FINAL DECISION
ActewAGL distribution determination
2015−16 to 2018−19

Attachment 9 – Efficiency benefit sharing scheme

April 2015

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Note

This attachment forms part of the AER's final decision on ActewAGL's revenue proposal 2015–19. It should be read with other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 - Annual revenue requirement

Attachment 2 - Regulatory asset base

Attachment 3 - Rate of return

Attachment 4 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

Attachment 9 - Efficiency benefit sharing scheme

Attachment 10 - Capital expenditure sharing scheme

Attachment 11 - Service target performance incentive scheme

Attachment 12 - Demand management incentive scheme

Attachment 13 - Classification of services

Attachment 14 - Control mechanism

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Attachment 16 - Alternative control services

Attachment 17 - Negotiated services framework and criteria

Attachment 18 - Connection policy

Attachment 19 - Pricing methodology

Attachment 20 - Analysis of financial viability

Contents

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	expenditure forecast assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model

Shortened form	Extended form
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

9 Efficiency benefit sharing scheme

The efficiency benefit sharing scheme (EBSS) provides an additional incentive for service providers to pursue efficiency improvements in opex.

To encourage a service provider to become more efficient it is allowed to keep any difference between its approved forecast and its actual opex during a regulatory control period. This is supplemented by the EBSS which provides the service provider with an additional reward for reductions in opex and additional penalties for increases in opex. In total these rewards and penalties work together to provide a continuous incentive for a service provider to pursue efficiency gains over the regulatory control period. The EBSS also discourages a service provider from incurring opex in the expected base year in order to receive a higher opex allowance in the following regulatory control period.

During the 2009–14 regulatory control period ActewAGL operated under the EBSS for the ACT and NSW 2009 distribution determinations, which was released in February 2008.[1]

9.1 Final decision

We will not apply EBSS carryover amounts accrued by ActewAGL during the 2009–14 regulatory control period. This is the same position as our draft decision.[2] The EBSS was intended to work in conjunction with a revealed cost forecast approach. Given how we are forecasting ActewAGL's opex for the 2014–19 period, we consider it would not be consistent with the intended operation of the EBSS, and it would not implement the EBSS in accordance with the terms of the NER, if we were to carryover the EBSS penalty.

No expenditure incurred by ActewAGL will be subject to the EBSS during the 2015–19 regulatory control period.[3] This position is also consistent with our draft decision.

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1 AER, *Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations*, February 2008.

2 AER, *Draft decision, ActewAGL distribution determination 2015–19*, November 2014, Attachment 9, p. 9-10.

3 We have previously determined that the EBSS that applied to ActewAGL in the 2009-14 regulatory control period will apply to ActewAGL in the 2014–15 transitional regulatory control period but modified to be in terms of version 2 of the EBSS as if the transitional regulatory control period was the first year of the subsequent regulatory control period 2015–19 (that is, the first year in a period running from 2014–19). The effect of our decision is that no expenditure will be subject to the EBSS during the 2014–19 period. See *, Essential Energy, ActewAGL - Transitional distribution decision 2014–15*, 16 April 2014, pp. 47–48; AER, *Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013.

9.2 Draft decision

9.2.1 Carryover amounts accrued during the 2009–14 regulatory control period

If we applied the EBSS carryover amounts to ActewAGL, we considered it should have received an EBSS carryover amount of –$19.6 million ($2013-14) from the application of the EBSS during the 2009–14 regulatory control period. Our calculation was in accordance with section 2.3 of the EBSS for the ACT and NSW 2009 distribution determinations. It was the same as ActewAGL's calculation in its original regulatory proposal.

However, our draft decision was not to apply the EBSS carryover amounts.

We did not use ActewAGL's actual opex as the base for forecasting its opex for the 2014–19 period, as this would not produce a total forecast that reasonably reflects the opex criteria. After benchmarking ActewAGL's base opex against other service providers in the NEM, we considered base opex needed to be adjusted to a lower level in our alternative forecast.

