

Essential Energy

3.07 EBSS concerns

November 2023



Summary

- > In the AER's Draft Decision, the Efficiency Benefit Sharing Scheme (EBSS) has been applied mechanistically for Essential Energy's overspending against the opex allowance in 2019–24. This has resulted in a significant penalty. Essential Energy has adopted this same position for our Revised Proposal (with a resulting \$297M penalty), but we do not agree with it and we urge the AER reconsider its application.
- > We believe that there are mitigating factors which mean the AER should carefully consider the extent of the penalty. Essential Energy did not apply the base-step-trend approach as it was intended when preparing its opex forecast for 2019–24 period, and this has distorted the outcomes under the EBSS.
- > Under the base step trend approach, revealed cost is used to set the future expenditure requirements in a relatively mechanistic manner, with adjustments made only for the trend and step changes. Instead of a mechanistic approach, Essential Energy sought to be ambitious in our opex forecast and proposed a larger efficiency improvement in advance of it being achieved. This was intended to deliver efficiency savings to customers earlier than would be the case if the base-step-trend approach was applied as intended.
- > Additional unanticipated efficient expenditure, caused by extreme weather events during 2019–24, has meant that Essential Energy was unable to deliver on the efficiency savings it had proposed (and from which customers were already benefitting). The managerial and operational focus that would otherwise have been on the efficiency program necessarily shifted – the additional expenses incurred do not represent efficiency losses in the conventional sense. Approved pass through expenditure reflects only some of this additional expenditure.
- > Essential Energy is being overly penalised because it sought to be ambitious rather than merely adopt the standard base-step-trend approach. If the AER is not willing to apply an adjustment to the EBSS penalty in these circumstances, networks will perceive that there is severe risk associated with submitting an honest and ambitious expenditure forecast. Instead, they will revert to relying only on a mechanistic adoption of the base-step-trend approach. This would be a worse outcome for consumers.

Non-standard approach to forecasting 2019–24 opex

In their Expenditure Forecast Assessment Guideline, the AER has been clear that the revealed cost approach (with adjustments made only for standard trend parameters and step changes) is its preferred approach to set the opex allowance for assessing operating expenditure and for motivating efficient expenditure¹.

'The 'revealed cost' approach is our preferred approach to assessing base opex'.

For the 2019–24 regulatory period, Essential Energy did not rely on this method. Instead an alternative was used which included large annual productivity improvements of between 1.30 per cent and 1.61 per cent. These assumed efficiency improvements fully offset forecast price and output growth. The AER's view has been that it would typically only seek alternative methods where it identifies material inefficiencies in expenditure, and that:

'When determining whether to adjust or substitute base year expenditure, we will also have regard to whether rewards or penalties accrued under the EBSS will provide for the DNSP and its customers to fairly share efficiency gains or losses'.

We note that it is highly unusual for the AER to accept an opex forecast that does not conform to its preferred base-step-trend approach. For instance, the AER precedent has been to reject proposals based on bottom-up forecasts. Had Essential Energy framed its proposal as a bottom-up forecast, even with the same proposed price path, it would have been consistent with precedent for the AER to reject the proposal on the basis that it would distort outcomes under the EBSS.

We estimate that if the AER had applied its now standard 0.5 per cent productivity improvement, rather than accepting Essential Energy's ambitious productivity improvements, the EBSS penalty would be in the order of \$229M (rather than \$297M). We consider that the AER should adopt a penalty of \$229M rather than \$297M, reflecting an application of its standard approach.²

¹ AER, Expenditure Forecast Assessment Guideline for Electricity Distribution, August 2022, p.24. [Link](#)

² Noting that Essential Energy is not seeking to adjust for the other element of its ambitious productivity forecast, which was included in a negative step change.

