Draft framework and approach for Murraylink

For regulatory control period commencing 1 July 2018

March 2016

AUSTRALIAN ENERGY REGULATOR

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Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) regarding this paper by the close of business **28 April 2016**.

Submissions should be sent electronically to: Murraylink2018@aer.gov.au .

Alternatively, submissions can be mailed to:

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The AER prefers that all submissions be publicly available to facilitate an informed and transparent consultative process. 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
- 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 at www.aer.gov.au. For further information regarding the AER's use and disclosure of information provided to it, see the *ACCC/AER Information Policy* (June 2014) available on the AER's website.

Enquiries about this paper, or about lodging submissions, should be directed to the Network Regulation branch of the AER on (02) 9230 9133.

Contents

Shortened forms

Shortened Form	Extended Form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
CESS	capital expenditure sharing scheme
capex	capital expenditure
EBSS	efficiency benefit sharing scheme
F&A	Framework and approach
MAR	maximum allowable revenue
MIC	market impact component
NCC	network capability component
NCIPAP	network capability incentive parameter action plan
NEM	National Electricity Market
NEO	National Electricity Objective
NER or the rules	National Electricity Rules
opex	operating expenditure
RAB	regulatory asset base
STPIS	service target performance incentive scheme
TNSP	transmission network service provider

About the framework and approach paper

The Australian Energy Regulator (AER) is the economic regulator for transmission and distribution electricity and gas businesses in Australia's national electricity market (NEM). We are an independent statutory authority, funded by the Australian Government. Our powers and functions are set out in the National Electricity Law (NEL) and National Electricity Rules (NER).

The framework and approach (F&A) is the first step in a process to determine efficient prices for electricity transmission and distribution services. The F&A highlights the broad nature of some regulatory arrangements that will apply for the next regulatory control period. It also facilitates early public consultation and assists network services providers to prepare revenue proposals.

Murraylink is an interconnector that provides a path for the flow of electricity to the limit of its 220MW capacity, in both directions, between the South Australian and Victorian transmission networks. In this way, it links the cheapest generation at a point in time with customers.

As a direct current network, Murraylink is comprised of highly specialised, complex and technologically advanced equipment compared to the conventional elements of most alternating current transmission networks in Australia.

Murraylink is dispatched by the Australian Energy Market Operator (AEMO), in a similar manner to that of a generator, to control electricity flow between South Australia and Victoria. Murraylink is therefore able to help overcome constraints in the National Electricity Market (NEM).

Murraylink's ability to transport electricity is limited by constraints within the adjoining regional transmission networks in South Australia and Victoria, which can reduce its effective capacity to well below its rated maximum capacity of 220MW. We are not required to assess demand forecasts because Murraylink's network expenditure is independent of the levels of, or growth in, peak energy demand.

The current five year regulatory control period for Murraylink ends on 30 June 2018. The rules require us to publish an F&A paper for Murraylink by 31 July 2016.[1]

In December 2015 Murraylink wrote to the AER providing suggestions for its first F&A. This draft F&A sets out our proposed approach for the 2018−23 regulatory control period, and beyond if appropriate, on the application of the following:

- service target performance incentive scheme (STPIS)
- expenditure efficiency benefit sharing scheme (EBSS)
- capital expenditure sharing scheme (CESS)
- expenditure forecast assessment guidelines, and

1 NER, cll. 6A.10.1A(a)(i) and (e).

- whether depreciation will be based on forecast or actual capital expenditure in updating the regulatory asset base.

We will use the F&A process to commence discussions with Murraylink about the treatment of confidential information as set out in our confidentiality guideline.[2] We encourage Murraylink to also consult consumers, as part of its consumer engagement, to gain a better understanding of the type of information consumers are interested in accessing.[3]

Table 1 summarises **indicative dates** for the Murraylink transmission determination process.

