

The Australian Energy Regulator

Public Forum
April 29

Expenditure incentive guidelines
Presentation on key issues

The aim of today's presentation

- **Inform stakeholders about the expenditure incentive guidelines and receive preliminary feedback**
 1. Measures for efficient capital expenditure (capex)
 - Ex ante measures
 - Capital expenditure sharing schemes
 - Whether to use actual or forecast depreciation to roll forward the RAB
 - Ex post measures
 - Statement on the efficiency of actual capex
 - Excluding capex from the RAB
 2. Revisiting existing efficiency mechanisms for operating expenditure (opex)

Overarching objectives of the guidelines

- The expenditure incentive guidelines will cover a number of mechanisms and approaches that, taken together, should:
 1. Incentivise electricity network service providers to undertake efficient capex and opex and balance incentives for cost reductions and service improvement
 2. Safeguard consumers from paying prices that reflect inefficiently incurred capex
 3. Provide for appropriate sharing of efficiency benefits between consumers and NSPs

Current incentives for efficient capex

- No formal sharing schemes currently apply to capex, but there are incentives for efficiency built into the regime:
 - NSPs can keep the benefit/bear the cost of an underspend/overspend during a regulatory period
 - consumers benefit/bear a share of the costs at the end of the regulatory period when expenditure is rolled into the RAB and new prices are set
- The current regime provides an average 'incentive power' of approximately 17 to 30 per cent, depending on the life of the asset
- **Problems:**
 1. the incentives for capex may need to be strengthened as incentives decline throughout the regulatory period
 2. the current arrangements may not provide sufficient protections for consumers

A capital expenditure sharing scheme (CESS)

- **What is a CESS?**

- Provides incentives for NSPs to incur efficient levels of capital expenditure
- Shares overspends/underspends between NSPs and their customers

- **What do the rules say?**

- Requirements for a CESS are contained in clauses 6A.6.5.A (transmission) and 6.5.8A (distribution)
- In developing any CESS the AER must take into consideration:
 - Principles: rewards and penalties to be commensurate with efficiencies and inefficiencies
 - The capital expenditure incentive objective (aligns with ex ante capex requirements – i.e. efficient and prudent)

How a CESS could address the issues

Initial positions

1. A CESS should provide continuous incentives for capex
2. The penalty for overspending would be greater than 30 per cent, and the reward for underspending would be between 20 and 30 per cent
3. One CESS could apply for all NSPs
4. Sharing ratios would be included in the guidelines to provide greater certainty to NSPs

How a CESS could address the issues

Continuity

- To address declining incentives, a CESS could be designed to provide continuous incentives over the regulatory period
 - i.e. the incentives would be the same in each year of the regulatory period
- Continuous incentives have the benefits of:
 1. better aligning the incentives between opex and capex
 2. providing NSPs with greater incentives to manage their capex programs on a continuous basis
- Submissions to the AEMC process tended to support a continuous CESS

How a CESS could address the issues

Rewards for underspending

- In light of the existing regime, we consider that a range of 20 – 30 per cent for rewards is an appropriate starting point
- High rewards for underspending would have perverse outcomes:
 - NSPs might under-invest to the detriment of service levels
 - NSPs might capitalise opex and substitute between opex and capex due to differing incentives between the two classes of expenditure

How a CESS could address the issues

Penalties for overspending

- For the penalty we believe that a higher incentive rate is justified (that is, greater than 30 per cent)
- Reasons why the penalty should be higher than the reward include:
 - NSPs should usually be able to spend within their allowances
 - We face asymmetries given the non-recurrent nature of capex in setting capital expenditure allowances, meaning that forecasts are likely to be biased upwards
 - The use of ex post revisions will be targeted and focussed
 - There are factors to prevent NSPs from uncontrollable or uncertain events

How a CESS could address the issues

A 'one size fits all' approach

- Different schemes could apply to different NSPs based on ownership (government owned or privately owned) or type (DNSP or TNSP)
- State government owned NSPs might respond differently to financial incentives than do privately owned NSPs
- There are differences in the nature of capex for TNSPs and DNSPs
 - TNSP capex tends to be associated with larger projects and longer lead times, whereas DNSPs' capex is usually composed of smaller programs of work
- We consider that these differences do not justify different schemes but are interested in your views

Key questions on the CESS

Key questions

- Do stakeholders support our initial view that any CESS should support continuous incentives?
- Do stakeholders agree that the reward for underspending should be between 20 and 30 per cent?
- Do stakeholders agree that the penalty for overspending should be greater than 30 per cent?
- Do stakeholders agree with our initial position that one CESS should apply for all NSPs?

Current incentives for efficient opex

- NSPs are incentivised to undertake efficient levels of opex spending through an efficiency benefits sharing scheme (EBSS)
 - Under the EBSS overspends and underspends are carried forwards for 5 years
- As well as providing incentives for efficiency, the EBSS allows us to use actual opex in year 4 to set future opex allowances.
- The EBSS has only been in place for a limited time, but it appears to have worked well to date

Changes to opex incentives

Why revisit the current incentives for opex?

