FINAL DECISION
Essential Energy distribution determination
2015−16 to 2018−19

Attachment 9 – Efficiency benefit sharing scheme

April 2015

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on Essential Energy'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

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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

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 Essential Energy operated under the EBSS for the ACT and NSW 2009 distribution determinations, which was released in February 2008.[1]

9.1 Final decision

We will not apply EBSS carryover amounts accrued by Essential Energy during the 2009–14 regulatory control period. This is the same position as our draft decision. The EBSS was intended to work in conjunction with a revealed cost forecast approach. Given how we are forecasting Essential Energy's opex for the 2014–19 period, we consider it would not be consistent with the intended operation of the EBSS, and it would not implement the EBSS in accordance with the terms of the NER, if we were to carryover the EBSS penalty.

No expenditure incurred by Essential Energy will be subject to the EBSS during the 2015–19 regulatory control period.[2] This position is also consistent with our draft decision.

9.2 Draft decision

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

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

2 We have previously determined that the EBSS that applied to Essential Energy in the 2009-14 regulatory control period will apply to ActewAGL 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 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.

We estimated Essential Energy would receive EBSS carryover amounts of –$231.4 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.

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

We considered that provisions should be excluded from EBSS calculations. This is because increases in provisions do not represent the actual cost incurred in delivering network services when calculating efficiency gains or losses.

9.2.2 Application of carryover amounts accrued during the 2009–14 regulatory control period

Our draft decision was not to apply the EBSS carryover amounts Essential Energy accrued during the 2009–14 regulatory control period. When considering how we forecast Essential Energy's opex for the 2014–19 period we considered that applying the EBSS carryover amounts would not give effect to the EBSS objective of promoting fair sharing of efficiency gains and losses.

We did not use Essential Energy's actual opex as the base for forecasting its opex for the 2014–19 period, as this would not produce a total forecast that reasonably reflects

the opex criteria. After benchmarking Essential Energy's base opex against other service providers in the NEM, we considered its base opex needed to be adjusted to a lower level in our alternative forecast.

If we applied both the EBSS penalties and a benchmark opex allowance for the next regulatory control period, this has implications for whether the efficiency losses Essential Energy made during the 2009–14 regulatory control period would be shared fairly with consumers. It would mean that Essential Energy could bear more than 100 per cent of the efficiency losses it made during the regulatory control period. We did not consider this would reflect fair sharing of efficiency losses as required by the EBSS.

9.2.3 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.

Economic benchmarking and other corroborating evidence indicate that Essential Energy's opex is higher than opex incurred by a benchmark efficient service provider. In our draft decision, we also noted that Essential Energy 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 Essential Energy'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 apply the current version of the EBSS.

For instance we consider Essential Energy 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 apply an EBSS to further strengthen its incentives.

9.3 Essential Energy's revised proposal and submissions

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

Essential Energy reproposed a total EBSS carryover amount of –$74.2 million ($2013–14) be subtracted to its regulated revenue in the 2014–19 period arising from the application of the EBSS in the 2009–14 regulatory control period.

Essential Energy did not agree with our draft decision. It considered:

- there is no rule that explicitly provides 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 Essential Energy

- retrospective adjustments may disincentivise service providers going forward because there is a risk that service providers will consider we will review or revise other efficiency gains or losses and jeopardise the incentive features of the EBSS
- even if it agreed with our contention that these are not actual costs, it considered that we had made an error by not adjusting forecast opex to exclude the amount for provisions from its forecast opex for the 2009–14 period.[3]

In support of its proposal, Essential Energy also submitted a report it commissioned from Ernst and Young.[4]

PIAC and the EMRF agreed with our draft decision to adjust for provisions.[5] 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.[6]

9.3.2 Application of carryover amounts accrued during the 2009–14 regulatory control period

Essential Energy considered that if we decided not to accept its opex and substitute a lower amount then any EBSS carryover penalty from the 2009–14 regulatory control period should not apply.[7]

9.3.3 Application of the EBSS in the 2015–19 regulatory control period

Essential Energy considered that if we accept its proposal then the EBSS should apply. However if we substitute a lower amount than it forecast which it considers unachievable, then it agrees that an EBSS should not apply.[8]

Origin Energy and the CCP agreed with our draft decision not to apply the EBSS.[9] Origin Energy noted that the EBSS would reward the NSW service providers in moving from an inefficient base to an efficient base.[10]

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3 Essential Energy, *Revised proposal*, January 2015, pp. 91-93.

