DRAFT DECISION

TasNetworks Distribution Determination 2019 to 2024

Attachment 8 Efficiency benefit sharing scheme

September 2018

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585165

Email: AERInquiry@aer.gov.au

AER reference: 60152

Note

This attachment forms part of the AER's draft decision on TasNetworks' 2019–24 distribution determination. It should be read with all other parts of the draft decision.

The draft 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 11 – Demand management incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanism

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Shortened forms

Shortened form	Extended form
ACS	alternative control services
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP 13	Consumer Challenge Panel, sub-panel 13
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIAM	demand management innovation allowance (menchanism)
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

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

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 opex, and provide for a fair sharing of these between distributors and network users. Consumers benefit from improved efficiencies through lower regulated prices.

This section sets out our decision and reasons on our carryover calculations and how we intend to apply the EBSS to TasNetworks in the 2019–24 regulatory control period.

8.1 Draft decision

Our draft decision is to approve EBSS carryover amounts totalling –$22.5 million ($2018–19) from the application of the EBSS in the 2017–19 regulatory control period. This is $1.0 million lower than TasNetworks' proposal of –$21.5 million ($2018–19). We have identified and corrected some errors relating to the inputs TasNetworks used to calculate its carryover amounts. We have also updated inflation to reflect the latest information.[1] These corrections are further discussed in section 8.4.

We set out our draft decision on the EBSS carryover amounts TasNetworks accrued during the 2017–19 regulatory control period in Table 8.1, along with TasNetworks' proposal and the difference.

Table 8.1 Draft decision on carryover amounts ($million, 2018–19)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
TasNetworks' proposal	–11.3	–11.3	–11.3	12.3	–	**–21.5**
AER draft decision	–11.3	–11.3	–11.3	11.5	–	–22.5
Difference	**–0.1**	**–0.1**	**–0.1**	**–0.8**	**–**	**–1.0**

Source: TasNetworks, *Post Tax Revenue Model (PTRM) Distribution*, 31 January 2018; AER, *Draft Decision – PTRM*, September 2018; AER analysis.

Note: Numbers may not add up to total due to rounding.

We will continue to apply version 2 of the EBSS to TasNetworks in the 2019–24 regulatory control period.[2]

We will exclude the following cost categories from the scheme:[3]

1 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2018; Australian Bureau of Statistics, 6401.0 - Consumer Price Index – Index Numbers All groups CPI Australia, Accessed on 22 August 2018 (http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6401.0Jun%202018?OpenDocument).

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

3 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, Section 1.4, pp. 9–10.

- debt raising costs
- Guaranteed Service Level (GSL) payments
- Electrical Safety Inspection (ESI) levy payments
- National Energy Market (NEM) levy payments.

Table 8.2 sets out our draft decision on the target opex for the EBSS we will use to calculate efficiency gains in the 2019–24 regulatory control period. It is based on TasNetworks' opex forecast, which we have accepted in this draft decision and is subject to further adjustments allowed by the EBSS.

We received one submission on TasNetworks' EBSS proposal from the AER's Consumer Challenge Panel 13 (CCP 13), which cautiously supported the application of the scheme. CCP 13 stated it supports the application of the EBSS for the 2019–24 regulatory control period only if we are satisfied that the TasNetworks' base year costs are efficient.[4] We have accepted TasNetworks' forecast opex in this decision. In making that decision we considered TasNetworks' base year opex is not materially inefficient. Our assessment of forecast opex is set out in Attachment 6 of this decision.

We discuss the reasons for our decision on applying the EBSS in the 2019–24 regulatory control period in section 8.4.

Table 8.2 Forecast opex for the EBSS ($million, 2018–19)

	2017–18	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24
Forecast total opex	69.6	68.0	83.3	83.0	82.2	81.4	80.6
Less debt raising costs	–1.1	–1.1	–0.9	–0.9	–0.9	–0.9	–0.1
Less guaranteed service level (GSL) payments	–2.4	–2.4	–2.9	–2.9	–2.9	–2.9	–2.9
Less electrical safety inspection (ESI) levy payments	–2.1	–2.1	–4.0	–4.0	–4.0	–4.0	–4.0
Less National Energy Market (NEM) levy payments	–0.4	–0.4	–0.6	–0.6	–0.6	–0.6	–0.6
Total opex for the EBSS target	**63.5**	**62.0**	**74.9**	**74.5**	**73.7**	**72.9**	**72.1**

Source: TasNetworks, *Post Tax Revenue Model (PTRM) PTRM Distribution*, 31 January 2018; TasNetworks, *Distribution Operating Expenditure Model*, 31 January 2018; AER, *Final Decision – PTRM*, April 2017; AER analysis.

