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20 September 2013

Mr Sebastian Roberts
General Manager, Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne Victoria 3001
via email: incentives@aer.gov.au

Dear Sebastian,

Draft Capital Expenditure Incentive Guidelines and Proposed Efficiency Benefit Sharing Scheme

SP AusNet welcomes this opportunity to respond to the Australian Energy Regulator's (AER's) Draft Capital Expenditure Incentive Guidelines and Proposed Efficiency Benefit Sharing Scheme and associated Explanatory Statements.

As stated in SP AusNet's submission on the AER's Expenditure Incentives Issues Paper, expenditure incentives are a critical part of the regulatory framework with a proven track record of driving efficiency improvements. SP AusNet welcomes the AER's endorsement of the centrality of incentive-based regulation to its future approach as part of the Better Regulation Framework. In particular, SP AusNet endorses:

- The adoption of a strengthened capital expenditure incentive that is symmetrical and continuous, in the form of the Capital Expenditure Sharing Scheme (CESS); and,

- The retention of a largely unchanged Efficiency Benefits Sharing Scheme (EBSS) for operating expenditure.

However, the broad discretion that has been introduced to the proposed EBSS to allow the AER to make ex post adjustments that are not fully defined on an ex ante basis is a backward step and should be removed from the final scheme. Network Service Providers (NSPs) must be given a clear understanding at the outset of each regulatory period of the consequence of their expenditure decisions for the outcome of their EBSS carry forward calculation in order for the incentive to operate as intended. This is detailed below, as are some additional improvements that could be made in finalising the expenditure incentive schemes.

Discretionary ex post adjustments should not be allowed in the incentive framework

Section 2.4 of the Proposed EBSS outlines adjustments to the forecast or actual operating expenditure that will be made in calculating carryover amounts. The third dot point under Section 2.4 suggests an ability for the AER to make wide ranging adjustments to carryover amounts.

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The proposed changes will weaken the operation of the incentive by introducing uncertainty over what the scale of benefits or penalties will be for expenditure decisions. At its worst, the consequence of such retrospective adjustments is to break the regulatory compact, such that NSPs do not receive the intended share of the efficiency benefits they create.

It is noted that the issue here is not with mechanistic ex post adjustments such as the inclusion of pass throughs and contingent projects, because while the size (in $ terms) of these inclusions or exclusions is unknown ex ante, once these events arise, their treatment under the scheme is clear.

The SP AusNet submission on the expenditure incentives Issues Paper warned of the risk of focussing too heavily on NSPs that are not responding to incentives in shaping the design of the incentive schemes (particularly for opex where evidence suggests that the current EBSS has been functioning effectively).

> *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.*

The AER's Draft Guidelines should be applauded for largely resisting this trap. However, in the case of broadly defined powers to make ex post adjustments this is not the case. The ability to make retrospective adjustments and the associated uncertainty diminishes the strength of the incentive to those NSPs that respond to such incentives.

Should the AER seek to redress concerns it has about an NSPs revealed costs, these issues should be addressed in the setting of the expenditure allowance through the price review process.

Suggested improvements to the draft expenditure incentive schemes

In responding to the expenditure incentives Issues Paper, SP AusNet also stressed the need for balance among incentive schemes and the need to be mindful of the interactions of the various elements of the regulatory framework. The balance between capital expenditure and operating expenditure incentives under the proposed schemes recognises these interactions.

One area that SP AusNet believes deserves further attention is the affect the proposed changes to expenditure incentives will have on reliability investment in Victoria. Under the Victorian arrangements, reliability expenditure is funded through the STPIS rather than through capital expenditure allowances. The inclusion of this expenditure in the CESS weakens the incentive DNSPs have to invest in reliability by lowering the sharing ratio relative to that which can be achieved under the current arrangements. SP AusNet views the current reliability arrangements in Victoria as successful. No case has been made that the incentive should be weakened. It is appropriate that the Final CESS Guidelines provide for the opportunity to make a direct consideration of the appropriate sharing ratio to apply to reliability improvement expenditure. The AER should note the submission of the Victorian Distribution businesses addresses this issue in further detail.

SP AusNet also believes that the expenditure incentive schemes could be improved by allowing greater flexibility to make ex ante (i.e. set out in the determination at the start of the regulatory period) exclusions or agreements to treat certain categories on a different basis.

One example, which the AER may already be considering, is how to treat certain opex categories in Transmission that are not suited to a revealed cost forecasting approach (e.g. due to lumpy expenditure profiles). It would be appropriate for such expenditures to be subject to incentive arrangements that account for the different forecasting approach.

Finally, the Proposed EBSS does not make clear how it would operate in circumstances where a regulatory period of other than five years is agreed. SP AusNet believes that it is appropriate that, at a minimum, NSPs get to retain the opex efficiencies they generate for the six years that would occur under the 'default' scheme. For regulatory periods of longer than five years it would be appropriate to match the EBSS to the duration of the regulatory period to reflect the additional forecasting risk in expenditure allowances for a longer period.

Closing remarks

This submission is intended to be read alongside the submission of the Victorian Electricity Distribution Businesses which SP AusNet supports. We 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