Incentive schemes for non-contestable network projects in NSW: Guidance Note
Draft

August 2023

AUSTRALIAN ENERGY REGULATOR

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AER reference: AER213602

Amendment record

Version	Date	Pages
1	3 August 2023	15

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Invitation to make submissions

We invite interested parties to make written submissions in response to this draft Guideline, and the other draft supporting guidelines for the Electricity Infrastructure Investment Act released by the AER, by close of business 23 August 2023.

Please contact us if you would like to meet with AER staff during this consultation period. Submissions should be sent electronically to REZ@aer.gov.au with the title 'Submission – Draft Guidelines EII Act' We ask that all submissions sent in an electronic format are in Microsoft Word or another text-readable document form.

Alternatively, submissions may be sent to:

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Enquiries about this paper, or about lodging submissions, should be directed to REZ@aer.gov.au.

Confidentiality

The AER prefers that all submissions be publicly available to facilitate informed and transparent consultation. Submissions will be treated as public documents unless otherwise requested.

Parties wishing to submit confidential information are requested to:

- clearly identify the information that is the subject of the confidentiality claim, and
- provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on the AER's website. For further information regarding the AER's use and disclosure of information provided to it, please see the ACCC/AER Information Policy available on our website.

Public forum

The AER will host an online public forum to allow stakeholders the opportunity to ask questions about our draft Guidelines before submissions close.

The public forum will be held from 10 am to 11 am (AEST) on 14 August 2023. To register your interest in the public forum, please email REZ@aer.gov.au by close of business on 11 August 2023.

Next steps

We will consider submissions received and feedback from the public forum before we publish a final Guideline in early September 2023.

1 Overview

1.1 Who are we?

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. We are the economic regulator for wholesale and retail energy markets, as well as electricity and gas networks in every state and territory in Australia except Western Australia. We regulate electricity networks under the National Electricity Law (NEL) and National Electricity Rules (NER).[1] We are also a regulator under the *Electricity Infrastructure Investment Act 2020 (NSW)* (EII Act).

1.2 Introduction

This draft guidance note outlines how we, under the EII Act and *Electricity Infrastructure Investment Regulation 2021 (NSW)* (EII Regulation), will apply incentive schemes for use in a non-contestable revenue determination.

In exercising our function to make contestable and non-contestable revenue determinations, we are to take into account the principle that incentives should be given to network operators to promote economic efficiency.[2] The guideline for making non-contestable revenue determinations (Guideline) was published on 27 April 2023 and outlines the application of supporting guidelines and guidance notes, incentive schemes and models.[3] As part of the Guideline, we are required to include an Efficiency Benefit Sharing Scheme (EBSS) and a Capital Expenditure Sharing Scheme (CESS) that we will use in making a non-contestable revenue determination.[4] This draft guidance note should be read in conjunction with the Guideline.

In developing this guidance note we have had regard to the recently completed Review of Incentive Schemes for Regulated Networks[5] which examined and refined the application of EBSS and CESS to ensure the schemes remained relevant and fit for purpose (see section 2.2).

By issuing this guidance note as a draft, we are seeking stakeholder's views and feedback on the structure and content of this guidance note. We are also seeking views and feedback on the approach we are proposing to take in applying the EBSS and CESS to non-contestable revenue determinations.

Under the NER, a person who owns, controls or operates (or proposes to) network infrastructure is called a *Network Service Provider*. Under the EII Act, a person who owns, controls or operates network infrastructure is called a *Network Operator*. When referring to

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[1] IPART has also been appointed as a Regulator to undertake certain functions under the EII Act. See: https://www.aer.gov.au/networks-pipelines/nsw-renewable-energy-zones.

[2] EII Act 2020, s. 37 and EII Regulation, cl. 46(1)(ii).

[3] AER, Final Guideline – Transmission Efficiency Test and revenue determination for non-contestable network infrastructure projects, April 2023, s. 3.3.

[4] EII Regulation, cl. 47B(1)(a) and cl. 47B(1)(b).