Note: Numbers may not add up to total due to rounding.

8.2 TasNetworks' proposal

[4] Consumer Challenge Panel subpanel 13, *Issues Paper – TasNetworks electricity network revenue proposal 2019–24*, 16 May 2018, p. 6.

8.2.1 Carryover amounts from the 2017–19 regulatory control period

TasNetworks proposed we include EBSS carryover amounts totalling –$21.5 million ($2018–19) in its regulated revenue for the 2019–24 regulatory control period, from applying the EBSS in the 2017–19 regulatory control period.[5] In its proposal, TasNetworks acknowledged that the difference in the length of the current period (2017–19) and that of the next regulatory period (2019–24) has the potential to drive some perverse outcomes if the EBSS were to apply as we published it.[6] That is, contrary to the intent of the scheme, TasNetworks would be rewarded for any efficiency loss in 2016–17 and penalised for any efficiency gain.

To prevent such outcomes and give effect to the intention of the scheme, TasNetworks proposed that three additional years of EBSS penalties or rewards be determined on the basis of actual opex in 2016–17 and this approach should correct the effect of a two year regulatory period.[7] Specifically, TasNetworks carried forward the difference between the assumed and actual 2016–17 opex for an additional three years through the EBSS.[8]

8.2.2 Application in the 2019–24 regulatory control period

TasNetworks proposed we apply version 2 of the scheme apply in the 2019–24 regulatory control period.[9] It proposed we exclude the following cost categories from the scheme:[10]

- debt raising costs
- ESI levy payments
- NEM levy payments
- GSL payments.

TasNetworks also proposed we remove movements in provisions from forecast and actual opex.

8.3 AER's assessment approach

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

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5 TasNetworks, *Post Tax Revenue Model (PTRM) PTRM Distribution*, 31 January 2018.

6 TasNetworks, *Transmission and distribution regulatory proposal I*, 31 January 2018, p. 177.

7 TasNetworks, *Transmission and distribution regulatory proposal,* 31 January 2018, p. 177.

8 TasNetworks, *TN-Response IR#3 - Reset RIN Final Template 5 - Efficiency Benefit Sharing Scheme Distribution*, 31 January 2018.

9 TasNetworks, *Transmission and distribution regulatory proposal,* 31 January 2018, p. 176.

10 TasNetworks, *Transmission and distribution regulatory proposal,* 31 January 2018, p. 177.

(1) the revenue increments or decrements for each year of the 2019–24 regulatory control period arising from the application of the EBSS during the 2017–19 regulatory control period.[11]

(2) how the EBSS will apply to TasNetworks in the 2019–24 regulatory control period.[12]

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.[13] We must also have regard to the following matters when implementing the EBSS:[14]

- 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 TasNetworks with a continuous incentive to reduce opex
- the desirability of both rewarding the 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.

8.3.1 Interrelationships

The EBSS is closely linked to our opex revealed cost forecasting approach. When we develop our opex forecast, the rules require us to have regard to whether the opex forecast is consistent with any incentive schemes.[15]

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.

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11 NER, cl. 6.4.3(a)(5).
12 NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).
13 NER, cl. 6.5.8(a).
14 NER, cl. 6.5.8(c).
15 NER, cl. 6.5.6(e)(8).

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 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 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 benefit through a lower revealed cost forecast in the subsequent period. Therefore, we typically exclude costs that we do not forecast using a single year revealed cost forecasting approach.

8.4 Reasons for draft decision

This section provides the reasons for the carryover amounts that arise from applying the EBSS during the 2017–19 regulatory control period, and how we will apply the EBSS in the 2019–24 regulatory control period.

8.4.1 Carryover amounts from the 2017–19 regulatory control period

We determine EBSS carryover amounts totalling –$22.5 million ($2018–19) from applying the EBSS during the 2017–19 regulatory control period. This is greater ($1.0 million, $2018–19) than TasNetworks' proposal of –$21.5 million ($2018–19) because:

- We have updated movements in provisions for 2014–16. TasNetworks submitted two versions of the economic benchmarking RIN for the period 2014–16, revising its movements in provisions in the second version. Our movements in provisions values reflect this second version. In contrast, TasNetworks' EBSS carryover amounts reflected movements in provisions as reported in the first version of its 2014–16 economic benchmarking RIN. TasNetworks supported this correction.[16]
- We have included NEM and retail contestability opex and non-network alternatives costs consistent with our previous determination.[17] In contrast, TasNetworks excluded these cost categories. We note that the EBSS template we sent to TasNetworks as part of this draft determination incorrectly excluded NEM and retail contestability opex and non-network alternatives costs.[18] We discuss our inclusion

[16] TasNetworks, *Response to AER information request IR#032*, 29 June 2018.

