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11 March 2022

Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Via email: incentivereview@aer.gov.au

Dear Sebastian

Submission to the AER's review of incentive schemes for network service providers

Essential Energy welcomes the opportunity to respond to the Australian Energy Regulator's (AER's) review of its incentive schemes. These schemes are a key part of the AER's regulatory framework, as they encourage network service providers (NSPs) to innovate and find better ways to service consumers. This review is particularly important and timely in the context of the evolving economic and interest rate outlook; the rapid transition the energy market is experiencing to accommodate more renewable energy and distributed energy resources. This is in addition to the ongoing challenges and risks NSPs such as Essential Energy face from climate change and the increasing frequency of extreme weather events.

A primary objective of the review should be to maintain strong incentives for the regulated networks to pursue efficiency gains, given the benefits of such incentives and to this end, we endorse Energy Networks Australia's (ENA) submission to this review. Analysis commissioned by the ENA shows that the AER's incentive schemes have significantly benefited consumers by lowering network prices and improving service quality, and that most of the benefits of the incentive schemes accrue to consumers rather than to networks. Weakening the efficiency incentives will not be in consumers' long-term interests. We do, however, suggest the Efficiency Benefit Sharing Scheme (EBSS) should be modified slightly so that the incentive rates under the EBSS and Capital Efficiency Sharing Scheme (CESS) are made equivalent at 30 percent.

The AER raised some potential concerns with the CESS. However, those concerns relate to information asymmetry between NSPs and the AER on expenditure allowances. Essential Energy suggests that these may be better addressed in other ways, rather than through weakening efficiency incentives under the CESS and the EBSS. Such a response would reduce incentives for expenditure efficiency at a time when they are most required, as the sector faces large investment requirements to transition to the network of the future. This would not be in the long-term interests of consumers and would not address the fundamental concern of information asymmetry.

Enhanced certainty and clarity around the application of the EBSS and CESS (particularly in relation to factors that are beyond NSPs' control) would also be important outcomes of the review. Further information on our positions and our responses to the AER's Discussion Paper are attached.

If you have any queries in relation to this submission, please contact our Network Regulation Manager, [redacted]

Yours sincerely

Chantelle Bramley
Executive General Manager Corporate Affairs

Submission to the AER's review of incentive schemes for network service providers

The incentive schemes deliver significant benefits for consumers, and the need for robust incentives for efficiency has never been more important

