20 September 2013

Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001
By email: incentives@aer.gov.au

Dear Mr Roberts,

Draft Capital Expenditure Incentives Guidelines and Proposed EBSS

CitiPower, Jemena Electricity Networks, Powercor Australia, SP AusNet and United Energy Distribution (**the Victorian Distributors**) welcome the opportunity to respond to the Australian Energy Regulator's (**AER**) Draft Capital Expenditure Incentive Guidelines (**Draft Capex Incentive Guidelines**), Proposed Efficiency Benefit Sharing Scheme (**Proposed EBSS**) and the associated explanatory statements, which were released for comment on 9 August 2013.

Having been subject to a number of different incentive schemes over the last 15 years, the Victorian Distributors have seen first-hand the benefits that a well-structured scheme can deliver, in terms of productive efficiency, reliability improvements and price reductions. The Victorian Distributors therefore welcome the AER's proposal to implement a symmetric and continuous incentive regime that provides balanced incentives for capital expenditure (**capex**), operating expenditure (**opex**) and service level decisions.

The Victorian Distributors are also broadly supportive of the AER's proposal to:

- implement a Capital Expenditure Sharing Scheme (**CESS**) that is symmetric, continuous and provides DNSPs stronger powered incentives than have been available in the past;
- apply the EBSS in largely the same form as it has been to date; and
- use a two stage assessment framework to carry out the ex post capex review, the first stage of which will be used to distinguish between NSPs that have:
  - incurred a 'significant' overspend and will be subject to a more detailed assessment in the second stage of the assessment framework; and
  - not incurred a 'significant' overspend and will be deemed 'broadly efficient'.

However, the Victorian Distributors are concerned with:

- the AER's proposal to incorporate a productivity factor in opex forecasts, given the effect it will have on the symmetry of the EBSS and the balance of incentives across other schemes;
- the effect that the AER's proposed treatment of Service Target Performance Incentive Scheme (**STPIS**) related expenditure under the CESS will have on the current incentives Victorian Distribution Network Service Providers (**DNSPs**) have to invest in reliability and quality improvements;
- the proposed discretion the AER will have to make ex post exclusions and adjustments under the EBSS;
- the fact that no consideration has been given to the effect that taxes will have on the rewards available under the CESS and the EBSS, the continuity of incentives under the CESS and the balance of incentives across the two schemes;
- the AER's decision not to leave the door open to allowing higher powered incentives to be applied to NSPs approaching the efficiency frontier under either the CESS or the EBSS; and
- the limited guidance that has been provided on the circumstances in which the AER may decide not to apply the CESS.

Each of these concerns is discussed below.

Productivity factor in opex forecasts

In the Draft Expenditure Forecast Assessment Guideline for Electricity Distribution (**Draft Assessment Guideline**), the AER has proposed to include a productivity factor in the rate of change parameter to be used to derive opex forecasts under the base-step-trend approach.[1]

This proposal constitutes a significant departure from the position the AER has previously taken on this issue,[2] and is of particular concern to the Victorian Distributors because it is contrary to a number of important EBSS provisions and revenue and pricing principles. It is

---

1 AER, Draft Expenditure Assessment Forecast Guideline for Electricity Distribution, August 2013, p16 and AER, Draft Expenditure Assessment Forecast Guideline – Explanatory Statement, August 2013, p36.

2 In the AER's final decision on the EBSS to apply to DNSPs, it decided not to make any provision for a productivity adjustment. In doing so, the AER noted the following:

> "The AER notes the concerns regarding the incorporation of assumed efficiency gains when determining opex allowances. The AER recognises that by assuming efficiency gains when determining forecast opex would only reward DNSPs for efficiency gains made in excess of the assumed gains. Were a DNSP to make efficiency gains less than those assumed the DNSP would receive negative carryover amounts through the EBSS.
>
> In considering this concern, the AER notes clause 6.5.8(c)(3) of the NER requires it to have regard to the desirability of both rewarding DNSPs for efficiency gains and penalising DNSPs for efficiency losses. Accordingly the AER will be mindful of whether a DNSP is penalised despite making efficiency gains when assessing its opex forecasts in the context of applying the EBSS. The AER also notes that in determining forecast opex for TNSPs the AER has not incorporated assumed efficiency gains."

