



# **DRAFT DECISION**

## **Powercor Distribution Determination 2021 to 2026**

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

September 2020

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Inquiries about this publication should be addressed to:

Australian Energy Regulator  
GPO Box 520  
Melbourne Vic 3001

Tel: 1300 585 165

Email: [VIC2021-26@aer.gov.au](mailto:VIC2021-26@aer.gov.au)

## Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Powercor 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

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

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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 regulated prices.

This attachment sets out our draft decision on the EBSS carryover amounts Powercor 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 –\$12.1 million (\$2020–21) from the application of the EBSS in the 2016–20 regulatory control period.<sup>1</sup> This is \$12.0 million (\$2020–21) lower than Powercor’s proposal of –\$0.0 million (\$2020–21).<sup>2</sup> This difference reflects a number of adjustments we have made to correctly apply the scheme. In particular, the following differences exist between Powercor’s proposal and our decision:

- we have updated the actual opex amounts for 2018 and 2019, decreasing total carryovers by \$12.3 million (\$2020–21)
- we did not accept Powercor's proposal to exclude the forecast and actual opex of cost categories that include defined benefit superannuation and licence fee adjustments in 2014 and 2015 from total opex. While these opex categories were excluded from Powercor's EBSS in the 2011–15 regulatory control period, they were not in the 2016–20 regulatory control period. Thus, the correct treatment would be to include them in the calculation of carryovers. This increases total carryovers by \$2.1 million (\$2020–21)
- we removed different amounts of movements in provisions from actual opex, decreasing total carryovers by \$0.2 million (\$2020–21)
- we used updated inflation figures to convert amounts into 2020–21 dollars, increasing total carryovers by \$1.1 million (\$2020–21)
- we have included the EBSS carryovers for the six month extension period to 2021–22, decreasing total carryovers by \$2.7 million (\$2020–21).

We set out our draft decision on Powercor’s EBSS carryover amounts in table 8.1.

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

<sup>2</sup> Powercor, *2021–2026 Regulatory proposal – Supporting document RIN005 – Workbook 5 – EBSS*, January 2020.

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

	HY2021	2021–22	2022–23	2023–24	2024–25	2025–26	Total
Powercor's proposal	–*	7.8	–0.6	–4.1	–3.2	–	–0.0
AER draft decision	–2.7	7.3	–3.1	–7.8	–5.7	–	–12.1
Difference	–2.7	–0.6	–2.5	–3.7	–2.5	–	–12.0

Source: Powercor, *2021–2026 Regulatory proposal – Supporting document RIN005 – Workbook 5 – EBSS*, January 2020; AER analysis.

\* Powercor calculated a carryover of –\$4.9 million (\$2020–21) for the six month extension period. It did not include this amount in its proposed revenues for the six month extension period or the 2021–26 regulatory control period.

Note: Numbers may not add up due to rounding.

We will continue to apply version 2 of the EBSS to Powercor in the 2021–26 regulatory control period.<sup>3</sup> Consistent with Powercor's proposal, we will exclude debt raising costs and guaranteed service level (GSL) payments from the EBSS because we have forecast them on a category specific basis and expect to continue doing so in the 2026–31 regulatory control period. We will also make other adjustments as permitted by the EBSS, such as removing demand management innovation allowance costs, and movements 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.

**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	267.1	273.1	138.9	259.7	260.7	263.6	266.5	270.0
Less GSL payments	–3.4	–3.4	–1.7	–2.6	–2.6	–2.6	–2.6	–2.6
Less debt raising costs	–2.1	–2.2	–1.1	–2.1	–2.2	–2.3	–2.3	–2.3
<b>Forecast opex for the EBSS</b>	<b>261.6</b>	<b>267.4</b>	<b>136.2</b>	<b>255.0</b>	<b>256.0</b>	<b>258.7</b>	<b>261.6</b>	<b>265.1</b>

Source: AER, *Draft decision, Powercor distribution determination 2021–26, PTRM*, September 2020; AER, *Draft decision, Powercor distribution determination 2021–26, EBSS model*, September 2020; AER analysis.

