Draft Decision

Essential Energy Electricity Distribution Determination 2024 to 2029

(1 July 2024 to 30 June 2029)

Attachment 9

Capital expenditure sharing scheme

September 2023

AUSTRALIAN ENERGY REGULATOR

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9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers (NSP) whose capital expenditures (capex) become more efficient and financial penalties for those that become less efficient. Customers benefit from improved efficiency through lower regulated prices. We first applied the CESS to Essential Energy in the 2014–19 regulatory control period.

This attachment sets out our decision for both the determination of the revenue impacts as a result of the CESS applying in the 2019–24 regulatory control period, and the application of the CESS for Essential Energy in the 2024–29 regulatory control period.

The CESS approximates efficiency gains and efficiency losses by calculating the difference between forecast and actual capex. It shares these gains or losses between service providers and consumers.

The CESS mechanism was recently updated in April 2023. The changes to the CESS only apply to its application in the 2024–29 period and onwards. Our decision on CESS revenue increments to be added to capex allowance in the 2024–29 uses the CESS mechanism as it was before the update.[1]

For spending in the current period, the CESS applies as follows:

- We calculate the cumulative efficiency gains or losses for the current regulatory control period in net present value terms.
- We apply the sharing ratio of 30% to the cumulative underspend or overspend to work out what the service provider's share of the underspend or overspend should be.
- We calculate the CESS payments taking into account the financing benefit or cost to the service provider of the underspend or overspend.[2] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB).[3]
- The CESS payments will be added or subtracted to the service provider's regulated revenue as a separate building block in the next regulatory control period.

1 That is, for CESS revenue increments based on spending in the 2019–24 regulatory period, we follow this guideline: AER, *AER capital expenditure incentive guideline - November 2013*, November 2013. However, in applying the CESS in the 2024–29 period, we refer to this guideline: AER*, AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023.

2 We calculate benefits as the benefits to the service provider of financing the underspend since the amount of the under-spend can be put to some other income generating use during the period. Losses are similarly calculated as the financing cost to the service provider of the overspend.

3 AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023, pp. 7–9.

9.1 Draft decision

9.1.1 Revenue impacts in the 2024–29 period from applying the CESS in the 2019–24 period

Our draft decision is to apply a CESS revenue increment amount of $15.64 million ($2023–24) to be paid across the 2024–29 regulatory control period. This is from the application of the CESS in the 2019–24 regulatory control period and the corresponding CESS carryover true-up for 2018–19. This is $23.66 million more than Essential Energy's forecasted decrement of $8.02 million due to an updated forecast from a cost-pass through and including an amount for the true-up for 2018–19.

The CESS increment arises as a result of an underspend in capex against the forecast for the 2019–24 period. Our draft decision on the revenue impact of the application of the CESS in the 2019–24 period and the corresponding CESS carryover true-up for 2018–19 is summarised in Table 9.1.

Table 9.1 CESS revenue increments in 2024–29 ($ million, 2023–24)

Revenue Adjustments	2024–25	2025–26	2026–27	2027–28	2028–29	Total
CESS revenue increment as per NER 6.4.3(a)(5)	-0.62	-0.62	-0.62	-0.62	-0.62	-3.12
CESS carryover true-up for 2018–19	3.75	3.75	3.75	3.75	3.75	18.77
AER draft decision CESS	**3.13**	**3.13**	**3.13**	**3.13**	**3.13**	**15.64**

Note: Numbers may not sum due to rounding.
Source: AER analysis. Essential Energy, *Essential Energy – 5.06 Standard Control Capital Expenditure Sharing Scheme – Jan23 - Public*, 31 January 2023.

Given the timing of this draft decision, we calculated the CESS revenue increments in Table 9.1 using estimates of Essential Energy's capex for 2022–23 and 2023–24 regulatory years. The CESS revenue increment we calculated ($15.64 million) is different to the revenue decrement that Essential Energy proposed ($8.02 million) because we applied updated modelling inputs, including inflation, rate of return, an update for our decision on the North Coast cost pass through,[4] and an adjustment for 2018–19 to reflect the difference between actual and estimated capex.

