



FINAL DECISION

Ergon Energy Distribution Determination 2020 to 2025

Attachment 8 Efficiency benefit sharing scheme

June 2020

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165

Email: EnergyQueensland2020@aer.gov.au

AER reference: 62728

Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ergon Energy for the 2020–25 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 14 – Pass through events

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Attachment A – Negotiating framework

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8 Efficiency benefit sharing scheme

The efficiency benefit sharing scheme (EBSS) is intended to provide a continuous incentive for distributors to pursue efficiency improvements in opex, and provide for a fair sharing of these between distributors and network users. Consumers benefit from improved efficiencies through lower regulated prices.

This attachment sets out our final decision on the EBSS carryover amounts Ergon Energy accrued over the 2015–20 regulatory control period. It also sets out how we will apply the EBSS over the 2020–25 regulatory control period.

8.1 Final decision

Our final decision is to approve EBSS carryover amounts totalling \$98.4 million (\$2019–20) for the 2015–20 regulatory control period. This is \$95.5 million lower than Ergon Energy's revised proposal of \$193.9 million (\$2019–20). This is primarily due to our different approach to two adjustments to actual opex proposed by Ergon Energy. We have also updated our carryover amounts to reflect inflation numbers as set out in the Reserve Bank of Australia's (RBA) latest *Statement on Monetary Policy*.¹

To calculate its EBSS carryover amounts Ergon Energy made two adjustments to the actual opex it reported for the 2015–20 regulatory control period:

- Ergon Energy adjusted opex in the base year (2018–19) to remove what it considered were non-recurrent costs caused by abnormally high storm activity in the base year
- Ergon Energy adjusted opex in the base year and the earlier years in the 2015–20 regulatory control period as a true-up to adjust actual opex for what it considers to be under- and over-recovery of corporate overheads.²

We have considered these adjustments and decided not to remove the non-recurrent storm costs as this is generally only justified where there has been a non-recurrent change at the total opex level, not the category level. This has not been observed, with total opex in the base year 2018–19 being similar to the previous year (2017–18). This change reduces our calculated EBSS carryovers by \$60.8 million (\$2019–20) relative to those calculated by Ergon Energy.

¹ Reserve Bank of Australia, *Statement on Monetary Policy - May 2020, Forecast Table*, May 2020, available at <https://www.rba.gov.au/publications/smp/2020/may/forecasts.html>. We have used the trimmed mean inflation series for conversion into \$2019–20. Our usual implementation is to use the (headline) CPI forecast for the year ending June 2020. In the current COVID circumstances, we consider the trimmed mean forecast better reflects core expectations of inflation as set out in the RBA's *Statement on Monetary Policy*. Further, the trimmed mean smooths the transient volatility in the CPI forecasts in the May *Statement on Monetary Policy*.

² Ergon Energy, *1.003 - Ergon Energy Revised Regulatory Proposal 2020–25*, December 2019, p. 47–48.

We have included an adjustment for the under- and over-recovery of corporate overheads; however, we have adopted a different approach to determine the adjustment. This is because we consider it provides a better reflection of true underlying opex than the proposed approach. This change reduces our calculated EBSS carryovers by \$34.4 million (\$2019–20) relative to those calculated by Ergon Energy.

Table 8.1 sets out our final decision on the EBSS carryover amounts Ergon Energy accrued during the 2015–20 regulatory control period (to be recovered over the next regulatory control period).

Table 8.1 Final decision on EBSS carryover amounts (\$ million, 2019–20)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Ergon Energy revised proposal	56.1	49.3	60.7	15.6	12.2	193.9
AER final decision	36.2	19.9	38.6	3.8	–	98.4

Source: Ergon Energy, 9.002 - *Efficiency Benefit Sharing Scheme (EBSS) Model*, December 2019; AER analysis.

Our final decision is to continue to apply version 2 of the EBSS to Ergon Energy in the 2020–25 regulatory control period.³ Consistent with our draft decision, and Ergon Energy's revised proposal, we will exclude debt raising costs from the scheme as a pre-defined 'excluded category'. We will also make other adjustments as permitted by the EBSS, such as removing demand management innovation allowance (DMIA) costs and movements in provisions (as outlined in section 8.4.2).

Table 8.2 sets out our final decision on the opex forecasts we will use to calculate efficiency gains in the 2020–25 regulatory control period, including forecast debt raising costs that will be excluded.

Table 8.2 Forecast opex for the EBSS (\$ million, 2019–20)

	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25
Total forecast opex	388.1	395.4	376.8	371.6	367.0	362.1	357.2
Less debt raising costs	–5.7	–5.7	–5.6	–5.7	–5.7	–5.8	–5.8
Forecast opex for the EBSS	382.5	389.7	371.2	365.9	361.3	356.3	351.4

Source: AER, Ergon Energy final decision—Post tax revenue model, April 2020; AER analysis.

Note: Numbers may not add up due to rounding.

We discuss the reasons for our final decision in section 8.4.

³ NER, cl. 6.12.1(9); AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

8.2 Ergon Energy's revised proposal

8.2.1 Carryover amounts from the 2015–20 regulatory control period

Ergon Energy calculated EBSS carryover amounts totalling \$193.9 million (\$2019–20) from the application of the EBSS in the 2015–20 regulatory control period. In its revised proposal, it elected to include these carryover amounts in its proposed revenues. This is a change from Ergon Energy's initial proposal, where it did not include carryover amounts in proposed revenues, subject to our accepting its regulatory proposal.⁴

To calculate its EBSS carryover amounts Ergon Energy made two adjustments to the actual opex it reported for the 2015–20 regulatory control period:

1. Ergon Energy adjusted opex in the base year (2018–19) to remove what it considered were non-recurrent costs caused by abnormally high storm activity in the base year. Ergon Energy included this adjustment using the scheme's non-recurrent efficiency gain mechanism. The amount Ergon Energy proposed to remove from the base year was \$12.2 million (\$2019–20).⁵
2. Ergon Energy adjusted opex in the base year and the earlier years in the 2015–20 regulatory control period, as a true up to adjust actual opex for what it considers to be under- and over-recovery of corporate overheads. This has the impacts on opex in the first four years of the current regulatory control period as shown in Table 8.3 below.⁶

Table 8.3 Ergon Energy's estimate of the over and under-recovery of corporate overheads (\$ million, 2019–20)

Year	2015–16	2016–17	2017–2018	2018–2019
Balance	15.34	3.86	-14.17	-12.88

Source: Ergon Energy, *9.002 Efficiency Benefits Sharing Scheme (EBSS) Model*, December 2019.

Note: Numbers may not add up due to rounding.

The corresponding adjustments to base year opex are included in the 'internal' opex forecast that was provided with Ergon Energy's revised proposal. As set out in attachment 6, in its revised proposal Ergon Energy re-submitted the same opex forecast as its initial proposal, which we accepted in our draft decision. Ergon Energy re-submitted its initial proposal on the basis of its "commitment to affordable customer outcomes" and "AER [acceptance] of our January forecast in its Draft Decision, having

⁴ Ergon Energy, *1.004 Ergon Energy Regulatory Proposal 2020–25*, January 2019, p. 103.

⁵ Ergon Energy, *Revised regulatory proposal 2020–25 - 7.001 Opex attachment*, December 2019, pp. 44–45.

⁶ Ergon Energy, *Revised regulatory proposal 2020–25 - 7.001 Opex attachment*, December 2019, pp. 46–47.

determined that it was not materially inefficient."⁷ However, even though it proposed the same opex forecast, it also provided an 'internal' opex forecast which took into account updated information. This internal forecast was 7.3 per cent higher than its initial proposal.

8.2.2 Application in the 2020–25 regulatory control period

Ergon Energy accepted our draft decision as it relates to the application of the EBSS in the 2020–25 regulatory control period.⁸

8.2.3 Stakeholder submissions

Ergon Energy's EBSS carryovers were not a particularly strong focus of submissions. Several submissions (CCP14⁹, the ECA¹⁰, Dynamic Analysis¹¹, the Chamber of Commerce and Industry Queensland (CCIQ)¹², and Origin Energy¹³) made note of the fact that in its revised proposal Ergon Energy had chosen to retract its commitment of the initial proposal to forego carryover amounts. The ECA noted that this retraction came late in the process and was not well socialised with advocates.¹⁴ The CCIQ stated that it strongly opposed Ergon Energy's proposal to retain its EBSS carryovers, after having previously elected to forego them.¹⁵

8.3 Assessment approach

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

- the revenue increments or decrements for each year of the 2020–25 regulatory control period arising from the application of the EBSS during the 2015–20 regulatory control period¹⁶
- how the EBSS will apply to Ergon Energy in the 2020–25 regulatory control period.¹⁷

⁷ Ergon Energy, *1.003 - Ergon Energy Revised Regulatory Proposal 2020–25*, December 2019, p. 36.

⁸ Ergon Energy, *Revised regulatory proposal 2020–25*, December 2019, p. 49.

⁹ CCP14, *Advice to the AER on the Energex and Ergon Energy 2020–25 Revised Regulatory Proposals*, January 2020, p. 13.

¹⁰ ECA, *ECA submission on Energy Queensland revised proposals*, January 2020, p. 4.

¹¹ Dynamic Analysis, *Technical report on Ergon revised proposal*, January 2020, p. 12.

¹² CCIQ, *CCIQ submission to the AER, 2020–25 Energy Queensland Price Determination*, January 2020, pp. 4–5.

¹³ Origin Energy, *Origin Response EQ Revised Proposals 2020–25_Redacted*, January 2020, p. 2.

¹⁴ ECA, *ECA submission on Energy Queensland revised proposals*, January 2020, p. 4.

¹⁵ CCIQ, *CCIQ submission to the AER, 2020–25 Energy Queensland Price Determination*, January 2020, p. 5.

¹⁶ NER, cl. 6.4.3(a)(5).

¹⁷ NER, cl. 6.3.2(a)(3) and 6.12.1(9).

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between Ergon Energy and network users.¹⁸ We must also have regard to the following matters when implementing the EBSS:¹⁹

- 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 Ergon Energy with a continuous incentive to reduce opex
- the desirability of both rewarding Ergon Energy for efficiency gains and penalising it for efficiency losses
- any incentives that Ergon Energy may have to capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

8.3.1 Interrelationships

The EBSS is closely linked to our revealed cost approach to forecasting opex. When we assess or develop our opex forecast, the NER require us to have regard to whether the opex forecast is consistent with any incentive schemes.²⁰

Our opex forecasting method typically relies on using the 'revealed costs' of the service provider in a chosen base year to develop a total opex forecast if the chosen base year opex is not considered to be 'materially inefficient'. Under this approach, a service provider would have an incentive to spend more opex in the expected base year. Also, a service provider has less incentive to reduce opex towards the end of the regulatory control period, where the benefit of any efficiency gains is retained for less time.

The application of the EBSS serves two important functions:

1. It removes the incentive for a service provider to inflate opex in the expected base year in order to gain a higher opex forecast for the next regulatory control period.
2. It provides a continuous incentive for a service provider to pursue efficiency improvements across the regulatory control period.

The EBSS does this by allowing a service provider to retain opex efficiency gains (or losses) for a total of six years, regardless of the year in which the service provider makes them. Where we do not propose to rely on the single year revealed costs of a service provider in forecasting opex, this has consequences for the service provider's incentives and our decision on how we apply the EBSS.

¹⁸ NER, cl. 6.5.8(a).

¹⁹ NER, cl. 6.5.8(c).

²⁰ NER, cl. 6.5.6(e)(8). Further, we must specify and have regard to the relationship between the constituent components of our overall decision: NEL, s 16(1)(c).

When a business makes an incremental efficiency gain, it receives a reward through the EBSS, and consumers benefit through a lower revealed cost forecast for the subsequent regulatory control period. This is how efficiency improvements are shared between consumers and the service provider. If we subject costs to the EBSS that are not forecast using a revealed cost approach, a business would in theory receive a reward for efficiency gains through the EBSS (at a cost to consumers), but consumers would not benefit through a lower revealed cost forecast in the subsequent regulatory control period.

Therefore, we typically exclude costs that we do not forecast using a single year revealed cost forecasting approach.

For these reasons, our decision on how we will apply the EBSS to Ergon Energy has a strong interrelationship with our decision on its opex (see Attachment 6).

8.4 Reasons for final decision

8.4.1 Carryover amounts from the 2015–20 regulatory control period

Ergon Energy calculated EBSS carryovers of \$193.9 million (\$2019–20) in its revised proposal.²¹ In its initial proposal it elected to forfeit its calculated carryovers (which it calculated as \$268.5 million (\$2019–20)), conditional on our acceptance of its initial proposal.²² In the draft decision, we presented our calculation of the EBSS increments we considered Ergon Energy were entitled to, which was \$157.6 million (\$2019–20). For reasons explained in section 8.4.1 of the draft decision, this was \$110.9 million (\$2019–20) lower than those calculated by Ergon Energy. However, the AER's draft decision for Ergon Energy was to not include any EBSS carryovers; i.e. we accepted Ergon Energy's proposal to forfeit its carryovers. We noted in the draft decision that, if, in its revised proposal, Ergon Energy elects to claim its EBSS carryovers, then we will add EBSS carryovers (of an amount we consider appropriate) to its total revenue for the 2020–2025 regulatory control period.²³

Our final decision is to approve EBSS carryover amounts totalling \$98.4 million (\$2019–20) for the 2015–20 regulatory control period. This is \$95.5million lower than Ergon Energy's revised proposal of \$193.9 million (\$2019–20). This is primarily due to our different approach to two adjustments to actual opex proposed by Ergon Energy.

As set out in section 8.2.1, to calculate its EBSS carryover amounts Ergon Energy relied on its internal forecast of opex and used actual opex over the 2015–20 regulatory control period, but made the two adjustments outlined in that section above and discussed further below.

²¹ Ergon Energy, *Revised regulatory proposal 2020–25*, December 2019, p. 48.

²² Ergon Energy, *Initial regulatory proposal 2020–25*, December 2019, p. 103.

²³ AER, *Draft decision Ergon Energy Attachment 8 Efficiency Benefits Sharing Scheme*, October 2019, p. 10.

Ergon Energy's internal opex forecast removed \$12.2 million (\$2019–20) from actual opex in the base year to account for the adverse impact of atypically high storm costs on emergency response expenditure. It considered these costs were non-recurrent and reflected one-off costs that would not be ongoing. Ergon Energy then made a corresponding revenue adjustment to its EBSS calculation through the use of the non-recurrent efficiency gain component.

As discussed in attachment 6, we have not removed this proposed amount from our alternative estimate of base year opex, and have therefore not made the corresponding non-recurrent efficiency adjustment in the EBSS as proposed by Ergon Energy. This is on the basis that the criteria for using a non-recurrent efficiency adjustment, as set out in the AER's *Expenditure Forecast Assessment Guideline*, have not been met. In particular, total opex in the base year 2018–19 is similar to the previous year (2017–18) and does not appear to be non-recurrent - total opex was \$401.0 million in 2017–18 and \$400.7 million in 2018–19. While categories of opex will generally fluctuate from year to year, we consider that a non-recurrent efficiency adjustment is generally only justified where there has been a non-recurrent change at the total opex level.

As a result of not making this non-recurrent efficiency adjustment, our calculated EBSS carryovers reduce by \$60.8 million (\$2019–20) relative to those calculated by Ergon Energy.

Ergon Energy's internal opex forecast also proposed that a true up adjustment should be made to reported opex in each of the years from 2015–16 to 2018–19 for corporate overheads over or under-recoveries. Ergon Energy then made corresponding revenue adjustments to its EBSS calculation, shown above in Table 8.3.

As discussed in attachment 6, we accept the need for such an adjustment. However, we have adopted a different approach to calculating this adjustment. Our approach allocates the balance of over- and under-recoveries between opex and capex on the basis of proportional direct opex/direct capex. This is because we consider that this approach will obtain adjusted opex that is more reflective of underlying opex in each of the four years than Ergon Energy's approach. The approach proposed by Ergon Energy involved allocate each of these balances 100 per cent to opex, with no allocation to capex. This was on the basis that this is the approach that would have occurred under its previous, 2010–15 Cost Allocation Methodology (CAM). We note that the approach we have used is broadly the same approach adopted in Energex's current (2015–20) CAM. The adjusted amounts in each year under our approach therefore differ to those proposed by Ergon Energy.

The net result of adopting our approach to adjusting opex for corporate overhead over- or under-recoveries is a reduction in EBSS carryovers by \$34.4 million (\$2019–20) relative to those calculated by Ergon Energy.

The only other reason for our calculation of EBSS carryovers being different from Ergon Energy's is that we updated the inflation forecast for the year to June 2020 to use the trimmed mean inflation forecast in the RBA's May 2020 *Statement on Monetary Policy*.²⁴

Table 8.1 above sets out our final decision on the EBSS carryover amounts Ergon Energy accrued during the 2015–20 regulatory control period (to be recovered over the next regulatory control period).

We consider that the EBSS carryover amounts we have calculated provide for a fair sharing of efficiency gains and losses between Ergon Energy and its network users. They reward Ergon Energy for the efficiency gains it has made and penalise it for its efficiency losses. Further, we consider that the benefit to networks users, through lower forecast opex, is sufficient to warrant the EBSS carryover amounts we have calculated.

8.4.2 Application in the 2020–25 regulatory control period

Our final decision is to continue to apply version 2 of the EBSS to Ergon Energy during the 2020–25 regulatory control period. We consider applying the scheme will benefit long-term electricity customers because it will provide continuous incentives for Ergon Energy to reduce opex. Provided that we forecast Ergon Energy's future opex using its revealed costs in the 2020–25 regulatory control period, any efficiency gains that Ergon Energy achieves will lead to lower opex forecasts, and thus lower network tariffs.

Version 2 of the EBSS specifies our approach to determining the length of the carryover period and adjusting forecast or actual opex when calculating carryover amounts.²⁵ We provide details on these below.

Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2020–25 regulatory control period will be the same as the length of Ergon Energy's following regulatory control period.²⁶ We expect Ergon Energy's next regulatory control period will be five years, starting from 1 July 2025.

²⁴ We have used the trimmed mean inflation series for conversion into \$2019–20. Our usual implementation is to use the (headline) CPI forecast for the year ending June 2020. In the current COVID circumstances, we consider the trimmed mean forecast better reflects core expectations of inflation as set out in the RBA's *Statement on Monetary Policy*. Further, the trimmed mean smooths the transient volatility in the CPI forecasts in the May *Statement on Monetary Policy*.

²⁵ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

²⁶ NER, cl. 6.5.8(c)(2).

Adjustments to forecast or actual opex when calculating carryover amounts

The EBSS allows us to exclude categories of costs that we do not forecast using a single year revealed cost forecasting approach. We do this to fairly share efficiency gains and losses. For instance, where a service provider achieves efficiency improvements, it receives a benefit through the EBSS and network users receive a benefit through lower forecast opex in the next regulatory control period. This is the way network users and the service provider share in the benefits of an efficiency improvement.

If we do not use a single year revealed cost forecasting approach, we may not pass the benefits of revealed efficiency gains through to network users. It follows that network users should not pay for EBSS rewards where they do not receive the benefits of a lower opex forecast.

As noted in section 8.2.2, Ergon Energy accepted our draft decision that we apply the opex adjustments allowed under version 2 of EBSS.²⁷

Consistent with version 2 of the EBSS, we will only exclude debt raising costs from the EBSS as a pre-defined 'excluded category'. This is because we do not forecast debt raising costs on a revealed cost basis. We instead forecast these based on a benchmark amount. These amounts are shown in Table 8.2 above.

In addition to the excluded cost categories discussed above, we will also make the following adjustments when we calculate the EBSS carryover amounts for the next regulatory control period:

- adjust forecast opex to add (subtract) any approved revenue increments (decrements) made after the initial regulatory determination, such as approved pass through amounts or opex for contingent projects²⁸
- adjust actual opex to remove DMIA opex because it is not included in the opex forecast (but is typically reported by service providers as part of their standard control services opex)²⁹
- adjust actual opex to add capitalised opex that has been excluded from the regulatory asset base³⁰
- adjust forecast opex and actual opex for inflation³¹

²⁷ Ergon Energy, *Revised regulatory proposal 2020–25*, December 2019, pp. 48–49.

²⁸ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

²⁹ Clause 6.5.8(c)(5) of the NER requires us to have regard to the possible effects of the scheme on incentives for the implementation of non-network options.

³⁰ Clause 6.5.8(c)(4) of the NER requires us to have regard to any incentives the service provider may have to capitalise expenditure.

³¹ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 7.

- adjust actual opex to reverse any movements in provisions
- adjust opex for any services that will not be classified as standard control services in the 2025–30 regulatory control period, where these costs are not forecast using a single year revealed cost approach and excluding these costs better achieves the requirements of clause 6.5.8 of the NER.³²

³² AER, *Explanatory Statement: Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 14.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
CAM	cost allocation method
capex	capital expenditure
CCP14	Consumer Challenge Panel, sub-panel 14
CPI	consumer price index
DMIAM	demand management innovation allowance mechanism
distributor	distribution network service provider
EBSS	efficiency benefit sharing scheme
ECA	Energy Consumers Australia
NER	National Electricity Rules
opex	operating expenditure
RBA	Reserve Bank of Australia