ENA Initial Perspectives: AER Incentive Scheme Review – CESS Position Paper

AER Stakeholder Forum

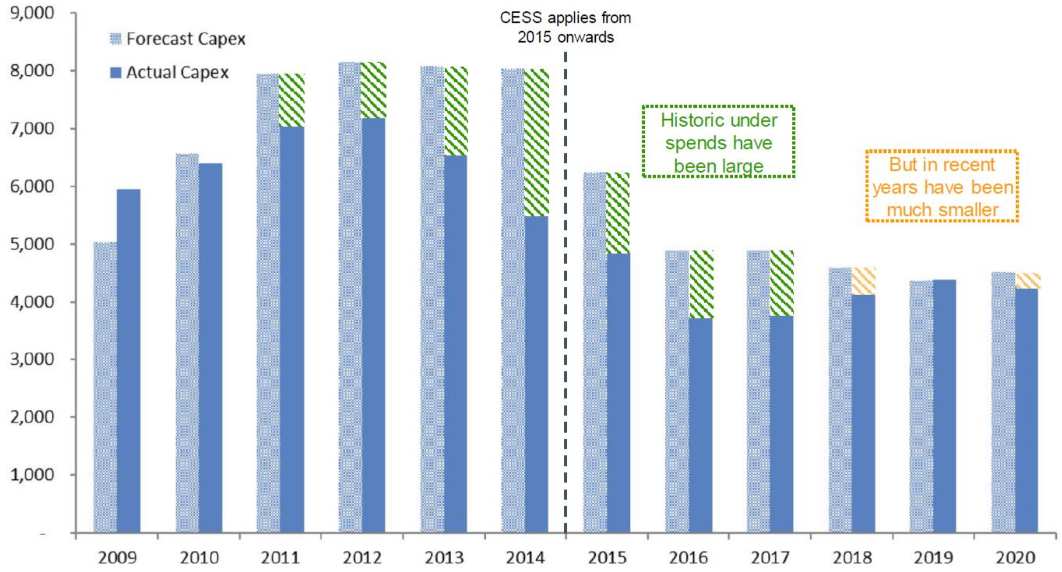
Friday 26 August 2022

Energy Networks Australia

CESS has delivered for consumers

- **Initial Perspective #1: ENA supports the AER's preliminary position that the CESS should not be abolished** as it has been successful in providing incentives to NSPs to incur efficient capex
- **Initial Perspective #2: ENA supports the AER's preliminary position to retain the 30%** CESS default sharing ratio
- Continued & consistent application of the incentive schemes provide networks with the confidence to invest in programs that reduce future costs (or improve future service levels)

Forecast and actual capital expenditure – all electricity distribution



Source: Figure 18 of AER Discussion paper.

*AER Position Paper: "…the CESS, as it stands seems to have **delivered significant efficiency gains and forecasting errors have fallen to relatively low** levels." [pg. 14]*

