DRAFT DECISION

Jemena
Distribution Determination
2021 to 2026

Attachment 8
Efficiency benefit sharing scheme

September 2020

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Jemena for the 2021–26 regulatory control period. 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 and demand management innovation allowance mechanism

Attachment 12 – Not applicable to this distributor

Attachment 13 – Classification of services

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Attachment 17 – Negotiated services framework and criteria

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Attachment A – Victorian f-factor incentive scheme

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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 regulated prices.

This attachment sets out our draft decision on the EBSS carryover amounts Jemena accrued over the 2016–20 regulatory control period and the six month extension period, and how we will apply the EBSS over the 2021–26 regulatory control period.

8.1 Draft decision

Our draft decision is to include EBSS carryover amounts totalling $25.0 million ($2020–21) from the application of the EBSS in the 2016–21 regulatory control period.[1] This is $1.2 million ($2020–21) higher than Jemena's proposal of $23.8 million ($2020–21).[2] This difference reflects a number of adjustments we have made to correctly apply the scheme. In particular, the following differences between Jemena's proposal and our decision:

- we have updated for actual figures for 2019 reported opex, decreasing total carryovers by $0.3 million ($2020–21)
- we did not exclude the forecast and actual opex of cost categories that include self-insurance, network growth adjustments, regulatory information notice (RIN) compliance costs and losses on the scrapping of assets in 2014 and 2015 from total opex as Jemena incorrectly proposed. These opex categories were excluded from Jemena's EBSS in the 2011–15 regulatory control period but not in the 2016–20 regulatory control period, increasing total carryovers by $1.9 million ($2020–21)
- we used updated inflation figures to convert amounts into 2020–21 dollars, decreasing total carryovers by $0.4 million ($2020–21).

We set out our draft decision on Jemena's EBSS carryover amounts in table 8.1.

Table 8.1 Draft decision on carryover amounts ($ million, 2020–21)

	HY2021	2021–22	2022–23	2023–24	2024–25	2025–26	Total
Jemena's proposal	0.2	8.1	6.5	4.9	2.1	2.1	**23.8**
AER draft decision	1.1	8.9	6.5	4.8	1.9	1.9	**25.0**
Difference	0.9	0.8	–0.1	–0.1	–0.2	–0.2	**1.2**

Source: Jemena, *JEN – RIN 7 – Workbook 5 – EBSS, January 2020*; AER analysis.

Note: Numbers may not add up due to rounding.

[1] NER, cl. 6.4.3(a)(5).

[2] Jemena, *JEN – RIN 7 – Workbook 5 – EBSS*, January 2020

We will not apply the EBSS to Jemena in the 2021–26 regulatory control period. As outlined in the Victorian distributors' framework and approach, the application of the EBSS will occur only if the opex forecast for the following period is based on the distributor's revealed cost.[3] Our assessment of Jemena's proposed opex has identified its base opex as inefficient, and Jemena's proposal has not shown that it aims to reach an efficient level of opex by the end of the 2021–26 regulatory control period. Consequently we cannot be satisfied that we are likely to use revealed cost in the following period.[4]

We discuss the reasons for our draft decision in section 8.4.

8.2 Jemena's proposal

8.2.1 Carryover amounts accrued during the 2016–20 regulatory control period

Jemena proposed we include EBSS carryover amounts totalling $23.8 million ($2020–21) in its revenue in the 2021–26 regulatory control period, from the application of the EBSS in the 2016–20 regulatory control period.[5] Jemena excluded the following cost categories in calculating its EBSS carryover amounts:[6]

- debt raising costs
- demand management innovation allowance (DMIA)
- guaranteed service level (GSL) payments
- self-insurance, network growth adjustments, RIN compliance costs and losses on scrapping of assets

It also reversed its movements in provisions related to opex.

Jemena also proposed including its EBSS carryovers for the six month extension period in its revenues for the six month extension period.[7]

8.2.2 Application in the 2021–26 control period

Jemena proposed we continue to apply the EBSS in the 2021–26 regulatory control period, which is consistent with the customer feedback it received.[8] It also proposed that we apply the following adjustments and exclusions for the 2021–26 regulatory control period:[9]

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3 AER, *Final framework and approach for AusNet Services, CitiPower, Jemena, Powercor and United Energy*, January 2019, pp. 80–83.
4 AER, *Jemena distribution determination 2021–26 – Attachment 6 – Operating expenditure*, September 2020.
5 Jemena, *JEN – RIN 7 – Workbook 5 – EBSS*, January 2020.
6 Jemena, *JEN – RIN 7 – Workbook 5 – EBSS*, January 2020.
7 Jemena, *Attachment 07-23 SCS PTRM (HY2021)*, 31 January 2020.
8 Jemena, *Attachment 07-05 Incentive mechanisms,* 31 January 2020, p. 2.
9 Jemena, *Attachment 07-05 Incentive mechanisms,* 31 January 2020, p. 3.

- debt raising costs
- GSL payments
- ESV levy
- cost pass-throughs and other approved adjustments.

8.2.3 Stakeholder submissions

The Victorian Community Organisation (VCO) raised concerns about whether the EBSS is getting opex to the efficiency frontier. VCO stated that it is unclear whether this is due to the framework design of the EBSS, or whether we are not using the benefits of our productivity analysis to its maximum potential. It considered that opex is becoming less productive and further from the efficient frontier. The VCO also raised concerns about the transparency of consumer funded capital expenditure programs that lead to opex reductions and therefore EBSS carryover benefits.[10]

Energy Users Association of Australia (EUAA) questioned whether some of the large EBSS carryovers accrued by some distributors suggests overly generous opex forecasts in the current period which lessens the effectiveness of the efficiency schemes.[11]

Similar to EUAA, the AER's Consumer Challenge Panel, sub-panel 17 (CCP17) noted the significant EBSS and capital expenditure sharing scheme (CESS) carryovers accrued by some Victorian distributors in the current regulatory control period. The CCP17 stated that the outcomes are not reflective of expected results for businesses operating at the efficiency frontier and suggested that a holistic review of the incentive schemes is required.[12]

We acknowledge the observations made from submissions on the high EBSS carryovers accrued by some distributors, however, these outcomes must be considered in light of the combined revenues, i.e. taking into account the EBSS revenues together with the opex forecast. The high EBSS revenues will reflect lower opex in the current period and where the distributor is operating efficiently this will mean lower opex forecasts for the subsequent regulatory control period. The interrelationship between the EBSS and our revealed cost approach is discussed further in section 8.3.1.

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10 VCO, *EDPR 2021–26 Submissions to Initial Proposal*, May 2020, pp. 69–70.

11 EUAA, *Submission AusNet Services EDPR 21–26,* 10 June 2020, p. 2.

12 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determinations 2021–26*, 10 June 2020, p. 2.

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[13]
- how the EBSS will apply to Jemena in the 2021–26 regulatory control period.[14]

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between service providers and network users.[15] We must also have regard to the following matters 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 Jemena with a continuous incentive to reduce opex
- the desirability of both rewarding Jemena for efficiency gains and penalising it for efficiency losses
- any incentives that Jemena 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.[17]

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.

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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).
17 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: NEL, s 16(1)(c).

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.

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 regulatory control 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 single year 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 necessarily 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 Jemena has a strong interrelationship with our decision on its opex (see Attachment 6). 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 Jemena's opex.

8.4 Reasons for draft decision

8.4.1 Carryover amounts from the 2016–20 control period

Our draft decision is to include EBSS carryover amounts totalling $25.0 million ($2020–21) from the application of the EBSS in the 2016–20 regulatory control period.[18] This is $1.2 million ($2020–21) higher than Jemena's proposal of $23.8 million ($2020–21). This difference reflects a number of adjustments we made to correctly apply the scheme with the key differences to Jemena's proposal and our decision summarised in section 8.1. We discuss each of these key differences in more detail below.

We consider that the EBSS carryover amounts we have calculated provide for a fair sharing of efficiency gains and losses between Jemena and its network users. It both rewards Jemena 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.

When we last made regulatory decisions for Jemena we decided to apply the EBSS during the 2016–20 regulatory control period. It is intended to provide a continuous

[18] NER, cl. 6.4.3(a)(5).

incentive for distributors to pursue efficiency improvements in opex, and provide for a fair sharing of these between distributors and network users. While Jemena has achieved some efficiency gains during the current regulatory control period, as reflected in its EBSS carryovers, we have nonetheless found its base opex to be inefficient.[19] So, while Jemena has made efficiency gains relative to our opex forecast in the current regulatory control period, they have not been sufficient for its base opex to be found relatively efficient, based on the currently available benchmarking analysis. The accrued EBSS carryover amount of $25.0 million ($2020–21), which is added to Jemena's allowed revenue, rewards Jemena for those opex reductions it achieved during the current regulatory control period.

8.4.1.1 Inflation

We used updated inflation forecasts compared to those Jemena proposed. For 2019 we used the actual headline CPI figure published by the Australian Bureau of Statistics, which was released after Jemena submitted its proposal.[20] For 2020–21 we used the inflation forecast in the Reserve Bank of Australia's August 2020 *Statement on monetary policy*.[21] This was also published after Jemena submitted its proposal.

8.4.1.2 Incremental efficiency gain in 2016

To calculate the incremental efficiency gain for 2016, we included self-insurance, network growth adjustments, RIN compliance costs and losses on scrapping of assets from Jemena's forecast and actual opex for 2014 and 2015. Jemena, however, incorrectly excluded these costs. These categories of opex were excluded from the operation of the EBSS for the 2011–15 regulatory control period, but not for the 2016–20 regulatory control period.[22] We did not exclude these costs because doing so would result in the incremental gain we calculated for 2015 and 2016 including the incremental gains made in 2014 and 2015 related to these costs.

To calculate the incremental gain (loss) made in the first year of a regulatory control period we start with the opex underspend (overspend) in that year. Since the forecast for that year will reflect the level of efficiency revealed in the base year in the previous regulatory control period, this underspend will reflect all efficiency gains or losses made after the base year. We then subtract any incremental gains or losses made after the base year in the previous regulatory control period. When we do this, we subtract efficiency gains made in all categories of opex subject to the EBSS in the new regulatory control period. This includes categories of opex that we excluded from the EBSS in the previous regulatory control period. This is because, we are calculating the incremental efficiency gain in 2016 for those categories of expenditure subject to the EBSS in the 2016–20 regulatory control period. For this reason we included

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19 AER, *Jemena distribution determination 2021–26 – Attachment 6 – Operating expenditure*, September 2020.

20 Australian Bureau of Statistics, *Catalogue number 6401.0, Consumer price index*, June 2020.

21 Reserve Bank of Australia, *Statement on monetary policy*, *Appendix: Forecasts*, August 2020.

22 AER, *Final decision Jemena distribution determination 2016– 2020 – Attachment 9 – Efficiency benefit sharing scheme*, May 2016, p. 12.

self-insurance, network growth adjustments, RIN compliance costs and losses on scrapping of assets from Jemena's forecast and actual opex for 2014 and 2015 to calculate the incremental efficiency gain for 2016 (they were not excluded from the EBSS for the 2016–20 regulatory control period). By doing this, the incremental efficiency gain we have calculated for 2016 does not include the incremental efficiency gains made in 2015 related self-insurance, network growth adjustments RIN compliance costs and losses on scrapping of assets.

8.4.1.3 Updating for 2019 actuals

Jemena calculated its proposed EBSS carryovers using an estimate of its 2019 opex because its actuals were not available at the time it submitted its proposal. We have updated the EBSS carryover calculations to reflect actuals reported in both the annual and economic benchmarking RIN. This has an impact on total reported opex, DMIA GSL payments and movements in provisions for 2019.

8.4.1.4 Six month extension period EBSS carryovers

As outlined in our six month extension guidance,[23] we have deferred the half year 2021 EBSS carryovers accrued to the beginning of 1 July 2021. Our calculation uses the half year 2021 weighted average cost of capital (WACC) and first year WACC of the 2021–26 regulatory control period to determine the present value equivalent amount, which we have included in revenues for 2021–22.

8.4.2 Application in the 2021–26 control period

As described in section 8.3, under the NER we must determine whether the EBSS will apply to Jemena in the 2021–26 regulatory control period.[24] In doing so we must have regard to a number of factors.[25] Our draft decision is not to apply the EBSS for Jemena in the 2021–26 regulatory control period. As outlined in the Victorian distributors' framework and approach, the application of the EBSS will occur only if the opex forecast for the following period is based on the distributor's revealed cost.[26] As our Jemena opex assessment has identified its revealed opex as materially inefficient, and Jemena's proposal has not shown it aims to reach an efficient level of opex by the end of the 2021–26 regulatory control period, we cannot be satisfied that we are likely to use revealed costs in the following period.[27] Uncertainty about whether or not revealed costs will be used for the next regulatory period (2026–31) when determining the opex forecast means Jemena's consumers could pay the costs of the EBSS without getting the benefits inherent in the revealed cost approach.

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23 AER, *Correspondence to Jemena – Victorian EDPR and the six-month extension*, 17 August 2020

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

25 NER, cl. 6.5.8(c).

26 AER, *Final framework and approach for AusNet Services, CitiPower, Jemena, Powercor and United Energy*, January 2019, pp. 80–83.

27 AER, *Jemena distribution determination 2021–26 – Attachment 6 – Operating expenditure*, September 2020.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
CCP17	Consumer Challenge Panel, sub-panel 17
CESS	capital expenditure sharing scheme
CPI	consumer price index
distributor	distribution network service provider
DMIA	demand management innovation allowance
EBSS	efficiency benefit sharing scheme
GSL payments	guaranteed service level payments
NEL	National Electricity Law
NER	National Electricity Rules
opex	operating expenditure
PTRM	post-tax revenue model
RIN	regulatory information notice
WACC	weighted average cost of capital