4 Ernst and Young, *Accounting for provisions; assessing the AER's approach*, 19 January 2015.

5 EMRF, *Response to revised proposals from Essential Energy, Endeavour Energy and Essential Energy,* February 2015, pp. 64-65; PIAC, *Submission to the AER"s draft determination for Essential Energy, Endeavour Energy and Essential Energy,* 13 February 2015, p. 20.

6 EMRF, *Response to revised proposals from Essential Energy, Endeavour Energy and Essential Energy,* February 2015, pp. 64-65.

7 Essential Energy, *Revised proposal*, January 2015, p. 90.

8 Essential Energy, *Revised proposal*, January 2015, p. 9.

9 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.

10 Origin Energy, *Submission to AER draft determination for NSW electricity distributors,* p. 21.

PIAC and the EMRF did not agree with our draft decision not to apply the EBSS.[11] The EMRF considered that we were not applying the EBSS because Essential Energy would receive a penalty under the EBSS. It could see the logic in our draft decision but it considered that not applying the EBSS would affect the balance between capex and service incentives.[12]

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[13]
2. how any applicable EBSS is to apply to Essential Energy in the 2014–19 period.[14]

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.[15] We must also have regard to the following factors 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 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.

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 forecast opex allowance for the following regulatory control period.

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11 PIAC, *Submission to the AER"s draft determination for Essential Energy, Endeavour Energy and Essential Energy,* 13 February 2015, p. 20; EMRF, *Response to revised proposals from Essential Energy, Endeavour Energy and Essential Energy,* February 2015, p. 64.

12 EMRF, *Response to revised proposals from Essential Energy, Endeavour Energy and Essential Energy,* February 2015, p. 64.

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).

- 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 of these interactions in developing and implementing the EBSS as well as the 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.[17]
- 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.[18]

9.5 Reasons for final decision

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

We estimate Essential Energy has accrued EBSS carryover amounts of –$231.8[19] million ($2013–14) from the application of the EBSS in the 2009–14 regulatory control period.

We disagree that our adjustment for movements in provisions was 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.[20]

We are not satisfied that the changes in provisions Essential Energy reported as opex accurately reflects the costs it faced in the 2009–14 regulatory control period. This is

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17 NER, cl. 6.4.3(a)(4),(5).

18 NER, cl. 6.5.8A(d).

19 We have made one change to calculation. This was to correct an error with respect to how we had estimated movement in provisions allocated between opex and capex.

20 AER, *Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations*, February 2008, p. 6.

because we consider changes in provisions reflect changes in estimates of costs that Essential Energy expects to incur. Thus for the purposes of calculating the EBSS carryover amounts, we have removed these estimates from Essential Energy's reported opex. We instead consider the amount Essential Energy incurred and charged against the provision better reflects the costs it 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 Essential Energy's provisions were reported by Essential Energy as opex. Assumptions underlying these estimates may help in ensuring its 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 Essential Energy and its consumers.[21] We consider to significantly reward Essential Energy 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 service providers[22]
- the desirability of both rewarding the service provider for efficiency gains and penalising it for efficiency losses.[23]

If we were to accept Essential Energy's approach, its consumers would pay more for a network service for no identifiable benefit. Moreover, we do not consider it desirable to reward Essential Energy 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 Essential Energy's reported opex the most over the 2009–14 regulatory control period are its provisions for long service leave entitlements. The estimated value of Essential Energy's provisions for long service leave entitlements materially increased in 2011–12 but then decreased again in 2012–13. This was driven largely by changes in discount rate and salary growth assumptions used to value Essential Energy's provisions for long service leave. This

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21 NER, cl. 6.5.8(a).