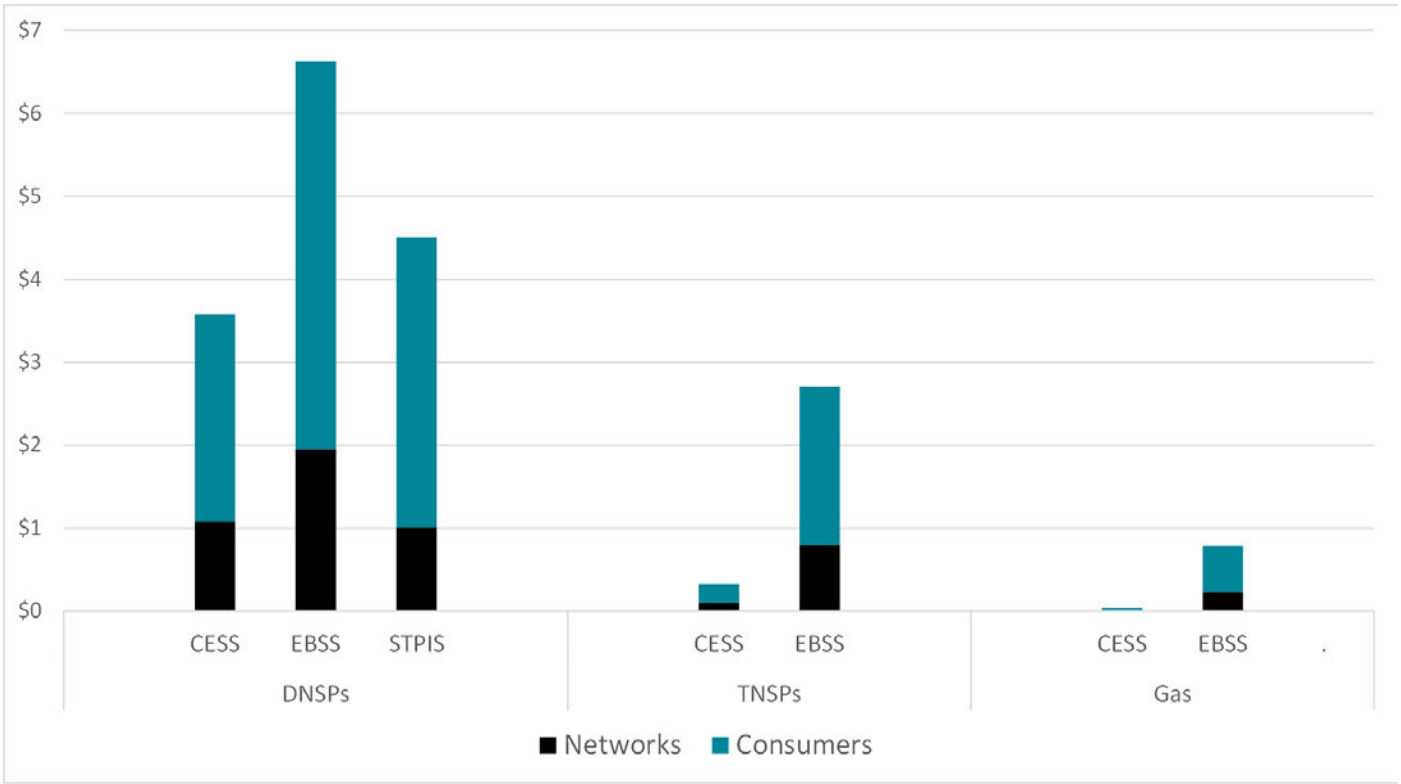
The Efficiency Benefit Sharing Scheme (EBSS) and Capital Efficiency Sharing Scheme (CESS) provide ongoing incentives for Network Service Providers (NSPs) to pursue efficiency gains. By providing rewards (or penalties) for efficiency gains (or losses), they incentivise NSPs to innovate and to reveal their efficient costs. This allows consumers to ultimately benefit, through lower prices and better services over time.

The significant efficiency gains that consumers have benefited from as a result of the introduction of the EBSS and CESS are demonstrated by HoustonKemp's analysis, commissioned by Energy Networks Australia (ENA).[1] HoustonKemp shows that the incentive schemes have benefitted consumers by delivering lower network prices and improved service quality (see separate submission from the ENA for details).

Notably, while these schemes reward NSPs for efficiency gains, the majority of benefits arising from these schemes are retained by consumers. Under the CESS, NSPs currently retain 30% of their efficiency gains, while NSPs' share of gains under the EBSS is currently estimated to be about 19%[2]. This means consumers retain 70% and 81% of the benefits of these schemes, respectively.

The fact that consumers have been the overwhelming beneficiaries under the EBSS and CESS is demonstrated clearly by the following figure compiled by HoustonKemp.

Figure 1: Present value of benefits retained by NSPs and consumer benefits under the EBSS and CESS ($billion, 2020)



Source: HoustonKemp, Consumer benefits resulting from the AER's incentive schemes, 8 March 2022, Figure 4.

A key property of both the EBSS and the CESS is that they create incentives for NSPs to realise expenditure efficiencies in any year of a regulatory control period. In the absence of these schemes, NSPs would have weaker incentives to pursue efficiencies in the later years of a regulatory control period, since they would retain the benefits of those efficiency gains for a shorter period of time. The higher the sharing ratios, the stronger are the incentives to

[1] HoustonKemp, Consumer benefits resulting from the AER's incentive schemes, 8 March 2022.