Note: Numbers may not add up due to rounding.

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

<sup>3</sup> NER, cl. 6.12.1(9); AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

## 8.2 Powercor's proposal

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

Powercor proposed we include EBSS carryover amounts totalling –\$0.0 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.<sup>4</sup> Powercor excluded the following cost categories in calculating its EBSS carryover amounts:

- debt raising costs
- demand management innovation allowance
- GSL payments
- defined benefit superannuation, licence fees and pass through opex
- It also reversed its movements in provisions related to opex.

In November 2019 we advised Powercor that we did not intend to include any EBSS carryovers in its revenues for the six month extension period. Instead any carryover increments or decrements would be deferred to begin from 1 July 2021.<sup>5</sup> Powercor did not propose including any EBSS carryovers in its half year extension period revenues. However, Powercor did not include the decrement it calculated for the half year extension period in the EBSS carryovers it proposed for the 2021–26 regulatory control period.

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

Powercor proposed we continue to apply the EBSS in the 2021–26 regulatory control period.<sup>6</sup> It also proposed that we apply the same adjustments and exclusions for the 2021–26 regulatory control period as we applied in the 2016–20 regulatory control period, including:

- debt raising costs
- GSL payments
- the demand management innovation allowance.

### 8.2.3 Stakeholder submissions

The Victorian Community Organisation (VCO) raised concerns about whether the EBSS is getting opex to the efficiency frontier. The VCO stated that it is unclear whether this is due to the framework design of the EBSS, or whether we are not using

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<sup>4</sup> Powercor, *2021–2026 Regulatory proposal – Supporting document RIN005 – Workbook 5 – EBSS*, January 2020.

<sup>5</sup> AER, *Letter to CitiPower, Powercor and United Energy—Reset timing interim measure*, 6 November 2019.

<sup>6</sup> Powercor, *2021–26 Regulatory proposal*, January 2020, p. 147.

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 capex programs that lead to opex reductions and therefore EBSS carryover benefits.<sup>7</sup>

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.<sup>8</sup>

Similar to EUAA, the AER's Consumer Challenge Panel, sub-panel 17 (CCP17) noted the significant EBSS and 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.<sup>9</sup>

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.

### 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>10</sup>
- how the EBSS will apply to Powercor in the 2021–26 regulatory control period.<sup>11</sup>

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between service providers and network users.<sup>12</sup> We must also have regard to the following matters when implementing the EBSS:<sup>13</sup>

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<sup>7</sup> VCO, *EDPR 2021–26 Submissions to Initial Proposal*, May 2020, pp. 69–70.

<sup>8</sup> EUAA, *Submission AusNet Services EDPR 21–26*, 10 June 2020, p. 2.

<sup>9</sup> CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determinations 2021–26*, 10 June 2020, p. 2.

<sup>10</sup> NER, cl. 6.4.3(a)(5).

<sup>11</sup> NER, cll. 6.3.2(a)(3), cl. 6.12.1(9).

<sup>12</sup> NER, cl. 6.5.8(a).

<sup>13</sup> NER, cl. 6.5.8(c).



- 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 Powercor with a continuous incentive to reduce opex
- the desirability of both rewarding Powercor for efficiency gains and penalising it for efficiency losses
- any incentives that Powercor 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>14</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.

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

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<sup>14</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: NEL, s 16(1)(c).

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 Powercor 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 Powercor'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 –\$12.1 million (\$2020–21) from the application of the EBSS in the 2016–20 regulatory control period.<sup>15</sup> This is \$12.0 million (\$2020–21) lower than Powercor's proposal of –\$0.0 million (\$2020–21). This difference reflects a number of adjustments we made to correctly apply the scheme with the key differences to Powercor's proposal and our decision are 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 Powercor and its network users. It both rewards Powercor 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 Inflation

We used updated inflation forecasts compared to those Powercor proposed. For 2019 we used the actual CPI figures published by the Australian Bureau of Statistics, which were released after Powercor submitted its proposal.<sup>16</sup> For 2020–21 we used the inflation forecast in the Reserve Bank of Australia's August 2020 *Statement on monetary policy*.<sup>17</sup> This was also published after Powercor submitted its proposal.

