Draft decision

Directlink transmission determination

2015-16 to 2019-20

Attachment 9: Efficiency benefit sharing scheme

November 2014

AUSTRALIAN ENERGY REGULATOR

Inquiries about this document should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Tel: (03) 9290 1444
Fax: (03) 9290 1457
Email: AERInquiry@aer.gov.au

AER reference: 53446

Note

This attachment forms part of the AER's draft decision on Directlink's revenue proposal 2015–20. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – maximum allowed revenue

Attachment 2 – regulatory asset base

Attachment 3 – rate of return

Attachment 4 – value of imputation credits

Attachment 5 – regulatory depreciation

Attachment 6 – capital expenditure

Attachment 7 – operating expenditure

Attachment 8 – corporate income tax

Attachment 9 – efficiency benefit sharing scheme

Attachment 10 – capital expenditure sharing scheme

Attachment 11 – service target performance incentive scheme

Attachment 12 – pricing methodology and negotiated services

Attachment 13 – pass through events

Contents

Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria

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 pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

9 Efficiency benefit sharing scheme

The efficiency benefit sharing scheme (EBSS) is a key component of incentive regulation employed under the NER. Because opex is largely recurrent and predictable, opex in one period is generally a good indicator of opex in the next period. Where a service provider is relatively efficient, we use the actual opex it incurred in a chosen base year of the regulatory control period to forecast opex for the next regulatory control period.

To encourage a service provider to become more efficient it is allowed to keep any difference between its approved forecast and its actual opex during a regulatory control period. This is supplemented by the EBSS which provides the service provider with an additional reward for any incremental efficiency gains it makes or imposes a penalty for any incremental efficiency losses incurred. In total, these rewards work together to provide a constant incentive for a service provider to pursue efficiency gains over the regulatory control period. The EBSS also discourages a service provider from incurring opex in the expected base year in order to receive a higher opex allowance in the following regulatory control period.

When a service provider is rewarded for making efficiency gains, consumers benefit through lower prices in the next regulatory control period. This is because forecast opex in the next regulatory control period will reflect the service provider's lower level of opex in the current regulatory control period. As a result, regulated prices will be lower.[1]

An EBSS did not apply to Directlink during the 2006–15 regulatory control period. Under the NER we must decide if and how the EBSS will apply to Directlink in the 2015–20 regulatory control period.[2]

9.1 Draft decision

We will apply version two of the EBSS to Directlink during the 2015–20 regulatory control period.[3] In applying the EBSS to Directlink in the 2015–20 regulatory control period we will exclude debt raising costs.

Table 9.1 illustrates the total opex forecasts we expect we will use to calculate efficiency gains and losses for the 2015–20 regulatory control period.

Table 9.1 Draft decision on Directlink's forecast opex for the EBSS ($ million, 2014–15)

	2015-16	2016-17	2017-18	2018-19	2019-20
Approved forecast opex for EBSS	3.79	3.08	3.17	3.12	3.14

Source: AER analysis

9.2 Proposal

Directlink proposed excluding two cost categories from version two the EBSS which will apply to it in the 2015–20 regulatory control period:

- debt raising costs

1 These concepts are explained more fully in the EBSS itself, released in November 2013.
2 NER, clause 6A.4.2(a)(6).
3 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

- fees levied by TransGrid under (forthcoming) Rules 6A.29A.4 or 6A.29A.5.[4]

Directlink proposed we exclude fees that may be levied by TransGrid under (forthcoming) Rules 6A.29A or 6A.29A.5 from the operation of the EBSS because of uncertainty around if and how much TransGrid would charge. From 1 July 2015, TransGrid will be able to levy fees on Directlink to cover its administrative costs for being the coordinating service provider in the region. Directlink considered the fees should be excluded from the EBSS because TransGrid has not advised them of any such fees, Directlink is unable to forecast whether these fees, if levied, will be a significant proportion of future opex and they are uncontrollable costs unrelated to Directlink's efficiency.

9.3 Assessment approach

Under the NER we must decide the values that are to be attributed to the EBBS parameters for the purposes of the application to Directlink of any EBSS that applies in the 2015–20 regulatory control period.[5]

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.[6] We must also have regard to the following factors when implementing the EBSS:[7]

- the need to provide service providers with continuous incentives to reduce opex
- the desirability of both rewarding service providers for efficiency gains and penalising it for efficiency losses
- any incentives that service providers may have to inappropriately capitalise opex
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

9.4 Reasons for draft decision

We will apply version two of the EBSS to Directlink during the 2015–20 regulatory control period.[8] We consider the EBSS is needed to provide Directlink with a continuous incentive to pursue efficiency gains during the during the 2015–20 regulatory control period. As we typically rely on a revealed cost approach to forecasting opex, we consider the EBSS is also needed to provide Directlink with an incentive not to increase its opex in the expected base year.

