



**FINAL DECISION**  
**Ausgrid distribution**  
**determination**  
**2015–16 to 2018–19**

**Attachment 9 – Efficiency**  
**benefit sharing scheme**

April 2015

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## Note

This attachment forms part of the AER's final decision on Ausgrid's revenue proposal for 2015–19. It should be read with other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 - Annual revenue requirement

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 - Demand management incentive scheme

Attachment 13 - Classification of services

Attachment 14 - Control mechanism

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	expenditure forecast assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
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 and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

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## 9 Efficiency benefit sharing scheme

The efficiency benefit sharing scheme (EBSS) provides an additional incentive for service providers to pursue efficiency improvements in opex.

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 reductions in opex and additional penalties for increases in opex. In total these rewards and penalties work together to provide a continuous 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.

During the 2009–14 regulatory control period Ausgrid operated under the EBSS for the ACT and NSW 2009 distribution determinations, which was released in February 2008.<sup>1</sup>

### 9.1 Final decision

We are not satisfied Ausgrid's proposed EBSS carryover amounts comply with the requirements of the EBSS that Ausgrid operated under during the 2009–14 regulatory control period. The difference between our calculations of the EBSS carryover amounts and Ausgrid's proposal is due to the treatment of provisions recorded as opex. Our final decision for the EBSS carryover amounts from the 2009–14 regulatory control period is outlined in Table 9.1. It is the same as our draft decision.

**Table 9.1 AER's final decision on Ausgrid's EBSS carryover amounts (\$ million, 2013–14)**

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Ausgrid's proposed carryover	99.7	108.9	83.3	134.3	0.0	426.3
Final decision	83.9	75.7	59.5	41.2	0.0	260.3

Source: AER analysis; Ausgrid, *Revised proposal - Attachment 4.07*.

No expenditure incurred by Ausgrid will be subject to the EBSS during the 2015–19 regulatory control period.<sup>2</sup> This position is also consistent with our draft decision.

<sup>1</sup> AER, *Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations*, February 2008.

<sup>2</sup> We have previously determined that the EBSS that applied to Ausgrid in the 2009-14 regulatory control period will apply to Ausgrid in the 2014–15 transitional regulatory control period but modified to be in terms of version 2 of the EBSS as if the transitional regulatory control period was the first year of the subsequent regulatory control period 2015–19 (that is, the first year in a period running from 2014–19). The effect of our decision is that no expenditure

## 9.2 Draft decision

### 9.2.1 Carryover amounts accrued during the 2009–14 regulatory control period

We considered Ausgrid should receive EBSS carryover amounts of \$260.3 million (\$2013–14) from the application of the EBSS during the 2009–14 regulatory control period. Our calculation was in accordance with section 2.3 of the EBSS for the ACT and NSW 2009 distribution determinations.<sup>3</sup>

Under the EBSS for the ACT and NSW 2009 distribution determinations the EBSS carryover amounts are to be based on the difference between:

- approved forecast opex which is set out in our determination for Ausgrid for the 2009–14 regulatory control period, and
- actual opex for the regulatory years from 2009–10 to 2012–13 and estimated opex for 2013–14 less opex on excluded cost categories.

Our draft decision amount was different to that proposed by Ausgrid due to the treatment of provisions.

A provision is a type of accrual accounting practice. A business records a provision for an anticipated cost when it expects it will incur a cost in the future but the amount and timing of the cost has not yet crystallised. For accounting purposes, increases in provisions are typically allocated to expenditure, and, in particular, to opex. Accordingly if a business considers it is likely it will incur a future cost, or it expects the amount of the cost will be higher to that it has previously recorded, reported actual expenditure will increase. This means a business may sometimes record increases in expenditure when it estimates there is a change in a liability it faces. It may not actually expect to incur the cost for some time and the cost will not necessarily eventuate in the amount predicted. Similarly, if a business no longer considers it will incur a future cost, or it expects the amount of the cost will be lower than that it has previously recorded, reported actual expenditure will decrease.

In the 2009–14 regulatory control period, Ausgrid's opex was materially affected by changes in the valuation of its employee entitlement provisions. If the AER accepted changes in provisions as actual opex it would materially affect Ausgrid's EBSS carryover amounts.

We considered that changes in provisions should not be treated as actual opex for EBSS calculations. This is because changes in provisions reflect estimates of costs

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will be subject to the EBSS during the 2014–19 period. See AER, *Ausgrid, Endeavour Energy, Essential Energy, ActewAGL - Transitional distribution decision 2014–15*, 16 April 2014, pp. 47–48; AER, *Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013.