If we applied both the EBSS penalties and a benchmark opex allowance for the next regulatory control period, this has implications for whether the efficiency losses ActewAGL made during the 2009–14 regulatory control period would be shared fairly with consumers. It would mean that ActewAGL could bear more than 100 per cent of the efficiency losses it made during the regulatory control period. We did not consider this would reflect fair sharing of efficiency losses as required by the EBSS.

9.2.2 Application of the EBSS in the 2015–19 regulatory control period

Our draft decision was that no expenditure will be subject to the EBSS during the 2015–19 regulatory control period.

We noted that the decision on how to apply the EBSS is intrinsically linked to the revealed cost forecasting method for opex.

Economic benchmarking and other corroborating evidence indicate that ActewAGL's opex is higher than opex incurred by a benchmark efficient service provider. In our draft decision, we also noted that ActewAGL has just over three years before it submits its next regulatory proposal. Based on these factors it is uncertain whether, and to what extent, we are likely to rely on ActewAGL's revealed costs in the 2014–19 period in forecasting opex in the following regulatory control period. If we do not use a revealed costs approach for forecasting opex in the future, there is not a strong reason to apply the current version of the EBSS.

For instance we consider ActewAGL will already face an incentive to make efficiency improvements while its actual opex is more than that of a benchmark efficient service provider. We do not need to apply an EBSS to further strengthen its incentives.

9.3 ActewAGL's revised proposal and submissions

9.3.1 Carryover amounts accrued during the 2009–14 regulatory control period

In its revised proposal, ActewAGL submitted that we should set its base year opex on the basis of its actual revealed costs, and continue to apply the EBSS.[4] ActewAGL reaffirmed its proposal that a total EBSS carryover amount of –$19.6 million ($2013–14) be subtracted from its regulated revenue in the 2014–19 period arising from the application of the EBSS in the 2009–14 regulatory control period.[5] However, it also considered that, if we maintain our decision to set the opex on a basis other than revealed costs, then ActewAGL's revenue should be adjusted for the 2014–19 period such that it achieves the 30:70 sharing principles underpinning the EBSS.[6]

9.3.2 Application of the EBSS in the 2015–19 regulatory control period

ActewAGL considered that our draft decision not to apply the EBSS in the 2015–19 regulatory period undermined the regulatory incentive framework.[7] In support of its proposal, ActewAGL submitted a report it commissioned from HoustonKemp criticising our approach.[8]

The Consumer Challenge Panel (CCP) supported our decision not to subject any expenditure to the EBSS for ActewAGL in the 2015–19 regulatory control period.[9]

9.4 AER’s assessment approach

Under the National Electricity Rules (NER) we must decide:

1. the revenue increments or decrements (if any) for each regulatory year of the 2014–19 period arising from the application of the EBSS during the 2009–14 regulatory control period[10]
2. how any applicable EBSS is to apply to ActewAGL in the 2014–19 period.[11]

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.[12] We must also have regard to the following factors when implementing the EBSS:[13]

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4 ActewAGL, *Revised regulatory proposal*, January 2015, pp. xi.
5 ActewAGL, *Revised regulatory proposal, PTRM*, January 2015.
6 ActewAGL, *Revised regulatory proposal*, January 2015, pp. xvii.
7 ActewAGL, *Revised regulatory proposal*, January 2015, p. iv.
8 HoustonKemp, *Attachment C1, Opex and the efficiency benefit sharing scheme*, January 2015.
9 CCP, *Submission on draft decision and ActewAGL's revised regulatory proposal*, 23 February 2015, p. 34.
10 NER, cl. 6.4.3(a)(5).
11 NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).
12 NER, cl. 6.5.8(a).

- 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 service providers with continuous incentives, so far as is consistent with economic efficiency, to reduce opex
- the desirability of both rewarding service providers for efficiency gains and penalising them for efficiency losses
- any incentives that service providers may have to capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non–network alternatives.

9.4.1 Interrelationships

The EBSS is intrinsically linked to a revealed cost forecasting approach for opex. Under this forecasting approach, the EBSS has two specific functions:

- To mitigate the incentive for a service provider to increase opex in the expected 'base year' to increase its forecast opex allowance for the following regulatory control period.
- To provide a continuous incentive for a service provider to make efficiency gains - service providers receive the same reward for an underspend and the same penalty for an overspend in each year of the regulatory control period.

