

Submission to the Essential Services Commission

Re: Electricity Distribution Price Review 2006 – 2010 Draft Decision

Efficiency Carryover Mechanism



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1 Key points

The key points of United Energy Distribution's (UED) submission on the Efficiency Carryover Mechanism (ECM) are that the Commission should not:

- Alter how the current period ECM operates; nor
- Remove capital expenditure from the ECM in the next period.

UED would like to point out to the Commission that its proposed decisions on these issues have broader implications than for the efficiency carryover mechanism itself. These implications go to the confidence that investors and infrastructure businesses have in the regulatory regime.

When regulators demonstrate a willingness to back track on their approaches to regulation when there is no overwhelming reason to do so, it damages confidence in the regulatory regime. It damages confidence because it creates the risk that other aspects of the regulatory regime might also change. This imposes costs on customers because it stifles the drive for efficiency and innovation by the businesses (eg. by penalising the business for responding to the incentives in place, such as the S-factor) and increases the risks imposed on investors. This is not in the long term interests of customers.

1.1 Current Period ECM

UED recognises that there must be flexibility to enable changes to be made to the regime where good reasons are demonstrated. However, altering the current period ECM, as the Commission proposes, would involve the regulator in making a retrospective decision. Changing the rules that applied in the current period does affect certainty, incentives and the long term interests of customers. Indeed the whole point of the Office of the Regulator General's (ORG) "comfort" in the 2001 Electricity Distribution Price Determination (EDPD) – to provide certainty to enhance incentives for efficiency – is defeated by changes that destabilise. Retrospective decision making can only impose incremental costs on customers.

UED's expert economic advice is that irrespective of whether regime changes are "good" or "bad", the arguments to support a retrospective application of change are weak since this change cannot influence distributor behaviour in the past regulatory period. Also, such changes should be implemented in a manner and within timeframes that minimise the damage to regulatory uncertainty and the consequent disincentives for efficiency.

Moreover, UED considers that it is contrary to law for the Commission to now resile from representations made by the ORG in the 2001 EDPD. UED's view is that the Commission's procedural statements that it could not bind a future decision maker must give way to the substance of the binding nature of the representations made. UED is continually required to

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act in reliance on the representations made by the Commission or its predecessor, and needs to be able to place trust in the stability of the regime and rules going forward.

The approach should be changed not from 2006, but from the commencement of the following regulatory period in 2011 (assuming the change is justified).

1.2 Next period ECM

Removing capital expenditure from the ECM in the next period would be a retrograde step for the incentive framework. It:

- reduces the incentive to make efficiency gains in respect of capital expenditure. Ofgem recently addressed this issue in the context of its recent price review, and managed to find a way of retaining an incentive for the business to outperform on their capital expenditure (although UED would not necessarily prefer the model adopted in that case);
- is contrary to the “fair sharing of efficiencies” requirement in the Tariff Order, as discussed at length in UED’s submission on operating expenditure;
- creates distortions between incentives to pursue operational expenditure or capital expenditure efficiency gains, which would encourage cost-shifting behaviour;
- indicates that rather than finding mechanisms that promote the twin objectives of achieving investment and efficiency, it focuses on the former at the expense of the latter. However, its capacity to achieve the first objective is likely to be undermined because it will reduce confidence in the regulatory regime and it is unlikely to achieve the second objective; and
- fails to properly weigh the costs such changes are likely to have indirectly on incentives from diminishing the stability and predictability of the regulatory regime.

A proper consideration of these issues would suggest, at a minimum, deferring such a step until the end of the next regulatory period when more information is available about the operation of the regulatory regime (even if the change is justified).

UED’s submission is supported by the regulator’s previous commitments on these issues, which highlight the importance of regulatory stability and certainty.

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2 Previous Regulatory Commitments

It is apparent from the following that at the 2001 Electricity Distribution Price Determination (2001 EDPD) the Office of the Regulator General (ORG) made a number of commitments regarding how the long term ECM would work.

