



**Better incentives, better outcomes:**

**PIAC submission to the AER's Issues Paper –  
*Expenditure incentives guidelines***

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## **Disclaimer**

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## **The Public Interest Advocacy Centre**

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights; and
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from the Trade and Investment, Regional Infrastructure and Services NSW for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

## **Energy + Water Consumers' Advocacy Program**

This program was established at PIAC as the Utilities Consumers' Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Park and Village Service;
- Ethnic Communities Council NSW;
- Rural and remote consumers;
- Retirement Villages Residents Association;
- Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

# 1. Introduction

The Public Interest Advocacy Centre (PIAC) appreciates the opportunity to respond to the Australian Energy Regulator's (AER) *Expenditure Incentives Guidelines Issues Paper*<sup>1</sup> (the Issues Paper), undertaken as part of The Better Regulation project.

The Expenditure Incentives Guideline (the Guideline) is an integral part of the reform of network regulation and needs to be considered in parallel to the developments in the Rate of Return and Expenditure Forecast Assessment Guidelines, to which it is closely linked.

It is only as part of a package of reform measures that all the Guidelines developed under Better Regulation will be able to effectively address the issues arising from the previous regulatory incentive framework that prompted the rule.

PIAC's response to the Expenditure Incentive Guidelines below is divided into two parts. The first part (Sections 1 and 2) outlines PIAC's key comments, including those related to the themes the AER should consider in developing the Guideline, as well as specific comments and recommendations on the issues PIAC considers most important. The second part (Section 3) contains more detailed responses to a number of the specific questions that are posed in the Issues Paper.

## 1.1 Overview

The lack of a strong capital expenditure sharing scheme (CESS) has been a major gap in the efficacy of the overall economic regulatory package to drive efficiency improvements in the provision of transmission and distribution electricity network services.

Rather than driving efficiency improvements, this gap in the capital expenditure (capex) incentive regime has been associated with a steady decline in productivity and rapidly rising network prices.<sup>2</sup>

The impact of the current relatively weak CESS varies between various network service providers (NSPs). Its impact depends on factors such as the spread between the regulated and actual cost of capital, the adoption of efficient capital management planning systems and, more generally, the extent to which a NSP might be responsive to economic incentives, or has conflicting expectations placed upon it.

There have been instances in previous regulatory periods of significant overspending of the regulated capex allowance. These events have already had a deleterious impact on consumer welfare and will continue to drive higher than necessary prices over the longer-term to the great concern of consumers.

For example, there are a number of cases where NSPs have been granted significant increases in their allowed capex, including additional allowances through regulated cost pass-through

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<sup>1</sup> AER, *Expenditure Incentives Guidelines – Issues Paper*, 2013.

<sup>2</sup> This has been confirmed in 2012 in the work of the AEMC and the Productivity Commission. For a recent assessment, see Productivity Commission, *An overview of Australia's productivity performance*, 2012.

arrangements, yet have still overspent their capex allowances by a considerable amount, up to 31 per cent in one instance.<sup>3</sup>

Whether 'justified' by the circumstances, or not, these additional expenditures have occurred without explanation to the regulator or consumers at the time they were incurred and, therefore, without the opportunity for assessment of their prudence and efficiency through the various regulatory mechanisms available to NSPs.

This additional expenditure on long-term assets will also continue to impact on prices for many years, particularly in the absence of tight management of future capex allowances by the regulator. Demand growth may over time 'catch up' with growth-related capital investments assuming there is restraint in new growth capex over the next few years. However, this will not be the case if the provision of services is conducted inefficiently.

Such a gap must, therefore, be addressed effectively and quickly in the Guideline and other processes, so that consumers are not burdened in the future with outcomes that lack transparency and are inconsistent with the National Electricity Objective (NEO) to act in the long-term interests of consumers.<sup>4</sup>

This same gap in the regulatory 'tool-kit' has encouraged some NSPs to maximise their revenue streams over time through actions such as the capitalisation of approved operating expenditure (opex) within the regulatory period, and by inflating the margins for capital and operating services provided by related bodies to NSPs. Under the current arrangements both of these actions will result in a higher regulatory asset base (RAB), and higher revenues in future determinations without any corresponding benefit to consumers.

PIAC is pleased, therefore, that the AER has put a priority on the development of a new CESS to strengthen the capacity of the regulator to bring greater discipline into NSP capital expenditures.

PIAC also supports the AER's aim to transition all electricity distribution and transmission businesses onto the new CESS as soon as possible, and in time for the next round of regulatory determinations. Current indications are that the CESS arrangements will apply to all determinations from 2015-16. This will include the NSW and ACT NSPs as the 2014-15 year is treated as a transitional year, with 2015-16 treated as the effective start of the new 4-year determination period.

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<sup>3</sup> For a discussion on capital overspending, see the report to the Australian Energy Market Commission (AEMC) by Parsons Brinckerhoff, *Report on capital expenditure overspends by electricity network service providers*, 2012. Of the four 'case studies' presented in the report, the actual capex of one DNSP was more than 31 per cent above their allowance (p 12).

<sup>4</sup> While it is noted, and welcomed, that some state governments are actively intervening to limit excess capital expenditure by the state owned NSPs, the regulatory process should not have reliance on state government intervention. Rather, and in line with the recommendations in the AEMC *Rule change: Economic regulation of network service providers*, 2012, address the regulatory flaws directly, albeit in parallel, with jurisdictional reforms.

## 2. Desired approach to incentive regulation

Overall, the Issues Paper provides an overview of the issues arising from the current incentive arrangements, as well as the directions provided by the Australian Energy Market Commission's (AEMC) rule changes<sup>5</sup>, and the risks to NSPs and consumers that will need to be considered in developing an effective CESS.

PIAC is hopeful that the AEMC's Rule changes, together with the proposed Guidelines developed by the AER, will go some way to ensuring the right balance between the legitimate rights of NSPs to an appropriate return on their investment and the long-term interests of consumers.

PIAC also acknowledges the difficulty in finding such a balance in a CESS. The CESS will need to reflect both the limitations of the data available to the AER and the additional difficulties in accurately forecasting demand, which are crucial in calculating any CESS incentives. This difficulty is exacerbated by changing consumer behaviour, including in response to various environmental programs and significant energy price rises.

### 2.1 Principles to be considered

Having noted the difficulty in calculating a CESS, there are several areas of principle that PIAC submits the AER must consider in developing their approach. These principles are:

- **The consumers' long-term interests should be the starting point of the discussion.** The AER proposes that NSPs should incur a penalty in excess of 30 per cent for capex overspending, but does not specify the amount.<sup>6</sup> Importantly, the threshold of 30 per cent and above represents an average penalty. Therefore, for some NSPs, under certain circumstances the penalty will be below 30 per cent. Consumers, on the other hand, would then face the penalty gap of over 70 per cent.

However, PIAC does believe consumers should not bear the larger penalty for such overspending. With this as a starting point, PIAC nevertheless accepts that there is a need for consumers to bear some of the risk of overspending, given the uncertainties in the forecasts. In addition, a penalty on the NSP of 100 per cent may lead to perverse outcomes for consumers and, therefore, at this stage of the development of the incentive scheme some caution is warranted.

PIAC would, however, argue strongly that the AER's default position for capex overspending should be that NSPs should bear the greater proportion of the penalty. More specifically, the minimum incentive penalty (from the NSPs perspective) should be more than 50 per cent with an average penalty even greater than this.