AER, Final Decision – Electricity distribution network service providers - Efficiency benefit sharing scheme, June 2008, p13.

also contrary to the AER's stated objective of implementing a balanced and symmetric incentive regime.

Put simply, if a productivity factor is included in the rate of change, then it will mean that:

- contrary to clause 6.5.8(c)(3) of the National Electricity Rule (**NER**), DNSPs achieving an efficiency gain less than the productivity factor would be penalised, notwithstanding the fact there has been an efficiency gain;
- contrary to clause 6.5.8(a) of the NER, the EBSS would no longer provide for a fair sharing of gains and losses, because DNSPs would only be rewarded if they achieved efficiency gains in excess of the productivity factor. DNSPs would therefore capture less than 30% of efficiency gains and bear more than 30% of efficiency losses (i.e. the EBSS would no longer be symmetric);
- contrary to section 7A(2) of the National Electricity Law (**NEL**), DNSPs may not have the opportunity to recover at least the efficient costs incurred in the provision of direct control services and/or complying with regulatory obligations; and
- contrary to section 7A(3) of the NEL, the effectiveness of the incentives accorded to DNSPs would be diminished, because:
  - the EBSS would no longer provide for the fair sharing or symmetric treatment of efficiency gains/losses; and
  - the incentives provided by the EBSS *vis-à-vis* the CESS would be unbalanced. This is because the rewards (penalties) for efficiency gains (losses) under the EBSS would be lower (higher) than the rewards (penalties) available under the CESS.

The Victorian Distributors are therefore of the view that no provision should be made for an assumed productivity improvement in the rate of change parameter.

Proposed treatment of STPIS expenditure under the CESS

Under the AER's proposed CESS, expenditure on reliability and quality improvements, undertaken in response to the STPIS, will be treated in the same manner as any other capital expenditure. In effect, this means that if a Victorian DNSP decides to carry out reliability and/or quality improvements, it will be:

- penalised under the CESS for carrying out the expenditure and bear 30% of the cost of that expenditure;[3] and
- rewarded under the STPIS and retain approximately[4] 30% of the benefit of the reliability improvement.

---

3 Note that unlike other forms of capex, Victorian Distributors are not funded on an ex ante basis for reliability and quality improvement expenditure. Rather, they are expected to fund this expenditure through the financial rewards provided under the STPIS. This expenditure is then rolled into the RAB on an ex post basis. Any expenditure on reliability and quality improvements will therefore attract a 30% penalty under the CESS because it does not form part of the approved capex allowance.

4 The precise share of the benefit received by the DNSP will depend on the weighted average cost of capital.

The Victorian Distributors understand that the AER's proposed treatment of STPIS related expenditure under the CESS is intended to provide balanced and continuous incentives across the two schemes. However, it will *diminish* the incentive Victorian DNSPs have to invest in reliability/quality improvements relative to the current arrangements, because they will bear a greater share of the costs of this type of expenditure under the proposed CESS than they would if this expenditure was rolled into the RAB using forecast depreciation.

In the Victorian Distributors' view, the dilution of incentives that would occur under the AER's approach is unwarranted, because there is no evidence to suggest that Victorian DNSPs are over investing in reliability/quality improvements, or that the current incentive rate is too high. They have therefore given further thought to how the current incentive rate could be maintained within the new incentive regime.

The two options that the Victorian Distributors have identified are set out below:

- **Option 1:** Exclude STPIS related expenditure from the CESS and roll this expenditure into the RAB using forecast depreciation; or
- **Option 2:** Include STPIS related expenditure in the CESS but apply a lower sharing ratio to this type of expenditure.

The principal benefit that Option 2 has over Option 1, is that the sharing ratio could be set at a level that provides DNSPs with a continuous incentive over the regulatory period. For example, the sharing ratio could be set equal to the average share of the costs the DNSP would incur in each year of the regulatory control period, if the expenditure was rolled into the RAB using forecast depreciation. The precise value of this sharing ratio will obviously depend on the WACC, so if this option was to be used, the sharing ratio would need to be defined in each regulatory determination.

While it is conceivable that there are other options that could be employed, it has not been possible in the time available to conduct a thorough investigation of these alternatives. The Victorian Distributors would therefore suggest that rather than trying to lock in a specific approach in the Capex Incentive Guidelines, the AER should consider how STPIS related expenditure should be treated under the CESS on a case-by-case ex ante basis, during the Framework and Approach stage.

