AUSTRALIAN ENERGY
REGULATOR

GPO Box 520
Melbourne VIC 3001

Telephone: (03) 9290 1444
Facsimile: (03) 9290 1457

www.aer.gov.au

Our Ref: 49598

19 October 2012

Ms Sophie Dunstone
Committee Secretary
Senate Select Committee on Electricity Prices
Parliament House
CANBERRA ACT 2600

By email: electricityprices.sen@aph.gov.au.

Dear Ms Dunstone

AER Response to Senate Select Committee Questions on Notice

Please find attached the AER's response to the Senate Select Committee's Questions on Notice.

Yours sincerely

Michael Cosgrave
Acting Chief Executive Officer

AER response to Senate Select Committee Questions on Notice – October 2012

1. AER use of capex incentive schemes

Question: How do you respond to the claim that the AER does not currently take up opportunities to reduce capex by network businesses?

Chapter 6 of the National Electricity Rules (Rules) permits the AER to include capital expenditure (capex) in an Efficiency Benefit Sharing Scheme (EBSS) to apply to distribution networks. [1] The characteristics of the EBSS are tightly prescribed in the Rules. In particular, the scheme must be symmetrical – i.e. it must both penalise overspending and reward underspending.

The AER has not adopted a capex EBSS due to concerns that it could create incentives for distribution businesses to inefficiently defer capex.[2] In plain language, the mechanism available to the AER under the current rules created a risk that distribution businesses could be rewarded for spending too little, with consequent risks for service standards.

In particular, the AER was worried about the interaction between a capex EBSS and the broader regulatory package. Under the current rules, there is nothing in the expenditure factors or criteria that permit the AER to disallow proposed expenditure on grounds that it was provided for as part of a forecast in a previous regulatory determination. Distribution businesses have the opportunity to include the same projects in more than one forecast – and be remunerated for the same projects on multiple occasions. In these circumstances, it is inappropriate to introduce an incentive mechanism which generates even greater rewards for deferring capex. To do so would potentially require customers to partly fund deferrals up to three times:

- through financing the expenditure forecasts
- through financing rewards under the benefit-sharing schemes
- where the same (deferred) capital projects are proposed in the next reset.

The AER was also influenced by the Essential Services Commission of Victoria's (ESCV's) experience of applying a similar mechanism in Victoria. The ESCV was obliged to discontinue its capex incentive scheme in the context of significant underspending by Victorian distribution businesses during the 2001-05 regulatory period, followed by an increase in capex forecasts submitted by those distribution businesses for the 2006-10 regulatory period.

Given these concerns, the AER's rule change proposal to the AEMC sought to establish a capex incentive mechanism which created appropriate incentives in relation to both overspending and underspending. The AEMC's draft determination on the network regulation rule change includes giving the AER flexibility to develop a capex incentive mechanism subject to certain guiding

---

[1] No similar provision exists in relation to transmission.

[2] AER, *Electricity distribution network service providers – Efficiency benefits sharing scheme*, June 2008, pp 10-11. The problem of a capex EBSS "over-counting" the benefit from project deferrals (unless appropriate adjustments to the scheme can be made) has been recognised in the joint consultant report commissioned by the ENA. PwC, Gilbert+Tobin, NERA, *Design of capital expenditure incentive arrangements – A joint report for the ENA*, 8 December 2011, pg 29.

principles. Unlike the current framework, this approach will enable the AER to design more suitable capex incentives having regard to a range of factors, including the incentives associated with other elements of the regulatory package and the NSP's past expenditure relative to allowances.

2. Differences in behaviour between privately and publicly owned utilities

Question: How do you respond to the claim that publically-owned utility businesses respond differently to regulation when compared with privately-owned businesses?

During the previous round of regulatory determinations, there were differences in the way that various network businesses responded to the regulatory framework.

Businesses in New South Wales and Queensland were more likely to incur capex overspends. Up to 25 per cent of increases in distribution network charges arising in New South Wales and Queensland during the most recent round of regulatory resets were attributable to capex overspends in the previous period.

The circumstances faced by each network business are unique and it is difficult to definitively attribute all these differences to government or private ownership. For instance, differing reliability standards was one of the factors driving different outcomes between jurisdictions.

However, the AER's network regulation rule change proposal highlighted that the rules do not provide sufficiently strong incentives to ensure that only efficient investment occurs. This is particularly an issue where the regulated cost of capital (or rate of return) is higher than the actual cost of capital for the network business, or where the network business is responding to a broader range of incentives, rather than just financial incentives.

Looking forward, a stronger capex incentive mechanism and the greater use of benchmarking will help address issues with businesses responding differently to the regulatory framework. Benchmarking will mean that all businesses will be subject to the same cost disciplines in terms of their allowed expenditures set by the regulator.

3. Ex-post reviews

Are you aware of the ERA (WA)'s ex-post scrutiny powers? Yes.

Can you explain why the AER does not have ex-post scrutiny powers?

When it redesigned the regulatory framework in 2006, the AEMC decided against the use of ex-post reviews of capex efficiency on grounds that they are intrusive and undermine regulatory certainty.[3] Instead, the AEMC preferred to rely on ex ante measures to create incentives for efficient expenditure.

