3 August 2016

Mr Jai McDermott
General Manager Corporate Affairs
United Energy and Multinet Gas
6 Nexus Court
Mulgrave Victoria 3170

Via Email: jai.mcdermott@ue.com.au

RE: Incentive Mechanisms position paper

Dear Mr McDermott,

Thank you for the opportunity to comment on the incentives mechanisms position paper.

The Consumer Utilities Advocacy Centre Ltd (CUAC) is a specialist consumer organisation established in 2002 to represent Victorian energy and water consumers in policy and regulatory processes. As Australia's only consumer organisation focused specifically on the energy and water sectors, CUAC has developed an in-depth knowledge of the interests, experiences and needs of energy and water consumers.

CUAC's advocacy maintains a focus on the principles of affordability, accessibility, fairness, and empowerment through information and education. We believe that consumer interests – particularly those of low income, disadvantaged and rural and regional consumers – must be a primary consideration in the development and implementation of energy and water policy and in service provision. CUAC supports informed consumer participation in energy and water markets.

CUAC is open to the idea of new incentives for the gas distribution businesses in Victoria to encourage more efficient investment in the long term interest of consumers, as articulated in the National Gas Law. However, we would like to see a greater reliance on empirical evidence as the basis for the proposed incentive mechanisms, rather than a dependence on theoretical economic arguments which often cannot predict unintended consequences. The gas businesses might also provide a clearer description of the problems with the current incentive regime, and explain these issues together with simple substantive positions. Further, it would be particularly useful to assess impact of the proposed incentive mechanisms - distributors should clearly outline the costs and benefits to consumers and could model the potential impact of incentive schemes on consumers' bills including likely scenarios for different user profiles.

Context in Victoria

For the vast majority of Victorians, gas is currently an essential part their energy mix, with both a high penetration of gas mains connections and high usage among consumers. As outlined in CUAC's research report, *Our Gas Challenge,* 83 percent of Victorian households have a gas mains connection.[1] CUAC's research found that a 'low usage' Victorian household – the bottom

[1] Martin Jones, 'Our Gas Challenge: The Role of Gas in Victorian Households' (Melbourne: Consumer Utilities Advocacy Centre Ltd., 2014), 3.

third of mains gas usage in Victoria - exceeds middle usage for households in NSW or SA, and is roughly equivalent to an upper usage household in QLD.[2] For many consumers, utility bills can be one of the primary causes of financial stress. According to the ESC, gas disconnections in Victoria remain high by recent historical standards, with 22,322 disconnections in 2014-15 due to a non-payment of an outstanding amount - roughly equivalent to two thirds of the absolute number of electricity disconnections over the same period.[3]

This can be explained to some extent by the increase in the cost of gas bills. According to the most recent DHHS Victorian Utility Consumption Household Survey, gas bills have increased approximately 40.0 percent between 2007 – 2014, despite a reduction in gas consumption of 25.1% over the same period.[4] While distribution accounts for approximately a third of the average gas bill in Victoria, reducing prices should be a key aim of the new incentive mechanisms, without compromising safety and reliability. This objective is clearly outlined in the National Gas Law:

*"… to promote efficient investment in, and efficient operation and use of, natural gas services for the **long term interests of consumers** of natural gas with respect to **price**, quality, safety, reliability and security of supply of natural gas".*[5]

CUAC recommends that the distributors clarify the total cumulative increase (or decrease) in return on equity, based on the incentive mechanisms proposed. It would also be particularly helpful to model the impact of this increase (or decrease) on consumers' bills.

It is also worth considering to what degree gas is a fuel of choice. According to ACIL Allen, there is "scant information on cross-price elasticity relevant to eastern Australian gas and electricity markets".[6] In our view, low-income consumers and renters have virtually no ability to switch their gas appliances, hot water and heating systems for electric substitutes in the short term. This group's ability to switch fuel and appliances is likely to remain unchanged in the longer term in the absence of a significant changes in government policy or incentives. Higher income customers may have a somewhat higher elasticity of demand should gas prices increase, though they are more likely to consider switching only at the point it becomes financially viable – for example when a hot water heating system breaks down or needs replacing, during a significant renovation or when planning a new build.[7] This means that the majority of Victorians will be directly impacted by price changes but have limited capacity to respond, other than through reduced usage.

