



# **FINAL DECISION**

## **United Energy Distribution Determination 2021 to 2026**

### **Attachment 8 Efficiency benefit sharing scheme**

April 2021

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## Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to United Energy for the 2021–26 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

### Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Customer Service Incentive Scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

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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 opex allowances in subsequent regulatory control periods.

This attachment sets out our final decision on the EBSS carryover amounts United Energy accrued over the 2016–20 regulatory control period, and how we will apply the EBSS over the 2021–26 regulatory control period.

### 8.1 Final decision

#### 8.1.1 EBSS carryover amounts

Our final decision is to approve EBSS carryover amounts totalling \$70.9 million (\$2020–21) from the application of the EBSS in the 2016–20 regulatory control period.<sup>1</sup> This is the same as United Energy's revised proposal of \$70.9 million (\$2020–21),<sup>2</sup> which is consistent with our draft decision.<sup>3</sup> The minor difference in the EBSS carryover for HY2021 due to updating for actual inflation and forecast inflation for the year to June 2021 using the latest Reserve Bank of Australia's (RBA) February 2021 *Statement on monetary policy*.<sup>4</sup>

We set out our final decision on United Energy's EBSS carryover amounts in table 8.1.

**Table 8.1 Final decision on carryover amounts (\$ million, 2020–21)**

|                                | HY2021 | 2021–22 | 2022–23 | 2023–24 | 2024–25 | 2025–26 | Total |
|--------------------------------|--------|---------|---------|---------|---------|---------|-------|
| United Energy revised proposal | -3.9   | 32.2    | 30.8    | 12.9    | -1.0    | -       | 70.9  |
| AER final decision             | -3.9   | 32.2    | 30.8    | 12.9    | -1.0    | -       | 70.9  |
| Difference                     | 0.0    | -       | -       | -       | -       | -       | -     |

Source: United Energy, *Revised Regulatory Proposal 2021–26*, December 2020, p. 134; AER, *Draft decision, United Energy distribution determination 2021–26, Attachment 8, Efficiency benefit sharing scheme*, September 2020, p. 5; AER analysis.

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

<sup>1</sup> NER, cl. 6.4.3(a)(5).

<sup>2</sup> United Energy, *Revised Regulatory Proposal 2021–26*, December 2020, p. 134.

<sup>3</sup> AER, *Draft decision, United Energy distribution determination 2021–26, Attachment 8, Efficiency benefit sharing scheme*, September 2020, pp. 4–5.

<sup>4</sup> Reserve Bank of Australia, *Statement on monetary policy*, February 2021.

## 8.1.2 Application in the 2021–26 control period

Our final decision is to apply version two of the EBSS to United Energy for the 2021–26 regulatory control period.<sup>5</sup> Consistent with United Energy's revised proposal and our draft decision we will exclude guaranteed service levels (GSL) payments and debt-raising costs from the scheme. We will also make other adjustments as permitted by the EBSS, such as removing demand management innovation allowance costs, and movement in provisions (as outlined in section 8.4)

We have set out in table 8.2 the opex forecasts we will use to calculate efficiency gains in the 2021–26 regulatory control period, including forecast debt raising costs.<sup>6</sup>

**Table 8.2 Forecast opex for the EBSS (\$ million, 2020–21)**

|                                   | 2019         | 2020         | HY2021      | 2021–22      | 2022–23      | 2023–24      | 2024–25      | 2025–26      |
|-----------------------------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|--------------|
| Total forecast opex               | 160.1        | 162.2        | 82.1        | 143.2        | 142.8        | 145.5        | 147.4        | 149.8        |
| Less GSL payments                 | -0.7         | -0.7         | -0.3        | -0.8         | -0.8         | -0.8         | -0.8         | -0.8         |
| Less debt raising costs           | -1.3         | -1.3         | -0.6        | -1.2         | -1.2         | -1.2         | -1.2         | -1.2         |
| <b>Forecast opex for the EBSS</b> | <b>158.1</b> | <b>160.2</b> | <b>81.2</b> | <b>141.2</b> | <b>140.8</b> | <b>143.4</b> | <b>145.4</b> | <b>147.7</b> |

Source: AER, *Final Decision, United Energy distribution determination 2021–26, PTRM*, April 2021; AER, *Final decision, United Energy distribution determination 2021–26, EBSS model, April 2021*; AER analysis.

Note: Numbers may not add up due to rounding.

