Consumer
Challenge
Panel

CCP10 Response to AER Issues Paper:

Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations operating expenditure

30 November 2017

Submitted to: NSWACTremittal@aer.gov.au

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Executive Summary

Context of remittals

There is no escape from the reality that consumers are paying very high prices for electricity across the NEM, including in NSW and ACT and that rapid price increases are having deleterious impacts in households as well as businesses.

The significant aspect of the context for remaking the 2104-19 decision is the uniqueness of the situation. In practice, there is no handbook or rules to follow that deals with the combination of unique circumstances, including the historically turbulent financial circumstances of the past decade that have been a significant factor in driving at least some aspects of the unprecedented regulatory situation of the last decade, and the last 4 years in particular. The goodwill of participants and the fairly applied discretion of the regulator will be central to the process of making effective remittal decisions.

We have proposed a set of 10 principles to help guide the decision making, in this unique set of circumstances, including:

- The AER's focus must be on the National Electricity Objective (NEO) without ignoring shorter-term impacts as well;
- The AER should use the best available evidence;
- The AER must apply the Tribunal and Federal Court directives, where they exist;

Use of benchmarking by the AER

- It is recognised that the application of benchmarking for the 2014-19 decisions has been strongly contested. This submission considers benchmarking in some detail, including further discussion in Appendix A "*Incentive Based Regulation and the role of benchmarking".*

We emphasise that:

- CCP10 is strongly in favour of the AER using benchmarking as an assurance tool to cross check forecasts of the distributors
- CCP10 supports the AER's annual benchmark publication and strong incentive based regulation (IBR) as discussed in Appendix A.

Introduction to the 4 methods

Recognising the uniqueness of the remit process, we have identified 4 methods by which the central questions from this issues paper could be considered. These 4 methods are intended to scope the options, to encourage debate and to provide a base for sound decision making. The methods are summarised as:

Method 1 Cost sharing between networks and consumers

There will be long-term benefits to consumers flowing from appropriate short-term overspend on opex, including paying for redundancies. We also note from the revealed costs, that during the period the businesses have or will reduce their costs

to achieve the AER forecast opex. On this basis CCP10 believes that it would be in consumers long-term interests to bear some portion of this opex overspend. Under method 1 the AER would decide on what proportion it believes in its discretion would be a reasonable portion for consumers to bear. CCP10 believes that there should be a rationale for any proportion that the AER chooses. Our approach to reducing the number of cost sharing options between consumers and network businesses has been to consider 5 scenarios, summarised by a percentage cost share between consumers and networks of: 100 – 0; 70 – 30; 50 – 50; 30 – 70 and 0 - 100.

Method 2 Apply retrospective EBSS

A sharing of 70% - 30% currently applies through the Efficiency Benefit Sharing Scheme (EBSS) which applied to Endeavour Energy for the 2014-19 period, but none of the other businesses. There are a number of reasons for this situation, but these are outside the scope of this submission.

We considered an option of effectively applying an EBSS sharing ratio, retrospectively to Ausgrid, and ActewAGL, noting that Essential Energy is outside the scope of the issues paper.

We concluded that there is no case for an EBSS if the current path for allowed costs is retained and an additional allowance for transition costs. If an EBSS were implemented no further adjustment would be required and the distributor would still recover its actual costs over the two regulatory periods (i.e. 'transition costs' would not be shared.)

Method 3 Glide path to efficient costs

Under this approach we suggest that the AER could ask what costs would be incurred by a prudent, efficient operator/manager given the initial conditions/costs. This provides for a transition in costs, as Ofwat and Ofgem have done. It does mean that consumers pay for costs that would not be incurred if the distributors were efficient from the outset, but it reduces the risk of assuming cost levels that may prove to be unsustainable. From this perspective, the options for a 'glide path' could be:

1. a straight-line cost path from opening costs to the 2018-19 costs. This is the simplest and could be argued to be the default option in the absence of specific cost information.
2. construct a profile by averaging the cost profile for each distributor (measured as the change in costs in each year relative to the end-point costs). The challenge for this is that while each of the distributors has the same incentives, the cost profiles seem very different.
3. use the actual costs to date for each distributor and then extrapolate to the target. This assumes each of the distributors has been doing the best they can to date and the differences in the time-profiles are due to specific issues for each distributor rather than differences in the level of effort to achieve efficient costs. This means each distributor recovers the costs it has occurred

to date but there are no rewards/sanctions for those that have achieved a faster/slower reduction in costs. However, this approach looks more like cost plus regulation rather than incentive based regulation.

We accept that choosing a glide path with the starting point of year 2014/15 means not starting with efficient opex spending level for any of the 4 businesses. However, finishing the glide path at an efficient level of spending is crucial for ongoing consumer benefit.

Method 4 allow redundancy costs above AER efficient opex

We consider that there is some merit in the AER looking at redundancy costs incurred by the businesses in meeting the AER's forecast opex as an area where these costs could be shared by consumers. Redundancies usually serve two purposes:

a) to reduce the number of FTEs surplus to requirements – reflected in a reduction in net staff numbers and ultimately operating costs, and

b) to change the skill mix, replacing skill X with skill Y – so staff are replaced, and net staff numbers do not decline, but enhanced skills matching to business needs should lead to improved operating efficiency.

Consequently, there is a reasonable basis to consider these redundancy costs to be efficient.

Our principal position is that consumers should not pay for redundancies that have not led to long term savings. This underpins our strongly held opinion that only businesses that have reached the AER's efficient opex level at end of year 4 and have a demonstrated relationship between the cost of redundancies and opex cost reductions should be eligible to recover and of these transition costs from consumers.

We believe that redundancy costs be applied to a business's approved opex expenditure provided the redundancies are prudent or efficient. If there is any doubt about the efficiency of the redundancy costs then the risk of this should lie with the business rather than with consumers and the AER should impose a cap on the amount of redundancy costs to be borne by consumers.

Specific questions asked by the AER in the Issues Paper

The final section of this submission applies the proposed principles and the 4 methods for considering the opex components of the remittal decisions, with application to the 7 questions posed in the AER's issues Paper.

Note that this submission has been prepared by a subpanel of the Consumer Challenge Panel (CCP), the 10th subpanel appointed to consider NSW and ACT distribution network business 2019-24 regulatory proposals. The remit issues impact on the 2019-24 proposals and so we are considering the remittal processes as well. This submission does not necessarily reflect the views of all CCP members, it does

reflect agreed views of the 4 CCP10 members who have actively considered the remit issues. Any reference in this submission to CCP opinions should be read as the views of the 4 subpanel members, being: Louise Benjamin, Eric Groom, Mark Henley and Mike Swanston.

The quantitative analysis presented in this document reflects data that has been gathered from the AER and the relevant distribution businesses. It is recognised that the information used in this analysis may change, and that some assumptions have been made regarding the nature of the data such as being real or nominal costs over time.

Despite these assumptions, CCP10 believes the indications and guidance drawn from the analysis of this data is valid and remains useful for the purposes of this document.

1. Context of remittals

The context in which this Issues Paper has been released is significant, as the last decade has seen several critical shifts in the regulatory environment in NSW/ACT. We have summarised some of the key elements of these shifts to highlight aspects of this context. We believe this is relevant to factors that the AER should take into account in remaking the remitted decisions

The global financial crisis of 2007-08 (GFC) had the impact of significantly increasing the cost of capital, globally. Energy network businesses are capital intensive. This means that the cost of capital significantly impacts on their cost of business and ultimately the price charged to consumers, in this case for distribution use of system charges, known as DUoS. Consequently, the regulated price for the NSW/ACT distribution businesses for 2009-14 included a much higher allowance for the cost of capital than the prevailing rate up to the GFC.

The history of increased Reliability Standards in NSW also meant that each of the businesses was required to invest greater capital to meet these standards, increasing the size of each businesses' Regulated Asset Base (RAB) to which the increased cost of capital was then applied; further driving up prices. Prices for consumers continued to rise with network charges being singled out in popular commentary as the main driver of price increases of energy bills for all customer classes. The term 'gold plating' was used frequently in reference to electricity networks.

Significant changes to network regulation rules were made in 2012 and separate decisions were made to focus any Limited Merits Review appeals on AER decisions to meet a consumer benefit test. In mid-2013 the Productivity Commission emphasised the loss of centrality of consumers in network regulation and also discussed the value of benchmarking in regulation. Meanwhile the AER undertook a comprehensive development of guidelines under the banner of "better regulation" during 2013 to consider application of the new network regulation rules.

When the AER came to make the 2014-19 regulatory determinations, the three NSW Government owned distribution network businesses and ACT's ActewAGL were the first businesses to which the 2012 rule changes would be applied. Since the regulatory process could not be commenced until the guidelines were established, a placeholder decision was made for the first year of the regulatory period, with a "true up" to occur once regulatory determinations were made for the full 5-year period, 2014-19.

The final determinations were for reductions in allowable revenue from the regulatory proposals of 33%, 28%, 31% and 31.5% percent for Ausgrid, Endeavour, Essential and ActewAGL respectively. The main component of the reductions being to apply rates of return to capital that reflected much lower post GFC rates and a reduction in operating expenditure (opex).

The network businesses all appealed the AER's decisions to the Australian Competition Tribunal (the Tribunal) by seeking limited merits review (LMR), a process which itself had also been subjected to changes.

The Tribunal upheld the network businesses' appeals regarding return on debt, operating expense allowance and the rate for imputation credits relating to tax allowance. The Tribunal set aside the AER's original decisions and directed the AER to remake the 2014-19 decisions, taking into account the Tribunal's reasons.

The AER appealed the Tribunal decisions to the Federal Court. During 2017 the Federal Court decisions have been made, reinforcing the Tribunal's decisions that the original decisions should be re-made by the AER, though with regard to a smaller number of issues. It is the remaking of the 2014-19 decisions that the AER is now undertaking, with limited direction on some aspects from the Tribunal and Court.

The time taken with the various appeal processes means that in remaking these decisions:

a) the AER and businesses have access to the actual expenditure of each of the businesses for the first 3 years of the regulatory period. It is very rare that a regulator's decision can be made with considerable actual, revealed costs data to draw upon, and

b) the regulatory proposals for the next period, 2019-24 are due to be lodged with the AER before the remitted decisions will be made, using standard regulated price determining processes.

A core implication of the background for remaking the 2104-19 decision is the uniqueness of the situation. In practice, there is no handbook or rules to follow that deal with this combination of unique circumstances, including the historically turbulent financial circumstances of the past decade that have been a significant factor in driving at least some aspects of the unprecedented regulatory situation of the last decade, and the last 4 years in particular.

Current Situation

In attending a range of consumer consultation events and talking with energy businesses as well as consumer groups, it is abundantly clear that the most important energy issue for residential and business customers is price. There is a clear expectation from consumers that future prices will be lower than the current very high prices.

The cost of living pressures exacerbated by high and rising energy costs are summarised by figure 1 which is taken from the ACCC progress report on retail energy prices[1].

