

Draft Decision

Ergon Energy Electricity Distribution Determination 2025 to 2030

(1 July 2025 to 30 June 2030)

Attachment 9

Capital expenditure sharing scheme

September 2024

© Commonwealth of Australia 2024

This work is copyright. In addition to any use permitted under the *Copyright Act 1968* all material contained within this work is provided under a Creative Commons Attributions 4.0 Australia licence with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos
- any illustration diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright but which may be part of or contained within this publication.

The details of the relevant licence conditions are available on the Creative Commons website as is the full legal code for the CC BY 4.0 AU licence.

Important notice

The information in this publication is for general guidance only. It does not constitute legal or other professional advice. You should seek legal advice or other professional advice in relation to your particular circumstances.

The AER has made every reasonable effort to provide current and accurate information, but it does not warrant or make any guarantees about the accuracy, currency or completeness of information in this publication.

Parties who wish to re-publish or otherwise use the information in this publication should check the information for currency and accuracy prior to publication.

Inquiries about this publication should be addressed to:

Australian Energy Regulator
 GPO Box 3131
 Canberra ACT 2601
 Email: aerinquiry@aer.gov.au
 Tel: 1300 585 165

AER reference: AER213702

Amendment record

Version	Date	Pages
1	23 September 2024	7

Contents

9	Capital expenditure sharing scheme	1
9.1	Draft decision.....	2
9.2	Ergon Energy’s proposal.....	3
9.3	Assessment approach	3
9.4	Reasons for draft decision	4
	Shortened forms.....	7

9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers whose capital expenditure (capex) becomes more efficient and financial penalties for those that become less efficient. Customers benefit from improved efficiency through lower regulated prices.

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 will apply for Ergon Energy for the 2025–30 regulatory period, as follows:

- We calculate the cumulative underspend or overspend for the current regulatory control period in net present value terms.
- We apply the sharing ratio of 30 per cent to all efficiency losses, and a tiered sharing ratio for efficiency gains, to work out what the service provider's share of the underspend or overspend should be.¹
- 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.

For the current regulatory period, the CESS version referred to in the regulatory information notice will apply.⁴

We consider that in addition to providing greater incentives to improve capex efficiency, the CESS provides a consistent incentive to incur capex efficiently during a regulatory control period and encourages more efficient substitution between capex and operating expenditure (opex).

¹ The tiered rate calculation for efficiency gains will apply a 30 per cent sharing ratio for any underspend amount up to and including 10 per cent of the approved forecast capex allowance, while any amount greater will incur a 20 per cent sharing ratio.

² We calculate benefits as the benefits to the service provider of financing the underspend since the amount of the underspend 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 The capex incentive guideline outlines how we may exclude capex from the RAB and adjust the CESS payment for deferrals. AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, April 2023, pp. 8, 13–19.

⁴ AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013.

This attachment sets out our draft decision for the determination of the revenue impact from the CESS in the 2020–25 regulatory control period and the application of the CESS for Ergon Energy in the 2025–30 regulatory control period.

9.1 Draft decision

9.1.1 Revenue impacts in the 2025–30 period

Our draft decision to apply a CESS revenue decrement amount of \$490.2 million (\$2024–25) across the 2025–30 regulatory control period. This is from the application of the CESS in 2020–25 regulatory control period and the corresponding CESS carryover true-up for 2019–20. This is \$224.2 million more than Ergon Energy’s forecast of \$714.4 million.

The CESS decrement arises as a result of an overspend in total capex to which the CESS applies against the forecast for the 2020–25 period. Our draft decision on the revenue impact of the application of the CESS in the 2020–25 period and the corresponding CESS carryover true-up 2019–20 is summarised in Table 9.1. This figure includes our ex-post capex adjustment which excludes \$625.5 million from the capex to which the CESS applies, this exclusion amount includes Ergon Energy’s proposed ICT exclusion of \$121.4 million.

Table 9.1 CESS revenue increments in 2025–30 (\$ million, 2024–25)

CESS item	2025–26	2026–27	2027–28	2029–29	2029–30	Total
CESS revenue increment as per NER 6.4.3(a)(5)	-93.22	-93.22	-93.22	-93.22	-93.22	-466.11
CESS carryover true-up for 2020–21	-4.81	-4.81	-4.81	-4.81	-4.81	-24.03
AER draft decision CESS	-98.03	-98.03	-98.03	-98.03	-98.03	-490.15

Note: Numbers may not sum due to rounding.