PIAC considers the above recommendation represents a reasonable sharing of risk between NSPs and consumers, particularly given the long-term harm to consumers that arises from excess capital investment on the one hand and, on the other, the enhanced

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<sup>5</sup> AEMC, *Rule change: Economic regulation of network service providers*, 2012.

<sup>6</sup> The Issues Paper recommends asymmetry in the penalties and rewards but is not precise about the extent to which the incentive on overspend is greater than 30 per cent (from a NSP perspective).

opportunities for NSPs to use regulatory mechanisms (such as pass throughs) to adjust their capex allowance.

The default approach recommended by PIAC would be in line with the NEO. It does not prevent NSPs using legitimate regulatory processes to manage their investment risks, but it does ensure transparency and accountability in decision making and require the NSP to demonstrate that consumers receive some net benefit from the additional capex expenditure.

PIAC submits that the AER must recognise that establishing a full CESS is complex but absolute priority, in the long term interests of consumers, must be on addressing the issue of over expenditure of capex—other issues can be progressively addressed but this focus must be front and centre.

### ***Recommendation 1***

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*PIAC recommends that where NSPs overspend on capex, the AER should set the minimum incentive penalty for NSPs at 50 per cent, with an average penalty greater than this.*

- **The CESS and the opex efficiency benefit sharing scheme (EBSS) type incentive schemes are designed to encourage cost minimisation by businesses that are seeking profit-maximisation.<sup>7</sup>**

It follows from this that where an NSP has multiple objectives, then the ability of the CESS and EBSS mechanisms to incentivise cost minimisation and efficiency may be reduced.

An effective CESS will need to address this issue and, as noted previously, ensure that the incentive power is set sufficiently high that even NSPs subject to multiple commercial and non-commercial objectives will, nonetheless, be encouraged to limit their capex to the regulatory allowance.

- **Where an NSP has access to significantly lower cost of capital than the allowed weighted average cost of capital (WACC), the incentive for efficient capex may be swamped by the benefits of greater revenue received by a higher RAB.**

When setting the incentives, particularly for overspending of capex, the AER needs to take into account the possibility of a NSP's actual WACC being less than the regulated WACC. This differential appears to have been an important factor undermining the natural incentives in the current regulatory regime, at least in some instances.

PIAC, therefore, recommends that the AER conduct some sensitivity testing so that the minimum penalty for overspending on capex is sufficient to influence the conduct of NSPs whose actual cost of capital is (significantly) less than the allowed cost of capital. PIAC has suggested that the minimum incentive power should be over 50 per cent, and the modelling could assist in defining the pre-conditions for this.

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<sup>7</sup> This is not to say that NSP's must only be driven by profit maximisation, but this must be a primary objective to which the management is held accountable. A government owned utility in particular, might have multiple objectives that will, in turn, dilute the actual power of the CESS incentives to drive efficient capex.

The impact of using actual rather than forecast depreciation (the latter being the AER's preferred position) could be assessed in conjunction with modelling the impact of WACC differentials.

### **Recommendation 2**

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*PIAC recommends that the AER conduct sensitivity testing to ensure the minimum penalty for overspending on capex is sufficient to influence the conduct of NSPs whose actual cost of capital is significantly less than the allowed cost of capital.*

### **Recommendation 3**

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*PIAC recommends that the AER undertake a critical assessment of whether there is a need for even higher incentives for capex overspending if there is evidence that a NSP is subject to multiple objectives, or if their actual WACC is significantly less than the AER's forecast WACC.*

- **Further investigation of the interactions between the CESS, EBSS and the service target performance incentive schemes (STPIS).**

The Issues Paper identifies the fact that there are interactions between a CESS, EBSS and STPIS that are important to consider in designing the CESS and EBSS.

The Issues Paper also notes that the current STIPs are 'lagging indicators'<sup>8</sup> which may limit their value in balancing the impact of CESS and EBSS on networks decisions. For instance, the impact of any postponement of capex and opex upon the quality of service delivery does not generally emerge in STIPs measures until subsequent regulatory periods.<sup>9</sup>

However, PIAC considers that the Issues Paper does not explore this issue, and the potential it provides to enhance incentive mechanisms, in sufficient depth.

A strong suite of performance incentives provides an important balancing role to a strengthened incentive regime. In particular, an effective performance incentive scheme provides a useful counter to the possibility under a stronger incentive regime that NSPs will underinvest (to avoid the risk of penalties and/or receive rewards).

PIAC therefore recommends the AER conduct further investigation into developing a suite of leading performance indicators, including specific measures on performance in known 'hot spots' in the distribution network.<sup>10</sup>

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<sup>8</sup> AER, above n 1, 38. STIPs for both distribution and transmission networks generally include measures on supply reliability such as (for distribution) system average interruption duration index (SAIDI) and system average interruption frequency index (SAIFI), but other measures are being developed by the AER.

<sup>9</sup> As the AER states, above n 1, 40 n 68, 'given the long life of electricity assets, a NSP's investment program for a given regulatory control period will only affect a small proportion of all its assets. Consequently, a decision to increase or decrease investment levels may have a negligible impact on service standards in the short run...'

<sup>10</sup> A number of possible leading indicators are identified briefly in AER, above n 1, 38, and provide a start to this process. However, PIAC would envisage further development of these over time, to provide a more integrated real time view of performance. Implementation of smart grid and smart meter technology should facilitate this process.

As part of this investigation, PIAC requests the AER to include consideration of the role that the progressive roll-out of smart grids and smart meters may play in the enhancement of performance data and the development of a leading performance indicator index.

#### **Recommendation 4**

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*PIAC recommends that the AER conduct further investigation into developing a suite of leading performance indicators, including specific measures on performance in known 'hot spots' in the distribution network.*

## **2.2 Elements of regulatory incentive design**

PIAC generally supports the AER's proposed approach to incentive regulation. Notwithstanding PIAC's view that the AER needs to further consider each of the four issues listed in Section 2.1, PIAC is largely in agreement with the AER's proposed approach.

PIAC identifies a number of key elements in the proposed approach by the AER, that require particular attention, including:

- asymmetric approach to setting the incentive power for capital expenditure, with higher penalties for over-spending capex allowances;
- a mixture of ex-ante and ex-post incentive measures;
- constant powered capex incentives during the regulatory period;
- preference for using forecast depreciation (assuming a strong ex-ante incentive regime is in place) rather than actual depreciation unless a NSP proves to be consistently resistant to other incentives;
- adjustment of the existing opex incentives approach to accommodate the use of benchmarking when setting the base operating costs; and
- retention of the symmetric 30 per cent penalty for over and underspending opex (irrespective of whether revealed cost or benchmarking was used to set the base year).

PIAC has responded to each of these proposals in detail in subsequent sections of this submission.

### **2.2.1 Continuity of incentives**

PIAC suggests that while the objective of including constant powered incentives in the CESS is reasonable in principle, there are considerable practical difficulties with its application. This is largely because the power of the incentive varies with the relative WACC, the age profile of the assets, and the year in which the investment occurs.

This difficulty was well illustrated by reference to Figure 3.1 in the Issues Paper<sup>11</sup>, which demonstrates the steep relationship between the powers of the incentive on the one hand and

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<sup>11</sup> AER, above n 1, 10.

the life of the assets, the asset class and the year in which the capex was incurred within a 5-year regulatory period on the other hand.