[5] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-incentive-schemes-for-regulated-networks

operations under the NER, the term '*Network Service Provider'* is used. When referring to operations under the EII framework, we use the term '*Network Operator'*.

1.3 What does the EBSS do?

Under the NER, the objective of the EBSS is to provide Network Service Providers (NSPs) with a consistent incentive to undertake efficient operating expenditure (opex) across each year of a regulatory control period.

The EBSS is intrinsically linked to the approach we use to forecast opex. When forecasting opex we typically use one year of actual opex as a 'base year' to forecast future opex. We then make changes for factors such as output growth, real price changes, productivity growth and any other efficient cost changes. This is known as the revealed cost base-step-trend forecasting approach. There are two potential incentive problems with this forecasting approach when an EBSS is not in place:

- A NSP has an incentive to increase opex in the expected base year to increase its forecast opex allowance for the following regulatory control period.
- Incentive levels aren't maintained through the regulatory control period. When a NSP underspends on its opex allowance, it retains the benefits for the remainder of the regulatory control period. Without the EBSS a NSP has declining incentives to reduce its recurrent opex as the regulatory control period progresses. It then increases again after the base year used to forecast opex for the following regulatory control period.

The EBSS addresses this by allowing NSPs to retain efficiency gains, and efficiency losses, for a total of six years after they have been incurred, regardless of when they were made. For example, if a NSP makes an efficiency gain in year 4 of a five-year regulatory control period, it will carry over those gains until the end of year 4 of the following regulatory control period.[6] This results in the EBSS sharing efficiency gains and losses between NSPs and consumers as consumers benefit from a reduction of recurrent opex into the future. The EBSS is designed to share the benefits between NSPs and consumers at approximately 30:70. The EBSS encourages NSPs to make sustainable efficiency gains and reveal true operating costs as early as possible for the benefit of consumers.

1.4 What does the CESS do?

Under the NER, the objective of the CESS is to provide NSPs with an incentive to undertake efficient capital expenditure (capex) during a regulatory control period. It achieves this by rewarding NSPs that underspend their capex allowance and penalising NSPs that spend more than their capex allowance. The CESS also provides a mechanism to share efficiency gains and losses between NSPs and consumers. For example, if a NSP makes an efficiency gain in one regulatory control period, they are also rewarded in the following regulatory

[6] Without the EBSS, the NSP would only receive benefits for the remaining 2 years of that regulatory control period.

control period. Consumers will benefit from a lower regulated asset base (lower revenue) into the future. The share of benefits between NSPs and consumers is set at 30:70.[7]

Without a CESS, a NSP will face incentives that decline over a regulatory control period. If a NSP makes an efficiency gain in the first year of a five-year regulatory control period any benefit will last for four more years before we update the RAB for actual capex. In the final year however, the benefit will be approximately zero. This may lead to inefficient capex and inefficient substitution of opex for capex towards the end of a regulatory control period.

The CESS is also linked to the EBSS. Without a CESS, a NSP may be incentivised to capitalise opex. This would increase capex with the aim to reduce opex and receive an EBSS benefit. Consequently, the CESS acts as a constraint on capitalisation due to the threat of a CESS penalty from a capex overspend.

1.5 Structure of this draft guidance note

There are two main parts to this guidance note:

1. Chapter 2 outlines the relationship of network expenditure between the EII Framework and the NER. It also explains similarities and any departures from the existing incentives schemes under the NER.
2. Chapter 3 outlines how the CESS and EBSS will apply to non-contestable revenue determinations and discusses other incentive schemes that will either not apply to the EII framework or will be developed at a later stage.

[7] The sharing ratio under the NER is now tiered for underspends over 10 per cent of forecast capex, but remains at 30 per cent for NSPs who underspend below 10 per cent.

