Ausgrid Endeavour Energy essential energy

22 May 2013
Mr. Sebastian Roberts
General Manager – Network Operations & Development
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr. Roberts

Further comments on AER's supplementary material on expenditure incentives

The NSW DNSPs prepared a joint submission on 10 May 2012 on the AER's issues paper on expenditure incentive guidelines. In our submission, we agreed to provide further comments on supplementary material provided by the AER on 6 May 2012.

The AER's supplementary information seeks to clarify and refine the incentives in response to stakeholder concerns. Our comments support the AER's proposed directions on the capex incentive scheme and raise concerns on the AER's proposed direction on opex incentives. We look forward to continued constructive feedback with the AER, and note the effective processes to date.

Refined model on capex incentive guidelines

In our submission, we raised substantive concerns on the proposed Capital Expenditure Sharing Scheme (CESS). Our analysis focused on a model provided in Appendix 3 of the AER's issues paper, which suggested that the scheme may apply a penalty rate of 70 per cent for overspends and 30 per cent for underspends.

Since that time, AER staff have clarified that the AER did not intend to apply a 70 per cent penalty rate, and this has seemingly been reflected in the new CESS model provided to stakeholders on 6 May 2013. The model includes a 30 per cent symmetric penalty / reward rate, which we would support as a more appropriate sharing framework.

At this stage we have not had sufficient time to assess the mechanics of the model. We will provide further comments as part of the draft guidelines.

New information on EBSS

In response to stakeholder questions, the AER has provided additional information on the application of the EBSS and its interaction with setting opex allowances. The information is highly complex and will require additional time to fully analyse. At a high level:

- We support the AER's email of 10 May 2013, which clarifies that the AER will not alter the penalty / reward accruing from the operation of the EBSS in existing determinations and we appreciate the AER's clarification of this matter;
- We consider there are risks in using benchmark costs to establish the efficiency of the base year. We consider that the high rate of incentive under the existing EBSS is already moving businesses towards the efficient costs in the circumstances of that business; and
- It is not clear how the EBSS models provided by the AER will operate when benchmark costs are used. Based on our understanding, it appears that the AER would provide financial compensation to a DNSP in recognition that the benchmark is a 'stretch' target. This could be in the form of a transition path to any such target.

Our view is that the discussion needs to go back to 'first principles' on the AER's obligations to assess the total opex in a DNSP's regulatory proposal. The Rules do not contemplate a binary approach of using either revealed or benchmark costs. Rather the AER must make a decision that has regard to the opex objectives, criteria and factors. In doing so, the AER must place weight on the evidence provided by the DNSP and other analysis, including factors such as previous costs, incentives and benchmark costs.

In this context, we consider that the 'revealed costs' approach should have primary weighting in the AER's decision. The high power of the EBSS is aligned to the initiatives in place in the NSW DNSPs to restructure their businesses to achieve cost savings. In turn, this provides compelling evidence to the AER that a DNSP has achieved a level of efficiency within its operating environment.

We note that the AER has not provided any strong evidence to suggest that the EBSS is not achieving its purpose in driving DNSPs to progressively lower costs over the period. Our experience demonstrates that the EBSS is a relevant driver of efficiency in the business and that the scheme can be relied on to demonstrate the efficient costs achievable by the business at that point in time.

In contrast, benchmark information should be used with caution. Any analysis to assess the increased use of benchmarking needs to be comprehensively reviewed and only given weight when or if the AER clearly identifies inefficiency. We consider that it is more appropriate to use benchmarking data as an input for moving the DNSPs to the AER's efficiency targets over time, rather than for directly setting base year allowances. Using benchmarking to set regulatory expenditure levels that DNSPs cannot reasonably achieve in the short to medium term will put pressure on the sustainability of the network.

We consider that further consultation needs to be undertaken regarding the design of the EBSS and its interaction with opex allowances. While we recognise that the expenditure guidelines incentives are an appropriate forum to discuss issues with the EBSS, we would suggest that the AER is still required to undertake formal consultation processes under clause 6.5.8(a) of the NER. We seek clarity from the AER on the timelines for this discussion.

Our responses to the AER's supplementary questions are attached.

If you would like to discuss this matter further, please do not hesitate to contact me on (02) 9249-3120 or via email on Michael.martinson@ensdeavourenergy.com.au or, alternatively, Mr Zubin Meher-Homji, Manager Regulatory Affairs at Ausgrid on (02) 9269-2395 or via email on ZMeher-Homji@energy.com.au.