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[2] ibid., 8.
[3] Essential Services Commission 2016, 'Energy Retailers Comparative Performance Report – Customer Service', May 2016, viii.
[4] Roy Morgan Research Ltd, 'Victorian Utility Consumption Household Survey 2015' (Department of Health and Human Services, 2015), 109.
[5] Section 23 National Gas Law
[6] ACIL Allen Consulting, 'Report to the Australian Energy Regulator - Review of Demand Forecasts for the AGN South Australia Gas Networks for the Access Arrangement Period Commencing 1 July 2016 – Public Version', 11 November 2015, 34.
[7] Alternative Technology Association, 'Are we still Cooking with Gas?', November 2014.

Capital Expenditure Sharing Scheme (CESS)

CUAC believes there is merit in a mechanism to incentivise gas distributors to invest efficiently across all years of the revenue period. While the proposed CESS incentive mechanism does in theory deliver this outcome, we have concerns about the potential for unintended consequences. A high powered incentive for gas businesses to underspend their capex allowances potentially creates the perverse incentive for the deferral of capex to future revenue periods. This potentially creates additional future costs for consumers, and could cause a decline in service levels to the detriment of customers.

Capex incentive schemes have previously been administered in Victoria in both the 2003-2007 and 2008-2012 gas access arrangement periods. During these periods, the ESC noted that distribution businesses underspent their capex allowance, received the incentive payment through the incentive mechanisms, but sought higher capex allowances in subsequent regulatory periods (referred to elsewhere as 'inter-period capex deferral').[8] We therefore encourage the AER to review the empirical evidence of distributor's spending during these periods and consider whether there is a risk of deferred capex as a result of the introduction of such a mechanism. It may also be useful to review the efficacy of the CESS mechanism for the electricity distribution regulatory period 2014-2019 in NSW/ACT to determine whether the incentive was effective and whether the power of expenditure sharing ratios is appropriate.

A further concern in regulating a CESS scheme is the increased complexity for the regulator to identify where and when distribution businesses defer capex. This is particularly problematic given the information asymmetry between regulator and business, and the significant time-lag between deferred capex and potentially adverse consequences in service quality.

Should the AER determine that a CESS is appropriate, we suggest an asymmetrical expenditure sharing scheme be introduced. Gas distributors could retain up to 30 percent of any underspend of their capex allowance. In our view, a higher powered incentive to underspend is inappropriate and may lead to gas distribution business pursuing excess cost reduction at the expense of service quality. A higher powered disincentive should be adopted for any overspend of a distributor's capex allowance - whereby gas distributors would be penalised 50 percent of any efficient overspend and the remaining 50 percent is borne by consumers. As argued elsewhere, there are a number of reasons for a higher powered disincentive for overspend, including;

- capex forecasts are likely to be biased upwards due to information asymmetry between regulator and distribution businesses,[9]
- consumers are not best placed to manage the forecast risks, while gas distributors have access to a variety of regulatory mechanisms to address significant forecast risks,[10]

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[8] Public interest Advocacy Centre, 'Having the desired effect: submission to the AER's Draft Expenditure Incentive Guideline', 20 September 2013, 26; Joskow, Paul L., 'Incentive Regulation in Theory and Practice: Electricity Distribution and Transmission Networks.', in *In Economic Regulation and Its Reform: What Have We Learned?* (University of Chicago Press, 2014), 321.

[9] PIAC, 'Having the desired effect', 19.

[10] ibid., 8; Australian Energy Regulator, 'Explanatory Statement, Draft Expenditure Forecast Assessment Guideline', 2013, 16.