Table 1 Murraylink transmission determination process

Step	Date
AER to publish F&A paper for Murraylink	By 31 July 2016
Murraylink to submit revenue proposal	31 January 2017
AER to publish issues paper on Murraylink revenue proposal	March 2017**
AER to hold public forum on issues paper	March 2017**
Submissions on revenue proposal/issues paper close	May 2017**
AER to publish draft transmission determination	September 2017*
AER to hold predetermination conference	October 2017*
Murraylink submits revised revenue proposal	December 2017*
Submissions on draft determination close	January 2017*
AER to publish final transmission determination	30 April 2018

Source: NER, Chapter 6A, Part E

* The NER does not provide specific timeframes in relation to publishing draft decisions. Accordingly, this timing is indicative only.

** The dates provided for submissions/cross submissions and forums are based on the AER receiving a sufficiently compliant proposal. These dates may alter if we receive a non-compliant proposal.

2 AER, *Confidentiality guideline*, 19 November 2013.

3 AER, *Consumer engagement guideline for network service providers*, 6 November 2013.

Part A: Overview

This F&A covers how we propose to apply a range of incentive schemes and guidelines to Murraylink along with our proposed approach to calculating depreciation. The positions we set out in our draft and final F&A are not binding on us or Murraylink.[4] This means that it is open to us to change our position, and for Murraylink to propose a different position, on matters set out in the F&A during the determination process. Where our position changes from that set out in the F&A, we will provide clear reasons.

The purpose of the F&A, therefore, is to provide Murraylink and stakeholders with an indication of our likely position on matters that Murraylink is required to address in its revenue proposal.

Incentive schemes are a component of incentive-based regulation and complement our approach to assessing efficient costs. Incentive schemes encourage transmission network service providers (TNSPs) to manage their businesses in a safe, reliable manner that benefits the long term interests of consumers. The schemes also provide TNSPs with incentives to spend efficiently and to meet or exceed service quality/reliability targets. In some instances, TNSPs may incur a financial penalty if they fail to meet set targets. The overall objectives of the schemes are to:

- encourage appropriate levels of service quality
- maintain network reliability as appropriate
- incentivise TNSPs to spend efficiently on capital expenditure (capex) and operating expenditure (opex)
- share efficiency gains and losses between TNSPs and consumers
- incentivise TNSPs to consider economically efficient alternatives to augmenting their networks.

We summarise the specific schemes below and provide an overview of our expenditure forecast assessment guideline and approach to calculating depreciation.

Service target performance incentive scheme

The transmission service target performance incentive scheme (STPIS) provides an incentive to TNSPs to maintain a high level of service for the benefit of participants in the National Energy Market (NEM) and end users of electricity.

We propose to apply our national STPIS to Murraylink. The version applied will be the version in existence at the commencement of the relevant regulatory control period. This is expected to be version 5 of the STPIS.

4 NER, cl. 6A.10.1A(f).

Efficiency benefit sharing scheme

The EBSS aims to provide a continuous incentive for TNSPs to pursue efficiency improvements in opex and provide for a fair sharing of these between TNSPs and network users. Consumers benefit from improved efficiencies through lower regulated prices in the future.

We propose to apply the EBSS to Murraylink. The version applied will be the version in existence at the commencement of the relevant regulatory control period.

Capital expenditure sharing scheme

The CESS provides financial rewards for TNSPs whose capex becomes more efficient and financial penalties for those that become less efficient. Consumers benefit from improved efficiency through lower regulated prices in the future.

We propose to apply the CESS to Murraylink, The version applied will be the version in existence at the commencement of the relevant regulatory control period for Murraylink.

Expenditure forecast assessment guideline

As part of our Better Regulation program we consulted on and published our expenditure forecast assessment guideline for electricity transmission (expenditure assessment guideline). The expenditure assessment guideline is based on a nationally consistent reporting framework allowing us to compare the relative efficiencies of TNSPs and decide on efficient expenditure allowance. The two regulated interconnectors, Murraylink and Directlink, have been excluded from our benchmarking analysis, given the smaller scale of their assets. We will therefore not apply benchmarking as a tool to determine the reasonableness of Murraylink's forecast operating expenditure. However, we will apply other assessment techniques, as set out in the expenditure assessment guideline, when assessing Murraylink's revenue proposal.