<sup>3</sup> AER, *Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations*, February 2008.



rather than changes in the actual cost incurred in delivering network services. This is consistent with the applicable EBSS which states:

In calculating carryover gains or losses, the AER must be satisfied that the actual and forecast opex accurately reflects the costs faced by the DNSP in the regulatory control period.<sup>4</sup>

We consider the actual amount incurred and charged against the provision in the regulatory control period better reflects the cost faced by the service provider. This is the amount actually paid by the service provider in meeting its liability. The difference between the recorded change in the provision and the amount incurred and charged against the provision is the movement in the provision. Our approach therefore is to remove the movement in provisions from a service provider's reported actual opex when calculating the EBSS carryover amounts. We have adopted this approach since the Victorian electricity distribution price review for the 2011–15 regulatory control period.<sup>5</sup>

The EBSS is designed to reward businesses for becoming more efficient over time and penalise them for becoming less efficient. It is the actual costs a service provider incurs that we are concerned about when measuring efficiency improvements. In contrast, provisions are estimates of future costs a business expects to incur. A change in a provision is, in essence, a revised estimate. Estimating future costs usually involves making assumptions. These assumptions often change over time as new information becomes available, creating forecasting uncertainty. The uncertainty about provisions and how to calculate them from year to year is what distinguishes them from other liabilities in the accounting standards.<sup>6</sup>

For example, to calculate the change in provisions for employee entitlements, a business must make assumptions about how much its current workers will be paid in the future, when it expects them to leave or retire, the rate at which they will take leave, as well as the time value of money. Significant discretion and judgment is involved in forming these assumptions. The valuation of the future liability can be very sensitive to small changes in assumptions. Accordingly, the amount charged to opex could change significantly in a given year with relatively minor changes in assumptions.

In implementing the EBSS we have regard to the desirability of both rewarding service providers for efficiency gains and penalising service providers for efficiency losses.<sup>7</sup> We considered that to reward or penalise a service provider for changes in provisions would reward or penalise it for changes in assumptions, not efficiency improvements. This undermines what the EBSS is intended to do. While provisions might need to be treated in a particular way for accounting purposes, for regulatory pricing purposes,

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<sup>4</sup> AER, *Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations*, February 2008, p. 6.

<sup>5</sup> AER, *Victorian electricity distribution network service providers - Distribution determination 2011–2015 Draft decision*, June 2010, pp. 586-587.

<sup>6</sup> AASB 137, clause. 11, p. 13.

<sup>7</sup> NER, cl. 6.5.8(c)(1).

treating provisions as actual costs can lead to perverse outcomes. Based on Ausgrid's calculations its consumers would pay for efficiency carryover amounts that do not reflect changes in the underlying level of efficiency in providing distribution services during the 2009–14 regulatory control period. We considered that to reward Ausgrid for changes in assumptions during the period would be contrary to the aims of the EBSS under the NER.

### **9.2.2 Application of the EBSS in the 2015–19 regulatory control period**

Our draft decision was that no expenditure will be subject to the EBSS during the 2015–19 regulatory control period.

We noted that the decision on how to apply the EBSS is intrinsically linked to the revealed cost forecasting method for opex.

Economic benchmarking indicates that Ausgrid's opex is higher than the opex incurred by a benchmark efficient service provider. In our draft decision, we also noted that Ausgrid has just over three years before it submits its next regulatory proposal. Based on these factors it is uncertain whether, and to what extent, we are likely to rely on Ausgrid's revealed costs in the 2014–19 period in forecasting opex in the following regulatory control period. If we do not use a revealed costs approach for forecasting opex in the future, there is not a strong reason to subject any expenditure to the current version of the EBSS.

For instance we consider Ausgrid will already face an incentive to make efficiency improvements while its actual opex is more than that of a benchmark efficient service provider. We do not need to subject any expenditure to an EBSS to further strengthen its incentives.

In the case where we apply the EBSS in the 2015–19 regulatory control period but do not rely on Ausgrid's revealed costs to forecast opex in the regulatory control period after that, there are some potentially perverse outcomes. For instance:

- If Ausgrid does not improve its efficiency over the period its revealed costs will not affect its opex forecast in the next period. This could result in Ausgrid incurring an EBSS penalty which would exceed its fair share of its efficiency loss. This outcome is not consistent with what we are seeking to achieve when we apply the EBSS.<sup>8</sup>
- If Ausgrid improves its efficiency it could receive EBSS rewards but it may still not benchmark well when compared to other service providers. In this case, Ausgrid's consumers would pay more than the efficient costs to receive the network service.

