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Australian Energy Regulator

Email: aerinquiry@aer.gov.au

Capital Expenditure Incentive Guideline Review – Consultation Paper

Dear Mr Gulbenkoglu,

SA Power Networks welcomes the opportunity to comment to the Australian Energy Regulator (AER) on the 'Capital Expenditure Incentive Guideline Review: Consultation Paper' (the Consultation Paper).

We welcome the AER extending this review beyond transmission and to examine issues of forecasting uncertainty facing electricity Distribution Network Service Providers (DNSPs, or distributors). While the CESS is largely fit-for-purpose, there are material challenges to ex-ante expenditure forecasting emerging from the transformation in the energy sector and broader economy. Regulatory response should be considered, via the CESS or other mechanisms, to maintain efficiency incentives while mitigating risks against good customer service outcomes.

Given the early stage of this review, our submission focuses on key concepts, and we would welcome the opportunity to workshop these more fully with the AER and stakeholders. Our key views are that:

- there are emerging forecasting risks facing distributors, particularly in relation to demand, climate resilience, cyber security, and new regulatory requirements, and these are more likely to result in networks incurring more capital expenditure (capex) than anticipated;
- the CESS could mitigate material forecasting risk by allowing each distributor to propose exclusions customised to their material risks, as these will vary, with proposals applying criteria to be stipulated upfront in the CESS Guideline – maintaining certainty and simplicity while allowing AER oversight; and
- addressing forecasting risk also warrants a broader review of regulatory mechanisms, which could entail allowing greater flexibility in cost pass-through arrangements, which at this stage are unlikely to capture the main sources of new forecasting uncertainty, and 'reset re-openers' with a view to making this mechanism potentially more targeted, focussed and accessible.

If you have any queries on the matters raised in this letter, please contact Bruno Coelho, Manager Regulatory Strategy on [redacted] or [redacted]

Yours sincerely

[redacted]

Jessica Morris
Chief Customer and Strategy Officer

The current CESS is largely fit for purpose

The CESS is a key pillar of the incentive regulatory framework for network businesses. It drives a continual focus on efficiency in the delivery of capex, and allows customers to share in the benefits of outperforming capex, while shielding customers from risks of over-expenditure.

In our view, the CESS remains largely fit-for-purpose. Therefore, any changes should be carefully assessed to maintain the integrity of the scheme's features that have ensured its success in driving good outcomes for customers, namely:

- simplicity, by applying to overall total capex networks have flexibility in managing their risk, innovation and efficiency efforts within this overall allowance;
- ongoing applicability, by being neutral to technology and investment drivers, the CESS does not presume that any particular expenditure category will present more or less potential to realise efficiencies over time, ensuring that it does not become out-dated; and
- up-front clarity on its symmetric application, by allowing networks to anticipate likely rewards or penalties, these factors can be accounted for in scenario planning as networks manage competing and new investment needs during the regulatory period.

There are emerging sources of increasing forecasting uncertainty

While any ex-ante forecast carries uncertainty, and mechanisms such as sensitivity testing and scenario formation, are routinely applied to reasonably manage this uncertainty, forecasting risks appear to be increasing. This is an issue not only for transmission networks, the primary driver of this consultation paper, but also for distribution networks.

Uncertainty / volatility is more pronounced when sectors undergo material structural change, and this is occurring in energy, where we see for example:

- unprecedented transformation with a rapid transition toward renewables, higher electrification, and demand-side flexibility (enabled by new tariffs and non-tariff signals) – creating challenges in forecasting demand and network capacity augmentation and potentially connections;[1]
- elevating risks for network resilience, posed by climate change driving increasingly severe and more frequent extreme weather events – creating challenges in forecasting network asset replacement and augmentation needs;
- increasing cyber security threats, with increasingly sophisticated and varied sources of cyber-crime, and increasing exposure as networks transform and rely more on Information and Communications Technology (ICT) systems in their operations – creating challenges in forecasting ICT expenditure; and
- continual changes in the role that networks must perform and their compliance obligations, including in respect to: interactions with the Australian Energy Market Operator as it evolves its own approaches to managing the NEM; ICT systems and data management etc.

Forecasting risk can materialise in either direction. However, our view is that the above factors are unlikely to lessen investment needs over time and will more likely drive networks to need to spend more than forecast in their AER Determinations. This is noting that:

- regulatory practice tends to err on the side of downward conservatism;

[1] The material revisions to AEMO's demand forecasting between its recent ISP and ESOO forecasts for South Australia, and the SA Government's recent moves toward creating its own demand forecasting capability, may be reflective of this increasing uncertainty / volatility in being able to forecast demand currently.