As set out in the explanatory statement to the expenditure assessment guideline, we have developed a guideline that is flexible in terms of the assessment techniques that may apply. If we decide at any time that the guideline requires amendment, we will commence a formal revision process, including stakeholder consultation, at a relevant time.[5]

Depreciation

As part of the roll forward methodology, when a TNSP's regulatory asset base (RAB) is updated from forecast capex to actual capex at the end of a regulatory control period, it is also adjusted for depreciation. The depreciation we use to roll forward the RAB can be based on either actual capex incurred during the regulatory control period, of the capex allowance forecast at the start of the regulatory control period. The choice of depreciation approach is one part of the overall capex incentive framework. The incentive based

5 AER, *Explanatory statement − Expenditure forecast assessment guideline*, November 2013, p. 38.

regulatory framework provides benefits to consumers from improved efficiencies through lower regulated prices.

We propose to use forecast depreciation to establish the RAB for the regulatory control period commencing in 2023 for Murraylink.

Small-scale incentive scheme

The rules provide that we may develop small-scale incentive schemes.[6] At this stage, we have not developed any such scheme to encourage more efficient investment or operation of networks, as may be envisaged under this provision of the rules. For this reason, we do not propose to apply a small-scale incentive scheme to Murraylink for future regulatory control periods. However, should our position change, we will consult broadly with stakeholders on the development and application of any small-scale incentive scheme.

6 NER, cl. 6A.7.5.

Part B: Attachments

1 Service target performance incentive scheme

This attachment sets out our proposed approach and reasons for our intended application of the service target performance incentive scheme (STPIS) to Murraylink in its upcoming regulatory control period.

We create, administer and maintain the STPIS in accordance with the requirements of the rules.[7] The STPIS provides incentives for each TNSP to provide greater transmission network reliability when network users place greatest value on reliability, and improve and maintain the reliability of the elements of the transmission network most important to determining spot prices.[8]

The STPIS consists of three components:

- a service component, which has four main parameters and various sub-parameters which act as key indicators of network reliability
- a market impact component (MIC), which encourages TNSPs to minimise the impact of network outages on the dispatch of generation
- a network capability component, which encourages TNSPs to undertake low cost projects to promote efficient levels of network capability from existing assets when most needed, while maintaining adequate levels of reliability.

Each year, the TNSP's maximum allowed revenue (MAR) is adjusted based on its performance against the STPIS parameters in the previous calendar year. The STPIS can result in a maximum revenue increment or decrement between one and five per cent of the annual MAR.[9]

1.1 Proposed approach

The version of the STPIS in existence at the commencement of the regulatory control period will apply to Murraylink. This is expected to be STPIS version 5 (October 2015). Two of the three components (service and market impact component) will apply. The network capability component does not apply to Murraylink.[10]

The MAR that Murraylink can earn in each regulatory year will be adjusted according to its performance against the values included in its transmission determination, as assessed by us in the annual compliance review process.[11]

1.2 Reasons for proposed approach

In its revenue proposal, Murraylink must:

- submit proposed values for the service component parameters.[12]

7 NER, cl 6A.7.4(a)
8 NER, cl. 6A.7.4(b)(1).
9 NER, cl. 6A.7.4(b)(3).
10 STPIS, version 4, cl 2.2(d)
11 STPIS, version 5, section 6

- submit data for its market impact component in accordance with Appendix C for the preceding seven regulatory years.[13] It must submit a proposed value for a performance target, unplanned outage event limit and dollar per dispatch interval incentive.[14]

We will accept Murraylink's proposed parameter values for the service and market impact components if the proposed values comply with STPIS version 5 clauses 3.2 and 4.2.[15]

Service component

The service component will apply to Murraylink to provide an incentive to it to maintain and improve network availability and reliability.

In this component, Murraylink can receive a revenue increment or decrement of up to 1.25 per cent of its MAR for the regulatory year.