Ex post exclusions and adjustments under the EBSS

The AER's proposed EBSS provides for the following treatment of exclusions and adjustments:[5]

- all adjustments or exclusions forecast at the time of the regulatory determination are to be identified in the regulatory determination; and
- the AER will have the discretion to make additional ex post adjustments or exclusions (ex post mechanism) when calculating the carryover amounts at the subsequent regulatory

5 AER, Proposed EBSS – Explanatory Statement, August 2013, pp. 28-29.

determination. The two circumstances in which the AER has noted it is likely to employ this mechanism, are:

- when the forecasting method for a particular category of opex changes; or
- when a service becomes unregulated between regulatory periods.

The proposed introduction of an ex post mechanism, represents a significant departure from the AER's current practice and is of particular concern, given the degree of uncertainty it will introduce into the EBSS. In the Victorian Distributors' view, the effect that this uncertainty will have on the incentive DNSPs have to pursue efficiencies and the overall effectiveness of the EBSS, have not been adequately considered by the AER. Nor has the AER given adequate consideration to the consistency of its proposal with the revenue and pricing principles and, in particular, section 7A(3) of the NEL.

Turning now to the two circumstances in which the AER has stated it is likely to employ this mechanism. As a threshold issue, the Victorian Distributors query whether changes in forecasting methodologies and service classification are likely to occur on a sufficiently frequent basis to warrant the introduction of so much uncertainty into the EBSS. The Victorian Distributors also have the following misgivings about the arguments the AER has presented in support of its proposal to use an ex post mechanism in these two circumstances:

- *Change in approach to forecasting a category of opex between regulatory periods* – Where a change in approach to forecasting occurs, the AER has stated it would exclude this category of costs from the calculation the carryover amounts in the current period. In effect, this means that any efficiency gains derived by the DNSP on that category of costs in the current regulatory period would be passed straight through to users. Rather than being more consistent with clause 6.5.8 of the NER, this proposed treatment would contravene some important provisions in this clause, including the fair sharing principle (cl. 6.5.8(a)) and the reward for efficiency gains principle (cl. 6.5.8(c)(3)).
- *Change in service classification from regulated to unregulated* – The AER's concern in this case appears to be that if a DNSP anticipates a change in service classification, it may try and reduce costs in the current period to derive a benefit under the EBSS and recoup the costs through a higher price once the service is unregulated. In the Victorian Distributors' view, this concern is misguided because:
  - a decision on service classification must be made by the AER having regard to a range of complex matters, including the form of regulation factors. The nature of these matters is such that a DNSP could *not* readily anticipate that the service would become unregulated in the next period. The strategy described by the AER would therefore be inherently risky; and
  - a service is only likely to become unregulated if it is subject to some form of competitive constraint. [6] A DNSP is therefore unlikely to be in a position to be able to raise prices once it becomes unregulated, in the manner suggested by the AER.

[6] As per the form of regulation factors in section 2F of the NEL.

For the reasons set out above, the Victorian Distributors strongly oppose the proposed ex post mechanism, and are of the view that all adjustments and exclusions should be defined upfront in the regulatory determination.

If, notwithstanding the issues set out above, the AER decides to introduce the ex post mechanism, then it should be clearly stated in the EBSS guideline that when deciding whether to exercise this discretion, the AER must be satisfied the adjustment or exclusion is consistent with both:

- the principles set out in clauses 6.5.8(a) and (c) of the NER; and
- the revenue and pricing principles set out in section 7A of the NEL.[7]

Given the harmful effect ex post measures can have on incentives, an important factor the AER would need to consider when assessing the latter of these matters, is the effect it will have on a DNSP's incentive to seek out efficiencies in the longer run.

Accounting for the effect of taxes

One matter that has been overlooked by the AER when developing the CESS and the EBSS, is the effect that tax (net of the value of imputation credits and tax deductions) will have on the incentives provided by the schemes.