If constant incentives were an important aim of the capex incentive scheme, then a method would need to be found to 'average' out these factors for a particular NSP and particular asset mix and investment cycle. This would be a complex task that threatens the objective of 'light-handed' regulation.

The intersection of these two issues makes this a problem without a simple solution. PIAC, therefore, suggests that the AER conduct further investigation of alternatives to the use of continuous incentives, including (but not limited to) the development of more tailored capex profiles in the original forecasts.

An alternative approach would be for the AER to use probabilistic modelling to arrive at a reasonable range of scenarios, provide a statistical range of 'incentive' values. From this, the AER could draw probabilistic conclusions such as (for instance) there is a 90 per cent probability that an NSP would have an incentive of more than 50 per cent for capex overspending.<sup>12</sup>

### **Recommendation 5**

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*PIAC recommends that the AER conduct further investigation of alternatives to the use of continuous incentives, which includes, but is not limited to, the development of more tailored capex profiles in the original forecasts.*

### **2.2.2 Ex-post capex reviews**

PIAC acknowledges the difficulties of conducting an ex-post review of capex and, in particular, determining what additional investment over the regulatory allowance was prudent and efficient given the circumstances of the time.<sup>13</sup> Therefore, ex-ante incentives are to be preferred, with the ex-post review a last resort measure when the ex-ante incentives have failed.

It is PIAC's view, however, that the ex-post review process should be included in the Guideline. Perhaps its greatest value is one of 'moral suasion'. That is, the threat of an ex-post review is likely to impose a greater discipline and accountability on the NSP's management and board for planning within their capex allowance. The NSP would then face similar controls on capital expenditure as those faced by capital-intensive businesses operating in a non-regulated market.

In line with this, the ex-post review could also drive improvements in forecasting, control systems and planning, including the longer term network planning desired by the AER.

PIAC would also expect that the existence of an ex-post review mechanism might encourage a NSP that is facing a 'blow-out' in capex (for reasons outside their control), to use the regulatory processes such as defined contingency events, pass-throughs, reopeners, and even the new Regulatory investment test – distribution (RIT-D).

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<sup>12</sup> This is used as an example only. It would not be possible for the modelling to provide measures of the precision implied, but they could provide reasonable guidance and also be expected to improve over time.

<sup>13</sup> NER Chapter 6.2.2A (h)(2), requires that the AER must only take into account information and analysis that the distribution NSP could 'reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure'. In effect, the AER is asked to act in the shoes of the NSP decision makers as the time they made the decision; a complex task!

The use of these regulatory mechanisms to address potential capex overspending not only reduces the risks facing the NSP from exogenous events, but also greatly enhances transparency compared to the past, to the benefit of the AER, NSPs and consumers alike.

### ***Recommendation 6***

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*PIAC recommends that the Guideline include a mechanism for an ex-post review of capex by NSPs*

#### **2.2.3 Asymmetric capex incentives**

There is no empirical or theoretical reason why incentives on capex should be symmetric, nor has a reasonable case been made that asymmetry in the incentive regime will distort investment between opex and capex.

However, the Issues Paper<sup>14</sup> lists a number of reasons why asymmetry should apply to capex overspenders, with penalties for capex overspending being greater than the rewards for capex underspending.

PIAC agrees with the AER's reasoning. From PIAC's perspective the increase in prices as a result of some NSPs overspending their generous capex allowances in the past has been so significant that it is reasonable for consumers to seek a reversal of the onus of proof for future determinations.

That is, the default assumption for overspending capex should be that the NSP, not their customers, bears the greater proportion of the 'cost' (in net present value (NPV) terms), implying at a minimum, an incentive power of over 50 - 60 per cent as discussed previously.<sup>15</sup> This will automatically enhance the accountability of management and the board for efficient capital management (see above). It may also actively discourage tactics such as capitalisation of opex and enhanced related party margins.

Given the new National Electricity Rules (the Rules) provide additional requirements for planning and enhanced protections for the NSPs with respect to contingency arrangements, pass throughs, RID-D etc., a NSP acting in good faith should have little to fear from the higher penalties for capex overspending. PIAC does caution, however, that while the higher incentives are appropriate to better manage the risks to consumers of capex overspending, a higher incentive regime will place a greater responsibility on the AER to critically evaluate capex forecasts in the NSP initial proposals. This is because a higher asymmetric incentive will encourage NSPs to manage their risk through over-forecasting their requirements in their regulatory proposals.

It is, therefore, important to ensure that the AER is equipped with the models and other tools to undertake a fair but critical evaluation of capex proposals (within the requirements of the NER<sup>16</sup>) so that the incentive is not diluted by inflated forecasts.

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<sup>14</sup> AER, above n 1, 16.

<sup>15</sup> That is, at a minimum, the NSP bears 50 – 60 per cent of the penalty costs of overspending, on average, rather than the current 17 – 30 percent, depending on the age of the asset (AER, above n 1, 6).

<sup>16</sup> See NER, Chapter 6.4A and 6.5.7(distribution), and the equivalent sections of Chapter 6A (transmission).

Effective benchmarking and independent forecasting of capital inputs will be central to the success of this process, particularly if combined with ‘rewards’ such as reduced regulatory intrusion following demonstrated capacity for accurate forecasting and contingency planning.

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#### **Recommendation 8**

*PIAC recommends the AER develop a suite of leading indicator performance measurements that provide real time information on the performance of the network, to balance stronger incentives for underspending.*

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#### **Recommendation 9**

*PIAC recommends that, when assessing the level of the capex overspending incentive, the AER adopt the default position that consumers should bear the minority of the penalty costs for overspending.*

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#### **Recommendation 10**

*PIAC recommends the AER take account of the ability of new technologies to provide and store real time information on the service performance of the network.*

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#### **Recommendation 11**

*PIAC recommends the AER investigate whether the issues associated with the declining incentive power of capex incentives within the regulatory period can be dealt with by other mechanisms, given the potential complexity of the constant incentive approach.*

### **2.2.4 Opex efficiency benefit sharing scheme (EBSS)**

In general, PIAC agrees with the AER’s proposal to make only a number of minor modifications to the current EBSS (including continuing to use constant powered incentives of about 30 per cent on average), in the event that ‘revealed’ costs<sup>17</sup> are used as a basis for forecasting future costs. However, we would caution against any proposals to broaden the scope of any ex-post adjustments (discussed earlier) beyond adjustments for changes in demand.<sup>18</sup> As noted, the existing arrangements have provided a reasonable balance, and it is probably best to avoid adding any further complexity to the system. It is more transparency, rather than more complexity that is required by consumers going forward.

PIAC also agrees that the current EBSS will have to be modified if it is to be applied to regulatory determinations that use external data such as benchmarking to forecast future opex costs rather than the businesses’ revealed costs.<sup>19</sup>

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<sup>17</sup> Revealed costs are generally based on the costs observed in Year 4 (the ‘base’ year) of the current determination, they are then adjusted by a ‘step and trend’ process to provide a forecast for opex in the next determination. The assumption is that when an EBSS is in place, revealed costs represent efficient costs of a profit maximising business.

<sup>18</sup> As noted by the AER, above n 1, 32, the current EBSS allows an adjustment of the carry over amount for differences between actual and forecast demand growth.

<sup>19</sup> This is because the base opex will be set independently of the businesses actual performance in the previous period, so (for instance) excess opex in one period will have no implications in the future for the NSP or the consumer.

