DRAFT DECISION

Directlink
Transmission Determination
2020 to 2025

Attachment 9
Capital expenditure sharing scheme

October 2019

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Note

This attachment forms part of the AER's draft decision on Directlink's 2020–25 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Maximum allowed revenue

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

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
capex	capital expenditure
CESS	capital expenditure sharing scheme
EBSS	efficiency benefit sharing scheme
F&A	framework and approach
NCIPAP	network capability incentive parameter action plan
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
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
TNSP	transmission network service provider

9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards to network service providers whose capital expenditure (capex) becomes more efficient and financial penalties for those that become less efficient. Consumers benefit from improved efficiency through lower regulated prices. We first applied the CESS to Directlink in the 2015–20 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 2015–20 regulatory control period, and the application of the CESS for Directlink in the 2020–25 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. Under the CESS a service provider retains 30 per cent of an under-spend or over-spend, while consumers retain 70 per cent of the under-spend or over-spend. This means that for a one dollar saving in capex the service provider keeps 30 cents of the benefit while consumers keep 70 cents of the benefit.

The CESS works as follows:

1. we calculate the cumulative efficiency gains or losses for the current regulatory control period in net present value terms
2. we apply a ratio of 30 per cent to the cumulative under-spend or over-spend to work out what the service provider's share of the under-spend or over-spend should be
3. we calculate the CESS payments taking into account the financing benefit or cost to the service provider of the under-spends or over-spends.[1] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB)[2]
4. 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] We calculate benefits as the benefits to the service provider of financing the under-spend 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 over-spend.

[2] The capex incentive guideline outlines how we may exclude capex from the RAB. AER, *Capex incentive guideline*, November 2013, pp. 13–20.

9.1 Draft decision

Revenue impacts in the 2020–25 regulatory control period from applying the CESS in the 2015–20 regulatory control period

Our draft decision is to apply a CESS revenue decrement amount of $0.7 million ($2019–20) from the application of the CESS in the 2015–20 regulatory control period.[3] CESS revenue decrements arise as a result of an over-spend in capex against the forecast for the relevant period (in this case, the 2015–20 regulatory control period).

Our draft decision on the revenue impact of the application of the CESS in the 2015–20 regulatory control period is summarised in Table 9-1.

Table 9-1 AER's draft decision on Directlink's CESS revenue decrement ($million, 2019–20)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Directlink's proposal	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1
AER draft decision	-0.1	-0.1	-0.1	-0.1	-0.1	-0.7

Source: Directlink, *Revenue proposal 2020–25, attachment 6-1 - CESS model (Public)*, 31 January 2019 and AER analysis.

Note: Numbers may not add up due to rounding.

Given the timing of this draft decision, we calculated the CESS revenue decrements in Table 9-1 using estimates of Directlink's capex for 2019–20 regulatory year.

Application of scheme in the 2020–25 regulatory control period

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to Directlink in the 2020–25 regulatory control period.[4] The guideline provides for the exclusion from the CESS of capex the service provider incurs in delivering a priority project approved under the network capability component of the service target performance incentive scheme (STPIS) for transmission network service providers.[5] This is consistent with the proposed approach we set out in our framework and approach paper.[6]

[3] NER, cl. 6A14.1(5A).

[4] AER, *Capital Expenditure Incentive Guideline*, November 2013, pp. 5–9.

[5] AER, *Capital Expenditure Incentive Guideline*, November 2013, p. 6.

[6] AER*, Final framework and approach, Directlink, Regulatory control period commencing 1 July 2020,* July 2018, p. 19.

9.2 Directlink's proposal

Revenue impacts in the 2020–25 regulatory control period from applying the CESS in the 2015–20 regulatory control period

Directlink proposed a $1.1 million ($2019–20) CESS revenue decrement to its regulated revenue in the 2020–25 regulatory control period.[7]

Application of scheme in the 2020–25 regulatory control period

Directlink proposed that the CESS for the 2020–25 regulatory control period forecast period is the same as that applied to the current regulatory control period.[8]

9.3 Assessment approach

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

- the revenue impacts on Directlink arising from applying the CESS in the 2015–20 regulatory control period
- whether or not to apply the CESS to Directlink in the 2020–25 regulatory control period and how any applicable scheme will apply.[9]

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2020–25 regulatory control period arising from the application of the CESS during the 2015–20 regulatory control period.[10]

We must also determine how any applicable CESS is to apply to Directlink in the 2020–25 regulatory control period.[11] In deciding whether to apply a CESS to Directlink for the 2020–25 regulatory control period, and the nature and details of the scheme, we must:[12]