Version two of the EBSS specifies our approach to determining the length of the carryover period, calculating the incremental efficiency gains and adjusting forecast or actual opex when calculating carryover amounts. These are detailed below.

Length of carryover period

The carryover period will be five years. We consider this provides Directlink with a reasonable reward for pursuing efficiency gains. A five year carryover period would share efficiency improvements between Directlink and its consumers approximately 30:70. We do not consider a longer carryover period is necessary to incentivise efficiency improvements.

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4 Directlink, *Revenue proposal*, p. 92.
5 NER, clause 6A.4.2(a)(6).
6 NER, clause 6A.6.5(a).
7 NER, clause 6A.6.5(b).
8 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

Incremental efficiency gains

We will calculate incremental efficiency gains differently depending on whether they are in:

- the first regulatory year
- the second regulatory year to the penultimate regulatory year
- the final regulatory year.

We will do this according to the formulas set out in version two of the EBSS except for the first regulatory year.[9] The formula to calculate the efficiency gain in the first regulatory year in version two of the EBSS subtracts any incremental efficiency gain made in the previous regulatory control period after the base year. [10] This approach is designed to ensure that the EBSS provides continuous rewards and penalties where it operates across two regulatory control periods and we use a base year forecasting approach.[11] This first year formula applies to service providers already subject to an EBSS.

Directlink is not subject to an EBSS in the 2006–15 regulatory control period and Directlink's opex was not forecast using a base year. For these reasons, it does not make sense to subtract any incremental gain made in the previous regulatory control period after the base year. Consequently, the formula to calculate the efficiency gain in the first year of the new period will be the difference between actual opex and forecast opex in that year. This is consistent with the formula used in previous versions of the EBSS to calculate first year efficiency gains when the EBSS was applied to a service provider for the first time.[12]

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

Adjustments to forecast or actual opex when calculating carryover amounts

The EBSS allows for exclusions of categories of costs from the EBSS where we do not use a single year revealed cost forecasting approach. This is designed to ensure the EBSS gives effect to fair sharing of efficiency gains and losses. If we do not use a single year revealed cost forecasting approach, there is a risk a service provider could receive EBSS carryover rewards or penalties that far exceed the cost reduction or increase.

When we apply the EBSS to Directlink we will exclude debt raising costs because these are not typically forecast using a single year revealed cost approach.

However, when we apply the EBSS to Directlink we will not exclude fees levied by TransGrid under (forthcoming) rules 6A.29A.4 or 6A.29A.5.

Directlink proposed excluding future fees TransGrid may levy from the EBSS on the grounds that they would be uncontrollable, uncertain and possibly significant. We do not accept that there are sufficient reasons to exclude cost categories from the EBSS on the grounds they are uncontrollable or uncertain. Rather, by including such costs in the EBSS, uncontrollable cost decreases or increases

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9 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, pp. 5-7.
10 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 6.
11 NER, clause 6A.6.5(b)(1).
12 AER, *Electricity transmission network service providers Efficiency benefit sharing scheme,* September 2007, p. 6.

are shared between service providers and consumers in the same way as any efficiency gain or loss (that is, approximately 30:70 with a five year carryover period). We acknowledge the EBSS will reward or penalise service providers for some forecasting error associated with uncontrollable or uncertain events. However, on the whole, the risk of uncontrollable or uncertain events presents both upside and downside risk to service providers. We do not think there is a compelling argument to share the cost of these events differently to all other costs facing service providers. Even if this were not the case, we would not exclude the cost of fees levied by TransGrid under (forthcoming) Rules 6A.29A.4 or 6A.29A.5 from the EBSS because we have not included an amount for such fees in Directlink's opex forecast. This is because TransGrid submitted that it was not going to charge Directlink this fee. We discuss this in the opex attachment.

In addition to excluding debt raising costs when we calculate Directlink's carryover amounts we will also:

- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the initial regulatory determination. This may include approved pass through amounts or opex for contingent projects
- adjust actual opex to add capitalised opex that has been excluded from the Regulatory Asset Base
- exclude categories of opex not forecast using a single year revealed cost approach for the regulatory control period beginning in 2020 where doing so better achieves the requirements of clause 6A.6.5 of the NER.

Table 9.2 sets out our draft decision on Directlink's target opex for the EBSS (total opex less excluded categories), against which we will calculate efficiency gains in the 2015–20 regulatory control period.

Table 9.2 Draft decision on Directlink's forecast opex for the EBSS ($ million, 2013–14)

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Directlink's total forecast opex	3.87	3.16	3.24	3.19	3.21	16.66
Debt raising costs	0.07	0.07	0.07	0.07	0.07	0.35
Forecast opex for the EBSS	3.79	3.08	3.17	3.12	3.14	16.31