9.1.2 Application of CESS in the 2024–29 regulatory control period

We will apply the CESS as set out in the updated capital expenditure incentives guideline.[5] The reasons for adopting this updated CESS are set out in our final decision for the review of incentive schemes for networks, and the final decision for capital expenditure incentive

4 AER, *Decision on Essential Energy North Coast flood event cost pass through*, March 2023.

5 AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023, pp. 3–9.

guideline.[6] This is consistent with the proposed approach we set out in our framework and approach paper.[7]

9.2 Essential Energy's proposal

9.2.1 CESS revenue increments from the 2019–24 regulatory control period

Essential Energy proposed a CESS decrement of $8.02 million ($2023–24) for the 2024–29 regulatory control period. Essential Energy cited a delay in its billing system project as the primary driver for the proposed CESS decrement. The subsequent delay has resulted in a proposed deferral of $20.84 million (nominal).

9.2.2 Final year actual capex true-up for 2018–19

Essential Energy did not submit a true-up calculation to account for the updated actual capex in 2018–19.

9.2.3 Application of CESS in the 2024–29 regulatory control period

Essential Energy proposed to apply the CESS in the 2024–29 regulatory period.[8]

9.3 Assessment approach

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

- the revenue impacts on Essential Energy arising from applying the CESS in the 2019–24 regulatory control period;[9] and
- whether or not to apply the CESS to Essential Energy in the 2024–29 regulatory control period and how any applicable scheme will apply; [10]

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2024–29 regulatory control period arising from the application of the CESS during the 2019–24 regulatory control period. [11]

In deciding whether to apply a CESS to Essential Energy for the 2024–29 regulatory control period, and the nature of the details of the scheme, we must: [12]

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6 AER, *AER - Final decision - Review of incentive schemes for networks - 28 April 2023*, April 2023, pp. 14-22; AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023.

7 AER, *AER - Final framework and approach for Ausgrid, Essential Energy and Essential Energy for the 2024-29 regulatory control period - July 2022, 29 July 2022*, p. 47.

8 Essential Energy, *Essential Energy – 2024-29 Regulatory Proposal – Jan23 - Public*, January 2023, p. 60.

9 NER, cl 6.4.3(a)(5).

10 NER, cl. 6.12.1(9).

11 Increments or decrements arising from the application of applicable incentive mechanisms, including any capital expenditure sharing scheme, form one of the building blocks that must be used to determine the annual revenue requirement for distribution network service providers for each regulatory year of a regulatory control period: NER, cl. 6.4.3(a)(5).

12 NER cl. 6.5.8A(e).

- make that decision in a manner that contributes to the capex incentive objective[13]
- take into account the CESS principles,[14] the capex objectives and, where relevant, the operating expenditure (opex) objectives,[15] the interaction with other incentive schemes,[16] and the circumstances of the service provider.[17]

Broadly, the capex incentive objective is to ensure that only capex that meets the capex criteria enters the RAB used to set prices. Therefore, consumers only fund capex that is efficient and prudent.

9.3.1 Interrelationships

The approval of CESS revenue increment determines the associated CESS building block as part of Essential Energy's overall forecast revenue requirement for the 2024–29 regulatory control period.

The CESS relates to other incentives Essential Energy faces to incur efficient opex, conduct demand management, and maintain or improve service levels. Related schemes include the efficiency benefit sharing scheme (EBSS) for opex, the service target performance incentive scheme (STPIS) for service levels and demand management incentive allowance mechanism (DMIAM). We aim to incentivise network service providers to make efficient decisions on when and what type of expenditure to incur and to balance expenditure efficiencies with service quality.

9.4 Reasons for draft decision

Our draft decision is to include an overall CESS revenue increment of $15.64 million ($2023–24). This is a $23.66 million increase from Essential Energy's proposed CESS revenue decrement of $8.02 million ($2023–24). We set out our reasons in the sections below.