- 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]

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7 Directlink, *Post tax revenue model (public)*, January 2019.
8 Directlink, *Revenue proposal 2020–25*, 31 January 2019, p. 98.
9 NER, cl. 6A.14.1(5A).
10 NER, cl. 6A.5.4(a)(5).
11 NER, cl. 6A.14.5(5A).
12 NER, cl. 6A.6.5A(e).
13 NER, cl. 6A.6.5A(e)(3); the capex incentive objective is set out in cl. 6A.5A(a).
14 NER, cl. 6A.6.5A(e)(4)(i); the CESS principles are set out in cl.6A.6.5A(c).
15 NER, cll. 6A.6.5A(e)(4)(i) and 6A.6.5A(d)(2); the capex objectives are set out in cl. 6A.6.7(a); the opex objectives are set out in cl. 6A.6.6(a).
16 NER, cll. 6A.6.5A(e)(4)(i) and 6A.6.5A(d)(1).
17 NER, cl. 6A.6.5A(e)(4)(ii).

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 payments/penalties determines the associated CESS building block and therefore Directlink's overall forecast revenue requirement for the 2020–25 regulatory control period.

The CESS relates to other incentives Directlink 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, and the STPIS for service levels. 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

9.4.1 CESS revenue increments from application of the CESS in the 2015–20 regulatory control period

We consider Directlink should receive a CESS revenue decrement of $0.7 million ($2019–20) from the application of version 1 of the CESS during the 2015–20 regulatory control period. This means that Directlink's allowed revenue in the 2020–25 regulatory control period is $0.7 million less than it would otherwise have been due to the application of the CESS to Directlink in the 2015–20 regulatory control period.

The timing of our draft decision means that the 2019–20 regulatory year incurred capex figure used to calculate the CESS revenue increments is an estimate. Our capital expenditure incentive guideline provides for the calculation of CESS revenue amounts to use both actual and estimated capex for all years of the current period to determine the CESS revenues in the forecast period.[18]

Given that the 2019–20 regulatory year capex will be an estimate at the time of our final decision we may need to make further adjustments to the revenue amount where actual underspending or overspending in the 2019–20 regulatory year is different to the estimate. These adjustments will be made when we undertake our revenue determination for the subsequent regulatory control period.[19]

Our calculation of the CESS is in accordance with section 2.3 of version 1 of the capital expenditure incentive guideline.[20]

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18 AER, *Capital Expenditure Incentive Guideline*, November 2013, pp. 7–8.

19 AER*, Explanatory Statement - Capital Expenditure Incentive Guideline*, November 2013, p. 21.

20 AER, *Capital Expenditure Incentive Guideline*, November 2013, p. 6.

In the 2015–20 regulatory control period, Directlink was subject to version 1 of the CESS. Under this scheme the CESS revenue increments are to be based on the difference between:

- approved forecast capex set out in our determination for Directlink for the 2015–20 regulatory control period
- actual capex for the 2015–20 regulatory control period, after the removal of any excluded cost categories such as NCIPAP capex and asset disposals.[21]

The formulas for calculating the revenue increments are set out in our determination CESS model.[22]

The CESS revenue decrement we calculated ($0.7 million) is different to the revenue decrement that Directlink proposed ($1.1 million) because we have used updated inputs to calculate the CESS revenue increments, including actual capex for the 2018–19 regulatory year.

We have used the CESS model that we applied in our recent final determinations for TasNetworks and TransGrid to determine the revenue increments for Directlink.[23]

9.4.2 Application of the CESS in the 2020–25 regulatory control period

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[24] In developing the guideline we took into account the capex incentive objective, capex criteria, capex objectives and the national electricity objective (NEO).

We will apply version 1 of the CESS to Directlink in the 2020–25 regulatory control period.[25] As we have set out in the framework and approach we consider the CESS is needed to provide Directlink with a continuous incentive to pursue efficiency gains. This approach is consistent with Directlink's revenue proposal.[26]

21 An estimate of 2019–20 capex has been used for the draft decision.

22 AER, *Directlink draft decision 2020–25 CESS model*, October 2019.

23 Directlink, *Revenue proposal 2020–25*, 31 January 2019, p. 98.

24 AER, *Capital Expenditure Incentive Guideline*, November 2013.

25 AER, *Capital Expenditure Incentive Guideline*, November 2013.

26 Directlink, *Revenue proposal 2020–25*, January 2019, p. 98.