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<sup>8</sup> NER, cl. 6.5.8.

## 9.3 Ausgrid's revised proposal and submissions

### 9.3.1 Carryover amounts accrued during the 2009–14 regulatory control period

Ausgrid repropoed a total EBSS carryover amount of \$426.3 million (\$2013–14) be added to its regulated revenue in the 2014–19 period arising from the application of the EBSS in the 2009–14 regulatory control period.

Ausgrid did not agree with our draft decision. It considered:

- there is no rule that explicitly provides us with discretion to exclude a cost category after the determination for the 2009–14 regulatory control period
- movements in provisions in employee related costs are actual costs incurred by Ausgrid
- retrospective adjustments may dis-incentivise service providers because there is a risk that they will consider we will review or revise other efficiency gains or losses and jeopardise the incentive features of the EBSS
- even if Ausgrid agreed with our contention that these are not actual costs, it considered we made an error by not adjusting forecast opex to exclude the amount from forecast opex for the 2009–14 period.<sup>9</sup>

In support of its proposal, Ausgrid also submitted a report it commissioned from Ernst and Young.<sup>10</sup>

PIAC and the EMRF agreed with our draft decision to adjust for provisions.<sup>11</sup> The EMRF noted that provisions can be driven by factors external to the service provider. It considered that to reward service providers for factors external to the business would be contrary to the EBSS which aims to reward a service provider for the actions it takes to reduce its costs.<sup>12</sup>

### 9.3.2 Application of the EBSS in the 2015–19 regulatory control period

Ausgrid considered that if we accept its opex proposal then the EBSS should apply. However if we substitute a lower amount than it forecast, then it agrees that an EBSS should not apply.<sup>13</sup>

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<sup>9</sup> Ausgrid, *Revised proposal*, January 2015, pp. 64-65.

<sup>10</sup> Ernst and Young, *Accounting for provisions; assessing the AER's approach*, 19 January 2015.

<sup>11</sup> EMRF, *Response to revised proposals from Ausgrid, Endeavour Energy and Essential Energy*, February 2015, pp. 64-65; PIAC, *Submission to the AER's draft determination for Ausgrid, Endeavour Energy and Essential Energy*, 13 February 2015, p. 20.

<sup>12</sup> EMRF, *Response to revised proposals from Ausgrid, Endeavour Energy and Essential Energy*, February 2015, pp. 64-65.

<sup>13</sup> Ausgrid, *Revised proposal*, January 2015, p. 7.

Origin Energy and the CCP agreed with our draft decision not to subject any expenditure during the 2014–19 period to the EBSS.<sup>14</sup> Origin Energy noted that the EBSS would reward the NSW service providers in moving from an inefficient base to an efficient base.<sup>15</sup>

PIAC and the EMRF did not agree with our draft decision not to subject any expenditure to the EBSS.<sup>16</sup> The EMRF considered that this would affect the balance between capex and service incentives.<sup>17</sup>

## 9.4 AER's assessment approach

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

1. the revenue increments or decrements (if any) for each regulatory year of the 2014–19 period arising from the application of the EBSS during the 2009–14 regulatory control period<sup>18</sup>
2. how any applicable EBSS is to apply to Ausgrid in the 2014–19 period.<sup>19</sup>

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.<sup>20</sup> We must also have regard to the following factors when implementing the EBSS:<sup>21</sup>

- 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 service providers with continuous incentives, so far as is consistent with economic efficiency, to reduce opex
- the desirability of both rewarding 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.

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<sup>14</sup> CCP, *Response to NSW draft determinations and revised proposals from electricity distribution networks*, p. 53; Origin Energy, *Submission to AER draft determination for NSW electricity distributors*, p. 20.

<sup>15</sup> Origin Energy, *Submission to AER draft determination for NSW electricity distributors*, p. 21.

<sup>16</sup> PIAC, *Submission to the AER's draft determination for Ausgrid, Endeavour Energy and Essential Energy*, 13 February 2015, p. 20; EMRF, *Response to revised proposals from Ausgrid, Endeavour Energy and Essential Energy*, February 2015, p. 64.

<sup>17</sup> EMRF, *Response to revised proposals from Ausgrid, Endeavour Energy and Essential Energy*, February 2015, p. 64.

<sup>18</sup> NER, cl. 6.4.3(a)(5).

<sup>19</sup> NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).

<sup>20</sup> NER, cl. 6.5.8(a).

<sup>21</sup> NER, cl. 6.5.8(c).