In the 2001 EDPD the ORG stated on pages 84 and 85:

“The Office considers that **a degree of certainty** about the Office’s approach to adopting a long-term efficiency carryover mechanism **will provide more effective incentives** for encouraging the efficient behaviour described above. Whilst the Office cannot now bind the future exercise of statutory powers, it considers that a **long-term approach** to determining the efficiency carryover (that is, spanning more than one regulatory decision-making period) **is consistent with the statutory objectives** the Office must meet.”

(our emphasis)

“The details of the post-2001 incentive mechanism are as follows:

- any efficiency gains (or losses) **will be retained by the distributor for five years** after the year in which the gains (losses) are achieved. This implies a sharing of benefits between the distributor and customers of around 30:70 in net present value terms and ensures that there will be an equal treatment of savings in each year;
- **a floor of zero will be set** on the carryover amount **in any one year**, (ie. there will be no *negative* carryover in any year of a future regulatory period). Where the combined carryover from operating and maintenance expenditure plus capital expenditure would be negative, the efficiency carryover will be set to zero for that year, and **the implied negative value will be used to offset any positive gain in the following year.**”

(our emphasis)

On page 87 of the 2001 EDPD, the ORG also stated:

“The Office recognises that to the extent there is **uncertainty** regarding the adoption of the post-2001 incentive mechanism outlined in this *Determination*, the **incentive properties of the mechanism will be reduced**. For this reason, the Office is now setting out in some detail what it considers to be the appropriate mechanics for applying the long-term carryover mechanism. This is intended to provide a clear and stable framework within which the distributors can make future expenditure decisions. The long-term carryover mechanism has been designed with the objective of making it transparent, easy to administer and replicable from one regulatory period to the next. **These features enhance the credibility of the Office’s commitment** to implementing the mechanism in the future.

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However, the future necessarily involves uncertainty. It is not therefore possible, or desirable, to make permanent now all aspects of the application of the mechanism in the future. The current regulatory framework is one within which the Office has the discretion to use judgment in exercising its statutory power. In the absence of an explicit legal power to bind future decision-makers, a decision-maker exercising statutory power now cannot bind future decision-makers in the exercise of that power. Moreover, the Office recognises the importance of not unduly fettering future decision-makers.

Nevertheless, **the guidance given in this *Determination*** to the operation of the long term efficiency carryover mechanism and the debate on the merits and incentive properties of the mechanism which has preceded this *Determination*, **provide a high degree of comfort** about its future application.”

(our emphasis)

Page 89 of the 2001 EDPD stated:

“There will be a floor of zero set on the carryover amount in any one year. That is, there will be no *negative* carryover in any year. Where the combined carryover from operating and maintenance expenditure plus capital expenditure would be negative, the efficiency carryover will be set to zero for that year, and the implied negative value will be used to offset any positive gain in the following year. Implied negative carryovers will be carried over and accrued in each year, until the end of the regulatory period”.

Notwithstanding the statements made by the ORG in the 2001 EDPD, the Commission stated at page 104 of the Issues Paper:

“This [new] approach calculates the operating and maintenance expenditure and capital expenditure carryover amounts and sums them over each year of the 2006-10 regulatory period. Where the sum of these annual amounts is positive in net present value terms over the 2006-10 regulatory period, the calculated amount in each year is added into the revenue requirement for the 2006-10 regulatory period. Where the sum is negative in net present value terms over the 2006-10 regulatory period, the amount of the carryover is set equal to zero, and the accrued negative sum is used to offset any gains made in subsequent regulatory periods.

