DRAFT DECISION
Endeavour Energy
Distribution determination

2019–24

Attachment 8 – Efficiency benefit sharing scheme

November 2018

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 Endeavour Energy for the 2019–24 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

Attachment 12 – Classification of services

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
AGL	AGL Energy
CCP/CCP10	Consumer Challenge Panel, sub-panel 10
distributor	distribution network service provider
EBSS	efficiency benefit sharing scheme
NER	National Electricity Rules
opex	operating expenditure

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 revenue.

This attachment sets out our draft decision on the EBSS carryover amounts Endeavour Energy (Endeavour) has accrued over the 2014–19 regulatory control period, and how we will apply the EBSS over the 2019–24 period.

8.1 Draft decision

Our draft decision is to include EBSS carryover amounts totalling $234.9 million ($2018–19) from the application of the EBSS in the 2014–19 regulatory control period.[1] This is $0.2 million lower than Endeavour's proposal of $235.1 million ($2018–19). This difference reflects our inflation forecast compared to Endeavour's, which incorporates the latest information.[2]

Our draft decision is based on Endeavour's estimated opex for 2017–18. In our final decision, we will update our calculation of the carryover amounts using actual opex in 2017–18. We will also update our inflation forecast in our final decision.

We set out our draft decision on Endeavour's EBSS carryover amounts in Table 8.1 along with Endeavour's 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
Endeavour's proposal	23.2	69.1	78.7	64.1	0.0	**235.1**
AER draft decision	23.1	69.0	78.7	64.0	0.0	**234.9**
Difference	**–0.1**	**–0.1**	**–0.0**	**–0.1**	**0.0**	**–0.2**

Source: Endeavour Energy, *0.03 Post tax revenue model*, April 2018; AER, *Endeavour Energy draft decision - Post tax revenue model*, November 2018; AER analysis.

Note: Numbers may not add up due to rounding.

We will continue to apply version 2 of the EBSS to Endeavour in the 2019–24 regulatory control period.[3] Consistent with Endeavour's proposal, we will exclude debt

1 NER, cll. 6.12.1(9); and 6.4.3(5).

2 Reserve Bank of Australia, *Statement on Monetary Policy*, August 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).

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

raising costs from the scheme as a pre-defined 'excluded category'. We will also make other adjustments as permitted by the EBSS, such as removing demand management innovation allowance costs, and reverse movements in provisions.[4]

Table 8.2 sets out the opex forecasts we will use to calculate efficiency gains in the 2019–24 regulatory control period, including forecast debt raising costs.

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
Total forecast opex	272.7	278.0	280.6	286.0	293.2	300.7	308.1
Less debt raising costs	–3.4	–3.4	–3.2	–3.3	–3.3	–3.4	–3.4
Forecast opex for the EBSS	269.4	274.6	277.3	282.7	289.9	297.3	304.7

Source: AER, *Endeavour Energy draft decision - Post tax revenue model*, November 2018; AER analysis.

Note: Numbers may not add up due to rounding.

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

8.2 Endeavour Energy's proposal

8.2.1 Carryover amounts from the 2014–19 control period

Endeavour proposed we include EBSS carryover amounts totalling $235.1 million ($2018–19) to its revenue in the 2019–24 regulatory control period, from the application of the EBSS in the 2014–19 period.[5]

Endeavour excluded the following cost categories in calculating its EBSS carryover amount:[6]

- demand management incentive allowance (DMIA)[7]
- capitalisation policy changes
- legal costs for its 2015 appeals process.

It also reversed its movements in provisions related to opex.

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4 The further adjustments are outlined in section 8.4.

5 Endeavour Energy, *0.03 Post tax revenue model*, April 2018.

6 Endeavour Energy, *RIN0.03 Final RIN workbook 5 EBSS (consolidated)*, 30 April 2018.

7 Endeavour referred to these costs as non-network alternative costs in its EBSS model. However, we have identified these as costs associated with its demand management incentive allowance.

8.2.2 Application in the 2019–24 control period

Endeavour proposed we continue to apply version 2 of the EBSS in the 2019–24 regulatory control period. It also proposed to exclude the following cost categories from the EBSS that are not forecast using a single year revealed cost approach:[8]

- debt raising costs
- demand management incentive allowance
- movements in provisions.

8.2.3 Stakeholder submissions

The Consumer Challenge Panel (CCP10) and AGL Energy (AGL) each provided a submission on the general application of the EBSS.

CCP10 stated it was concerned soft assumptions on productivity creates positive expected EBSS bonuses for utilities, and is consequently inconsistent with the long-term interests of consumers.[9] We agree that inefficient opex allowances can create a positive or negative expected EBSS carryover for businesses. However, we don't consider this is a problem with the EBSS. Rather, this is best addressed by providing a forecast of opex that reasonably reflects the efficient costs of a prudent distributor.