[1] https://www.accc.gov.au/publications/accc-retail-electricity-pricing-inquiry-preliminary-report

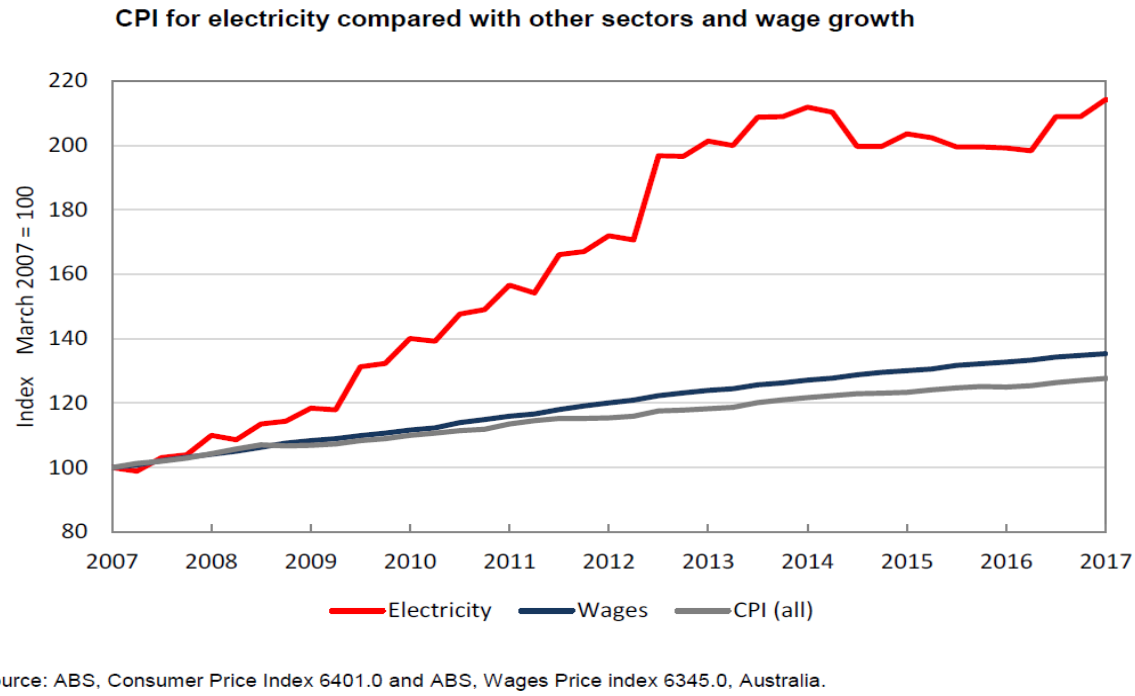


Figure 1: CPI for Electricity compared with wage growth, 2007 – 17

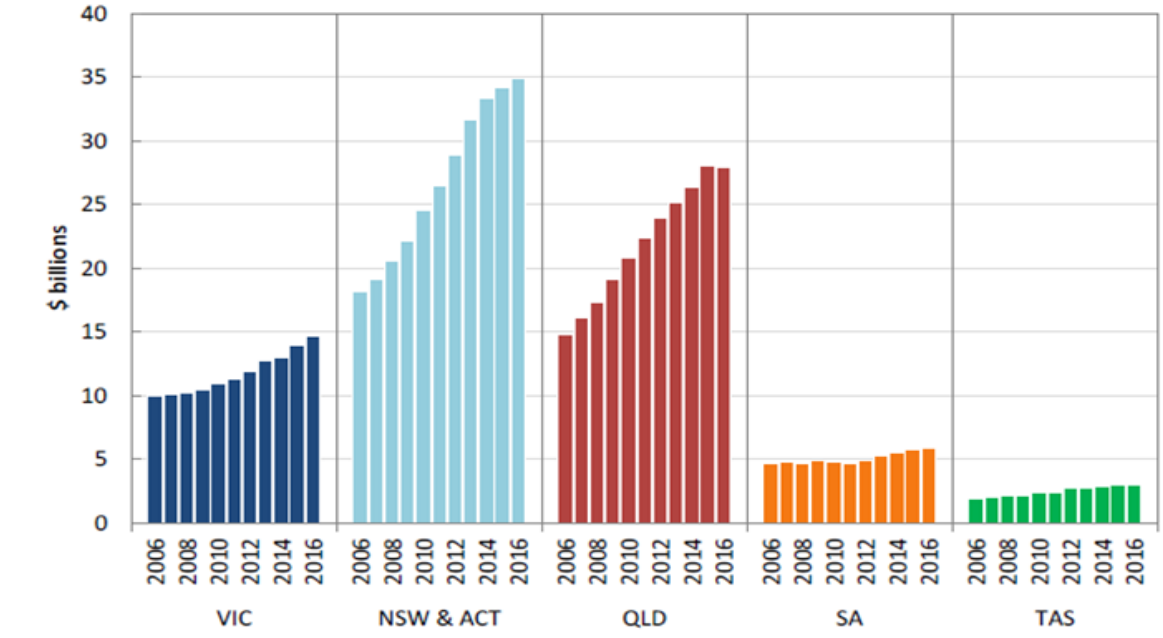
(Source ACCC Retail Electricity Pricing Inquiry: Preliminary Report)

This chart is presenting aggregate data, NEM wide, but similar data applies to individual NEM jurisdictions. The chart justifies the concern of consumers that energy prices have risen at a much faster rate than wages or CPI. Note that incomes of recipients of transfer payments are more likely to align with CPI rather than wages, so the impact of high and rising energy costs on lower income people is greater than for 'average' households.

The ACCC stated: "Key components of the cost that determine the amount of revenue that network operators are allowed to recover have increased significantly since 2006. The total RAB of the NEM (the value of assets that the networks can receive return on) increased in real terms by 75% from $49 billion in 2006 to $86 billion (in 2016 dollars)."

The growth in RAB over the jurisdictions is shown in figure 2, which indicates substantial RAB growth in NSW, particularly between 2006 and 2014, which was significantly influenced by the Government's imposed Reliability Standards.

The ACCC stated: "These large investments occurred during a time of instability in financial markets which increased financial costs, resulting in high revenue growth across the NEM. Similarly, operating expenditure in 2014 was 43 per cent higher than in 2006. However, since 2014, operating expenditure has been declining and in 2016 was only 27% higher than 2006 levels. The return on capital and operating costs are the two largest components of revenue and respectively account for over 50per cent and 25 per cent of network revenue across the NEM."



Source: AER economic benchmarking, Regulatory Information Notice responses.

Figure 2: Regulatory Asset Base 2006 - 2016 by NEM region, real values in 2015-16 dollars

(Source ACCC Retail Electricity Pricing Inquiry: Preliminary Report)

There is no escape from the reality that consumers are paying very high prices for electricity across the NEM, including in NSW and ACT, and that rapid price increases are having deleterious impacts in households as well as businesses. While price increases have been a little lower in ACT than in NSW, in aggregate, the reality of high and rising electricity prices in both jurisdictions remains.

2. Principles

In recognising the uniqueness of the circumstances leading up to the current 2014-19 remits for NSW and ACT network businesses, and observing the significant price impacts on households and businesses of rapidly rising energy costs, CCP10 has proposed principles to help shape the more specific aspects of the matters raised in the Issues Paper.

We propose the following 10 principles:

1. The AER's focus must be on the National Electricity Objective (NEO) without ignoring shorter-term impacts as well;
2. A recognition of the uniqueness of the current situation;
3. The AER should use the best available evidence;
4. The AER must apply the Tribunal and Federal Court directives, where they exist;
5. There is a process to transition from an inefficient network business to an efficient business;
6. There should be objective fairness between businesses;
7. Levels of opex must be sustainable;
8. The AER is dealing with "a new reality";
9. Making remit decisions as a whole and
10. Trust and goodwill are needed to produce outcomes that work for all parties.

Principle 1. The focus must be on National Electricity Objective (NEO)

The National Electricity Objective is:

"to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to – price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system."

It is widely quoted that the focus is on the "long-term interests of consumers" with the rider, we suggest that shorter-term impacts can also affect the longer-term interests of consumers. Indeed, the very first CCP submission to the AER, which was dealing with the 3 NSW distribution business 2014-19 regulatory proposals was titled; "*Jam tomorrow.*[2]" This title was chosen to reflect a prevailing view amongst consumers that the better outcomes for consumers (jam in this analogy) were always promised, but beyond reach in reality.

[2] https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausgrid-

The remitted decisions for 2014-19, have to apply the NEO, with reference to more immediate benefits for consumers as well.

Principle 2. Recognition of the uniqueness of the current situation

This principle is considered above, but its significance cannot be overstated; the current situation is unique and so traditional approaches for resolving the issues are unlikely to be helpful.

Principle 3. Use the best available evidence

A part of the uniqueness of the remittal process is the availability of revealed costs for at least 3 years of the period under consideration.

The actual costs achieved to date and projected reflect bottom-up cost information held by the businesses. Hence, they represent the best available evidence on achievable bottom-up costs and cannot be ignored by the AER.

Accepting the final opex as the base for the next period's opex is consistent with the AER's established policy that revealed costs be accepted as efficient if there is not strong evidence that they are inefficient

Use of actual data is a significant advantage for this process, compared to standard regulatory decisions that must rely on forecasts.

Principle 4. Apply Tribunal and Federal Court directives, where they exist

Of course, the AER must apply directions from the legal processes in remaking the 2014-19 decisions. We also recognise that there are important aspects of re-making the decisions where there are no clear directives from the Tribunal / Court, so the discretion of the AER will need to be exercised in such circumstances.

The Tribunal finding, upheld by the Federal Court, was that the AER was entitled to conclude that the forecast costs of each of ActewAGL, Ausgrid and Essential were inefficient. See Table 2 on page 10 of the Issues Paper where the Tribunal says: "*There was material upon which it could have reached that conclusion.*" This leaves it open for the AER to determine the path for the estimated efficient costs from the previous level of costs.

The AER could revisit this *material* to justify why the businesses should not be given their revealed costs, however that is not an approach preferred by CCP10, the businesses nor the AER.

We support the underlying objective of the AER's Issues Paper to find a basis that does NOT involve it having to remake these decisions as if it were at the beginning of the 2014-19 reset using other tools to work out what the prudent/efficient costs were. That is consistent with the view expressed by most parties at the Roundtable on 16 August 2017.

Principle 5. Transition from inefficient to efficient

As part of the context for remaking the decisions, it is important that the principle is accepted that a clear objective of the remittal processes is for regulatory decisions that enhance the movement from inefficiency to efficiency for each business. This principle is not about apportioning blame for past inefficiencies, it is about focussing on an effective and timely transition to efficient businesses. The businesses argued in the Tribunal to be given a transition for this process.

The Federal Court and the Tribunal did not determine what the efficient costs would be nor if the AER should assume a transition to the costs it determines to be efficient. This leaves it open for the AER to determine the transition path for the estimated efficient costs from the previous level of costs.

Principle 6. Objective fairness – between businesses

When the original 2014-19 decisions were made by the AER, the three NSW businesses were working together under the umbrella of Networks NSW. Ownership arrangements have since changed for two of the businesses following the privatisation process of the NSW government with the sale of a 99-year lease of Ausgrid and Endeavour's network businesses. Each business now reports to different Boards and are acting quite separately from each other.

A principle for the remits will be to regard each business as being autonomous, despite being 'together' at the start of the 2014-19 process. Each business will need to be treated fairly, but this will likely mean different details in the final remitted decisions.

It is also our opinion that objective fairness means that any business that provides leadership in seeking resolution of the remittal issues or shows leadership in their consumer engagement should not end up being treated adversely compared to the other businesses. (We note some commentary from the UK suggesting that the fast-tracked business, under RIIO, may be worse off than if they had stayed with standard process. A contrary outcome to the intent of RIIO)

Principle 7. Sustainable Opex

Revealed costs of operation of the distribution businesses for the first three years of the 2014-19 period indicate over-expenditure when compared to the AER's efficient costs as determined through the benchmark model and other mechanisms (Figure 3). These levels of over expenditure, including the cost of redundancies, ranges from 5% in the case of Essential Energy to 46% for Ausgrid.

Against this data, the revealed costs are considered to be inefficient, however we have no way of directly observing what the true prudent or efficient costs were.

In discussion with the network businesses, we understand that:

a) Ausgrid, Essential Energy and AAD (ActewAGL Distribution) believe that they can reduce costs to the level forecast by AER for the final year of the current regulatory period (although ActewAGL has publicly indicated that this may not

be a sustainable level of costs);

b) Endeavour Energy[3] requires opex for 2019-24 of $1,502M, which suggests a continued spend of around 23% above the AER determination; and

c) all distributors forecast that over the period 2014-19 their actual opex will exceed the opex allowed in the AER's determination.

