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Australian Energy Regulator

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Positions Paper – Review of incentive schemes: Options for the Capital Expenditure Sharing Scheme

CitiPower, Powercor and United Energy welcome the opportunity to respond to the Australian Energy Regulator's (AER) Issue Paper – Review of incentive schemes: Options for the Capital Expenditure Sharing Scheme (the issues paper).

We agree with the AER's preliminary position to retain the CESS at the 30 per cent default sharing ratio. As previously submitted, we maintain our view that the case has not been made to justify a departure from the current CESS, including:

- there is insufficient evidence from one regulatory period of actuals to determine a systematic over-forecasting problem
- the AER has already increased its scrutiny over expenditure forecasts through the previous round of regulatory reviews and has recently introduced the Better Resets Handbook which places additional stakeholder scrutiny over forecasts, and the AER has not yet observed the outcomes of these new measures
- the AER already has extensive information gathering power during the regulatory reset process, including demonstrated effective powers to adjust CESS carryover allowances

Through reviewing the AER's issues paper, we view the core issue at hand as being information asymmetry between networks, stakeholders, and the AER regarding the drivers of CESS outcomes. We therefore support the AER's preliminary position to introduce greater transparency requirements for networks on actual and forecast capital expenditure (capex). We encourage a high degree of engagement and collaboration between networks, the AER, and stakeholders to develop and define what these requirements are before the draft decision is made.

We consider that greater transparency combined with the new AER expenditure assessment tools and the introduction of the Better Resets Handbook will be adequate to address concerns regarding the drivers of CESS outcomes. We urge the AER to allow time to see the combined effect of these changes to understand whether there are any residual concerns present to warrant further intervention in the functioning of the CESS.

Notwithstanding our above positions, of the options considered in the AER's issues paper, *Bright line option two* (where the 30 per cent sharing ratio is retained until a specified trigger level is reached and then reduces to 20 per cent, irrespective of past performance or forecast requirements) presents the least risk in terms of introducing perverse incentives, regulatory discretion and unintended consequences that are not in customers' long-term interests.

Compared with the other proposed options to amend the CESS, *Bright line option 2* provides a transparent, objective, and neutral scheme which is equally applicable to all networks in all circumstances. This option continues to incentivise networks to seek efficiency savings, albeit at a diminishing incentive rate.

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Bright line option 2 recognises the AER and stakeholders have less confidence that the drivers of underspends which exceed the specified trigger level are due to managerial efficiencies and therefore are less willing to reward efficiencies beyond this level. The lower incentive rate applying to efficiencies achieved beyond the specific trigger level reflects the lower level of confidence. This option therefore better addresses the core of the AER and stakeholder concerns compared with the other proposed options to amend the CESS.

However, by design *Bright line option 2* blunts the incentive to achieve large efficiencies as soon as possible and therefore it is important to ensure an appropriate trigger threshold is set. As such, we recommend the trigger for reducing the sharing ratio under this option be increased to 15 per cent to ensure the stronger incentive to seek managerial efficiencies and deliver better long-term customer outcomes applies within a reasonable range of outcomes.

In summary, we retain our view that the AER must provide evidence and analysis to support a case for change prior to any amendments to the CESS. In addition, we urge the AER to observe the outcomes of greater transparency, the introduction of the Better Resets Handbook and the increased AER scrutiny over expenditure forecasts prior to making any further changes to the CESS. If the AER remains convinced there is an issue to address now, the variable rate sharing ratio *Bright line option 2* would better promote efficient investment for long term customer outcomes compared with the other proposed options to amend the CESS.

Should you have any queries please do not hesitate to contact me on [redacted] or [redacted]

Yours sincerely,

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1 There is insufficient evidence of the problem to justify scheme amendments

1.1 Further evidence is needed to demonstrate over-forecasting is a material driver of CESS outcomes

The AER's primary concern is that some of the CESS rewards received by networks may be attributable to network businesses over-forecasting their capex needs and deferring projects to future regulatory periods, rather than genuine efficiency savings delivered through managerial effort.

We note the AER's concerns come from analysis on aggregated network trends with a pattern of underspending in the last regulatory period followed by an increase in the forecast for the current period. However, we note this initial pattern is equally consistent with networks efficiently responding to the CESS by driving efficiency savings early to deliver savings for customers, followed by increases in forecasts reflecting the changing demands being placed on networks. Notably the industry experienced a period of acquisition and consolidation in the last regulatory period, as well as unanticipated growth in solar and energy efficiency which materially impacted energy demand. It is difficult to draw legitimate conclusions regarding the effectiveness of the CESS from one regulatory period which reflected a time of significant transition.

We also note that the incentives were materially different prior to 2016 when CESS and forecast depreciation were introduced. Prior to these, businesses were under the actual depreciation approach and there was no adjustment for deferrals. Therefore, relevant data for AER consideration should be from 2016 onwards and given the short time framework, there is insufficient data to conclude a systematic issue with CESS.

Given reasonable alternative explanations for the AER's observed patterns, and the short period over which it has observed the pattern, further evidence and analysis should be conducted to better understand the issues before any adjustment to the CESS is justified.

1.2 It is necessary to observe the outcomes of the AER's new assessment techniques and the Better Resets Handbook before the case for change can be made

The AER has recently made amendments to the regulatory framework that directly address its concerns regarding the potential for over-forecasting, including:

- the AER has applied increased scrutiny through both the application of its expenditure level assessment tools, the introduction of expenditure category level guidance notes, an extensive bottom-up review on each expenditure category, additional external expert reviews and workshops, and an extensive information request process
- additional scrutiny applied to expenditure forecasts in the next round of regulatory determinations with the introduction of the AER's Better Resets Handbook which further uplifts expectations in relation to earlier and deeper engagement with AER, customers, and stakeholders throughout the development of the proposal

The AER is yet to see the impact of the increased scrutiny and the introduction of the Better Resets Handbook on CESS outcomes. Particularly in Victoria, where the reporting of the first year of actual spend against allowances is not available until November 2022. Notably the AER has observed a narrowing of the gap in recent years across the industry more broadly which may be indicative that the increased scrutiny of expenditure forecasts has had an impact.

It is important for the AER to observe the outcomes of the changes to the regulatory framework it has already made before it can conclude there is a valid case for change for amending the CESS. Further, it is unclear how the AER's proposed incremental amendments to the CESS address the AER's perceived over-forecasting concern.

2 Amendments to the CESS

2.1 Increased transparency and accessibility for stakeholders and the AER

Through reviewing the AER's issues paper and lack of evidence of over-forecasting, we consider the core issue at hand an information asymmetry between networks, stakeholders, and the AER regarding the drivers of CESS outcomes. We therefore support the AER's proposal to increase transparency and accessibility regarding the reasons for differences between actual capex incurred and our approved forecasts. We encourage a high degree of engagement and collaboration between networks, the AER, and stakeholders to develop and define what these requirements are before the draft decision is made.

The AER's existing powers regarding information collection and adjustments to the CESS are extensive and proven to be effective, and we note that external stakeholders may not be aware of how comprehensive this is. Networks are required to report material deviations between forecast allowance and actual spend by category in the Regulatory Information Notice (RIN) and in response to AER questions issued through either the RIN or regulatory reset process. The AER has demonstrated its ability to adjust networks CESS carryover values in multiple instances.

Case study AER CESS adjustment

The AER has demonstrated the effectiveness of its information gathering powers and its ability to make CESS adjustments in Powercor's 2021-2026 regulatory determination. The AER successfully applied a CESS adjustment of $51 million (nominal).

However, we understand the current reporting requirements and process for validating drivers of underspends may not be adequate or sufficiently accessible to give the AER and stakeholders confidence the efficiencies delivered were predominately the result of managerial effort.

We also acknowledge that networks should increase direct engagement with stakeholders on the drivers of underspends. This recommendation, in part, is baked into the AER's Better Resets Handbook. The AER's Better Resets Handbook uplifts expectations in relation to earlier and deeper engagement with AER and customer stakeholders throughout the development of the proposal and specifically in relation to explaining current period performance against allowances.

We are already committed to improving transparency of the drivers of our actual spend against allowance with both the AER and our broader stakeholders, and to demonstrate the CESS is providing value for money for customers.

Proactive and accessible engagement with our stakeholders on our allowance verse actuals

In recognition of the growing role of stakeholder engagement and the need for increased transparency, we have initiated a project to better track our actual spending relative to the regulatory allowances at both a **category level** and for **marquee projects** approved in the regulatory reset.

We are intending to communicate the outcomes with our Customer Advisory Panel (CAP), the AER and other stakeholders annually following preparation of the RINs. This analysis will include a breakdown on annual spending against regulatory allowances including the explanatory narrative to accompany the quantitative analysis.

An increase in proactive and accessible engagement will assist the AER and stakeholders to engage on the drivers of network spends relative to allowances in a more meaningful and timely manner. We also propose to link the analysis of our spending to key customer outcomes, such as price and reliability to assist stakeholders in building the bigger picture.

In line with our commitment to increasing transparency of spending against allowances, we recommend the AER review the existing reporting requirements to assess whether they are fit-for-purpose for understanding the key drivers of deviations between forecasts and actuals, and whether these existing requirements could be improved or evolved, before considering introducing additional reporting requirements.

We consider increased transparency would greatly improve AER and stakeholder ability to assess the effectiveness of the CESS in driving managerial effort to deliver efficiencies savings for customers. We consider increased transparency to be a no regrets approach, which when combined with the Better Resets Handbook and new AER expenditure assessment tools, will be adequate to address concerns regarding the drivers of CESS outcomes. We therefore urge the AER to allow time to see the combined effect of these three changes to understand whether there are any residual concerns present to warrant further intervention in the functioning of the CESS.

2.2 Option one – 20 per cent sharing ratio

We do not support the AER's option to **lower the CESS sharing ratio to 20 per cent.**

The AER is consulting on an option to lower the CESS sharing ratio from 30 per cent to 20 per cent. It is unclear how this proposed option would address the AER's perceived over-forecasting concern. In addition, this option does not address the information asymmetry issue which we see as the key challenge.

We agree with the AER's statement that the current CESS has delivered significant efficiency gains and the 30 per cent sharing ratio has been effective to date.

The current incentive framework drives networks to seek efficiencies for customers. However, it becomes increasingly challenging to drive efficiencies over time once the 'quick wins' have been realised and therefore greater management focus and effort is required to take on higher risk, higher cost investment and innovations necessary to deliver greater efficiencies. Therefore, retaining a strong incentive over time is required to continue incentivising networks to meaningfully focus, invest and innovate in evolutions that will drive transformational shifts in operational process and deliver permanent savings for customers.

Delivered efficiencies in our 2016-2020 regulatory period

In the 2016-2020 regulator period, our efficiency savings were predominately delivered through a holistic overhaul of our resource partner contracting arrangements, merging our CitiPower, Powercor and United Energy operations, and extensive investment in automating processes and systems across the organisation.

Notably, many of these initiatives have not yet been adopted by other networks and therefore those customers have not yet received the benefits of these innovations. To continue to drive innovation to seek out more efficiency savings above those already achieved, we must work harder and take on greater risk, which requires management to be adequately focussed and incentivised.

As a result of our persistent commitment to delivering efficient cost saving for our customer, our electricity tariffs are one of the lowest across the National Electricity Market (NEM), while we continue to deliver the most reliable networks. These outcomes are a result of significant management effort to seek genuine efficiencies in response to the current effective incentive arrangements.

Risk is taken on commensurate with potential reward, and we are concerned that a lesser incentive to seek efficiencies under a lower CESS sharing ratio will lead to management being less willing to put in the discretionary effort needed to continue to deliver more savings for customers. This will ultimately lead to poorer customer outcomes over the long-term. A lesser incentive seems particularly problematic during a time of such transformation and reform within the energy sector, where the role of regulation is becoming increasingly important to ensure a just and fair transition in consumers best interests.

Contextualising this reform further, incentivising businesses to continue to seek efficiencies is crucial within the broader macroeconomics context with the rising cost of living. We acknowledge the energy industry must play its part in ensuring an affordable and sustainable future for Australians. To this end, the CESS is ensuring network businesses are incurring only efficient capex and the benefits of efficiencies are shared with customers, reflecting long term savings for customers. Continued and consistent application of the incentive schemes provide networks with the confidence to invest in programs that reduce future costs.

2.3 Option two – Variable incentive rate

Principles based test

We do not support the introduction of the AER's ***principles-based test.***

Under the AER's variable incentive rate option, the AER is consulting on the introduction of a principle-based test to determine when a 20 per cent sharing ratio should apply to a network.

This approach introduces an unreasonable degree of subjectivity. Under this option, the AER has discretion to determine the incentive rate based on its view of the quality of a regulatory proposal.

The introduction of a principle-based test of regulatory proposals will compound the existing information asymmetry issue between the AER, networks, and stakeholders through the introduction of an arbitrary test on what constitutes a 'regulatory proposal of concern'. A principle-based test also creates potential incentives for networks to optimise investment plans, and potentially defer efficiency savings, to satisfy the perception of the AER's capex preferences and expectations. Such an outcome contrasts with the overall Better Resets Handbook and the National Electricity Objective to promote efficient investment.

The lack of transparency regarding the CESS criteria also reduces certainty for networks which is a key requirement of effective ex-ante incentive regulation. The uncertainty dilutes the incentive for networks to continue to invest effort to deliver greater efficiencies as soon as able. The introduction of uncertainty would likely lead to management being less willing to put in the discretionary effort needed to continue to deliver more savings for customers. This uncertainty would also be problematic in the scenario where networks are planning efficiency programs that span multiple regulatory periods, as they will not have certainty over how efficiencies will be treated in the latter periods.

Providing transparent and objective criteria for when the AER applies a reduced sharing ratio is critical for an effective trusted incentive regime. We do not recommend a principles-based test is adopted by the AER given the likely perverse impacts introduced.

If the AER however considers this a preferred option, the draft design of the principles-based test must be included in the draft determination to allow industry and stakeholders to provide feedback on the criteria.

Bright line option one: 10/10 test

We do not support the introduction of the AER's ***Bright line option 1***.

It is not appropriate to link the forward-looking incentive rate to performance in the previous regulatory period, and whether a network has requested a step-up in their forecast capex allowance.

This option implicitly assumes that capex requirements should be relatively stable over time. There are likely to be numerous scenarios where capex requirements are not stable between periods and thus the 10/10 threshold would be tripped even if there is no over-forecasting.

The energy industry is undergoing a time of significant reform and transformation with accelerating growth in solar, expected uptake of electric vehicles, the political preference for substitution of gas resources and lower emissions generation, greater network resilience to extreme weather events and potential overhaul of roles and responsibilities for managing decentralised energy sources. Assuming stable capex requirements as the industry transitions to a new energy future is an unrealistic assumption for the AER to introduce.

The AER has a suite of sophisticated tools and processes to review and assess network businesses regulatory proposals. While we acknowledge that using history as a reference point is a starting position, an arbitrary comparison between history and current performance as the deciding factor in determining a networks sharing ratio under the CESS is problematic.

