3 March 2023

Mr Sebastian Roberts
Network Expenditure
Australian Energy Regulator

Submitted via email

Review of incentive schemes for networks – Draft Decision

Dear Mr. Roberts,

Energy Networks Australia (**ENA**) appreciates the opportunity to respond to the Australian Energy Regulator's (**AER**) incentive scheme review draft decision.[1]

ENA is the national industry body representing Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

The AER's incentive schemes have benefited consumers by delivering lower network prices and improved service quality, producing outcomes that are in the long-term interests of consumers. The schemes have encouraged networks to innovate and become consistently more productive over time, and ENA strongly supports the AER's proposal not to abolish the schemes.

ENA also supports the introduction of information transparency measures that are focused on improving explanations of the drivers of a network's actual capital expenditure outcomes compared to allowances. However, the proposed *asymmetric* design of the recommended tiered rate capital expenditure sharing scheme (**CESS**) has not been sufficiently justified and requires further consideration by the AER.

AER's incentive schemes have delivered for consumers

The AER's assessment of available data shows that the incentive schemes have driven significant efficiency gains, which provides long term benefits to consumers in terms of lower prices. While network service providers (**NSPs**) have been rewarded for the efficiency gains, the AER concludes that most of the incentive scheme benefits have gone to consumers.[2]

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[1] AER, Review of incentive schemes for networks: Draft decision, December 2022; and AER, Incentive review: Draft capital expenditure incentive guideline for electricity network service providers, December 2022.

[2] AER, Review of incentive schemes for networks: Draft decision, December 2022, Page 5.

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This aligns with the key findings of HoustonKemp (engaged by ENA) who estimated that the total benefits attributable to the incentive schemes is $18.6 billion (present value (PV), 2020), with consumers retaining $13.4 billion (PV, 2020) and networks receiving $5.2 billion (PV, 2020). Importantly, HoustonKemp found that the majority of benefits accrue to consumers rather than to networks, consistent with the intention and mechanics of the incentive schemes.[3]

The efficiency benefit sharing scheme (**EBSS**) provides a continuous, or constant, incentive to reduce operating expenditure, with efficiency gains and losses shared between NSPs and consumers, and the recent inclusion of a positive productivity factor that guarantees that consumers receive 100 per cent of the expected improvement in productivity over the regulatory period.

ENA supports the AER's conclusion that the EBSS is fit for purpose and operating as intended. It is incentivising efficient operating expenditure and delivering benefits to consumers, and ENA strongly supports the AER's recommendation to retain the EBSS and the current design of the scheme.

Similarly, the CESS provides networks with financial incentives to undertake efficient capital expenditure over time, to ensure that only efficient capital expenditure is added to the regulatory asset base.

The scheme is intentionally designed so that consumers receive the majority of the benefits, with consumers retaining 70 per cent of the present value of all capital cost underspends. The CESS also provides symmetric incentives, meaning that the penalties imposed on networks mirror the rewards provided by the scheme.

The AER has found that the CESS has been successful in providing incentives to NSPs to incur efficient capital expenditure and should therefore not be abolished, which ENA strongly supports.

However, the AER is concerned that in addition to incentivising efficiency gains, the CESS has the potential to also reward underspends that are not genuine efficiency gains (due to forecast error) and proposes to introduce a variable CESS rate.

As explored in prior submissions, application of a variable CESS rate can weaken incentives to deliver efficiencies and has the potential to distort incentives and create unintended consequences that are not in consumers' best interests. The potential design and implementation of any variable CESS rate option is therefore critically important.

Variable CESS rate design needs further consideration

The AER is proposing to introduce the following asymmetric tiered rate CESS to future regulatory control periods, which will apply:

» a 30 per cent sharing ratio for any underspend up to 10 per cent of the forecast capital expenditure allowance in the previous regulatory control period,

» a 20 per cent sharing ratio for any underspend that exceeds 10 per cent of the forecast capital expenditure allowance in the previous regulatory control period, and

[3] As part of this review, ENA engaged HoustonKemp to provide an independent estimate of the consumer and network benefits of the AER's incentive schemes. For more information, HoustonKemp's report can be found at Appendix A of ENA's March 2022 submission, and FAQs on the independent report can be found at Appendix A of ENA's September 2022 submission.

» a 30 per cent sharing ratio for any overspend of the forecast capital expenditure allowance in the previous regulatory control period.

Where incentive schemes have been introduced with the goal of impacting long-term investment decision-making, and they appear to be operating effectively to the benefit of consumers, there should be a 'high bar' for change and a preference for stability. The review has not found sufficiently strong evidence indicating that there is a widespread problem that requires a change to the design of the CESS, and therefore the case for reforming the CESS has not been made.