[2] Assuming a Weighted Average Cost of Capital (WACC) of 3.60%.

seek out opportunities for efficiencies, and to deliver those savings—which ultimately benefit consumers. In Essential Energy's view, the efficiency gains that consumers have benefited from under the AER's regulatory framework would have been much lower in the absence of the EBSS and CESS.

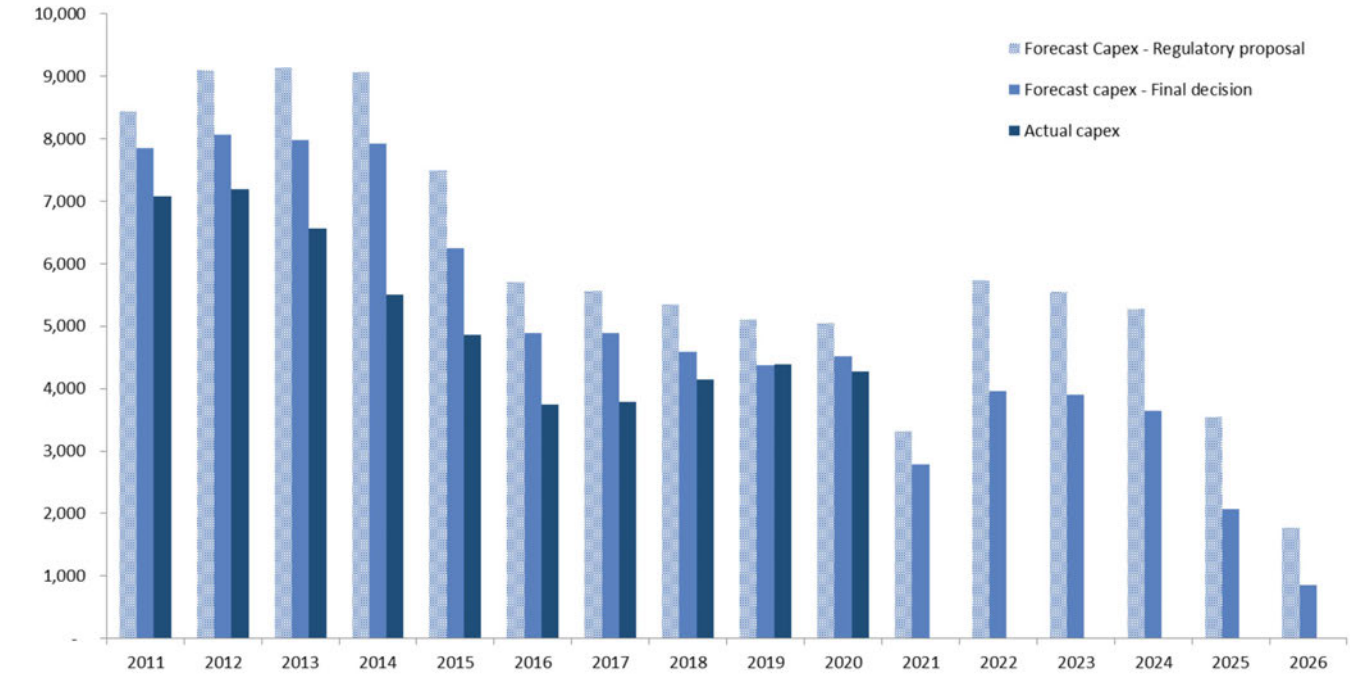
Therefore, as these schemes deliver significant benefits to consumers through lower prices and better services over time, it stands to reason that it would not be in consumers' long-term interests to weaken these incentives. Further, as the electricity industry is now undergoing a significant period of transformation to accommodate more renewable energy and distributed energy resources, requiring unprecedented levels of expenditure and investment by NSPs across the National Electricity Market (NEM), the need for strong efficiency incentives is more important than ever. Now would be a particularly bad time to reduce incentives for NSPs to invest efficiently. Essential Energy, like other NSPs, will need to invest significantly and efficiently to respond to consumer needs and new industry obligations to develop the network of the future.