Under the Commission’s template models, where accrued negative efficiency carryover amounts for the 2001-05 regulatory period result in a negative net present value (NPV) over the 2006-10 regulatory period, the zero floor is applied to all years. This results in zero efficiency carryover amounts for each year of the 2006-10 regulatory period. Where the NPV is positive, efficiency carryover amounts are treated on an annual basis with any negative amounts being offset against the revenue requirement. This treatment means that, while negative carryover amounts are applied to the revenue requirement, the total revenue requirement for the 2006-10 regulatory period is still greater than that calculated based on the building block cost approach (that is, is greater than if the efficiency carryover were not applied).”

At page 105 of the Issues Paper the Commission stated:



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“While the NPV approach to applying the zero floor may be a departure from what may be a literal interpretation of the 2001-05 Determination, the Commission maintains that this approach is consistent with the intention of the 2001-05 Determination. The Commission’s approach only includes an efficiency carryover amount in the 2006-10 revenue requirement where the NPV of the 2001-05 efficiency carryover amounts is positive. Where the NPV is negative, there are no efficiency carryover amounts for any year of the 2006-10 regulatory period.

The principle of implementing a zero floor, or ‘no negative carryover’ approach, was to prevent the carryover mechanism resulting in a reduction in the overall revenue requirement below the level of the building block cost elements. This is achieved under the Commission’s NPV floor approach. However, the intent of this principle could also be achieved by a ‘no negative in any one year’ approach (that is, the approach discussed below), with any negative amount either being rolled forward, or used to offset gains in an earlier year.

To provide further certainty to distributors regarding the impact of the efficiency carryover on their revenue requirement, the Commission proposes that, in addition to the application of the NPV approach to the zero floor, a zero floor also be applied in any one year. To facilitate this accrued negative carryover amounts would be offset against positive carryover amounts in either the preceding or following year(s) depending upon the profile of the efficiency carryover amounts. To maintain the same NPV of efficiency carryover amounts under this method, accrued negative carryover amounts will be adjusted by the weighted average cost of capital (WACC).”

3 Commission's Draft Decision

In relation to the NPV approach to the zero floor, in the Position Paper the Commission adopted a position which emphasised the benefits of regulatory certainty and the costs of regulatory uncertainty. UED supported this correction of the issues paper position. Now, the Draft Decision proposes efficiency carry over arrangements that are consistent with those outlined in the Issues Paper. The Commission also proposes to change the operation of the ECM in the 2006-10 regulatory period. Page 153 of the Draft Decision states:

"In calculating the efficiency carryover amounts to apply in the 2006-10 regulatory period, the Commission has applied a net present value approach to the treatment of no negative carryover amounts.

The Commission has also changed the operation of the efficiency carryover mechanism in the 2006-10 regulatory period. The mechanism will continue to apply to operating and maintenance expenditure, but will no longer apply to capital expenditure."

The Draft Decision also states on page 351 that:

"To be consistent with the Commission's obligation to ensure a fair sharing of efficiency benefits, the Commission has therefore decided not to apply an efficiency carryover mechanism to capital expenditure during the 2006-10 regulatory period"

A chronology of the Commission's positions:

- 2001 EDPD – zero floor set in any one year, provides certainty
- 2004 Issues Paper – zero floor set to 5 year NPV of efficiencies
- 2005 Position Paper – Commission reverts to zero floor applied to any one year
- 2005 Draft Decision – Commission reverts to NPV approach and adjusts mechanism to exclude capital expenditure.

4 UED's Response to the Draft Decision

UED recognises that there must be flexibility to enable changes to be made to the regime where the weight of evidence very firmly supports such a change. However, changing the rules that applied in the current period does affect certainty, incentives and the long term interests of customers. Indeed the whole point of the ORG's "comfort" in the 2001 EDPD – to provide certainty to enhance incentives for efficiency – is defeated by changes that destabilise.

But there is a balance that can be found - such changes should be implemented in a manner and within timeframes that minimises the damage from regulatory uncertainty and the consequent disincentives for efficiency. This suggests that retrospective changes should not be made and that forward looking changes should be phased in if possible.

