



20 September 2013

Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Dear Mr Roberts

AER Draft Expenditure Incentive Guidelines and Explanatory Statements

APA Group (APA) welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) draft explanatory statements and guidelines for the capital and operating expenditure incentive schemes.

APA is a major ASX-listed energy infrastructure business, owning and/or operating over \$12 billion of assets. These assets include significant gas transmission and distribution interests, as well as investments in the Murraylink and Directlink electricity interconnectors which operate in the National Electricity Market.

Capital and operating efficiency incentive schemes

Symmetrical incentives

APA notes that the AER considers that its proposed Capital Efficiency Sharing Scheme (CESS) and Efficiency Benefit Sharing Scheme (EBSS) operate symmetrically because the reward for efficiency savings is the same as the penalty for efficiency losses. APA does not agree with this conclusion.

APA considers that for a scheme to be symmetrical it is not sufficient for just the rewards and penalties to be symmetrical; a service provider must also have a reasonably symmetrical opportunity to either earn a reward or face a penalty.

APA is concerned that the interaction between the proposed incentive schemes and the AER's intended approach under the Expenditure Assessment Guideline may make both the capital and operating expenditure incentive schemes effectively asymmetric. This is because, under the Expenditure Assessment Guideline, the AER intends to substitute benchmark data where the business's historic or forecast expenditure is considered to be inefficient, instead of using the business's revealed costs. In this case, the regulated business's opportunity to make an efficiency gain in respect of its allowance is not symmetrical, as the allowance is set significantly below the business's actual costs.

Embedded in the AER's approach is an assumption that the only efficiency gains that should be rewarded through incentive schemes are those that are made at the efficiency frontier. By implication, the AER assumes that all other efficiency gains made by businesses are catching up to the frontier, and therefore ought not to be rewarded. Notwithstanding the data issues that will, for the foreseeable future, necessarily limit the AER's scope to determine the difference



between these two circumstances, APA considers that for a scheme to operate symmetrically in respect of efficiency gains at the frontier, it must be as likely for a business at the efficiency frontier to make an efficiency gain as to make an efficiency loss.

In practice, efficiency gains at the frontier are difficult to execute, and often involve the risk of an initial cost outlay. In order to encourage businesses to take such risks (and in effect to ensure that the scheme operates to encourage efficiency), rewards for efficiency gains should be greater than penalties for efficiency losses. This is required to at least compensate the business for costs associated with efficiency gains as these costs erode the value of efficiency gains and make efficiency projects harder to justify. Without recognition that efficiency gains at the frontier are more difficult to make than efficiency losses, APA considers that the AER's incentive schemes cannot be considered to be symmetrical.

Incentivising efficiency

The AER states that its proposed incentive schemes are intended to operate as mechanisms that reward businesses for expenditure efficiency gains, and penalise businesses for expenditure efficiency losses.¹ APA is concerned that the AER's schemes are not sufficiently targeted to achieve this outcome, and instead operate to reward or penalise businesses for changes in costs compared to forecasts, regardless of the driver of those changes in costs. Where these changes in costs are not related to efficiency, the schemes can operate to discourage efficient investment rather than encourage it.

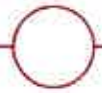
APA considers that this concern particularly arises where an incentive scheme would operate to reward or penalise a business for changes in costs that are not within its control. APA considers that uncontrollable costs include changes in fees, taxes or levies, and other changes in costs that are externally imposed or not controlled by the service provider, for which there is not a reasonable expectation of symmetry in forecasting risk (that is, that costs can both increase or decrease). By definition, movements in these costs are not related to efficiency gains or losses. For a frontier efficient firm, changes in these costs can also lead to a penalty under the scheme as there are limited (if any) further offsetting cost reductions to be made.

For these reasons, APA does not support the AER's draft decision to include changes in uncontrollable costs in calculations of rewards or penalties under the EBSS. Uncontrollable costs are not limited to changes in network growth as suggested in the Explanatory Statement, where arguably network businesses do face symmetrical forecasting risk. In practice, uncontrollable costs are those where changes are unrelated to the business's efficiency or forecast accuracy.

In contrast, the AER's intent in including uncontrollable costs appears to be more closely related to shielding customers from these cost changes (that is, having businesses bear a higher proportion uncontrollable cost increases) than providing incentives around changes in efficiency of regulated businesses.² APA considers that shielding customers from uncontrollable changes in costs is not the intention of the schemes, either in the National Electricity Rules or as stated by the AER in its draft Explanatory Statements, and ought not to be an outcome of either of the schemes.

¹ Australian Energy Regulator 2013, *Better Regulation: Draft Capital Expenditure Incentive Guidelines Explanatory Statement*, August, p 16; Australian Energy Regulator 2013, *Better Regulation: Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, August, p 6

² AER 2013, *Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, pp 26-7



The National Electricity Rules focus on the fair sharing of *efficiency* gains or losses arising from differences between actual and forecast expenditure, rather than just simply the difference between actual and forecast expenditure.³ The Explanatory Statements similarly discuss promoting efficiency as the primary aim. APA does not consider that this is achieved by including uncontrollable costs in the calculation of the EBSS or CESS. APA therefore considers that uncontrollable costs should be excluded from the operation of the EBSS and CESS.