The AER has raised concerns about information asymmetries, but it should target its response to address these rather than weaken incentives for efficiency

Essential Energy understands the challenge of ensuring that the CESS is rewarding genuine efficiency gains. The AER and other stakeholders have identified some potential concerns with the CESS that relate to information asymmetry, where some NSPs may overstate their capital expenditure (capex) requirements and consequently receive CESS rewards.

However, there is no evidence that NSPs are overstating their expenditure requirements in response to the CESS. Rather, the AER's analysis in the Discussion Paper shows that the difference between NSPs' capex proposals and the determined allowances has reduced since the introduction of the CESS in 2015 up to 2020. While Figure 2 below shows that the gap between NSPs' capex proposals and the AER's final decision has widened since 2022, Essential Energy notes that very few regulatory determinations covering the period 2022-26 have been finalised to date by the AER. Therefore, the apparently widening gap between capex proposals and final decision allowances from 2022 onwards identified by the AER represents the outcomes from very few regulatory decisions, and may reflect NSP-specific circumstances that are not reflective of the industry as a whole. We do not consider that it would be reasonable to conclude that the CESS has encouraged over-forecasting of capex across the whole sector based on this information.

Figure 2: Difference between proposed capital expenditure and AER final decision

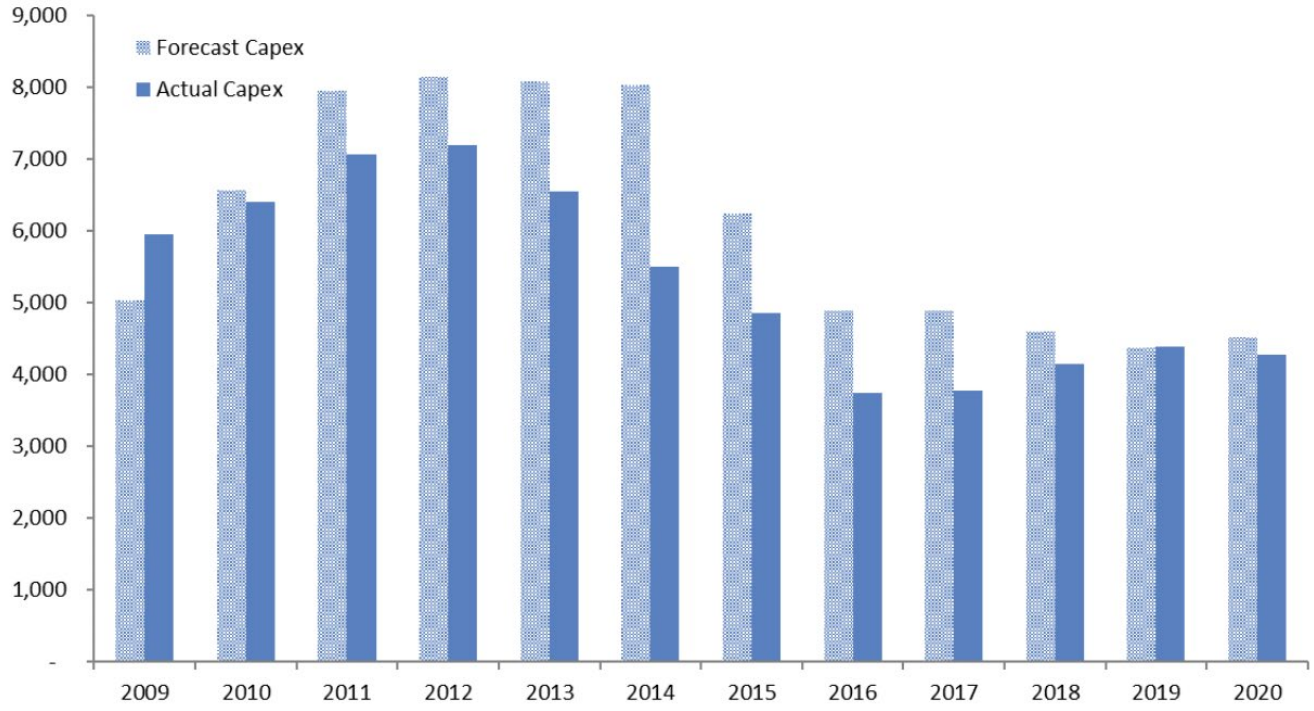


Source: AER, Review of incentive schemes for networks discussion paper, December 2021, Figure 21, p. 57.

Having said that, we acknowledge that information asymmetry in relation to expenditure allowances is a legitimate concern for economic regulators. However, reducing the incentive power of the CESS would not address the source of the problem—namely, the information asymmetry between the AER and NSPs about the true scope for efficiency savings and expenditure requirements. The AER's analysis shows that actual capex for electricity distribution networks in the NEM was materially below the forecasts set in revenue determinations between 2010 to 2017, with this difference narrowing from 2018 onwards (see Figure 3 below). This indicates that the difference between

determined capex allowances and actual capex (a potential indication of information asymmetry) has not increased since the CESS was introduced in 2015. In fact, the AER notes that since 2015 it has improved its expenditure forecasting techniques, which has allowed it to assess forecast capex needs more accurately, and that distribution networks have recently spent near their allowances.

