FINAL DECISION
CitiPower distribution determination
2016 to 2020

Attachment 9 – Efficiency benefit sharing scheme

May 2016

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on CitiPower's distribution determination for 2016–20. It should be read with all 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 mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – f-factor scheme

Contents

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
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

Shortened form	Extended form
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 2011–15 regulatory control period, CitiPower operated under the Electricity distribution network service providers' EBSS released in June 2008.[1]

9.1 Final decision

Our final decision is to approve an EBSS carryover of -$3.2 million ($2015) from the application of the EBSS in the 2011–15 regulatory control period. This is consistent with our preliminary decision which CitiPower accepted in its revised proposal.[2] However, we have updated the carryover amounts to reflect the most recent actual CPI available.[3]

Our final decision for the EBSS carryover amounts from the 2011–15 regulatory control period is outlined in Table 9.1.

Table 9.1 AER's final decision on CitiPower's EBSS carryover amounts ($ million, 2015)

	2016	2017	2018	2019	2020	Total
Final decision	-0.1	-2.7	1.0	-1.3	0.0	-3.2

Source: AER analysis; CitiPower, *Revised regulatory proposal*, *PTRM*, January 2016.

Note: The total may not add up due to rounding.

We have maintained our preliminary decision to apply version two of the EBSS to CitiPower in the 2016–20 regulatory control period.[4]

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1 AER, *Electricity distribution network service providers - Efficiency benefit sharing scheme* , June 2008.

2 CitiPower, *Revised regulatory proposal*, January 2016, p. 391.

3 December 2015 CPI has become available since our preliminary decision.

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

When we apply version two of the EBSS, we will exclude the cost categories listed in section 9.5.2 from forecast and actual opex for the calculation of EBSS carryover amounts. Table 9.2 sets out our final decision on CitiPower's target opex for the EBSS (total opex less excluded categories[5]), against which we will calculate efficiency gains in the 2016–20 regulatory control period.

Table 9.2 AER's final decision on CitiPower's forecast opex for the EBSS ($ million, 2015)

	2016	2017	2018	2019	2020
Total opex forecast	82.5	83.7	86.8	88.3	90.3
Less debt raising costs	–0.9	–0.9	–1.0	–1.0	–1.0
Less GSL payments	–0.1	–0.1	–0.1	–0.1	–0.1
Target opex for the EBSS	81.5	82.7	85.8	87.2	89.2

Source: AER, *Final decision, CitiPower determination, opex model*, May 2016.

Note: The demand management incentive allowance (DMIA) is not part of the opex building block and therefore is not included in the opex target.

9.2 Preliminary decision

In our preliminary decision we calculated an EBSS carryover of -$3.1 million ($2015).[6] This was different to the carryover CitiPower proposed of -$6.7 million. The difference between our calculations of the EBSS carryover amounts and CitiPower's proposal was mainly because we used a different formula to calculate carryover amounts for 2011.[7]

9.3 CitiPower's revised proposal and submissions

CitiPower accepted our preliminary decision on the EBSS carryover amounts from the application of the EBSS during the 2011–15 regulatory control period.[8]

CitiPower mostly accepted our preliminary decision on how the EBSS will apply in the 2016–20 regulatory control period:

- It accepted our preliminary decision to exclude debt raising costs and GSL payments.
- It accepted our preliminary decision not to exclude superannuation for defined benefits and self-insurance costs.

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5 Debt raising costs and GSL payments.

6 AER, *Preliminary decision, CitiPower determination, Attachment 9*, October 2015, p. 9-6. AER, *Preliminary decision, CitiPower determination, Attachment 9*, October 2015, p. 9-6.

7 AER, *Preliminary decision, CitiPower determination, Attachment 9*, October 2015, p. 9-9.

8 CitiPower, *Revised regulatory proposal*, January 2016, p. 391.

- It did not accept our preliminary decision to exclude losses on scrapping of assets because losses on scrapping of assets is not an operating expenditure item and therefore is not relevant to the EBSS.[9]

We received submissions from the Consumer Challenge Panel (CCP)[10] and the Victorian Energy Consumer and User Alliance (VECUA)[11] who commented on the EBSS in the context of the regulatory framework. We address these comments in our opex attachment. The CCP also commented on excluded cost categories in 2016–20. We address its concerns below. We did not receive submissions on the calculation of carryover amounts from the application of the EBSS in 2011–15.

9.4 Assessment approach

Under the NER we must decide:

1. the revenue increments or decrements (if any) for each regulatory year of the 2016–20 period arising from the application of the EBSS during the 2011–15 regulatory control period[12]
2. how any applicable EBSS is to apply to CitiPower in the 2016–20 period.[13]

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.[14] We must also have regard to the following factors when implementing the EBSS:[15]

- 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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9 CitiPower, *Revised regulatory proposal*, January 2016, pp. 397 and 405.