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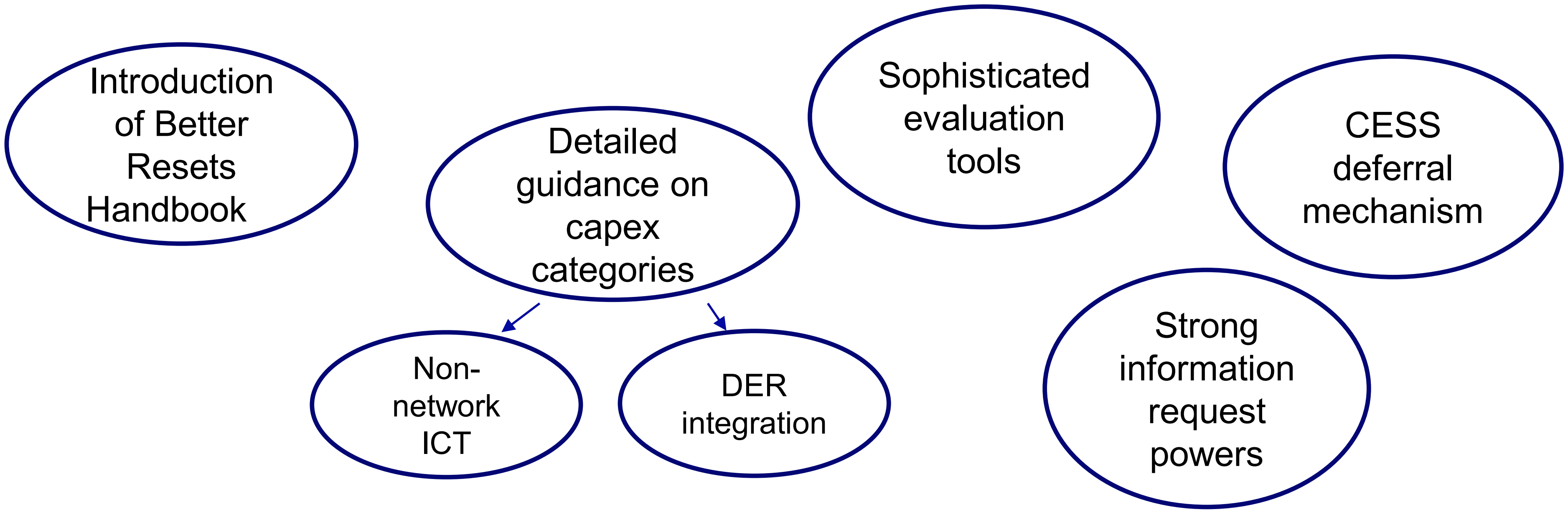
AER's Assessment Toolkit: Continuous improvement

» **Improvement in overall accuracy of allowance setting** over time and **reduction of the information asymmetry** between the AER and networks → resulting from AER's significant investment in regulatory assessment tools that are now well-developed.



CESS adjustment process for deferrals working well:

- » Powerlink: $18M in deferred capex [2022-27 DD]
- » Powercor: $51 million in deferred capex [2021-26 FD]
- » Jemena: $9 million in deferred capex [2021-26 FD]
- » Ergon Energy: $63 million in deferred capex [2020-25 FD]
- » AusNet (D): $14 million in deferred capex [2019-24 FD]
- » Transgrid: $40 million in deferred capex [2018-23 FD]

Initial Perspective #3: ENA supports the AER's preliminary position to introduce greater transparency requirements for networks on actual & forecast capex → will further enhance BRH capex expectations for networks, and AER's annual Network Performance Report & Regulatory Information Notice releases.

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Better Resets Handbook – Endeavour Energy experience so far

» Endeavour Energy is participating in the BRH process for its 2024-29 Revenue Determinations.

» Our experience so far with respect to capex:

– **In depth information sharing:** we published a business narrative & Preliminary Proposal in April 2022 (in advance of Draft Proposal in October 2022) to **give stakeholders confidence in the direction of our period-to-period forecasts and to identify key investment drivers**.

– **Transparent current period performance:** through BRH engagement we have **been transparent about current period performance**. In pursuit of efficiencies, we re-prioritised our allowance to increase ICT investment. At the same time there was an early period reduction in some system categories of capex driven by COVID-19, responding to natural disasters and the broader economic downturn.

  - Our Preliminary Proposal proactively **proposes a CESS adjustment of $67M ($FY24) for augmentation spending** that is likely to be deferred from this period to the next.

Better Resets Handbook (BRH) seeks to encourage networks to better engage and have **consumer preferences drive the development of regulatory proposals** → includes capex expectations for networks

AER CCP recommendation: *"A **good narrative regarding what has happened in the current regulatory period and how that has informed what is being proposed for the upcoming regulatory period** would confirm the network's commitment to customers, and its credibility as an efficient manager of network services."[CPP submission to AER Incentive Scheme Discussion Paper]*

Better Resets Handbook – Endeavour Energy experience so far

Benefits promoted by the BRH

- a **'no surprises' approach** promoting transparency & early oversight of current period performance & key components of the next period forecast.
- proposals that **provide the transparency and "good narrative"** sought by the AER's CCP.
- operational and reputational benefits to the network participating in the process and a **more efficient determination process**.
- a **clear understanding of the AER's expectations** → regardless of whether a network formally participates in the BRH process, **all networks are aware of the need to provide a good explanation of any material period-to-period variances** in expenditure proposals.