The AER's proposed approach, in which benchmarking is used for setting future opex, of using a symmetrical, 30 per cent, constant powered EBSS (albeit calculated and applied in a somewhat different manner to the current EBSS) appears to provide a practical solution and a degree of consistency with current practices, benefiting NSPs and consumers alike. It would be useful, however, to have more examples of the operation of this type of fixed incentive under different conditions.

More fundamentally, PIAC questions whether the existing 30 per cent (approximately) opex incentive power has driven the efficiency improvements that consumers might expect, particularly when consumers are the ones being asked to fund some 70 per cent of the opex overspend. PIAC submits that the AER has not provided any evidence that NSPs have become more efficient in their opex management, despite considerable investment in network and non-network technologies and information systems over the last 10 years. In fact, as Figure 4.1<sup>20</sup> suggests, some NSPs consistently overspend their opex allowances during the whole of the regulatory period, an outcome that would be surprising if the incentive was working as intended (as the NSP gets no additional revenue in the current regulatory period).

From this, it would appear that there are several factors working against the effectiveness of the current incentives for efficient opex:

- some NSPs are not responsive to the incentive;
- reliance on revealed costs is circular; future costs will only be at efficient levels if past costs have been at efficient levels; and
- the revealed costs plus 'step and trend' approach appears to lead to an emphasis on the factors that increase costs, rather than the trend for new technology to lower costs.

The new approach to include benchmarking as part of the opex forecasting process may address this apparent stagnation in opex efficiency growth. PIAC therefore supports the AER in further developing the proposals for applying EBSS alongside using benchmarking for the base year.

PIAC further requests, and before the opex incentive power is finalised in the Guideline, that consumers be shown more evidence that the current 30 per cent power of the EBSS has worked to drive down NSP operating costs.

### ***Recommendation 12***

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*PIAC recommends that as part of its Expenditure Incentives and Expenditure Assessment Guidelines, the AER consider that higher incentives will require more effective benchmarking of forecast capex costs.*

### ***Recommendation 13***

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*PIAC requests the AER provide more evidence that the 30 per cent incentive regime for opex has in fact driven down operating costs (measured for instance at a dollar per unit rate).*

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<sup>20</sup> AER, above n 1, Figure 4.1, 26.

### **2.2.5 Conclusion**

PIAC recognises the complexity of implementing an effective CESS and the transitional issues faced by the AER and NSPs in moving to such a regime. However, PIAC also considers this a matter of such importance to the future integrity of the regulatory regime and the trust of consumers in the process, that we urge the AER to ensure that a CESS is implemented across all electricity distribution and transmission NSPs in the next round of regulatory determinations.

PIAC submits that there are a number of important principles that the AER must consider, and the long-term interests of consumers is the starting point of the development of the Guideline. The success of regulation in this area in bringing down costs for consumers will also rest on factors including correctly targeting the continuity of incentives, including incentives that place a greater penalty on NSPs than consumers for overspending, and an efficient and effective opex benefit sharing scheme.

### 3. Response to questions

***Q1: 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?***

The Issues Paper has identified some of the key risks associated with declining incentives for efficient capex over the course of a regulatory period, including:

- lack of capex discipline in the last years (year 4 and 5) of a regulatory period;
- distortion of an NSP's decisions between capex and opex expenditure (e.g. between renewal and maintenance), including capitalisation of operating expenditure during the regulatory period; and
- risk of higher costs if capex is concentrated in later years of the regulatory period.

These risks, particularly the first risk of excess or inefficient capex expenditure in the last years of the regulatory period, are exacerbated when the regulatory WACC is greater than the actual cost of capital. Overspending against the regulatory allowed capex in the last years of the regulatory period also allows the NSP to enjoy a higher RAB in the future regulatory periods at comparatively little net cost to the NSP in the current period.

If the allowed WACC equals the actual WACC (averaged over the periods), then the benefit to the NSP of overspending their capex allowance is limited.<sup>21</sup> However, where the allowed WACC is greater than the actual WACC, which is the more common outcome of the WACC regulatory process,<sup>22</sup> then the benefit multiplies in direct relationship to the difference.

In addition, if the capex allowance for the next regulatory period is based largely on 'revealed costs' (rather than benchmark costs or bottom up engineering costs), then the impact of declining incentives will be exacerbated.

In particular, the capex incurred in the second last regulatory year (year 4), which would form the base for 'revealed costs', may be inflated above efficient levels, and thus also inflate future capex allowances. This effect would more than compensate the NSP for the approximately 10 per cent average power of the incentive in year 4.<sup>23</sup>

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<sup>21</sup> This is because, although the NSP will have a higher RAB at the start of the next regulatory period as a result of overspending of capex and, therefore, a higher return on capital allowance (in \$ terms), this does not improve the NSP's margin as the cost of capital is effectively a pass through cost. The NSP may, however, benefit in the future from a high depreciation cost allowance and/or a higher capex allowance (if the regulator applies some version of the 'revealed cost' approach to setting capex).

<sup>22</sup> This bias towards over-estimation of WACC arises from a number of factors such as: a heightened concern to encourage investment; adoption of a conservative position on each of the input parameters (i.e. no 'cancelling out' of estimation errors) and the assumed debt to equity ratio of 60 per cent (actual debt ratios are usually higher and the cost of debt is less than the cost of equity).

<sup>23</sup> The 10 per cent average figure is estimated from AER, above n 1, Figure 3.1, 10.

Further, there is a corresponding loss in long-term costs for consumers, irrespective of any differences between actual and allowed WACC because of the flow through of the higher year 4 expenditure to higher network prices in the future. These higher prices will reflect a combination of:

- greater return on capital (as a result of the increased RAB);<sup>24</sup> and
- inflated forecasts of regulatory costs (assuming a revealed cost approach).

***Q2: Do stakeholders support our initial view that any capex sharing scheme should provide continuous incentives in each year of a regulatory control period?***

PIAC understands the issues that are of concern to the AER if the power of the capex incentive regime declines over the course of the regulatory period. This could happen under an incentive regime that does not provide continuous incentives as demonstrated in the Issues Paper. That is, the power of the incentive system is undermined if it encourages an NSP to move capital expenditure into the last years of the regulatory period so that the costs of their excess investments are low, and the potential rewards higher because of the subsequent increase in the RAB.

The AER already applies a continuous incentive approach to opex assessments in the EBSS and it appears, from the data provided by the AER, to have worked reasonably well in providing consistent rewards and penalties for operating expenditure. Moreover, it may be the case that adopting a similar approach to using continuous incentives (albeit calculated differently) in the CESS and the EBSS would reduce incentives for inefficient allocation between opex and capex in any one year. That is, if the capex incentive is calculated on a yearly basis, but the opex incentive is assessed over a 5-year rolling it is possible that the balance sought between capex and opex incentives is undermined.

PIAC's major concern, however, is the likely complexity of a continuous incentive CESS process, a complexity that does not arise with a continuous incentive scheme in an EBSS.

The much greater complexity arises for capex incentives because the scheme will apply to a mix of assets with different life-cycle characteristics. Achieving a constant incentive, irrespective of the mix of assets underlying the investment cycle, will require a detailed assessment of that mix. The AER will need to specify both the capex allowance and the actual spend by asset by year by asset life, and to have a specific sharing scheme for each asset class to ensure that the power of the incentive is constant for each class over the 5 years of the continuous incentive approach. This poses a very significant regulatory challenge, and will certainly result in a scheme with significant data requirements and whose outcomes are likely to be opaque to consumers and perhaps even to the NSPs.