10 CCP3, *Submission to the Victorian DNSPs revenue reset, Comments on the preliminary decision,* pp. 9, 12–14, 24, 26, 61, 105.

11 VECUA, *Submission to the Victorian DNSPs revenue reset, Comments on the preliminary decision,* January 2016, p. 58.

12 NER, cl. 6.4.3(a)(5).

13 NER, cll. 6.3.2(a)(3); 6.12.1(9).

14 NER, cl. 6.5.8(a).

15 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 affects 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.[16]
- 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.[17]

9.5 Reasons for final decision

9.5.1 Carryover amounts from the 2011–15 regulatory control period

Our final decision is to approve an EBSS carryover amount of –$3.2 million ($2015) from the application of the EBSS in the 2011–15 regulatory control period. This is consistent with our preliminary decision which was accepted by CitiPower in its revised proposal.[18] However, we have updated the carryover amounts to reflect the most recent actual CPI available.[19]

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

17 NER, cl. 6.5.8A(d).

18 CitiPower, *Revised regulatory proposal*, January 2016, p. 391.

19 December 2015 CPI has become available since our preliminary decision.

9.5.2 How the EBSS will apply in the 2016–20 regulatory control period

We have maintained our preliminary decision to apply version two of the EBSS to CitiPower in the 2016–20 regulatory control period.

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

Length of carryover period

The length of the carryover period for the 2016–20 regulatory control period will be five years. This aligns the EBSS carryover period with the length of CitiPower's regulatory control periods.

Incremental efficiency gains

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

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

We will do this according to the formulas set out in version two of the EBSS.[20]

When calculating actual opex under the EBSS, we will adjust reported actual opex for the 2016–20 regulatory control period to reverse any movements in provisions. We consider actual opex net of movement in provisions best reflects the actual opex incurred by the service provider during the regulatory control period.

In our preliminary decision, we proposed to remove losses on the scrapping of assets from reported opex. This was on the basis that they were accounting adjustments to expenditure, rather than an actual outlay made by a service provider in providing network services.[21] We have changed our position on this matter in response to CitiPower's revised proposal. CitiPower stated in its case, losses on the scrapping of assets are not an operating expenditure item and therefore are not relevant to the EBSS.[22] Given this, we agree it is unnecessary to remove such losses.

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[20] AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, pp. 7–9.

[21] AER, *Preliminary decision, CitiPower determination, Attachment 9*, October 2015, p. 9-12.

[22] CitiPower, *Revised regulatory proposal*, January 2016, p. 405.

Adjustments to forecast or actual opex when calculating carryover amounts

The EBSS allows for exclusions of categories of costs from the EBSS where we do not use a single-year revealed cost forecasting approach. This is designed to fairly share efficiency gains and losses. For instance, where a service provider achieves efficiency improvements, it receives a benefit through the EBSS and consumers receive a benefit through lower forecast opex in the next period. This is the way consumers and the service provider share in the benefits of an efficiency improvement.

If we do not use a single-year revealed cost forecasting approach, lower actual opex will not necessarily be passed through to consumers. Consumers should not pay for EBSS benefits where they do not receive the benefits of a lower opex forecast.

We will exclude the following categories of costs from the EBSS:

- debt raising costs
- GSL payments.

As debt raising costs and GSL payments are not forecast based on revealed expenditure, they should be excluded from the EBSS.

In addition to the excluded cost categories we will also:

- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the regulatory determination. This may include approved pass through amounts
- adjust actual opex to remove demand management innovation allowance (DMIA) operating expenditure because it is not included in the opex forecast
- adjust actual opex to add capitalised opex that has been excluded from the RAB
- exclude categories of opex not forecast using a single-year revealed cost approach for the regulatory control period beginning in 2021 where doing so better achieves the requirements of clause 6.5.8 of the NER.

In its submission, the CCP supported our decision to limit the number of categories excluded from the EBSS. It supported our decision to exclude DMIA, GSL payments and losses on the scrapping of assets from the scheme. However, it did not support our decision to exclude debt raising costs. The CCP considered there needs to be an incentive for network service providers to limit the costs of debt raising and including this in the EBSS would provide an appropriate incentive.[23]

We disagree that debt raising costs should be included in the EBSS. If debt raising costs were included in the EBSS, consumers might pay for efficiency gains that they

[23] CCP3, *Submission to the Victorian DNSPs revenue reset, Comments on AER Preliminary Decisions*, 25 February 2016, p. 73.

would not receive through the opex forecast. As discussed above, this is because debt raising costs are not forecast based on revealed expenditure.