Extreme weather events imposed legitimate costs that do not represent efficiency losses

Bushfires impacted our business from July 2020, and across the summer of 2019–20 burnt three million hectares in Essential Energy's distribution network, destroying electrical infrastructure in the north and in the south of NSW. Major flooding in 2021, 2022 and 2023 damaged more assets. There were even compounding impacts in some areas, with newly restored assets being washed away and floodwaters crossing ash filled firegrounds from earlier bushfires - resulting in very challenging working conditions to repair the network.

In the context of a more frequently changing climate (and greater likelihood of unforeseen natural disaster expenditure), these operating cost overruns in 2019–24 should not be viewed as 'efficiency losses'.

During extreme weather events, providing reliable, secure and safe distribution services to our communities becomes more challenging. Additional costs are incurred so that Essential Energy can fulfill its fundamental obligations to customers. As a NSW State Owned Corporation and energy distributor, there are several objectives that we are obliged to follow, and which are of equal importance³. Amongst these are the following requirements:

- '1 (a) (iii) to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates',
- (d) to operate efficient, safe and reliable facilities for the distribution of electricity and other forms of energy,

In this context, these additional costs to operate the distribution network do not represent efficiency losses in the conventional sense. These additional costs incurred benefited Essential Energy's connected customers. This has been reinforced by continual feedback and observations made by Essential Energy's customers to the many different disaster responses including in the customer engagement carried out during the 2024–29 regulatory proposal process. Customer-developed priorities included improving resilience for both the network and for communities because of this lived-experience.

In applying the EBSS, the AER should consider Essential Energy's unique position as a rural and regional distribution network that covers 95% of NSW. The impacts of more frequent extreme weather events are relatively greater due our geographic footprint as well as the physical structure of our network.

Limitations of cost pass through events and EBSS

The AER is of the view that costs from extreme weather events should be recovered through natural disaster cost pass through applications. Despite this, there are limitations with this approach.

Essential Energy submitted pass through applications for some extreme weather events during 2019–24, and we acknowledge that any approved pass through values are reflected in a higher approved allowance for EBSS purposes. However, over this regulatory period, the volume of these significant events has resulted in changes to costs and phasing of expenditure, compared to that proposed and approved.

While Essential Energy has responded to many extreme weather events during the current regulatory period, relatively few events met the materiality threshold to submit as pass throughs. This means that many incurred costs have not been recovered.

The extreme weather events that met eligibility and materiality thresholds and were submitted as pass through events, had a proportion of costs not recovered due to the following:

- The cost pass through applications were limited in scope:
 - Not all costs were able to be identified accurately given the nature of the natural disaster events. Due to the all-consuming and emergency nature of these extreme weather events, not all costs are able to be captured in timely manner, and in a form suitable for cost pass through applications.
 - Proactive actions were taken to absorb costs and minimise expenditures submitted in the pass through applications, so that the bill impact on customers would be minimal, given that they were also experiencing a range of challenges following these extreme weather events
- The AER did not permit recovery of all of the costs included in the cost pass through applications.

³ Energy Services Corporations Act 1995 No 95, Part 3 (8) [Link](#)

- In terms of those costs that were not specifically approved as part of a pass through application (and an approved allowance added), Essential Energy is bearing that loss if the costs did not occur in base year (that was subsequently accepted by the AER for the next regulatory period).
- Essential Energy's planned work programs were re-scheduled across 2019–24 due to prioritising repair and restorations from disasters, and caught up in the latter years of the period. So, despite some additional opex allowance for cost pass throughs in FY20-22, for EBSS purposes the phasing changes have resulted in a disproportionate impact.

Suggestions for future improvements

We acknowledge that the AER has recently reviewed incentive schemes and no changes were implemented for the EBSS. However, given the EBSS Draft Decision that Essential Energy is facing, we suggest that the AER should investigate ways to motivate networks to submit ambitious expenditure proposals and not face large penalties where these ambitions do not materialise for reasons outside of their control. Another factor that the AER should consider is the increasing 'lumpiness' now appearing in businesses opex plans due to SaaS expenditure. This affects EBSS outcomes as the mechanism is premised on opex being recurrent, with penalties and rewards occurring in perpetuity.