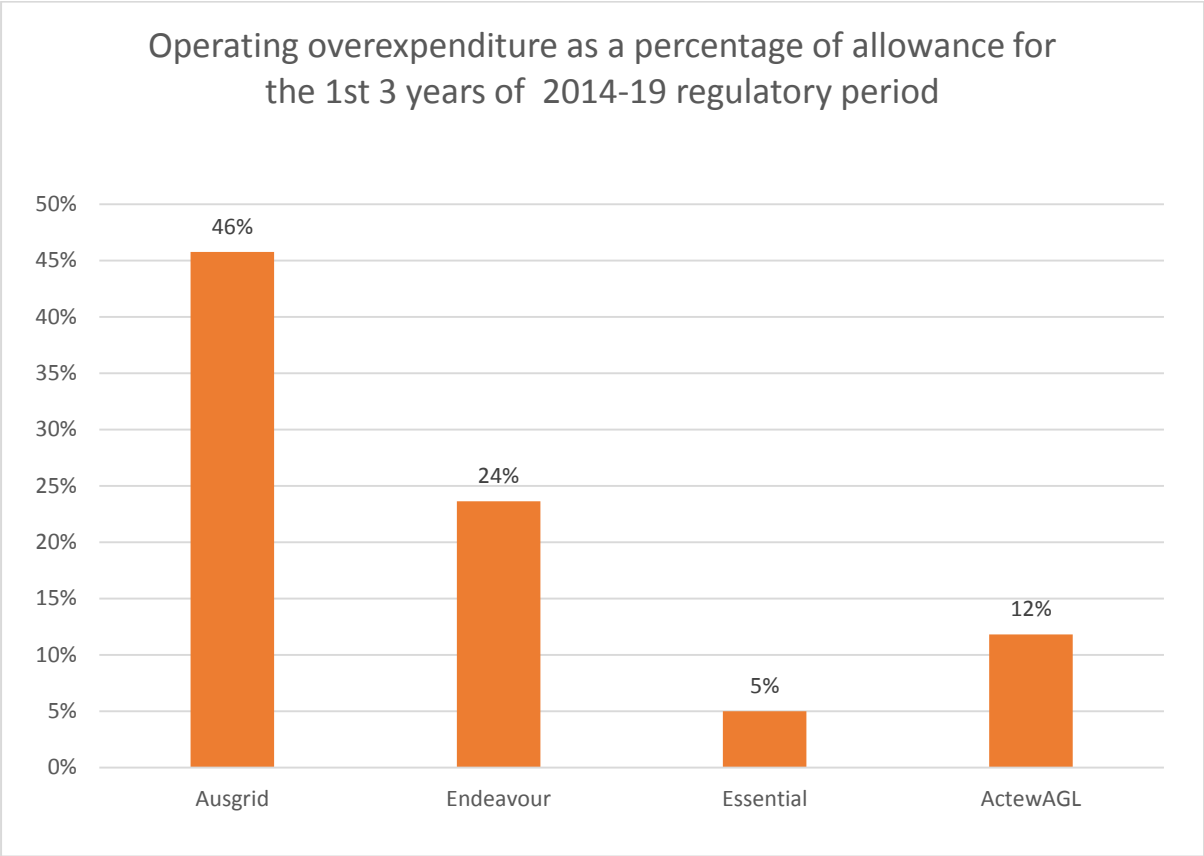


Figure 3: 3-year total operating Expenditure as a proportion of allowance, 2014-17

(Source AER data, TCA analysis)

From data provided by the businesses and presented in Figure 4, each of the businesses has approached the challenge to reduce operating costs in different ways and at different rates. All cost trajectories support the common claim that the final (2019) annual opex cost proposed by the AER is achievable.

a) Ausgrid has a distinct and steady cost reduction path from a significantly inefficient position towards the AER target, but still has some way to go in the final 2 years of the period;

b) Endeavour Energy is showing little progress in achieving operating cost

[3] *Endeavour Energy Presentation to their Consumer panel, 22 Nov 2017*

reductions, supporting their position that they will require opex of $1,502M, 23% above the AER determination, for the 5-year period;

c) Essential Energy has made considerable progress towards efficient operating costs; and

d) ActewAGL was able to reduce costs significantly in the early part of the period to well below the AER target, creating some questions as to the mechanism of the cost reduction and the sustainability of the cost reduction measures.

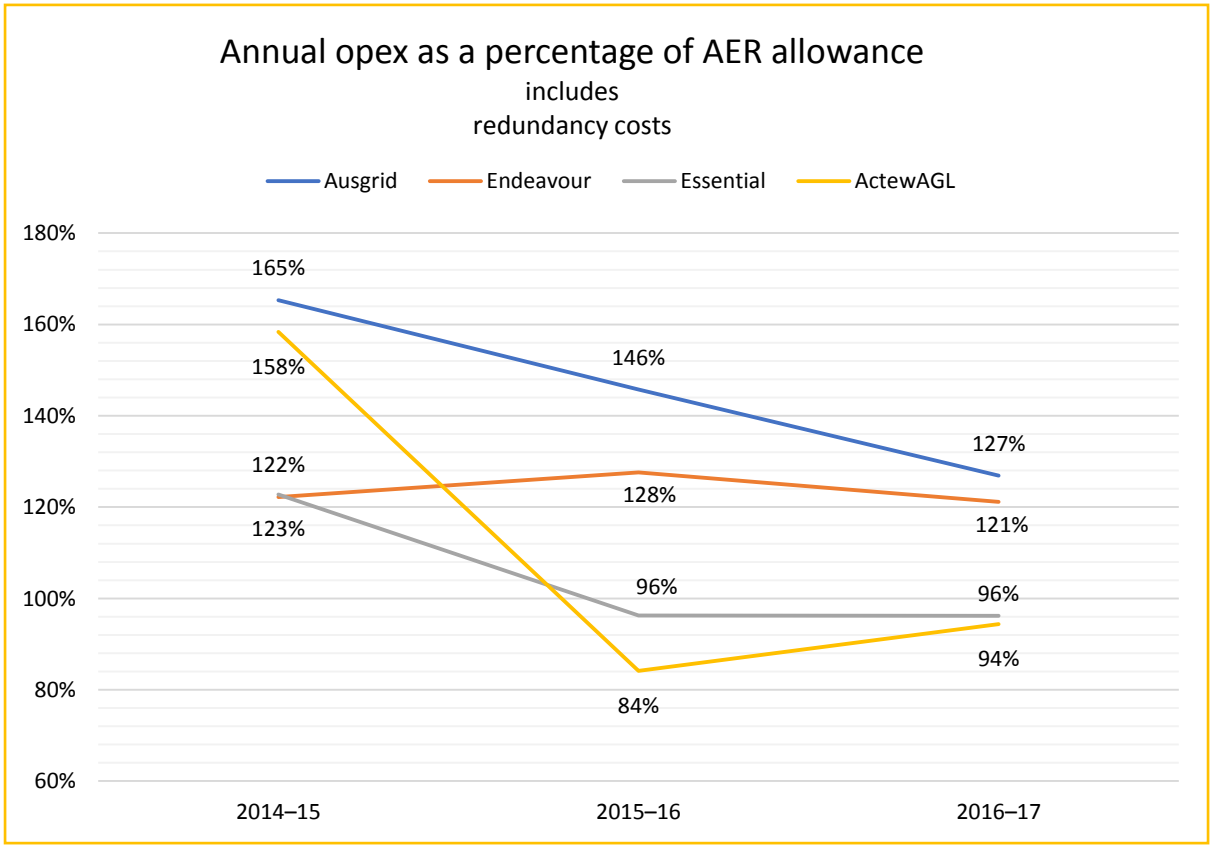


Figure 4: Annual Operating Expenditure as a proportion of AER allowance, 2014-17

(Source AER data, TCA analysis)

Reducing operating costs requires changes to labour costs, contracting expenses (especially pole inspection, property costs and vegetation management) and overheads. It is recognised that these costs cannot be reduced quickly without some impact to the operation of the businesses.

The observations and questions raised by the data are:

a) There is reasonable evidence that all businesses can achieve efficient annual operating costs by the end of the 2014-19 determination period.

b) The revealed costs are converging, but not yet equal to, the best achievable costs.

c) The rate of change demonstrated by ActewAGL and to some extent Essential

Energy and Ausgrid suggests the need for some investigation into the sustainability of the change and possible impact on the safe, reliable operation of the businesses, with a possibility of a 'bow wave' of costs emerging in areas such as vegetation management or asset inspection. Information such as IPART's compliance auditing for network businesses will assist.

d) Is any reward equitable for the networks that have reduced costs more quickly?

e) How should the transition costs (in the sense of the difference between actual costs and the assumed costs) be shared?

On option that could be trialled is to ask the utilities to consider their own benchmarking between similar organisations in Australia and abroad – such as the UMS process – to support their case of efficient operating and capital expenditure.

Principle 8. Dealing with "A New Reality"

In their submission in response to the original 2014-19 proposals from the business, CCP1 contextualised their submission in response saying: "*We consider that there is a new reality facing distribution businesses (and indeed, others in the energy sector) and yet we see limited evidence that the submissions from the New South Wales distribution businesses reflect this and move beyond "business as usual". The new reality is a result of changes in demand and changes in customer willingness to pay high electricity bills, leading to a need for businesses to adapt to meet these new circumstances*."

While this "new reality" may not be quite so new in 2017, responding to this new reality remains an important role for the remittal decisions. Transition to an uncertain future energy market structure is important context and an area where the regulator will need to exercise discretion.

Principle 9. Making remit decisions as a whole

The AER will be remaking the remitted decisions as a whole. This Issues Paper and this response deals only with the opex issues associated with making that remit decision. The AER will shortly be releasing their Issues Paper on the debt issues in the 2014-19 remitted decisions, and there are other factors which also may be relevant in making full decisions. The opex considerations will be an important part of the final remit decisions that will need to incorporate other significant factors into final decisions.

Principle 10. Trust and goodwill are needed to produce outcomes that work for all parties

CCP10 has observed increasing levels of goodwill demonstrated by some of the businesses in developing their 2019-24 regulatory proposals and in dealing with CCP. We recognise that past practices and perceptions have reduced trust between parties involved in regulatory processes.

Building trust and goodwill must also remain a crucial principle throughout the remittal processes and beyond.

We believe these 10 principles and the unique set of circumstances described above, are an appropriate framework for when the AER exercises its discretion in remaking the remitted decisions. CCP10 suggests allowing the businesses to claim no more than, 50% (preferably less) of their operating expenditure on a net basis when the decision is considered as a whole. We acknowledge that there is no quantitative economic principle to support a 50% upper limit, however CCP10 believes that it is in the long-term interests of consumers for the businesses to transition to efficient businesses, where they can then have the benefit of incentive schemes in the 2019-24 determinations, which will in turn deliver ongoing efficiencies to consumers.

3. Additional Remittal Considerations

Recently, there has been considerable discussion between network businesses and the AER, including a roundtable discussion of all businesses that are involved in the remittal decisions, some consumer representative groups and the CCP10 on 16 August 2017. These discussions lead us to understand that the following observations also apply to the remittal considerations.

Ausgrid and Endeavour have each indicated that they expect to achieve the cost levels in the AER's original decision by 2018-19. ActewAGL exceeded those cost levels in both 2015-16 and 2016-17, however publicly claims that is not sustainable in 2018-19. In its Discussion Paper released in July 2017 Actew stated on page 15*:*

> *"The opex reduction that we have achieved since 2015 has been driven by the need to manage the risk that (in the absence of a settled outcome to the ongoing process of review of the Regulator's 2015 determinations) the Regulator's opex determination may be upheld, rather than to reflect ActewAGL Distribution's view of what an efficient and prudent program for maintenance of our distribution network would look like. We consider that the Regulator's opex allowance is not consistent with the level of opex required for sustainable maintenance of a safe and reliable supply of electricity."*

Essential has also indicated that they will achieve the opex assumed in the original decision by 2018-19 however, they are outside of the scope of this Issues Paper. In these circumstances, it has been proposed that those costs would be the base costs for the next regulatory period. (It remains to be clarified how a significant variation between final year costs and the estimate of efficient costs in the 2014-19 decision would be handled).