However, ENA recognises that out of all the potential variable CESS rate options, the proposed tiered rate CESS performs well from the perspective of minimising regulatory burden and maintaining simplicity. It also has predictability and certainty in application by nature of it being a "bright line" test and maintains strong incentives until the threshold is hit, all key design criteria that ENA supports. Nonetheless, it must be highlighted that this mechanism is not costless – under it, the incentive to achieve large efficiencies is blunted by its introduction. Indeed, this option may perversely impact the most efficient firms.[4]

As mentioned above, the CESS as currently designed provides symmetric incentives, meaning that the penalties imposed on networks mirror the rewards provided under the scheme. When originally developing the CESS, the AER concluded that:

> *"**We consider a symmetric CESS**, in combination with additional protection for consumers through an ex post review of capex, and the ability to adjust the CESS where capex is deferred between regulatory periods **will best ensure that future capex incurred by NSPs is consistent with the capital expenditure incentive objective**." [emphasis added]*[5]

The AER further noted that application of an *asymmetric* CESS, in combination with ex post review, could lead to perverse outcomes – in particular, the AER highlighted that NSPs would be greatly penalised for overspending whether or not their capital expenditure overspend is efficient.

The ex post mechanism allows the AER to consider the efficiency and prudency of any capital expenditure overspend explicitly. This, alongside a symmetric CESS, the AER concluded, can better address the issue of less responsive or inefficient NSPs in a more targeted way than would an asymmetric CESS.

In response to stakeholders' concerns about potential forecasting bias, the AER concluded the following when developing the original CESS:

> *It is unclear why we would introduce a higher CESS penalty to address any apparent bias towards conservatism. If there is evidence that, on average, our capex forecasts have been too conservative, this is something we should take into account when setting our capex forecasts. **Introducing a higher CESS penalty to address the apparent bias would seem to be an indirect and inferior mechanism for addressing any such imbalance**." [emphasis added]*[6]

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[4] For more information, refer to NERA's report at Appendix B of ENA's September 2022 submission.

[5] AER, Better Regulation – Explanatory Statement: Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013, Page 23.

[6] AER, Better Regulation – Explanatory Statement: Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013, Page 27.

The AER, however, is now proposing to materially alter the design of the scheme to be asymmetric in nature, based on a concern that the risk of over forecasting capital expenditure requirements remains higher than under forecasting.

It is unclear what has materially changed from the AER's previous conclusions that the introduction of an asymmetric scheme to address any potential (upwards) forecasting bias would be an indirect and inferior mechanism and, in combination with the current ex post review mechanism, could lead to perverse outcomes where a NSP is greatly penalised for overspending whether or not their capital expenditure overspend is efficient.

ENA therefore does not support the introduction of an *asymmetric* tiered rate CESS and recommends that the AER reconsider the design of the proposed tiered rate CESS to provide symmetric tiered incentives, meaning that the penalties imposed on networks for cost increases will mirror the rewards provided under the CESS.

Strong transparency measures

As explored in prior submissions, the AER has developed over time a diverse toolkit to assess and determine a networks expenditure allowance, including:

- sophisticated evaluation tools,
- detailed guidance on capital expenditure categories,
- strong information request powers,
- CESS deferral mechanism and ex post review mechanism, and
- the recent introduction of the Better Resets Handbook.

Notwithstanding these reforms, ENA does support the AER's proposal to introduce greater transparency requirements for networks on actual and forecast capital expenditure (linked to the timing of regulatory proposal submissions). These requirements, however, should focus on enabling transparency of explanations of the drivers of capital expenditure outcomes rather than a detailed line by line data collection that cost customers more without commensurate benefit.

In developing these requirements, ENA supports the Consumer Challenge Panel's recommendation that businesses should be required to provide a credible narrative to explain why their outturns differed from regulatory decisions, highlighting that this would go some way towards giving stakeholders better information to support their understanding regarding whether and to what extent incentive payments are justified.[7]

We look forward to continuing to engage with the AER through the Networks Information Requirements Review to ensure that any required reporting is made available to stakeholders in an accessible and transparent manner, thereby supporting stakeholders to make informed contributions to AER decision making.

[7] Consumer Challenge Panel (Sub-Panel CCP29), Submission to the AER on Review if Incentive Schemes Discussion Paper, 11 March 2022.

Large transmission projects require flexibility

The existing CESS may not be fit for purpose for large, discrete, non-recurrent transmission projects required to support the energy transition, and ENA therefore supports the AER's proposal to assess the application of the CESS to these projects.

ENA understands that the AER intends to allow for the flexibility, in consultation with networks and stakeholders, to either apply the CESS, not apply the CESS, or apply a weakened incentive rate to large transmission projects, dependent on a NSP's capital expenditure proposal and the degree of forecasting risk. To give effect to this position, we understand that the draft guideline will require further refinement.[8]

ENA also strongly supports the AER's proposal to undertake a review of the market impact component (**MIC**) in the transmission Service Target Performance Incentive Scheme as market developments have resulted in the MIC no longer being an effective incentive mechanism. However, we recommend that the AER reconsider the timing to ensure that the review is completed in a timely manner and able to be integrated into TasNetworks' 2024-29 transmission regulatory determination.

If you wish to discuss any of the matters raised in this response further, please contact Lucy Moon, Head of Regulation, on lmoon@energynetworks.com.au.

Yours sincerely,

Garth Crawford
Acting Chief Executive Officer

[8] AER, Incentive review: Draft capital expenditure incentive guideline for electricity network service providers, December 2022.