Another limitation of a continuous incentives scheme may arise if the scheme is applied as set out in the worked example in the Issues Paper.<sup>25</sup> Unless the constant discount factor used to

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<sup>24</sup> If the actual and allowed WACC are the same, theoretically, the net profits to the company will be same in percentage terms irrespective of the size of the RAB. However, consumers will still pay more than is necessary and there is an overall loss in consumer welfare.

<sup>25</sup> AER, above n 1, 52-53.

standardise the investment incentives across the years reflects the actual cost of capital for that investment, there will still be incentives to shift capital investment to different periods.

Given the concerns above, the question must be will the benefits to consumers of a constant incentive scheme outweigh the regulatory complexities and limitations of data?

PIAC would seek further advice from the AER with respect to these issues. PIAC would also like to see additional consideration of two issues. Firstly, whether there are simpler ways to address the issue of back-loading investment. Secondly, whether stronger incentives on over-spending capex (both ex-ante and ex-post) will address some of the issues that the AER is trying to solve through the continuous incentive proposal.

***Q3: Do stakeholders support our initial view that any capex sharing scheme should provide a reward for underspending of between 20 and 30 per cent?***

PIAC acknowledges the competing risks that must be addressed in setting the level of rewards for underspending. Given that the AER's capex allowance is designed to reflect the capital investment objective of efficient investment, to the extent that an NSP can 'beat' the efficient level of performance, they should be rewarded and to a level commensurate with the greater business risks associated with innovation and cost reduction.

Consumers benefit too, not only directly, but indirectly through the impact that a better performing NSP will have on the future performance of the all the NSPs. For instance, consumers will benefit because the good performance of one network sets an example to the industry of better management and/or technological innovation. More generally, consumers will benefit because the good performance of one NSP will move the efficiency frontier of the industry as a whole, against which other NSP's will be benchmarked in future determinations. Because the potential benefits of underspending go beyond the individual NSP and their customers, there is an argument for a strong incentive to apply where the NSP underspends its regulated capex allowance.

However, as the AER correctly highlights in the Issues Paper<sup>26</sup>, reductions in capex below allowed capex levels might arise not only from greater efficiency, but also from inefficient underinvestment, such as postponing or cancelling important capital projects, including innovative projects. Such an outcome would not be in the long-term interests of consumers even if it led to reduction in prices in the short term. In addition, there is a very real risk of 'double dipping', where an agreed capex program was not undertaken in a regulatory period but postponed to the next regulatory period, or beyond (triple dipping). In this instance, the NSP gets to keep the funds allocated to that capex project for the current regulatory period<sup>27</sup> and may then seek an additional revenue allowance to undertake the same project in the next regulatory period. Particularly if the project is critical to security by the next period, the regulator will be in a very difficult position and may find it hard to deny new capital expenditure.<sup>28</sup>

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<sup>26</sup> Ibid, 15.

<sup>27</sup> More specifically, this would be the revenue allowed in relation to recovery of the return on capital for that program and the depreciation costs for the remaining years of the regulatory period.

<sup>28</sup> The regulatory framework provides a cap on total capital expenditure, but generally does not enforce the actual expenditure on individual programs.

A further risk can arise when implementing a higher incentive reward for underspending. A high reward for underspending the regulatory allowance increases the likelihood that the NSP will seek to *over-forecast* its capex requirements in the first place. The higher the approved forecast, the easier it will be for an NSP to 'beat' the target allowance. This risk is exacerbated under the NER's Propose-Respond model, particularly when the AER has limited data available to effectively benchmark proposed capital expenditure at the proposal evaluation stage.

Such conduct (double dipping and over-forecasting) by the NSP should clearly not be rewarded in an effective incentive scheme. The regulatory determination could be regarded as a contract between the network, the AER and consumers for delivery of the agreed network services, subject to their ongoing prudence, given changing circumstances such as slower growth in demand.

However, PIAC understands that it may be difficult for the AER to decide between whether underspending reflected greater efficiency (good) or underinvestment (bad) in any particular capex project. The underinvestment risk can be reduced, but not eliminated, by the parallel development of a stronger and more comprehensive service target performance incentive scheme (STPIS) to apply to NSP service delivery performance. This is particularly the case if the STPIS, which are currently focussed on lagging indicator measures, can be extended to include output measures that are early warning signs of a decline in the condition of the network and level of services to consumers.<sup>29</sup>

Given these conflicting interpretations of underspending the allowed capex amount, along with the current limited capacity for benchmarking and information generally, PIAC agrees that a more conservative approach to setting the power of the incentive is warranted. That is, it would be preferable for the underspending incentive to be in the lower end of the range of 20 per cent to 30 per cent in the current regulatory determination process.

Over time, PIAC expects that the AER will obtain better information that will allow them to more readily discern whether underspending is a result of genuine efficiency and innovation improvements, or not. At that point, the power of the incentive for underspending might be increased. Similarly, as the AER becomes more confident in their performance measures, the STPIS can provide an increasing role in balancing the financial incentives.

***Q4: Do stakeholders agree with our initial position that the penalty for overspending should be greater than 30 per cent?***

PIAC submits that there were some very significant levels of overspending of capital by some NSPs in the previous determination period. These were subsequently rolled into the RAB for the current regulatory period. This was, in turn, an important factor in the rate of network price increases in the current regulatory period, and will continue to drive higher prices in the next regulatory period.<sup>30</sup> It is more than appropriate that the regulator impose larger penalties (and

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<sup>29</sup> For instance, average time taken to connect a customer, time taken to respond to a service call, service delivery in supply 'hot spots' etc.

<sup>30</sup> While PIAC understands there is no regulatory intention to write down inflated network assets at this stage, it should not be dismissed as an option in the event that demand continues to decline; the alternative is continued network price increases even if new capital expenditure is reduced.

therefore greater consumer protection) on NSPs that exceed their capex allowances under future determinations.

PIAC, therefore, agrees with the AER's initial position that the penalty for overspending should be greater than the rewards for underspending and in excess of 30 per cent. The AER has set out some cogent reasons for their preference for asymmetric incentives, which PIAC largely supports, including that:

- the NSP should usually be able to spend within their capital allowance, given that the AER is required under the revenue and pricing principles in the National Electricity Law (NEL) to provide a NSP with a 'reasonable opportunity to recover at least the efficient costs' incurred by the NSP in delivering the regulated services;<sup>31</sup>
- the AER faces information asymmetries in setting the capital expenditure allowance;
- NSPs respond differently to financial incentives, some requiring stronger incentives to overcome the benefits of a higher future RAB;
- ex-post provisions should be used only in limited circumstances, so greater reliance must be placed on ex-ante incentives to constrain capex; and
- the NSPs have mechanisms available in the regulatory framework to limit the risks of penalties for overspending their original capex allowance, such as provisions for contingent projects, pass throughs and reopeners.

In contrast to PIAC's support for the AER's proposal, PIAC finds no reasonable basis for the claims by some parties that there needs to be 'symmetry' between the rewards for underspending and the penalties for overspending. For example, PIAC agrees with the AER's view that asymmetric penalties and rewards between over and underspending will not, of themselves, create incentives for NSPs to distort investment. On the other hand, PIAC expects that the asymmetric penalties would actively discourage capitalisation of operating costs during the regulatory period or the inflating of related party margins (where services are provided by related parties to the NSP).

