SP AusNet™
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Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne Victoria 3001
via email: incentives@aer.gov.au

Dear Sebastian,

Expenditure Incentives Guidelines– Issues Paper

SP AusNet welcomes this opportunity to contribute to the development of the Australian Energy Regulator's (AER's) Expenditure Incentives Guidelines as part of the Better Regulation program.

Expenditure incentives are a critical part of the regulatory framework. SP AusNet has been a longtime advocate of incentive based regulation. The strengthening of the capital expenditure incentive regime that has been enabled by the AEMC's *Economic Regulation of Network Service Providers* Rule Changes, and the form of which is being contemplated in this review, is a necessary and important step that will aid the achievement of the National Electricity Objective (NEO).

In developing new expenditure incentive arrangements, attention will need to be paid to how these sit within the broader regulatory framework. This is because the operation and effect of expenditure incentives is closely tied to other components of the regulatory framework (such as reliability incentives and the approach to setting expenditure forecasts), many of which are also subject to change as a result of current reviews.

This letter sets out some overarching comments on the Issues Paper, the review process and what we see as the critical matters to get right. Detailed responses to questions from the Issues Paper are provided in an attachment.

Incentives first

While the AER have consistently articulated a preference for 'incentives first' as a principle that will be embedded in their Better Regulation Guidelines, there has been a great focus in the Review so far on non-incentive based approaches to regulation, or approaches that can work where incentives are 'failing', and specifically, where Network Service Providers (NSPs) are not responding to them.

SP AusNet believes that there is a risk of unintentionally diminishing the incentive properties of the framework. If the review's focus is driven by designing a scheme for NSP's that do not respond to incentives, elements of the framework that provide significant benefits may be too quickly dismissed or altered.

For example, the talk of a shift to an exogenous (benchmarking-based) approach to forecasting operating expenditure (opex) does not make much sense in the context of most NSPs. Indeed evidence, including that provided by the AER, suggests that the incentive scheme is working effectively. That is, it is driving NSPs to find opex efficiencies that benefit customers, and the administrative simplicity of the 'revealed cost' approach to opex forecasting benefits both NSPs and the AER. On this basis, a strong case would need to be built to justify a change.

Questions have also been raised that NSPs in some circumstances may be 'ripping-off' incentive schemes. These examples have been cited and used to discredit the effectiveness of incentives, rather than being used to examine whether the right incentives were in place to begin with. In these cases, it would seem the wrong lessons are being learnt. The correct lesson is to seek to revise incentive arrangements to address design flaws. By engaging in a regular review process, regulators are able to change the balance of incentives over time from observing networks response to these schemes.

The ground on which the incentive based approach to regulation is founded is firm. In Victoria, the record of an extended period of price decreases and reliability improvements over the last 15 years is *prima facia* evidence of this as the regulatory regime has used incentive schemes to drive these outcomes rather than mandating particular outcomes (for example, mandating planning standards).

It is important that the Expenditure Incentive Guidelines clearly lay out a framework that adheres to the principles of incentive regulation. Where the AER plans to depart from reliance on incentives, the guidelines should set out the trigger for such a departure and principles upon which such a decision would be made.

Balance needed – expenditure incentives and the regulatory framework

Designing expenditure incentives involves some delicacy and consideration. The goal is to achieve balance: to ensure the framework encourages efficient investment, not mindless cost cutting; performance levels that reflect customer preferences, not gold plating.

Balance is achieved in a broad context. The expenditure decisions made by NSPs will be affected by the totality of regulatory arrangements, including operating and capital expenditure incentives, but also, the approach to expenditure forecasting; reliability incentives and other service and safety obligations; demand management schemes; and the form of price control (revenue or price cap) in place. All of these elements are, therefore, relevant to getting incentive arrangements right.

Because aspects of the framework vary by sector (transmission or distribution), jurisdiction and NSP, a one-size-fits-all approach to setting expenditure incentives is unlikely to achieve the best outcome.

Expenditure forecasting

Both capital and operating expenditure incentives are affected by the approach the regulator takes to setting expenditure allowances (expenditure forecasting). This is because the sharing ratios depend on specific assumptions about how much an NSP's spending in one regulatory period will affect expenditure allowances in the next.

