



**FINAL DECISION**  
**TransGrid transmission**  
**determination**  
**2015–16 to 2017–18**

**Attachment 9 – Efficiency**  
**benefit sharing scheme (EBSS)**

April 2015

© Commonwealth of Australia 2015

This work is copyright. In addition to any use permitted under the Copyright Act 1968, all material contained within this work is provided under a Creative Commons Attributions 3.0 Australia licence, with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos
- any illustration, diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright, but which may be part of or contained within this publication. The details of the relevant licence conditions are available on the Creative Commons website, as is the full legal code for the CC BY 3.0 AU licence.

Requests and inquiries concerning reproduction and rights should be addressed to the:

Director, Corporate Communications  
Australian Competition and Consumer Commission  
GPO Box 4141, Canberra ACT 2601

or [publishing.unit@acc.gov.au](mailto:publishing.unit@acc.gov.au).

Inquiries about this publication should be addressed to:

Australian Energy Regulator  
GPO Box 520  
Melbourne Vic 3001

Tel: (03) 9290 1444

Fax: (03) 9290 1457

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au)

AER reference: 53444

## Note

This attachment forms part of the AER's final decision on TransGrid's revenue proposal for 2015–18. It should be read with other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – maximum allowed revenue

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 – pricing methodology

Attachment 13 – pass through events

Attachment 14 – negotiated services

# Contents

Note .....	9-2
Contents .....	9-3
Shortened forms .....	9-4
9 Efficiency benefit sharing scheme.....	9-6
9.1 Final decision .....	9-6
9.2 Draft decision .....	9-7
9.3 TransGrid’s revised proposal .....	9-9
9.4 Assessment approach.....	9-11
9.5 Reasons for final decision .....	9-12

## Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider

Shortened form	Extended form
NTSC	negotiated transmission service criteria
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
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
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 2004–09 regulatory control period, TransGrid operated under a predecessor of the EBSS, the efficiency carry forward mechanism (ECFM). During the 2009–14 regulatory control period TransGrid operated under the EBSS released in September 2007 for transmission network service providers (version one of the EBSS).<sup>1</sup> In the 2014–18 period TransGrid will receive an adjustment to its revenue for carryover amounts in relation to both the ECFM and version one of the EBSS.

In November 2013 we released version two of the EBSS. We will apply this version of the EBSS to TransGrid during the 2014–18 period.

### 9.1 Final decision

We are not satisfied TransGrid's proposed ECFM and EBSS carryover amounts, totalling \$74.8 million (\$2013–14) comply with the requirements of the EBSS. We consider carryover amounts of \$60.9 million (\$2013–14) comply with the relevant requirements. The main difference between TransGrid's proposed carryover amounts and the carryover amounts we have calculated is due to different treatment of provisions.

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

	2014–15	2015–16	2016–17	2017–18	Total
TransGrid's proposed carryover	22.5	13.5	15.5	23.3	74.8
Final decision	21.1	13.2	15.0	11.6	60.9

Source: TransGrid, EBSS model; AER analysis.

---

<sup>1</sup> AER, *Electricity transmission network service providers: Efficiency benefit sharing scheme*, September 2007.

We will apply version two of the EBSS to TransGrid in the 2014–18 period. We will exclude debt raising costs, network support, opex on network capability projects and superannuation contributions from the calculation of EBSS carryover amounts. Table 9.2 outlines the total opex forecasts we will use to calculate efficiency gains and losses for the 2014–18 period.

**Table 9.2 AER's final decision on TransGrid's forecast opex for the EBSS (\$ million, 2013–14)**

	2014–15	2015–16	2016–17	2017–18
Forecast opex for EBSS	153.5	152.8	157.6	151.4

Note: Excludes forecast superannuation contributions and debt raising costs.

Source: AER analysis.

## 9.2 Draft decision

### 9.2.1 Carryover amounts from 2008–09

Our draft decision was to carryover amounts of \$15.4 million (\$2013-14) as an adjustment to the ECFM from the 2008–09 regulatory year. The only difference between TransGrid's calculation and our calculation was the discount factor used to convert the carryover amounts from \$2008–09 to \$2013–14. TransGrid's discount factor is partly based on its proposed rate of return for the 2014–18 regulatory control period. In our draft decision we substituted TransGrid's proposed rate of return with our proposed rate of return.

### 9.2.2 EBSS carryover amounts from the 2009–14 regulatory control period

We proposed TransGrid carryover \$45.6 million (\$2013-14) from the application of the EBSS in the 2009–14 regulatory control period. Our calculation of the EBSS carryover amounts was different to TransGrid's calculation in two respects:

1. treatment of movement in provisions
2. treatment of uncompleted easement maintenance in 2012–13.

#### **Treatment of movement in provisions for the 2009–14 regulatory control period**

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, TransGrid's opex was materially affected by changes in the valuation of its provisions for long service leave entitlements. If we accepted changes in provisions as actual opex it would affect TransGrid's EBSS carryover amounts.

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

In calculating carryover gains or losses, the AER must be satisfied that the actual and forecast opex accurately reflects the costs faced by the TNSP in the regulatory control period.<sup>2</sup>

We consider the amount incurred and charged against the provision better reflects the cost faced by the service provider in the regulatory control period. This is the amount actually paid by the service provider in meeting the 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>3</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 is what distinguishes them from other liabilities in the accounting standards.<sup>4</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 with relatively minor changes in assumptions.

---

<sup>2</sup> AER, *Electricity transmission network service providers - Efficiency benefit sharing scheme*, September 2007, p.6.

<sup>3</sup> AER, *Victorian electricity distribution network service providers - Distribution determination 2011–2015 Draft decision*, June 2010, pp. 586-587.

<sup>4</sup> AASB 137, clause. 11, p. 13.

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>5</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, treating provisions as actual costs can lead to perverse outcomes. Based on TransGrid's calculations its consumers would pay for efficiency carryover amounts that do not reflect changes in the underlying level of efficiency in providing transmission services during the 2009–14 regulatory control period. We considered to reward TransGrid for changes in assumptions would be contrary to the aims of the EBSS under the NER.

### **9.2.2.1 Treatment of easement maintenance in 2012–13**

In its initial proposal, TransGrid made an adjustment to actual opex incurred in 2012–13 for uncompleted easement maintenance. This approach increased the EBSS carryover amounts relative to TransGrid's proposal but reduced TransGrid's forecast opex.

We did not consider such an adjustment was allowed by the EBSS. We also did not reinstate uncompleted easement maintenance for opex forecasting purposes.

### **9.2.3 Application of the EBSS in the 2014–18 period**

We proposed to apply version two of the EBSS to TransGrid for the 2014–18 period.<sup>6</sup> We proposed a four year carryover period to align the EBSS carryover period with the length of TransGrid's regulatory control periods (that is the 2014-15 transitional period and 2015-18 regulatory control period).

We proposed to exclude the following categories of costs from the EBSS:

- debt raising costs
- network support
- opex on network capability incentive projects
- employer contributions for defined benefits superannuation.

## **9.3 TransGrid's revised proposal**

### **9.3.1 Carryover amounts from 2008–09**

---

<sup>5</sup> NER, cl. 6A.6.5(b)(2).

<sup>6</sup> AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

TransGrid updated its carryover amounts from 2008–09 for a discount rate consistent with its rate of return proposal. The ECFM amount in TransGrid's revised proposed is outlined below in Table 9.3.

**Table 9.3 TransGrid's proposed ECFM amount (\$ million, 2013–14)**

	2014–15	2015–16	2016–17	2017–18	Total
TransGrid's proposed ECFM	0.0	5.3	5.3	5.3	16.0

Source: TransGrid, EBSS model.

### 9.3.2 EBSS carryover amounts from the 2009–14 regulatory control period

TransGrid disagreed with our approach to excluding movements in provisions. It considered that the EBSS does not allow for a retrospective change to target or actual expenditure as we proposed in our draft decision. It considered that in the 2009–10 to 2013–14 period forecast opex was based on a provisions approach to forecast opex so actual opex must be measured on the same basis.<sup>7</sup> We also received submissions from the Energy Networks Association and ElectraNet which disagreed with our adjustment for provisions.<sup>8</sup>

TransGrid accepted our draft decision not to reinstate uncompleted easement maintenance into the base year but considered this to be a sub-optimum outcome.

TransGrid's proposed EBSS carryover amounts in its revised proposal are outlined below in Table 9.4.

**Table 9.4 TransGrid's proposed EBSS amount (\$ million, 2013–14)**

	2014–15	2015–16	2016–17	2017–18	Total
TransGrid's proposed EBSS	22.5	8.2	10.1	18.0	58.8

Source: TransGrid, EBSS model.

### 9.3.3 How the EBSS will apply in the 2014–18 period

TransGrid accepted our draft decision to apply a four year carryover period. It accepted our draft decision to exclude debt raising costs, network support, opex on network capability incentive projects and employer contributions for defined benefits superannuation from the EBSS.

<sup>7</sup> Transgrid, *Revised revenue proposal 2014-15 to 2017-18*, pp. 140-141.

<sup>8</sup> ENA, *Submission to Transgrid's revised proposal*, p. 3.

In addition to our proposed exclusions, it also considered that insurance, self insurance and the Demand Management Innovation Allowance should be excluded from the EBSS.

The EUAA did not consider we should apply the EBSS to TransGrid. It was not convinced that past efficiencies made by TransGrid were being returned to consumers.<sup>9</sup>

## 9.4 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 2014–18 period arising from the application of the EBSS during the 2009–14 regulatory control period<sup>10</sup>
2. the values that are to be attributed to the EBSS parameters for any EBSS that is to apply to TransGrid in the 2014–18 period.<sup>11</sup>

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.<sup>12</sup> We must also have regard to the following factors when implementing the EBSS:<sup>13</sup>

- the need to provide service providers with a continuous incentive (that is equal in each year of any regulatory control period) to reduce opex
- the desirability of both rewarding the service providers for efficiency gains and penalising them for efficiency losses
- any incentives that service providers may have to inappropriately capitalise opex
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

Details of how the EBSS will operate are set out in the explanatory statement to the Efficiency benefit sharing scheme for electricity network service providers.<sup>14</sup>

### 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:

---

<sup>9</sup> EUAA, *Submission to TransGrid's revised proposal*, p. 14.

<sup>10</sup> NER, cl. 6A.5.4(a)(5).

<sup>11</sup> NER, cl. 6A.14.1(iv).

<sup>12</sup> NER, cl. 6A.6.5(a).

<sup>13</sup> NER, cl. 6A.6.5(b).

<sup>14</sup> AER, *Explanatory Statement - Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013.

- 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.
- 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 this has consequences for the service provider's incentives to make productivity improvements and consequently our decision on how we apply the EBSS.

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.<sup>15</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>16</sup>

## 9.5 Reasons for final decision

### 9.5.1 Carryover amounts from 2008–09

We have updated TransGrid's carryover amounts from 2008–09 so the discount rate is consistent with the rate of return approved as part of our final decision. This is consistent with the approach we used in our draft decision.

### 9.5.2 EBSS carryover amounts from the 2009–14 regulatory control period

For the final decision we approve an EBSS carryover amount of \$45.5 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 TransGrid and transmission network users of the actual efficiency gains made by TransGrid over the 2009–14 regulatory control period, as required by the NER.

---

<sup>15</sup> NER, cl. 6A.6.5(b)(3).

<sup>16</sup> NER, cl. 6A.6.5A(d)(1).

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 opex and forecast operating expenditure accurately reflects the costs faced by the TNSP in the regulatory control period.<sup>17</sup>

We are not satisfied that the changes in provisions TransGrid 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 TransGrid expects to incur. Thus for the purposes of calculating the EBSS carryover amounts, we have removed these estimates from TransGrid's reported opex. We instead consider the amount TransGrid incurred and charged against the provision better reflects the costs TransGrid 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 TransGrid's provisions were reported by TransGrid as opex. Assumptions underlying these estimates may help in ensuring TransGrid'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 TransGrid and its consumers.<sup>18</sup> We consider to significantly reward TransGrid 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 desirability of both rewarding TransGrid for efficiency gains and penalising it for efficiency losses.<sup>19</sup> We do not consider it desirable to reward TransGrid 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 TransGrid's reported opex the most over the 2009–14 regulatory control period are its provisions for long service leave. The estimated value of TransGrid's provisions for long service leave entitlements materially increased in 2011–12. This was driven by a change in the discount rate

---

<sup>17</sup> AER, *Electricity transmission network service providers - Efficiency benefit sharing scheme*, September 2007, p.6.

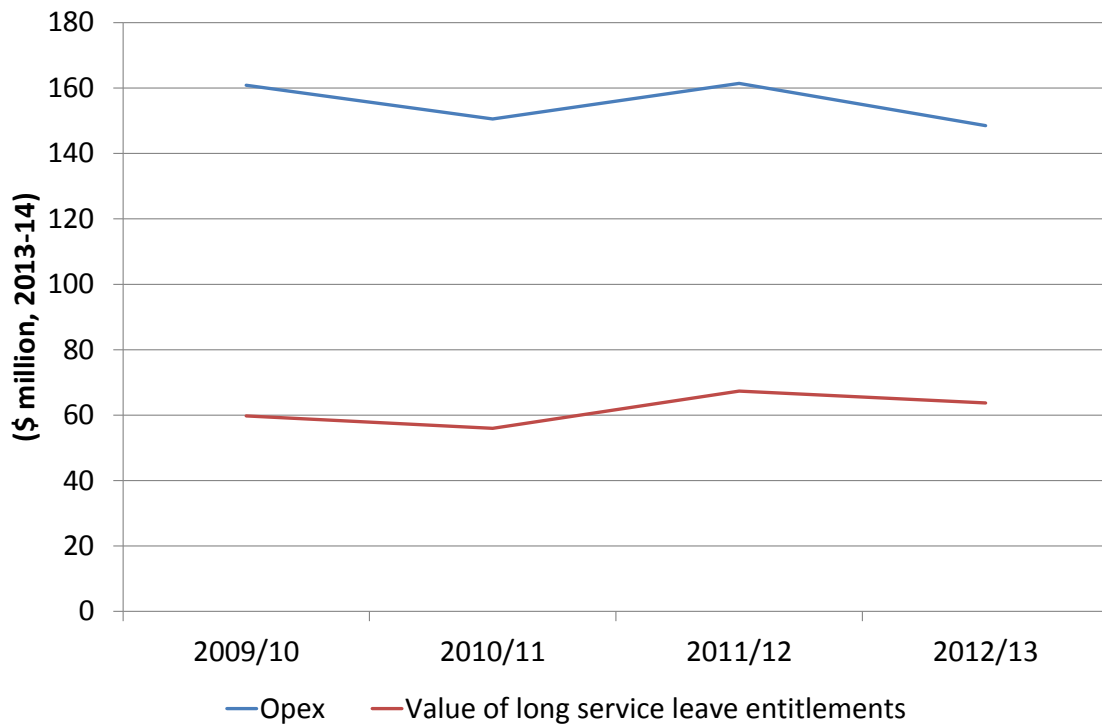
<sup>18</sup> NER, cl. 6A.6.5(a).

<sup>19</sup> NER, cl. 6A.6.5(b)(2).

used to value these provisions. 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 TransGrid'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 TransGrid's provisions for employee entitlements in 2011–12 is similar to the change in TransGrid's reported opex in 2011–12 which indicates the effect of the change in provisions on TransGrid's opex.

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



Source: TransGrid, Economic benchmarking - Regulatory Information Notice response 2009–10 to 2012–13.

Under TransGrid's proposed approach to calculating the EBSS, its reported change in the valuation of its long service leave 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 TransGrid's carryover amounts than the efficiency loss in 2011–12.<sup>20</sup> In net terms, this means that TransGrid would be rewarded because of changes in discount rates used in valuing its long service leave entitlements over the 2009–14 regulatory control period.

<sup>20</sup> The EBSS is designed to ensure the service provider 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.

Changes in discount rates used to value TransGrid's long service leave in different years of the 2009–14 regulatory control period should not affect the EBSS carryover amounts. The cost of long service leave which TransGrid 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 TransGrid'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 TransGrid's current obligations when they crystallise in the future. As the amount to be paid out by TransGrid does not change when a different discount rate is used, the change in the valuation does not reflect an efficiency gain or loss in opex.

We note that there are various techniques an actuary can use to value long service leave entitlements. 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>21</sup> This technique reduces the volatility in the value of 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.

We acknowledge that we did not state that we would take this approach when we determined the EBSS would apply to TransGrid for the 2009–14 regulatory control

---

<sup>21</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



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 TransGrid's actual costs 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, we applied this discretion in reaching our decision.

TransGrid also considers that because its target forecast opex included reported provisions, we cannot determine that actual opex must be exclusive of movement in provisions.

While TransGrid'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.

We also disagree with TransGrid's view that this decision would have a significant bearing on incentives of network service providers going forward. The main purpose of our adjustment is to ensure that TransGrid 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 TransGrid 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.

Our final decision amount is lower than our draft decision by \$0.1 million (\$2013–14) because of a different modelling approach for inflation. In our draft decision we lagged inflation by one year. This was to be consistent with the PTRM. For our final decision we have adopted the same modelling approach as TransGrid.

### **9.5.3 How the EBSS will apply in the 2014–18 period**

#### **9.5.3.1 Exclusions for insurance and self-insurance**

We do not agree with TransGrid's proposal to exclude insurance and self-insurance from the EBSS.

TransGrid notes that for the 2014–18 period its opex forecast is based on the insurance premiums it can access through the NSW Government self insurer, SICorp. It states that SICorp manages the Treasury Managed Fund, which offers a more competitive market rate than TransGrid would be able to secure in the competitive market. TransGrid considers that in the event it is no longer able to access TMF insurance cover, for instance because of a change in ownership, its insurance and self insurance costs would increase by approximately \$6.5 million per year. It considered this to be uncontrollable and a basis for excluding these costs from the EBSS.<sup>22</sup>

As outlined in our explanatory statement to version 2 of the EBSS we considered there was not a strong reason to exclude uncontrollable costs from the EBSS.<sup>23</sup> By including such costs in the EBSS, uncontrollable cost decreases or increases are shared between service providers and consumers in the same way as any efficiency gain or loss (that is, approximately 30:70 with a five year carryover period). If we excluded such costs, uncontrollable cost increases would be shared in the same way as an efficiency loss would be without an EBSS. Without an EBSS, NSPs' share of cost increases differs across the regulatory control period. We saw no reason why uncontrollable cost increases should be shared differently between service providers and consumers in different regulatory years.

If TransGrid is no longer able to find an equivalent level of insurance at current rates, we also note it is increasing the cost to provide the same service to consumers. All else being equal this is an efficiency loss. For this reason we are also not convinced that the penalty for increases in insurance costs should be any different to how other cost increases are treated. While a change in ownership may affect TransGrid's ability to insure through SICorp, it will still need an incentive to purchase cost effective insurance if ownership does change. The EBSS provides an incentive for TransGrid to pursue such efficiencies.

While the cost of TransGrid's insurance could increase with a change in ownership, other costs could decrease from the same ownership change. TransGrid will receive EBSS rewards if the change in ownership leads to greater efficiencies. We see no reason why cost increases that arise from a change in ownership should be treated differently from cost decreases from the same event.

### 9.5.3.2 Exclusions for Demand Management Innovation Allowance

We do not agree with TransGrid's proposal to exclude Demand Management Innovation Allowance from the EBSS.

TransGrid considers it is perverse to include Demand Management Innovation Allowance in the EBSS given the nature of the expenditure is discretionary and consumers support this expenditure.<sup>24</sup>

---

<sup>22</sup> TransGrid, *Revised revenue proposal 2014-15 to 2017-18*, pp. 142-143.

<sup>23</sup> AER, *Explanatory statement - Efficiency Benefit Sharing Scheme*, November 2013, p. 19.

<sup>24</sup> Transgrid, *Revised revenue proposal 2014-15 to 2017-18*, p. 143.

We are not convinced by TransGrid's arguments. The EBSS applies to total opex. Typically if expenditure is discretionary we would expect a business to fund it by finding equivalent savings in its existing budget. By doing this, it can avoid any EBSS penalties even if it increases expenditure on a particular category of opex. It is not clear why demand management should be treated any differently to other discretionary spending by TransGrid.

We have also had regard to the incentives for the implementation of non-network alternatives.<sup>25</sup> However we do not consider excluding a Demand Management Innovation Allowance from the EBSS would better promote these incentives. The decision to spend on demand management should be an efficient capex/opex trade-off. That is, in spending opex on demand management, a service provider should expect to save capex which is at least as great in NPV terms. As considered in the development of the CESS, we consider opex and capex incentives facing TransGrid are best balanced when we:

- apply a revealed cost forecasting approach for opex in combination with the EBSS
- apply the CESS.<sup>26</sup>

Not applying the EBSS would distort incentives between opex and capex - particularly towards the end of a regulatory control period. Therefore, we are not convinced that excluding opex on demand management is the best way to achieve balance between opex and capex incentives.

---

<sup>25</sup> NER, cl. 6A.6.5(b)(4).

<sup>26</sup> See AER, *Explanatory statement - Capital expenditure incentive Guideline for electricity network service providers*, November 2013, p. 29.