ActewAGL has been able to achieve the large reduction in costs in 2015/16 to the opex levels assumed in the initial decision. To varying degrees the other distributors have not, although they anticipate reaching the allowed costs in the final year. For all distributors, total costs over the current regulatory period will be higher than those allowed in the initial determination.

The AER has asked how the transition costs from previous cost/revenue levels to the final year cost/revenues should be shared between the distributors and the consumers. In its original decision, the AER assumed a step change in the first year to the estimated efficient costs. It could retain this approach but provide a revenue path that provides a sharing of the transition costs in addition to the build-up of efficient costs from the cost building blocks.

An alternative would be to move away from the assumption of a single step change in costs and allow a transition path for costs. The transition path could be based on the concept of the prudent efficient operator taking into account the starting costs and systems of operation. That is, how quickly could a prudent efficient operator reduce costs in practice? This could be informed by the actual path for reduction in costs but not necessarily based on the actual cost reduction path for each distributor.

These matters are also covered in the issues paper.

To address the issues paper, we first provide some analysis of the key issues raised before concluding this submission with summary responses to the specific questions posed in the issues paper and considered in the following 2 sections.

In section 5 we discuss four methods which summarise our thinking of approaches that could be applied in making the remittal decisions. These differing approaches came about because we could not find any single established method by which these decisions could be made. We have attempted to scope a range of approaches within which the AER's discretion will fall.

Before outlining the four methods, section 4, and appendix A consider benchmarking, which was one of the contested aspects of the original 2014-19 final decisions by the AER.

4. Use of benchmarking by the AER

As part of the context for the 2014-19 regulatory processes, we note that benchmarking was widely discussed at the time as part of the response to high network charges. The Productivity Commission wrote in its 2013 report on electricity network regulation:

> "In the immediate future, benchmarking would be most useful:
>
> - as a diagnostic tool to help assess the reasonableness of bottom-up detailed proposals. Operating expenses, such as the costs of vegetation clearance around poles and wires, are more generally amenable to benchmarking than capital expenditure. Such specific benchmarking may be reasonably reliable because there are fewer confounding variables. It may also be possible to expand the number of comparisons by analysing performance outcomes from the many regions of any given network business. The AER has already made some use of such benchmarking, as have the network businesses themselves for commercial purposes, underlining that it is sufficiently robust to be useful.

The implication of this role for benchmarking is that it is unlikely to reduce to any degree the page counts of regulatory proposals and counterproposals, though it should improve the quality of the outcomes

- in providing information to consumers and others, thereby providing pressure for improved performance by network businesses. The 2012 Rule change requiring the AER to produce annual benchmarking reports about the performance of network business should assist.[4]"

As part of the original set aside 2014-19 decisions the AER rejected the businesses' forecast revenue allowances. Once the AER concluded that the distributor's forecasts were inefficient it needed to identify its own view of the efficient costs for 2014-19, the argument for benchmarking was persuasive and the AER had been encouraged to increase its application of benchmarking approaches.

The AER said it used a variety of tools, including its benchmarking model, to work out the substituted efficient costs in the set aside determinations. The Tribunal and the Federal Court didn't accept this and found that the AER appeared to rely purely on the benchmarking model for the substituted opex.

There are sound reasons why 100% reliance on benchmarked costs is inappropriate and nor was this proposed by the Productivity Commission. The question was about the extent of application rather than the appropriateness of applying benchmarking. See Appendix A: "*Incentive Based Regulation and the role of benchmarking"* for further discussion about the continuing importance of and application of benchmarking approaches. Regarding benchmarking, CCP10:

- is strongly in favour of the AER using benchmarking as an assurance tool to cross check forecasts of the distributors
- supports the AER's annual benchmark publication and strong incentive based regulation (IBR) as discussed in the attached "*Incentive Based Regulation and the role of benchmarking"* and
- favours stronger, future incentives than the EBSS and encourages the AER to do an international review to check world's 'best practice' for IBR mechanisms.

5. Introduction to the 4 methods

[4] Quoted from overview, page 29, accessed through link http://www.pc.gov.au/inquiries/completed/electricity/report

Earlier in this submission we make the observation that there are no clear or obvious approaches to dealing with the unique situation provided by making the remitted decisions for 2014-19. This section summarises the efforts of CCP10 to develop a methodology to apply the principles given in section 2. We have identified four methods as a basis for analysis. These methods are not all developed in detail, and a couple are presented more as 'strawman' notions to aid consideration of options and should not be considered as definitive. Appendix A' *Incentive Based Regulation and the role of benchmarking"* discusses the meaning of long-term in the NEO. The key to any proposal for 'sharing' benefits or costs between 'consumers' and network owners or 'transitioning' is to focus on the long-term interests of consumers while being careful about balancing the consumers interests in 2014-19 with the interests of the consumers in the future. Future consumers may reap the benefit of lower prices from the move to efficient levels of opex that would be paid for by the consumers of 2014-19 – an intergenerational fairness consideration, all consumers present and future should only pay for the efficient network services that they use.

Specifically for these remits, strongly submits that there should not be any sharing of costs by consumers if the relevant distribution business is not going to reach the AER's benchmarked efficient level of costs by year 4, 2017-18

Method 1: Cost sharing between networks and consumers

CCP10 believes that there will be long-term benefits to consumers flowing from the short-term overspend opex, which included significant redundancies. We also note from the revealed costs, that during the period the businesses have or will reduce their costs to achieve the AER forecast opex. On this basis CCP10 believes that it would be in consumers long-term interests to bear some portion of this opex overspend. Under method 1 the AER would decide on what proportion it believes in its discretion would be a reasonable portion for consumers to bear. CCP10 believes that there should be a rationale for any proportion that the AER chooses. To assist with analysis, we identify the following as a subset of possible options:

Customers	Networks	Rationale
100%	0%	Money spent already, customers benefit in the longer term
70%	30%	EBSS split percentages which applies to Endeavour
50%	50%	Split 50/50 which might seem fair

30%	70%	EBSS split reversed
0%	100%	It is the networks that have decided to overspend, they bear the costs

If the AER were to choose 0%, CCP10 believes this would be a focus on short-term interests only and would ignore the long-term interests of consumers. Similarly giving the business 100% would be taking a long-term view at the expense of the 2014-19 consumers.

Either of the 30/70 or 70/30 splits would be based on the percentages that underpin the EBSS. However, the sharing in the EBSS is different to the concept of sharing of a one-off transition costs. The sharing in the EBSS compares the benefit of a reduction in costs that the business retains under the EBSS compared to if it retained those ongoing services in full in perpetuity. The sharing of transition costs sees these costs as a one-off and asks should the network bear all of these.

As we discuss in method 2 below we do not support the application of the EBSS so we see no reason for the AER imposing a 30% cap on the transition costs to be allowed to ensure that it is consistent with the EBSS.

50% seems attractive because it appears to be “fair” in that there is equal share of costs between consuemrs and a business, but there is no obvious regulatory basis to support it. It might however be a maximum cap that the AER may want to consider under either of the methods we recommend in methods 3 and 4 below.

Method 2: Apply retrospective EBSS

Objectives of the Efficiency Benefit Sharing Scheme. (EBSS)

The EBSS seeks to:

1. equalise the incentives for the distributor to make ongoing efficiency improvements (relative to the allowed efficient costs) in each year of the regulatory period and
2. share the benefits of sustained efficiency savings between the distributor and customers in a fixed 70:30 ratio irrespective of the year in which the efficiency saving is made.

The design of the mechanism assumes that the costs in the base year (usually the second last year of the regulatory period) will be accepted as efficient and used as the basis for the first-year costs in the next regulatory period.

Without any EBSS there is:

- a stronger incentive to reduce costs in the early years of a determination than the latter years and

- the possibility that the distributor could allow costs to drift up in the last two years of a regulatory period to provide a higher base for costs in the next regulatory period and the opportunity to make quick efficiency gains in the early years of the next regulatory period.

Initial AER Decision

In its original decision, the AER established a path for efficient costs that assumed a large reduction in costs to the estimated efficient costs in the first year and then a relatively flat path for opex in the remaining years of the regulatory period. It also chose not to apply the EBSS.

Under this path the distributors could expect that:

1. the incentives to reduce incentives were strongest in the early years of the regulatory period – i.e. the distributor should 'cut early and cut hard' and
2. if the distributors' costs in the base year could not be determined to be inefficient those costs would be accepted as the base for costs in the subsequent regulatory period (consistent with the AER's established policy).

Consideration of the application of the EBSS

As noted above the EBSS seeks to address two problems: the stronger incentive to reduce costs in the early years of the determination and the opportunity to allow costs to drift up in the latter years to set a higher cost base for the next regulatory period. The question to be considered is whether these problems are still relevant in the context of the remittal. Firstly, the approach foreshadowed to setting costs for the next regulatory period reduces the opportunity for the networks to gain a high cost allowance at the next reset by allowing actual costs to increase in the last years of the current period. Secondly, we are now into the third year of the regulatory period and the opex paths have been substantially set in response to the incentives without an EBSS.

Taking both points together adoption of an EBSS may increase the incentives to pursue efficiency gains in the last two years of the regulatory period, but the benefits of adopting an EBSS now are far smaller than adopting an EBSS at the start of regulatory period.

The application of the EBSS will affect the:

1. average prices in the next regulatory period and
2. the 'sharing' of the transition costs from the period.

These impacts will vary depending on the basis for sharing of transition costs as the reference point for assessment of efficient cost varies. However, the key outcomes in both cases are clear:

1. average prices are higher in the next period due to the operation of the EBSS. The increase in prices/revenues in the next period is greater if there is not a glide path for allowed costs (rather than a single step change).

2. For the distributor, the EBSS allows it to recover in the next period the difference between allowed costs and its actual costs in the current period. That is, it gets its costs back eventually even though there may be a lag and there is no sharing of transitional costs between the distributor and customers
3. If the EBSS is applied when there is a single step change in allowed costs (rather than a glide path) and there is an adjustment to the revenues for transitional costs the customers pay twice for the transitional costs.

The exception to these results is if a glide path for efficient costs is adopted which approximately equals the actual costs. In this case the EBSS may not affect allowed costs in the next period (see ActewAGL example with a glide path, below). However, this still means that customers bear the 'transition costs' as defined by AER.

On this basis, there is no case for an EBSS if the current path for allowed costs is retained and an additional allowance for transition costs. If an EBSS were implemented no further adjustment would be required and the distributor would still recover its actual costs over the two regulatory periods (i.e. 'transition costs' would not be shared.

If the opex glide path were considered the true efficient costs it would not be inconsistent to apply an EBSS but it would still result in:

1. customers bearing all of the difference between actual costs and the originally determined efficient cost path and
2. a significant increase in charges in the next period.

On both grounds, the application of an EBSS is not supported even if a glide path is adopted for the allowed costs.

Impacts of adoption of an EBSS

The tables below summarise the impact of an EBSS on allowed costs in the next regulatory period for Ausgrid and ActewAGL. Endeavour Energy is not included as the EBSS already applies to Endeavour. The analysis uses the AER EBSS model with the following assumptions:

1. the efficient costs in 2018-19 are those in the original determination
2. the actual spending by Ausgrid and ActewAGL to 2017-18 is sourced from the AER Opex Discussion Paper
3. opex in the remaining years of the current regulatory period are estimates based on (1) and (2) and a final year opex equal to that assumed in the AER decision and
4. the opex allowance for the next regulatory period is based on (1).

For each distributor two cases are examined: a) assuming the opex allowance in the AER's original decision; b) assuming a glide path for costs from prior levels to the 2018-19 value in the original determination.

The EBSS measures ongoing efficiency gains as the reduction in costs relative to the allowed efficient costs between years, exclusive of one-off effects in base years.

The efficiency gains in each year are carried forward to the next regulatory period so that the distributor gets the benefit of the gains for 5 years. After that the gains are passed through to consumers. For example, this means that the ongoing efficiency gain of $72.8m in 2016-17, being the reduction in the excess of costs over efficient costs relative to 2015-16, is added to the cost allowance in 2019-20 to 2021.