Where we do not propose to rely on the revealed costs of a service provider in forecasting opex there are consequences for a service provider's incentives to make productivity improvements. This effects our decision on how we apply the EBSS. We have taken into account the interrelationship between the EBSS and our approach to opex forecasting, in reaching our decision.

Incentives to reduce opex may also affect a service provider's incentives to undertake capex. We take into account of these interactions in developing and implementing the EBSS as well as the developing the CESS. For instance:

- In developing and implementing the EBSS, the AER must have regard to any incentives that distributors may have to capitalise operating expenditure as well as the possible effects of the scheme on incentives for the implementation of non-network alternatives.[14]
- In developing the CESS, the AER must take into account the interaction of the scheme with other incentives that distributors may have in relation to undertaking efficient opex or capex as well as the capex objectives and, if relevant, the opex objectives.[15]

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[13] NER, cl. 6.5.8(c).

[14] NER, cl. 6.4.3(a)(4),(5).

[15] NER, cl. 6.5.8A(d).

9.5 Reasons for final decision

9.5.1 Carryover amounts accrued during the 2009–14 regulatory control period

We have considered ActewAGL's revised proposal and have determined to maintain our draft decision not to apply the EBSS carryover amounts accrued by ActewAGL during the 2009–14 regulatory control period.[16] The EBSS was intended to work in conjunction with a revealed cost forecast approach. Given how we are forecasting ActewAGL's opex for the 2014–19 period, it would not be consistent with the intended operation of the EBSS, and it would not implement the EBSS in accordance with the terms of the NER, if we were to carryover the EBSS penalty.

As discussed above and in the opex attachment 7, we have not used ActewAGL's actual opex as a base for forecasting its opex for the 2014–19 period.

We disagree with ActewAGL's statement that our draft decision not to use the revealed cost forecasting approach for the 2014–19 period and not to apply the EBSS carryover is flawed and inconsistent with the NEL and the NER. [17]

We must determine an opex forecast that reasonably reflects the opex criteria. We have found ActewAGL's revealed opex to be materially inefficient. An opex forecast based on the revealed costs of a service provider that is found to be materially inefficient would not reasonably reflect the opex criteria.

As outlined above, ActewAGL considers that where we do not use its costs to forecast is opex, its revenue should be adjusted to give effect to a 30:70 share of efficiency gains and losses in opex from the 2009–14 regulatory control period. The 30:70 sharing ratio that ActewAGL refers to is not a fixed sharing of efficiency gains and losses that we pre-determined in the 2009–14 regulatory control period. It is an outcome that is achieved by applying the EBSS to opex in one regulatory control period and using a revealed cost approach to forecast opex in the next regulatory control period.

The decision to use revealed cost to forecast opex in a regulatory control period is subject to an assessment against the opex criteria. We outlined this in the EBSS for the ACT and NSW determinations:

> The AER does not consider it appropriate, however, to mechanistically set forecast costs to actual costs in the fourth year of the regulatory control period. Consequently, when the AER assesses forecast opex figures proposed by DNSPs the AER will assess the forecasts against the opex objectives, criteria and factors outlined in the NER. The amount of opex incurred in the fourth year

[16] AER, *Draft decision, ActewAGL distribution determination 2015–19*, November 2014, Attachment 9, p. 9-10.

[17] ActewAGL, *Revised regulatory proposal*, January 2015, pp. xvi.

of a regulatory control period will however be used as a starting point for analysing forecast opex in the next regulatory control period.[18]

It therefore does not follow that ActewAGL would somehow need to be compensated because a 30:70 share of efficiency gains and losses in the 2009–14 regulatory control period has not been achieved. It would imply that the we would always use ActewAGL's opex from the 2009–14 regulatory control period to forecast its opex for the 2014–19 period, no matter how inefficient we found those costs to be. This approach would not reasonably reflect the opex criteria.