Changing the NPV approach to the zero floor is an example of a retrospective change and the Commission should not proceed with it. The removal of capex from the efficiency carryover mechanism is a prospective change but one that should be reconsidered on its merits. At a minimum, it should at least be delayed one regulatory period to provide greater certainty in the application of the regulatory regime and to assess the evidence that emerges over the next regulatory period.

4.1 The NPV Approach to the Zero Floor

In relation to the NPV approach to the zero floor, in its Position Paper the Commission was attracted to the argument that the erosion of regulatory certainty from its proposed change of approach will reduce the incentive for efficiency with consequent adverse long term effects for customers. The Commission accepted the proposition that the approach be changed not from 2006, but from the commencement of the following regulatory period in 2011. However in the Draft Decision the Commission has reversed its position, placing greater weight on what it considers to be the perverse outcomes of the current methodology, and its view that those outcomes are contrary to the purpose and intent of the regulatory framework and approach, than regulatory certainty.

The Commission is therefore proposing a retrospective change to the efficiency carryover mechanism.

UED's expert economic advice is that irrespective of whether regime changes are "good" or "bad", the arguments to support a retrospective application of change to interpretation are weak since this change cannot influence distributor behaviour in the past regulatory period.

Retrospective decision making can only impose incremental costs on customers. It cannot have incremental benefits, because it cannot alter the behaviour the distributors have already engaged in. However, it will impose incremental costs because it reduces the stability and predictability of the regime. In other words, when deciding how to respond to

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the new incentives provided by the regime, the businesses will naturally weigh up the risk of the rules being changed after the fact at the next review. As a result, retrospective decisions cannot be in the long term interests of customers.

Hence where the Commission is proposing to change any commitment, the application of this new interpretation should apply only to future periods where distributor behaviour can be influenced. The regulator recognised this when introducing the ECM in the 2001 EDPD, and our submission on Relevant Costs reiterates the importance of this.

UED considers this is a relevant matter that the Commission should consider carefully in framing its Final Decision.

In addition, UED also recognises the doctrine that supports it is in the public interest that an administrative decision maker cannot fetter its discretion. However, the ORG went to some lengths in its 2001 EDPD to give comfort and certainty to UED – it gave a “commitment” that was supposed to have “credibility”.

The Commission’s Final Decision needs to properly recognise the public interest in providing certainty from and preventing damage to investors who have relied on regulatory representations purporting to provide “high degrees of comfort” such as those given by the ORG.

On the face of the Draft Decision, the Commission has had little if any regard to this important consideration, and the Commission’s related long term objective. The Commission’s Final Decision should address this matter.

But not only that, UED considers that it is contrary to law for the Commission to now resile from representations made by the ORG in the 2001 EDPD. It is the UED’s view that the Commission’s procedural statements that it could not bind a future decision maker must give way to the substance of the binding nature of the representations made. UED acted in reliance on the representations made by the ORG in circumstances where it will suffer detriment if the Commission is now allowed to change the position established in the 2001 EDPD.

4.2 The removal of Capital Expenditure from the ECM

The removal of capital expenditure from the ECM would have a number of undesirable consequences.

First, it reduces the incentive to make efficiency gains in respect of capital expenditure.

Second, it is contrary to the “fair sharing of efficiencies” requirement in the Tariff Order. This is because the businesses will enjoy less of the benefits of any capital efficiency achieved. Overall, the likely result is that the businesses will get less than the 30% share of efficiency gains the regulator has previously determined to be “fair”. It would therefore appear to be consistent with the regulator’s previous interpretation of the Tariff Order. The



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issue of the fair sharing of gains is discussed at length in UED's submission on operating expenditure.

Third, it may create distortions between incentives to pursue operational expenditure or capital expenditure efficiency gains, which would encourage cost-shifting behaviour. Indeed, the symmetry of incentives was one of the main reasons the Commission advanced for including capital expenditure in the ECM in the 2001 EDPD. The removal of capital expenditure from the ECM is likely to lead to the Commission demanding more intrusive powers to police the delineation between capital expenditure and operational expenditure.