In the case of opex, the sharing ratio is based on the assumption that revealed costs are used to set future benchmarks – in other words, that future opex is entirely driven by current expenditure.

In the case of capex, the opposite assumption applies. Namely future allowances are assumed to be independent of current spending. If an NSP achieves savings in the current period, the savings to customers are assumed to only include a lower opening RAB in the next period, and not any decrease in future capex allowances.

If the assumptions upon which the incentive mechanisms are based do not hold, such as when opex allowances are set based on industry benchmarks or when capital allowances incorporate an NSP's own unit rates, the share of the benefits (or penalties) that accrues to the NSP will be different to that assumed. Expenditure forecasting techniques under consideration through the Better Regulation program will differ in how consistent they are with the assumptions of the incentive scheme. Therefore, this affect should be taken into account in setting the final incentive rates.

Performance incentives and obligations

Service performance incentive schemes and safety and other service obligations are critical to ensuring the expenditure incentives encourage NSPs to find better ways to operate their networks rather than just cutting the quality of service they deliver.

Some elements of performance can be difficult to measure for TNSPs and DNSPs. However, a number of initiatives as part of the Better Regulation program (e.g. annual reporting obligations) are likely to improve the visibility of all aspects of NSP operations.

In making changes to capex and opex incentives, consideration should be given to what performance incentives and other obligations are in place and how they will interact with the expenditure incentives. These arrangements will vary by jurisdiction and between Transmission and Distribution.

How should NSPs spend their allowance?

The expenditure incentives scheme can influence not only the level of expenditure but the type of expenditure that NSPs make. Does the regulatory framework encourage investment in long lived or short lived assets? In opex solutions or capex? In demand management solutions or peak capacity?

In particular, stronger capital expenditure incentives can work with Price Caps and Demand Management incentives to deliver more efficient network investment by revealing customer preferences (e.g. for how they value different aspects of network services including when those services are available).

If opex incentives and capex incentives are unbalanced, certain types of investments will be favoured. For example, a stronger capital incentive will generally favour demand management solutions and maintenance programs to extend asset lives. However, total expenditure will not be efficient if savings in one type of expenditure are rewarded more strongly than others.

From the examples above, it is clear that a poorly designed expenditure incentive regime can also lead to inadvertent prescription on how NSPs run their networks, but a well-designed scheme can let customer preferences determine what the most highly valued

expenditure decisions are. Because of the many benefits from capital expenditure incentives, SP AusNet supports high power capital incentives.

Shape and form of incentive guidelines

An important part of the Better Regulation process is determining what particular information needs to be set out in the Guidelines.

The Guidelines play an important role in the regulatory process. From the perspective of an NSP, good guidelines give a clear indication of how the mechanism will work and the principles on which it is based. They provide enough certainty and guidance to allow expenditure decisions to be made with a reasonable degree of confidence as to how they will be treated within the regulatory framework (i.e. of what the financial consequences for the business will be). This includes providing for the scheme to be relatively stable over time, as the long life of many electricity network assets means that the planning horizon can and does span multiple regulatory periods.

Good guidelines also serve to streamline the regulatory process by reducing the administrative burden on both NSPs and the AER: they identify information requirements and narrow the focus of regulatory determinations. Guidelines should establish what is and is not fixed in the framework, and what process and principles will be applied to determine those outstanding elements at a later stage in the regulatory process.

As detailed throughout this submission, SP AusNet believes there is good cause to leave some aspects of the incentive framework open to determination as part of the regulatory cycle (for example at the Framework and Approach stage). A good example of how the Guideline could provide for this flexibility, while maintaining a useful level of information and certainty is provided by the AER's Guideline for the Electricity Distribution Service Target Performance Incentive Scheme (STPIS).

The STPIS guideline provides a level of detail on the structure of the scheme and its components (including definitions, formulations for how measures will be calculated, and information and reporting requirements), as well as the mechanics of how the scheme will operate (including timing). It also identifies parameters that DNSPs may seek to vary and the process by which proposals for variations can be made. For some elements of the scheme the STPIS Guideline sets out a range in which the value must fall (e.g. share of Revenue at Risk), for others it sets out principles that must be adhered to (e.g. that performance targets must not deteriorate), or a method for establishing parameter values (e.g. that incentive rates be based on Value of Customer Reliability).