Source: AER analysis. Ergon Energy, 7.02 – Model – SCS CESS True-Up Model – January 2024, 31 January 2024.

9.1.2 Application of CESS in the 2025–30 regulatory control period

We will apply the CESS as set out in the 2023 capital expenditure incentives guideline.⁵ The reasons for adopting this CESS are set out in our final decision for the review of incentive schemes for networks, and the final decision for capital expenditure incentive guideline.⁶ This is consistent with the proposed approach we set out in our framework and approach paper.⁷

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

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

⁷ AER, *AER - Final framework and approach - Ergon Energy, Energex 2025–30 – July 2023*, July 2023, p. 16.

9.2 Ergon Energy’s proposal

9.2.1 CESS revenue increments from the 2020–25 regulatory control period

Ergon Energy proposed a CESS decrement of \$714.4 million (\$2024–25) for the 2025–30 regulatory control period. Ergon Energy cites works to address its ageing network as the primary driver for its overspend during the 2025–30 regulatory control period. Specifically, it cites pole and conductor replacements and investments, towards its non-network ICT.⁸ Ergon Energy proposed to exclude its ICT overspend of \$121.4 million from the current regulatory period from the CESS and also from its actual capex.⁹

9.2.2 Final year actual capex true-up for 2019–20

Ergon Energy submitted a true-up calculation method, which proposed a true-up decrement of \$88.6 million (\$2024–25) to be added to its CESS revenue increments in the 2025–30 period.¹⁰

9.2.3 Application of CESS in the 2025–30 regulatory control period

Ergon Energy proposed to apply the CESS in the 2025–30 regulatory period.¹¹

9.3 Assessment approach

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

- the revenue impacts on Ergon Energy arising from applying the CESS in the 2020–25 regulatory control period;¹² and
- whether or not to apply the CESS to Ergon Energy in the 2025–30 regulatory control period and how any applicable scheme will apply;¹³

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2025–30 regulatory control period arising from the application of the CESS during the 2020–25 regulatory control period.¹⁴

In deciding whether to apply a CESS to Ergon Energy for the 2025–30 regulatory control period, and the nature of the details of the scheme, we must:¹⁵

- make that decision in a manner that contributes to the capex incentive objective¹⁶

⁸ Ergon Energy, *2025–30 Regulatory Proposal*, 31 January 2024, p. 85.

⁹ Ergon Energy, *2025–30 Regulatory Proposal*, 31 January 2024, p. 148.

¹⁰ Ergon Energy, *7.02 – Model – SCS CESS True-Up Model – January 2024*, 31 January 2024.

¹¹ Ergon Energy, *2025–30 Regulatory Proposal*, 31 January 2024, p. 148.

¹² NER, cl. 6.4.3(a)(5).

¹³ NER, cl. 6.12.1(9).

¹⁴ 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).

¹⁵ NER cl. 6.5.8A(e).

- take into account the CESS principles,¹⁷ the capex objectives and, where relevant, the operating expenditure (opex) objectives,¹⁸ the interaction with other incentive schemes,¹⁹ and the circumstances of the service provider.²⁰

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 Ergon Energy’s overall forecast revenue requirement for the 2025–30 regulatory control period.

The CESS relates to other incentives Ergon 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 the 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 decrement of \$490.2 million (\$2024–25) in the 2025–30 period, comprising a \$466.1 million decrement for the 2020–25 capex performance and a \$24.0 million decrement for the final year true-up (for 2019-20). This is \$224.2 million higher than Ergon Energy’s proposed CESS revenue decrement of \$714.4 million. We set out our reasons in the sections below.

9.4.1 CESS revenue increments from the 2020–25 regulatory control period

Our draft decision includes a CESS decrement of \$490.2 million for Ergon Energy’s capex performance in the 2020–25 period. The differences between Ergon Energy’s proposal and our draft decision reflects the inclusion of updated RFM values that include the proposed ICT exclusion. Findings from our assessment of the inputs included updates to asset disposals and capitalised leases, and modelling inputs such as CPI and the WACC to reflect more up-to-date information. We will update these inputs, where relevant, in our final decision.