9.4.1 CESS revenue increments from the 2019–24 regulatory control period

We are broadly satisfied with Essential Energy's calculation of CESS revenue decrements for capex in the 2019–24 period. The difference between its proposal and our draft decision reflects adjustments for modelling inputs such as CPI and the WACC to reflect more up-to-date information. We will also update these inputs, where relevant, in our final decision.

We have also updated forecast and actual capex, with the major update accounting for the 2022 North Coast Flooding cost pass through which added $11.95 million ($2018–19) to forecast capex in 2021–22 and 2022–23.[18] This cost-pass through decision was released in March 2023 and not available at the time of Essential Energy's proposal submission.[19] We

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13 NER, cl. 6.5.8A(e)(3); the capex incentive objective is set out in cl. 6.4A(a).

14 NER, cl. 6.5.8A(e)(4)(i); the CESS principles are set out in cl.6.5.6A(c).

15 NER, cll. 6.5.8A(e)(4)(i) and 6.5.6A(d)(2); the capex objectives are set out in cl. 6.5.7(a); the opex objectives are set out in cl. 6.5.6(a).

16 NER, cll6.5.8A(d)(1).

17 NER, cl. 6.5.8A(e)(4)(ii).

18 AER – *Essential Energy 2019–24 – Post-tax revenue model – 2023–24 RoD update (inc cost pass throughs),* March 2023.

19 AER, *Decision on Essential Energy North Coast flood event cost pass through*, March 2023.

have confirmed that the actual capex already included the expenditure for the North Coast flood event.

The CESS requires the following three criteria must be satisfied before we apply a CESS adjustment:[20]

1. the amount of the estimated underspend in capex in the current regulatory control period is material
2. the amount of the deferred capex in the current regulatory control period is material
3. total approved capex in the next regulatory control period is materially higher than it is likely to have been if a material amount of capex was not deferred in the current regulatory control period.

We have accepted Essential Energy's proposed deferral for its billing system project of $20.84 million (nominal). Essential Energy submitted the deferral in the CESS calculation because it considered this is consistent with our guidelines.[21] We consider it is appropriate and good practice for networks to identify deferrals so that customers share in the benefits from deferred capex.

9.4.2 Final year actual capex true-up for 2018–19

We consider that Essential Energy should receive a true-up adjustment of $18.77 million ($2023–24). The true-up is the major difference between Essential Energy's proposed CESS revenue adjustment and our draft decision because Essential Energy did not submit a true-up calculation.

The true-up calculation takes into account the difference in CESS payments between using estimated 2018–19 capex and actual 2018–19 capex. We then include the net present value of any CESS benefit or cost as a result of the difference between the estimate and actual capex.

9.4.3 Application of CESS in the 2024–29 regulatory control period

9.4.3.1 Updates to the CESS Guideline in April 2023

After Essential Energy submitted its initial proposal, the AER published its final decision on its review of incentive schemes for regulated networks in April 2023. This included an update to the workings of the CESS mechanism.[22]

The changes to the CESS mechanism will affect the application of the CESS to Essential Energy starting in the 2024–29 period.

The new guideline contains the following main changes to the CESS mechanism:

- application of a lower sharing factor of 20% to any underspend amount greater than 10% of the approved forecast capital expenditure allowance; and

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[20] AER, *Capital Expenditure Incentive Guideline for Electricity Networks Service Providers*, November 2013, p. 9.

[21] Essential Energy, *5.08 EBSS and CESS approach – 2024–29 Regulatory Proposal,* January 2023, p. 4.

[22] AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, 28 April 2023.

- new transparency measures which require NSPs to explain variations between capital expenditure forecasts and outcomes.[23]

More information on the application of the updated CESS is available in our April 2023 capital expenditure incentive guideline.

23 AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, 28 April 2023, p. 1.

Shortened forms

Term	Definition
AER	Australian Energy Regulator
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIAM	demand management innovation allowance mechanism
EBSS	efficiency benefit sharing scheme
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital