchase materials, allocate staff and action work. Timeframes can vary between networks due to executive and board processes, and by the nature of the AER Decision;
    - there may be emergency or unforeseen events or market developments, which might re-direct a network's efforts and staff and delay action on capital programs; and
- there were examples of these factors having influenced spend profiles in the first CESS period. This was true for SA Power Networks as set out in Box 1.[6] We also understand this was the case for several other networks – a key example appearing to be the leasing of New South Wales electricity assets, contributing to capital scarcity early in their regulatory period.

Box 1: Factors affecting timing of capex for SAPN

Factors influencing SAPN spend profile in 2015-20

1. AER transitional rules / decision uncertainty – due to the Transitional NER applying, there was uncertainty going into the 2016 calendar year budget preparations in mid-2015 as we only had access to the AER 'Preliminary Decision' and budgets had to be set conservatively with the Final Decision not published until 29 October 2015, 4 months after the regulatory year start and after the 2016 budget had been approved by SAPN's Board.
2. Emergency events - severe weather with 9 Major Event Days in SA in 2016 (year 2), caused widespread customer outages, and led to re-prioritised resources and delaying capital programs.
3. New information – more efficient asset management approaches were initially implemented on a trial basis before broader roll-out across SAPN, driving a gradual repex ramp-up.
4. Market developments – required system changes to implement mandatory Power of Choice Metering Contestability reforms prior to 1 December 2017, delayed implementation of customer relationship management and billing system projects.

[5] While we note that the AER does not approve specific projects but rather an overall set of allowances, in practice, networks would feel constrained to not undertake activities that the AER explicitly reviewed and deemed inefficient.

[6] These were explained to the AER as part of SA Power Networks' last Distribution Determination: AER information requests; SAPN Regulatory Proposal 2020-25 Attachment 9 CESS; SAPN Revised Regulatory Proposal Attachment 5 capex.

4.2 Does the regulatory framework deal effectively with deferrals?

The Discussion Paper suggested that some stakeholders are concerned with information asymmetry regarding the drivers of CESS payments that the AER approves for networks, and therefore on how the CESS operates – that is, does it reward genuine efficiency or deferrals from one period to the next.

Any concerns should be directly addressed. In this case, we see no underlying lack of scope in AER discretion to fully assess the drivers of CESS payments. Rather, there does appear to be an information asymmetry issue, that should be addressed by better engagement and communication from networks and the AER.

In our experience, it is not necessarily apparent to stakeholders that the AER already has sufficient discretion to assess the drivers of CESS payments, and to adjust the payments if it considers that material expenditure has been deferred from one regulatory period to the next. This is noting that:

- AER incentive scheme guidelines are complex and not pitched at stakeholders – there is value in having more fact sheets or other information to improve understanding of how schemes operate;
- it may not be apparent that the CESS Guideline has since inception contained clauses providing explicit AER discretion to adjust payments if it considers deferrals may have materially affected the capex for a forecast regulatory period;[7]
- networks already provide the AER with multiple rounds of information (as outlined in Box 2) to explain the drivers of their CESS payments, including in response to AER Information Requests which are not publicly visible;
- the AER has to date used its discretion to approve CESS payments for some networks while materially reducing CESS payments for other networks;[8] and
- as the CESS Guideline expects material deferrals to be accounted for, several networks have themselves adjusted their CESS payments for material deferrals into their forecast periods.[9]

Box 2: AER information on CESS payment drivers

Information provided by SAPN to AER on CESS payments: 2020-25 Regulatory Determination

Draft Plan:

- Size and drivers of capex allowance underspend

Annual Regulatory Information Notice (RIN):

- Explanations of material differences between allowances and actual spends by capex category.

Reset RIN:

- CESS workbook answers on capex deferred into the regulatory period from the earlier period.

Regulatory Proposal:

- Explanation of drivers of capex allowance underspends in: (1) capex chapter; (2) CESS chapter

Revised Regulatory Proposal:

- CESS chapter explained capex underspend drivers

Responses to AER information requests

- Answers and spreadsheets replying to 3 information requests and 6 questions on drivers of underspends and any deferrals into the regulatory period.

Other

- Responses to questions from AER staff and AER engineering consultants in workshops on drivers of underspends and any deferrals.