## 9.4.1 Interrelationships

The EBSS is intrinsically linked to a revealed cost forecasting approach for opex. Under this forecasting approach, the EBSS has two specific functions:

- To mitigate the incentive for a service provider to increase opex in the expected 'base year' to increase its approved opex forecast for the following regulatory control period.
- To provide a continuous incentive for a service provider to make efficiency gains - service providers receive the same reward for an underspend and the same penalty for an overspend in each year of the regulatory control period.

Where we do not propose to rely on the revealed costs of a service provider in forecasting opex there are consequences for a service provider's incentives to make productivity improvements. This effects our decision on how we apply the EBSS. We have taken into account the interrelationship between the EBSS and our approach to opex forecasting, in reaching our decision.

Incentives to reduce opex may also affect a service provider's incentives to undertake capex. We take into account these interactions in developing and implementing the EBSS as well as developing the CESS. For instance:

- In developing and implementing the EBSS, we must have regard to any incentives that service providers may have to capitalise operating expenditure as well as the possible effects of the scheme on incentives for the implementation of non-network alternatives.<sup>22</sup>
- In developing the CESS, we must take into account the interaction of the scheme with other incentives that service providers may have in relation to undertaking efficient opex or capex as well as the capex objectives and, if relevant, the opex objectives.<sup>23</sup>

## 9.5 Reasons for final decision

### 9.5.1 Carryover amounts accrued during the 2009–14 regulatory control period

We have considered Ausgrid's revised proposal and have determined not to depart from our draft decision to approve an EBSS carryover amount of \$260.3 million (\$2013–14) from the application of the EBSS in the 2009–14 regulatory control period. We are satisfied that this amount is consistent with the terms of the EBSS and provides a fair sharing between Ausgrid and distribution network users of the actual efficiency gains made by Ausgrid over the 2009–14 regulatory control period, as required by the NER.

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<sup>22</sup> NER, cl. 6.4.3(a)(4),(5).

<sup>23</sup> NER, cl. 6.5.8A(d).

We disagree that our adjustment for movements in provisions is not allowed for under the EBSS. The EBSS states that:

the AER must be satisfied that the actual and forecast opex accurately reflects the costs faced by the DNSP in the regulatory control period.<sup>24</sup>

We are not satisfied that the changes in provisions Ausgrid reported as opex accurately reflects the costs it faced in the 2009–14 regulatory control period. This is because we consider changes in provisions reflect changes in estimates of costs that Ausgrid expects to incur. Thus for the purposes of calculating the EBSS carryover amounts, we have removed these estimates from Ausgrid's reported opex. We instead consider the amount Ausgrid incurred and charged against the provision better reflects the costs Ausgrid faced in meeting its obligations in the 2009–14 regulatory control period.

Changes in provisions reflect changes in expectations about when a cost will be incurred or the amount that will be incurred. A business re-estimates the value of its obligations every year so the amount recorded in its financial accounts best reflects current estimates. A revaluation may be based on different methods or assumptions for estimating those obligations than the year before.

Changes in the estimated value of Ausgrid's provisions were reported as opex. Assumptions underlying these estimates may help in ensuring Ausgrid's reported opex meets accounting standards. However, we disagree that this is something that should be rewarded or penalised for through the EBSS. Changes in assumptions about estimates for the future from year to year do not reflect efficiency gains that have been realised. The EBSS must provide for a fair sharing of efficiency gains and losses between Ausgrid and its consumers.<sup>25</sup> We consider to significantly reward Ausgrid for changes in estimates of costs which are yet to materialise, and which are attributable to changes in underlying assumptions, would not be consistent with this objective or the NEO.

In addition, we have had regard to:

- 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 for the service provider<sup>26</sup>
- the desirability of both rewarding the service provider for efficiency gains and penalising it for efficiency losses.<sup>27</sup>

If we were to accept Ausgrid's approach, its consumers would pay more for a network service for no identifiable benefit. Moreover, we do not consider it desirable to reward

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<sup>24</sup> AER, *Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations*, February 2008, p. 6.

<sup>25</sup> NER, cl. 6.5.8(a).

<sup>26</sup> NER, cl. 6.5.8(c)(1).

