



# Attachment 12.01

Incentive schemes

31 January 2023

PowerWater

# Contents

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<b>Abbreviations</b>	<b>ii</b>
<b>Overview</b>	<b>1</b>
<b>1. Current period performance</b>	<b>2</b>
1.1 Capital expenditure sharing scheme	2
1.2 Demand management incentive scheme	4
1.3 Demand management innovation allowance	4
1.4 Schemes not applied	5
<b>2. Next period proposal</b>	<b>6</b>
2.1 Overview	6
2.2 Capital expenditure sharing scheme	6
2.3 Efficiency benefit sharing scheme	7
2.4 Service target performance incentive scheme	7
2.5 Demand management mechanisms	7
2.6 Small scale incentive scheme	8

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# Abbreviations

The following table provides a list of abbreviations and acronyms used throughout this document. Defined terms are identified in this document by capitals.

Term	Definition
AER	Australian Energy Regulator's
CESS	Capital Expenditure Sharing Scheme
CSIS	Customer Service Incentive Scheme
DMIA	Demand Management Innovation Allowance
DMIAM	Demand Management Innovation Allowance Mechanism
DMIS	Demand Management Incentive Scheme
EBSS	Efficiency Benefit Sharing Scheme
F&A	Framework and Approach
NT	Northern Territory
Opex	Operating Expenditure
STPIS	Service Target Performance Incentive Scheme

# Overview

Incentive schemes provide us with additional incentives to make efficient decisions in relation to expenditure and service quality, share the benefits with our customers of these efficiencies over time, support research and development to deliver efficiencies, and improve customer outcomes.

This document explores how Power and Water has performed under the incentive schemes that apply to the 2019–24 period and what we are proposing for the 2024–29 period.

Over the 2019–2024 period, we expect to have:

- Overspent our capital expenditure allowance by \$6.9 million, with the Australian Energy Regulator’s (AER) capital expenditure sharing scheme (CESS) meaning that we will incur a penalty of \$2.7 million.
- Undertaken three initiatives that seek to find innovative ways to lower our network costs by reducing demand pressures, making use of the AER’s demand management mechanisms.

Consistent with the AER’s framework and approach paper, for the 2024–29 period, we propose to:

- Apply the CESS in much the same way that it has applied over the 2019–24 period.
- Apply the efficiency benefit sharing scheme (EBSS) because, unlike the 2019–24 period, we propose to rely on revealed costs to set our operating expenditure allowance.
- Not apply the AER’s service target performance incentive scheme (STPIS).
- Retain the AER’s demand management mechanisms (DMIA and DMIS).
- Not apply other incentive schemes, such as a customer service incentive scheme (CSIS).

Our proposed incentive schemes are summarised in the figure below. The next two chapters explore our performance over the 2019–24 period and our proposal for the 2024–29 period. All dollar values in this Attachment are in real 2024 unless otherwise stated.

Figure 1.1: Proposed incentive mechanisms compared with those applying at present

	2019–24 period	2024–29 period
CESS	✓	✓
EBSS	✗	✓
STPIS	✗	✗
Demand management mechanisms	✓	✓
CSIS	✗	✗

# 1. Current period performance

We face three incentive mechanisms over the 2019–24 period: the CESS, demand management incentive scheme (**DMIS**), and demand management innovation allowance (**DMIA**). This is the first time these mechanisms have applied to us, and we have sought to respond to them as effectively as we could.

This chapter explores our performance over the 2019–24 period. It also explains our proposal to not take up any CESS rewards as a one-off measure to help mitigate upward pressure on customer bills – a central theme of our proposal.