This option will also introduce perverse behaviour whereby firms near the 10 per cent threshold may reduce efficiencies to avoid tripping the threshold. In addition, networks concerned about overspending their allowance next period could also be incentivised to intentionally trip the threshold to get a lower penalty rate.

In the scenario that capex requirements *are* relatively stable, this mechanism has the potential to punish the most efficient and innovative firms by giving lower future incentive rates to those firms that achieve the largest efficiencies. Giving these firms a lower incentive in the next regulatory period may mean they achieve less efficiencies next period, which is not in consumers interests.

Notwithstanding the above positions, if the AER continues to consider this option, it would be prudent to lift the 10 per cent trigger thresholds to a higher value. As highlighted above, there are several scenarios where capex requirements would not reasonably be expected to be stable and thus the 10/10 threshold would be tripped.

Bright line option two: tiered incentive rate

The AER's *Bright line option 2* retains the default sharing ratio of 30 per cent for the first 10 per cent of underspending and introduces a lower sharing ratio of 20 per cent for any underspend exceeding 10 per cent.

The concept of *Bright line option 2* is the most preferable option out of the AER's proposed options to change the CESS, provided the AER presents evidence of the case for change. Prior to any proposed amendments, we would expect confirmation that *Bright line option 2* does not seek to link the future sharing ratio to either a networks past performance or its forecast requirements. This feature means that *Bright line option 2*, unlike the other variable rate option, does not introduce the risk of creating the abovementioned perverse incentives and introducing an unreasonable degree of discretion into the regulatory framework.

Bright line option 2 explicitly recognises the AER and stakeholders have less confidence that the drivers of underspends which exceed the specified trigger level are due to managerial efficiencies and therefore are less willing to reward efficiencies beyond this level. The lower incentive rate applying to efficiencies achieved beyond the specific trigger level reflects the lower level of confidence.

At a time when the industry is undergoing significant transition and there is a lack of transparency regarding the drivers of underspends, the *Bright line option 2* provides a neutral scheme which is equally applicable to all networks in all circumstances. This option will continue to incentivise networks to seek efficiency savings, albeit at a diminishing incentive rate. This option also ensures the strongest incentive rate of 30 per cent remains within the specified trigger level, thereby not reducing the initial incentive on networks to meaningfully invest and innovate in evolutions that will drive transformational shifts in operational process and deliver permanent savings for customers.

The *Bright line option 2* also provides transparency and objectivity to the AER's assessment on which networks will have a reduced sharing ratio. Transparency and objectivity are critical for an effective and trusted incentive scheme.

The reduced sharing ratio of 20 per cent once the specified trigger is reached, while arbitrary, seems reasonable within the context of this option. Any sharing ratio lower than 20 per cent is very likely to risk materially diluting the incentive to invest managerial effort and take risks on innovations to pursue further efficiencies beyond the specified trigger, particularly where there is potential to defer pursuing further efficiencies into the next regulatory period to receive the higher sharing ratio.

This option by design blunts the incentive to achieve large efficiencies and therefore it is important to ensure an appropriate trigger threshold is set. As such, we recommend the trigger for reducing the sharing ratio be increased to 15 per cent to provide the stronger incentive to seek managerial efficiencies and deliver better customer outcomes within a reasonable range. A higher trigger is more appropriate particularly given the AER's acknowledgement that the CESS is currently working well and delivering benefits to customers. A higher trigger level is less likely to result in a lower incentive rate for most networks and will instead take effect in circumstances where the AER and stakeholders may have concerns about the drivers of underspends.

We retain our view that the AER must provide evidence and analysis to support a case for change prior to any amendments to the CESS. In addition, we urge the AER to observe the outcomes of greater transparency, the introduction of the Better Resets Handbook and the increased AER scrutiny over expenditure forecasts prior to making an assessment. If the AER does this and is convinced there remains an issue, the variable sharing ratio *Bright line option 2* would better promote efficient investment for long term customer outcomes compared with the other proposed options to amend the CESS.