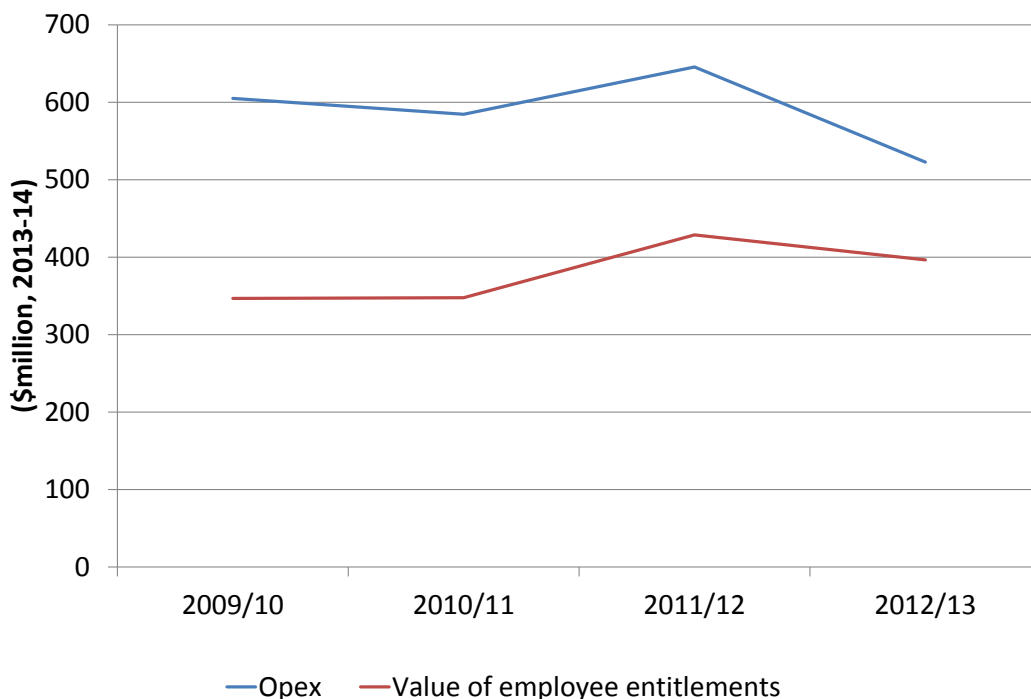
<sup>27</sup> NER, cl. 6.5.8(c)(3).

Ausgrid for changes in provisions under the EBSS when they, in effect, amount to changes in assumptions and not efficiency gains.

The changes in provisions which have affected Ausgrid's reported opex the most over the 2009–14 regulatory control period are its provisions for employee entitlements. This is mainly made up of provisions for long service leave but also includes provisions for annual leave and other employee entitlements available to a limited number of Ausgrid employees.<sup>28</sup> The estimated value of Ausgrid's provisions for employee entitlements materially increased in 2011–12 but then decreased again in 2012–13. This was driven largely by changes in discount rates used to value Ausgrid's provisions for long service leave. This reflected a change in assumption used to value these entitlements, rather than an efficiency gain or loss.

Changes in opex and the value of Ausgrid's provisions for employee entitlements in the 2009–14 regulatory control period are outlined in Figure 9.1. As illustrated below, the change in the value of Ausgrid's provisions for employee entitlements in 2011–12 and 2012–13 is similar to the change in Ausgrid's reported opex in those years which indicates the effect of the change in provisions on Ausgrid's opex.

**Figure 9.1 Ausgrid's reported opex and valuation of provisions for employee entitlements (\$ million, 2013–14)**



Source: Ausgrid, Economic benchmarking - Regulatory Information Notice response 2009–10 to 2012–13; Ausgrid, Response to Information Request AER020, August 14 2014.

<sup>28</sup> Including a provision for supplementary superannuation benefit, preserved sick leave, and Orion Severance Allowance. The description of these provisions are outlined in Cumpston Sarjeant, *Actuarial Assessment of Long Service Leave and other Employee Entitlements as at 31 December 2012*, July 2013.



Under Ausgrid's proposed approach to calculating the EBSS, its reported change in the valuation of its employee entitlements contributes to a relative efficiency loss in opex in 2011–12 and a relative efficiency gain in opex in 2012–13. Under the formula we use to calculate the EBSS carryover amounts, the efficiency gains from 2012–13 have a greater impact on Ausgrid's carryover amounts than the efficiency loss in 2011–12.<sup>29</sup> In net terms, this means that Ausgrid would effectively be rewarded because of changes in discount rates used in valuing its long service leave entitlements over the 2009–14 regulatory control period.