Operation of incentive schemes under longer regulatory periods

The National Electricity Rules for electricity transmission and distribution businesses provide for regulatory control periods that are longer than five years. As currently drafted, the CESS and EBSS guidelines appear to only contemplate five-year regulatory terms. APA considers that the operation of the incentives schemes should be able to accommodate longer regulatory control periods without changing the level of risk to be faced by the regulated business under the incentive schemes as determined by the AER in the guidelines.

AER proposed Capital Efficiency Incentive Scheme

APA considers that large customer driven augmentations are not within the control of the regulated business and ought not be included in the operation of the CESS.

Customer driven augmentations can vary considerably in respect of scope and timing as the customer in question develops and alters its plans, potentially in response to other market pressures (for example commodity prices). As a result, these types of augmentations can arise very quickly. Conversely, previously 'certain' projects can be significantly delayed or even cancelled at short notice.

Expenditure associated with customer-driven augmentations is likely to be beneficial to other customers (otherwise it would not pass the relevant regulatory test); however this expenditure may not be included in forecast capital expenditure, or contemplated in existing contingent projects. For this reason, APA previously recommended that augmentations of this type be excluded from the operation of a CESS for transmission businesses. This is particularly an issue for transmission businesses because of the potential for a small number of projects to represent a very significant proportion of proposed or actual capital expenditure.

APA considers that the inclusion of such projects in the CESS is likely to lead to transmission businesses receiving a significant windfall gain or loss as a result of changes in customer activities that are in no way related to the efficiency of the regulated business. Forecasting risk is also unlikely to be symmetrical as a change in a single project can dominate the incentive scheme outcome for a business. In light of the AER's aim to incentivise efficient investment, APA urges the AER to reconsider its draft decision to include these projects in any CESS applying to transmission businesses.

Ex post capital measures

APA supports the AER's decision to shield any capital expenditure that is excluded from the regulatory asset base as part of the *ex post* review from the operation of the CESS. APA considers that it is inappropriate for businesses to be penalised twice for such expenditure.

³ For example, National Electricity Rule cl 6A.6.5(a)



AER proposed Efficiency Benefit Sharing Scheme

Exclusions from the scheme

APA considers that it is very important for any incentive scheme to be fully specified up front so that the regulated business can understand and calculate likely efficiency rewards and penalties before making expenditure decisions. This is because many efficiency gains involve some initial expenditure, and the regulated business must be able to determine whether any rewards it receives under the scheme are sufficient to justify that expenditure. Without such knowledge, regulated businesses are unlikely to undertake such investments, and customers would miss out on efficiency improvements.

Because of the need to be able to quantify the costs and benefits of efficiency improving investments up front, APA is concerned over the AER's stated intention to retain discretion to make additional adjustments or exclusions *ex post* to carry over amounts.⁴ APA considers that the AER's proposed criteria to exclude categories of operating expenditure where the exclusion "would better achieve the requirements" of the rules to be so broad and vague as to be meaningless in providing certainty to service providers as to the AER's likely actions in setting forecast expenditure, and adjusting incentive scheme penalties or rewards.

The AER states in the Explanatory Statement that this discretion will be applied where it determines to use a different methodology to forecast a category of costs between regulatory periods. In this case the AER states that it will exclude those costs when calculating the carryover amounts of the current period.⁵ Notwithstanding that this guidance is not included in the draft Guideline, APA considers that this approach is almost certain to remove any incentive for businesses to make efficiency gains in the very areas where the AER would argue efficiency gains should be made (that is, those areas where costs are higher than the benchmark). This is because any expected rewards from those efficiency gains will not be retained by the business in the following period, as that category of costs will be removed from the scheme for the purposes of calculating carryover amounts.

The AER further argues that the discretion it seeks is necessary to ensure there is "fair sharing" of efficiency gains.⁶ APA is unclear how the AER would determine whether a particular outcome represented fair sharing of efficiency gains or not. The AER recognised this earlier in its explanatory statement where it states "In practice it can be difficult to conclude that some increases in opex are inefficient."⁷ This suggests a level of subjectivity in the AER's decisions that would be inappropriate under the regulatory regime.

The AER's proposed approach also runs contrary to statements on the same page of the Explanatory Statement that:

For instance, if a NSP expects it will not be able to deliver opex at or below our new forecast, an efficiency improvement that lowers its opex in one period will reduce the costs it faces in the next period as a result of the lower forecast. In addition, such an efficiency improvement will also increase the carryover amounts the NSP receives in the next period through the EBSS.⁸

⁴ AER 2013, *Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, p 16

⁵ AER 2013, *Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, p 28

⁶ AER 2013, *Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, p 29

⁷ AER 2013, *Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, p 23

⁸ AER 2013, *Proposed Efficiency Benefit Sharing Scheme Explanatory Statement*, p 23



The AER's proposed approach would make this reasoning incorrect and undermine the scheme.

APA considers that the AER should reconsider its proposed approach to reserve discretion to adjust the operation of the scheme *ex post*. APA considers that this approach will undermine the incentive properties of the scheme and ought not to appear in the AER's final Guideline.

Please contact Alexandra Curran, Regulatory Manager on 02 9275 0020 if you would like further information on this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. Bolding', written in a cursive style.

Peter Bolding
General Manager Regulatory & Strategy