The AEMC has subsequently revised its position. The draft determination on the network regulation rule change proposes the use of ex-post reviews of capex efficiency. If the AER forms the view that the network business has spent in excess of efficient levels, then the AER would be able to preclude

[3] AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, pg. 98.

inefficiently incurred capex (above the level of the capex allowance) from being rolled into the Regulatory Asset Base (RAB). The AEMC also proposes to require the AER to make a statement on the efficiency of capex going into the RAB in its draft and final determination for each network business.

Would ex-post scrutiny powers assist the AER to regulate capex in the National Electricity Market (NEM)?

The current regime, which requires all capex incurred by network businesses to be rolled into the RAB at the next regulatory reset even if it is in excess of allowances, does not provide adequate supervision of expenditure.

The AEMC's proposed approach to ex-post reviews provides an appropriate balance between providing investment certainty for network businesses and providing incentives to invest efficiently. Network businesses would have flexibility to spend in excess of allowances when necessary whilst retaining incentives to incur only efficient capex.

The AER also supports the requirement for the AER to make a statement on the efficiency of capex going into the RAB. Such a statement has the potential to provide information to all stakeholders on the efficiency of the NSP and may be a useful input into the analysis of capex allowances for the next regulatory period.

What would be the likely impact on the NEM if the AER had ex-post scrutiny powers?

The use of ex-post reviews is likely to make network businesses more cautious about incurring capex in excess of their regulatory allowances. It removes the risk – which is present under the current regime – that network businesses may be incentivised to spend in excess of allowances.

If a network business overspends relative to its allowance, and the AER finds that the expenditure is inefficient, then the AER will preclude the inefficient expenditure (that is above the allowance) from entering the RAB. In this case, the network businesses will not be able to recover their inefficient capex from consumers.

However, if there are legitimate reasons why a network business needs to spend more than was envisaged at the time of the previous reset, then the ex-post review mechanism provides flexibility for the network business to undertake the additional efficient expenditure and be remunerated for it.

If the AER was to be given ex-post scrutiny powers, what would the AER require with regards to:

(a) resources and funding;

(b) skills and expertise;

(c) statutory / legislative changes; and

(d) enforcement and penalties for non-compliance by network businesses?

As part of the process for determining a business's future capex requirements, the AER will also consider previous expenditure, including major investments that businesses have undertaken in the

past. Analysing the past behaviour of a business is important as it can inform the AER's assessment of the business's likely capex requirements in future. As such, there has always been an element of ex-post assessment by the AER of the business's investment decisions.

However, the introduction of ex-post reviews in the manner contemplated by the AEMC, as highlighted above, involves a more comprehensive ex-post assessment. This is likely to have some impact on AER resourcing during regulatory reviews. However, it is relatively common for utility regulators both in Australia and elsewhere to undertake ex-post reviews along the lines being proposed by the AEMC.

In terms of the legal framework, ex-post reviews could be given effect via changes to the National Electricity Rules. As discussed above, the AEMC already proposes to make such changes. It would not be necessary to amend the National Electricity Law to give the AER additional enforcement powers. If a network business is found to have incurred inefficient capex in excess of allowances, they would be penalised via the RAB roll forward mechanism since the network business would not be able to recover the inefficient expenditure from customers.

4. Asset valuations of privately and publicly owned utilities

Question: The Energy Users Association at page viii of their submission suggest that ownership affects asset valuations. They claim in 2014 regulated assets of government owned distributers will be valued a little under twice as highly per kilometre of line to those of privately owned distributors. Does this view accord with AER research / investigations and if so why?

The AER has not undertaken the specific analysis carried out by the Energy Users Association so is not in a position to verify their figures. It notes more generally that there are a number of possible benchmark measures that can be used to compare the relative efficiency of different businesses and it makes no particular claims that the EUAA's measure is necessarily better or worse than any other. For its part the AER has looked at a substantial number of performance indicators comparing all network businesses operating in the national electricity market, which suggests that there are differences in the cost performance of government-owned and privately owned businesses – see the AER reports on Aurora and the Victorian DNSPs[4]. See also response to Q2 above.

However, the critical issue with all such comparisons is whether the apparent differences are all due to differences in efficiency or whether they also reflect other differences, such as network, geographic and other characteristics that are beyond the control of the business. For this reason, the AER is developing more sophisticated benchmarking tools that try to better capture such differences. In so doing, the AER will be better able to set efficient expenditure allowances for all network businesses.

The changes to the rule framework proposed by the AEMC will facilitate the ability of the AER to effectively benchmark network businesses in this way. The changes will also prevent businesses

[4] AER, *Draft Distribution Determination Aurora Energy Pty Ltd, 2012–13 to 2016–17*, November 2011, Appendix B pg 321, Nuttall Consulting, *Aurora Electricity Distribution Revenue Review, Final report to the AER*, 11 November 2011, pg 148 and AER, *Final decision – appendices, Victorian electricity distribution network service providers Distribution determination 2011–2015*, October 2010, Appendix H, pg 99.

being able to automatically roll-in inefficient and inflated expenditure into their regulatory asset bases to be funded by consumers (see also response to Q3 above).