PRELIMINARY DECISION
Energex determination 2015−16 to 2019−20

Attachment 9 − Efficiency benefit sharing scheme

April 2015

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's preliminary decision on Energex's 2015–20 distribution determination. It should be read with all other parts of the preliminary decision.

The preliminary 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

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Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

Contents

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

Shortened form	Extended form
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 it makes and additional penalties for increases in opex. In total these rewards and penalties work together to provide a constant 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 2010–15 regulatory control period Energex operated under the Electricity distribution network service providers EBSS, which was released in June 2008.[1]

9.1 Preliminary decision

We estimate Energex would receive an EBSS carryover amount of –$56.9 million ($2014–15) from the application of the EBSS during the 2010–15 regulatory control period. The difference between our calculations of the EBSS carryover amounts and Energex's proposal is due to the treatment of expenditure recorded as a provision and a number of adjustments Energex proposed when calculating the carryover amounts.

However, given how Energex is forecasting opex for the 2015–20 regulatory control period we consider we should not apply the EBSS penalty. The EBSS was intended to work in conjunction with a revealed cost forecast approach; but we are not using a revealed cost forecast approach to forecast Energex's opex for the 2015–20 regulatory control period. Rather, we are using Energex's forecast which is substantially lower than a forecast based on its revealed costs. Given Energex's forecasting approach, we consider if we were to carryover the EBSS penalty, it would be inconsistent with the intended operation of the EBSS and it would not implement the EBSS in accordance with the NER. Therefore, our preliminary decision is not to apply an EBSS carryover penalty to Energex from the 2010–15 regulatory control period.

Our preliminary decision is to apply version two of the EBSS to Energex in the 2015–20 regulatory control period.[2] When we apply version two of the EBSS we will exclude the cost categories listed in section 9.4.3 from forecast and actual opex for the calculation of EBSS carryover amounts. Table 9.1 sets out our preliminary decision on Energex's target opex for the EBSS (total opex less excluded categories), against which we will calculate efficiency gains in the 2015–20 regulatory control period.

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

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

Table 9.1 AER's preliminary decision on Energex's forecast opex for the EBSS ($ million, 2014–15)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Forecast opex for the EBSS	336.0	332.6	337.2	348.0	350.0	1703.8

Note: excludes debt raising costs and the DMIA.

Source: Energex, *Regulatory proposal*, *PTRM*, October 2014. We accept Energex's forecast opex.

9.2 Energex's proposal

Carryover amounts accrued during the 2010–15 regulatory control period

Energex proposed a total EBSS carryover amount of $33.8 million ($2014–15) be added to its regulated revenue in the 2015–20 regulatory control period arising from the application of the EBSS in the 2010–15 regulatory control period.[3] Energex made several adjustments to its actual opex in calculating its carryover amounts.

Application of the EBSS in the 2015–20 regulatory control period

Energex proposed that version two of the EBSS should be applied in the 2015–20 regulatory control period. However, it does not agree that we should exclude cost categories that are not forecast using a revealed cost approach.[4]

9.3 AER's assessment approach

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

1. the revenue increments or decrements (if any) for each year of the 2015–20 regulatory control period arising from the application of the EBSS during the 2010–15 regulatory control period[5]
2. how any applicable EBSS is to apply to Energex in the 2015–20 regulatory control period.[6]

The EBSS must provide for a fair sharing between service providers and network users of opex efficiency gains and efficiency losses.[7] We must also have regard to the following factors when implementing the EBSS:[8]

3 Energex, *Regulatory proposal,* October 2014, p. 190.
4 Energex, *Regulatory proposal,* October 2014, p. 191.
5 NER, cl. 6.4.3(a)(5).
6 NER, cl. 6.3.2(a)(3); cl. 6.12.1(9).
7 NER, cl. 6.5.8(a).
8 NER, cl. 6.5.8(c).

- 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 the service providers with continuous incentives 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 capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non–network alternatives.

9.3.1 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.
- 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.

Under the carryover provisions of the EBSS, the fair sharing of efficiency gains and losses in one regulatory control period is intrinsically linked to the use of a revealed costs forecasting approach for the following regulatory control period. Where a different forecasting approach is used in the following period, the effective penalty for an increase in opex will be different. Where this imposes a higher penalty on a service provider than under a revealed cost forecasting approach we may consider it is not appropriate to apply the carryover penalty.

9.4 Reasons for preliminary decision

This section provides the reasons for our preliminary decision on the EBSS carryover amount from the 2010–15 regulatory control period and how we will apply the EBSS in the 2015–20 regulatory control period.

9.4.1 Carryover amounts accrued during the 2010–15 regulatory control period

If we applied the EBSS carryover amounts to Energex, we estimate it would receive an EBSS carryover amount of –$56.9 million ($2014–15). Our calculation is in accordance with section 2.3 of the Electricity distribution network service providers EBSS.[9]

In the 2010–15 regulatory control period, Energex was subject to the Electricity distribution network service providers EBSS.[10] Under this scheme the EBSS carryover amounts are to be based on the difference between:

- approved forecast opex which is set out in our determination for Energex for the 2010–15 regulatory control period
- actual opex for the regulatory years from 2010–11 to 2013–14 less excluded cost categories.

The formulae for calculating the carryover amounts are set out in this scheme.[11]

The difference between our calculations (–$56.9 million) and Energex's calculations ($38.8 million) is due to:

- how we have accounted for movements in provisions
- Energex's approach of reducing its actual opex to take account of a greater share of overhead costs being allocated to opex due to a lower capex work program
- Energex's approach of excluding costs related to the 2011 flood event and Cyclone Oswald.

We address these issues below.

The treatment of provisions

A provision is a type of accrual accounting practice. A business records an increase in a provision where it expects it will incur a future cost. Increases in provisions are often 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 future cost will be different 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.

We consider that movements in provisions should be excluded from EBSS calculations. This is because the increases in provisions do not represent the actual

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9 AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008, pp. 4−6.

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

11 AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008, pp. 5−6.

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 DNSP in the regulatory control period.[12]

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.[13]

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.

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, namely reward efficiency improvements and penalise declines in efficiency. 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 Energex's calculations its consumers would pay for efficiency carryover amounts that do not reflect changes in the underlying level of efficiency in providing standard control services during the 2010–15 regulatory control period. Instead, a proportion of the proposed amount simply represents changes in assumptions Energex used in valuing its long service leave obligations during that period. To reward Energex for changes in assumptions would be contrary to the aims of the EBSS under the NER.

Adjustments

Energex proposed two adjustments to its actual opex for EBSS purposes prior to determining the carryovers to take account of:

- a provision for service line inspection costs in 2011–12, incurred due to a serious manufacturing fault

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[12] AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008, p. 7.

[13] AASB 137, clause 11, p. 13.

- a greater share of fixed overhead costs being allocated to opex due to the change in the opex/capex proportions.

Energex adjusted its actual opex to reverse a provision it made for service line inspection costs, incurred due to a manufacturing fault. It reversed the provision because it received compensation for the fault. Without the adjustment Energex stated it would notionally recover around 70 per cent of the fault costs from consumers even though it has been compensated for those costs.[14] We agree with the adjustment Energex made because it is consistent with our decision that all movements in provisions should be excluded from EBSS calculations, as discussed above.

Energex stated it had adjusted the EBSS to account for increased overheads allocated to opex. It stated that consistent with the application of its cost allocation method (CAM), the significant reduction in capex has created a higher allocation of overhead costs to opex. Energex stated it had adjusted for the impact of the higher proportion of overhead costs such that the actual and forecast opex for EBSS purposes were prepared on the same basis. Without the adjustment, it considered customers would be worse off. [15]

We do not agree with Energex's proposed adjustment to the opex used to calculate its EBSS carryover amounts, to account for increased overheads allocated to opex, There is no provision for this type of adjustment within the scheme. The EBSS sets out a formula which rewards (penalises) the network service provider based on its actual opex compared with its approved opex forecast. The scheme does not allow for these costs to be excluded from that comparison.

We also note that Energex's proposed adjustment for overheads increases its EBSS carryover, it does not decrease it. Therefore, contrary to Energex's reasoning, its customers would be worse off as a result of the adjustment not better off.

Exclusions

Energex excluded the costs of the 2011 flood event and Cyclone Oswald from its EBSS calculations.[16] We note that if we were to exclude these two events from the EBSS Energex, it would reduce Energex's EBSS carryover amounts.

The Queensland distribution determination 2010–15 provided an EBSS exclusion for "other specific uncontrollable costs incurred and reported by the Qld distributors during the next regulatory control period, which the AER considers should be excluded after assessment against the relevant principles expressed in clause 6.6.1(j) of the NER and EBSS."[17] We note that clause 6.6.1(j) lists factors that the AER must take into account in making a cost pass through decision.

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[14] Energex, *Regulatory proposal*, October 2014, p. 188.
[15] Energex, *Regulatory proposal*, October 2014, p. 188.
[16] Energex, *Regulatory proposal*, October 2014, p. 187.
[17] AER, *Final decision, Queensland Distribution determination 2010–15*, May 2010, p. 287.

Our preliminary decision is that we will not exclude the costs of the 2011 flood event and Cyclone Oswald from the EBSS. In coming to our position we had regard to the relevant principles expressed in clause 6.6.1(j) of the NER and in the EBSS.[18] We note that clause 6.6.1(j)(8) of the pass through provisions allows us to consider any factors we consider relevant.

While we acknowledge that Energex wants to reduce the cost to consumers of the two natural disasters, there are other ways Energex could achieve this objective. The EBSS is one input into Energex's revenue requirement. If Energex does not wish to share the costs of these events with consumers, it can do this in other ways, rather than by adjusting the EBSS. For example, it is free to reduce the costs to consumers by reducing its prices, thereby earning less than the maximum allowable revenue it can recover from its consumers. We consider this would be a preferable way of achieving this objective.

9.4.2 Application of carryover amounts accrued during the 2010–15 regulatory control period

Our preliminary decision is not to apply the negative carryover amounts Energex has accrued during the 2010–15 regulatory control period.

As noted above, the opex forecasting approach and the EBSS are closely related. For instance, if a service provider reduces its costs in the most recent year of the regulatory control period it will receive EBSS rewards. If we then use its actual opex to forecast its opex in the next regulatory control period it will also receive a lower opex forecast.

In this way, the service provider receives a reward, spread out over a number of years, for making an efficiency gain. The efficiency gain is eventually passed on to consumers through lower forecast opex. Both the service provider and the consumer benefit from the gain. When the EBSS is applied in combination with a revealed cost forecasting approach to opex, the efficiency gain will effectively be shared between a service provider and its consumers at a ratio of 30:70.

Conversely, if a service provider increases its opex in the most recent year of the regulatory control period it will receive an EBSS penalty. This is in addition to the fact that it will carry the cost (or face a reduced benefit) of funding the increase in opex in the short term. The penalties will last for a number of years. In this way, the service provider carries a penalty in the short term, but eventually the efficiency loss will be shared with consumers at a later time through higher forecast opex. Again, when the EBSS is applied in combination with a revealed cost forecasting approach to opex, the penalty will effectively be shared between a service provider and consumers at a ratio of 30:70.

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[18] In addition to the matters listed in cl. 6.6.1(j)(1)-(7), cl. 6.6.1(j)(8) of the pass through provisions allows us to consider any factors we consider relevant.

We consider this approach gives effect to fair sharing of efficiency gains and losses and provides the appropriate incentive to service providers to avoid efficiency losses and to promote efficiency gains.

In most circumstances, we consider we should apply the EBSS rewards and penalties that have accrued during a regulatory control period. Incentives work best where the rewards and penalties facing a business are clear in advance of its decision to spend money. A business bases its expenditure decisions on the potential rewards and potential penalties it would face. If rewards and penalties are not applied consistently between different service providers it may create investment uncertainty for all service providers subject to those arrangements. For that reason, we consider a decision not to apply incentive rewards and/or penalties should only be considered in limited circumstances.

In this case, we consider Energex's forecasting approach warrants reconsideration of the EBSS penalties that apply to it. As discussed in the opex attachment 7, Energex did not use its revealed costs to forecast its opex for the 2015–20 regulatory control period. Rather its total opex forecast was substantially lower than if it had used revealed costs. We have accepted that Energex's forecast reasonably reflects the opex criteria.

If we applied both the EBSS penalties and a lower opex allowance for the next regulatory control period, this has implications for whether the efficiency losses Energex made during the 2010–15 regulatory control period would be shared fairly with consumers. This would mean Energex would carry a greater share of efficiency losses than was intended when we decided to apply the EBSS prior to the start of the 2010–15 regulatory control period.

If we used a revealed cost forecasting approach, Energex’s increase in opex in the 2010–15 regulatory control period would be reflected in our forecast of Energex's opex in each year of the 2015–20 regulatory control period. That is, Energex's opex forecast would be higher in each year of the 2015–20 regulatory control period as a result of its increase in opex in the 2010–15 regulatory control period. This forecasting approach, in combination with the EBSS penalties is the way the increase in opex in these years is shared between Energex and its consumers.

However, as Energex did not use revealed costs to forecast its opex, Energex's increase in opex in this time does not affect its opex forecast. This means, if we applied the EBSS penalties, Energex would wear a greater penalty from increasing its opex in these years than it would under a revealed cost forecasting approach. We consider that applying the EBSS would not give effect to the objectives of fair sharing of efficiency losses as defined under the NER. We consider we should not apply the EBSS penalties to Energex for this reason.

We acknowledge that this is a different position to that in the Electricity distribution network service providers EBSS.[19] We intended to apply all EBSS carryover amounts - both positive and negative. However, at the same time, we also highlighted the inter-relationships between the EBSS and a revealed cost forecasting approach.[20] For instance, we considered we were likely to be relying on revealed costs to some degree to forecast Energex's opex in the next period.[21]

When implementing an efficiency benefit sharing scheme, we have regard to whether benefits to electricity consumers from the scheme are sufficient to warrant a penalty we might apply under the scheme. As Energex has not used a revealed cost forecasting approach, we have revisited our earlier position that all negative EBSS carryover amounts should apply when implementing the EBSS. A change in opex forecasting approach away from a revealed cost approach leads to different sharing of efficiency losses than was intended when we established the EBSS. We do not believe a carryover penalty is warranted in these circumstances.

We note that this preliminary decision only applies because of the change in opex forecasting approach. We still intend to apply negative EBSS carryover amounts to other service providers where we continue to rely on a revealed cost forecasting approach.

The Consumer Challenge Panel (CCP) and other stakeholders raised concerns about Energex's proposed EBSS carryover. Submissions questioned if this carryover amount was a result of genuine efficiency gains that would benefit consumers.[22] The CCP was concerned that the large proposed EBSS carryover amounts reflected an overly generous opex allowance rather than genuine efficiency savings.

As we state above, our preliminary decision is that Energex's EBSS carryover amounts should be negative rather than positive. However, for the reasons outlined above, we do not consider these amounts should apply.

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19 AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008, pp. 7.

20 AER, *Electricity distribution network service providers Efficiency benefit sharing scheme*, June 2008, pp. 4; AER, *Better regulation, Explanatory statement efficiency benefit sharing scheme for electricity network service providers*, November 2013, pp. 11.

21 AER, *Draft decision, Queensland Distribution determination 2010–15*, November 2009, p. 312.

22 CCP, *Submission on Energex and Ergon Energy capex and opex proposals*, 30 January 2015, p. 26.
AGL, *Submission on Energex's regulatory proposal* 2015-20, 30 January 2015, p. 15.
EUAA, *Submission on Energex's regulatory proposal 2015-20*, 30 January 2015, p. 30.
COTA, *Submission on Energex's regulatory proposal 2015-20*, 30 January 2015, p. 2.
Queensland Council of Social Service, *Submission on Qld distributors' regulatory proposals 2015-20*, 30 January, p. 91.

9.4.3 How the EBSS will apply in the 2015–20 regulatory control period

Our preliminary decision is to apply version two of the EBSS to Energex in the 2015–20 regulatory control period.

We consider the EBSS is needed to provide Energex with a continuous incentive to pursue efficiency gains during the 2015–20 regulatory control period. As we often rely on a single year revealed cost approach to forecasting opex, we consider the EBSS is also needed to provide Energex with an incentive not to increase its opex in the expected base year.

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 2015–20 regulatory control period will be five years. This aligns the EBSS carryover period with the total length of Energex'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.[23]

When calculating actual opex under the EBSS we will adjust reported actual opex for the 2015–20 regulatory control period to reverse any movements in provisions. As outlined in section 9.4.1 above, for regulatory purposes we consider actual opex net of movement in provisions best reflects the actual opex incurred by the service provider during the regulatory control period.

Adjustments to forecast or actual opex when calculating carryover amounts

Energex states that all opex categories should be included in the EBSS.[24] In particular, it does not agree that we should allow for exclusions of categories of costs from the

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[23] AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, pp. 5–7.

[24] Energex, *Regulatory proposal*, October 2014, p. 191.

EBSS where we do not forecast them using a single year revealed cost forecasting approach. Energex states that the business faces equivalent and continuous incentives regardless of how costs are forecast. It also states that including all opex categories provides administrative simplicity and that we should not make adjustments on an ex-post basis.

Version two of the EBSS allows for exclusions of categories of costs from the EBSS where we do not forecast them using 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 in a single year will not necessarily be passed through to consumers. Consumers may pay for EBSS benefits without receiving the benefits of lower opex. We consider this would not give effect to fair sharing of efficiency gains and losses.

We propose to exclude debt raising costs and the demand management innovation allowance (DMIA) from the EBSS. We have developed a category specific forecast for debt raising costs and the DMIA is defined by the demand management incentive scheme (DMIS). As neither forecast is based on revealed expenditure they should be excluded from the EBSS.

In addition to the excluded cost category we will also:

- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the initial regulatory determination. This may include approved pass through amounts
- 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 2020 where doing so better achieves the requirements of clause 6.5.8 of the NER.