

Draft Decision

Essential Energy

Electricity Distribution

Determination 2024 to 2029

(1 July 2024 to 30 June 2029)

Attachment 8

Efficiency benefit sharing scheme

September 2023

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AER reference: AER212495

Amendment record

Version	Date	Pages
1	28 September 2023	11

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8 Efficiency benefit sharing scheme

The efficiency benefit sharing scheme (EBSS) is intended to provide a continuous incentive for distributors to pursue efficiency improvements in operating expenditure (opex) and provide for a fair sharing of these between distributors and network users. Consumers benefit from improved efficiencies through lower regulated prices.

This attachment sets out our draft decision on the EBSS carryover amounts Essential Energy (Essential) accrued over the 2019–24 regulatory period, and how we will apply the EBSS over the 2024–29 regulatory period.

8.1 Draft decision

Our draft decision is to include EBSS carryover amounts totalling –\$316.3 million (\$2023–24) from the application of the EBSS in the 2019–24 regulatory period.¹ This is a \$198.5 million (\$2023–24) decrease compared to Essential’s proposed carryover amount of –\$117.8 million (\$2023–24).² This difference reflects adjustments we made to account for:

- the most recent inflation figures (not available at the time Essential submitted its proposal) to convert amounts into 2023–24 dollars;
- the most recent PTRM update (not available at the time Essential submitted its proposal), which included an updated opex amount for Essential’s approved 2022 North Coast flooding cost pass through;
- the inclusion of Essential’s historical data from 2017–18 and 2018–19 in our draft decision, consistent with the operation of version 2 of the EBSS; and
- a non-recurrent efficiency adjustment to ensure consistent application of the EBSS rewards and penalties despite the non-standard approach Essential proposed to forecast its final year (2023–24) opex.

We set out our draft decision on Essential’s EBSS carryover amounts in Table 8.1.

¹ NER, cl. 6.4.3(a)(5).

² Essential Energy, *5.05 Standard Control Efficiency Benefit Sharing Scheme*, January 2023; Essential Energy, *5.08 EBSS and CESS Approach*, January 2023, p. 2.

Table 8.1 Draft decision on carryover amounts (\$ million, 2023–24)

	2024–25	2025–26	2026–27	2027–28	2028–29	Total
Essential’s proposal	–31.4	–30.6	–15.1	–40.7	–	–117.8
AER draft decision	–71.5	–70.1	–54.6	–80.8	–39.3	–316.3
Difference	–40.1	–39.5	–39.5	–40.1	–39.3	–198.5

Source: Essential Energy, *5.05 Standard Control Efficiency Benefit Sharing Scheme*, January 2023; AER analysis.

Note: Numbers may not add up to total due to rounding. Differences of '0.0' and '-0.0' represent small variances and '-' represents no variance.

We will continue to apply version 2 of the EBSS to Essential in the 2024–29 regulatory period.³ Consistent with Essential’s proposal, we will exclude debt raising costs from the scheme because we have forecast them on a category specific basis and expect to continue doing so in the 2029–34 regulatory period. We will also make other adjustments as permitted by the EBSS, such as removing demand management innovation allowance mechanism costs and movements in provisions from actual opex, and adding approved opex for pass throughs and contingent projects to forecast opex (as outlined in section 8.4).

8.2 Essential Energy’s proposal

8.2.1 Carryover amounts accrued during the 2019–24 regulatory period

Essential proposed we include EBSS carryover amounts totalling –\$117.8 million (\$2023–24) in its revenue in the 2024–29 regulatory period, from the application of the EBSS in the 2019–24 regulatory period.⁴ Essential proposed adjustments to the following cost categories in calculating its EBSS carryover amounts, consistent with our decision in its 2019–24 revenue determination:⁵

- exclude debt-raising costs from the EBSS as a pre-defined ‘excluded category’;
- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the initial regulatory determination, such as approved pass through amounts;
- adjust actual opex to remove Demand Management Innovation Allowance opex;

³ We must make a decision on how any EBSS is to apply to distributors as part of this determination under cl. 6.12.1(9) of the NER; See also AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

⁴ Essential Energy, *5.08 EBSS and CESS Approach*, January 2023, p. 2.

⁵ Essential Energy, *5.08 EBSS and CESS Approach*, January 2023, p. 3; Essential Energy, *5.05 Standard Control Efficiency Benefit Sharing Scheme*, January 2023.