## 1.1 Capital expenditure sharing scheme

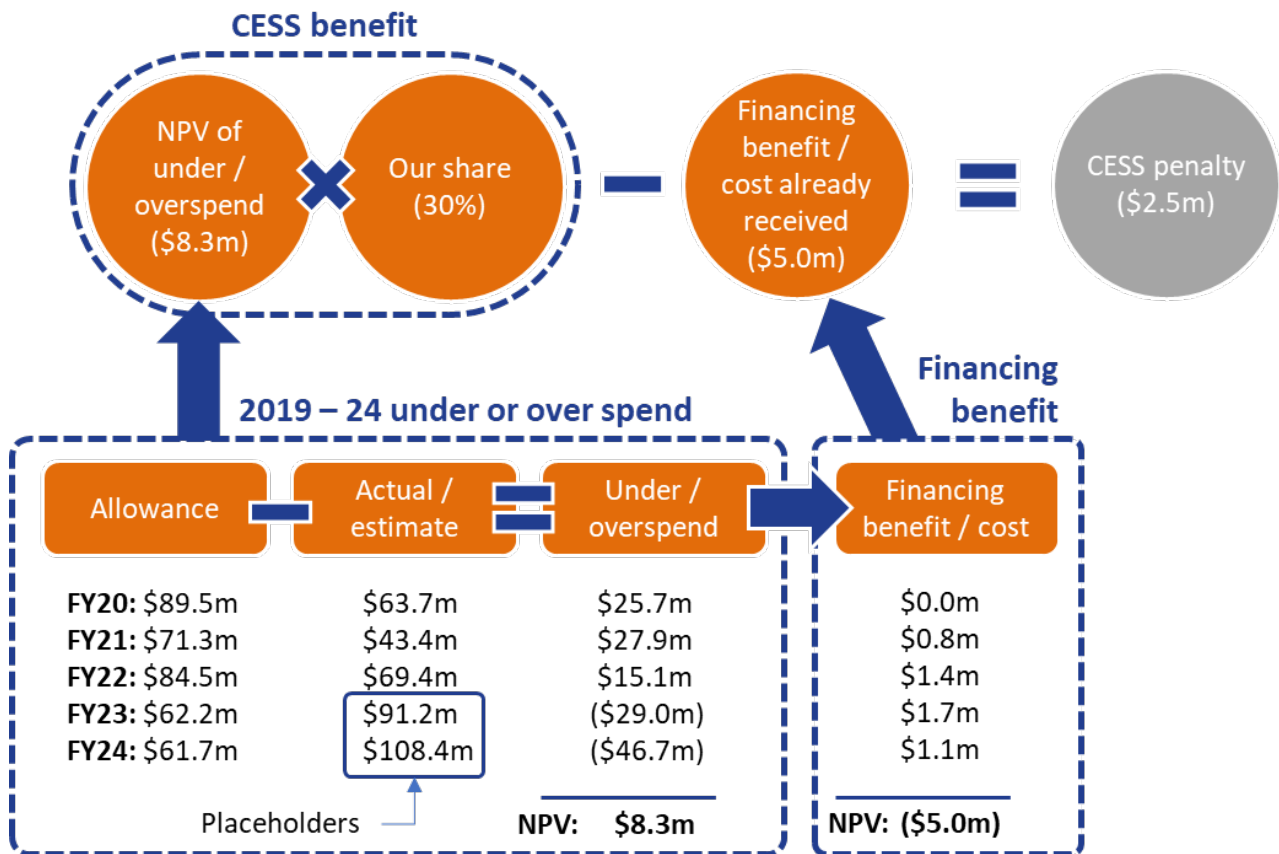
The AER decided to apply the CESS to us over the 2019–24 period – a scheme that rewards or penalises us if we under or over spend the capex allowance set by the AER for that period. By encouraging us to spend capex efficiently, our consumers benefit through lower regulated prices in the future.

The AER adopted version 1 of the CESS for the 2019–24 period. This scheme works by:

- **First**, calculating the cumulative under or over spend of capex against the allowance for the 2019–24 period in net present value terms.
- **Second**, applying a sharing ratio of 30 per cent (i.e., 30 per cent to us and 70 per cent to our customers) to the cumulative under or over spend from the first step to work out our share of it.
- **Third**, calculating the CESS payments as the difference between our share of the under or over spend calculated in step 2 and the financing benefit that we have already realised or cost we have incurred during the 2019–24 period.
- **Fourth**, adding the CESS payments (either positive or negative) as revenue in the revenue building blocks for the 2024–29 period – see Attachment 10.01.