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7 These clauses in section 2.5 of the CESS Guideline were inserted to provide the AER explicit power to address deferrals, having observed the experiences of regulators such as the Essential Services Commission of Victoria. AER, *Better Regulation – Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013; and, AER, *Better Regulation Explanatory Statement – Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p.31

8 To date, the AER has made an adjustment to CESS payments to account for deferred capex in the following decisions:

- Jemena: $9 million in deferred capex (2021-26 Final Decision); and
- Powercor: $51 million in deferred capex (2021-26 Final Decision).

9 This includes:

- Ergon Energy: adjustment for $63 million in deferred capex, as identified in their initial Regulatory Proposal;
- Ausnet distribution: adjustment for $14 million in deferred capex, as identified in their Revised Regulatory Proposal;
- Transgrid: adjustment for $40 million in deferred capex, as identified in their initial Regulatory Proposal; and
- Powerlink: adjustment for $18 million in deferred capex, as identified in their initial Regulatory Proposal.

However, networks can continue to improve engagement, and there may be diversity in the detail and clarity of how they have explained to their consumers, the factors that may have / are driving their actual spends to diverge from AER approved forecasts. Therefore, we support the suggestion that:

- improved consumer engagement by networks can help address the information asymmetry concern for stakeholders – and, our business intends to factor this topic into our ongoing (business as usual) as well as Regulatory Proposal focused engagement with our consumers and stakeholders; and
- the detailed expectations the AER provided in its Better Resets Handbook on how networks should conduct consumer engagement, will help drive improvements in engagement across all networks the AER regulates.[10] Enhanced engagement is likely to be a better solution here than simply adding another reporting template onto all the regulatory information we already provide.

More broadly, SA Power Networks has been a strong supporter of the Better Resets Handbook. We believe that effective and genuine engagement by networks with consumers (and AER involvement in pre-lodgement), will not only ensure that proposals reflect consumer expectations, but hopefully also reduce the volume of documentation required for a Regulatory Proposal and reduce stakeholder burden in participating in the regulatory process.

4.3 Is bespoke or tiered application of the CESS warranted?

The Discussion Paper raises the possibility of applying the CESS on a bespoke or tiered basis if the AER is concerned with its capex forecast or a network's past behaviour – for example, varying the benefit for each network and at each Distribution Determination. In our view, bespoke application, such as via a tiered (by distributor) or variable incentive would present significant risks, including:

- it might drive networks to moderate efforts to achieve efficiencies. For example, if the threshold for reducing the incentive benefit to be retained by a network was set at say a capex forecast underspend of larger than 10 percent, this would incentivise a network to target an underspend at just below that threshold, say 9 percent, to avoid the reduction in the incentive;
- if a network expected to overspend in capex in a future period, it might deliberately trigger the variable incentive so that the future overspend penalty is lower;
- networks that have driven the most benefits for consumers would be punished:
    - SA Power Networks and other networks that lead AER benchmarking on most metrics, and which have derived the most capex efficiencies over time for consumers, have done so by taking significant risks and investing in innovation; and
    - it is more important for networks such as ours who have derived the most efficiencies, to continue to access strong capex incentives, as it is genuinely harder for networks who have found the most efficiencies to date, to push for further efficiencies; and
- bespoke application introduces investment uncertainty for networks. Network investments require long-term planning in taking strategies into actions in the field, are long-lived in nature, and some investment programs cross over multiple regulatory control periods.[11] For networks to make efficient long-term decisions within this context, stability in the incentive regime is needed so that networks know what it is that incentives are driving networks to achieve.

[10] The Handbook outlines, in assessing the reasonableness of networks' proposed capex forecast, the AER will have direct regard to not only whether the network has well-justified reasons for material incentive payments but also if these reasons were explained to customer groups. AER, *Better Resets Handbook: Towards consumer centric network proposals*, December 2021, p.20.

[11] This is the case for example with SA Power Networks' 'Assets and Work' program, which has been conceived as a three regulatory period program of various investments to drive greater efficiency in work planning and delivery, drawing on processes and systems using ICT.