The CESS requires that the following three criteria must be satisfied before we apply a CESS deferral adjustment:²¹

¹⁶ NER, cl. 6.5.8A(e)(3); the capex incentive objective is set out in cl. 6.4A(a).

¹⁷ NER, cl. 6.5.8A(e)(4)(i); the CESS principles are set out in cl.6.5.8A(c).

¹⁸ NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(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).

¹⁹ NER, cl. 6.5.8A(d)(1).

²⁰ NER, cl. 6.5.8A(e)(4)(ii).

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 are satisfied a deferral adjustment is not required because there was not a material underspend in capex. We discuss exclusions and amendments following our ex-post review below.

9.4.1.1 Ex-post period exclusions

Under our CESS Guideline, there are also certain defined circumstances in which we may make adjustments for ex-post exclusions from the RAB. Therefore, by default, the CESS applies to all categories of capex and we are only able to adjust if certain criteria are met for the mentioned circumstances. One of these circumstances is that “when a NSP has overspent, the amount of capex above the allowance that does not reasonably reflect the capital expenditure criteria can be excluded from the RAB”.²² Ex-post exclusions are important to consider to potentially avoid the NSP from bearing more than 100 per cent of the cost of the excluded capex.²³ The exclusions from our ex post review are included in the model by deducting those amounts from the actual capex, which also reduces the amount of capex to which the CESS applies.

Our assessment of the proposed exclusions for 2019–24 against the NER requirements

Ergon Energy’s CESS proposal included exclusions for its ICT overspend of \$121.4 million during the first three years of the 2020–25 regulatory control period. Through our ex-post review, we have considered the proposed ICT exclusion and assessed Ergon Energy’s overall \$1.2 billion overspend during the ex-post period. As outlined in Attachment 5 of our draft decision, we have reduced Ergon Energy’s ex-post total by \$504.1 million (\$2024–25), in addition to the ICT overspend of \$121.4 million. As the exclusion will result in a reduction in the RAB, the ex-post exclusions have been included in the actual/estimated capex to reflect the same changes in the RFM. This results in a CESS decrement of \$466.1 million and true up adjustment of -\$24.0 million.

The following tables below demonstrate the impact of the exclusions to the CESS.

²¹ AER, *Capital Expenditure Incentive Guideline for Electricity Networks Service Providers*, November 2013, p. 9.

²² AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 17.

²³ AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 9.

Table 9.2 CESS revenue increments in 2025–30 with no exclusions (\$ million, 2024–25)

CESS item	2025–26	2026–27	2027–28	2029–29	2029–30	Total
CESS revenue increment as per NER 6.4.3(a)(5)	-122.53	-122.53	-122.53	-122.53	-122.53	-612.64
CESS carryover true-up for 2020–21	-18.39	-18.39	-18.39	-18.39	-18.39	-91.95
AER draft decision CESS	-140.92	-140.92	-140.92	-140.92	-140.92	-704.60

Table 9.3 CESS revenue increments in 2025–30 including exclusion of ICT overspend and ex-post adjustment (\$ million, 2024–25)

CESS item	2025–26	2026–27	2027–28	2029–29	2029–30	Total
CESS revenue increment as per NER 6.4.3(a)(5)	-93.22	-93.22	-93.22	-93.22	-93.22	-466.11
CESS carryover true-up for 2020–21	-4.81	-4.81	-4.81	-4.81	-4.81	-24.03
AER draft decision CESS	-98.03	-98.03	-98.03	-98.03	-98.03	-490.15

As a result of these exclusions, there is a reduction of the CESS decrement when compared to Table 9.2 which shows what the CESS decrement would have been before the ex-post adjustment exclusion were applied. The exclusion of the ICT overspend results in a reduction of CESS of \$33.3 million and the inclusion of our ex-post adjustments results in a reduction of \$214.5 million. The reduction of \$214.5 in the overall CESS decrement is important, as it reflects the CESS mechanism and ex-post adjustment operating together to avoid the business and consumers being penalised twice as a result of Ergon Energy's overspend.

9.4.2 Final year actual capex true-up for 2019–20

Our draft decision includes a true-up adjustment of -\$24.0 million (\$2024–25) to account for Ergon Energy's updated actual capex for 2019–20. This is \$64.6 million more than Ergon Energy's forecast true-up adjustment of -\$88.6 million.

Shortened forms

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