- networks are having to balance affordability concerns of customers, and in the case of our own Regulatory Proposal, this drove us to err toward lower cost scenarios or investment options and also not directly including climate change forecasts as a driver of network capex;
- there are remaining gaps in the regulatory framework for network resilience, inhibiting a more fulsome evaluation of efficient ex-ante expenditure to improve resilience; and
- the requirements that networks must comply with are increasingly diverse, rapidly changing and being enacted as further additions to, rather than replacements of, existing requirements.

Efficient and prudent responses to materially increased needs should not be penalised

We accept that the regulatory framework needs some constraints to networks materially over-spending capex. However, a key principle should be for the framework to not penalise a network, nor limit its ability to recover at least its efficient costs, from having to respond to a materially higher than anticipated / unanticipated identified customer service need during the regulatory period. This is providing that the network's response is prudent and efficient under the NER and NEL. Doing otherwise would not promote good customer outcomes, as it would create perverse incentives to either not effectively respond, or drive down customer service in other areas.

To promote this principle, we see a need to consider both:

- revisions to the exclusions framework in the CESS, the focus of the consultation paper; and / or
- revisions to other regulatory mechanisms, particularly cost pass-throughs and 'reset re-openers'.

The CESS should allow for customised and targeted responses to forecasting risk

Mitigating material forecasting risk via the CESS could be approached via either of two option types:

1. upfront exclusions or criteria providing triggers for exclusions (i.e. if a circumstance eventuates, the costs of the action are excluded); or
2. ex-post assessments for exclusion from penalties, noting the AER already undertakes under the NER, ex-post reviews in the case of material capex overspends.

At this early stage of this consultation, our general views on potential approaches are that:

- we do not support a one-size-fits-all CESS amendment, say by excluding a particular capex category, on the basis that:
    - each network will have differing operating environments, be at different stages of the energy transition, and be facing differing challenges and sources of forecasting risk; and
    - exclusions need to be carefully applied to ensure that they do not negate the potential that may exist to drive efficiency in a particular capex area (e.g. a capex category considered for exclusion may have both elements of non-discretion as well as potential to drive efficiency in how they are delivered);
- upfront options (1 above) by their nature will better maintain the certainty / predictability and are likely to be simpler in their application (e.g. not requiring granular assessment);
- distributors should have provision in the CESS guideline to propose in their Regulatory Proposals, the sources of material forecasting risk that they foresee, and propose their own customised exclusions, with such proposals assessed against a set of criteria:

- the criteria could mirror the approach to the transmission CESS with some nuancing;[2]
- the AER would assess proposed exclusions against the criteria via its Determination;
- distributors would have flexibility on the exclusions they can propose, be they exclusions of an entire capex category, project, program, or specific aspect of a project / program;
- distributors would need to adequately consult with customers / stakeholders; and

- ex-post options (2 above) will more likely drive uncertainty, high administrative burden on the AER and networks, and present challenges given the timing issues involved in the current capex ex-post review mechanism (i.e. the period over which actual spend is assessed) and integrating this with the CESS' measurement period.

Complementary regulatory mechanisms should also be considered

While the consultation paper focuses on the CESS, the issue of forecasting risk warrants broader consideration as there are other mechanisms that could also be improved, either in place of, or in combination with, any amendments to the CESS. For example, while CESS amendments can address the perverse outcomes from CESS penalties, the alternative would be to look to mechanisms that revise the capex forecast itself, including:

1. revising and introducing greater flexibility in the approach to cost pass-throughs, such as by:
   - revising the materiality threshold, noting there can be many large unanticipated cost imposts that while not individually material are material in aggregate; and / or
   - revising the list of potential types of cost pass-throughs, noting that of the potential sources of forecasting uncertainty that we described above, only new regulatory requirements would currently be captured by pass-through provisions (again only if they meet the high materiality threshold individually); and
2. revising the current 'reset re-opener' mechanism in the NER, to potentially make it a more targeted and focussed process, and with a potentially more accessible materiality threshold.

[2] The current criteria of considering consumer benefits from the exemption, the size of project (this could be augmented with reference to programs also), degree of capex forecasting risk, and views of customers / stakeholders, all appear to be relevant principles for a distribution context.