Overall, PIAC's view is that the respective rewards and penalties for over and under spending on both capex and opex should reflect the intent and nature of the regulatory framework and the respective risk and rewards for consumers of under and overspending and capitalisation policies (including excess related party margins on capital projects).

As noted previously, PIAC is strongly of the view that the regulatory regime must provide strong signals to prevent any repeat of this capex overspending<sup>32</sup> in the long term interests of consumers as set out in the National Electricity Objective (NEO).<sup>33</sup> The ex-post capex review process goes only part of the way to addressing this; it is limited by both the Rules and by

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<sup>31</sup> NEL s.7A.

<sup>32</sup> PIAC notes that in the current regulatory period, some NSPs appear to have reduced their previous approach to overspending. However, this is in the context of firstly being granted significant increases in their allowance (which may not have been justified) and pressures from their owners, state governments, to restrain this excess.

<sup>33</sup> *National Electricity Law* s 7.

practical considerations such as the difficulty of differentiating prudent expenditure from inefficient expenditure based on the circumstances of the time.<sup>34</sup>

PIAC supports the AER's views that the ex-ante incentives must provide the real 'heavy lifting' in constraining capex overspending. In addition, PIAC would expect that, from the NSP's perspective, a clearly articulated and strong ex-ante incentive mechanism would serve to reduce any regulatory risk for the NSP that might arise under an ex-post review of expenditure. That is, the 30 per cent+ penalty on capex overspends sets the minimum cost of any capital overspending to the firm (subject to approved pass through allowances and the like) and will be known by the NSP's Board and management in advance for their internal budgeting and planning processes.

This measure would encourage the sort of disciplines that already prevail for businesses in non-regulated environments, that is:

- a greater emphasis on accurate forecasting and capital budgeting;
- early action in the event that the capital budget is expected to be exceeded, such as making applications to the AER for pass throughs; and
- transparent communication with stakeholders and the AER about the capital budget constraints and potential capital budget 'blow-outs'.

The potential under the new regulatory regime for identifying possible contingency events in advance, and more generally, the move by the AER to encourage network planning over a 15 year horizon, will also contribute to this process of improved forecasting and capex management processes. A stronger ex-ante incentive will, therefore, also ensure the NSP's management team and Board has greater accountability in their capital expenditure decision-making, certainly compared to the current era where capex over expenditure was effectively a direct pass through cost from the business to consumers.

PIAC's position on this is based on the view that (with respect to networks):

- the NSP's proposal should represent their best forecast of capital investment requirements and efficient costs to deliver on these;
- the NSPs have access to recognised external independent forecasting bodies to validate their forecast assumptions, including the forecasts provided by AEMO, the use of which would help satisfy the ex-post prudency test;
- the networks have now had sufficient experience as disaggregated businesses to understand 'pure' network costs and to allocate all costs reasonably between the competitive and non-competitive elements of their business; and

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<sup>34</sup> The Rules establish that the AER can only remove capex that fails the prudency and efficiency tests based on the knowledge available at the time of making the determination (NER s 6.2.2A(h)(2)).

- the new Rules provide multiple mechanisms for the NSP to manage their risks arising from unexpected events, providing they do so in a structured and transparent way and with AER approval as set out under the Rules<sup>35</sup> (as noted previously in this submission).

In addition, PIAC argues with respect to the AER that:

- following the amendments to the Rules and the extensive consultation and research conducted by the AER as part of the Better Regulation program, it is reasonable for consumers to expect that the forecast capex in a final network price determination represents the best forecast of at least the efficient capex required to deliver the services; and
- the AER will have in place enhanced tools, such as benchmarking and reporting, to objectively assess any additional applications from NSPs for pass throughs and reopeners.

### **Capex Incentives and Opex Incentives**

PIAC acknowledges the AER's argument that the penalty rate for capital overspends should not be too different than that for operating cost overspend to avoid incentives for inefficiently shifting between capital costs and operating costs. However, such shifting from capital to operating costs is self-limiting, particularly as opex are increasingly subject to benchmarking. It should also be accepted that the risks to consumers arising from capital overspending are likely to be more significant over time, particularly when the overspending arises from poor cost control or poor network investment planning decisions.

There is an argument, therefore, that the penalty for overspending capex needs to be greater than the penalty for exceeding the allowed opex (perhaps significantly so) to provide at least partial compensation to consumers for the long-term price risk that this excess capital expenditure imposes on them. As with any incentive program, there is also a need for the incentive framework to limit the opportunities for gaming. For instance, a NSP whose capex is running at excessive levels, and in the face of stronger penalties, may choose to postpone some capex to another regulatory period, even though consumers have effectively paid for it and it would be more efficient and prudent to deliver it in the current period.<sup>36</sup>

Even if consumers benefited in the long-term, it seems to be inappropriate for consumers to pay twice for the same activity, as would occur if the project was proposed again by the NSP in the next regulatory period. In this case, the careful examination of proposals and the ex-post review would be important in controlling the risk to consumers of paying twice for the same investment proposal.<sup>37</sup> Indeed, without such vigilance, there is a chance that consumers could pay in both the original and the next regulatory period although the project is not delivered in either period; a triple jeopardy.

<sup>35</sup> See for instance, NER Chapter 6.6, 'Adjustments after making of building block determination, which sets out in detail adjustments such as cost pass through arrangements (6.6.1), reopening (6.6.5), contingent projects (6.6A).

<sup>36</sup> That is, consumers have been charged a return on capital and a return of capital (depreciation) for this expenditure, even though it has not actually been delivered to them.

<sup>37</sup> This is similar to the underspending situation discussed previously, but is a particular risk if the penalties for overspending are greater than the rewards for underspending, because a NSP has a very strong motivation to shift excess capex, and may find this preferable than undertaking a regulatory process for approval within the regulatory period.

**Q5: Do stakeholders agree with our initial position that one capital expenditure sharing scheme should apply to all NSPs?**

**Q6: If we were to tailor different schemes for individual NSPs, what criteria should we use to differentiate between NSPs?**

PIAC agrees with the AER's position that there should be one capital expenditure sharing scheme to apply to all NSPs. This does not mean, however, that the level of capital expenditure incentive should necessarily be set to the same percentage for all transmission network service providers (TNSPs) and distribution network service providers (DNSPs). For instance, there may be an argument that TNSPs, which tend to have very lumpy capital investment projects relative to their overall capital program and to their RAB, may benefit excessively from underspending (through postponement of a single large project, for instance) relative to a DNSP.

In addition, as noted previously, the power of an incentive will depend on the life of the assets concerned. This raises the question as to whether businesses whose capex is dominated by very long-lived assets (such as a TNSP) should have the incentive adjusted accordingly. More controversially, perhaps, is the question of whether the power of the incentive should be modified for other factors such as the ownership of the NSP.

The various reports prepared over the last few years by Mountain and Mountain and Littlechild, the Productivity Commission, et al<sup>38</sup> suggest a correlation between ownership structures and rapid increases in both capital expenditure and the NSP's RAB, with consequent steep price increases to consumers. There has also been a tendency for the government owned entities to consistently overspend their regulatory capex allowances.<sup>39</sup> Together, these observations suggest that the current limited incentives are not effective in driving prudent and more efficient capex.