Risks to be managed

- ensuring the BRH process **does not become a 'checklist' exercise** with period-to-period variances addressed determinatively rather than investigated collaboratively.
- engagement fatigue - the **BRH process (if done well) should reduce the overall burden of a regulatory determination** by embedding genuine and high-quality engagement rather than simply shift the traditional review process from post-lodgement to pre-lodgement.
- BRH process commences with of only one or two years of actuals for the current period – **sharing early forecasts requires a high trust environment between participants**.

Our observation: The **quality of proposals is trending in a positive direction**.

Is a change to the CESS necessary if the BRH and industry-wide uplift in customer and stakeholder engagement, combined with expanded AER guidance notes, information gathering powers and assessment tools, continues to deliver improvements?

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Introduction of a variable rate CESS

» AER to retain 30% default rate but, to address a ‘regulatory proposal of concern’, AER considering weakening incentives to achieve capex efficiencies by applying the CESS with a 20% sharing ratio under a:

– Principles based approach (linked to Better Resets Handbook)

– Bright line test #1 (10/10 mechanistic adjustment)

– Bright line test #2 (tiered incentive rate)

» Recent developments demonstrate the **increased sophistication of the AER’s assessment** of capex forecasts → full positive impact of these reforms will be borne out in future regulatory determinations, but their **future expected impact should be taken into consideration** when assessing the effectiveness of, and the need for changing, the CESS.

» ENA encourages **further consideration of how the AER’s expanded regulatory toolkit can be used to address any business specific issues** in a targeted manner, thereby maintaining regime stability and promoting strong and continuous exploration by networks of potential efficiencies.

Initial Perspective #4: the case for introducing a variable sharing ratio to address a ‘regulatory proposal of concern’ has not been made → further consideration required on the need, role and potential design of a variable rate CESS application

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Variable rate CESS – Design considerations

» Key desired outcomes
  – Maintain strong incentives to continually achieve efficiencies
  – Ensure incentive rewards are targeted at efficiencies
  – Minimise regulatory burden and maintain simplicity
  – Predictability in application

» Instead, application of a variable CESS rate could weaken incentives to deliver efficiencies, and has the potential for perverse incentives and unintended consequences that are not in consumers' best interests

Variable CESS rate options

Principles based approach (linked to BRH)

- Risks becoming a subjective version of the 10/10 bright line test → lack of transparency for stakeholders
- Does not provide sufficient certainty to networks, a key requirement of ex-ante incentive regulation
- Creates potential incentives for networks to optimise investments plans to satisfy their perception of AER's capex preferences/expectations → conflict with overall BRH objective?

AER BRH: *"Further, we intend to apply the expectations for each topic holistically, rather than in strict 'checklist' type approach"* → is this approach turning the BRH into a 'checklist'?

Bright line test #1 (10/10 mechanistic adjustment)

- Boundary point issues → risks resulting in an inefficient cost path & higher costs for consumers
- 'Punishing' networks that achieve large efficiencies can perversely lower incentives for future efficiencies
- Vulnerable to periods of significant change (e.g., customer preferences, energy transition) → where history may be a less useful guide

AER: *"We consider <u>our overall approach to expenditure assessments can appropriately consider change</u>. However, our experience has shown that comparisons to historical expenditure and benchmarks serve as an appropriate <u>starting point</u> in our expenditure assessments"* → will embedding this mechanistic 10/10 approach allow for that?

Bright line test #2 (tiered incentive rate)

- Disincentives large efficiencies
- May perversely punish the most efficient firms

Key points

» **Support:**

- **AER's preliminary position that the CESS should not be abolished** as it has been successful in providing incentives to networks to incur efficient capex
- **AER's preliminary position to introduce greater transparency requirements** for networks on actual & forecast capex → will further enhance BRH capex expectations for networks & AER NPR and RIN releases
- **AER's preliminary position to retain the 30%** CESS default sharing ratio

» However, **the case for introducing a variable sharing ratio to address a 'regulatory proposal of concern' has not been made** → further consideration required on the need, role and potential design of a variable rate CESS application

- potential for perverse incentives and unintended consequences that are not in consumers' best interests
- importance of regime stability → matching business specific issues with the right tools

> *Where **incentive schemes have been introduced with the goal of impacting long-term investment decision-making**, and they appear to be operating effectively to the benefit of consumers, there should be a **'high bar' for change and a strong preference for stability**.*