Figure 3: Forecast and actual capital expenditure – all electricity distribution



Source: AER, Review of incentive schemes for networks discussion paper, December 2021, Figure 18, p. 54.

Rather than reducing the incentive power of the CESS, we consider the AER should allow some time for its recent refinements to its approach and framework (particularly in relation to NSPs' expenditure proposals and its assessment of these proposals) to further take effect. For example, in the Discussion Paper (p. 59) the AER notes that capital expenditure proposals that are aligned with the expectations set out in its recently released *Better Resets Handbook*:

> *"will provide us greater confidence that over forecasting and deferral do not outweigh efficiency gains in capital expenditure."*

If necessary, the AER could also consider additional measures to specifically target the information asymmetry issue – which should be considered before reducing CESS incentives. These may include, for example:

- Refinement to the AER's approach to identifying and adjusting CESS payments for capex that is deferred between regulatory periods (i.e., incremental refinements to the application of the CESS).
- Further, targeted scrutiny of NSPs' expenditure forecasts and outcomes. This could involve a framework, for example, where further review is targeted based on the quality of a NSP's expenditure forecasts and/or historical performance.
- Making greater use of capex benchmarking to provide insights into capex performance. This would be separate to the capital efficiency benchmarking currently undertaken by the AER, which measures how efficiently networks use their stock of capital to produce outputs or services.
- Exploring mechanisms that would incentivise NSPs to provide more accurate forecasts of their capex requirements. For example, regulators in the UK, such as Ofgem and Ofwat, had similar information asymmetry concerns as the AER, about the motivation for NSPs to over-state their capex requirements - they developed and applied incentive schemes designed specifically to alleviate those concerns.

We suggest the AER should directly address the issue of information asymmetry, rather than reduce the incentive power of the CESS for all NSPs in response to a concern that some NSPs may be overstating their capex requirements. Reducing incentives for NSPs to pursue efficiency gains would be to the detriment of consumers, who have clearly been the main beneficiaries of the EBSS and CESS, and does not ultimately address the source of the problem identified by the AER.

In addition to directly addressing the specific concern at hand, we also consider the AER should allow for more time for the CESS to be applied (as it has applied to relatively few regulatory periods) before looking to make substantial changes such as a reduction to its incentive power.

