AUSTRALIAN ENERGY REGULATOR – BETTER REGULATION PROGRAM DRAFT CAPITAL EXPENDITURE INCENTIVE & EFFICIENCY BENEFIT SHARING SCHEME GUIDELINES

COMMENTS

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1 Introduction

The Council of Small Business Australia (COSBOA) supports the need for better regulation in Australia, the Australian Energy Regulator's (AERs) involvement in this and the efforts of the AER to engage with consumers (and their representatives) in a meaningful way on its Better Regulation Program (BRP). COSBOA also appreciates the opportunity to provide written and other input to the BRP, including through this submission.

This submission responds to the AER's *Draft Capital Expenditure Incentive and Efficiency Benefits Sharing Scheme Guidelines* and the accompanying *Explanatory Statements,* released in August 2013. We appreciate the considerable thinking, work and effort that have gone into producing these documents.

COSBOA has previously provided a submission on the AER's Expenditure Incentives Issues Paper in which it made detailed comments on many issues raised in that paper. Our comments in this submission therefore are more targeted and respond to a selected number of matters raised in the Draft Guideline that are important to small business. These mainly relate to areas where the AER has diverged from the position it took in the Issues Paper, or where we felt further comment was otherwise warranted.

Our previous submission also outlined why the matter of expenditure incentives is important to small business, COSBOA's position on expenditure incentives and the BRP more generally, and established COSBOA's *bona fides* in relation to the BRP. A list of COSBOA members is attached to this submission.

The following section (2) comments on the Draft Capital Expenditure Incentive Guideline. Section 3 then comments on the Draft Efficiency Benefit Sharing Scheme (EBSS) Guideline.

2 Comments on Capital Expenditure Incentive Guideline

This section comments on parts of the AER's Draft Capital Expenditure Incentive Guideline that are particularly relevant to small business. As mentioned earlier, these mainly relate to areas where the AER has diverged from the preliminary position it took in the Issues Paper or where we felt further comment was otherwise warranted.

By way of background, COSBOA remains extremely concerned that the capital expenditure (capex) of network service providers (NSP) has grown excessively and without justification, and has been one of the main contributors to rapidly rising network charges. This applies especially to government-owned NSP, which make up the bulk of the NSP sector. This is not a situation that can be allowed to continue.

We acknowledge that the AER's expenditure incentives work stream aims to help address this issue, which we believe is one of the most important aspects of network regulation that need to be corrected in the next regulatory period. However, after reviewing the Draft Guideline, we are very concerned that the opportunities to do this have not been maximised and that the AER has opted for approaches in some areas which are backward steps from its previous position. This is not in the long term interests of consumers, nor does it, as adequately as it should, support the desire of the Council of Australian Governments (COAG) and the Standing Council on Energy and Resources (SCER) to see reform of network prices in the interests of consumers. We therefore urge the AER to review these parts of its Guideline prior to finalisation.

2.1 Capital Expenditure Sharing Scheme

A number of elements of the AER's Capital Expenditure Sharing Scheme (CESS) are commented on below.

2.1.1 Continuity

The AER proposes to implement a CESS which is continuous in the sense that it provides penalties (rewards) that are continuous over time, i.e., within each year of a regulatory period and between regulatory periods. COSBOA agrees with the principal behind this and supported the AER's approach in its previous submission. However, after reviewing the Draft Guideline and submissions on the Issues Paper we formed some doubts about the ability of the continuous incentives approach.

The point has been made that the uncertainties of forecasting into the future detract from continuous incentives and that declining incentives might be more appropriate, including to reduce incentives on NSPs to defer capex between regulatory periods. The AER acknowledges this in the Explanatory Statement, but feels that it would be difficult to determine whether a decision to defer capex is inefficient or opportunistic. It proposes that the issues of capex deferral should be addressed through forecasting and assessing proposed capex.

Whilst we can see merit in adopting declining incentives, we accept the outcome of the AER's consideration of the issues raised and its need to balance conflicting matters in forming its position. However, we remain concerned that reliance on forecasting and assessments of capex proposals also has weaknesses which may not overcome the problem.

2.1.2 Scheme Symmetry and Levels

The AER proposed an asymmetrical approach to the CESS in its Issues Paper, with penalties for overspending proportionately larger than rewards for underspending. COSBOA supported this approach on the basis of its consideration of the arguments in support of it. In particular, the propensity for NSPs, especially government-owned ones to overspend capex, including through their actual Weighted Average Cost of Capital (WACC) being much lower than their regulated WACC, made larger penalties for overspending capex important. We further suggested separate treatment of government-owned NSPs to recognise this.

We felt that such asymmetry was an important component of the CESS and that it would give consumers greater confidence about the scheme, as well as the ability of network regulation to discipline capex overspends. We are therefore disappointed that the AER has changed its position on this.

We have examined the AER's reasons for this and comment on these below:

- The AER was concerned about the generous capex allowances received by NSPs, a view that we share. Whilst it appears that the AER still holds this view, it now holds a position that this would be better addressed through its assessments of expenditure proposals rather than by asymmetric incentives in the CESS. This appears to have followed questioning by and suggestions put by NSPs. Whilst in a perfect world it might be best to address the generosity of capex allowances directly through expenditure assessments, there are also risks in such an approach with less than perfect information, a situation the AER will continue to face notwithstanding its endeavours to improve its expenditure assessment approach. It is highly unlikely that the improved techniques the AER is developing will completely overcome the information asymmetry issues it faces in assessing NSP expenditure proposals. Moreover, some of these techniques are new and untried (at least in the NEM context). Even though the application of an asymmetric CESS has some problems, we believe that it would complement the new and improved assessment techniques. The obvious, widespread and immediate nature of the problem of capex overspends also favours such an approach. To the extent that there are any inequities in applying asymmetric CESS incentives, the AER would be able to recognise this in setting incentives on an NSP specific basis.

- The Explanatory Statement also discusses that an asymmetric scheme would penalise NSPs that had not overspent. By the same reasoning, it would also penalise (to a greater extent) those who had, which seems to COSBOA to be more of a concern for the foreseeable future. Moreover, as mentioned above, it would be possible for the AER to single out thrifty NSPs and apply different or symmetric penalties and rewards to them. In this context, the AER also discusses the case where an NSP has overspent but is still undertaking efficient capex, noting that an asymmetric scheme would penalise it for this. Whist this is true, it needs to be seen in context given that NSP overspending on inefficient capex is a more common problem. The AER needs to take care that 'the tail is not wagging the dog'. In any case, if this were the case and the NSP could show this, it would be possible to adjust the CESS penalties/rewards *ex post* to allow for it.
- It was also noted that the *ex post* assessment of capex could impose a 100 per cent penalty on any inefficient overspend. This assumes that any *ex post* assessment is perfect, which is very unlikely to be the case given the nature of such assessments and the information disadvantage of the AER. Accordingly, we have limited faith in the ability of *ex post* assessments to bridge the gap with what an asymmetric scheme will achieve. It also assumes that the scheme being proposed by the AER is, in fact, symmetric. However, there are some doubts about this (see below).
- There are a number of comments in the Explanatory Statement, the rationale for which, we find difficult to understand. It discusses the risk that a symmetric scheme is less likely to result in perverse outcomes. We have some difficulty understanding this comment. It seems to us even more likely that a symmetric scheme will result in a very significant perverse outcome in terms of the National Electricity Objective, that being perpetuating overspending of capex by NSPs. It also says that a symmetric scheme will allow the AER to review how NSPs have responded to the CESS and change it if necessary. However, we do not find this convincing as the same logic would apply to an asymmetric CESS.
- The Explanatory Statement then goes on to make the point that a symmetric scheme will promote efficient substitution between capex and opex. Whilst we can see the inherent rationale for this and do not dispute it, we have two concerns. First, that this is not as significant a problem as the need to have an effective way to control capex overspends which, as we mentioned above, is an overriding concern for consumers. Second, there are doubts about whether the AER's approach is actually symmetric (see below).
- We have doubts as to whether the AER's CESS is actually symmetric. The 30/30 reward/penalty the AER proposes is symmetric but this is not necessarily the same as having a symmetric CESS when other factors are taken into account. First, the regulatory regime also allows for a range of pass throughs of additional costs, including capex. The application of pass throughs is very asymmetric given that NSPs are only likely ever to apply for higher costs and that consumers have no ability to apply for pass throughs of lower costs. Second, there is provision for re-openers and for consideration of contingent projects in transmission, about which similar points can be made. Finally, there are aspects of the regulatory regime which favour NSPs and result in further asymmetry, including the setting of capex conservatively to avoid reliability risks and the resource and information asymmetry faced by the AER, which will favour higher capex. These matters are not fully addressed or compensated for in a CESS

with symmetric sharing factors. Nor will the improved assessment techniques to be used by the AER be guaranteed to overcome them. In all likelihood they will continue to inject some asymmetry into the regime.

- We note that pragmatically, the application of a higher penalty is unlikely to disadvantage privately-owned NSPs who have an enviable record of not overspending capex.
- We also note that in competitive markets there is a higher penalty for overspending (typically at or near 100 per cent) than proposed by the AER for NSPs and such markets are what good regulatory practice should be modelled on.