- mechanisms such as pass through arrangements protect distributors from unforeseen efficient overspends,[11]
- an efficient overspend increases the Regulated Asset Base (RAB) of a distribution business, resulting in a reduced penalty through the long term benefit to a distributor through the return of capital.[12]

Further, we suggest that any inefficient overspend should be borne entirely by the gas distributors and monitored through the conforming capex assessment process.

We consider it inappropriate for distribution businesses to receive different sharing ratios. This would add a further complexity and increase the burden on the AER to determine whether businesses receive particular ratios and develop a consistent basis for these decisions. The option of different sharing ratios potentially provides gas businesses with the opportunity to pursue higher ratios when they can deliver larger efficiencies and windfall profits, and avoid larger penalties when they expect their efficient costs might exceed their approved revenue to avoid windfall losses.

Customer Service Incentive Scheme

The introduction of the CESS incentive should be contingent on an effective complementary scheme to ensure a capex underspend does not result in compromised service standards. The metrics proposed in the incentive mechanism position paper may not be the most appropriate metrics to address compromised reliability, safety and quality of supply standards resulting from capex underspend. The proposed metrics consider customer service outcomes which appear more closely linked to opex than capex. The distributors should reconsider revising the incentive metrics as part of this proposed mechanism so that they are more closely linked to capex. It may be the case that a revised and strengthened Guaranteed Service Level scheme could provide a more appropriate check on capex underspend than a customer service incentive.

In considering the merit of the proposed Customer Service Incentive Scheme as a standalone proposition, recent research conducted by AGN found that customers "value the current standard of reliability".[13] This suggests that this proposed incentive mechanism may be unwarranted, particularly given the proposed link between the customer service incentive and ±1 percent of revenue. Distributors could consider a stronger empirical basis for this incentive, developed through transparent customer satisfaction research that examining willingness to pay for varying levels of service quality, or a rigorous value of customer reliability study. Consumers need to be properly equipped to participate in these surveys and questions need to be framed appropriately to ensure consumers can provide an informed and meaningful response.

The AER might consider whether a further financial incentive is warranted if this mechanism was introduced as a complementary scheme to a CESS incentive with a reasonably powered ratio.

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[11] PIAC, 'Having the desired effect', 14.

[12] ibid., 16; Uniting Care Australia, 'Response to the Expenditure Incentive Draft Guidelines', September 2013, 3; CHOICE, 'Submission to the AER on the Draft Capital Expenditure Incentive Guidelines', September 2013, 3.

[13] Deloitte, 'Australian Gas Network Customer Insights Report: Victorian and Albury Stakeholder Engagement Program', (Australian Gas Network, May 2016), 16.

Network Innovation Scheme

CUAC recognises the value of innovation to discover further efficiencies to deliver benefits for distributors and their customers through lower prices. However, it is unclear from the position paper how networks would financially account for the Network Innovation Scheme incentive. It is also unclear how the efficiencies that distributors uncover through innovation would be shared between the distributors and their customers.

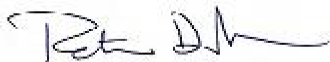
Efficient savings delivered through a CESS or EBSS might provide an adequate mechanism to finance innovation, which then provides the opportunity for a business to discover further efficiencies, realise these efficiencies in subsequent periods and benefit through underspending their revenue allowance.

Concluding remarks

We would like to thank the networks for taking a collaborative approach to consultation through the Incentive Mechanism forum. We strongly suggest that the distributors give further consideration to their engagement strategies with their consumers in exploring these complex scenarios, providing simple explanations and examples to assist understanding and shifting from theoretical to more empirically based discussion about the merits of the different incentive mechanisms. The best case for the proposed incentive mechanisms is for the distribution businesses to demonstrate the costs and benefits to consumers, and better articulate the price and service quality mix on offer. Without this information it is difficult for consumers and consumer advocates to meaningfully engage with the proposed mechanisms and provide a more definitive judgement on the value proposition of new incentive mechanisms.

Thank you for the opportunity to submit feedback and should you have any questions, please do not hesitate to contact Ben Martin Hobbs on ben.martinhobbs@cuac.org.au or 03 9639 7600.

Yours sincerely,



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