#### 8.4.1.2 Incremental efficiency gain in 2016

To calculate the incremental efficiency gain for 2016, we included defined benefit superannuation and licence fee adjustments from Powercor's forecast and actual opex for 2014 and 2015. Powercor, however, incorrectly excluded these costs. These

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<sup>15</sup> NER, cl. 6.4.3(a)(5).

<sup>16</sup> Australian Bureau of Statistics, *Catalogue number 6401.0, Consumer price index*, June 2020.

<sup>17</sup> Reserve Bank of Australia, *Statement on monetary policy, Appendix: Forecasts*, August 2020.

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.<sup>18</sup> We did not exclude these costs because doing so would result in the incremental gain calculated for 2016 including the incremental gain made in 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 defined benefit superannuation and licence fee adjustments from Powercor'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 gain made in 2015 related to defined benefit superannuation and licence fee adjustments.

#### **8.4.1.3 Movements in provisions**

We have updated the value of movement in provisions in 2018 to align with values reported in the Economic Benchmarking regulatory information notices (RINs). There was also an immaterial variance in 2016 between Powercor's EBSS proposal and the Economic Benchmarking RIN. Powercor confirmed that the submitted RIN contained an immaterial error.<sup>19</sup>

#### **8.4.1.4 Updates for 2018**

We have updated the actual opex amount for 2018 to align with the 2018 Annual RIN.<sup>20</sup> Powercor confirmed that the reported actual opex amount in the Annual RIN was correct.<sup>21</sup>

#### **8.4.1.5 Updating for 2019 actuals**

Powercor calculated its proposed EBSS carryovers using an estimate of its 2019 opex because its actuals were not available at the time Powercor submitted its proposal.

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<sup>18</sup> AER, *Final decision, Powercor distribution determination 2016–20, Attachment 9 Efficiency benefit sharing scheme*, May 2016, pp. 11–12.

<sup>19</sup> Powercor, *Information Request 33*, 10 June 2020.

<sup>20</sup> Powercor, *Powercor 2018 – Annual RIN – Templates – Consolidated*, April 2019.

<sup>21</sup> Powercor, *Information Request 33*, 10 June 2020.

We have updated the EBSS carryover calculations to reflect actuals reported in both the annual and economic benchmarking RINs. This has an impact on total reported opex, GSL payments and movements in provisions for 2019.

#### **8.4.1.6 Half year 2021 EBSS carryovers**

As outlined in our six month extension guidance,<sup>22</sup> we have deferred the half year 2021 EBSS carryovers accrued to the beginning of 1 July 2021. Our calculation uses the half year 2021 weight 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**

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

Version 2 of the EBSS specifies our approach to adjusting forecast or actual opex when calculating carryover amounts.<sup>23</sup> We provide details on these below.

#### **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 regulatory control 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 benefits of these revealed efficiency gains to network users. It follows that network users should not pay for EBSS rewards where they do not receive the benefits of a lower opex forecast.

For the 2021–26 regulatory control period we have not forecast debt raising cost and GSL payments using a single year revealed cost forecasting approach. If we do the same for the 2026–31 regulatory control period we will exclude these costs from the EBSS for the 2021–26 regulatory control period.

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<sup>22</sup> AER, *Correspondence to Powercor – Victorian EDPR and the six-month extension*, 17 August 2020.

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

In addition to the excluded cost categories discussed above, we will also make the following adjustments when we calculate the EBSS carryover amounts accrued during the 2021–26 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.
- 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>24</sup>
- Adjust actual opex to add capitalised opex that has been excluded from the regulatory asset base.<sup>25</sup>
- Adjust forecast opex and actual opex for inflation.<sup>26</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>27</sup>

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<sup>24</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>25</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>26</sup> AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

<sup>27</sup> AER, *Efficiency benefit sharing scheme for electricity network service providers, Explanatory Statement*, November 2013, p. 14.

## 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
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

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