However where we do consider some latitude is desirable with the application of negative EBSS carryovers that ActewAGL accrued during the 2009–14 regulatory control period. If we applied both the EBSS penalties and a benchmark opex allowance for the 2009–14 regulatory control period, ActewAGL could bear more than 100 per cent of efficiency losses it made in the 2009–14 regulatory control period. We do not consider this would be a fair share of ActewAGL's efficiency losses. We have addressed this by not applying these negative amounts.

9.5.2 Application of the EBSS in the 2015–19 regulatory control period

We maintain our draft decision not to subject any expenditure to the EBSS in the 2015–19 regulatory control period. We do not consider the EBSS is needed to incentivise efficient opex. ActewAGL will already bear any costs in transitioning to efficient levels so there does not seem to be a strong reason to provide it with an additional incentive to become more efficient.

Given our forecasting approach, if we applied the EBSS, the following outcomes, which are not consistent with what we are seeking to achieve with the application of the EBSS, may result:[19]

- If ActewAGL does not improve its efficiency over the period its revealed costs will not affect its opex forecast in the next period. This could result in ActewAGL incurring an EBSS penalty which would exceed its fair share of its efficiency loss.
- If ActewAGL improves its efficiency it could receive EBSS rewards but it may still not benchmark well when compared to other service providers. In this case, ActewAGL's consumers would pay more than the efficient costs to receive the network service.

For these reasons, we do not consider we should apply the EBSS to ActewAGL in the 2015–19 regulatory control period.

ActewAGL asked HoustonKemp to provide one or more illustrative EBSS that could operate where the distribution network service provider's opex in the following

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[18] AER, *EBSS for the NSW and ACT determinations - Final decision*, February 2008, p. 15.

[19] NER, cl.6.5.8.

regulatory control period may be set on the basis of either the network's revealed opex or by reference to comparative efficiency. HoustonKemp provided its report in February 2015.[20] When using a benchmark, the illustrative scheme shows if costs were incurred above or below the benchmark, they would be shared between service providers and consumers according to a fixed ratio.[21]

We previously considered a similar scheme in developing version 2 of the EBSS. The main flaw of this type of scheme is that for all costs incurred above the forecast opex we approve, they are shared with consumers (eg. 30:70). There is a significant risk that, in sharing the cost of overspends between network service providers and consumers, consumers would end up paying more than the efficient cost of providing that service. We do not consider this to be a desirable outcome.[22]

We also note we do not have the scope to give detailed consideration to alternative EBSS mechanisms in time for us to publish our final decision for ActewAGL's 2015–20 distribution determination. Consideration of the design of incentive schemes take some time. It involves developing a scheme, consulting with relevant stakeholders and refining the scheme in response to stakeholder submissions. Under the NER, if we amend or replace an EBSS we must do so in accordance with the distribution consultation procedures.[23] These procedures require us to publish our proposed scheme and allow 30 days for submissions before publishing our final scheme within 80 days after that.

We note that ActewAGL and HoustonKemp also raised concerns about the balance between incentives to reduce opex and other incentives in the regime.[24] We acknowledge this is a tension with our approach. However, the balance between different incentives is only one consideration we must take into account when determining forecast opex and how the EBSS should apply. We are not aware of any option available to us that would deliver deliver perfectly continuous and balanced incentives, while ensuring consumers only pay efficient costs of receiving a safe and reliable network service.

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[20] HoustonKemp, *Illustrative EBSS Mechanisms, A report for ActewAGL*, 11 February 2015.

[21] HoustonKemp, *Illustrative EBSS Mechanisms, A report for ActewAGL*, 11 February 2015, pp.8-9.

[22] While we note the illustrative scheme is similar to the Capital Expenditure Sharing Scheme (CESS) we apply, the CESS is supplemented by an ex post review of capex. For costs incurred above the forecast capex we approve, we have scope to exclude them from the RAB. This provides protection to consumers from paying for inefficient costs.

[23] NER, cl. 6.5.8(d); Distribution consultation procedures NER, section (6.16).

[24] ActewAGL, *Revised regulatory proposal*, January 2015, p. iv.