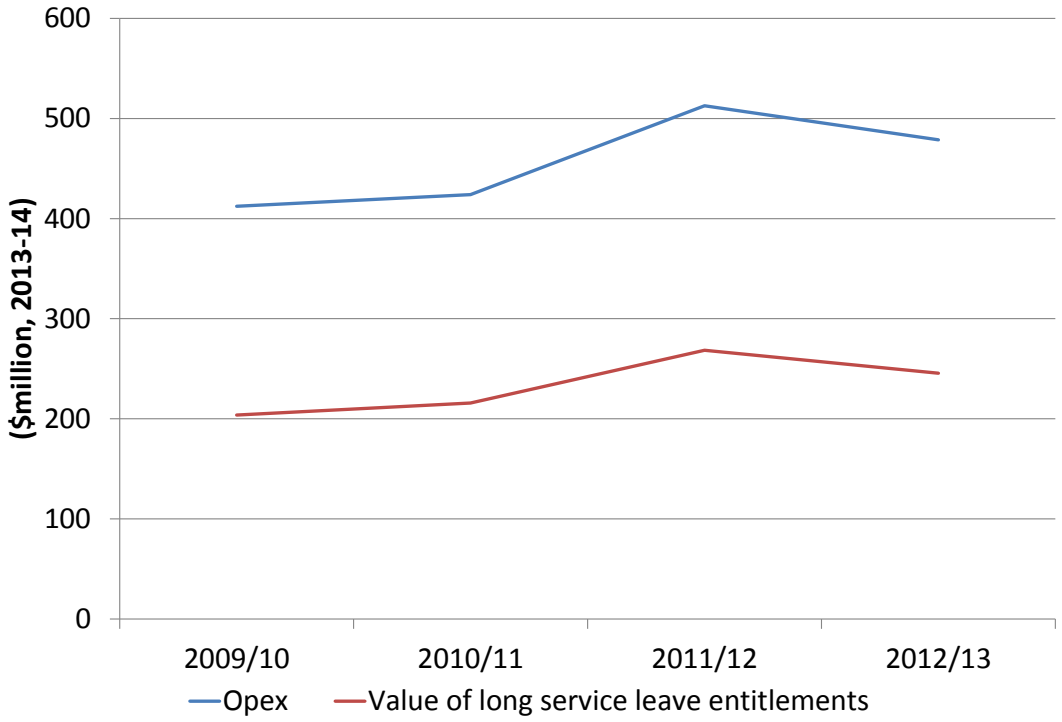
22 NER, cl. 6.5.8(c)(1).

23 NER, cl. 6.5.8(c)(3).

reflected a change in assumption used to value these entitlements, rather than an efficiency gain or loss.

Changes in opex and the value of Essential Energy's provisions for long service leave entitlements in the 2009–14 period are illustrated in Figure 9.1. As outlined below the change in the value of Essential Energy's provisions for long service leave entitlements in 2011–12 and 2012–13 is similar to the change in Essential Energy's reported opex in those years which indicates the effect of the change in provisions on Essential Energy's opex.

Figure 9.1 Essential Energy's reported opex and valuation of provisions for long service leave entitlements ($ million, 2013–14)



Source: Essential Energy, Economic benchmarking - Regulatory Information Notice response 2009–10 to 2012–13; Essential Energy, Attachment 3 2014 Essential Reset RIN Workbook Consolidated Information, Public, May 2014.

Under Essential Energy's proposed approach to calculating the EBSS, its reported change in the valuation of its long service leave 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 Essential Energy's carryover amounts than the efficiency loss in 2011–12. [24] In net terms, this means that Essential Energy

[24] The EBSS is designed to ensure the service providers receive 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.

would effectively be rewarded because of changes in discount rates and salary growth assumptions used in valuing its employee entitlements.

Changes in discount rates used to value Essential Energy' 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 entitlements which Essential Energy must pay out when an employee 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 Essential Energy's long service leave 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 Essential Energy's current obligations when they crystallise in the future. As the amount to be paid out by Essential Energy does not change when a different discount rate is used, it does not reflect an efficiency gain or loss in opex.

Under Essential Energy's proposed approach, the reason the discount rates had a material impact on the value of its employee entitlements is because it used a different methodology to value these entitlements during the 2009–14 regulatory control period.

For its valuation of its employee entitlements in 2009–10 and 2010–11, Essential Energy based its valuation on advice from Cumpston Sarjeant. It advised Essential Energy that the discount rate should be based on market yields in Australian Government bonds. However it 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.[25] The discount rate net of general salary growth it determined as at March 2009 and September 2011 was 2.25 per cent.[26] This technique reduces the volatility in the value of provisions for employee obligations where there are fluctuations in bond rates. It would reduce the effect of actuarial assumptions on actual opex and therefore reduce the effect that actuarial assumptions have on the EBSS.

For its valuation of its employee entitlements for 2011–12, Cumpston Sarjeant was asked by Essential Energy to prepare two scenarios:

1. assume general salary growth rates for 2013–14 and 2014–15 are 3.5 per cent per annum, but keep all other assumptions as they are
2. assume general salary growth for all years after 30 June 2013 is 3.5 per cent per annum.[27]

Cumpston Sarjeant advised Essential Energy that scenario two would produce unrealistically high values for the liability when discount rates are low.

