



DRAFT DECISION
Essential Energy
Distribution determination

2019–24

Attachment 8 – Efficiency
benefit sharing scheme

November 2018

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Note

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

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

Attachment 13 – Control mechanism

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 - Tariff structure statement

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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 operating expenditure (opex), and provide for a fair sharing of these between distributors and network users. Consumers benefit from improved efficiencies through lower regulated revenues.

This attachment sets out how we will apply the EBSS to Essential Energy (Essential) over the 2019–24 regulatory control period.

8.1 Draft decision

Our draft decision is to apply version 2 of our EBSS to Essential in the 2019–24 regulatory control period.¹ This is consistent with Essential's proposal.²

The EBSS is closely linked to our opex revealed cost forecasting approach in choosing a base year to assess and develop a total opex forecast. Under this approach, a service provider has 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 to:

- remove 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
- provide a continuous incentive for a service provider to pursue efficiency improvements across the regulatory control period.

Where we do not propose to rely on the 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.

In our April 2015 opex decision for Essential's 2014–19 regulatory control period, we determined not to subject Essential's opex to the EBSS.³ This was because we relied on economic benchmarking to determine Essential's forecast opex for the 2014–19 period rather than a revealed cost approach. In this circumstance, we did not consider the EBSS was needed to incentivise efficient opex over the 2014–19 regulatory control period. We also noted in our 2015 decision that it is uncertain whether and to what extent we were likely to rely on Essential's revealed costs in the 2014–19 period in forecasting opex in the following regulatory control period.

¹ NER, cl.6.12.1(9).

² Essential Energy, *2019–24 Regulatory proposal*, April 2018, p.43.

³ AER, *Final decision Essential Energy distribution determination*, Attachment 9, Efficiency benefit sharing scheme, April 2015, p.6.

As set out in Attachment 6, we have relied on Essential's revealed costs as the base year to forecast efficient opex over the 2019–24 regulatory control period. This is because we consider Essential's revealed costs in 2017–18 are no longer materially inefficient.⁴ We also consider it is reasonably likely that we will rely on Essential's revealed costs over the 2019–24 regulatory control period to forecast opex in the following regulatory control period.

For these reasons, we are applying the EBSS to Essential in the 2019–24 regulatory control period.

8.1.1 Stakeholder submissions

The AER 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 create positive expected EBSS bonuses for utilities, and are consequently inconsistent with the long-term interests of consumers.⁵ 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 opex that reasonably reflects the efficient costs of a prudent distributor.

Our opex forecast set out in Attachment 6 provides our best estimate of Essential'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.⁶

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.⁷

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 costs to forecast opex. We then support this with other tools, such as benchmarking, to ensure businesses have responded to the incentives in place.⁸

⁴ AER - Essential Energy 2019-24 - Draft decision - Attachment 6 - Operating Expenditure - November 2018, p.20.

⁵ CCP10 - *Submission on Essential Energy 2019–24 regulatory proposal*, 8 August 2019, p.34.

⁶ AER - Essential Energy 2019-24 - Draft decision - Attachment 6 - Operating Expenditure - November 2018, p.27.

⁷ AGL - *Submission on Essential Energy 2019–24 regulatory proposal*, 14 September 2018, p.5.

⁸ 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>.

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

Under the National Electricity Rules (NER) we must determine how the EBSS will apply to Essential in the 2019–24 regulatory control period.⁹

Our draft decision is to apply version 2 of the EBSS to Essential during the 2019–24 regulatory control period.¹⁰ We consider applying the scheme would result in benefits for electricity customers and it will provide continuous incentives for Essential to reduce opex. This is because, as stated earlier, we have relied on Essential's revealed costs to forecast opex over the 2019–24 regulatory control period.

Version 2 of our EBSS guideline specifies our approach to determining the length of the EBSS carryover period, and adjusting forecast or actual opex when calculating carryover amounts. We provide details on these below.

8.2.1 Length of carryover period

The EBSS operates by carrying forward a service provider's incremental efficiency gains or losses for the length of a carryover period. These carryover amounts will be added or subtracted as an additional building block when determining Essential's revenue allowance for the 2024–29 regulatory control period.

The length of the carryover period for the 2019–24 regulatory control period should be the same length as the regulatory control period commencing on 1 July 2024. This aligns the EBSS carryover period with the total length of Essential's regulatory control period and ensures continuous incentives.¹¹ We expect Essential's next regulatory control period will be five years; that is, the period starting 1 July 2024.

8.2.2 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.

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

¹⁰ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

¹¹ NER, cl. 6.5.8(c)(2).

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.

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 base¹²
- 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 that this better achieves the requirements of clauses 6.5.8 of the NER.¹³

Essential proposed to apply the EBSS in accordance with the relevant guideline. It did not propose to exclude any specific cost categories from the scheme in the 2019–24 regulatory control period.¹⁴

¹² NER, cl. 6.5.8(c)(4) requires us to have regard to any incentives the service provider may have to capitalise expenditure.

¹³ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p.9.

¹⁴ Essential Energy, *2019–24 Regulatory proposal*, April 2018, p.43.