A detailed assessment of this issue can be found in the CitiPower, Powercor Australia and South Australia Power Networks joint submission. In short, this analysis indicates that if the incentives provided by the CESS and the EBSS are not adjusted to account for the effect of tax, then the following will occur:

- the post-tax rewards received by DNSPs will be *less* than 30%;
- DNSPs will *not* have a continuous incentive to pursue capex efficiencies under the CESS because the post-tax reward available to the DNSP will differ depending on the year in which the underspend occurs;[8] and
- DNSPs may have an incentive to *substitute* between opex and capex over the regulatory control period, because the incentives provided by the CESS and EBSS are not balanced.[9]

The latter two of these factors are likely to be of particular concern to the AER given its stated intention of introducing a balanced and continuous incentive regime. The Victorian Distributors would therefore recommend the AER adjust the incentive levels under both schemes to account for the effect of tax.

---

7 Given the harmful effect ex post measures can have on incentives, an important factor that the AER would need to consider in this context is whether the adjustment or exclusion is likely to have any effect on the DNSP's incentive to seek out efficiencies in the longer run.

8 As the analysis carried out by CitiPower, Powercor Australia and South Australia Power Networks reveals, the post-tax share of the reward received by DNSPs will be lower (higher) if the underspend occurs earlier (later) in the regulatory period.

9 The imbalance arises because:

- the post-tax share received by the DNSP differs across the two schemes; and
- the EBSS provides a continuous incentive to pursue opex efficiencies over the regulatory control period but the CESS does not.

Higher powered incentives for DNSPs approaching the efficiency frontier

In a number of the original submissions made to the AER's issues paper, it was suggested that higher rewards for efficiency gains should be made available to DNSPs approaching the efficiency frontier, because it can be more difficult for these DNSPs to achieve efficiencies.[10] Notwithstanding the sound theoretical basis underpinning this proposal and the success Ofwat has had in implementing a similar scheme in the United Kingdom,[11] no provision has been made for this to occur under the proposed CESS or EBSS. The AER has instead, proposed to maintain the status quo on the basis that: [12]

- there is 'limited evidence' to assess whether the current incentive is too low; and
- maintaining the current incentive rate will lead to balanced incentives across all schemes.

In the Victorian Distributors' view, the AER's dismissal of this proposal is premature, particularly given the benchmarking work it is about to embark on, which as the AER has itself acknowledged, could be used to investigate this proposal further.[13] While the Victorian Distributors recognise that this work may take some time, they consider:

- the option of applying a higher incentive rate to NSPs approaching the efficiency frontier should be left open under both the EBSS and CESS; and
- the AER's concerns about 'limited evidence' and the need for 'balanced incentives', could be addressed by making the availability of the option conditional upon:
  - the AER developing a sufficiently robust data set and methodology to identify NSPs approaching the efficiency frontier;
  - the AER or NSP demonstrating it is more difficult for NSPs approaching the frontier to achieve efficiency gains; and
  - the same high powered incentive rate being applied under the CESS and the EBSS so that capex and opex incentives are not distorted.

Circumstances in which the CESS may not be applied

Clause 6.5.8A(e) of the NER allows the AER to decide whether or not to apply the CESS to a DNSP for a regulatory control period. The Explanatory Statement also appears to contemplate that there may be times when the CESS will not be applied to a DNSP.[14] However, it is unclear from the Draft Capex Incentive Guidelines when the AER may decide not to apply the CESS.

---

10 See for example, CitiPower, Powercor and SA Power Networks, Response to the Expenditure Incentives Guidelines for Electricity Network Service Providers – Issues Paper, 10 May 2013, pp. 12-13 and ENA, AER Efficiency Incentives Guidelines for Electricity Network Service Providers – Response to Issues Paper, May 2013, p26.

11 Ofwat, Future water and sewerage charges 2010-15: Final determination, November 2009, p108.

12 AER, Proposed EBSS – Explanatory Statement, August 2013, p22.

13 ibid.

14 AER, AER, Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement, August 2013, pp. 16-32.

To provide DNSPs with greater guidance on this issue, the final Capex Incentive Guidelines should set out the circumstances (or examples of the types of circumstances) in which the AER envisages the CESS would not be applied.

Other observations

In addition to the issues raised above, the Victorian Distributors have identified the following inconsistencies when reviewing the expenditure assessment forecast and expenditure incentive draft guidelines and explanatory statements.

Firstly, the description of how the base year opex will be determined when a DNSP is found to be materially inefficient differs across the two documents. In the Draft Assessment Guideline, the following options have been identified:[15]

1. using a different base year that reasonably reflects the opex criteria; or
2. adjusting the actual base year expenditure so it reasonably reflects the opex criteria.