Ausgrid Opex Allowance in Original Determination

As the table below shows the net result of the application of the EBSS is that there is a large increase in the allowed opex of almost $500m over the next regulatory period. This equals the difference between actual costs and the target (allowed) costs in the current period, before allowing for the time value of money. This result occurs because there is such a large systematic difference between the allowed costs and actual cost and a sustained reduction in costs to the target levels by the end of the period. If there was a transitional allowance in the period to 2018-19 plus an EBSS, Ausgrid would recover more than the difference between the allowed costs and actual costs.

Year	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Target (F)	390.8	396.6	404.3	397.5	403.6	403.6	403.6	403.6	403.6	403.6
Actual (A)	545.9	578.1	513	450	403.6	403.6	403.6	403.6	403.6	403.6
Cumulative saving (F-A)	-155.1	-181.5	-108.7	-52.5	0	0	0	0	0	0
Incremental saving (E)	-155.1	-26.4	72.8	56.2	52.5	-62.5	0	0	0	0
Carry-over of gains made in										
2014-15		-155.1	-155.1	-155.1	-155.1	-155.1				
2015-16			-26.4	-26.4	-26.4	-26.4	-26.4			
2016-17				72.8	72.8	72.8	72.8	72.8		
2017-18					56.2	56.2	56.2	56.2	56.2	
2018-19						52.5	52.5	52.5	52.5	52.5
2019-20							-62.5	-62.5	-62.5	-62.5
2020-21								0	0	0
2021-22									0	0
2022-23										0
2023-24										
Carry-over, (B)						0	155.1	181.5	108.7	52.5
Forecast opex + Carry-over (F+B)	390.8	396.6	404.3	397.5	403.6	403.6	558.7	585.1	512.3	456.1

Ausgrid Opex Glide path

In this case the transition costs are allowed for in the opex glide path. This reduces the measured efficiency gains in the current period to $237m which in turn reduces the amount added to costs in the next period to $237m. This avoids the 'double counting of transition costs that occurred under the first option. However, it still means that, except for the time value of money, the network recovers all of the difference between its actual spend and the originally allowed opex in this period (through the adjusted opex path) or next (through the EBSS).

Year	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Target (F)	500	475	450	425	403.6	403.6	403.6	403.6	403.6	403.6
Actual (A)	545.9	578.1	513	450	403.6	403.6	403.6	403.6	403.6	403.6
Cumulative saving (F-A)	-45.9	-103.1	-63	-25	0	0	0	0	0	0
Incremental saving (E)	-45.9	-57.2	40.1	38	25	-35	0	0	0	0
Carry-over of gains made in										
2014-15		-45.9	-45.9	-45.9	-45.9	-45.9				
2015-16			-57.2	-57.2	-57.2	-57.2	-57.2			
2016-17				40.1	40.1	40.1	40.1	40.1		
2017-18					38	38	38	38	38	
2018-19						25	25	25	25	25
2019-20							-35	-35	-35	-35
2020-21								0	0	0
2021-22									0	0
2022-23										0
2023-24										
Carry-over, (B)						0	45.9	103.1	63	25
Forecast opex + Carry-over (F+B)	500	475	450	425	403.6	403.6	449.5	506.7	466.6	428.6

ActewAGL Opex Allowance in Original Determination

As the table below shows the net result of the application of the EBSS is that there is an increase in the allowed opex of almost $17m or 7% over the next regulatory period. This equals the difference between actual costs and the target (allowed) costs in the current period, before allowing for the time value of money. The impact is smaller relative to total opex for ActewAGL because they have made the efficiency gains earlier in the regulatory period than Ausgrid. Even so, if there was a transitional allowance in the period to 2018-19 plus an EBSS, ActewAGL would recover more than the difference between the allowed costs and actual costs.

Year	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Target (F)	46.1	47.3	48	48.9	50.3	50.3	50.3	50.3	50.3	50.3
Actual (A)	73	39.8	45.3	48.9	50.3	50.3	50.3	50.3	50.3	50.3
Cumulative saving (F-A)	-26.9	7.5	2.7	0	0	0	0	0	0	0
Incremental saving (E)	-26.9	34.4	-4.8	-2.7	0		0	0	0	0
Carry-over of gains made in										
2014-15		-26.9	-26.9	-26.9	-26.9	-26.9				
2015-16			34.4	34.4	34.4	34.4	34.4			
2016-17				-4.8	-4.8	-4.8	-4.8	-4.8		
2017-18					-2.7	-2.7	-2.7	-2.7	-2.7	
2018-19						0	0	0	0	0
2019-20							0	0	0	0
2020-21								0	0	0
2021-22									0	0
2022-23										0
2023-24										
Carry-over, (B)						0	26.9	-7.5	-2.7	0
Forecast opex + Carry-over (F+B)	46.1	47.3	48	48.9	50.3	50.3	77.2	42.8	47.6	50.3

ActewAGL Opex Glide Path

ActewAGL has achieved substantial reductions in costs in 2015-16. As a result, for the glide path used in the example ActewAGL its actual costs are close to the allowed costs. The efficiency gains, relative to the efficient costs allowed are largely offsetting. Hence, there is no significant impact on allowed costs over the next regulatory period. This means that the transition costs are fully borne by customers

through the glide path allowed for efficient costs. The adoption of an EBSS would have no significant impact.

	Period 1					Period 2				
Year	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**
Target (F)	65	50	45	47.5	50	50	50	50	50	50
Actual (A)	73	39.8	45.3	48.9	50.3	50	50	50	50	50
Cumulative saving (F-A)	-8	10.2	-0.3	-1.4	-0.3	0	0	0	0	0
Incremental saving (E)	-8	18.2	-10.5	-1.1	1.1	0	0	0	0	0
Carry-over of gains made in										
2014-15		-8	-8	-8	-8	-8				
2015-16			18.2	18.2	18.2	18.2	18.2			
2016-17				-10.5	-10.5	-10.5	-10.5	-10.5		
2017-18					-1.1	-1.1	-1.1	-1.1	-1.1	
2018-19						1.1	1.1	1.1	1.1	1.1
2019-20							0	0	0	0
2020-21								0	0	0
2021-22									0	0
2022-23										0
2023-24										
Carry-over, (B)						-0.3	7.7	-10.5	0	1.1
Forecast opex + Carry-over (F+B)	65	50	45	47.5	50	49.7	57.7	39.5	50	51.1

For these reasons CCP does not support the application of a retrospective EBSS type approach

Method 3: Glide path to efficient costs

Benchmarking can provide useful information as to directional change and potential long-term outcomes. But the AER should have regard to what would be prudently achievable by an efficient operator given the starting point.

The Tribunal had concerns with the initial AER decision in that:

1. they placed too much weight on the benchmarking results – more weight than they could support. AER had other information that indicated that the NSW businesses were highly inefficient but the Tribunal found that it did not appear from their decision that it was given substantive weight.
2. The businesses each argued that the large step reduction in costs proposed was impractical. The Tribunal left open the issue of a transition to efficient costs and left this as an issue for the AER in the remittal. If the large step reduction required actions that put safe, reliable operation at risk or required cuts focussed on short-term reductions in costs that may not be consistent with long term efficient costs. In that case deep immediate cuts may not be in the long-term interest of consumers.

These concerns are discussed in Appendix A “Incentive Based Regulation and the role of benchmarking”.

The AER could ask what costs would be incurred by a prudent, efficient operator/manager given the initial conditions/costs. This provides for a transition in

costs, as Ofwat and Ofgem have done. It does mean that consumers pay for costs that would not be incurred if the distributors were efficient from the outset, but it reduces the risk of assuming cost levels that may prove to be unsustainable. Posing it this way is closer to 'method 4' below with the caveat that it is difficult to do at the individual cost levels, so typically broader 'macro' transition paths are used. From this perspective, the options could be:

1. a straight-line cost path from opening costs to the 2018-19 costs. This is the simplest and could be argued to be the default option in the absence of specific cost information.
2. construct a profile by averaging the cost profile for each distributor (measured as the change in costs in each year relative to the end-point costs). The challenge for this is that while each of the distributors has the same incentives, the cost profiles seem very different.
3. use the actual costs to date for each distributor and then extrapolate to the target. This assumes each of the distributors has been doing the best they can to date and the differences in the time-profiles are due to specific issues for each distributor rather than differences in the level of effort to achieve efficient costs. This means each distributor recovers the costs it has occurred to date but there are no rewards/sanctions for those that have achieved a faster/slower reduction in costs. It looks more like cost plus regulation rather than incentive based regulation.

The challenge is how to determine the step change. If the transition path is intended to be a 'prudent efficient cost' path the step change should be based on what is a reasonably achievable reduction in costs in the first year. It is probably reasonable to assume a larger reduction could be made in the first year, especially if there are large reductions (as is the case for Ausgrid and ActewAGL). This assumes substantial excess staff which can be made redundant without requiring substantial process redesign or investment in new equipment or outsourcing contracts. The AER should be able to now get information on the level of excess staff identified and assume a 'decay' function.

Method 4: Allow redundancy costs above "AER efficient opex"

Under this approach the AER would seek to identify each of the items that contributed to the overspend in opex above the AER's forecast opex and then make a judgement about which costs consumers could legitimately bear and which costs the businesses should be required to bear.

The AER's current approach under the 'base-step-trend' methodology that it uses is to establish the efficient costs for the first year of the regulatory period by:

1. starting with the actual costs in the base year - usually the second last year of the previous regulatory period;

2. testing whether these costs can be accepted as efficient (there is a presumption that the incentives under regulation will encourage the distributors to reveal efficient costs and there needs to be clear evidence that they are inefficient for them to be deemed so). If deemed efficient those costs become the base for the projected costs;
3. if the costs are not accepted as efficient the AER needs to come to a view as to what the efficient costs are by looking at a range of information; and
4. the AER will adjust the costs to remove inefficient costs. They then add additional opex not reflected in the base year ('step changes') and trend it forward to reflect forecast changes in input costs, productivity and output growth.

CCP10 believes that there is some merit in the AER looking at redundancy costs incurred by the businesses in meeting the AER's forecast opex as a type of costs which could be shared by consumers. Redundancies serve two purposes:

(a) to reduce the number of FTEs surplus to requirements – reflected in a reduction in net staff numbers and ultimately operating costs, and

(b) to change the skill mix, replacing skill X with skill Y – so staff are replaced, and net staff numbers do not decline. In this case, the relationship between the cost of redundancies and the reduction in operating costs are not as clear.

In the case of staff number reductions through redundancies, there are competing arguments as to the pass-through of redundancy costs to customers. Firstly, there is a case that redundancies are an 'upfront' cost to the business that results in a positive return to the business after 12 months in labour efficiency and reduced opex costs. In that view, redundancies are a valid operating cost to business and should not be singled out in considering operating costs.

Assuming an average length of service of 15 years, current Enterprise Bargaining Agreement (EBA) conditions in NSW indicate the average redundancy payment is equivalent to about 12 months' pay, after which time the positive impact of most redundancies should be evident in the reduction in operating costs.

Alternatively, the distributors might, with some justification, argue that staffing costs were effectively an externally imposed cost that the (NSW) businesses had little control over, therefore they should not be held fully responsible for redundancy costs. CCP1 considered the 2014-19 regulatory period and strongly opposed acceptance of the higher salary costs arguing that these were not costs that consumers chose, as the then owner of the businesses was requiring the overpayment in labour costs, so the businesses should bear the cost. This view was not accepted by the Tribunal in the Ausgrid decision, however the recent Tribunal in Victoria took a slightly different approach to EBAs.