Changes in discount rates used to value Ausgrid's employee entitlements in different years of the 2009–14 regulatory control period should not affect the EBSS carryover amounts. The cost of long service leave which Ausgrid must pay out when an employee entitled to long service takes leave, retires or is made redundant does not change because of the discount rates used. Discount rates only convert the estimated future value of Ausgrid's long service leave obligations to an estimated present value required to settle the obligation. In essence, this amount only reflects an assumption of the amount that should be invested today at a particular rate to meet Ausgrid's current obligations when they crystallise in the future. As the amount to be paid out by Ausgrid does not change when a different discount rate is used, a change in the valuation of these entitlements does not reflect an efficiency gain or loss in opex.

Under Ausgrid's proposed approach, the reason the discount rates had a material impact on the value of its employee entitlements is because the actuaries which advised it adopted discount rate assumptions that were set independently of other assumptions used to value its employee entitlements. Under the approach used by Ausgrid's actuaries, the discount rate or rates were based on market yields in Australian Government bonds.<sup>30</sup> Bond rates fell in 2011–12 and then rose again in 2012–13 which contributed to the fluctuations in the value of Ausgrid's employee entitlements in these years.

An alternative technique used by actuaries is to set the discount rate by reference to forecast long term salary growth. For instance, we note that Endeavour Energy's and Essential Energy's actuaries previously advised that the salary inflation and discount rate assumptions should be a matched pair determined by the discount rate net of forecast salary rate increases.<sup>31</sup> This technique reduces the volatility in the value of

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<sup>29</sup> The EBSS is designed to ensure the service providers receives the same reward or penalty for an efficiency gain or loss regardless of the year in which it occurs. Without the EBSS an efficiency gain made later in the regulatory control period is retained for less time than one made earlier in the period. This is why outcomes later in the regulatory control period are given greater weighting when calculating the EBSS carryover amounts.

<sup>30</sup> Ernst and Young, *Actuarial Assessment of specified employee entitlements as at 31 December 2010*, June 2010, pp. 14-15; Ernst and Young, *Actuarial Assessment of specified employee entitlements as at 31 December 2011*, June 2010, pp 15-16; Ernst and Young, *Actuarial Assessment of specified employee entitlements as at 31 December 2011*, June 2012, pp 14-15, Cumpston Sarjeant *Assessment of Long Service Leave and other Employee Entitlements for Endeavour Energy as at 31 December 2012*, July 2013, p, 14.

<sup>31</sup> Cumpston Sarjeant, *Assessment of Long Service Leave and other Employee Entitlements for Endeavour Energy as at 31 December 2009*, July 2010, p, 6.; Cumpston Sarjeant, *Assessment of Long Service Leave and other Employee Entitlements for Essential Energy as at 31 December 2009*, July 2010, p, 10.



provisions for employee obligations where there are fluctuations in bond rates. This technique would reduce the effect of actuarial assumptions on actual opex and therefore reduce the effect that actuarial assumptions have on the EBSS.

We do not have a view about the most appropriate accounting methodology a service provider should apply when valuing its employee entitlements to meet its financial reporting obligations. This is a matter for the service provider to consider in preparing its statutory accounts. However, for EBSS purposes, assumptions made by a service provider or its actuary should have a minimal effect on the rewards or penalties a service provider receives under the EBSS. While a particular set of assumptions or techniques may be appropriate for statutory financial reporting purposes, it is not appropriate to rely on changes in assumptions or methods to reward or penalise a service provider for efficiency gains or losses. We see no reason why consumers should pay higher or lower EBSS carryover amounts because of the particular assumptions a service provider has chosen to value its obligations at a point in time. The EBSS is designed to reward efficiency gains and penalise efficiency losses and fairly share those gains and losses with consumers. An efficiency gain or loss should only depend on outcomes which have been realised by a service provider. To reward or penalise a service provider just because of the particular assumptions it or its actuary has used would not be consistent with the aim of an EBSS. To do so, would mean consumers would be paying more or less because of changes in assumptions, not efficiency gains or losses.

There are several other examples where long term assumptions made by Ausgrid and its actuaries affects reported opex. Therefore, if used in measuring actual opex, it would affect Ausgrid's EBSS carryovers. For instance,

- For 2011–12, Ausgrid based on its estimate of the value of its long service leave obligations on advice from Ernst and Young. In 2012–13, Ausgrid was advised by a different consultant, Cumpston Sarjeant. Based on its experience, it advised Ausgrid the long term rate of salary growth due to promotions should be significantly lower than previously assumed.<sup>32</sup> This change in assumption leads to a reduction in opex in 2012–13, and a greater EBSS carryover amount than would otherwise occur.
- In estimating the long term rate of salary growth other than due to promotions, all estimates made during the 2009–14 regulatory control period are based on assumptions of the rate of long term salary growth made by Ausgrid. For instance, in 2011–12, the long term assumption for salary growth was for 4 per cent per annum.<sup>33</sup> For 2012–13, the assumption was for 3.5 per cent per annum.<sup>34</sup> This

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<sup>32</sup> Cumpston Sarjeant, *Actuarial Assessment of Long Service Leave and other Employee Entitlements as at 31 December 2012*, July 2013, p. 1.