Detailed responses on the aspects of the Expenditure Incentive arrangements that should vary, and the relevant principles and approaches that should be applied to determine them are provided the attachment.

Closing remarks

This submission is intended to be read alongside the submissions of Energy Networks Australia and Grid Australia, both of which are supported by SP AusNet. Those submissions provide some detailed thinking on the specific design issues for expenditure incentives and their theoretical basis.

We look forward to continuing participation in the development process, and would be happy to meet with the AER at any stage to discuss matters of interest. Please contact

Katie Yates, Principal Economist at 03 9695 6622 if you wish to discuss any aspect of this submission further.

Yours Sincerely,

Tom Hallam
Manager Economic Regulation

Attachment:
SP AusNet's answers to the questions contained in the Issues Paper on the Expenditure Incentives Guidelines

ATTACHMENT

SP AusNet's answers to questions in the Expenditure Incentives Guidelines Issues Paper

Chapter 3 Ex ante measures for capital expenditure

Question 1: ***Do stakeholders agree with the issues that we have identified about declining incentives for efficient capex? Are there any other issues that could arise from declining incentives for efficient capex?***

If so, what are these?

SP AusNet agrees that the existing framework has provided a declining incentive to reduce capital expenditure within the regulatory period, and a relatively weak overall level of capital expenditure incentive, and supports the Electricity Networks Australia (ENA) and Grid Australia (GA) submissions on this issue.

Analysis in the AER's issues paper regarding recent trends in capital expenditure (p.12) and in Attachment 2, regarding capital expenditure trends in Victoria are misleading. This was picked up by various parties so it is worth clarifying.

The Issues Paper states that there has been more overspending in Victoria in the most recent regulatory control period, than in either NSW or Queensland. However, no data for the current regulatory control period are included for Victoria. The Victorian overspending that is identified occurred in 2009 and 2010, the last two years of the previous regulatory period. The AER appears to be comparing this to the most recent regulatory period for NSW and Queensland, periods in which capex allowances were significantly increased across the NEM.

Importantly, in the context of concerns over capital expenditure levels as a driver of higher electricity prices, and also of the historical performance of capex incentives in Victoria, in the years leading up to the current regulatory period, networks in both Queensland and NSW were consistently (every year) overspending their allowances, whereas networks in Victoria mostly underspent. To be clear, for the 2006-10 regulatory period, Victorian DNSP's did not overspend the regulatory allowance.

Question 2: ***Do stakeholders support our initial view that any capex sharing scheme should provide continuous incentives in each year of a regulatory control period? Please give reasons to support your view.***

SP AusNet strongly supports the application of a continuous capital expenditure incentive in line with the ENA and GA responses.

Question 3: Do stakeholders support our initial view that any capex sharing scheme should provide a reward for underspending of between 20 and 30 per cent? Please give reasons to support your view.

As outlined in our submission, capital expenditure incentives are central to the regulatory framework. The capex expenditure incentive works in concert with other parts of the

framework, including the operating expenditure incentive, performance incentives, the form of price control, and the methods used to set expenditure allowances, to establish the overall incentives firms face when making decisions on how they operate their networks.

The objective of the regulatory framework is that, as a whole, it influences network owners to make efficient and sustainable investments that are in the long term interest of customers.

As part of a complex framework, there are many relevant considerations to setting the 'right' level of capital expenditure incentive. As such, it is not possible to be definitive about the right level of incentive to provide NSPs, especially while many other aspects of the regulatory framework are also still to be settled as part of the Better Regulation program.

Nevertheless, evidence that has been presented through much of the reform push of the last year (including the AEMC rule changes initiated by the AER) that capital incentives have not been strong enough.

Even for NSPs that have not exhibited material overspending, there are strong arguments that a stronger capital incentive will drive greater efficiency in the operation of their networks. For example, a sound capital expenditure incentive can encourage greater use of demand management. Similarly, it can enhance the efficiency dividends of using a Price Cap form of price control, because where capex incentives are weak and decline through the regulatory period, the reward to NSPs from efficient pricing will be small. When NSPs have a reason to set prices that reflect costs, customers have a reason to align their consumption patterns with those costs, so customer decisions will drive the network services that are provided. The market behaves more like a competitive market and there is less 'dead weight loss' or over-delivery of services that customers don't value.

For these reasons, SP AusNet supports a stronger capital expenditure incentive. As a starting point, or default, 20 to 30 per cent seems reasonable. However, it is appropriate for the Guidelines to provide flexibility to have regard to balancing the power of the capital incentive with other aspects of the framework. When differences in circumstances are taken into account, it may be that a different incentive rate is appropriate for some NSPs, and in some jurisdictions.

Question 4: ***Do stakeholders agree with our initial position that the penalty for overspending should be greater than 30 per cent? Please give reasons to support your view.***

SP AusNet does not agree that an asymmetric incentive is appropriate. Particularly, it is not clear that full consideration has been given to some of the important implications of asymmetry. Rather, the AER appear focused on how the incentive can be designed for those NSPs that are a long way from the efficient frontier. This clearly does not cover the circumstances of all NSPs in the NEM. It is critical that the design of the incentive mechanism also contemplates how it will affect NSPs that do respond to incentives. SP AusNet would argue that this should be the primary concern when designing the scheme.

If the expenditure benchmark is an unbiased forecast of efficient cost, an asymmetric incentive would encourage NSPs to inefficiently defer costs when unforecast expenditures arise.

Given the broader changes under the new rules, it would be expected that any upward bias in expenditure forecasts that has historically occurred is likely to be removed or at least substantially reduced. In which case, it is not appropriate for there to be an asymmetric incentive, because the risk of the Revenue Decision being below the requirement for the operation of the business is higher.

The new ex post assessment provisions will further reinforce this signal to NSPs to avoid overspends at all costs. Given the introduction of ex post assessment to the regulatory framework, further asymmetry of capital expenditure incentives is unwarranted.

Given the complex interaction between aspects of the regulatory framework, rather than making a definitive pronouncement on the best level of penalty to apply, the AER should keep an open view to adjust the penalty and achieve the right balance of incentives for NSPs.

Question 5: ***Do stakeholders agree with our initial position that one capital expenditure sharing scheme should apply to all NSPs? Please give reasons to support your view.***

As stated earlier, there should be one scheme, but aspects of the scheme should be adjusted by sector, jurisdiction and NSP. This is necessary to ensure the overall balance of incentives provide the right signals to NSPs regarding their expenditure decisions.

The Distribution STPIS guidelines provide a good template for how the guidelines can provide useful detail on the mechanics of the incentive scheme, and on the process and principles that would apply to setting final parameters to apply to an NSP for a given regulatory period. NSPs should be able to propose their own variations, for example regarding the power of the opex and capex incentives, and on exclusions and adjustments that should apply.

Question 6: ***If we were to tailor different schemes for individual NSPs, what criteria should we use to differentiate between NSPs?***

The primary criteria for tailoring the expenditure incentive scheme should be whether it meets the National Electricity Objective and the *capital expenditure incentive objective*.

As noted our submission, many other elements of the regulatory framework will affect how the capital expenditure incentive operates in practice. In setting the specific parameters of the incentive scheme, the question to ask is, in light of other regulatory arrangements and circumstances, which design will provide the best incentives for an NSP?

It may be appropriate to tailor elements of the scheme, including the power of the incentive, exclusions and adjustments, and interaction with the AER's chosen approach to expenditure forecasting, to achieve the best balance given the circumstances in a jurisdiction or for an individual NSP.

Where the scheme is to be tailored, NSPs should have an opportunity to propose adjustments consistent with the NEO and the *capital expenditure incentive objective*. The guidelines should also set out criteria against which these proposals would be assessed (e.g. that there is a reasonable expectation that an adjustment mechanism is unbiased).

The AER should provide a statement of the reasons that the parameters and settings it selects, are those that best meet the NEO, and the *capital expenditure incentive objective* and their capex incentive criteria.

Question 7: ***Are there any categories of capex that should not be covered by a capital expenditure sharing scheme? Why?***

Exclusions and adjustments to the capital expenditure incentive scheme affect the level of risk (especially in relation to uncertainty) that NSPs face in relation to their revenues. They also can impose prescription over how NSPs operate their businesses. Therefore, it is appropriate for NSPs to be able to propose what exclusions are necessary and appropriate to their networks.

As a general criterion it is appropriate to consider excluding categories of expenditure that are not controlled by the NSP and that are likely to be material and asymmetric (where expenditure variations are likely to be biased in one direction). One example of this is the Easement Tax which applies to the Victorian Transmission network, which is a large expenditure that is determined by the Victorian Government.

If an asymmetric incentive scheme is adopted, with larger penalties than rewards, even uncontrolled expenditures that are symmetric in their uncertainty would have asymmetric consequences and therefore may be appropriate to exclude from the incentive arrangements.

Another consideration is whether it is appropriate to provide an incentive to minimise that category of expenditure. For example, do other mechanisms or obligations ensure that the level of service is optimal?

In Victoria, it is appropriate to exclude expenditure for reliability improvement in Distribution Networks. Victorian DNSPs are funded to maintain reliability, with cost effective improvements funded by the reliability incentive scheme (the STPIS). It is not appropriate to treat expenditure made in line with the incentives of that scheme as 'overspending'.

Question 8: ***When, if at all, might it be appropriate to make adjustments to a type of capex before applying a CESS? Why?***

See response to Question 7.

Adjustment mechanisms are likely to vary between Transmission and Distribution.

Question 9: ***Do stakeholders agree with our initial position to apply a continuous asymmetric capex scheme with higher penalties for overspending than rewards for underspending? Please provide reasons.***

SP AusNet supports the introduction of a stronger capital incentive mechanism in the framework as is contemplated in the Issues Paper. Such a scheme has many benefits. It addresses concerns articulated through the AEMC's rule change process that the existing arrangements may provide some NSPs with an incentive to over-invest. A well designed capital incentive will also address the concerns addressed in the issues paper regarding declining capital incentives within regulatory period.

As outlined in response to Question 3, there are additional benefits from strengthening capital expenditure incentives.

SP AusNet does not favour an asymmetric scheme, as explained in response to Question 4.

Question 10: ***Do stakeholders agree with our initial position that the penalties and rewards for a capex scheme should be included in the guidelines rather than determined as part of a determination? Please provide reasons.***

The Expenditure Incentives Guidelines should set out the design of the incentive mechanisms and set out how the AER will approach its decision on setting the level of penalties and rewards.

An NSP must know before the commencement of each regulatory period what penalties and rewards will apply during that regulatory period. This is necessary in order for the NSP to respond to the incentive scheme in making its management decisions.

Where the AER is intending to switch between incentive schemes due to a change in forecasting approach (e.g. adopting a benchmarking approach) it should provide the earliest possible indication of this intent.

Question 11: ***Do stakeholders agree that forecast depreciation should be the default form of depreciation used to roll forward the RAB except where there is no capex sharing scheme in place or where there is persistent overspending by a NSP?***

SP AusNet strongly agrees that forecast depreciation should be used, and refers the AER to the ENA and GA submissions on this topic.

Question 12: ***Do stakeholders agree with the factors that we have identified for consideration in determining whether to apply forecast or actual depreciation?***

SP AusNet agrees that the factors identified are important considerations.

The use of actual depreciation introduces a large distortion to the strength of the incentive related to asset life heavily punishing expenditure on short lived assets in particular. In practice, SP AusNet has found that the incentive regime distorts the investment decision process in extreme ways.

The IT allowance provided for under the Rules is a maintain case only, therefore, any increase in IT expenditure to materially increase functionality or introduce new functionality can only be justified by savings generated to capital or operating costs or benefits from

service standard improvements. However, the assessment of such expenditure starts with a massive disadvantage when being ranked against alternative investment opportunities, particularly at the start of a regulatory period.

For example, in the first year of SP AusNet's current electricity distribution regulatory control period a $10M IT project will need to generate an NPV efficiency/service standard benefit of around $8.5M before it becomes NPV positive on a stand alone basis whereas a $10M network investment need only generate a NPV saving of $3M. Therefore, all things being equal, IT projects are artificially pushed down the priority list of capex projects in the investment optimisation processes. Given many of these projects would generate net benefits for customers, the current approach detracts from the achievement of the NEO.

This is particularly perverse given that potential solutions to mitigate future network costs require substantial investments in IT systems (for example, dynamic monitoring, self-healing networks, smart meter enabled TOU tariffs and DSM to address peaky load).

Chapter 4 Ex ante measures for operating expenditure

Question 13: ***If we continue to use a revealed cost approach to forecast opex, should the same EBSSs remain largely in place, or are more significant changes required?***

As noted in our submission, SP AusNet believes that the evidence suggests that the EBSS has been largely effective. In our own experience, all three of our networks have had an EBSS or similar opex incentive in place for extended periods, and we do not believe material, if any, changes are required.

Question 14: Does an incentive power of 30 per cent provide a sufficient incentive to achieve efficiency gains?

Consistent with earlier statements, the power of the opex incentive should balance with the capex incentive and be set with due consideration to its interaction with other components of the regulatory framework.

But broadly the 30 % incentive has been effective.

Question 15: ***Are there any circumstances where balancing the opex incentive with the capex and service level incentives may not encourage economic efficiency?***

Balancing expenditure and service level incentives is central to providing the correct overall signals to NSPs. Further detail of the theoretical underpinnings of this principle are provided in the ENA and GA submissions.

Question 16: ***Do stakeholders agree the EBSSs should provide a continuous incentive in each year of a regulatory control period? Are there any circumstances where a continuous incentive may not encourage economic efficiency?***

A continuous incentive is appropriate for opex. This is particularly so when used with a revealed cost approach to forecasting opex, as it provides reassurance that base year costs reflect efficient costs.

Question 17: ***Do stakeholders agree the EBSS rewards and penalties should be symmetrical, regardless of the forecasting approach?***

Symmetry is appropriate for similar reasons to those stated in support of symmetry of capex incentives.

Question 18: ***Should uncontrollable costs be excluded from the operation of the EBSSs?***

NSPs should have the option to propose to exclude uncontrollable costs and how they would be dealt with (e.g. to propose adjustment mechanisms). For some NSPs there will be a benefit in maintaining a reasonably complete bundle of costs to be covered by the EBSS as this will enable greater flexibility and risk management.

Question 19: ***Should the approach to addressing uncontrollable costs differ depending on the forecasting approach?***

Refer to response of Grid Australia. Exogenous forecasting techniques may inadequately account for the component of an NSPs costs that are uncontrollable.

Question 20: ***Are there any other reasons to exclude costs from the operation of the EBSSs?***

Refer to ENA and GA responses.

Question 21: ***Should the EBSSs define specific costs to be excluded from its operation? If yes, which costs should be excluded from the scheme? If no, should criteria be defined which would guide which costs would be nominated as excluded costs?***

Refer to ENA and GA responses.

Question 22: ***Should all excluded cost categories be determined prior to the commencement of the regulatory control period in which the scheme applies?***

Refer to ENA and GA responses.

Question 23: ***Should the EBSSs provide greater flexibility as to how opex forecasts are adjusted for the purposes of calculating rewards and penalties under the scheme?***

Not in the default scheme, but it would be appropriate for the AER to consider proposals where the NSP can establish a fair mechanism for adjustments (i.e. that is unbiased).

Ex post measures for capital expenditure

Question 24: ***Do stakeholders agree with having a staged approach to the ex post review?***

The preliminary approach outlined in the Issues Paper appears sensible.

SP AusNet supports the submissions of ENA and GA and refers the AER to those submissions for a detailed response to 'ex post assessment' issues.

Question 25: ***Are the issues that the AER proposes to consider as part of the ex post review appropriate?***

Question 26: ***Are there any other factors that the AER should consider in conducting an ex post review?***

Question 27: ***Are there any additional factors that we should consider before excluding an amount of an over-spend from a NSP's RAB?***

Question 28: ***Do you think our approach for the assessment of related party margins is reasonable? What other approaches may be appropriate?***

Question 29: ***Do you think our approach for the assessment of capitalisation requirements is reasonable? What other approach may be appropriate?***