The legislated Employment Guarantees in NSW for the non-government-owned businesses Ausgrid and Endeavour Energy are also relevant to this issue, although

the recent compliance figures from IPART suggest that it is the EBA that is causing inefficient labour numbers rather than the Employment Guarantees.[5]

Our initial analysis suggests that the redundancy cost per change in staff varied widely across the businesses. For instance, Ausgrid may argue if its redundancy costs are inefficient compared to Endeavour and Essential it is because they have the mandatory employment guarantee legislation and the EBA. However, in our view it is not the legislation that is the real issue as Endeavour is subject to the same Employment Guarantee.

As the recent IPART compliance numbers show that both Endeavour and Ausgrid exceed the mandatory employment numbers by 11% and 22% respectively. This suggests that it is the no forced redundancy provision of its EBA that is the real issue.

In our opinion, the effect of the varying Tribunal decisions and the Federal Court decision, clouds the position of EBAs, and provides no guidance as to whether compliance with EBAs is something that could have been managed differently by the businesses or provides clarity as to the ability to pass some costs through to customers.

Voluntary Redundancy (VR) packages are similar across the businesses

As best as we can determine from public data, all the distributors are offering 3 weeks' pay per year of service plus 8 weeks early severance. This is a reasonably common framework across the industry. On that basis, no business appears to be any more generous (inefficient) than another.

Union public statements tend to focus on Ausgrid and the sunset of the employment guarantee requirements in 2020.

Modelling Redundancy efficiency

We recognise that redundancies are a mechanism to either:

a) Reduce overall staff numbers in response to process efficiencies (in the case of many IT investments), changes to workload or change in the scope of the business; in which case net staff numbers will fall; or

b) To replace staff with those with a different skill mix as business needs evolve.

CCP10 believes that the efficient application of redundancy programmes should result in a reduction in ongoing operating costs and/or capital expenditure overhead rates, indicating improvements in the labour efficiency of business processes.

Figure 5 shows that each business has undertaken reductions in total staff numbers since 2014.

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[5] https://www.ipart.nsw.gov.au/files/sharedassets/website/shared-files/licensing-compliance-employment-guarantee/fact-sheet-compliance-with-legislated-employment-guarantees-updated-13-november-2017.pdf

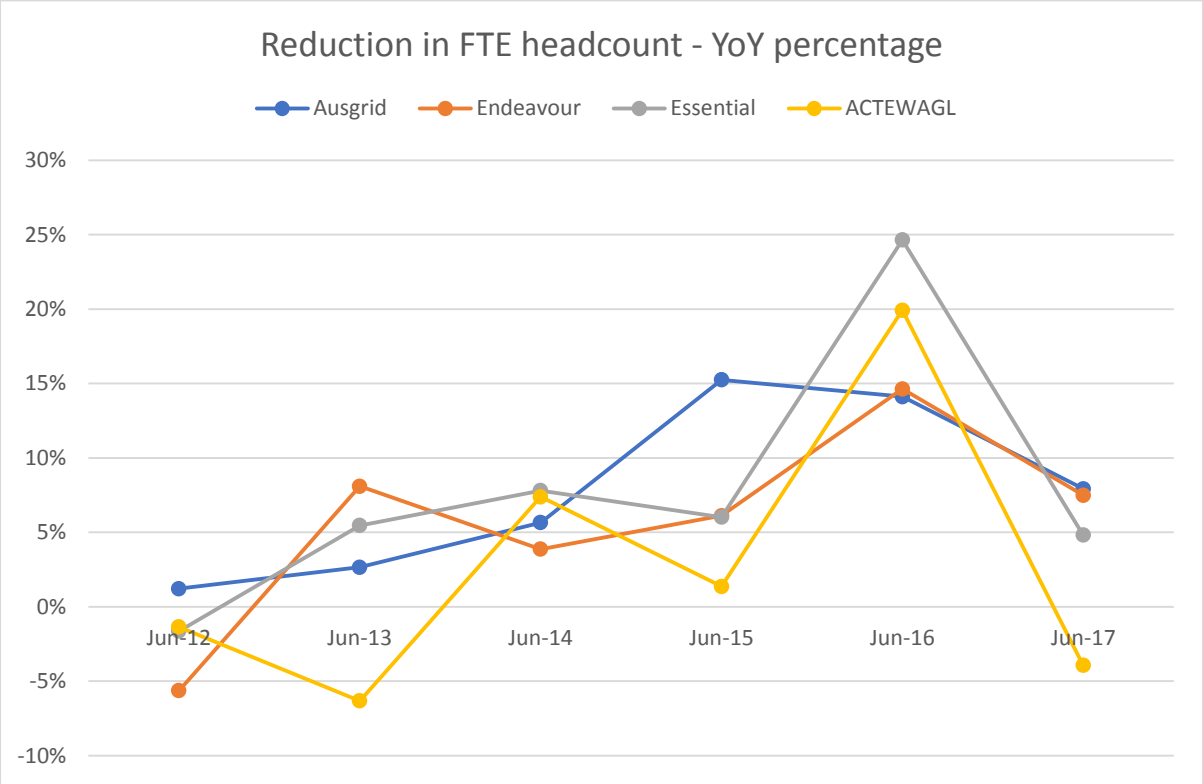

Figure 5: Reduction in Full-Time Equivalent (FTE) staff numbers

(Source AER RIN data, TCA analysis)

It is recognised that the ability to directly compare staff redundancy costs and reductions in labour expense with changes in employee numbers year-on-year is complicated by accruals and the timing of the staff departures within each financial year.

To ascertain redundancy efficiency would be to consider the complementary information regarding opex reduction, change in FTE numbers, and cost per redundancy. This analysis is not conclusive; however, it would provide a basis for the AER to make enquiries of the distributors to better understand the effective and efficient application of their redundancy policies.

As an example, on the assumption that around 60% of opex costs relate to internal labour, Figure 6 below suggests that both Ausgrid and Essential are receiving reasonable returns from process efficiencies that lead to staff number reductions.

In the case of Endeavour, a reported 26% reduction in staff numbers from mid-2014 to mid-2017 appears not to have translated to a reduction in operating costs, or has funded other operating costs such as external works contracts.

ActewAGL appear to have achieved operating cost reductions through means other than just staff number reductions.

In these cases, further investigation is recommended.

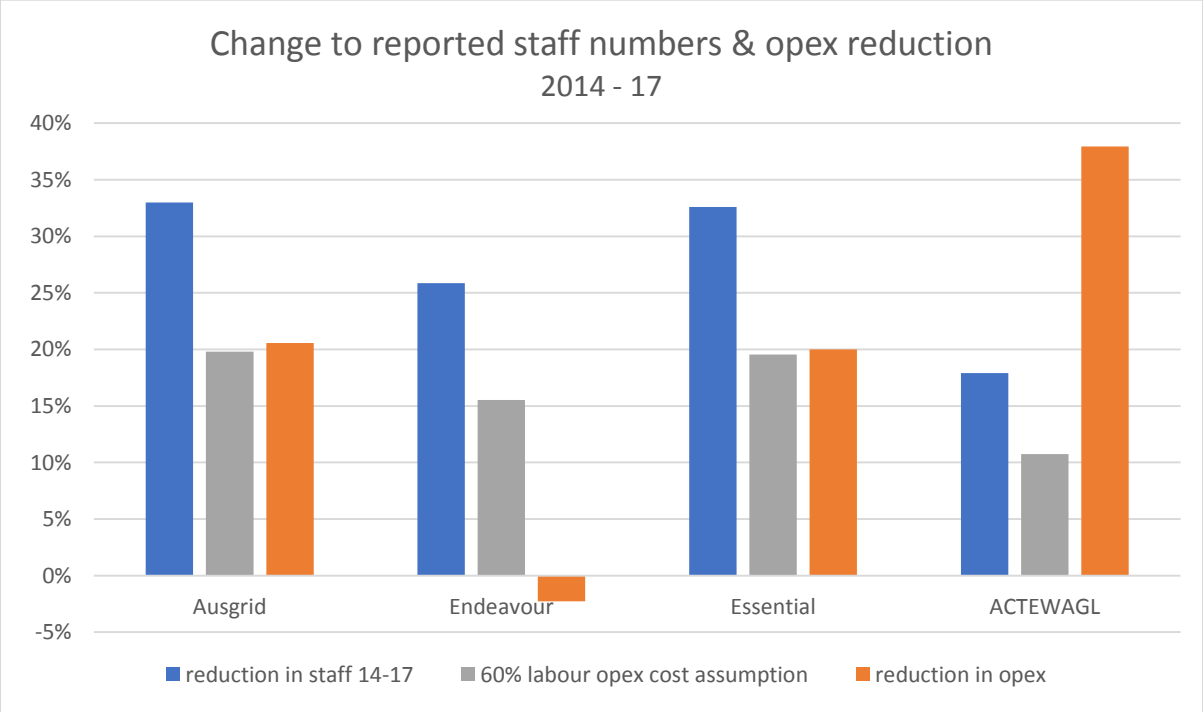

Figure 6: Comparison of the change in staff numbers and opex reduction

(Source AER RIN data, TCA analysis)

There is little evidence in the data to support the suggestion that ActewAGL is now required to re-hire staff as a result of an over-aggressive redundancy programme, as the data indicates that ActewAGL has reduced staff by 18% in the first 3 years of the period – no more aggressively than Ausgrid or Essential (33%) or Endeavour (26%)

Recommendation on method 4 redundancy costs

The relevant principles that CCP10 believes the AER should follow when considering what proportion of redundancies consumers should bear are:

1. consumers should not pay for redundancies that have not led to long term savings. This means that only businesses that have reached the AER's efficient opex level at end of year 4 and have a demonstrated relationship between the cost of redundancies and opex cost reductions should be eligible to recover.
2. only prudent (or efficient) redundancies should be considered. Consumers should not bear the cost of redundancies above the level being paid by the other comparable businesses. CCP10 believes that the 3 businesses are comparable with Ausgrid and Endeavour sharing several common characteristics.
3. the AER could analyse whether each businesses' redundancy costs are

similar on an FTE basis. This may involve an averaging or checking by reference to amount paid per FTE reduced. This is to ensure that consumers pay nothing towards inefficient redundancy costs.

4. If the AER cannot determine for certain that each businesses' redundancies are efficient then the AER could choose a cap on the portion to be borne by consumers instead of trying to substitute efficient redundant costs for the revealed redundant costs.
5. We refer to the percentages discussed in method 1 above and principle 10 and suggest the AER impose a cap of at most 50% of a businesses' actual redundancy costs in the first 4 years on the redundancies that each business can recover from consumers.

6. Specific questions asked by the AER in the Issues Paper

The questions from the opex issues Paper are shown in italics with our summary responses drawing on the discussion in the previous sections of this submission.

1. *For distributors whose revealed costs to date or revised targets for 2018 - 19 are close to our final decision 2018 - 19 opex forecasts, do you consider it reasonable for us to rely on these revealed costs or revised targets to forecast opex? If we are not to rely on the distributors' revealed costs or revised targets, what other tools or approaches should we use to forecast opex?*

In accordance with the decisions of the Tribunal the AER has to come to a view as to what are efficient costs taking into a broader range of evidence, including bottom-up cost analysis. The revealed costs are an important piece of new information that can be given significant weight in its decision-making.
The distributors have had strong incentives to improve efficiency. Despite the uncertainty, the distributors benefit from any reduction in costs from the start of the regulatory period (irrespective of the final outcome). The costs achieved to date and projected reflect bottom-up cost information held by the distributors. Hence, they represent the best available evidence on achievable bottom-up costs.

It is consistent with AER's established policy that revealed costs be accepted as efficient if there is not strong evidence that they are inefficient. However, it is important that the AER not rely on this alone. They need to demonstrate that they have assessed this against the other information that they had available at the time of the previous decision, including the benchmarking information, and any other new information.

This will then lead to the question as to whether they have strong information that suggests the projected 2018-19 costs are inefficient. But given that they are consistent with their previous evaluation and the Federal Court has indicated they should place less weight on the benchmarking, this is unlikely. Importantly it should not be presented as 'proof' that the benchmarking models were right.