Figure 1.1 shows how this works. Adjustments can be made in some cases (e.g. if we have deferred capex that we re-propose for a subsequent period).

Figure 1.1: How the CESS works (\$ million real 2024)



Applying the CESS to our actual and estimated capex over the 2019–24 period gives an estimated carryover penalty of \$2.5 million, as summarised in Table 1.1. The CESS penalty is calculated in Attachment 10.07. We have not identified any capex deferrals that need to be adjusted for.<sup>1</sup>

Table 1.1: CESS carryover (\$ million real 2024)

Component	2019/20	2020/21	2021/22	2022/23	2023/24	Total
<b>Comparison to allowance</b>						
Allowance	89.5	71.3	84.5	62.2	61.7	369.2
Actual / forecast	63.7	43.4	69.4	91.2	108.4	376.1
Under / over spend	25.7	27.9	15.1	(29.0)	(46.7)	(6.9)
<b>CESS payment</b>						
NPV of under / over-spend						8.3
Our share (@30%)						2.5

<sup>1</sup> If some of the savings we expect to make over the 2019–24 period related to capex on projects or programs that we deferred into the 2024–29 period, then our customers could end up unfairly rewarding us (through prices) if no adjustment were made. We did not identify any such projects or programs.

Component	2019/20	2020/21	2021/22	2022/23	2023/24	Total
Financing benefit						5.0
CESS payment						(2.5)
Revenue added to building blocks (i.e., carryover)						(2.7)

## 1.2 Demand management incentive scheme

The AER also decided to apply the DMIS to us over the 2019–24 period.<sup>2</sup> Together with the Demand Management Innovation Allowance Mechanism (**DMIAM**), the DMIS seeks to incentivise us to identify lower-cost alternatives and undertake efficient expenditure on non-network options relating to demand management.

Given the increasing role that distributed energy resources are now playing in the energy supply chain, such projects and initiatives can create meaningful value for our customers. With such mechanisms, we may not be incentivised to otherwise undertake them.

The DMIS contains three components:<sup>3</sup>

1. A cost uplift on the expected costs of efficient demand management projects – which provides the incentive for us to undertake such projects.
2. A net benefit constraint – which ensures that any incentive payments that we receive for an eligible project does exceed expected net benefits.
3. Overall incentive constraint – which limits the total incentive that we can earn in any year to 1% of our allowed revenue.

We have not yet sought to apply the DMIS to any initiatives or projects over the 2019–24 period.

## 1.3 Demand management innovation allowance

The AER also decided to apply the DMIAM to us over the 2019–24 period,<sup>4</sup> approving a DMIA for that period of \$1.9 million.

In essence, the DMIA provides research and development funding to support us to explore and trial new demand management solutions that keep costs down for our electricity consumers in the future by reducing ongoing demand or peak demand. In this way, the DMIAM complements the DMIS. The DMIA is provided on a forward-looking basis – meaning that, if we do not spend it, then we must return it to customers (through lower tariffs in the future).

We committed to using the DMIA to explore ways to lower our network costs in a way that benefits our customers. Over the last decade, the traditional energy supply in the Northern Territory (**NT**) has undergone a monumental shift with increasing penetration of small-scale renewable energy. Our customers have been leading the change by installing solar systems to meet their energy needs and export into the grid. The NT Government’s Roadmap to Renewables will accelerate change in the energy market.

<sup>2</sup> AER, April 2019, *Final decision: Power and Water Corporation Distribution Determination 2019 to 2024 – Overview*, p. 37.

<sup>3</sup> AER, December 2017, *Demand management incentive scheme, Electricity distribution network service providers*.

<sup>4</sup> AER, April 2019, *Final decision: Power and Water Corporation Distribution Determination 2019 to 2024 – Overview*, p. 37.

The Government’s recent report identifies strategies to achieve a 50 per cent renewable target for all electricity consumed from our network by 2030.