2 Relationship with the NER

Under the EII Regulation schemes included as part of making a non-contestable revenue determination must be consistent with the equivalent schemes under the NER, Chapter 6A.[8]

However, there are some fundamental differences between revenue determinations made under the NER and the EII framework (the EII Act and the EII Regulation). As such we are required to consider modifications to the NER schemes to ensure they can be applied to the non-contestable framework. We have therefore made this draft guidance note for the application of the EBSS and CESS consistent with the equivalent schemes under the NER where possible. This section explains the differences between the two regulatory regimes and how the application of incentive schemes may require modification.[9]

2.1 EBSS

During a revenue determination under the NER, we calculate the rewards and penalties a NSP has accrued from the application of the EBSS in the current regulatory control period. These rewards and penalties are included as an additional 'building block' when setting the NSP's regulated revenue for the next regulatory control period.

The EBSS removes the incentive for a NSP to inflate its base year opex and provides a consistent incentive to reduce opex across a regulatory control period. As the EII Act requires us to provide incentives to promote economic efficiency, it is important to also apply the EBSS for EII revenue determinations.

When calculating an EBSS reward/penalty under the NER for the current regulatory control period, the EBSS may exclude any opex that we don't forecast on a revealed cost basis for the following regulatory control period. That is, if a NSP hasn't used single year (base year) revealed costs from the current regulatory control period to forecast an opex category for the following regulatory control period, the EBSS may exclude that category from the calculations for the current regulatory control period. When a single year revealed cost approach is not used to forecast opex the EBSS may not share efficiency gains 30:70 between NSP's and consumers. If such an approach is not used a different sharing ratio may result leading to a risk of the EBSS providing windfall gains or losses to an NSP.

For an initial revenue determination under the EII framework, there is a greater level of uncertainty that a Network Operator's forecast opex will reflect efficient revealed costs. This is due to the following:

- A Network Operator will not have historical revealed opex to base its forecast on.
- The one-off and bespoke nature of EII non-contestable projects means a Network Operator won't be able to use suitable benchmarking.

[8] EII Regulation, cl. 47B(3).

[9] For clarity, in this guidance note a NSP is a network service provider under the NER and a Network Operator operates a network under the EII Act.

- The initial regulatory control period will be a design and construction phase meaning opex may not reach a level of recurrency or a steady state.

Similar to how the EBSS is applied under the NER, it may not be appropriate in the initial non-contestable revenue determination for us to state with certainty that the EBSS will apply to a Network Operator's forecast opex.[10]

2.2 CESS

The CESS applies to each capex forecast under the NER.[11] Like the EBSS, during a revenue determination a CESS calculation is made based on a NSPs current regulatory control period capex. This determines whether a CESS payment or penalty will be added as an additional 'building block' when setting the NSP's regulated revenue for the next regulatory control period.

Under the NER, the CESS rewards NSPs that make efficiency gains and penalises those that make efficiency losses. In this way, if a NSP is subject to the CESS, its capex is more likely to be efficient and will reflect the costs of a prudent NSP. This concept is synonymous with the principle of providing incentives to promote economic efficiency under the EII Act.

When submitting a revenue determination under the NER, an NSP includes a capex forecast including many programs and projects across its entire network. Portions of this forecast are considered recurrent (such as replacement expenditure) and some non-recurrent (such as large transmission projects). When we determine the capex allowance, the NSP can use this 'bucket' however it chooses to best manage its network over the regulatory control period.

Under the EII non-contestable framework, a Network Operator is authorised (or directed) to undertake a network infrastructure project.[12] Each individual project is subject to its own revenue determination where the Network Operator submits a revenue proposal that includes a capex forecast. The main differences between the EII framework and the NER are:

- EII infrastructure projects are non-recurrent in nature and can therefore be difficult to forecast. Capital expenditure under the NER is more recurrent. NSPs can better utilise historical data to assist in forecasting.
- The CESS would apply to capex for single projects rather than the entire network.

Large transmission projects such as Integrated System Plan (ISP) or EII projects can have more forecasting risk. This is because of the large scale and bespoke nature of such projects relative to recurrent projects that can utilise historical revealed costs to assist in forecasting. Forecasting risk is heightened in an environment of uncertainty around inflation, supply chains and the labour market.

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[10] AER, *AER explanatory statement – efficiency benefit sharing scheme*, 2013, pg. 14

[11] This is subject to some conditions such as asset disposals, excludable capex, and deferrals.

[12] EII Act, s. 31(1).

Due to the single-project nature under the EII framework, a Network Operator has limited scope to re-prioritise its capex. Should a Network Operator face a CESS penalty from a capex overspend, it has limited opportunity to underspend in other areas to mitigate this risk.

Review of Incentives Schemes for Networks

The Review of Incentives Schemes for Regulated Networks under the NER explored the issue of large transmission projects (contingent projects) and forecasting risk. The review found that these types of projects are non-recurrent and can be difficult to forecast.

The review decided that in response to contingent project proposals by Transmission Network Service Providers (TNSPs), we will have discretion whether to apply the CESS or not and whether to apply a lower sharing ratio than 30 per cent.[13] A lower sharing ratio means NSPs will receive a smaller penalty from an overspend. If we vary the CESS sharing for contingent projects, these projects will have their own CESS applied outside of the total capex 'bucket'.

We consider EII non-contestable projects to be similar in nature to large transmission contingent projects under the NER and therefore have taken the same approach as the review. Allowing flexibility to deal with each project on a case-by-case basis gives us the option to evaluate Network Operators' risks and make a decision on the CESS accordingly.

[13] AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, pg. 7

3 Application of incentive schemes

3.1 EBSS

First regulatory control period

At the completion of the initial regulatory control period (during the revenue determination for the second regulatory control period) we will have discretion to apply the EBSS or not to opex incurred during the initial regulatory control period. When considering whether to apply the EBSS or not, we will consider the extent to which the Network Operator has revealed opex that is efficient and has reached a steady state such that it could be used to forecast opex for the following regulatory control period.

Second regulatory control period

If the Network Operator's opex hasn't reached a steady state by the end of the initial regulatory control period and the base-step-trend forecast methodology isn't used, we will take the same approach for the EBSS as we did for the initial regulatory control period. That is, we will have discretion to apply the EBSS at the completion of the second regulatory control period.

In non-contestable revenue proposals (for any regulatory control period), Network Operators can submit why they believe we should not apply the EBSS for either forecast opex or opex incurred during the current regulatory period. Network Operators should provide sufficient information and evidence to substantiate their position.

3.1.1 How the EBSS will apply

Should we decide to apply the EBSS, the scheme will operate the same as it does under the NER.[14] The EBSS will work as follows:

- The Network Operator keeps the benefit (or incurs the cost) of delivering actual opex lower (higher) than forecast opex in each year of regulatory control period *n*.
- We calculate EBSS carryover amounts for opex efficiency gains or losses made in regulatory control period *n* prior to the start of regulatory control period *n + 1*. The carryover amounts allow the Network Operator to retain incremental efficiency gains or losses for the length of the carryover period (usually five years) after it makes the gain or loss.
- We add the carryover amounts as an additional 'building block' when setting the Network Operator's regulated revenue for regulatory control period *n + 1*.
- The actual opex incurred in the base year is used as the starting point for forecasting opex for regulatory control period *n + 1*. This passes the efficiency gains made on to consumers.
- Under this approach, the benefits of any increase or decrease in opex is shared approximately 30:70 between Network Operators and consumers.

[14] AER, *AER efficiency benefit sharing scheme*, 2013, pg. 5

The EBSS will use the same methodology as described in the NER EBSS guideline under section 1.3 and 1.4.[15]

3.2 CESS

During a revenue determination (including the initial determination), we will have discretion to apply the CESS to a Network Operator's forecast capex or not. Our default position is to apply the CESS and we will be careful in making exclusions. We will also have discretion to apply a different sharing ratio. This is consistent with how we will treat contingent project proposals by Transmission Network Service Providers under the NER.[16]

In determining whether to apply a different sharing ratio or to exclude the application of the CESS to forecast capex, we will take into account:

- the Network Operator's proposals for CESS and capital expenditure.
- benefits to consumers from the exemption.
- the size of the project.
- the degree of capital expenditure forecasting risk (both the overall project uncertainty and forecasting uncertainty).
- actions the Network Operator has taken to mitigate forecasting risk or reduce contract prices, and their ability to take action (rebalancing within their existing portfolio).
- stakeholder views.

In their non-contestable revenue proposals, Network Operators can submit why they believe we should not apply the CESS or how the sharing ratio should be varied. Network Operators should provide sufficient information and evidence to substantiate their position. This can include details about the risk profile of the project (for both Network Operators and contractors) and the types of contracts used.

3.2.1 How the CESS will apply

Should we decide to apply the CESS, the scheme will operate the same as it does under the NER including any adjustment of the sharing ratio.[17] The sharing ratio is a parameter that can be adjusted in the CESS model. The CESS will work as follows:

1. We calculate efficiency gains and losses in net present value (NPV) terms. We do this for each year of regulatory control period *n* and then the total efficiency gain/loss is calculated for regulatory control period *n*.
2. We apply a sharing factor to the total efficiency gain/loss to calculate the Network Operator's share of the gain/loss.
3. We calculate financing benefits/costs that accrue through regulatory control period *n*.

[15] AER, *AER efficiency benefit sharing scheme*, 2013, pgs, 4-7.

[16] AER, *Capital Expenditure Incentive Guideline*, 2023, pg 7.

[17] AER, *Capital Expenditure Incentive Guideline*, 2023, pg 5.

4. We calculate the CESS reward/penalty by subtracting the financing benefit/cost that has accrued from the Network Operator's share of the total efficiency gain/loss.
5. We add the CESS reward/penalty amounts as an additional 'building block' when setting the Network Operator's regulated revenue for regulatory control period *n + 1*.

The CESS will largely use the same methodology as described in section 2 of the NER Capital Expenditure Incentive Guideline.[18] The only difference is the method used to apply the sharing ratio will be determined in the final revenue determination.

3.3 Other incentive schemes

Service Target Performance Incentive Scheme

The Service Target Performance Incentive Scheme (STPIS) will not be applied to non-contestable revenue determinations in the initial regulatory control period. Instead, we expect the project deed between the Infrastructure Planner and the Network Operator will stipulate service level standards that will attach financial penalties to metrics such as unplanned outages, planned outages and availability.

During the initial regulatory control period, we will collect performance data to determine how a bespoke STPIS could be designed and applied from the second regulatory control period onwards. This guidance note will be amended in accordance with the introduction of this scheme under the EII framework.

Other schemes

Under the NER, there are a number of other schemes designed to encourage NSPs to improve customer service and the performance of their networks. The EII Regulation states that our non-contestable Guideline must not deal with small-scale incentive schemes and the Demand Management Innovation Allowance Mechanism (DMIAM).[19] These schemes are either not relevant or out of the scope of the EII framework.

[18] AER, *Capital Expenditure Incentive Guideline*, 2023, pg 2.

[19] EII Regulation, cl. 47A(5).

Glossary

Term	Definition
Australian Energy Regulator	has the meaning set out in the National Electricity Law.
EII Act, the Act	Electricity Infrastructure Investment Act 2020 (NSW).
EII framework	means the EII Act and the EII Regulation.
EII Regulation	Electricity Infrastructure Investment Regulation 2021 (NSW) made under the EII Act.
Guideline	Final Guideline – Transmission Efficiency Test and revenue determination for non-contestable network infrastructure projects, April 2023.
Regulator	a Regulator under the EII Act.
National Electricity Law	means the National Electricity Law set out in schedule to the National Electricity (South Australia) Act 1996.
National Electricity Rules	means the rules, as defined in the National Electricity Law.
Network Operator	means a person who owns, controls, or operates, or proposes to own, control or operate, network infrastructure under the EII Act.
Network Service Provider (NSP)	Means a person who owns, controls, or operates, or proposes to own, control or operator distribution or transmission network infrastructure under the NER.