There are four parameters in the service components, however only two parameters will apply to Murraylink: 'unplanned outage circuit event rate' and 'proper operation of equipment'. Appendix A and Appendix B define the service component parameters for Murraylink.[16] The standard definition for the 'Unplanned outage circuit event rate' parameter is modified as set out in Appendix B. The standard definition of 'Proper operation of equipment parameter' applies (Appendix A). The two parameters: 'Loss of supply event frequency' and 'Average outage duration' will not apply to Murraylink.

We will assess whether Murraylink's proposed performance targets, caps, collars and weightings comply with the parameter definitions, values and weightings set out in Section 3 [Table 3.2], Appendix A, B and E of the STPIS.

Our method of assessment of the parameter values is set out in section 3.2 of the scheme. We may reject the proposed values where we are of the opinion that they are inconsistent with the objectives listed in clause 1.4 of the STPIS.[17]

Market impact component

The market impact component will be applied to Murraylink to incentivise it to minimise the impact of its transmission outages that can affect NEM market outcomes.

In this component, Murraylink will receive a financial incentive which falls within a range of minus one percent (penalty) and plus one per cent (reward) of its maximum allowed revenue.[18]

We will assess Murraylink's proposed parameter values using the methodology set out in section 4, Appendix C and Appendix F of the STPIS.[19]

12
13 STPIS, version 5, section 4.2(a)
14 STPIS, version 5, section 4.2(b)
15 STPIS, version 5, October 2015
16 STPIS, version 5, Appendix A and B
17 STPIS, version 5, cl 3.2(l)
18 STPIS, version 5, cl 4.3
19 Specifically, clause 4.2(f)(1)-(5) applies to Murraylink because it is commencing STPIS version 5 during the forthcoming

Network capability component

The network capability component (NCC) does not apply to Murraylink, as per clause 2.2(d) of the STPIS version 5.

regulatory control period and therefore, Appendix F–Example 1 is relevant.

2 Efficiency benefit sharing scheme

The EBSS aims to provide a continuous incentive for TNSPs to pursue efficiency improvements in opex, and provide for a fair sharing of these between TNSPs and network users. Consumers benefit from improved efficiencies through lower regulated prices in the future.

This attachment sets out our proposed approach and reasons on how we intend to apply the EBSS to Murraylink.

2.1 Proposed approach

We propose to apply the version of the EBSS applicable to Murraylink at the commencement of future regulatory control periods. In summary, this will include:

- the formulae for calculating efficiency gains and losses
- our approach to adjustments to forecast or actual opex when calculating carryover amounts
- our approach to determining the carryover period.

The EBSS must provide for a fair sharing between TNSPs and network users of opex efficiency gains and efficiency losses.[20] We must also have regard to the following factors in developing and implementing the EBSS:[21]

- the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme
- the need to provide service providers with a continuous incentive to reduce opex
- the desirability of both rewarding service providers for efficiency gains and penalising service providers for efficiency losses
- any incentives that service providers may have to capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

2.2 Reasons for proposed approach

We revised the EBSS in 2013 and merged the distribution and transmission schemes. Changes to the EBSS relate to the criteria for adjustments and exclusions under the scheme.[22] We may also exclude categories of opex not forecast using a single year revealed cost approach from the scheme on an ex post basis if doing so better achieves the requirements of the rules. In 2013, we also amended the scheme to provide flexibility to

20 NER, cl. 6A.6.5(a).

21 NER, cl. 6A.6.5(b).

22 We will no longer allow for specific exclusions such as uncontrollable opex or for changes in opex due to unexpected increases or decreases in network growth. We may also exclude categories of opex not forecast using a single year revealed cost approach from the scheme on an ex post basis if doing so better achieves the requirements of the rules.

account for any adjustments made to base year opex to remove the impacts of one-off factors. The EBSS also clarifies how we will determine the carryover period. These revisions affect how we will calculate carryover amounts for future regulatory control periods.[23]

In developing the EBSS we had regard to the requirements under the rules, as set out in the scheme and accompanying explanatory statement. This reasoning extends to the factors we must have regard to in implementing the scheme.