[17] AER, *TasNetworks distribution draft determination 2017–19: Attachment 9 – EBSS*, September 2016, pp. 9–14; AER, *Final Decision TasNetworks distribution determination 2017−18 to 2018−19, Attachment 9 – Efficiency benefit sharing scheme*, April 2017, pp. 9–11.

[18] TasNetworks, *Response to AER information request IR#032*, 29 June 2018.

of these costs further below by explaining how we have calculated incremental efficiency gain for 2017–18.

- We have also updated inflation to reflect the latest information.[19]

Our draft decision takes into account the change in the length of TasNetworks' regulatory control period from two (2017–19) to five years (2019–24). We engaged with TasNetworks during the Framework and Approach consultation to address potential perverse EBSS outcomes driven by the change in the length of the regulatory period. For the current regulatory period (2017–19), the operation of the EBSS is affected by the two year duration. If the EBSS were applied as set out in the scheme it would not operate as intended under the NER.[20] Specifically, contrary to the NER,[21] it would reward TasNetworks by retaining efficiency loss in 2016–17 for only a short period (two years instead of five years). As a result, we and TasNetworks have carried forward any efficiency loss in 2016–17 for additional three, making it five years in total.[22]

In our final decision, we will update our EBSS carryover calculations to reflect actual opex for 2017–18. Our draft decision is based on an estimate because actual data for 2017–18 is not yet available. We will also update inflation.

8.4.1.1 Incremental efficiency gain in 2017–18

When TasNetworks calculated the incremental efficiency gain for 2017–18, it excluded categories of opex from its reported opex for 2014–15, 2015–16 and 2016–17 that we did not exclude from the EBSS in the 2017–19 regulatory control period. These include non-network alternatives and NEM and retail contestability costs. We have corrected this by not excluding these costs categories from TasNetworks' reported opex for 2014–15, 2015–16 and 2016–17.

8.4.2 Application of the EBSS in the 2019–24 regulatory control period

Our decision is to continue to apply version 2 of the EBSS to TasNetworks during the 2019–24 regulatory control period. We consider applying the scheme would result in benefits for electricity customers and it will provide continuous incentives for TasNetworks to reduce opex. This is because we have relied on TasNetworks' revealed costs to forecast opex over the 2019–24 regulatory control period. Version 2 of the EBSS specifies our approach to determining the length of the carryover period

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19 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2018; Australian Bureau of Statistics, 6401.0 - Consumer Price Index – Index Numbers All groups CPI Australia, Accessed on 22 August 2018 (http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6401.0Jun%202018?OpenDocument).

20 NER, cl. 6.5.8(c).

21 NER, cl. 6.5.8(c)(3).

22 TasNetworks, *Transmission and distribution regulatory proposal,* 31 January 2018, p. 177.

and adjusting forecast or actual opex when calculating carryover amounts.[23] We provide details on these below.

8.4.2.1 Length of carryover period

The length of the carryover period for the 2019–24 regulatory control period should be the same length as the regulatory control period commencing on 1 July 2024. This aligns the EBSS carryover period with the total length of TasNetworks' regulatory control period and ensures continuous incentives.[24] We expect TasNetworks' next regulatory control period will be five years, starting 1 July 2024.

8.4.2.2 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 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 revealed efficiency gains through to network users. Network users should not pay for EBSS benefits where they do not receive the benefits of a lower opex forecast.

Consistent with TasNetworks' proposal, we will exclude from the EBSS:[25]

- debt raising costs
- ESI levy payments
- NEM levy payments
- GSL payments.

We agree with TasNetworks' proposal to exclude these costs because we typically do not use revealed expenditure in a single year to forecast them.

In addition to the excluded cost categories outlined above, we will adjust actual opex to reverse any movements in provisions.

Consistent with version 2 of the EBSS 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

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

24 NER, cl. 6.5.8(c)(2).

25 TasNetworks, *Transmission and distribution regulatory proposal*, 31 January 2018, p. 177.

- adjust actual opex to add capitalised opex that has been excluded from the RAB[26]
- exclude categories of opex not forecast using a single year revealed cost approach for the regulatory control period beginning in 1 July 2024 where doing so better achieves the requirements of clause 6.5.8 of the NER.[27]

[26] NER, cl. 6.5.8(c)(5) requires us to have regard to any incentives the service provider may have to capitalise expenditure.

[27] AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 9.