1. Capex and opex are somewhat substitutable
 - It is important to reassess the opex guidelines in light of the new capex incentives framework to limit any distortions
2. We are proposing changes to the opex forecasting methodology (through the expenditure forecast assessment guidelines) and this will change the role of the EBSS

Changes to opex incentives

Opex incentives under benchmarking

- If we use a different approach other than revealed cost to forecast opex, the current EBSS will need to be modified.
- Under exogenous forecasting approaches, without an EBSS a NSP will have a very strong incentive to reduce its opex (i.e. a marginal sharing ratio of 100:0)
 - But, there are a number of reasons to dilute the strength of this incentive:
 - to share efficiencies between NSPs and customers
 - to balance the incentives of efficiency against service standard improvements
 - to share the impact of forecasting error between NSPs and customers

Changes to opex incentives

Initial position

- Retain existing form of EBSS where revealed costs approach is used to forecast opex
- If revealed cost is not used, apply incentive mechanism that achieves similar outcomes as the current EBSS:
 - Symmetry
 - Continuity
 - 30:70 sharing ratio

Key questions on opex incentives

Key questions

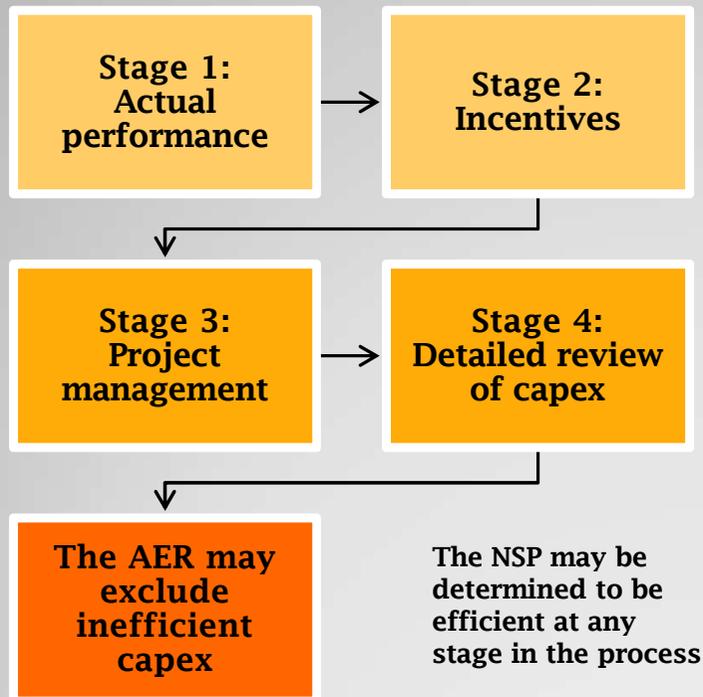
- Do stakeholders support our initial position that the current form of EBSS should be retained where the revealed cost approach is used to forecast opex?
- Do stakeholders agree with our initial position that if revealed cost approach is not used, a 30:70 sharing ratio should apply?

Statement on the efficiency of capex

- **What is the statement on the efficiency of capex?**
 - An assessment of a NSP's capex after it has been incurred
 - Outlined in clauses 6.A.14.2(b) (transmission) and 6.12.2(b) (distribution)
- **What the review will address and how**
 - Aims to address a pre-existing lack of regulatory scrutiny regarding capex before it is rolled into the RAB
 - The AER is explicitly allowed to preclude inefficient capex above a NSP's allowance from entering the RAB
 - The review covers the last two years of the previous period and the first three years of current period

Statement on the efficiency of capex

The review may be a staged process



Selected sample questions by stage

Stage 1: How does the NSP's actual capex compare to its ex ante capex allowance?

Stage 2: Does the NSP have incentives to undertake only efficient capex?

Stage 3: Does the NSP use appropriate asset management and planning tools?

Stage 4: Engineers are engaged to assess a sample of the NSP's projects to assess these for prudence and efficiency

Excluding capex from the RAB

- **Capex exclusions from the RAB**

- Three categories of capex may be excluded from the regulatory asset base:

1. Inefficient overspends
2. Capitalised opex
3. Related party margins

- **Inefficient overspends**

- This will draw on the conclusions of the ex post statement – there will be no double penalty between the CESS and capex removed from an ex-post review
- While there are ex ante incentives for NSPs to spend within their allowances, some NSPs may not respond strongly to these incentives
- Without the ability to review a NSPs actual capex, and exclude any inefficient capex from entering the RAB, consumers will bear the majority of the inefficient costs

Excluding capex from the RAB

Key questions

- Do stakeholders agree with our initial positions on the ex post review process?