Yours sincerely,

Mike Martinson
Group Manager Network Regulation
Networks NSW

Attachment A – Responses to the AER's supplementary questions

1.In the interests of providing certainty on matters to be raised during a determination process, should the AER decide whether to accept or potentially adjust base year opex at the Framework and Approach stage?	Our view is that the AER should make this decision as part of the regulatory proposal process. There are 2 reasons for our view: • The AER has an obligation under the NER to start its analysis with an examination of our regulatory proposal. The AER's constituent decision must either accept, or reject and substitute the total forecast opex that is included in the current building block proposal. This means that the necessary starting point for the AER's assessment is the information submitted by a DNSP in its proposal. Clause 6.10.1(b) makes it clear that in making a draft distribution determination in relation to the Distribution Network Service Provider, and subject to clause 6.14, the AER must have regard to the information included in or accompanying the regulatory proposal. • The matters that are decided on as part of the Framework and Approach paper do not extend to an assessment of opex efficiency. We are pleased that the AER has recognised that the Framework and Approach alternative cannot be used for NSW DNSPs for the 2014-19 determination process.
2. What are the risks and other practical implications of the AER attempting to determine the effectiveness of the opex incentive framework by reference to an NSP's performance, which may be the result of other incentives or exogenous factors?	Our view is that it is impossible to accurately identify the level to which a DNSP has responded to an incentive, or to some other exogenous factor. The key issue is not the source of the efficiency driver, but whether the combination of the EBSS, the exogenous source or other factors incentivise a DNSP to continuously find efficiencies. In this respect, the current EBSS provides a very high level of incentive to progressively reduce costs (or avoid inefficiencies) and therefore is a catalyst for a business to deliver lower costs over time.
3. Should the AER consider placing a higher threshold on making adjustments to the base year and departing from the current revealed cost framework? (How) could this be accommodated in the staged assessment process outlined above? For example, should the AER base its decision on several years of identified inefficiencies or upon a certain quantum of inefficiency?	The EBSS must be seen as a long term framework, where the DNSP is encouraged to continuously 'reveal' efficiencies, and thereby lower opex over successive determinations. The strength of the penalty / reward means that a DNSP will constantly be reviewing is operations and practices to drive down costs, and therefore at any point time reveals the level of efficiency that can be practically achieved. By contrast, benchmarking is too crude a tool to use in setting an opex allowance. While granular benchmarking may provide insights into areas of inefficiency, it cannot adequately account for different accounting practices and network (both operational and design) characteristics of the business in the revenue setting process.

	In terms of the assessment process, our view is that the AER has an obligation under the Rules to assess the total forecast in a DNSP's regulatory proposal based on the Rule requirements. This includes the opex objectives, criteria and factors. The AER's approach, therefore, should not be based on benchmark costs, but rather a proper assessment of the expenditure under the Rules. In this respect, we note that revealed costs and benchmarking are part of a series of considerations in this assessment: • The opex factors in the Rules identify previous expenditure and consistency with incentive schemes. In other words, the AER must have regard to the 'revealed costs' under the incentive scheme that applied in the previous determination. In our view, this factor should be given primary weighting. • Benchmarking is a relevant opex factor, and therefore consideration should be given to cost comparisons between DNSPs. However, caution should be applied to the findings that arise from such analysis, as there are inherent limitations in using benchmarks. If there is an area that appears to be inefficient, the AER should undertake a thorough review to assess whether there is a level of inefficiency, or whether there is a reasonable explanation to justify cost differences.
4. Are there preferable alternatives to addressing material inefficiencies in an NSP's base year expenditure to simply adjusting the expenditure of that year (prior to applying step and trend changes)? For example, are there circumstances where it would be appropriate for opex allowances to reflect the progressive removal of inefficiencies over several years?	As noted above the AER's obligations under the NER are to either accept or reject the total opex forecast proposed by a DNSP in accordance with the assessment process in 6.5.6 of the Rules. In making this decision, the AER cannot simply choose a binary assessment method; rather, it must consider the information included in a DNSP's proposal and test this against the objectives, criteria and the factors in the Rules. Our view is that revealed costs should be given primary weighting in the AER's decision, given the strength and design of the incentive. A rational DNSP would respond to the incentive by reducing costs, with recognition that such efficiencies involve a significant transition in a firm's operations. Benchmarking, in contrast, may result in the AER applying the lowest cost based on a comparison with benchmark peers (of which there is unlikely to be close matches for any of the NSW DNSPs) and will not take into account the degree of errors that arise from benchmarking analysis. A more appropriate use of benchmarking is to inform decisions regarding the transition to higher or lower cost structures over time, if benchmarking indicates such a move is warranted.
Do stakeholders agree that any transitional arrangements should aim to provide NSPs with the same marginal benefit if we set opex forecasts exogenously or by applying a base year approach?	We consider that the AER's primary obligation is to set an efficient opex allowance in accordance with the Rule requirements. If the allowance is set correctly, we consider there is no need to develop an alternative scheme for different assessment methods.

Do stakeholders agree with the transitional issues identified above?	No. We consider that the AER needs to demonstrate that the existing EBSS is not providing significant incentives for a DNSP to reveal its costs. Such evidence has not been provided, and therefore we consider that the weight attached to the revealed costs method should be highest in the AER's assessment of proposed opex.
Are there other issues that stakeholders consider are material if an NSP is transitioned from the current opex forecasting approach and EBSS, to the new proposed exogenous forecasting approach and associated EBSS?	We will give further consideration to these issues as part of further consultation processes on this matter.