In relation to the levels to apply we support the application of a 30 per cent reward on the basis that this is a suitable starting point, is moderate but still provides NSP with sufficient incentive to underspend and is symmetric with the opex reward. In relation to the penalty, we believe that this needs to be set so as to provide an effective discipline on NSPs to only spend efficient capex, recognising that it is inherently more difficult to control overspending and also recognising the asymmetries elsewhere in the regulatory regime which favour overspending. We are aware of modelling supporting a 70 per cent level and support that the AER consider this suggestion in detail.

2.1.3 Government-owned NSP

In our earlier submission, we supported the application of a more severe penalty in the CESS when applied to government-owned NSPs. We are disappointed that the AER has not seen fit to recognise the specific issues associated with government-owned NSPs, namely their systemic overspending of capex, in its design of the CESS.

The AER has acknowledged the issues around government ownership in the Explanatory Statement but commented that:

> *"However, to the extent that government owned NSPs are potentially less responsive to financial incentives, it is not clear that a higher powered incentive would achieve the desired results. Instead we consider that perhaps some other form of mechanism is justified. In particular, we now have the ability to exclude inefficient capex overspends from the RAB* ex post*. To the extent that NSPs are less responsive to financial incentives, the* ex post *review should provide some protection against customers paying for inefficient overspends. In addition, to the extent that NSPs (government or privately owned) may have incentives to overspend due to having a lower WACC, this can also be addressed through the* ex post *review."* (p. 23)

COSBOA acknowledges that it would be possible to take account of the issues to do with government-owned NSP in *ex post* reviews, but is not confident that this will either be the case, or be an effective way to deal with the issues. This essentially turns on the effectiveness of *ex post* reviews and the previous reluctance of regulatory agencies to recognise WACC differences due to government-ownership as an issue to be addressed in regulatory determinations.

2.2 Other Issues

2.2.1 Forecast or Actual Depreciation?

In our response to the Issues Paper, we supported the AER's preferred position of applying forecast depreciation where a CESS is in place and leaving open the option of applying actual depreciation where this was not the case, or where an NSP has persistently overspent or incurred inefficient capex. We still support this position but wish to clarify that our strong preference would be for the AER to normally apply a CESS, along with asymmetric incentives, such that the need to resort to the application of actual depreciation due to the absence of a CESS becomes the exception.

2.2.2 *Ex post* Measures

In our comments on the Issues Paper, we supported the AER's approach to *ex post* assessments but noted the practical difficulties with these. Accordingly, we preferred a limited role for sch assessments (effectively as a 'last resort'). We continue to hold this view and again raise our concerns about the intrusive and resource intensive nature of such assessments, with the likelihood of limited effectiveness. There are also risks that such assessments will provide strategic openings for NSPs to exploit should they wish to (even with the best of intensions on the part of the AER).

This also goes to the heart of some of our earlier concerns about the effectiveness of *ex post* assessments in place of asymmetric capex penalties under a CESS.

COSBOA therefore questions the comment in the Explanatory Statement that:

> *"The CESS we have recommended is less high powered in respect of overspends than that we were considering in the issues paper. For this reason the CESS in isolation might provide less protection for customers against inefficient overspends. Given this, the role of the* ex post *review will potentially be greater than what we foresaw when drafting the issues paper. That said, the existence of the CESS and the threat of the* ex post *review should provide NSPs with an incentive to be more efficient and prudent in their capex. This should limit our need to progress the* ex post *review and our need to exclude inefficient capex overspends from the RAB."* (p. 37)

We are concerned that the AER is too sanguine about the ability of a symmetric CESS and an *ex post* review to incentivise NSP to be more efficient and prudent with their capex, especially government-owned ones. This situation will make it even more imperative that the AER conducts highly effective *ex post* reviews and places considerable onus on it to do so. This may be ‘a bridge too far.’

The AER has outlined three changes to the *ex post* review process it proposed in the Issues Paper. In relation to the removal of the consideration of service standards in Stage 1, we consider that the AER’s approach is logical, noting also that the consideration of service standards may still enter Stage 2 if necessary. Second, the AER proposed to remove the Stage 2 consideration of efficient capex. This seems sensible on the basis that the AER intends to apply the same symmetric CESS to all NSPs. We support the decision to combine the consideration of an NSP’s planning and management processes with a detailed assessment of its capex. We agree that undertaking the former without the latter could be deficient.

We have no objection to the inclusion of an additional step examining whether capex and opex incentives are relatively balanced in the consideration of an NSP’s capitalisation policies.

2.2.3 Transitional Arrangements

We have examined the transitional arrangements proposed by the AER as outlined in the Explanatory Statement. Whilst we recognise that these arrangements stem, in part, from the NER, from the way that network regulation and the capex arrangements work, and from pre-existing decisions, we express a sense of frustration that many of the aspects of the capex incentives in the Guideline will not begin to take effect until near the end of this decade, or later. Consumers have been asked to pay a high price for the past failures of network regulation and had hoped for an earlier application of reforms such as these.