4.4 Is there material forecast risk such that CESS payments are inappropriate?

The AER queried if there is a risk that its own capex forecasts may be materially incorrect leading to inflated CESS payments to networks for spending less than these forecasts. Our perspective is that:

- any ex-ante expenditure forecast carries some risk that it could under or over reflect expectations – this has been a feature of the NEM network regulatory framework since inception;
- the AER capex forecast and CESS do not exist in isolation, such that the CESS is compensating for the regulator never really being able to know what the efficient forecast should be:
    - it is precisely the role of AER Determinations to set efficient forecasts based on reasonable judgement of information at the time, drawing on the vast assessment methods and information gathering powers the National Electricity Rules allow the AER to apply; and
    - the more accurate role of the CESS is to drive networks to take risks, push their organisations and staff to find innovation driving further efficiency, with that 'more efficient' level of spend benefiting consumers through a lower than otherwise Regulatory Asset Base (RAB).
- the AER now has the largest budgetary and staffing resources (including technical advisory experts) it has had since commencing network regulation, allowing unprecedented levels of forensic and detailed assessment of Regulatory Proposals and forecasting assumptions; and
- contrary to the Discussion Paper, we have observed an increasing link forming between this 'more efficient' capex level (revealed by the CESS) and the setting of subsequent AER capex forecasts. While capex is not forecast using a single 'base-year' of revealed spend like opex, we have seen AER assessment methods relying more on revealed capex spends. For example:
    - in its most recent Distribution Determinations, the AER typically defaulted to revealed spend levels if it was concerned with the reasonableness of the network's proposal;
    - it is clear from the expectations in its Better Resets Handbook that the AER judges the reasonableness of a Regulatory Proposal in the context of networks' revealed capex spent over a historic period (typically the previous regulatory period) – 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;[12] and
    - in expenditure areas like ICT, the AER has started to require detailed Post Implementation Reviews of initiatives proposed in networks' previous Regulatory Proposals, and intends to use this to inform its assessment on a reasonable forecast spend.

It is unclear what problem with its assessment methods the AER thinks it may need to solve. If a problem exists it should be solved directly via assessment methods. We caution against premature decisions. The CESS has only applied in one period and the effects on mitigating forecast risk of all reforms to AER assessment methods over recent years may not be evident. This is noting that:

- while there was diversity in networks' forecasting approaches when the AER commenced regulation, these approaches are aligning and conforming to the explicit and bottom-up forecasting expectations set by the AER in multiple guidance documents many of which were only introduced in recent years.[13]

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[12] This includes conversely, the costs and risks to consumers from service performance decreases if maintaining current spend levels is considered to be insufficient. Also, we note there are nuances in how the AER considers revealed spend, with revealed spend generally having greater direct correlation to forecast assessment where spend is recurrent in nature – noting that this applies to much of repex which is generally one of the largest spend categories for networks.

[13] For example, a Regulatory Proposal submitted in 2008 would not have been framed by any explicit forecasting guideline. However, a proposal submitted from 2023, must conform to detailed expectations in five AER guidance documents:

(1) the Expenditure Forecasting Assessment Guideline;

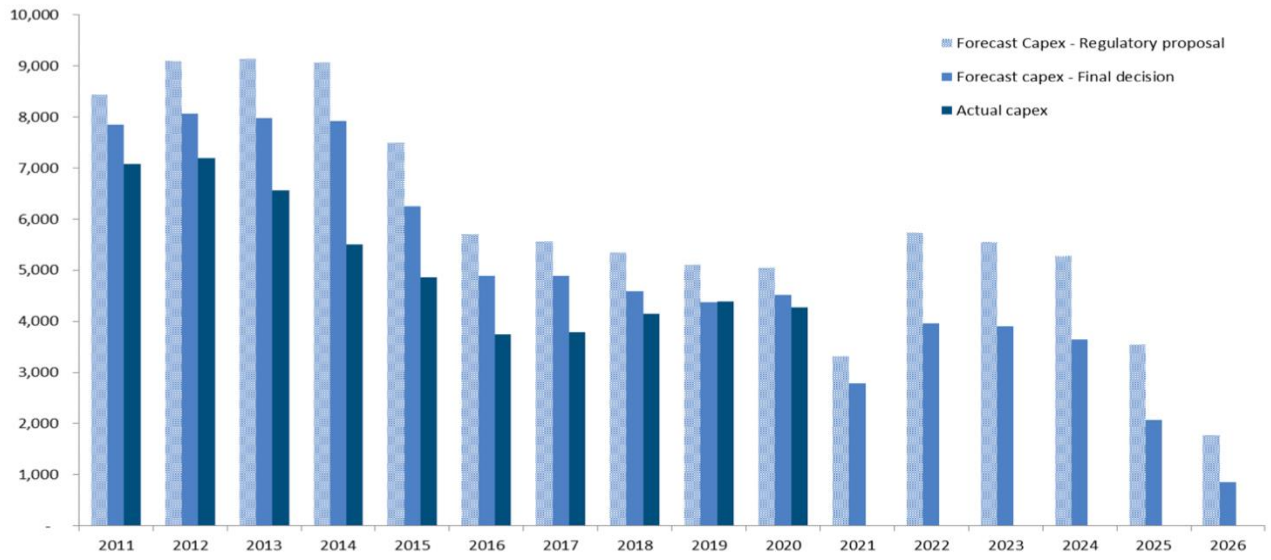
(2) the Guidance Note on Non-network ICT capex assessment;