We are embracing a renewable future where more customers actively participate in the market. We need to be active leaders in the Territory’s transition to a renewable future. Our network planning is pivoting to meet the challenges and opportunities of a future market, including innovative ways to manage emerging demand and voltage issues.

Some of the initiatives that we have explored over the 2019–24 period are summarised in Table 1.2.

Table 1.2: Summary of DMIA projects undertaken over the 2019–2024 period

Project / initiative	Summary / benefits
<b>Future Network Readiness Plan</b>	Identification of optimal programs for effective demand management through pilot and trial programs
<b>Network visibility and forecasting</b>	Assessment of network data and systems to improve visibility, better incorporate distributed energy resources (DER) and manage increasing two-way energy flows
<b>Future Network Strategy and Coordination</b>	Comprehensive strategy to cost-effectively and safely transition Power and Water’s networks in line with the clean energy goals of the Northern Territory

Of the \$1.9 million allowed by the AER, we have so far spent \$0.4 million and expect to incur a further \$1.5 million – meaning that we expect to spend just over 100 per cent of the total allowances.

## 1.4 Schemes not applied

Although the AER often applies other incentive mechanisms to DNSPs, it decided not to apply either the STPIS or the operating expenditure (**opex**) EBSS to us.

In the case of the STPIS, the AER decided to not apply the STPIS to us over the 2019–24 period because it considered our historical supply interruption data – which is needed to estimate the service performance targets – were either unreliable or not available. The explained that it intended to collect data over the 2019–24 period so it could apply the scheme over the 2024–29 period.<sup>5</sup>

Similarly, the AER decided to not apply the EBSS to us over the 2019–24 period because:

- Revealed costs were not used to set the opex allowance for the 2019–24 period.
- It was unclear whether revealed costs would be used to set the opex allowance for the 2024–29 period.

The AER was concerned that consumers would not share the benefits of any efficiency improvements that are promoted by the EBSS if revealed costs were not used.<sup>6</sup> The AER also considered that we already faced a strong continuous incentive to make efficiency improvements without an EBSS.

<sup>5</sup> AER, April 2019, *Final decision: Power and Water Corporation Distribution Determination 2019 to 2024 – Overview*, p. 38.

<sup>6</sup> AER, April 2019, *Final decision: Power and Water Corporation Distribution Determination 2019 to 2024 – Overview*, p. 38.



## 2. Next period proposal

Consistent with the AER's Framework and Approach (F&A), we propose to apply the CESS, EBSS, DMIS and DMIA to the 2024–29 period. Doing so will add additional incentive for us to improve our expenditure performance and support demand management activities.

This chapter explains our proposed incentive mechanisms for the next period.

### 2.1 Overview

We are a big believer in using incentive mechanisms to encourage efficient or otherwise desirable behaviour where this is not otherwise expected (or incentivised) and where that behaviour is expected to deliver a genuine customer benefit.

For the 2024–29 period, we have carefully considered what package of incentive mechanisms make the most sense for us and our customers. After considering our performance over the 2019–24 period, customer feedback, proposed expenditure for the 2024–29 period, and availability of reliable data, we propose that:

- The CESS, EBSS, DMIAM and DMIS should continue to apply to us, consistent with the AER's Framework and Approach paper.
- The STPIS and any small scale incentive schemes (like the CSIS) should not apply.

The next sections explain our proposal further.

### 2.2 Capital expenditure sharing scheme

The AER stated in its Framework and Approach that it intends to apply the CESS to us over the 2024–29 period.<sup>7</sup>

Consistent with this, we propose to apply the CESS as set out in the Framework & Approach without variation or departure. Retaining this scheme will ensure that we continue to have a continuous incentive to spend capex efficiently over the 2024–29 period.

As noted in Chapter 10 of our Regulatory Proposal and Attachment 10.01, we also propose to adopt forecast depreciation to roll-forward the 2024–29 period, consistent with the AER's default position.<sup>8</sup>

Also, although we have proposed not to realise any CESS rewards that would otherwise result from our performance over the 2019–24 period to help mitigate upward pressure on customer bills, we are not proposing to take that approach indefinitely (i.e. in future determinations).

