


03.01.03

Application of Incentive Schemes

Contents

1. Introduction

The National Electricity Rules (NER) give rise to a variety of schemes that provide network businesses with incentives to be efficient in their spending, to maintain service standards, and to economically manage demand for regulated services. These incentive schemes form part of a network business' distribution determination and are designed to reward network operators for over-performance or penalise them for under-performance, as measured against predefined benchmarks of reliability and efficiency.

The Australian Energy Regulator (AER) has published a set of guidelines for the incentive schemes and has also set out in its Framework and Approach Paper[1] how it proposes to apply these schemes to Ergon Energy for the regulatory control period 2015-20. Ergon Energy is required under the NER to provide, as part of its Regulatory Proposal, a description of how it proposes to meet the AER's expectations as outlined in those documents. This document therefore provides a description of how Ergon Energy intends to apply the incentive schemes under the NER for the next regulatory control period.

2. Incentive Schemes

The AER's Framework and Approach Paper proposed to apply the following incentive schemes[2] to Ergon Energy in the next regulatory control period, with the objective of providing financial incentives for Ergon Energy to make efficient investment decisions and to maintain the efficiency of our expenditure, performance and services over time:

- **Demand Management Incentive Scheme (DMIS)** - provides incentives to Ergon Energy to commission efficient non-network solutions, such as distributed generation, to meet network constraints
- **Efficiency Benefit Sharing Scheme (EBSS)** - rewards Ergon Energy for efficiency gains and penalises Ergon Energy for efficiency losses as benchmarked against our approved operating expenditure forecasts, with any gains and losses outstanding at the end of a regulatory control period carried over into the next period
- **Service Target Performance Incentive Scheme (STPIS)** – encourages Ergon Energy to maintain and improve service performance by delivering financial rewards for over-performance or by imposing financial penalties for under-performance against service standard targets in the areas of reliability and customer service
- **Capital Expenditure Sharing Scheme (CESS)** – rewards Ergon Energy for underspends and penalises Ergon Energy for overspends as benchmarked against the approved capital expenditure program for the regulatory control period 2015-20. The CESS also allows the AER to undertake an ex-post review of capital works where an electricity distribution business overspends relative to its capital allowance and adjust the Regulatory Asset Base (RAB) for capital overspends which are not deemed prudent or efficient.

Ergon Energy supports the AER's proposed approach to the application of each scheme, however, Ergon Energy suggests that in the application of the CESS the AER should carefully consider the

[1] AER (2014), *Final Framework and Approach for Energex and Ergon Energy, Regulatory control period commencing 1 July 2015*, April 2014.

[2] While the AER may apply a Small Scale Incentive Scheme (SSIS) to an electricity distribution business as part of a distribution determination, the AER has advised in its Framework and Approach Paper that it does not intend to apply this scheme to Ergon Energy in the regulatory control period 2015-20.

potential impacts on the operation of the CESS that may be generated by customer initiated capital works (CICW) expenditure being above or below the expected AER allowances or forecasts for the 2015-2020 period or by decisions by a DNSP to not apply for pass-throughs for events that may meet the threshold but generate capital costs that could contribute to over-expenditure of allowances. This latter concern also applies to the operation of the EBSS.

The method and timing of the Annual Revenue Requirement (ARR) adjustments associated with these incentive schemes vary, as shown in Table 1. The proposed schemes can result in rewards or penalties within the current regulatory control period or adjustments within future periods. As such, this document does not identify revenue increments or decrements associated with the EBSS and CESS for the regulatory control period 2015-20, as the adjustments resulting from these schemes will be made in the regulatory control period 2020-25.

Table 1: Adjustments associated with application of incentive schemes in 2015-20

Incentive scheme	Method and timing of adjustment
DMIS	Revenue increment in the ARR calculation for 2015-20.
EBSS	Revenue increment/decrement in the ARR calculation for 2020-25. There will be no revenue impact in 2015-20.
STPIS	Adjustment to the ARR during the annual Pricing Proposal process. There is a two year lag between the performance year and the pass through of the reward or penalty in prices.
CESS	Revenue increment/decrement in the ARR calculation for 2020-25. There will be no revenue impact in 2015-20.

The details of these adjustments are specific to each scheme and are detailed below.

2.1 DMIS

2.1.1 Overview

The DMIS provides incentives to Ergon Energy to implement efficient non-network alternatives for managing expected demand on the network and efficiently connecting embedded generators. In its Framework and Approach Paper, the AER proposed to apply Part A of the DMIS (i.e. the Demand Management Innovation Allowance (DMIA)) in the regulatory control period 2015-20. The AER proposed to allow a $5 million DMIA ($1 million each year), consistent with the scheme applied to Ergon Energy in the current regulatory control period.

Consistent with the Framework and Approach Paper, Ergon Energy has proposed a total DMIA allowance of $5 million over the next regulatory control period.

The AER noted in its Framework and Approach Paper that it may develop and implement a new DMIS during the next regulatory control period, depending on the progress of the Australian Energy Market Commission's Power of Choice rule change process.[3]

2.1.2 Current period outcomes

Ergon Energy has an active program to pursue non-network alternatives to the construction of network assets to deliver energy to customers. In the current regulatory control period the non-network program for Ergon Energy's regulated network amounted to $65 million. This non-network

[3] AER, *Final Framework and Approach for Energex and Ergon Energy, Regulatory control period commencing 1 July 2015*, April 2014.

expenditure was incurred where Ergon Energy could demonstrate that it was more cost-effective than traditional network solutions. As a consequence of this large program, Ergon Energy has not yet fully spent our allowance under the DMIA for the current regulatory control period.

Ergon Energy's DMIA expenditure for the current regulatory control period is listed in Table 2 below and reflects 2010-14 actuals and the 2015 budget. Based on the DMIA expenditure outlined, Ergon Energy expects an adjustment to revenue in year 2 of the regulatory control period 2015-20 of $1.99 million (nominal)[4].

Table 2: Actual expenditures associated with DMIS, 2010-15

$m (real 2014-15)	2010-11	2011-12	2012-13	2013-14	2014-15
DMIS (Part A, DMIA) 2010-15	0.50	0.58	0.93	0.87	1.00

2.1.3 Application of the incentive in the next period

Table 3 summarises the revenue allowances included in the building blocks for the DMIS for the regulatory control period 2015-20, consistent with the Framework and Approach Paper. For revenue modelling purposes, Ergon Energy has included the $5 million (in real $2014-15) of DMIA as a bottom up item in our operating expenditure forecast. To avoid double counting of the allowance, no further adjustments have been made to the revenue model.

Table 3: Estimated revenue allowances associated with DMIS, 2015-20

$m (real 2014-15)	2015-16	2016-17	2017-18	2018-19	2019-20
DMIS (Part A, DMIA) 2015-20	0.97	0.95	0.93	0.90	0.88

2.2 EBSS

2.2.1 Overview

The EBSS seeks to provide a financial incentive for Ergon Energy to improve the efficiency of our operating expenditure and to share any resulting efficiency gains (or losses) with our customers. Any efficiency gains (or losses) are retained by Ergon Energy for five years after the gain (or loss) is realised. This means the EBSS revenue adjustment in the regulatory control period 2015-20 relates to our performance under the EBSS in the regulatory control period 2010-15.

2.2.2 Current period outcomes

The AER has applied an EBSS for operating expenditure to Ergon Energy in the current regulatory control period which results in carryover revenue adjustments in the regulatory control period 2015-20.

During 2010-11 and 2011-12, Ergon Energy's operating expenditure exceeded forecast expenditure resulting in carry over amounts that will be attributed to 2015-16 and 2016-17.

[4] Further explanation on the DMIA revenue adjustment in 2016-17 is set out in supporting attachment *04.01.00 – Compliance with Control Mechanisms*

Ergon Energy implemented a series of initiatives in 2011-12 to reduce operating expenditure, and as a consequence, the operating expenditure in 2012-13 and 2013-14 was reduced significantly compared to allowances. The total operating expenditure in the current regulatory control period will be less than the approved operating expenditure allowance for the period.

These operating expenditure outcomes are reflected in the EBSS adjustments included in the ARR for the regulatory control period 2015-20.

Table 7.5.1 in the Reset RIN provides further information on EBSS related operating expenditure outcomes over time and the annual Performance RINs provide an explanation of the variances in operating costs compared to the EBSS.

Table 4 summarises the revenue adjustments included in the building blocks for the regulatory control period 2015-20 as a result of the application of the EBSS in the current regulatory control period.

Table 4: Estimated revenue increments and decrements associated with the EBSS, 2015-20

$m (real 2014-15)	2015-16	2016-17	2017-18	2018-19	2019-20
EBSS carry over amounts	36.59	52.37	73.83	(16.65)	0.00

2.2.3 Application of the incentive in the next period

The AER has advised in its Framework and Approach Paper that it intends to apply its new EBSS[5] for the regulatory control period 2015-20 and Ergon Energy accepts this approach, subject to one additional proposal which is set out in section 2.4 below.

The effect on revenue adjustments from the EBSS will not be known until the regulatory control period 2020-25.

2.3 STPIS

2.3.1 Overview

The STPIS rewards Ergon Energy when we improve our average service quality to customers and penalises us for a reduction in average service quality to customers. The rewards or penalties are applied by adjusting the amount of allowed revenue in a year in accordance with the mechanism set out in the distribution determination. Ergon Energy currently receives a maximum reward or penalty of +/-2% of its ARR and proposes that this remain at +/-2% in the regulatory control period 2015-20.

2.3.2 Current period outcomes

Ergon Energy is subject to the jurisdictional requirements which specify minimum limits on the reliability of the network, the Minimum Service Standards (MSS). These are in addition to the STPIS under the NER.

[5] Better Regulation - Efficiency Benefit Sharing Scheme for Electricity Network Service Providers - November 2013

The MSS targets are set out in our Distribution Authority[6] and Ergon Energy is required to make best endeavours not to breach these. The jurisdictional MSS are more stringent than the STPIS requirements and as such Ergon Energy has exceeded the targeted performance under the STPIS in the last three years of the current period. This has resulted in adjustments to our revenue allowances that will carry over into the next regulatory control period.

Table 5 identifies the current period revenue adjustments applicable for the STPIS.

Table 5: Current period revenue adjustment for the STPIS.

$m (real 2014-15)	2010-11	2011-12	2012-13	2013-14	2014-15
STPIS reward (penalty)	0	0	(14.27)	1.90	31.48

Table 6 summarises the revenue adjustments included in our Total Allowed Revenue for the regulatory control period 2015-20 as a result of the application of the STPIS in 2010-15.

Table 6: Estimated revenue adjustments associated with the STPIS, 2015-20[7]

$m (real 2014-15)	2015-16	2016-17	2017-18	2018-19	2019-20
STPIS reward (penalty)	29.46	0.00	0.00	0.00	0.00

2.3.3 Application of the incentive in the next period

The AER has noted in its Framework and Approach Paper that it intends to continue to apply the STPIS to Ergon Energy in the regulatory control period 2015-20, with a maximum reward or penalty of +/-2% of our ARR. Ergon Energy supports this approach.

Our supporting document *03.02.02 – Proposed Application of STPIS for the 2015-16 to 2019/20 Regulatory Control Period* sets out Ergon Energy's proposed STPIS targets for the regulatory control period 2015-20.

2.4 CESS

2.4.1 Overview

The CESS seeks to provide incentives to Ergon Energy to improve the efficiency of its capital expenditure allowance and to share any resulting efficiency gains (or losses) with customers. Ergon Energy will receive a reward (or penalty) equivalent to 30 per cent of the net present value of any capital underspends (or overspends) relative to the amount approved by the AER in the distribution determination, adjusted for the financing benefit[8] of the overspend (or underspend). This amount is added (subtracted) from Ergon Energy's regulated revenue in the next regulatory control period.

The AER plans to apply a CESS in conjunction with forecast depreciation to roll forward the RAB. The two mechanisms work together to provide Ergon Energy with a reward of 30 per cent of any

[6] Up until 1 July 2014, the MSS were contained in the Queensland Electricity Industry Code.

[7] Further information on revenue adjustments included in our proposed forecast revenues is set out in in supporting attachment *04.01.00 – Compliance with Control Mechanisms*

[8] The financing benefit is the rate of assets associated with the capital expenditure over or under-spend.

underspend and a penalty of 30 per cent of any overspend during the regulatory control period. The AER's desired objective is to:

- encourage more efficient capital expenditure - particularly towards the end of a regulatory control period
- encourage more efficient substitution between capital and operating expenditure.

Ergon Energy notes that in its explanatory statement the AER has framed the creation of the CESS around the following issue set of issues:

> " ...the benefits to a NSP of underspending a given amount of capex are progressively less in each year during a regulatory control period. For instance, if a NSP underspends in the first year of a five year regulatory control period, it will not lead to a lower RAB until four and a half years later when we roll forward the RAB. If, on the other hand, the NSP underspends in the middle of the final year of a five regulatory control period, it will lead to a lower RAB half a year later when we roll forward the RAB. As the benefits of underspending to a NSP are smaller as the regulatory control period progresses, we say a NSP's incentives for efficient capex decline over the regulatory control period.
>
> There are three main reasons why declining incentives for efficient capex may be a problem:
>
> There is a lack of discipline on capex towards the end of the regulatory control period.
>
> There is little reward for underspending towards the end of the regulatory control period. Conversely, there is little penalty for overspending towards the end of the regulatory control period. This may mean NSPs are not as disciplined with their capex towards the end of a regulatory control period.
>
> It could distort decisions about whether to undertake capex or opex:
>
> A NSP's incentives to pursue efficient opex are the same in each year. As the incentives for efficient capex differ significantly from the incentives for efficient opex - particularly towards the end of a regulatory control period - this could distort decisions on whether to undertake opex or capex. It could also lead a NSP to change its capitalisation policy to reclassify costs between capex and opex.
>
> Capex might be less efficient if NSPs skew their capex towards the end of the regulatory control period:

> Unnecessary peaks and troughs in a NSP's investment programs can result in higher costs than a more stable work program. For example, if a large number of projects are undertaken during the final years of the regulatory control period, NSPs may rely more on external contractors for projects that could have been undertaken more efficiently by in-house staff. NSPs may also enter into less cost-effective contracts with external contractors if they are contracting at shorter notice and for a smaller scope of work rather than if they were offering a steady stream of work.
>
> To address the issues identified above, regulators can apply a capex incentive mechanism to complement the rewards or penalties the NSP already receives for beating its capex forecasts. After such a mechanism is applied, the reward a NSP receives for an underspend, or the penalty it would face for an overspend, would be the same in each year. The additional reward or penalty is generally added to or subtracted from regulated revenues as an additional building block in the next regulatory control period."

Whilst Ergon Energy appreciates the above concerns have been raised by stakeholders and others in developing new rules to support the 'Better Regulation' agenda, not all forms of capital expenditure undertaken by DNSPs are subject to the distortions and forms of 'gaming' that may be implied by the AER's analysis above. Equally, there are certain types of expenditure for which outturn expenditure will be driven, to a very significant extent, by circumstances beyond the DNSP's control. Ergon Energy submits that the AER's incentive schemes need to take such matters into account to ensure that the incentive scheme minimises the possibility of windfall gains or losses that are driven by factors unconnected to a DNSP's performance.

In particular, a DNSP, in meeting the relevant capital expenditure objective for Customer Initiated Capital Works (CICW) expenditure, has little ability to unduly influence, accelerate, defer or delay the timing of such customer driven requirements and the DNSP remains ultimately under a regulatory obligation to connect the relevant customer.

In its explanatory statement published in support of the CESS, the AER stated:

> " We acknowledge that the CESS will reward or penalise NSPs for some uncontrollable events. However, on the whole, the risk of uncontrollable events presents both upside and downside risk to NSPs and this risk can already be managed somewhat through pass-through events and contingent projects. We do not think that there is a compelling argument as to why uncontrollable costs should be shared differently to all other costs facing NSPs.

While we accept that some events may be uncontrollable, in most cases, a NSP also still has the ability to control the costs associated with such events. Allowing exclusions would increase the risk that we would dilute a NSP's incentives to improve its efficiency."

These observations fail to address the rationale behind the proposal to exclude or make appropriate allowances for significant fluctuations in CICW capex for CESS purposes. Irrespective of the nature of the incentives provided to a DNSP, it is simply a fact that there is less that a DNSP can do to improve efficiency in relation to capex, such as CICW, where demand is externally driven and essentially, triggered at the customer's discretion. There do need to be incentives to meet demand more efficiently, but there is almost nothing the DNSP can do to control volume or defer expenditure. This is why uncontrollable costs are different.

To the extent that a DNSP does have an ability improve efficiency, the DNSP will continue to be rewarded or penalised by reference to the difference between the forecast CICW allowance and outturn expenditure in a given year. However, this effect should not exacerbated by the additional reward or penalty associated with the CESS. In either scenario the DNSP will be excessively rewarded or penalised (with the corresponding impact on customers) for a level of performance that was driven, to a material extent, by factors other than the DNSP's efficiency.

Likewise, DNSPs acting in the long term interests of consumers to avoid unnecessary price increases may make decisions to absorb the capital costs of events that might otherwise qualify for a pass through during the period under review, only to find themselves penalised later on if economic conditions, network demand or customer requirements necessitate over-expenditure of the allowances later on in the same period.

When these were put the AER in developing the CESS, the AER responded in the following terms:

" A NSP would avoid an automatic CESS penalty for increased capex if we approved the capex as part of a pass-through event. If a NSP wishes to avoid a CESS penalty it should submit a pass-through application. If we approve an increase in regulated revenue after assessing the pass-through application, then it is a business decision for the NSP as to whether it increases its tariffs to recover the additional revenue."

It is not clear to us why the AER would insist that a DNSP incur the administrative costs of applying for a pass through (costs which are ultimately borne by a consumers), as well as imposing on the regulator the costs of a public consultation process and administrative decision, when the DNSP does not in fact wish to pass the costs of the relevant event through to customers. A pass through event, if granted, does not simply affect CESS calculations, it affects the DNSP's return on capital and depreciation in the period in which the pass through occurs, and arms the DNSP with the ability to pass those costs through to customers, whether or not it had intended to do so when the pass through application was made.

These outcomes are all avoidable if there is a mechanism, within both the CESS and EBSS, for a DNSP to ask for costs to be excluded where they would have qualified for a pass through. Given the potential costs and downside of the alternative, it is difficult to understand why a carefully framed mechanism for the exclusion of such costs would be resisted.

Ergon Energy does not consider the approach as outlined in the AER's explanatory statement to necessarily be in the best long term interests of consumers and submits that the AER should consider the impact of decisions to not apply for pass through on a more flexible basis under the CESS and EBSS, given the schemes principles are subject to overall assessment of how the DNSP actually meets the relevant expenditure objectives, criteria and factors at a given point in time.

Ergon Energy is not proposing that the above two areas of expenditure be subject to automatic exclusions under the CESS. Rather Ergon Energy proposes that in assessing the operation of the scheme for a particular scheme, the AER properly and fully consider whether any overspend or underspend of capital attributable to events that qualify as a pass through or that relate to CICW expenditure are considered against the capital objectives, criteria and factors under the Rules in assessing whether the capital spend under consideration is efficient or inefficient. Ergon Energy considers that such flexibility of assessment is both consistent with the Rules and the EBSS and CESS itself, and notes the detailed list of factors contained in Stage 2 of the CESS guidelines and impacts referred to above by Ergon Energy in terms of pass through events and CICW spend are consistent with the types of matters that should be taken into account in any event under the Stage 2 analysis.

2.4.2 Application of the incentive in the next period

The CESS will commence and be applied to the results for the regulatory control period 2015-20 but will not affect customers until the regulatory control period 2020-25.

To determine the incentive or penalty to be shared between Ergon Energy and our customers, the AER will calculate efficiency gains or efficiency losses, using the following method:

- calculate efficiency gains and losses in net present value terms for each year of the regulatory control period and then calculate the total efficiency gain/loss for the regulatory control period
- apply a sharing factor to the total efficiency gain/loss to calculate Ergon Energy's share of the gain/loss
- calculate financing benefits/costs that accrue through the regulatory control period
- calculate the CESS reward/penalty by subtracting the financing benefit/cost that has accrued from our share of the total efficiency gain/loss.

2.5 Small Scale Incentive Scheme

2.5.1 Overview

The Small Scale Incentive Scheme (SSIS) is an incentive scheme that the AER can apply to a distributor as part of the distribution determination and is applicable only to that distributor for that determination. The AER is required to advise of its intention to apply a SSIS during the Framework and Approach process.

2.5.2 Application of the incentive in the next period

The AER advised in its Framework and Approach Paper for the regulatory control period 2015-20 that it is has not developed this scheme and therefore proposes to not apply this scheme to Ergon Energy in the next regulatory control period.