Fourth, it is an odd way of responding to the challenges presented to regulators in recent reviews of the application of incentive regulation. Rather than finding mechanisms that promote the twin objectives of achieving investment and efficiency, it attempts to focus on the former at the expense of the latter. However, its capacity to achieve the first objective is likely to be undermined because it will reduce confidence in the regulatory regime and it is unlikely to achieve the second objective.

Moreover, UED believes that if the Commission is minded to remove capital expenditure from the ECM, it should properly weigh the costs such changes are likely to have indirectly on incentives together with the stability and predictability of the regulatory regime. UED's submission on Relevant Costs includes a discussion about the proper assessment of these costs.

Notwithstanding that the removal of capital expenditure from the ECM would not be retrospective, it clearly significantly alters the regulatory framework. It is therefore likely to alter how the businesses behave and the likelihood they attach to more changes occurring in the future.

A proper consideration of these issues would suggest, at a minimum, deferring such a step until the end of the next regulatory period when more information is available about the operation of the regulatory regime (even if the change is justified).

Phasing in changes is more likely to provide a stable and predictable regulatory environment, which, in turn, is likely to be more conducive to encouraging efficiency and innovation. In the long run, the interests of customers can only be served if the regulatory regime is stable and predictable.

Finally, as an aside, it is noteworthy that the Commission justifies its proposal to exclude capital expenditure from the ECM from 2006 as follows:

"The Commission also recognises that, by not applying the efficiency carryover mechanism to capital expenditure, distributors may have a greater incentive to increase their capital expenditure in order to increase the regulated asset base and earn a return on this expenditure."

UED has lodged a separate detailed submission regarding the Commission's proposed capital expenditure benchmarks for the 2006-10 period. As noted in that submission, UED



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considers that the Commission and its adviser (Wilson Cook) have adopted benchmarks that are substantially below the levels required to ensure that UED will be capable of achieving its reliability targets. Moreover, UED's submission on capital expenditure benchmarks has demonstrated that Wilson Cook - and therefore the Commission - are taking a short-term view to trim capital expenditure without having proper regard to the Commission's objectives or the long-term impact on customers.

The Commission's justification (cited above) for abandoning the capital expenditure ECM provides evidence that the Commission itself is aware that the capital expenditure benchmarks it is proposing may well be too low to facilitate achievement of the Commission's primary objective. The Commission's reasoning strongly implies that there is a likelihood of distributors expending higher levels of capital than that provided in their benchmarks. Under these circumstances, the exclusion of capital expenditure from the ECM would reduce – but not eliminate - the additional costs borne by distributors as a result of their needing to expend amounts of capital that exceed their benchmarks.

4.3 Combined Effects

It is also worth noting that the justification for applying negatives in the efficiency carryover mechanism is weakened if the Commission is going to remove capex and is not going to use the reported costs to set the operating and maintenance expenditure benchmarks in the next period. This is simply because the customer is no worse off, if a distributor overspends on opex.

5 Conclusion

UED's response to the Draft Decision can be summarised as follows:

- The erosion of regulatory certainty from the changes proposed in the Draft Decision will reduce the incentive for efficiency with consequent adverse long term effects for customers. The Final Decision must have proper regard for this important consideration.
- In these circumstances any changes to the ECM which are proposed at the beginning of the 2006 regulatory period should apply from the start of the 2011 period.
- The new approach proposed by the Commission expressly varies the current regulatory approach and retrospectively removes the ongoing treatment of positive efficiency gains in the 2001 – 05 period. Being a retrospective determination, it is invalid.
- The economic costs of the Commission's proposed approach to exclude capital efficiencies in future periods is likely to be reduced certainty on the future setting of operating expenditure benchmarks and the future treatment of efficiency gains. These costs will be borne by customers over the longer term.