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<sup>7</sup> AER, July 2022, *Framework and approach: Power and Water Corporation (Northern Territory) – Regulatory control period commencing 1 July 2024*, p.40.

<sup>8</sup> AER, November 2013, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, section 3.3.

## 2.3 Efficiency benefit sharing scheme

The AER stated in its F&A that it intends to apply the EBSS to us over the 2024–29 period, provided that the opex allowance for that period is based on our revealed costs.<sup>9</sup>

As discussed in Chapter 9 of our Regulatory Proposal and Attachment 9.01, we do not propose adjusting our revealed costs to determine base opex. This means that applying the EBSS to us remains appropriate and should ensure that we can fairly share efficiency gains and losses between us and our customers.

As such, we propose adopting the EBSS for the 2024–29 period. The only expenditure that we propose excluding from the EBSS is debt raising costs given it is not forecasts using the base-step-trend approach.

## 2.4 Service target performance incentive scheme

As noted in the F&A, the AER does not intend to apply the STPIS to us over the 2024–29 period.<sup>10</sup>

We agree with the AER. Although we support the incentive properties that the scheme provides for DNSPs to maintain their service performance, we are concerned that continued data quality and timeliness issues means that the scheme cannot operate as intended over the 2024–29 period.

As such, consistent with the AER's determination for the 2019–24 period and the AER's Framework and Approach, we do not propose applying the STPIS over the 2024–29 period.

Importantly, despite not proposing to apply the STPIS, we remain subject to a guaranteed service level scheme administered the Utilities Commission, which requires us to pay our customers automatically when certain service targets are not met. The benefit of this scheme is that it encourages to maintain and improve our service while at the same time compensating those affected when we do not meet those targets.

## 2.5 Demand management mechanisms

The F&A states that the AER intends to apply the new DMIS and DMIAM to us over the 2024–29 period.<sup>11</sup> Consistent with the Framework and Approach, we propose adopting the DMIS and DMIAM without any variation or departure.

Applying the AER's DMIAM,<sup>12</sup> we estimate a DMIA allowance of \$2.0 million over the 2024–29 period, as shown in Table 2.1. We calculated this in Attachment 10.02. We have also reflected this allowance in our forecast revenue discussed in Attachment 10.01.

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<sup>9</sup> AER, July 2022, *Framework and approach: Power and Water Corporation (Northern Territory) – Regulatory control period commencing 1 July 2024*, p.40.

<sup>10</sup> AER, July 2022, *Framework and approach: Power and Water Corporation (Northern Territory) – Regulatory control period commencing 1 July 2024*, p.40.

<sup>11</sup> AER, July 2022, *Framework and approach: Power and Water Corporation (Northern Territory) – Regulatory control period commencing 1 July 2024*, p.40.

<sup>12</sup> AER, December 2017, *Demand Management Innovation Allowance Mechanism Electricity distribution network service providers*.

Table 2.1: Demand management innovation allowance for the 2024–29 period (\$ million real 2024)

Component	2024/25	2025/26	2026/27	2027/28	2028/29	Total
<b>Allowance</b>	0.4	0.4	0.4	0.4	0.4	<b>2.0</b>

## 2.6 Small scale incentive scheme

Under the NT NER,<sup>13</sup> the AER can use the small scale incentive mechanism to apply other incentive schemes to us.

Although – at this stage – we are not proposing any such schemes, we are certainly open to these being applied where there is a clear customer benefit from doing so. For instance, during 2020 the AER developed a CSIS that is intended to incentivise networks like us to provide customer service that aligns with customers’ preferences.<sup>14</sup>

While we support this kind of incentive scheme, we do not consider it appropriate to propose a CSIS for the 2024–29 period given that customer feedback did not support it. We are, however, committed to improving our customer service and will seek to find better ways to delivering this outcome over the period. Like other networks, we will continue to collect customer service performance data so that if an opportunity arises to develop a scheme, we have the information available.

<sup>13</sup> NT NER, cl. 6.6.4.

<sup>14</sup> AER, July 2020, *Customer Service Incentive Scheme*.

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