2. *ActewAGL's revealed costs in the regulatory years 2015 - 16 and 2016 - 17 are less than the forecasts we determined in our final decision. There is no information or evidence before us that suggests ActewAGL's network has been adversely affected during the 2014 - 19 regulatory control period, including from a safety and reliability perspective. Based on this observation, does this suggest that ActewAGL's revealed costs in 2015 - 16 and 2016 - 17 represent a prudent and efficient level of opex? If we cannot rely on revealed costs in this case, what other tools or approaches should we use to forecast ActewAGL's opex?*

The answer to question 3 below is relevant. If the AER was back in 2014 making the original decision would you give a transition path for one and not the others (or vice versa)?

As discussed in Appendix A, as Professor Yarrow has noted, the consequences of the AER getting the allowed costs 'wrong' are asymmetric. Hence, the optimal strategy is one of caution in assuming cost reductions. In principle, better information allows the AER to narrow this risk and the action needed.

The AER should justifiably be wary of putting ActewAGL in a position where, even if it acts prudently and reasonably efficiently, it is not financially sustainable and cannot fund its continued operation and investment in the network. Not only is it not in the interests of ActewAGL's customers, but it increases perceived regulatory risk and reduces the credibility of the regulatory regime. This can have an adverse effect on the cost of debt and access to funding for the sector as a whole to the detriment of other utilities and their customers.

Throughout the regulatory reset period ActewAGL had strong incentives to improve efficiency, notwithstanding uncertainty about the regulatory outcome of the appeals. Despite the uncertainty, ActewAGL benefited from any reduction in costs from the start of the regulatory period (irrespective of the final outcome). In the absence of any evidence about adverse impact to its network since it reduced its operating expenditure CCP10 believes that the revealed costs are an important piece of new information that should be given significant weight in AER's decision-making and can be presumed to be an efficient operating level.

3. *In the context of the incentive regime established in Chapter 6 of the NER, and in the circumstances of transitioning from a higher level of opex to a materially lower level of opex (specifically transactional transition costs and the inefficient costs over and above the forecast), should:*

   a) consumers solely bear those costs (that is, a distributor's forecast opex should include an amount for a transition path allowance); or

   b) distributors solely bear those costs (that is, a distributor's forecast opex should not include an amount for a transition path allowance); or

   c) those costs be allocated or shared between consumers and distributors (that is, a distributor's forecast opex should include a partial amount for a transition path allowance)?

We refer to what we have written above on method 3 glide path and our comments on the nature of a transition path. We see the transition path as recognising that the prudent efficient cost path involved a transition rather than a step change. That is, determining efficient costs was a question of what was practically achievable by an efficient prudent operator that took into account the starting point rather than a theoretical concept of efficiency. Given that, we did not see the transition path in terms of 'sharing the cost of inefficiency'. From this perspective, the 'sharing' question is about the sharing of the benefits/costs if actual costs are below/above the transition path – which the EBSS addresses.

Hence the question the AER should ask is: what costs would be incurred by a prudent, efficient operator/manager given the initial conditions/costs? We think this is consistent with how Ofwat and Ofgem have allowed transition paths. Posing it this way is closer to 'method 4' with the caveat that it is difficult to do at the individual cost levels so typically broader 'macro' transition paths are used.

4. *How do you justify your answer to question 3 having regard to the opex criteria, the revenue and pricing principles (RPP) and the National Electricity Objective (NEO) and in particular, the long - term interests of consumers?*

The intention of the rule change by the Australian Energy Market Commission (AEMC) in 2012 was to clarify the AER's powers to utilise benchmarking, not to remove altogether the need to have regard to a network service provider's actual circumstances in assessing the 'costs that a prudent operator would require'. This was made clear by the AEMC in its reasons for the changes (Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, 29 November 2012, section 8.4.2 at 107) where the AEMC stated:

> "The Commission is of the view that the removal of the "individual circumstances" clause does not enable the AER to disregard the circumstances of a NSP in making a decision on capex and opex allowances. Benchmarking is but one tool the AER can utilise to assess NSPs' proposals. It is not a substitute for the role of the NSP's proposal. Should the phrase remain, it appears that the AER's interpretation of it may restrict it from utilising appropriate benchmarking approaches to inform its decision making.
>
> • Clause 7A(2) of the NEL indicates clearly (in referencing 'at least the efficient costs the operator incurs') that efficient cost is intended as a minimum or floor. That is, the AER is clearly given discretion to provide an allowance greater than efficient cost. The circumstances in which this occurs may be limited, but it is clear that the AER does have discretion in appropriate circumstances.
>
> Further, this is only one of the RPPs - while efficiency in expenditure is an important criterion in making a determination, it is not intended to be the sole criterion to which the AER is required to have regard."

How do the Revenue Pricing Principles (RPP) give effect to the NER?

The intention when developing the regulatory framework was to provide the AER with discretion to make decisions on the application and interpretation of the framework as might be required so as to promote the NEO and to be consistent with the RPPs. In summary:

- the RPPs were framed so as to provide the opportunity for network

businesses to be allowed to earn in excess of determined efficient costs, where doing so would be consistent with the NEO

- there is a need to ensure that regulated businesses are provided with a reasonable opportunity to recover at least the efficient costs
- incentives to promote economic efficiency within the regulatory framework need to be effective
- when making regulatory decisions, consideration needs to be given to the potential implications for costs and risks of under or over investment; and
- the AER has an inherent discretion to interpret and apply the regulatory framework so as to promote the NEO and to be consistent with the RPPs.

5. *If you consider the costs that constitute a transition path allowance should be shared between consumers and distributors (i.e. that referred to in question 3(c)), how should these costs be allocated between the two? For example, should consumers fund the short - term transactional transition costs of distributors transitioning to an efficient level of opex (i.e. redundancy costs)?*

This question is considered in our preferred methods described, above applying our method 3; “glide path” and method 4; “redundancies” consistently with our 10 principles in Section 2 above.

Our principal position is that consumers should not pay for redundancies that have not led to long term savings. This underpins our strongly held opinion that only businesses that have reached the AER’s efficient opex level at end of year 4 and have a demonstrated relationship between the cost of redundancies and opex cost reductions should be eligible to recover and of these transition costs from consumers.

From the previous section, we repeat our conclusion that redundancies costs be applied to a business’s approved opex expenditure provided the redundancies are prudent or efficient. If there is any doubt about the efficiency of the redundancy costs then the risk of this should lie with the business rather than with consumers and the AER should impose a cap on the amount of redundancy costs to be borne by consumers.

6. *Ausgrid, Endeavour Energy and ActewAGL (in 2014 - 15 only) have underspent against the capital expenditure (capex) forecasts we determined for them. Given we are required to have regard to the interrelationships between opex and capex, does this affect your answers to questions 3, 4 and 5, and if so, how?*

All distribution businesses have underspent their capital allowances for 2014-17, as shown in Figure 7 below. Particularly for Ausgrid and Endeavour, the under expenditure encompasses both replacement capital and augmentation capital.

Endeavour has advised its intention to make up the shortfall and spend the total 2014-19 allocation. Other distributors have not expressed such a target to the CCP.

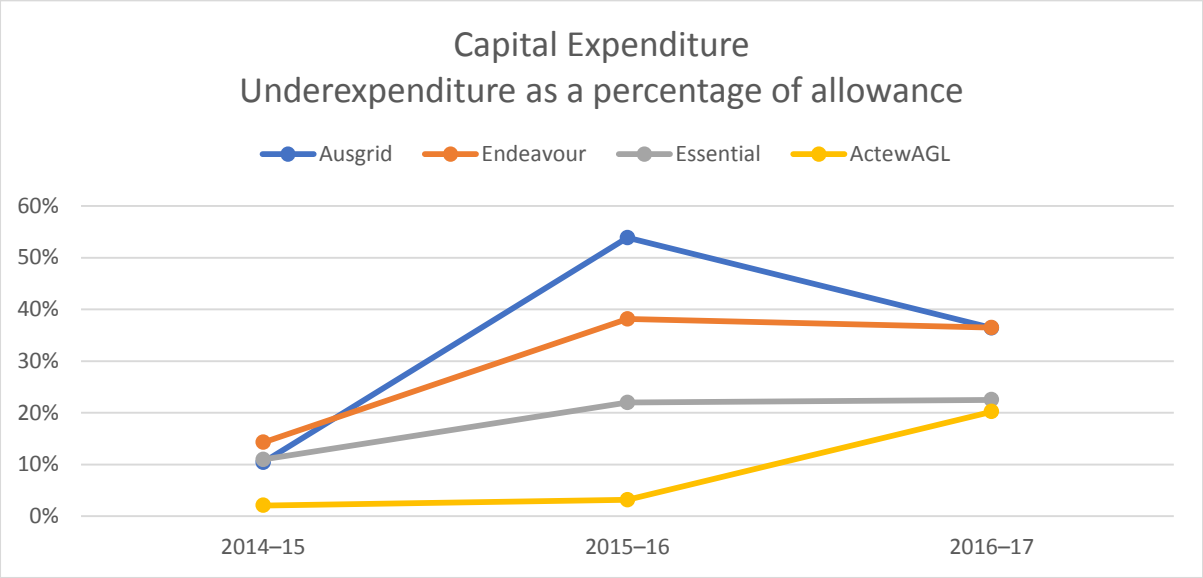

Figure 7: Under- expenditure of allocated capital

(Source AER RIN data, TCA analysis)

Assuming a capital spend rate similar to that of 2017, it is expected that all distributors, with the exception perhaps of Essential, will have a considerable flow-on of revenue through the Capital Efficiency Sharing Scheme (CESS). When the capital requirements of the 2019-24 period are considered, these underspends and the implications of the reduction in capital requirements will need to be considered.

There is no evidence of improper transfers of overhead costs between operating and capital activities. It is assumed that the AER has greater visibility of the allocation of cost overheads against a background of capital underspend.

Finally, all distributors have the opportunity to transfer demand management costs between operating and capital through the use of demand response capability. There is no evidence that operating costs have been increased as a result of the reduced need for augmentation or replacement capital.

7. An efficiency benefit sharing scheme (EBSS) applies to Endeavour Energy, which means it only bears around 30 per cent of the costs it considers constitutes a transition path allowance. Does this affect your answers to questions 3, 4 and 5, and if so, how?

The application of the EBSS to Endeavour does not affect the consideration of the transition path for the other networks. The concept of sharing of costs under the EBSS – which is the sharing of ongoing efficiency gains relative to the position if the network retained those gains in perpetuity – is very different to the concept of

‘sharing’ the one-off transition costs of going from costs now agreed to be well in excess of efficient costs to sustainable efficient costs.

As discussed above the EBSS should not be extended to the other networks as a mechanism for sharing transition costs.

7. Concluding Comments

This submission is made during a period of rapid change and with pressure on network businesses and the AER to make decisions that provide outcomes that are in the best interests of consumers, meet requirements of the remittal process for 2014-19 decisions and provide an efficient base for the development of regulatory proposals for the 2019-24 period.

CCP10 members appreciate the opportunity to be a part of the discussion that seeks to balance these requirements. We welcome the opportunity to continue discussing these remits and the application of matters that we have raised in this submission.

Attachment A

Incentive Based Regulation and the role of benchmarking

Executive Summary

There is a risk that benchmarking will be given a lower priority in response to the decisions of the Federal Court and Australian Competition Tribunal. We consider that this would be a mistake. Benchmarking can assist the regulator form a better view on efficient costs. This is clearly in the long-term interests of consumers, but it is also in the interest of the networks and the regulator. We consider that the Court and Tribunal decisions provide an opportunity for networks and consumer groups to work collaboratively with the AER to further develop benchmarking as a tool to be used in conjunction with other sources of information in forming a judgement on efficient costs in future reviews.

Quantitative benchmarking analysis – if undertaken and used with care – can improve the transparency and predictability of regulatory assessments of allowed costs and strengthen the incentives to improve efficiency and so disclose efficient costs.

