



FINAL DECISION
Ergon Energy determination
2015–16 to 2019–20

Attachment 9 – Efficiency
benefit sharing scheme

October 2015

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457

Email: AERInquiry@aer.gov.au

Note

This attachment forms part of the AER's final decision on Ergon Energy's 2015–20 distribution determination. It should be read with all 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

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

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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

Shortened form	Extended form
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
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 2010–15 regulatory control period, Ergon Energy operated under the Electricity distribution network service providers EBSS, which was released in June 2008.¹

9.1 Final decision

Our final decision is to approve an EBSS carryover amount of \$131.2 million (\$2014–15) from the application of the EBSS in the 2010–15 regulatory control period.² Our final decision is different to our preliminary decision because we:

- adjusted Ergon Energy's allowed opex to account for new regulatory information notice (RIN) reporting costs
- revised the CPI adjustments in the EBSS model to be consistent with our opex model.

Our final decision for the EBSS carryover amounts from the 2010–15 regulatory control period is outlined in Table 9.1.

Table 9.1 AER's final decision on Ergon Energy's EBSS carryover amounts (\$ million, 2014–15)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Ergon Energy's revised proposal	33.8	47.9	63.8	-18.3	0.0	127.2
AER's final decision	33.8	46.6	64.6	-13.8	0.0	131.2

Source: AER analysis; Ergon Energy, *Revised proposed PTRM 2015–20*.

¹ AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008.

² AER, *Electricity distribution network service providers' EBSS*, June 2008.

Our final decision is to apply version two of the EBSS to Ergon Energy during the 2015–20 regulatory control period.³ This is also a change in position from our preliminary decision.

When we apply version two of the EBSS we will exclude the cost categories listed in section 9.5.2 from forecast and actual opex for the calculation of EBSS carryover amounts. Table 9.2 sets out our final decision on Ergon Energy's target opex for the EBSS (total opex less excluded categories⁴), against which we will calculate the EBSS carryover amounts in the 2015–20 period.

Table 9.2 Forecast opex for EBSS purposes (\$ million, 2014–15)

	2015–16	2016–17	2017–18	2018–19	2019–20
Forecast opex for EBSS purposes	334.3	340.0	345.7	352.8	359.5

Source: AER analysis.

Note: Total forecast opex less forecast opex on debt raising costs and DMIA.

9.2 Preliminary decision

In our preliminary decision we accepted Ergon Energy's proposal to apply a positive carryover amount to the 2015–20 regulatory control period, but we reduced the carryover amount from \$146.1 million to \$130.1 million.⁵ This was because movements in provisions were included in the carryover amounts. We consider that movements in provisions should be excluded from EBSS calculations because they do not represent changes in actual costs incurred in delivering network services.

In our preliminary decision we also determined that no opex would be subject to the EBSS for the 2015–20 regulatory control period.⁶ This was because we were uncertain whether we would rely on Ergon Energy's revealed costs as the basis for forecasting opex in the 2015–20 regulatory control period. We considered that applying an EBSS, but setting the forecast on the basis of benchmarking, rather than revealed costs for the 2015–20 regulatory control period, may have resulted in Ergon Energy being penalised twice for incremental efficiency losses.

9.3 Ergon Energy's revised proposal and submissions

Ergon Energy accepted our preliminary decision about the carryover amount we will apply to the 2015–20 regulatory control period.⁷ However, Ergon Energy disagreed with our preliminary decision not to apply the EBSS in the 2015–20 regulatory control

³ AER *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

⁴ Debt raising costs, GSL payments and DMIA.

⁵ AER, *Preliminary decision, Ergon Energy determination 2015-20, Attachment 9*, April 2015, p. 9-6.

⁶ AER, *Preliminary decision, Ergon Energy determination 2015-20, Attachment 9*, April 2015, p. 9-6.

⁷ Ergon Energy, *Revised regulatory proposal, 03.01.03 Incentive scheme response document*, 3 July 2015, p. 6.

period.⁸ Ergon Energy proposed that we apply an EBSS for the 2015–20 regulatory control period as outlined in the Framework and Approach Paper, subject to proposed adjustments for uncontrollable costs.⁹ Specifically, Ergon Energy proposed it should be able to ask for costs to be excluded from the EBSS where they would have qualified for a pass through.¹⁰

In its submission the Alliance of Electricity Consumers (Alliance) considered we should not apply the EBSS to Ergon Energy in the 2015–20 regulatory control period.¹¹ We disagree with the Alliance. If the best information we have about Ergon Energy's efficient opex is its revealed costs, without the EBSS there is a risk it will not improve its efficiency. With the EBSS in place, we are more confident it will improve its efficiency over time. The Alliance also considered consumers should not have to share 30 per cent of inefficient costs incurred by Ergon Energy. We consider it is important that the EBSS is symmetrical. That is, if consumers share in ongoing cost reductions, they should also share in ongoing cost increases. This represents a fair sharing of efficiency gains and losses as required by the NER.¹²

9.4 AER's assessment approach

Under the NER we must decide:

1. the revenue increments or decrements (if any) for each regulatory year of the 2015–20 period arising from the application of the EBSS during the 2010–15 regulatory control period¹³
2. how any applicable EBSS is to apply to Ergon Energy in the 2015–20 regulatory control period.¹⁴

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.¹⁵ We must also have regard to the following factors when implementing the EBSS:¹⁶

- 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

⁸ Ergon Energy, *Revised regulatory proposal, 03.01.03 Incentive scheme response document*, 3 July 2015, p. 6.

⁹ AER, *Final framework and approach for Energex and Ergon Energy* - April 2014, pp. 75-81.

¹⁰ Ergon Energy, *Revised regulatory proposal, 03.01.03 Incentive scheme response document*, 3 July 2015, p. 11.

¹¹ Alliance of Energy Consumers, *Submission to the AER's preliminary decision (Queensland)*, 3 July 2015, p. 30.

¹² NER, cl. 6.5.8(a).

¹³ NER, cl. 6.4.3(a)(5).

¹⁴ NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).

¹⁵ NER, cl. 6.5.8(a).

¹⁶ NER, cl. 6.5.8(c).

- 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 approved opex forecast 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 these interactions in developing and implementing the EBSS as well as developing the CESS. For instance:

- in developing and implementing the EBSS, we must have regard to any incentives that service providers may have to capitalise operating expenditure as well as the possible effects of the scheme on incentives for the implementation of non-network alternatives.¹⁷
- in developing the CESS, we must take into account the interaction of the scheme with other incentives that service providers may have in relation to undertaking efficient opex or capex as well as the capex objectives and, if relevant, the opex objectives.¹⁸

¹⁷ NER, cl. 6.4.3(a)(4),(5).

¹⁸ NER, cl. 6.5.8A(d).

9.5 Reasons for final decision

9.5.1 Carryover amounts from the 2010–15 regulatory control period

Ergon Energy accepted our preliminary decision about the carryover amount we will apply to the 2015–20 regulatory control period.¹⁹ However, the carryover amount in our final decision is different to our preliminary decision because we:

- adjusted Ergon Energy's opex allowance for the 2010–15 regulatory control period to account for increased costs it has incurred to comply with new RIN reporting requirements
- revised our CPI adjustment in our EBSS model to be consistent with our opex model.

This changed the carryover amount from \$130.1 million to \$131.2 million (\$2014–15).

In 2013–14 all distribution network service providers were required to report new information in our economic benchmarking and category analysis RINs for the first time. Consequently, CitiPower and Powercor stated in their regulatory proposals to the Victorian electricity determination, that adjustments must be made to the EBSS where there are compliance costs as a result of new or changed regulatory requirements:²⁰

The opex forecast must include any necessary adjustments for changes in responsibilities that result from compliance with a new or amended law or licence, or other statutory or regulatory requirement.²¹

Consistent with the approach we have adopted for CitiPower and Powercor, we have also adjusted Ergon Energy's EBSS carryover amounts to account for these increased costs.

Our calculations of the EBSS carryover amounts also differ because we revised the CPI adjustment in our EBSS model. We did this so the EBSS model is consistent with our opex model. We consider the CPI adjustment in the EBSS model should be the same as the CPI adjustment in the opex model because of the interaction between the EBSS and our opex forecast. If they are not consistent, a service provider could receive a reward or penalty for different inflation assumptions.

We note that the Alliance considered we should revoke Ergon Energy's \$130.1 million carryover from the 2010–15 regulatory control period.²² This course of action is not open to us. The carryover is calculated under the terms of the EBSS which we set out and applied in our determination for the 2010–15 regulatory control period. Incentives work best where the rewards and penalties facing a business are clear in advance of

¹⁹ Ergon Energy, *Revised regulatory proposal, 03.01.03 Incentive scheme response document*, 3 July 2015, p. 6.

²⁰ CitiPower, *Regulatory proposal*, April 2015, p. 249; Powercor, *Regulatory proposal*, April 2015, p. 257.

²¹ AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008, p. 7.

²² Alliance of Energy Consumers, *Submission to the AER's preliminary decision (Queensland)*, 3 July 2015, p. 30.

when it makes a decision to spend money. A distributor bases its expenditure decisions on the potential rewards and potential penalties it would face. To not apply the EBSS when we have committed to this approach undermines the incentive based arrangements in the regulatory regime.

9.5.2 How the EBSS will apply in the 2015–20 regulatory control period

We have changed our preliminary decision not to subject any expenditure to the EBSS in the 2015–20 regulatory control period. Our final decision is that version two of the EBSS will apply to Ergon Energy in the 2015–20 regulatory control period.²³

As noted above, our decision about whether to apply the EBSS depends largely on whether we will use a service provider's revealed opex to forecast its opex in the future or whether we rely on other information (such as benchmarking).

We have changed our position on applying the EBSS because we have changed our decision to use Ergon Energy's revealed opex to forecast its opex. In our preliminary decision we based our forecast on a benchmark. We do not consider the EBSS should apply when using a benchmarking approach to forecast opex. However in our final decision we have used Ergon Energy's revealed costs to forecast its opex. Where we use this approach, we consider an EBSS is needed to incentivise efficient opex. Having the EBSS in place will increase the possibility that Ergon Energy will become more efficient over time. It will also reduce the risk that it will increase its opex towards the end of the 2015–20 regulatory control period. We consider this helps to contribute to the NEO.²⁴ We discuss the reasons we changed our starting point to forecast Ergon Energy's opex in the base year appendix.

We propose to apply version two of the EBSS as follows:

Length of carryover period

The carryover period will be five years. We will apply any carryover amounts that have accrued in the 2015–20 regulatory control period when determining regulated revenue for the regulatory control period beginning in 2020.

Incremental efficiency gains

We will calculate incremental efficiency gains as follows:

- For the first year, 2015–16, we will apply the formula set out in section 1.3.2 of the EBSS
- For regulatory years from 2016–17 to 2018–19 we will apply the formula set out in section 1.3.3 of the EBSS

²³ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

²⁴ NER, cl. 6.5.8(c).

- For the 2019–20 regulatory year we will apply the formula set out in section 1.3.4 of the EBSS.

When calculating actual opex under the EBSS we will adjust reported actual opex for the 2015–20 regulatory control period to reverse any movements in provisions. We consider actual opex net of movements in provisions best reflects the actual opex incurred by the service provider during the regulatory control period.

Adjustments to forecast or actual opex when calculating carryover amounts

The EBSS allows for exclusions of categories of costs from the EBSS where we do not use a single year revealed cost forecasting approach. This is designed to fairly share efficiency gains and losses. For instance, where a service provider achieves efficiency improvements, it receives a benefit through the EBSS and consumers receive a benefit through lower forecast opex in the next period. This is the way consumers and the service provider share in the benefits of an efficiency improvement.

If we do not use a single year revealed cost forecasting approach, lower actual opex will not necessarily be passed through to consumers. Consumers should not pay for EBSS benefits where they do not receive the benefits of a lower opex forecast.

When we apply the EBSS to Ergon Energy we will exclude debt raising costs and the demand management innovation allowance (DMIA) because the forecasts for these categories are not based on a single year of revealed expenditure.

In addition to excluding these costs when we calculate Ergon Energy's carryover amounts we will also:

- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the initial regulatory determination. This may include approved pass through amounts
- adjust actual opex to add capitalised opex that has been excluded from the regulatory asset base
- exclude categories of opex not forecast using a single year revealed cost approach for the regulatory control period beginning in 2020 where doing so better achieves the requirements of clause 6.5.8 of the NER.

Adjustments to forecast opex for costs that would have qualified for a pass through

Ergon Energy proposed there should be a mechanism within the EBSS for a network service provider to ask for costs to be excluded where they would have qualified for a

pass through.²⁵ It stated it is not clear why we would insist that a network service provider incur the administrative costs of applying for a pass through as well as the costs to us of a public consultation process, when it does not wish to pass the costs of the relevant event through to customers. Ergon Energy considered it would face greater penalties through the EBSS if the costs of such an event were not excluded from the EBSS.²⁶

We do not consider Ergon Energy would face a greater penalty if we do not exclude these costs from the EBSS.

With the EBSS in place, if the cost is incurred outside the base year, we would expect that all costs would be shared between consumers and the service provider. For instance, for a one-off increase in opex, the service provider bears the costs of the event upfront but receives it back through an increased EBSS carryover six years later. This is equivalent to a sharing ratio of approximately 30:70.²⁷

If the event occurs in the base year, and the service provider does not wish to pass the costs onto consumers through its opex forecast in the next regulatory control period, then we have the ability to adjust the EBSS carryover amounts for non-recurrent costs under clause 1.3.2.²⁸ Subject to clause 1.4 we have also have the ability to exclude costs from the EBSS ex post.²⁹ We see no need to include an additional mechanism in the EBSS to exclude these costs.

²⁵ Ergon Energy, *Revised regulatory proposal, 03.01.03 Incentive scheme response document*, 3 July 2015, pp. 10–12.

²⁶ Ergon Energy, *Revised regulatory proposal, 03.01.03 Incentive scheme response document*, 3 July 2015, p. 10.

²⁷ AER, *Explanatory Statement - Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, pp. 25–29. Section 2.4 explains the reason for our approach to uncontrollable costs.

²⁸ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, Section 1.3.2, p. 6.

²⁹ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, Section 1.3.2, p. 6.