However, the Proposed EBSS Explanatory Statement only refers to the second option.[16]

To resolve this inconsistency, the Victorian Distributors suggest the AER:

- revise the relevant sections of the Proposed EBSS Explanatory Statement[17] so they refer to the two options set out in the Draft Assessment Guideline; and
- use the term 'adjusted base year' rather than 'base year minus adjustments' in the Proposed EBSS Explanatory Statement.

Secondly, the description of how related party contracts will be assessed differs between the Draft Assessment Explanatory Statement[18] and the Draft Capex Incentive Guidelines.[19] To remove this inconsistency, the Victorian DNSPs suggest the assessment framework in the Draft Capex Incentive Guidelines and associated explanatory statement, be brought into line with the description set out in the Draft Assessment Explanatory Statement.

Summary

The table below provides a summary of the Victorian Distributors' recommendations on how each of the issues outlined above should be addressed.

15 AER, Draft Expenditure Forecast Assessment Guideline for Distribution, August 2013, p15 and AER, Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement, August 2013, p35.

16 See for example pages 7, 15, 18 and 23 of AER, Proposed EBSS - Explanatory Statement, August 2013.

17 ibid.

18 AER, Draft Expenditure Forecast Assessment Guidelines – Explanatory Statement, August 2013, pp. 26-29.

19 AER, Draft Capital Expenditure Incentive Guidelines, August 2013, p20 and AER, Draft Capital Expenditure Incentive Guidelines – Explanatory Statement, August 2013, pp. 35-36 and 39-40.

Table 1: Summary of recommendations

Issue	Recommendations
EBSS specific issues	
Productivity factor	Including a productivity factor in the rate of change parameter violates clauses 6.5.8(c)(3) and 6.5.8(a) of the NER, sections 7A(2)-(3) of the NEL and is contrary to the AER's stated objective of implementing a balanced and symmetric incentive regime. The productivity factor should therefore be excluded from the rate of change parameter.
Ex post exclusions and adjustments	The AER's proposal to make ex post exclusions or adjustments under the EBSS will introduce a significant degree of uncertainty into the scheme and undermine the incentive DNSPs have to pursue efficiencies. The ex post mechanism should therefore be removed from the final design of the EBSS. Any adjustments or exclusions should be defined on an ex ante basis in the regulatory determination.
CESS specific issues	
Treatment of STPIS related expenditure under the CESS	The AER's proposed treatment of STPIS related expenditure under the CESS will *diminish* the incentive Victorian DNSPs have to invest in reliability and quality improvements relative to the current arrangements. This proposed dilution of incentives is unwarranted and could be addressed by either: ▪ excluding this expenditure from the CESS; or ▪ adopting an alternative sharing ratio for this type of expenditure under the CESS, with the sharing ratio set at a level that preserves the current incentive rate applying to this expenditure. Rather than trying to lock in a particular approach in the Capex Incentive Guidelines, the AER should consider this issue on a case-by-case basis in the Framework and Approach stage.
When the CESS will not be applied	The AER should set out the circumstances (or examples of the types of circumstances) in which it envisages the CESS would not be applied.
EBSS and CESS joint issues	
Effect of taxes on incentives	The incentives provided under both the CESS and the EBSS should be adjusted to account for the effect of tax (net of the value of imputation credits and tax deductions).
Higher powered incentives for NSPs approaching frontier	The option to apply a higher incentive rate to NSPs approaching the efficiency frontier should be left open under both the EBSS and CESS.

Closing remarks

The Victorian Distributors look forward to continuing to be involved in the development of both the Capex Incentives Guidelines and the EBSS and would be happy to meet with the AER if it would like to discuss any of the matters outlined in this submission further. If you would like to arrange such a meeting, or would otherwise like to discuss any of the issues set out above, please contact Renate Tirpcou on (03) 9683 4082 or rtirpcou@powercor.com.au.

Finally, it is worth noting that the Victorian Distributors have contributed to the development of the ENA's response to the Draft Capex Incentive Guidelines and Proposed EBSS. A number of the Victorian Distributors have also prepared their own submissions on issues that are of particular interest to their business. This submission should therefore be read alongside these submissions.

Yours sincerely,

Renate Tirpcou

Manager of Regulatory Projects
CitiPower Pty and Powercor Australia Ltd
On behalf of the five Victorian Distributors