<sup>33</sup> Ernst and Young, *Actuarial Assessment of specified employee entitlements as at 31 December 2011*, June 2012, p. 15.

<sup>34</sup> Cumpston Sarjeant, *Actuarial Assessment of Long Service Leave and other Employee Entitlements as at 31 December 2012*, July 2013, p. 14.

change in assumption leads to a reduction in opex in 2012–13 and a greater EBSS carryover amount than would otherwise occur.

As with the choice of discount rate, we consider these reflect changes in opex driven by assumptions and not outcomes realised by Ausgrid, so they should not affect Ausgrid's EBSS rewards and penalties. We note that Ausgrid's actuaries have undertaken sensitivity modelling that demonstrates the effect that different discount rate and salary assumptions have on the valuation of its entitlements.<sup>35</sup>

Ausgrid has contended that because provisions are to be paid in the future it does not change its nature of being a cost incurred in providing the service.<sup>36</sup> We understand that long service leave obligations and other obligations must ultimately be settled by Ausgrid. This is not the issue we have with its proposed approach. As outlined above, we are concerned that at the time a change in provision is recorded as opex, it reflects an estimate of the present value of an obligation and not an amount that has actually been incurred. It is not an amount that allows us to appropriately measure an efficiency gain for the purposes of the EBSS. As outlined above, the amount recorded depends on the assumptions used to form the estimate. We do not agree that Ausgrid should be rewarded for changing an estimate of its costs during a regulatory control period.

We also do not consider that our approach involves excluding a category of expenditure, as Ausgrid has submitted.<sup>37</sup> We are not excluding a category of expenditure called provisions from our calculations. We are assessing what actual opex should be for the purposes of calculating the EBSS carryover amounts. The fundamental requirement for the EBSS under the NER is to derive efficiency gains and losses from the comparison of forecast and actual opex over the period, not merely accounting gains or losses. In doing so, we must be satisfied that actual opex is the actual opex faced by the service provider in the regulatory control period. We consider that given the changes in provisions allocated to opex reflect changes in assumptions it would mean that Ausgrid's calculation of efficiency gains and losses over the period does not accurately reflect actual efficiency gains and losses achieved. Consequently, we consider that an adjustment is necessary to correct for the changes in assumptions. The question then becomes what adjustment is appropriate.

Ausgrid has submitted that, because we removed the movement in provisions from actual opex, we should have also adjusted its forecast opex for EBSS purposes for the 2009–14 regulatory control period to remove any movement in provisions embedded in this forecast.<sup>38</sup>

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<sup>35</sup> Ernst and Young, *Actuarial Assessment of specified employee entitlements as at 31 December 2011* (CONFIDENTIAL), June 2012, p. 29; Cumpston Sarjeant, *Actuarial Assessment of Long Service Leave and other Employee Entitlements as at 31 December 2012* (CONFIDENTIAL), July 2013, p. 14.

<sup>36</sup> Ausgrid, *Revised proposal*, January 2015, p. 65.

<sup>37</sup> Ausgrid, *Revised proposal*, January 2015, p. 65.

<sup>38</sup> Ausgrid, *Revised proposal*, January 2015, p. 65.

We do not consider there is a strong reason to take this approach. While Ausgrid's proposed opex forecast for the 2009–14 period may have included an estimate of provisions to be recorded as opex during the 2009–14 regulatory control period, we did not approve its proposed forecast. We approved a total forecast for the 2009–14 regulatory control period was for a total amount only, without reference to provisions. Accordingly, there would be an element of artificiality to any exercise that involves removing provisions on the basis that they are embedded in the forecast. If we implemented such an approach, we would need to arrive at a view on the amount we implicitly forecast at the time for provisions, such as long service leave and annual leave for the 2009–14 period, and re-forecast this amount based on an estimate of what the forecast cash amount would have been for these costs. We do not consider this methodology would be robust given the hypothetical nature of this exercise.

Faced with these circumstances, we are satisfied that the best approach, which gives better effect to both the terms and the intent of the EBSS, is to only adjust Ausgrid's reported actual opex and not adjust its approved forecast. We have done this by replacing the movement in provisions with actual costs faced by Ausgrid in the form of cash expenses. We are satisfied this provides a fair sharing between Ausgrid and distribution network users of the actual efficiency gains made by Ausgrid over the 2009–14 regulatory control period.