There should be equal incentives for capex and opex efficiency gains, which can be achieved by equalising NSPs' share of efficiency gains between the EBSS and CESS

The Discussion Paper notes (p. 36) that:

> *"A guiding objective in developing and applying incentive schemes has been that network service providers should ideally be financially indifferent between investing in network assets or incurring operating expenditure to provider network services and meet reliability targets. Network service providers should make investment decisions over time that are aligned with efficient outcomes for consumers, including service performance."*
>
> *…*
>
> *"Providing balance between the schemes was seen as particularly important where networks have options available to substitute between capital and operating expenditure to meet service levels, such as choosing to invest in a new asset or incur operating expenditure (e.g. maintain existing assets), or where there are abilities to capitalise or expense specific costs within a cost allocation framework (e.g. overheads, leases). While there are non-financial reasons that may influence investment decisions, the financial incentive schemes should ensure that decisions are appropriately aligned with customer values and are fit-for-purpose within the overall framework."*

Essential Energy agrees with the AER's observation that NSPs should face equal incentives to pursue capex and opex efficiencies (so as not to distort opex/capex trade-off decisions), and also face incentives to achieve a balance between costs and service quality ('price-quality' trade-off) that is valued by consumers.

However, as recognised in the AER's Discussion Paper, the current expenditure incentive schemes do not provide equal financial rewards and penalties for capex and opex efficiencies.

The current design of the EBSS, whereby marginal efficiency gains and losses are retained by the NSP for a fixed period of time, means that the NSPs' share of efficiency gains (and hence their incentives) varies with the Weighted Average Cost of Capital (WACC). In turn, this also means that the incentives for efficiency gains between the CESS and EBSS are not aligned; with NSPs currently retaining 30% and 19% of efficiency gains and losses under the CESS and EBSS, respectively. It is unclear to Essential Energy why the incentive rate faced by NSPs should rise or fall as the AER's estimate of the investors' required rate of return changes over time.

As the Discussion Paper explains, the EBSS sharing ratio declines as the AER's estimate of the WACC declines. A lower EBSS sharing ratio would (all else remaining equal) weaken incentives for NSPs to realise opex savings and, to the extent that there are substitution opportunities between opex and capex, may lead NSPs to favour capex rather than opex solutions. That is, lower EBSS incentives (relative to CESS incentives) may increase NSPs' bias in favour of capex solutions over opex solutions. This, in turn, could incentivise NSPs to over-forecast their true capex requirements. In other words, to the extent that some NSPs may be motivated to overstate their true capex needs, one contributing factor to that perceived problem may be the current unequal financial incentives between the EBSS and the CESS.

The solution to that problem would not be to reduce CESS incentives to the level of current EBSS incentives — because that would weaken incentives across the board to pursue opex and capex savings, to the detriment of consumers. Rather, the appropriate solution would be to align EBSS incentives with current CESS incentives, thus removing one possible source of capex bias.

Essential Energy considers that NSPs' share of opex efficiency gains (i.e., the EBSS incentive rate) should be:

- aligned with the CESS incentive rate of 30%, to equalise incentives for efficiency gains between opex and capex, and to not diminish incentives for efficiency gains given the benefits they derive for consumers; and
- set independent to the required rate of return.

There are means of aligning the incentive rates between the EBSS and CESS. For instance, the AER could consider applying a longer carry-over period for the EBSS to achieve a 30% incentive rate. However, the variability inherent in the design of the EBSS would mean that this would not be a permanent solution, since the EBSS incentive rate would quickly depart from this level as the AER's estimate of the required rate of return changes. The carry-over period would continue to require frequent modification over time to maintain a constant 30% EBSS incentive rate.

A more permanent solution would be to decouple the EBSS from a carryover term, and instead allow the NSPs to retain 30% of the present value of opex efficiency gains or losses. Such a scheme could work as follows, for example:

- The marginal efficiency gain or loss would be calculated in each year of the determination period (as currently occurs with the EBSS)
- These gains or losses would be assumed to be permanent, and their present value calculated (as currently occurs with the EBSS)
- The EBSS payment (or deduction) to apply at the next price/revenue determination would be calculated as 30% of this present value less the portion of the present value that has already been retained by the business in the current determination period.