It is also suggested that this outcome reflects the fact that the regulatory WACC allowance is significantly higher than the actual WACC of these particular NSPs. As a result, the rewards of increasing the RAB outweigh any regulatory penalties for overspending; that is, they dilute the power of the incentive.

PIAC would be concerned if this continues. On the other hand, there are now other parts of the regulatory package that may reduce the underspending risks outlined above. This is worthy of further investigation by the AER.

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<sup>38</sup> Bruce Mountain and Stephen Littlechild, 'Comparing electricity distribution network revenues and costs in New South Wales, Great Britain and Victoria', (2010) 38 *Energy Policy* 5770; Bruce Mountain, *Australia's rising electricity prices and declining productivity: the contribution of its electricity distributors*, 2011; Productivity Commission, *Electricity Network Regulatory Frameworks: Draft Report*, 2012.

<sup>39</sup> Although this trend has modified in recent years, perhaps reflecting more active intervention by the state governments in the management and operation of state owned NSPs.

**Q7: Are there any categories of capex that should not be covered by a capital expenditure sharing scheme?**

**Q8: When, if at all, might it be appropriate to make adjustments to a type of capex before applying a CESS?**

The AER is proposing that ‘once pass-throughs, reopeners and any contingent projects are added to the allowance, all other categories should be included in the CESS’.<sup>40</sup> PIAC’s view is that the new Rules provide for both the NSP and the regulator to achieve a reasonable capex forecast in the circumstances prevailing at the time, particularly given the introduction of an allowance for pre-specified contingency events. This allows uncertain projects to be reviewed and assessed at the time of the regulatory determination, facilitating subsequent inclusion in the revenue allowance if appropriate.

In addition, the NSPs can seek to recover costs associated with ‘unexpected’ exogenous events (including regulatory changes) through the pass through and reopening arrangements in the Rules as discussed previously.<sup>41</sup> Based on this, PIAC considers that all other categories of capital expense associated with the normal course of business delivering network services should be covered by the CESS.

One possible expenditure area would need to be further investigated, around the costs of innovation and IT systems. Adapting to a changing world of energy supply and demand will require investment in innovation and IT. However, these types of cost are notoriously difficult to accurately cost even with careful planning and have relatively shorter asset lives than traditional NSP assets.

Thus, issues raised by PIAC previously regarding the impacts of different classes of assets with different asset lives on the power of the capex incentive might be partly addressed by excluding short lived assets from the main CESS assessment. The AER could also introduce a modified approach to controlling overspending on short-lived assets such as IT investments with the CESS applying only to the longer-lived assets.

In addition, PIAC notes that the energy regulator in the United Kingdom, Ofgem, has recently introduced a specific revenue allowance for the costs of ‘innovation’ in recognition of the need to encourage NSPs to invest in more risky innovation projects.<sup>42</sup> PIAC would not necessarily recommend this approach in Australia at this stage. However, it is important that the regulatory framework does not penalise risks taken by NSPs in pursuit of genuine innovation, as innovation by NSPs will generally be in the long-term interests of consumers.

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<sup>40</sup> AER, above n 1, 18.

<sup>41</sup> NER s 6.6, and equivalent for transmission. Claims for pass through of exogenous events raises a separate issue regarding what ‘events’ should be built into the original forecasts. For instance, should a Victorian NSP build into their initial proposal the expected capital costs arising from a ‘standardised’ rate of bushfire events.

<sup>42</sup> Ofgem, *RIO-GD1: Final Proposals – Supporting Document – Outputs, incentives and innovation*, 2012, 54-58. For distribution NSPs, Ofgem applies a set allowance of 0.5 per cent of revenue, and additional allowances for specific approved projects.

**Q9: 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.**

PIAC has indicated its support for higher penalties on overspending than rewards for underspending; see answer to Question 4. PIAC also understands that the principle of applying a continuous capex incentive scheme has merit if there is a demonstrated issue of declining incentives and of gaming the investment profile during a regulatory period. PIAC also notes that the constant incentive approach appears to have worked reasonably well to 'smooth out' opex within a regulatory period although the circumstances and drivers for capex and opex expenditure profiles are not always the same.

However, PIAC has also argued previously that a continuous incentive scheme for capex will be considerably more complex to apply in practice because of the mix of asset types and asset age profiles that underpin the capital expenditure and the timing of the capital investments. As a result, PIAC considers that more analysis must be undertaken to clearly identify the risks and benefits of a continuous capex scheme.

Further investigation by the AER of alternatives to a constant incentive scheme that addresses the same risks without the complexities would be welcome, along with an assessment of whether the new ex-ante and ex-post incentives would of themselves reduce the problem.

**Q10: 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.**

PIAC agrees that the general approach to assessing penalties and rewards of a capex scheme should be set out in the Guideline rather than determined as part of each individual determination. It may also be beneficial to give some indication of the proposed power of the incentive to apply to all DNSPs or TNSPs in the Guideline. However, the degree to which the AER can be specific about this may be complicated by the relationship observed between average asset life (and mix of assets) and the power of any incentives.

A further consideration in using specific targets for the incentive scheme effectiveness, is that different NSPs may need different incentives to achieve the same effective incentive, because of differences in (for example), the relative cost of capital between the regulatory WACC and their actual WACC.

What is important is that the AER's incentive regime approach is:

- clearly articulated and understood through the Guideline and other communication processes; and
- the ex-ante incentive scheme is understood to be part of a package that includes the ex-post capital review, benchmarking and a strong performance incentive scheme.

Benchmarking, for example, is integral to the effectiveness of the ex-ante scheme as it limits the opportunities for NSP's to 'over-forecast' their costs in order to reduce the risk of penalties. The better the benchmarking processes, the more confidence the AER can have in the use of strong penalties for overspending and rewards for underspending.

***Q11: 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?***

***Q12: Do stakeholders agree with the factors that we have identified for consideration in determining whether to apply forecast or actual depreciation?***

In the first instance, PIAC would be most concerned if the implications of Question 11 were that there was a chance there would be no CESS in place for the next round of determinations. In saying this, PIAC recognises that establishing a robust CESS that does not create further perverse incentives is a difficult task and one that will see continuous improvement over a number of determination periods.

Nevertheless, the harm to many consumers through higher prices, caused by the previous excess capital investment spending in some jurisdictions cannot go unaddressed. Assuming that the AER has put in place a CESS to take effect from 2014/2015, and that it is a strong program that combines ex-ante and ex-post penalties, then PIAC would agree that it is most appropriate for the AER to rely on forecast depreciation, rather than actual depreciation to roll-forward into the RAB. At the same time, the AER should also ensure that these penalties are reinforced by an effective service target performance incentive program.

PIAC takes this position provided that, as suggested by the AER<sup>43</sup> with all the incentive elements in place, there should be little need to further increase the power of the incentives against overspending by using actual depreciation.

Nevertheless, PIAC agrees that it would be useful for the AER to set out in its Guideline when and under what circumstances they might prefer to use actual depreciation. For example, this would certainly be the case if there were evidence that a particular NSP was not responding appropriately to the incentive regime.

If a NSP persistently or grossly overspent the regulatory capex allowance,<sup>44</sup> and if they failed to identify these risks in their planning or take advantage of regulatory remedies, then the AER might choose to use actual depreciation in the next regulatory period, to write down the value of the 'excess' asset more quickly. This would reduce the future cost burden on consumers.