- adjust actual opex to add capitalised opex that has been excluded from the Regulatory Asset Base;
- adjust actual opex to reverse any movements in provisions;
- adjust opex for any services that will not be classified as standard control services in the 2024–29 regulatory period to the extent that this better achieves the requirements of clause 6.5.8 of the National Energy Rules (NER); and
- the impact on opex caused by changes in capitalisation policies and/or accounting standards which occurred over the 2019–24 period.⁶

8.2.2 Application in the 2024–29 regulatory period

Essential proposed we continue to apply the EBSS in the 2024–29 regulatory period.⁷

8.2.3 Stakeholder submissions

We only received one submission on Essential's proposed EBSS carryover amounts, from Essential itself. We discuss this submission in section 8.4.1.3.

8.3 Assessment approach

Under the NER we must determine:

- the revenue increments or decrements for each year of the 2024–29 regulatory period arising from the application of the EBSS during the 2019–24 regulatory period;⁸ and
- how the EBSS will apply to Essential in the 2024–29 regulatory period.⁹

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between service providers and network users.¹⁰ We must also have regard to the following matters when developing and implementing the EBSS:¹¹

- the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme
- the need to provide Essential with a continuous incentive to reduce opex
- the desirability of both rewarding Essential for efficiency gains and penalising it for efficiency losses

⁶ Essential's EBSS model reversed the effect of the mid-period accounting treatment changes to lease capitalisation by continuing to record these costs as opex throughout the 2019–24 regulatory period. This negated the impact of these mid-period accounting changes on opex and the EBSS.

⁷ Essential Energy, *2024–29 Regulatory Proposal*, January 2023, p. 60.

⁸ These amounts constitute one of the building blocks we must use to determine the annual revenue requirement: cl. 6.4.3(a)(5) of the NER.

⁹ NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).

¹⁰ NER, cl. 6.5.8(a).

¹¹ NER, cl. 6.5.8(c).

- any incentives that Essential may have to capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

8.3.1 Interrelationships

The EBSS is closely linked to our revealed cost approach to forecasting opex. When we assess or develop our opex forecast, the NER require us to have regard to whether the opex forecast is consistent with any incentive schemes.¹²

Our opex forecasting method typically relies on using the 'revealed costs' of the service provider in a chosen base year to develop a total opex forecast if the chosen base year opex is not considered to be 'materially inefficient'. Under this approach, a service provider would have an incentive to spend more opex in the expected base year. Also, a service provider has less incentive to reduce opex towards the end of the regulatory period, where the benefit of any efficiency gains is retained for less time.

The application of the EBSS serves two important functions:

1. it removes the incentive for a service provider to inflate opex in the expected base year in order to gain a higher opex forecast for the next regulatory period
2. it provides a continuous incentive for a service provider to pursue efficiency improvements across the regulatory period.

The EBSS does this by allowing a service provider to retain efficiency gains (or losses) for a total of six years, regardless of the year in which the service provider makes them. Where we do not propose to rely on the single year revealed costs of a service provider in forecasting opex, this has consequences for the service provider's incentives and our decision on how we apply the EBSS.

When a business makes an incremental efficiency gain, it receives a reward through the EBSS, and consumers benefit through a lower revealed cost forecast for the subsequent regulatory period. This is how efficiency improvements are shared between consumers and the business. If we subject costs to the EBSS that are not forecast using a single year revealed cost approach, a business would in theory receive a reward for efficiency gains through the EBSS (at a cost to consumers), but consumers would not necessarily benefit through a lower revealed cost forecast in the subsequent regulatory period. Therefore, we typically exclude costs that we do not forecast using a single year revealed cost forecasting approach.

For these reasons, our decision on how we will apply the EBSS to Essential has a strong interrelationship with our decision on its opex (see Attachment 6 – operating expenditure). We have careful regard to the effect of our EBSS decision when making our opex decision,

¹² NER, cl. 6.5.6(e)(8). Further, we must specify and have regard to the relationship between the constituent components of our overall decision: NEL, s 16(1)(c).

and our EBSS decision is made largely in consequence of (and takes careful account of) our past and current decisions on Essential's opex.

8.4 Reasons for draft decision

8.4.1 Carryover amounts from the 2019–24 regulatory period

Our draft decision is to include EBSS carryover amounts totalling –\$316.3 million (\$2023–24) from the application of version 2 of the EBSS in the 2019–24 regulatory period, consistent with our decision in Essential's 2019–24 revenue determination.¹³ This is a \$198.5 million (\$2023–24) decrease compared to Essential's proposed carryover amount of –\$117.8 million (\$2023–24). This difference reflects adjustments we made to account for:

- the most recent inflation figures (not available at the time Essential submitted its proposal) to convert amounts into 2023–24 dollars. This is discussed further in section 8.4.1.1;
- the most recent PTRM update (not available at the time Essential submitted its proposal), which included an updated opex amount for Essential's approved 2022 North Coast flooding cost pass through. This increased our draft decision EBSS carryover amounts by \$0.5 million (\$2023–24) compared to Essential's estimate;
- the inclusion of Essential's historical regulatory information notice (RIN) data from 2017–18 and 2018–19 in our draft decision, consistent with the operation of version 2 of the EBSS. This is discussed further in section 8.4.1.2; and
- a non-recurrent efficiency adjustment to ensure consistent application of the EBSS rewards and penalties despite the non-standard approach Essential proposed to forecast its final year (2023–24) opex. This is discussed further in section 8.4.1.3.

We discuss the impact of these adjustments in more detail below.

We consider that the EBSS carryover amounts we have calculated provide for a fair sharing of efficiency gains and losses between Essential and its network users. It both rewards Essential for the efficiency gains it has made and penalises it for its efficiency losses. Further, we consider that the benefit to networks users sufficient to warrant the EBSS carryover amounts we have determined.

8.4.1.1 Inflation

Consistent with our standard approach and our opex forecast, we used unlagged inflation to convert amounts to \$2023–24 real terms.¹⁴ We have also used the latest inflation forecasts which were not available at the time Essential submitted its proposal, which decreased our draft decision EBSS carryover amount by \$1.7 million (\$2023–24) compared to Essential's estimate.

¹³ AER, *Essential Energy – 2019–24 Determination*, November 2018.

¹⁴ This ensures Essential is not accruing carryovers that are not being passed on to customers.

For 2022–23, we used the actual headline Consumer Price Index figure published by the Australian Bureau of Statistics.¹⁵ For 2023–24, we used the inflation forecast in the Reserve Bank of Australia's August 2023 *Statement on monetary policy*.¹⁶

8.4.1.2 Inclusion of 2017–18 and 2018–19 data

Essential proposed the exclusion of data from 2017–18 and 2018–19 when calculating the carryover amounts, which is consistent with the operation of an earlier version (version 1) of the EBSS.¹⁷ In its proposal, Essential noted that it technically considered version 2 of the EBSS to be the correct version to be applied in this instance, consistent with our decision in its 2019–24 revenue determination.¹⁸ However, it argued that under version 2 of the EBSS it would be rewarded for the efficiency gain made in 2018–19, even though the scheme was not operating in that year. Therefore, it proposed the application of version 1 of the EBSS as this results in a more favourable outcome for customers.

Consistent with the standard operation of version 2 of the EBSS, we have included historical data from the base and final years of the previous (2014–19) regulatory period. Despite Essential's proposal to the contrary, we consider the application of version 2 of the EBSS to be the most appropriate method to calculate the Essential's EBSS carryover amounts over the 2019–24 period. This is because it allows for the sharing of any efficiency gains or losses in the final year of the previous period between the network service provider and its customers.

Additionally, we note that the application of Essential's historical RIN values for 2017–18 and 2018–19 results in a decrease of \$0.6 million (\$2023–24) in our draft decision EBSS carryover amounts compared to Essential's estimate. This means that the application of version 2 of the EBSS results in a more favourable outcome for customers.

8.4.1.3 Non-recurrent efficiency adjustment for alternate approach to final year opex

In its proposal, Essential did not use our standard approach to estimate opex for the final year of the current period (2023–24).¹⁹ It considered our standard approach was unlikely to produce a realistic estimate of opex for 2023–24. We have examined Essential's proposal and we agree that, in this specific instance, our standard approach was not likely to produce an accurate estimate of 2023–24 opex if we were to assume a non-recurrent efficiency gain for the base year of zero. However, the purpose of our standard approach is to ensure we assume the same estimate of final year opex both when we calculate EBSS rewards and penalties, and when we forecast opex. This ensures that a network is only rewarded for efficiency gains that are passed on to network users through lower forecast opex. Or, as in

¹⁵ Australian Bureau of Statistics, *Catalogue number 6401.0, Consumer price index*, June 2023

¹⁶ Reserve Bank of Australia, *Statement on monetary policy, Appendix: Forecasts*, August 2023.

¹⁷ Essential Energy, *5.08 EBSS and CESS Approach*, January 2023, p. 3.

¹⁸ Essential Energy, *5.08 EBSS and CESS Approach*, January 2023, p. 2.

¹⁹ Essential Energy, *9.03 Opex approach*, January 2023, p. 4.

this case, the network is penalised for efficiency losses that are assumed to occur after the base year we use to forecast opex. (See Attachment 6 – operating expenditure for further information on this adjustment).

In our alternative estimate of forecast opex we included a non-recurrent efficiency adjustment of \$39.3 million (\$2023–24) (or \$196.7 million (\$2023–24) over the regulatory period) to align the 2023–24 opex estimate under our standard approach with Essential’s proposed 2023–24 estimate. We have also included a non-recurrent efficiency adjustment of \$39.3 million (\$2023–24) to its opex for the purposes of calculating its EBSS carryover amounts. This decreased our draft decision EBSS carryover amounts by \$196.7 million (\$2023–24) compared to Essential’s estimate.

Stakeholder submissions

Essential Energy acknowledged that it had been inconsistent between its calculation of proposed EBSS carryovers and its final year (2023–24) opex estimate, and appreciated the guidance we provided in the issues paper on the two options we outlined to address this inconsistency.²⁰ However, Essential argued that it was already absorbing additional costs it had incurred in the current period above its opex allowance, and the application of further disproportionate penalties due to external events outside of its control appeared unreasonable and did not reflect the underlying efficiency improvements it had made. Essential noted that it had proposed the application of version 1 of the EBSS in the interest of customer affordability but encouraged us to look pragmatically at the opex it requested when deciding the most appropriate version of the EBSS to apply for the 2019–24 regulatory period.

Our decision to apply version 2 of the EBSS

For the 2019–24 regulatory period, our determination accepted Essential Energy’s estimate of total forecast opex, which was based on Essential Energy’s revealed costs in its base year (2017–18).²¹ We also determined to apply version 2 of the EBSS to Essential Energy’s opex in the 2019–24 period, consistent with Essential Energy’s proposal.²² We considered that applying the scheme would result in benefits for electricity customers and provide continuous incentives for Essential to reduce opex, consistent with the purpose of the ex-ante incentive framework.

²⁰ Essential Energy, *Submission - 2024-29 Electricity Determination - Essential Energy*, May 2023, pp. 3–4; AER, *Issues Paper - Essential Energy - 2024-29 Distribution revenue proposal*, March 2023, pp. 26–27.

²¹ AER, *Essential Energy 2019-24 - Draft decision - Attachment 6 - Operating expenditure*, November 2018, p. 5.

²² AER, *Essential Energy 2019-24 - Draft decision - Attachment 8 - Efficiency benefit sharing scheme*, November 2018, p. 5.

Essential Energy has acknowledged that the significant EBSS penalty it has accrued for the 2019–24 period is largely due to its opex forecast for 2019–24 being ambitious and the downward trend it had foreshadowed to reduce opex not eventuating.²³

We acknowledge Essential's request to consider the impact of significant EBSS penalties on its forecast opex and revenue for the 2024–29 regulatory period. We consider that, in these circumstances, suspending or limiting the application of the EBSS retrospectively would mean that efficiency gains and losses in the 2019–24 regulatory control period would not be shared with consumers as intended under the EBSS. While the EBSS carryover penalty is material in this case, Essential Energy overspent against its 2019–24 opex forecast, including in the 2022–23 base year. This has resulted in its proposed forecast opex for 2024–29 also being materially higher (in the order of \$200 million) than it would have been had it spent in line with its opex forecast for the 2019–24. The EBSS acts to share the cost of these inefficiencies between consumers and the business.

We have also examined the profitability impacts of our EBSS decision on Essential's allowed revenues for the 2019–24 regulatory control period. Despite the large EBSS penalty, we consider that Essential will continue to have a reasonable opportunity to recover its efficient costs and maintain its operation over the 2024–29 regulatory period. We believe it is appropriate to apply version 2 of the EBSS, with a non-recurrent efficiency adjustment, to Essential's 2019–24 regulatory period as intended, as it maintains the integrity of the incentives under the EBSS.

We also engaged with Essential regarding our calculation of the \$0.6 million (\$2023–24) decrease in carryovers under version 2 of the EBSS compared to version 1, as it was significantly different to the \$23.8 million (\$2023–24) increase Essential suggested in its proposal.²⁴ In response to our information request, Essential noted this calculation difference was driven by the treatment of movements in certain provision categories and acknowledged our calculation of the applicable EBSS carryovers under EBSS version 2 was correct.²⁵ Given this relatively minor difference in carryover amounts between version 1 and version 2, we continue to consider version 2 of the EBSS to be the most appropriate approach to apply to Essential for its 2019–24 regulatory period, consistent with our standard approach.

8.4.2 Application in the 2024–29 regulatory period

Our draft decision is to continue to apply version 2 of the EBSS to Essential during the 2024–29 regulatory period. We consider applying the scheme will benefit long-term interests of electricity customers as it will provide continuous incentives for Essential to reduce opex.

²³ Essential Energy, *Submission – 2024–29 Electricity Determination - Essential Energy*, May 2023, pp. 3–4

²⁴ \$23.8 million (\$2023–24) is the difference between the –\$94 million (\$2023–24) penalty Essential suggested under EBSS version 2 and the –\$118 million (\$2023–24) penalty it submitted in its proposal. Essential Energy, *5.08 EBSS and CESS Approach*, January 2023, p. 2.

²⁵ Essential, *Response to information request IR#048 - Historical movements in provisions and DMIA values*, 11 August 2023.

Provided we forecast Essential’s future opex using its revealed costs in the 2024–29 regulatory period, any efficiency gains that Essential achieves will lead to lower opex forecasts, and thus lower network tariffs.

Version 2 of the EBSS specifies our approach to adjusting forecast or actual opex when calculating carryover amounts.²⁶ We provide details on these below.

8.4.2.1 Adjustments to forecast or actual opex when calculating carryover amounts

The EBSS allows us to exclude categories of costs that we do not forecast using a single year revealed cost forecasting approach. We do this to fairly share efficiency gains and losses. For instance, where a service provider achieves efficiency improvements, it receives a benefit through the EBSS, and network users receive a benefit through lower forecast opex in the next regulatory period. This is the way network users and the service provider share in the benefits of an efficiency improvement.

If we do not use a single year revealed cost forecasting approach, we may not pass the benefits of these revealed efficiency gains to network users. It follows that network users should not pay for EBSS rewards where they do not receive the benefits of a lower opex forecast.

For the 2024–29 regulatory period, we have not forecast debt raising costs using a single year revealed cost forecasting approach. If we do the same for the 2029–34 regulatory period, we will exclude these costs from the EBSS for the 2024–29 regulatory period.

As well as excluding costs not forecast using a single year revealed cost approach, our standard approach is to exclude the impact of mid-period capitalisation and/or accounting treatment changes from the EBSS. This is achieved by ensuring any mid-period capitalisation and/or accounting changes are not implemented until the start of the new period. We do this to ensure the EBSS rewards (and penalties) reflect genuine efficiency changes rather than capitalisation and/or accounting treatment changes. We consider that under this approach there would be no opportunity for a service provider to incur windfall gains or losses that have resulted purely from movement of expenditure between opex and capital expenditure due to mid-period cost reclassification.

For the 2024–29 regulatory period, we have excluded the impact on opex of changes in the accounting treatment of lease and software-as-a-service costs from the EBSS. We intend to do the same for any capitalisation and/or accounting treatment changes which occur in the 2024–29 regulatory period.

In addition to the excluded cost categories discussed above, we will also make the following adjustments when we calculate the EBSS carryover amounts accrued during the 2024–29 regulatory period:

²⁶ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the initial regulatory determination, such as approved pass through amounts or opex for contingent projects²⁷
- adjust actual opex to remove demand management innovation allowance mechanism expenditure because it is not included in the opex forecast (but is often reported by service providers as part of their standard control services opex)²⁸
- adjust actual opex to add capitalised opex that has been excluded from the regulatory asset base.²⁹
- adjust forecast opex and actual opex for inflation³⁰
- adjust actual opex to reverse any movements in provisions
- adjust opex for any services that will not be classified as standard control services in the 2029–34 regulatory period, to the extent these costs are not forecast using a single year revealed cost approach and excluding these costs better achieves the requirements of clause 6.5.8 of the NER.³¹

²⁷ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

²⁸ Clause 6.5.8(c)(5) of the NER requires us to have regard to the possible effects of the scheme on incentives for the implementation of non-network options.

²⁹ Clause 6.5.8(c)(4) of the NER requires us to have regard to any incentives the service provider may have to capitalise expenditure.

³⁰ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

³¹ AER, *Explanatory Statement: Efficiency benefit sharing scheme for electricity network service providers*, November 2013, pp. 14–16.

Shortened forms

Term	Definition
AER	Australian Energy Regulator
CPI	consumer price index
EBSS	efficiency benefit sharing scheme
NEL	national electricity law
NER	national electricity rules
opex	operating expenditure
RIN	regulatory information notice