(3) the Industry Practice Application Note on Asset Replacement Planning;

An attempt to materially inflate forecasts will likely be very evident when the AER is being explicit on: how cost benefit analyses and Regulatory Investment Tests should be conducted, how risk should be assessed,[14] in some cases specifying input assumption parameters or information sources[15], and in some cases applying averages of input cost assumptions from multiple forecasters;[16]

- while the AER appears concerned by the larger divergence in recent Determinations between capex forecast in distributors' Proposals and the AER Final Decision capex forecasts (seen in Figure 4), it is generally too soon to observe the impact of the AER's new assessment methods. The AER observation on Figure 4 may actually result from its greater ability now to scrutinise the reasonableness of distributors' forecasts; and
- finally, if the concern is more to reduce the burden of arriving at an efficient AER capex forecast, we would welcome engagement on potential solutions. We observe for example, that OFGEM in the United Kingdom has applied a number of incentive arrangements designed to drive networks to minimise the divergence between their first forecasts / proposal and OFGEM decisions.[17]

Figure 4: Difference between proposed capex and AER final decision



Source: AER, Discussion Paper, 2021

(4) the DER integration expenditure assessment guideline, and within this, the (a) Customer Export Curtailment Value; and (2) the Value of DER methodology;

(5) the AER outline of the replacement expenditure model; and

(6) the Better Resets Handbook.

[14] E.g. in respect of repex, the AER's industry note sets out the typical parameters of risk / value that are reasonable to assess and indicates the sources of information for reasonable estimates on different parameters.

[15] E.g. in respect of DER integration expenditure, the AER is intending to specify which independent forecasts of DER uptake should be used, and the values for estimating wholesale market benefits etc.

[16] E.g. in the application of real labour price growth, the AER applies an average of the forecast from the network's consultant and its own consultant.

[17] OFGEM, *RIIO_ED2 Sector Methodology Decision: Annex 2 Keeping bills low for consumers*, 17 December 2020, p.95.

4.5 Do current differences in sharing ratios drive perverse behaviour?

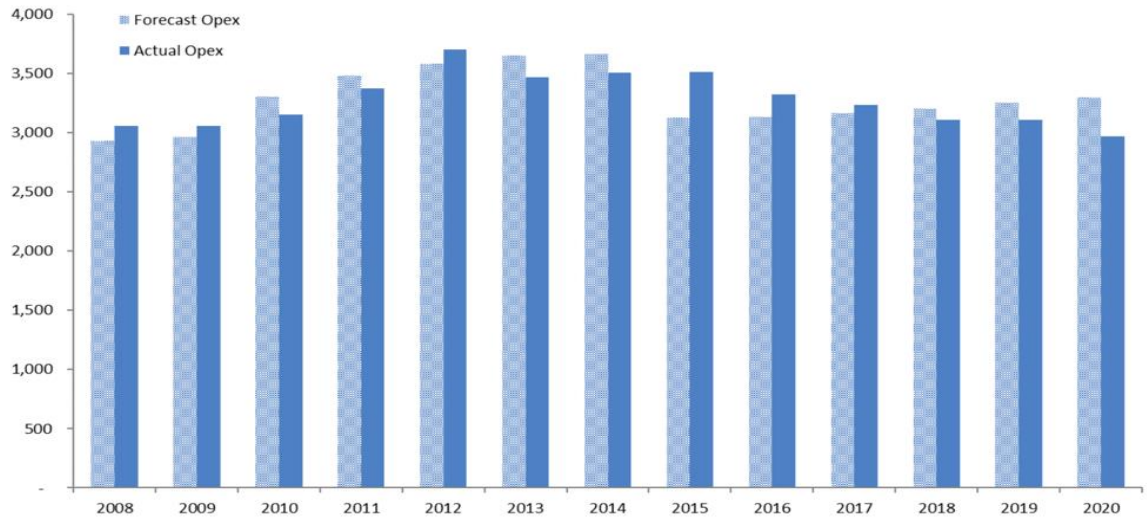
The AER questions if the current differences in network benefit sharing ratios between the CESS (30 percent) and EBSS (circa 15 percent) may drive perverse behaviour. We do not see evidence that this has occurred, and that it is unlikely to be possible in practice, noting that:

- while it is too soon to observe trends, Figure 5 shows that networks have still been focused on finding opex efficiencies since 2017, even though the real WACC has declined from around 3.9 percent to 3.4 percent since 2017;
- a theoretical concern that a lower benefit for underspending opex than capex might drive networks to shift spend into opex, is unrealistic:
    - there is little expenditure that is not clearly capex or opex in nature, with any discretion in the allocation between these two expenditure types likely to be at the margin, noting the strict accounting standards and scrutiny by auditors;
    - material shifts between capex and opex would be very evident in regulatory reporting;
    - factors outside of incentives will also drive networks to not inefficiently shift capex to opex, noting effects on opex benchmarking and the risks of the base-year being deemed inefficient; and
- as the Discussion Paper observes, the opex framework is working effectively, is fit-for-purpose and there is no evidence of networks inflating their base-years – such as by inefficiently shifting spend into opex.

Further, in hopefully observing opex trends over a longer period of time, we also caution against misinterpreting these trends. In coming years, we expect there to be legitimate increases in opex particularly as technology change drives networks to, for example:

- draw on third-party solutions such as non-network options and Stand-Alone Power Systems, or paying to access data from Metering Coordinators for network visibility;
- host more of their ICT in the 'cloud', rather than on servers; and
- purchase 'Software-as-a-Service' (SaaS) for their ICT requirements where this is more efficient than owning software in-house – with such solutions needing in future to be accounted for as opex.

Figure 5: Opex underspends over time



Source: AER Discussion Paper 2021

5. Other issues

We welcome the Discussion Paper having accurately assessed that the other key aspects of the incentive framework, namely the incentives for operating expenditure efficiency and service performance are fit-for-purpose and working effectively. In particular we welcome the observations that:

- for operating expenditure – the EBSS has clearly driven networks to find continual efficiencies in their operations, driving down opex costs, growing opex productivity, while maintaining / improving service reliability performance; and
- for service performance – the STPIS has driven fewer and shorter outages for consumers over time even as networks have found efficiencies in capex and opex (i.e. spent less than AER forecasts), and even as the AER forecasts for capex and opex themselves have generally declined over time.

Further, we also encourage the AER to consider:

- the importance of separately progressing the review of potential service incentives to apply to export services, as required by the recent AEMC Access, Pricing and Incentive Arrangements rule changes – with networks approaching their next round of Regulatory Proposals it is fundamental that there is clarity on incentives that may apply in the next regulatory periods;
- the merit of revising / increasing the potential revenue cap applicable to the Customer Service Incentive Scheme. As discussed earlier in this submission, we consider that the AER's decision to apply this scheme within the existing STPIS, results in a scheme that is too low powered to drive material change in the area of 'customer experience' that customers and third-party energy services firms are increasingly telling networks is important to them;
- how to streamline and simplify the existing Demand Management Incentive Scheme (DMIS), which while it is yet to be materially utilised by networks, will likely increase in relevance, particularly for example, as networks seek to manage demand for export services; and
- as a general point, in examining DMIS amendments or the design of new incentive schemes, we encourage the AER to consider how these schemes can be made to be readily explainable to 'the average employee' within a network, in order to drive material change in network behaviours and priorities.