PIAC notes here the concerns by some NSPs that excess capex is not, of itself, an indication of inefficient expenditure and should not automatically be 'punished' through the incentive scheme, including by the application of actual depreciation by the AER. However, PIAC would respond to this by suggesting that if excess expenditure is a regular feature of an NSPs business performance, then the NSP should be subject to an incentive regime that encourages them to improve their planning and forecasting processes, support their claims with rigour and data, and take more advantage of regulatory instruments such as pass throughs and contingency events. This should occur in a way that provides transparency about the causes of the overspending and

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<sup>43</sup> AER, above n 1, 22.

<sup>44</sup> For instance, this could arise if there is a significant disparity between allowed WACC and the NSP's actual WACC.

more opportunity for consumer engagement in the assessment of the value to them of the relevant projects.

Such enhanced practices would also be in the long-term interests of the NSP, its stakeholders and consumers, and would be consistent with good practice and accountability in non-regulated businesses.

Finally, NSPs should not expect consumers to continuously incur the greater share of the burden, even if it was otherwise efficient. Risk exists even in the best of forecasts, but they should be shared equitably between the NSP and its customers.

***Q13: If we continue to use a revealed cost approach to forecast opex, should the same EBSS remain largely in place, or are more significant changes required?***

PIAC appreciates that there has been limited time to assess the effectiveness of the current EBSS. In addition, PIAC acknowledges that the data provided in the Issues Paper<sup>45</sup> provide little evidence that the EBSS is distorting the expenditure profile within a regulatory period for most of the NSPs. However, the data also suggests that at least some NSPs may be enhancing the fourth year (the base year for future forecasts), and this should be closely watched in the next regulatory period.

Of additional concern is that some NSPs, such as Powerlink, appear to be incurring opex consistently above their approved opex allowance.<sup>46</sup> It is not clear why this is so, and PIAC would seek further investigation as to why the EBSS appears to have failed in these particular circumstances to constrain overspending in opex. This investigation should include consideration of whether the relevant NSPs had accessed the regulatory options available for amending their forecasts (pass throughs etc.) and the impact, if any, of adjustments for exogenous factors (see Question 23 below).

***Q14: Does an incentive power of 30 per cent provide a sufficient incentive to achieve efficiency gains?***

PIAC considers that in principle, an incentive power of 30 per cent (as in the current EBSS) should provide an incentive for improved efficiency and certainly for constraining excess operating expenditure. As pointed out previously, however, there appear to be a number of NSPs where this has not happened. In these instances, if the AER continues to rely on the revealed cost approach then consumers may be paying more than necessary (noting that consumers pay around 70 per cent of the excess costs, as these revealed costs set the base for the next regulatory period).

More generally, the data provided does not in itself suggest the incentive scheme has successfully driven efficiency gains across the board (even if there has not been a decline in efficiency). It would appear most NSP's opex proposals, and the AER's approvals of these, work on the assumption of the 'revealed cost plus, plus, plus' (i.e. the so called 'step and trend' is

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<sup>45</sup> AER, above n 1, 26.

<sup>46</sup> Ibid, Figure 4.1, 26-27.

generally a step up<sup>47</sup>). Consumers, therefore, are not convinced on the evidence provided that the combination of the EBSS applied to revealed cost and 'step and trend' has delivered more efficient prices.

PIAC requests that the AER conduct a more extensive analysis to determine if the EBSS has been effective in driving improved efficiency in opex, before settling on an appropriate incentive power for opex. The adoption of benchmarking, in addition to or even replacing revealed costs, will provide some clarity on whether sufficient efficiency improvements have emerged across all NSPs. If they have not, then consideration might be given to strengthening the incentives. However, as a first step, PIAC considers that using benchmarking, together with a modified version of the EBSS that retains the average of 30 per cent incentive power, is the more appropriate approach.

***Q15: Are there any circumstances where balancing the opex incentive with the capex and service level incentives may not encourage economic efficiency?***

***Q16: Do stakeholders agree the EBSS 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?***

***Q17: Do stakeholders agree the EBSS rewards and penalties should be symmetrical, regardless of the forecasting approach?***

PIAC is not entirely clear what is meant by 'balancing' at a practical level (Question 15). However, PIAC strongly supports an approach that is based on a comprehensive assessment of how the various incentive schemes work together to achieve the desired regulatory outcomes.

The current EBSS provides a continuous incentive in each year of the regulatory control period, and this approach will continue to be useful (and practical) under either a revealed cost or a benchmarking approach. PIAC considers that there are not the same drivers for adopting an asymmetrical approach as there is for the CESS. Therefore, there is no particular issue with retaining the current symmetry between penalties and rewards, irrespective of whether the AER applies a revealed cost approach or a benchmarking approach.

***Q23: Should the EBSS provide greater flexibility as to how opex forecasts are adjusted for the purposes of calculating rewards and penalties under the scheme?***

The Issues Paper<sup>48</sup> identifies that the current EBSS allows the opex forecasts used to calculate carryover amounts to the next regulatory period to be adjusted to reflect differences between forecast demand growth and actual demand growth. That is, it limits the NSP's exposure to factors largely outside the control of the NSP.

However, PIAC would note that this removes some of the incentives to prepare more accurate forecasts, and transfers the penalties for all such forecasting error to consumers. This might be

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<sup>47</sup> For instance, labour costs are generally increased using some form of labour cost index (higher than the CPI), but there is no off-setting proposal for greater labour efficiency. Thus, overall labour costs increase above CPI.

<sup>48</sup> AER, above n 1, 31.

reasonable, if there was no incentive to bias the forecasts in the first place. However, outside Victoria, it is generally the NSP who provides the demand forecasts in their proposal and who can potentially achieve a financial benefit from over-forecasting. Although the AER can (and does) modify these forecast proposals, there remains some concern about the independence of the forecasts.

With respect to the AER's question regarding flexibility to adjust for other exogenous events, PIAC would urge caution on this Pandora's Box. The default assumption should be that there is no automatic adjustment for other events, and it is for the NSP to identify and justify why any particular event should be excluded from the calculation of rewards and penalties.

***Q24: Do stakeholders agree with having a staged approach to the ex post review?***

***Q25: Are the issues that the AER proposes to consider as part of the ex post review appropriate?***

***Q26: Are there any other factors that the AER should consider in conducting an ex post review?***

PIAC considers that the ex-post review process should not be the primary weapon in the AER's armoury, as there are many limitations in the practical application of an ex-post review. As a result, PIAC's view is that the value of the ex-post review is more one of 'moral suasion' to discourage NSPs exploiting gaps in the ex-ante incentive framework. For instance, the board of a NSP would be very cautious about exposing the business to an ex-post review that would risk recovery of its capital. It would (as appropriate) hold the management of the business accountable for their capex overspending, their failure to manage their capital budgets and/or to appropriately use the regulatory instruments available to them. In doing so, an NSP's Board would be acting with due diligence to its shareholders and in much the same way a board would act in a non-network capital intensive business.

The ex-post review process should, therefore reflect this secondary (albeit sometimes important) role of 'moral suasion'. The staged approach outlined by the AER<sup>49</sup> is consistent with this. That is, the proposed stage approach outlines a process of high level assessments against previous performance, 'reasonableness checks' and additional assessments of whether good business practices were in place. Only if these tests are not passed would the AER initiate a more detailed review of the NSP's capex program.

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<sup>49</sup> Ibid, 37.