AUSTRALIAN ENERGY REGULATOR

Better Regulation: Draft expenditure incentives

9 August 2013

The Australian Energy Regulator (AER) commenced the Better Regulation program in December 2012. Today we released our draft capital expenditure incentive guideline and proposed operating expenditure efficiency benefit sharing scheme for consultation. Together, these provide better incentives for network businesses to spend efficiently and to share the benefits of efficiencies with consumers.

What is the Better Regulation program?

The AER initiated the Better Regulation program following changes to the electricity and gas rules in late 2012. The program brings together improvements to our regulatory approach with other important reforms announced by the Prime Minister in December 2012.

> The Better Regulation program delivers an improved regulatory framework focused on the long term interests of electricity consumers.

The Better Regulation program involves:

- extensive consultation on seven new guidelines that outline our revised approach to determining electricity network revenues and prices
- establishing a consumer reference group for our guideline development work
- forming an ongoing Consumer Challenge Panel
- improving our internal technical expertise and systems.

What are expenditure incentives?

There are several mechanisms to promote network businesses spending efficiently. Some mechanisms provide up front incentives, these are called ex ante measures. Other mechanisms look at past expenditure, called ex post measures. Service providers' spending can be on two types of expenditure—capital expenditure (capex) and operating expenditure (opex).

In developing incentive mechanisms for capex and opex our overall objectives are to:

- incentivise businesses to spend more efficiently on capex and opex
- protect consumers from paying prices that reflect inefficient capex
- share efficiency improvements and losses between businesses and consumers.

Incentives don't operate in isolation. Our ex ante measures and ex post measures interact with one another, along with our approach to forecasting set out in our draft expenditure forecast assessment guideline. Our expenditure incentives measures and expenditure forecasting approach operate as an overall package.

> Together, our expenditure incentives and our approach to expenditure forecasting provide appropriate incentives for businesses to spend efficiently. Consumers will not pay for inefficient overspends.

What are the upfront incentives on capital expenditure?

The draft capital expenditure incentives guideline outlines our new capital expenditure sharing scheme (CESS). The CESS creates better incentives for businesses to spend efficiently on capital, and share efficiency gains with consumers.

> Consumers and businesses will share the cost of efficient overspends on capital, and share the benefits of efficiency savings on capital.

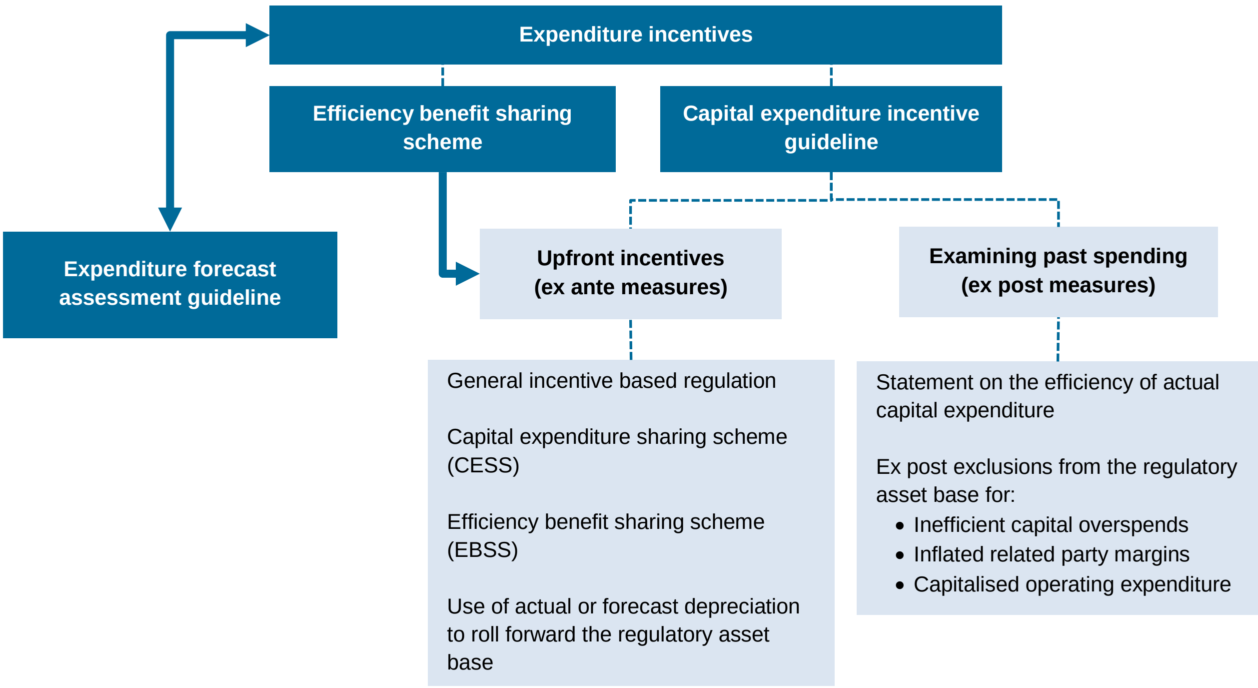
Our proposed CESS will apply equally to all network businesses. It provides a 30 per cent reward to businesses for becoming more efficient with capex (underspending), and a 30 per cent penalty for becoming less efficient (overspending).

What are the upfront incentives on operating expenditure?

Our proposed efficiency benefit sharing scheme (EBSS) gives businesses an incentive to spend efficiently on opex, and share efficiency gains with consumers. The EBSS is already in operation and rewards businesses for becoming more efficient with opex, and penalises them for becoming less efficient.

We reviewed the EBSS to ensure it provides opex incentives consistent with our improved forecasting approach and new capex incentives. Our decision is closely linked with our approach to forecasting.

How the expenditure measures fit together



We propose the current EBSS continue largely in its current form. We propose to make some changes to ensure it operates in conjunction with the new CESS and with our new approach to expenditure forecasting.

> We will largely maintain the current EBSS under each of our opex forecasting approaches. The EBSS provides incentives for businesses to pursue on-going efficiencies. We will address concerns about inefficient spending on opex through our forecasting approach—we won't use a business' past spending to set its expenditure allowance where a business is materially inefficient.

How will we examine past capital expenditure?

Our draft capital expenditure incentives guideline also outlines the new ex post measures. Ex post measures ensure consumers do not pay for inefficient spending on capital.

> The ex post measures alongside a CESS with equal rewards and penalties, will minimise inefficient capex overspends. Under the CESS and the ex post review together, a business will lose between 30 and 100 per cent of any overspend.

If a business spends more on capex than its allowed capex forecast, we will review the efficiency of the overspend. We can exclude inefficiencies from the service provider's asset base meaning consumers will not pay for inefficiencies.

How can I provide a submission or comments?

We invite interested parties to make submissions or comments on our draft capital expenditure incentives guideline and proposed EBSS. If you would like to have your say prior to us publishing the final guidelines and schemes, you have until close of business **20 September 2013** to get your submission or comments to us. You can find further details on how to provide your submission on our incentives web page www.aer.gov.au/node/18869, or you can email us at incentives@aer.gov.au.

For more information

For more information or to get involved in the consultation processes for the Better Regulation program, please visit our website www.aer.gov.au/better-regulation-reform-program or email us at betterregulation@aer.gov.au.