However, it is important that regulators:

1. recognise the inherent limitations of benchmarking models and comparison
2. use a range of models and benchmarking approaches and give weight to them in decision-making according to their relative strengths and weaknesses
3. consider the results of benchmarking analysis alongside other qualitative and quantitative information on costs, including actual and projected costs
4. use the results of the benchmarking analysis to inform judgements on allowed costs rather than determine the costs to be allowed and
5. consider allowing a transition if large reductions in costs are proposed, to ensure the proposed cost reductions can be achieved prudently without creating service risks and limit the consequences of estimation errors. (the transition approach).

The transition approach recognises:

1. that efficient cost cannot be known with certainty and the consequences of error are significant; and
2. that the long-term interests of consumers are best served by strengthening the incentive for efficiency and the continuous disclosure of efficient costs rather than the assumption of efficient costs.

Such an approach is consistent with the approach of overseas regulators – such as Ofgem and Ofwat – and setting prices on the basis of efficient costs and the need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers. This supports an approach that focuses on strengthening the incentives to improve efficiency but having regard to the costs incurred. It is consistent with the recommendations of experts – such as Professors Yarrow and Littlechild – on the role of estimates of efficient costs. An approach that gives sole weight – or too much weight – to estimates of efficient costs would not be consistent with these requirements.

Benchmarking and the long-term interests of consumers

The question of the interests of consumers, efficient costs and efficiency incentives has been explicitly discussed in the development and interpretation of the National Electricity Objective (the NEO). The NEO succinctly sets both the objective and how it can be achieved. The objective is the long-term interests of electricity consumers; the means is to promote efficient investment in, and efficient operation and use of, electricity service. Two key points should be noted. Firstly, in specifying the "long-term interests of electricity consumers" the NEO allows for a distinction between the long-term and short-term interests of consumers and that there may be differences between these. Secondly, this is to be achieved by promoting (as distinct from imposing or requiring) efficiency.

The distinction between long-term and short-term interests of consumers is clear from the Second Reading Speech of the legislative amendments which introduced the NEO in 2005 (Second Reading Speech, Hansard, South Australia House of Assembly, 9 February 2005, at 1452):

> *The long-term interests of consumers of electricity requires the economic welfare of consumers, over the long-term, to be maximised. If the National Electricity Market is efficient in an economic sense the long-term economic interests of consumers in respect of price, quality, reliability, safety and security of electricity services will be maximised.*

The Second Reading Speech also emphasised that it is long-term efficiency that is to be promoted:

> *The market objective is an economic concept and should be interpreted as such. For example, investment in and use of electricity services will be efficient when services are supplied* ***in the long run at least cost****, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities.*

It should be noted that this emphasises the benefits of *achieving* greater efficiency in the provision of the services as opposed to the benefits of *assuming* greater efficiency. Delivering services more efficiently provides scope to reduce prices for the consumer and, importantly, it reduces the resources used in providing the

services, freeing those resources for more productive use elsewhere. The incentive to increase efficiency depends on period and strength of the de-linking of revenues and costs rather than the size of the 'X-factor' assumed. Reducing prices in the short-term to assume efficient costs is in the interests of consumers so long as the costs are achievable and so long as it is also consistent with the continued financial viability of the service provider if it acts as efficiently and prudently as possible.

The long-term interests of consumers also require a balancing of the interests of consumers at different points in time; neither the interest of current consumers nor future consumers should dominate. Assuming lower costs for pricing may provide a benefit for consumers in the current period, but it may not be in the long-term interests of consumers if it prompted short-term expenditure reductions that are not consistent with long-term efficiency gains – e.g. not investing in system re-design and associated supporting business infrastructure, cutting costs in areas easiest to cut in the very short-term rather than where the greatest long-term efficiency gains are available, and deferring investment.

(a) How does Incentive-Based Regulation (IBR) promote the long-term interests of consumers?

The key insight of IBR is to recognise the importance of information asymmetry and incentives in designing better regulatory systems. As Sappington and Stiglitz explain:

> *It is this limited information [on costs, technology, demand etc] that poses the central problem for the government [regulator]. The government can only order the firm to do something that is feasible, but it may not know what is feasible. … But if the government is to rely on the firm to tell it what the costs are, what is the government to do? It cannot in general rely on the firm to tell it the truth … Much of the detailed modeling we describe … is aimed at devising methods by which the firm is induced to reveal this information truthfully (although at a cost, often in the form of 'distorted' behaviour).*[6]

IBR provides the utility with incentives to pursue efficiency improvements, thereby revealing efficient costs, for the long-term benefit of consumers. Hence, the focus of IBR has been on the strengthening of the incentives for the pursuit and revelation of efficient costs. As noted above, the key to this is length of the period for which costs and revenues are delinked (the regulatory period) and mechanisms for the carry-forward of efficiency gains in previous periods. More recently menu regulation – such as Ofwat and Ofgem's IQI – has been used to create direct incentives for the networks to reveal their true costs in their proposals.

[6] D Sappington and J Stiglitz, "Information and Regulation", in E Bailey (ed), Public Regulation, New Perspectives on Institutions and Policies, MIT, 1987, p6.

As Professor Yarrow notes "it is *not* central to this (cost-reduction) incentives that the price path be set on the basis of fully efficient costs…".[7]

Benchmarking and the estimation of the efficient costs are still important for the sharing of efficiency benefits in the short-term and the risk/sustainability of the regulatory framework. Hence, regulators have rightly sought to improve the quality of benchmarking and the range of information available for estimating efficient costs. But both the theory and practice of regulation suggests caution in the use of benchmarking results. For example, in its advice to Ofgem CEPA advised that "Benchmarking is an important tool that can inform judgements about efficiency. However, it is only a tool and cannot substitute for judgements based on a wider range of evidence."[8]

(b) Should regulation mimic competitive outcomes in pursuit of the long-term interests of the consumer?

Regulators often state that they seek to replicate the outcomes of competitive markets. In the text book model of perfect competition all firms are on the efficiency frontier or they do not survive. However, while perfectly competitive markets provide a useful theoretical tool of analysis they do not provide a practical benchmark for the regulator. A more practical standard that aligns with the data regulators can observe is the test of effectively competitive markets in practice. Firms in the same market do have different cost structures and levels of efficiency that persist over time – as illustrated by the inter-company variations in Tobin q statistics.[9] It is unrealistic to set a standard for the regulator to achieve (especially given the pervasive problems of information asymmetry that the regulator faces) that effectively competitive markets do not achieve in practice.

(c) How do other regulators pursue the long-term interest of consumers?

The specification of objectives varies between jurisdictions, however the requirement to consider the interest of consumers is common where regulatory objectives are set out in legislative instruments.[10] The weight given to the interest of consumers varies between jurisdictions, however the legal framework governing the regulators in the

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[7] Advice to AEMC on Rule Change on the Economic Regulation of NSPs, p6.

[8] CEPA, Background to Work on Assessing Efficiency for the 2005 Distribution Price Control Review, Report to Ofgem, p8.

[9] A point well-made by Professor Yarrow in the "Preliminary Views" he provided for the AEMC rule change review

[10] The US has a long history of regulation which has been shaped through judicial determinations under which utilities are 'affected by the public interest'. While there is extensive discussion of a 'regulatory compact' protection of the utility arises from the constitutional prohibition on unfair takings.

UK gives primary weight to the long-term interest of consumers [11]. Hence, the approaches of UK regulators, such as Ofwat and Ofgem, are particularly relevant[12]. The UK is often seen as the pioneer of IBR and the first approaches were characterised by a relatively 'light' review of costs and an emphasis on incentives. Estimating efficient costs and basing prices on these was considered less important than the incentives for the utilities to pursue and reveal efficient costs for future determinations. Over time regulation became more complex with greater emphasis on both bottom-up detailed reviews of costs and top-down benchmarking in setting prices. However, both Ofwat and Ofgem have recently reviewed their approach to regulation to give greater focus on incentives, innovation, and outputs in their approach to regulation. Both will continue to challenge the cost proposals put forward by the utilities using benchmarking and other information to come to their assessment of the efficient costs. But both have adopted a menu approach to determining the allowed revenues that gives explicit weight to the proposal of the utility. Importantly it provides stronger incentives for the utilities to reveal their true costs and manage the risks that actual costs will be higher or lower than the allowed costs.

Both Ofgem and Ofwat have been cautious in their use of top-down benchmarking results and have tempered it with the consideration of other information sources, including the utilities' own proposals. In assessing efficient costs, Ofgem and Ofwat have, in common with other regulators:

1. had regard to multiple source of information on efficient costs
2. included allowances for specific cost factors not included in the benchmarking models
3. used a conservative estimate of benchmark costs
4. in some reviews, allowed for a transition to cost benchmarks over time.

Principle – IBR and Efficient Costs

As noted above, the key insight of IBR is to recognise the importance of information asymmetry and incentives in designing better regulatory systems. The challenge for the regulator is that monopoly businesses do not face the same incentives to strive for efficient costs that businesses facing competition do. The regulator can observe the current costs of utilities and variations in costs between utilities. However, the regulator cannot directly observe whether these differences are due to differences in efficient costs because of underlying cost drivers and utility specific factors or due to

[11] This primary duty is conditioned by obligations to ensure that the utility has an opportunity to maintain its financeability.

[12] Although there is less difference in the practice of regulators than the variations in legislative charters may suggest. This is because regulators often stress the complementarity of objectives such as financial sustainability and the long-term interest of consumers.

differences in the level of effort and efficiency. In these circumstances, the regulator faces two key challenges: providing strong incentives for the utility to pursue efficiencies (reducing 'moral hazard'); and reducing the risk that prices will not reflect the true efficient costs ('adverse selection').

> *Faced with these information disadvantages, the social welfare maximizing regulator will seek a regulatory mechanism that takes both the social costs of adverse selection and moral hazard into account, subject to the firm participation or budget balance constraint that it faces, balancing the costs associated with adverse selection and the costs associated with moral hazard. The regulator may also take actions that reduce her information disadvantages by, for example, increasing the quality of the information that the regulator has about the firm's cost opportunities.* [13]

This remains the fundamental challenge for regulators and the reason for the need for discretion and caution in estimating efficient costs.

Since regulators cannot know efficient costs with certainty, IBR emphasises the design of incentives for the utilities to pursue efficiency gains. This 'reveals' the efficient costs that can then be the basis of the regulator's next determination. Efficiency savings carry forward mechanisms, such as the EBSS, are an important part of this approach to avoid incentives to defer cost savings from the end of one regulatory period to the start of the next. As noted above, it is through the incentives to pursue, and so reveal, efficient costs that the long-term interest of the consumer is best served. The successful utility will, for a time, earn higher profits. This is to be applauded as it flows through to benefits for future consumers.

Professor Yarrow has noted that the consequences of getting the allowed costs 'wrong' may be asymmetric. In principle, better information allows the regulator to narrow this risk and the action needed. This has led regulators to improve the availability and quality of information for assessing the feasible efficient costs and put more effort into better benchmarking. This is welcomed as it can improve the transparency and quality of decision-making. The key issue is how this information is used. There are inherent limitations to benchmarking that need to be considered and factored into the regulators use of the information:

1. Models are necessarily incomplete. There are many factors specific to a utility that affect its costs and not all can be incorporated in the models.
2. Data is of variable quality and the results can be susceptible to data errors
3. The number of comparators is limited

Typically, regulators, such as Ofwat and Ofgem, have been cautious in their use of benchmarking information and allow a transition to the assumed efficient costs.

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[13] P Joskow, Incentive Regulation in Theory and Practice: Electricity Distribution and Transmission Networks, 2006, http://www.hks.harvard.edu/hepg/Papers/Joskow_Incentive_2006.pdf, p5

Importantly, Joskow specifically mentions the “budget balance constraint” in the quote above. Regulators should not, and do not, guarantee that utilities will not fail. However, regulators are justifiably wary of putting a utility in a position where, even if it acts prudently and reasonably efficiently, it is not financially sustainable and cannot fund its continued operation and investment in the network. Not only is it not in the interests of the customers of the utility concerned, but it increases perceived regulatory risk and reduces the credibility of the regulatory regime.