3 Comments on Efficiency Benefits Sharing Scheme Guideline

This section provides COSBOA's comments on the Draft Efficiency Benefits Sharing Scheme (EBSS) Guideline and its accompanying Explanatory Statement.

As mentioned in our previous submission on Expenditure Incentives, we support the use of an EBSS to help ensure that NSPs are efficient in their approaches to opex. However, we are concerned that reliance on revealed costs, even in combination with an EBSS, would be insufficient to protect consumers from inefficient opex and that additional recourse to other assessment techniques, particularly benchmarking, is needed to overcome this problem. We are pleased to see that the AER will be moving in this direction in future determinations.

The remainder of this section comments on some of the changes that the AER has proposed to the EBSS which differ from its position in the Issues Paper.

3.1 Opex Forecasting Approach

As previously mentioned, we have doubts about the ability of the 'base-step-trend' approach to opex forecasting and believe that, if the AER is to continue to have a preference for this approach, it is imperative that it be supplemented by rigorous and transparent benchmarking analysis. The Explanatory Statement also outlines that the AER will depart from this approach where an NSP appears materially inefficient in relation to its peers and where, in tandem with the application of incentive schemes, the revealed cost forecast would yield an outcome that is not consistent with the opex criteria. We support this approach.

COSBOA supports applying expenditure review techniques, especially economic benchmarking and category analysis, to determine material inefficiency and, where this is confirmed, adjustments to base year opex to address the inefficiencies.

Conceptually, we also have some sympathy for the view that NSPs operating at the efficient frontier could be provided with a stronger incentive to continue to pursue efficiency gains, but accept the AER's conclusion that there is insufficient information at present to assess the need for this. However, we would urge that the AER keep this under review given that the additional data it will collect for benchmarking purposes may well shed further light on it.

In the Issues Paper, the AER proposed a fixed sharing scheme for circumstances where it applied a fully exogenous forecast to an NSP. On the basis that it is no longer proposing the use of fully exogenous forecasts, but to rely instead on revealed costs supplemented by other assessment techniques, it now proposes not to proceed with fixed sharing. COSBOA is disappointed by the proposal not to use fully exogenous forecasts and can see no reason why it should not have proceeded. However, on the basis that the AER maintains its current position, we can see why the AER would not go ahead with a fixed sharing scheme. We also note the AER's view that:

> *"We consider a higher powered incentive to be appropriate for relatively inefficient NSPs, particularly where such NSPs are relatively unresponsive to financial incentives. A higher powered incentive increases the likelihood that a NSP will reduce its opex over time and become efficient in the future." (Explanatory Statement, p. 23)*

3.2 Exclusions and Adjustments

In our previous submission, we generally supported the inclusion of all opex items in the EBSS on the basis that excluding them would blunt any incentive for NSPs to ensure these costs are efficient. We continue to support that view.

We note that the AER has reconsidered its position in relation to uncontrollable costs and network growth and now proposes that these costs no longer be excluded or adjusted. We support the reasons outlined for this.

The AER is also now proposing a broad criterion for exclusions of opex costs that is not specific but rather is pegged to enhanced achievement of the relevant parts of the NER. More specifically, it highlights those categories of opex where the revealed costs approach has not been used, such as debt raising costs. COSBOA believes that this change is consistent with its own position on exclusions.

COSBOA understands that the AER is now proposing to add any pass through and contingent project amounts to the forecast opex for those years for which the additional costs are approved and include them in an EBSS. We note that this will provide NSPs with the same incentive as for other categories of included opex.

3.3 Other Comments

The Explanatory Statement notes that there may be circumstances in which NSPs face unbalanced incentives in relation to capex versus opex, notwithstanding a balanced level of incentives as between the CESS and EBSS. We support that the AER should retain some discretion to allow for such circumstances.

We also support the formalisation of the treatment of inflation in the EBSS and the amalgamation of the EBSSs for TNSPs and DNSPs on the basis that they are very similar.

ATTACHMENT: List of COSBOA Members

Australasian Association of Convenience Stores

Australian Booksellers Association

Australian Digital Television Association

Australian Equipment Lessors Association

Australian Hairdressing Council

Australian Human Resources Institute

Australian Livestock and Rural Transporter Association

BPW Australia (Australian Federation of Business and Professional Women)

Business Enterprise Centres Australia

CITT (Council of Information Technology & Telecommunications)

Commercial Asset Finance Brokers Association of Australia

Convenience and Mixed Business Association

Fitness Australia

FSV

Independent Retailers Organisation

Institute of Public Accountants

National Financial Services Federation

National Independent Retailers Association

Pharmacy Guild of Australia

Pittwater Business Limited

Real Estate Institute of Australia

Stocktakers Institute of Australia

Tasmanian Small Business Council

University of Western Sydney