## 8.2 United Energy's revised proposal

### 8.2.1 Carryover amounts from the 2016–20 regulatory control period

United Energy accepted our draft decision on the EBSS carryovers accrued from the application of the EBSS in the 2016–20 regulatory control period in its revised regulatory proposal. It made no updates to the amounts we calculated.<sup>7</sup>

### 8.2.2 Application in the 2021–26 regulatory control period

United Energy accepted our draft decision to apply the EBSS in the 2021–26 regulatory control period.<sup>8</sup>

<sup>5</sup> NER, cl. 6.12.1(9); AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

<sup>6</sup> Subject to other adjustments required by the EBSS.

<sup>7</sup> United Energy, *Revised regulatory proposal 2021–26*, December 2020, p. 134.

<sup>8</sup> United Energy, *Revised regulatory proposal 2021–26*, December 2020, p. 134.

### 8.2.3 Stakeholder submissions

We received three submissions relating to the EBSS. They all focused on the effectiveness of all the incentive schemes (including Capital Expenditure Sharing Scheme (CESS) and Service Target Performance Incentive Scheme) and whether a broader review was required to ensure they were operating as intended.

Victorian Community Organisations (VCO) consider the EBSS is insufficient to drive opex to the efficient frontier. They note that the productivity of distributors has not matched or exceeded economy wide productivity increases and often distributor productivity has been negative.<sup>9</sup>

The Consumer Challenge Panel, sub-panel 17 (CCP17), questioned the effectiveness of the EBSS and CESS and strongly supported a broad review of these incentive schemes. It urged the AER to assign a high priority to this work program in 2021.<sup>10</sup>

Origin Energy questioned whether expenditure underspends represented genuine efficiency gains and if the incentive schemes were operating as intended. Origin Energy also supported the review of our incentive schemes.<sup>11</sup>

In our draft decision we announced a broad review of incentive schemes to address stakeholder concerns.<sup>12</sup> We reaffirmed our plan to undertake an incentive review as part of our 2020–25 strategic plan. As part of our priorities to deliver efficient regulation of monopoly infrastructure, we will review and refine our incentive schemes to ensure they remain relevant and fit for purpose.<sup>13</sup>

## 8.3 Assessment approach

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

- the revenue increments or decrements for each year of the 2021–26 regulatory control period arising from the application of the EBSS during the 2016–20 regulatory control period<sup>14</sup>
- how the EBSS will apply to United Energy in the 2021–26 regulatory control period.<sup>15</sup>

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<sup>9</sup> VCO, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, pp. 57–58.

<sup>10</sup> CCP17, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, p. 68.

<sup>11</sup> Origin Energy, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, pp. 1–2.

<sup>12</sup> AER, *Draft decision, United Energy distribution determination 2021–26, Overview*, September 2020, p. 5.

<sup>13</sup> AER, *Strategic plan 2020–2025*, December 2020, p. 18.

<sup>14</sup> NER, cl. 6.4.3(a)(5).

<sup>15</sup> NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between service providers and network users.<sup>16</sup> We must also have regard to the following matters when implementing the EBSS:<sup>17</sup>

- 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 United Energy with a continuous incentive to reduce opex
- the desirability of both rewarding United Energy for efficiency gains and penalising it for efficiency losses
- any incentives that United Energy 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.<sup>18</sup>

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 control 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 control period.
2. It provides a continuous incentive for a service provider to pursue efficiency improvements across the regulatory control 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.

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<sup>16</sup> NER, cl. 6.5.8(a).

<sup>17</sup> NER, cl. 6.5.8(c).

<sup>18</sup> 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: National Electricity Law, s. 16(1)(c).



When a distributor 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 control period. This is how efficiency improvements are shared between consumers and the distributor. If we subject costs to the EBSS that are not forecast using a revealed cost approach, a distributors would in theory receive a reward for efficiency gains through the EBSS (at a cost to consumers), but consumers would not benefit through a lower revealed cost forecast in the subsequent regulatory control 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 United Energy 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, and our EBSS decision is made largely in consequence of (and takes careful account of) our past and current decisions on United Energy's opex.

## **8.4 Reasons for final decision**

### **8.4.1 Carryover amounts from the 2016–20 regulatory control period**

United Energy addressed each of the issues we identified in our draft decision and adopted the same approach to calculate the EBSS carryover in its revised regulatory proposal as we used in our draft decision.<sup>19</sup> The only change we have made to United Energy's revised proposal is to update actual inflation in the year to December 2020 and forecast inflation for the year to June 2021 using the RBA's February 2021 *Statement on monetary policy*.<sup>20</sup>

We consider that the EBSS carryover amounts we have calculated, as set out in table 8.1, provide for a fair sharing of efficiency gains and losses between United Energy and its network users. It both rewards United Energy for the efficiency gains it has made and penalises it for its efficiency losses. Further, we consider that the benefit to networks users, through lower forecast opex, is sufficient to warrant the EBSS carryover amounts we have determined.