This would ensure the incentive rate is the same under both the EBSS and CESS, regardless of the AER's estimate of the required rate of return. Apart from explicitly setting the NSPs' efficiency sharing rate to 30%, it would also require only relatively minor changes to the existing EBSS.

Notably, we do not consider that the incentive rates should be equalised between the EBSS and CESS by reducing the incentive rate in the CESS below 30%. As outlined above, this would diminish incentives for expenditure efficiency at a time when they are required more than ever, and hence would not be in the long-term interests of consumers.

We also recognise that, in addition to the expenditure incentive schemes, there may be other factors that can impact on a NSP's decision to incur capex versus opex, and vice-versa – including, for example, the methodologies used to assess the efficiency of expenditure proposals.

However, at a minimum, to equalise the financial incentives for efficiency gains between opex and capex the incentives rates of the CESS and EBSS should be equalised at 30%. There is no basis for having different incentive rates for these schemes and, given the objective of equalising incentives for efficiency gains between opex and capex, any difference in these rates would be arbitrary.

To maximise the effectiveness of the AER's incentive schemes, it also important that there is greater clarity around the application of the EBSS and CESS

To maximise the effectiveness of the incentive schemes and avoid perverse outcomes, it is important there is clarity and certainty around the application of the EBSS and CESS. It is equally important that these schemes do not impose gains or losses on NSPs for events that are beyond their control such as natural disaster and climate related events that are increasingly disrupting NSPs' operations.

We consider there are aspects of the application of the EBSS and/or CESS that would benefit from greater clarity to minimise uncertainty and ensure that they do not have unintended adverse impacts. For example, these include:

- Uncontrollable changes in the expected patterns of opex expenditure: Exogenous events outside NSPs' control (such as bushfire or floods) can significantly disrupt the typical flow of operating and maintenance activities and hence expenditure (and marginal efficiency gains/losses) from year to year. For example, in response to a significant bushfire early in the regulatory period, expenditure may be significantly lower than the allowance in the early years of the regulatory period, and significantly higher in the later years. The AER should ensure that this does not give rise to unintended penalties or distortions in EBSS outcomes and provide clarity about how it would treat or respond to such an event in applying the EBSS.
- Implications of changes in opex and capex definitions: There may be changes in the definition of a significant proportion of costs, due to accounting rule changes or interpretation by the International Financial Reporting Interpretations Committee, within a regulatory period. A current example is the change in the treatment of cloud computing costs, which were previously treated as capex and are now treated as opex in financial statements. These represent significant costs. As well as the need to ensure that these efficient costs can be recovered, the incentive payment impacts of this change need to be considered. This is a particular issue under the current incentive scheme arrangements where the effective sharing ratios between the EBSS and CESS are unequal.
- The AER's treatment of cost pass through events in the EBSS and CESS: we consider the AER's guidance material would benefit from greater clarity and explanation on specifically how the EBSS and CESS will be adjusted to account for the costs of these events within a regulatory period.
- The circumstances in which the AER would cease to operate or apply the EBSS and CESS: that is, enhanced clarity on the criteria the AER will use to determine when the EBSS and CESS would not apply during a regulatory period (i.e., when an NSP would not accrue efficiency gains or losses under the EBSS and CESS), and when the AER would not adjust revenue in an upcoming regulatory period for the EBSS balance of the current period (i.e., when an EBSS or CESS balance may not be 'paid out' in a new determination).
- The calculation of efficiency gains in the first year of a regulatory period after the EBSS has been reintroduced: that is, clarity on the calculation of the marginal efficiency gain in the first year of a regulatory period, following a period in which the EBSS did not apply (i.e., in moving from a regulatory period when the EBSS is not in operation to a new regulatory period when it is in operation).