Regulatory Protections

Presentation for Customer Forum

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Context and Objective

Context: AusNet Services has sought to add regulatory protections to the scope of negotiations.

Objective: To provide a holistic overview of the risk management mechanisms that exist under the current rules, that may be relevant to negotiations.

Incentive Regulation – Premise

- Incentives under the regulatory framework designed so incentives of networks (profit maximisation) aligned with long run interests of customers

- Set up to encourage businesses to make efficient decisions (reducing costs, but not at the expense of poor service performance), without the need for regulatory oversight of every decision.

- The approach to setting allowances for expenditures and targets for operational incentive schemes are reviewed periodically to ensure they reflect efficient benchmarks.

- This ensures that customers continue to benefit from incentive-based regulation as businesses recover no more and no less than their benchmark-efficient costs, and operational targets remain efficient.

Why not refund actual costs?

If actual costs are provided (once known after the event), there is a lower incentive for networks to minimise cost. May have the following implications:

- **Capex –** Replace assets before required, as no $ benefit in deferral. Better off not taking any risk that the assets will fail.
- **Opex –** Continue to increase salaries and headcount beyond reasonable (efficient) levels. Improves working conditions, but not optimal for customers.
- **Financing –** Could issue high cost debt, rather than seeking out cheaper rates in foreign markets, for example.

If actual costs were funded, the AER would need to micro-manage the businesses to ensure every single operational decision was the most efficient one. This would be impossible.

Risks are allocated between customers and networks

The regulatory regime shares risk between customers and networks.

The regulated rate of return should be set to compensate debt holders and equity investors for risks faced by an efficient entity.

Examples of some risks faced by networks are listed below (source: Frontier Economics report for the AER, July 2013)

Business Risk	Financial Risk
Demand risk	Refinancing risk
Input price risk	Interest rate reset risk
Cost volume risk	Illiquidity risk
Supplier risk	Default risk
Inflation risk	Financial counterparty risk
Competition risk	
Stranding risk	
Political/ regulatory risk	
Other business risks	

Sometimes the risk is too material…

- In some extreme circumstances, networks can ask the AER to increase funding mid-period.
  - Linked to event or trigger defined in the regulatory decision or in the Rules
  - Two alternatives:
    - Cost pass throughs
    - Contingent projects
- Provisions in rules allow networks to recover efficient costs that result from events that could not be forecast at the time of the regulatory proposals that, if not funded, would have significant financial effect on ability of networks to invest in and operate their networks.
- The AER will assess whether the event meets the rules requirements and (if this is the case) approve the efficient costs.

Cost pass through events

Rules events	2016-20 EDPR events
Regulatory change event	Insurance cap event
Service standard event	Natural disaster event
Tax change event	Terrorism event
Retailer insolvency event	Insurer credit risk event

- Must increase or decrease costs by > $6.5m
- Network to submit details to AER within 90 days of event
- AER has 40 days to make decision

Contingent projects

- Value exceeds approx. $32.5m (5% of allowed revenues)
- A trigger event is specified in the decision; must be:
  - An event or condition that is probable but the occurrence is, or costs associated with the occurrence are, not sufficiently certain.

  Once trigger has occurred, network must apply to the AER as soon as is practicable. The AER has 40 days to make a decision (can be extended)
  - Contingent projects more common in transmission (ie TransGrid network reinforcement for Snowy 2.0).
  - Has been used for REFCLs in current period.

Re-opener

- An event occurs that means capex exceeding 5% of the RAB must be incurred.
- And the network would not be able to fund this without material deterioration in the reliability and security of the network.
- The AER can revoke and substitute the determination to adjust the capex allowance.
- This provision has never been used.

Incentive Schemes

- Incentive to invest in service performance improvements through the Service Target Performance Incentive Scheme (STPIS), and in demand management through the Demand Management Incentive Scheme (DMIS).

- Rules include provisions for a Small Scale Incentive Scheme
  - +/- 0.5% of revenue (approx $3.25m)
  - Benefits to customers must warrant the rewards

Question for Customer Forum

Is an alternative cost-risk sharing mix more appropriate for delivering some specific customer outcomes?