#### **8.4.1.1 2020 and half year 2021 EBSS carryovers**

As outlined in our six month extension guidance, we have deferred the payment of the half year 2021 EBSS carryover amount until 2021–22.<sup>21</sup> Our calculation uses the half year 2021 weight average cost of capital (WACC) and first year WACC of the 2021–26

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<sup>19</sup> United Energy, *2021–26 Revised regulatory proposal*, December 2020, p. 134.

<sup>20</sup> Reserve Bank of Australia, *Statement on monetary policy*, February 2021.

<sup>21</sup> AER, *Correspondence to United Energy – Victorian EDPR and the six-month extension*, 17 August 2020, p. 4.

regulatory control period to determine the present value equivalent amount, which we have included in revenues for 2021–22.

Due to the six month extension, we have also modified our standard formulae in the EBSS model<sup>22</sup> to ensure the incremental gains or losses accrued in calendar year 2020 and half year 2021 are carried forward for five years as intended by our decision for the 2016–20 regulatory control period.<sup>23</sup>

## 8.4.2 Application in the 2021–26 regulatory control period

Our final decision is to continue to apply version 2 of the EBSS to United Energy during the 2021–26 regulatory control period. We consider applying the scheme will benefit long-term electricity customers by providing continuous incentives for United Energy to reduce opex. Provided that we forecast United Energy future opex using its revealed costs in the 2021–26 regulatory control period, any efficiency gains that United Energy achieves will lead to lower opex forecasts, and thus lower network tariffs.

Version 2 of the EBSS specifies our approach to determining the length of the carryover period and adjusting forecast or actual opex when calculating carryover amounts.<sup>24</sup> We provide details on these below.

### 8.4.2.1 Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2021–26 regulatory control period will be the same as the length of United Energy's following regulatory control period.<sup>25</sup> This ensures that any gains or losses are retained by United Energy for the same length of time (usually five years) regardless of the year in which they are achieved. United Energy's following regulatory control period is expected to be five years, starting from 1 July 2026.

### 8.4.2.2 Adjustments to forecast or actual opex

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.

Consistent with version 2 of the EBSS, we will exclude GSL payments and debt raising costs from the EBSS. This is because we do not forecast these costs on a single year revealed cost basis. We instead forecast GSL payments based on an historic average, not a single year. The category specific forecast for debt raising costs is based on a benchmark amount.

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<sup>22</sup> See rows 50, 70 and 71 of the EBSS model.

<sup>23</sup> The Order in Council made on 27 October 2020 under section 16VE of the National Electricity (Victoria) Act 2005 allows for such modifications.

<sup>24</sup> AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

<sup>25</sup> NER, cl. 6.5.8(c)(2).

In addition we will also make the following adjustments when we calculate the EBSS carryover amounts for the next regulatory control period:

- 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 projects<sup>26</sup>
- adjust actual opex to remove demand management innovation allowance opex because it is not included in the opex forecast (but is often reported by service providers as part of their standard control services opex)<sup>27</sup>
- adjust actual opex to add capitalised opex that has been excluded from the regulatory asset base<sup>28</sup>
- adjust forecast opex and actual opex for inflation<sup>29</sup>
- 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 2026–31 regulatory control 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 clauses 6.5.8 of the NER.<sup>30</sup>

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<sup>26</sup> AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

<sup>27</sup> 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.

<sup>28</sup> 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.

<sup>29</sup> AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

<sup>30</sup> AER, *Explanatory Statement: Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 14.

## Shortened forms

| Shortened form | Extended form                          |
|----------------|--|
| AER            | Australian Energy Regulator            |
| distributor    | distribution network service provider  |
| CCP17          | Consumer Challenge Panel, sub-panel 17 |
| CESS           | Capital Expenditure Sharing Scheme     |
| EBSS           | efficiency benefit sharing scheme      |
| GSL            | guaranteed service levels              |
| NEL            | National Electricity Law               |
| opex           | operating expenditure                  |
| RBA            | Reserve Bank of Australia              |
| WACC           | weighted average cost of capital       |