We acknowledge that we did not state that we would take this approach when we determined the EBSS would apply to Ausgrid for the 2009–14 regulatory control period. However nor did we state that changes in reported provisions would be rewarded or penalised under the EBSS. As outlined in the EBSS, we stated in calculating EBSS carryover amounts we must be satisfied that Ausgrid's actual opex accurately reflect the costs it faced during the regulatory control. Under the EBSS, we have the discretion to calculate the EBSS rewards and penalties using an amount that differs from that proposed by a service provider where we are not satisfied that the reported costs accurately reflect the costs faced by the service provider. As provisions reflect estimates of costs, and Ausgrid's reported opex reflects changes in these estimates over the 2009–14 regulatory control period, we applied this discretion in reaching our decision.

We also disagree with Ausgrid's view that this decision would have a significant bearing on incentives of network service providers going forward. We have made our adjustment so Ausgrid will not be rewarded or penalised through the EBSS for changing estimates of its costs during a regulatory control period. This is not something that the EBSS was intended to reward or penalise service providers for. We do not see how our decision to clarify this position would impact on productive investments that Ausgrid or any other regulated network service provider may make. In fact we note our decision to clarify our position on this matter could have benefits as it would mean a service provider can revise its provisions in future regulatory control periods without fear of facing EBSS penalties.

In reaching our position we have also considered the report submitted by Ausgrid from Ernst and Young. It considered that by adjusting for movements in provisions, our

approach would effectively represent a move towards 'cash accounting' for provisions, since:

- this excludes the element of the economic cost that has been deferred to future periods
- cash payments in a given regulatory period do not represent the full cost incurred by the businesses in the provision of standard control services.<sup>39</sup>

Ernst and Young's report addressed the following matters:

- the supporting arguments for maintaining an accruals-based approach to forecasting opex from the perspective of Australian Accounting Standards
- the limitations of adopting a cash based approach to forecasting opex and possible regulatory implications
- the results of its outreach to other Ernst and Young offices (dealing with the US energy markets) to determine whether this issue has been considered by other regulators
- possible implications and practical considerations associated with moving to a 'cash based' approach.<sup>40</sup>

The report was predominantly concerned with the implications of using different accounting approaches in forecasting opex. It did not consider why it may or may not be preferable to reward or penalise a service provider through the EBSS for changes in provisions. As this is the issue we have considered for this final decision, we do not consider the Ernst and Young report provides any reasons why we should depart from our position in the draft decision.

### **9.5.2 Application of the EBSS in the 2015–19 regulatory control period**

We maintain our draft decision not to subject any expenditure to the EBSS in the 2015–19 regulatory control period. We do not consider that the EBSS is needed to incentivise efficient opex. As noted by Origin Energy in its submission, Ausgrid will already bear any costs in transitioning to efficient levels so there does not seem to be a strong reason to provide it with an additional incentive to become more efficient.

We note that the EMRF questioned whether our decision not to apply the EBSS was because Ausgrid would face a penalty. It also questioned whether this would affect the balance between opex, capex and service incentives.

The EBSS rewards and penalties depend on the difference between forecast and actual opex in one regulatory year when compared to the previous year. It is not possible to determine ex ante whether Ausgrid would or would not receive an EBSS

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<sup>39</sup> Ernst and Young, *Accounting for provisions; assessing the AER's approach*, 19 January 2015, p. 3.

<sup>40</sup> Ernst and Young, *Accounting for provisions; assessing the AER's approach*, 19 January 2015, pp. 4-5.

penalty if we applied the EBSS in the 2015–19 regulatory control period. This is because it depends on Ausgrid's actual performance during the period. However we note that if Ausgrid makes efficiency improvements, it could receive an EBSS reward.

We acknowledge that the balance between different incentives is important. We have considered the balance between these incentives in reaching our decision.<sup>41</sup> However, this balance is affected by a number of different factors - in particular our decision to use benchmarking when forecasting opex. Applying the EBSS would further strengthen Ausgrid's incentive to reduce its opex. In this circumstance, we are not satisfied that applying the EBSS would lead to better balance between the different incentives Ausgrid faces.

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<sup>41</sup> In particular as required by NER, cl. 6.5.8A(d) we have had regard to any incentives that service providers may have to capitalise operating expenditure as well as the possible effects of the scheme on incentives for the implementation of non-network alternatives.