Our opex forecast set out in Attachment 6 provides our best estimate of Endeavour's efficient costs over the 2019–24 regulatory control period. This includes our best estimate of productivity growth. However, we note we are currently reviewing our approach to forecasting productivity. This is discussed in more detail in our opex attachment.[10]

AGL stated that it is yet to observe any benefit for consumers through the EBSS. It also stated that the benchmarking of expenditure allowances provides ample incentives for networks to pursue improvements in efficiency. Consequently, it is not a supporter of the EBSS.[11]

We note that the EBSS is an important part of our incentive regulation framework. It works in conjunction with our revealed cost approach to address the potential incentive problems of using a single year to forecast opex. The EBSS provides distributors a continuous incentive to reduce opex and allows us to use a single year of revealed opex to forecast. We then support this with other tools, such as benchmarking, to ensure businesses have responded to the incentives in place.[12]

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8 Endeavour Energy, *0.01 Regulatory proposal*, April 2018, p.90.

9 CCP10 - *Submission on Endeavour Energy 2019–24 regulatory proposal*, 8 August 2019, p.34.

10 AER, Attachment 6 Operating expenditure, *Endeavour Energy draft decision*.

11 AGL - *Submission on Endeavour Energy 2019–24 regulatory proposal*, 14 September 2018, p.5.

12 More information on the EBSS can be found here: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/efficiency-benefit-sharing-scheme-ebss-%E2%80%93-november-2013.

8.3 AER's assessment approach

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

- the revenue increments or decrements for each year of the 2019–24 regulatory control period arising from the application of the EBSS during the 2014–19 regulatory control period[13]
- how the EBSS will apply to Endeavour in the 2019–24 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 Endeavour 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 assess or develop our opex forecast, the rules 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

[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).

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 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

8.4.1 Carryover amounts from the 2014–19 control period

Our draft decision is to include EBSS carryover amounts totalling $234.9 million ($2018–19) from the application of the EBSS in the 2014–19 regulatory control period. This is $0.2 million ($2018–19) less than what Endeavour proposed, and is driven by our inflation forecast incorporating the latest information.[18]

In determining the EBSS carryover amount, we have excluded costs associated with Endeavour's demand management incentive allowance, its capitalisation policy changes, and its 2015 legal costs for its appeals process.[19] We have also reversed Endeavour's movements in provisions related to opex. Our adjustments are consistent with the National Electricity Law, version 2 of the EBSS, and Endeavour's proposal.[20]

In our final decision, we will update our calculation of the carryover amounts using actual opex in 2017–18. Our draft decision is based on Endeavour's estimated opex for 2017–18 because actual data is not yet available. We will also update our inflation forecast in our final decision.

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18 Reserve Bank of Australia, *Statement on Monetary Policy*, August 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).

19 NER, cl. 6.5.8(c).

20 AER, Efficiency benefit sharing scheme for electricity network service providers, November 2013, p.7; NEL, cl. 71YA(2)(b); Endeavour Energy, *0.01 Regulatory proposal*, April 2018, p.90.

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

Our decision is to continue to apply version 2 of the EBSS to Endeavour 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 Endeavour to reduce opex. This is because we have relied on Endeavour's 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 and adjusting forecast or actual opex when calculating carryover amounts.[21] We provide details on these below.

Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2019–24 regulatory control period will be the same as the length of Endeavour's following regulatory control period.[22] We expect Endeavour's next regulatory control period will be five years, starting 1 July 2024.

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.

As noted in section 8.2, Endeavour proposed to exclude debt raising costs, expenditure associated with its DMIA, and movements in provisions. [23]

Consistent with version 2 of the EBSS, we will only exclude debt raising costs from the EBSS as a pre-defined 'excluded category'. This is because we have not forecast debt raising on a revealed cost basis as part of base year operating expenditure. We instead forecast these using benchmarking.

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

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

23 Endeavour Energy, *0.01 Regulatory proposal*, April 2018, p.90.

In addition to the excluded cost category, we will also make the following adjustments when we calculate the efficiency gains and losses that will be carried over into the next 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.
- adjust actual opex to remove demand management innovation allowance operating expenditure because it is not included in the opex forecast (but is typically reported by service providers as part of their standard control opex)
- adjust actual opex to add capitalised opex that has been excluded from the regulatory asset base[24]
- 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 2024–29 regulatory control period, to the extent this better achieves the requirements of clauses 6.5.8 of the NER.[25]

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

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