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[25] Cumpston Sarjeant , *Assessment of Long Service Leave and other Employee Entitlements for Essential Energy as at September 2011,* February 2012, p, 9.

[26] Cumpston Sarjeant , *Assessment of Long Service Leave and other Employee Entitlements for Essential Energy as at March 2009,* August 2009, p, 7; Cumpston Sarjeant , *Assessment of Long Service Leave and other Employee Entitlements for Essential Energy as at September 2011,* February 2012, p, 9.

[27] Cumpston Sarjeant, *Response to Queries on Essential Energy Employee Entitlements Valuation*, 19 July 2012.

Despite the advice from Cumpston Sarjeant, Essential Energy adopted scenario two. Applying these assumptions, the discount rate used to value Essential Energy's employee entitlements was 3 per cent and its long term salary growth assumption was 3.5 per cent.[28] Therefore, in effect, the discount rate net of forecast long term salary growth had fallen from 2.25 per cent in 2010–11 to –0.5 per cent in 2011–12. This change in assumptions led to increase in the present value of Essential Energy's employee benefit obligations and increase in its reported opex.

In 2012–13, it used the same technique. The discount rate used to value Essential Energy's employee entitlements was 3.75 per cent and the long term salary growth assumption remained at 3.5 per cent.[29] These changes in assumptions led to a reduction in the increase in the present value of Essential Energy's employee benefit obligations and a decrease in its reported opex.

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 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 or methods 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.

Essential Energy has contended that because provisions are to be paid in the future it does not change its nature of being a cost incurred in the providing the service.[30] We understand that long service leave obligations and other obligations must ultimately be settled by Essential Energy. 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

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[28] Essential Energy, *Response to AER Essential 008 (Employee entitlements Nominal PV amounts.xlsx*, 30 July 2014.

[29] Essential Energy, *Response to AER Essential 008 (Employee entitlements Nominal PV amounts.xlsx*, 30 July 2014.

[30] Essential Energy, *Revised proposal*, January 2015, p. 91.

amount recorded depends on the assumptions and the methodology used to form the estimate. We do not agree that Essential Energy 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 Essential Energy has submitted.[31] 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 and changes in methodologies, it would mean that Essential Energy'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.

Essential Energy 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.[32]

We do not consider there is a strong reason to take this approach. While Essential Energy'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 for provisions at the time, such as long service leave and annual leave for the 2009–14 period, and reforecast 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 in estimating the EBSS carryover amounts that apply to Essential Energy, which gives better effect to both the terms and the intent of the EBSS, is to only adjust Essential Energy'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 Essential Energy in the form of cash expenses.

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31 Essential Energy, *Revised proposal*, January 2015, p. 92.

32 Essential Energy, *Revised proposal*, January 2015, p. 92.

We acknowledge that we did not state that we would take this approach when we determined the EBSS would apply to Essential Energy 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 Essential Energy'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 Essential Energy'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 Essential Energy's view that this decision would have a significant bearing on incentives of network service providers going forward. We have made our adjustment so Essential Energy 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 Essential Energy 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 Essential Energy 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.[33]

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

[33] Ernst and Young, *Accounting for provisions; assessing the AER's approach*, 19 January 2015, p. 3.

- possible implications and practical considerations associated with moving to a 'cash based' approach.[34]

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 carryover amounts accrued during the 2009–14 regulatory control period

We have maintained our draft decision not to apply the EBSS carryover amounts accrued by Essential Energy during the 2009–14 regulatory control period.[35] The EBSS was intended to work in conjunction with a revealed cost forecasting approach. Given how we are forecasting Essential Energy's opex for the 2014–19 period, it would not be consistent with the intended operation of the EBSS, and it would not implement the EBSS in accordance with the terms of the NER, if we were to carryover the EBSS penalty it has accrued.

We note that Essential Energy agreed with this approach where we use a forecast opex amount that is substantially lower than its proposal.

9.5.3 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 Essential Energy to become more efficient. As noted by Origin Energy in its submission, Essential Energy 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 Essential Energy 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 Essential Energy would or would not receive an EBSS penalty if we applied the EBSS in the 2015–19 regulatory control period. This is because it depends on Essential Energy's actual performance during the period.

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[34] Ernst and Young, *Accounting for provisions; assessing the AER's approach*, 19 January 2015, pp. 4-5.

[35] AER, *Draft decision, Essential Energy distribution determination 2015–19*, November 2014, Attachment 9.

However we note that if Essential Energy makes efficiency improvements, it is possible that 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.[36] 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 Essential Energy'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 Essential Energy faces.

[36] 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.