The EBSS must provide for a fair sharing of efficiency gains and losses.[24] Under the scheme, TNSPs and consumers receive a benefit where a TNSP reduces its costs during a regulatory control period and both bear some of any increase in costs.

Under the EBSS, positive and negative carryovers reward and penalise TNSPs for efficiency gains and losses, respectively.[25] The EBSS provides a continuous incentive for TNSPs to achieve opex efficiencies throughout the regulatory control period. This is because the TNSP receives carryover payments so it retains any efficiency gains or losses it makes within the regulatory period for the length of the carryover period. This is regardless of the year in which it makes the gain or loss.[26]

This continuous incentive to improve efficiency encourages efficient and timely opex throughout the regulatory control period, and reduces the incentive for a TNSP to inflate opex in the expected base year. This provides an incentive for TNSPs to reveal their efficient opex which, in turn, allows us to better determine efficient opex forecasts for future regulatory control periods.

The EBSS also leads to a fair sharing of efficiency gains and losses between TNSPs and consumers. For instance the combined effect of our forecasting approach and the EBSS is that opex efficiency gains or losses are shared approximately 30:70 between TNSPs and consumers. This means for a one dollar efficiency saving in opex the TNSP keeps 30 cents of the benefit while consumers keep 70 cents of the benefit.

Example 1 shows how the EBSS operates. It illustrates how the benefits of a permanent efficiency improvement are shared approximately 30:70 between a network service provider and consumers.

23 AER, *Efficiency benefit sharing scheme*, 29 November 2013.
24 NER, cl. 6A.6.5(a).
25 NER, cll. 6A.6.5(b) and 6A.6.5(a).
26 NER, cl. 6A.6.5(b)(1).

Example 1 How the EBSS operates

Assume that in the first regulatory period, a network service provider's forecast opex is $100 million per annum (p.a.).

Assume that during this period the service provider delivers opex equal to the forecast for the first three years. Then, in the fourth year of the regulatory period, the service provider implements a more efficient business practice for maintaining its assets. As a result, the service provider will be able to deliver opex at $95 million p.a. for the foreseeable future.

This efficiency improvement affects regulated revenues in two ways:

1. Through forecast opex. If we use the penultimate year of the regulatory period to forecast opex in the second regulatory period, the new forecast will be $95 million p.a. If the efficiency improvement is permanent, all else being equal, forecast opex will also be expected to be $95 million p.a. in future regulatory periods.

2. Through EBSS carryover amounts. The service provider receives additional carryover amounts so that it receives exactly six years of benefits from an efficiency improvement. Because the service provider has made an efficiency improvement of $5 million p.a. in Year 4, to ensure it receives exactly six years of benefits, it will receive annual EBSS carryover amounts of $5 million in the first four years (Years 6 to 9) of the second regulatory period.

As a result of these effects, the service provider will benefit from the efficiency improvement in Years 4 to 9. This is because the annual amount the service provider receives through the forecast opex and EBSS building blocks ($100 million) is more than what it pays for opex ($95 million) in each of these years.

Consumers benefit from Year 10 onwards after the EBSS carryover period has expired. This is because what consumers pay through the forecast opex and EBSS building blocks ($95 million) is lower from Year 10 onwards.

Table 2 provides a more detailed illustration of how the benefits are shared between service providers and consumers over time.

(Example 1 continued)

Table 2 Example of how the EBSS operates

	Reg. period 1					Reg. period 2					Future
Year	1	2	3	4	5	6	7	8	9	10	
Forecast (Ft)	100	100	100	100	100	95	95	95	95	95	95 p.a.
Actual (At)	100	100	100	95	95	95	95	95	95	95	95 p.a.
Underspend (Ft – At = Ut)	0	0	0	5	5	0	0	0	0	0	0 p.a.
Incremental efficiency gain (It = Ut – Ut–1)	0	0	0	5	0	0*	0	0	0	0	0 p.a.
Carryover (I1)		0	0	0	0	0					
Carryover (I2)			0	0	0	0	0				
Carryover (I3)				0	0	0	0	0			
Carryover (I4)					5	5	5	5	5		
Carryover (I5)						0	0	0	0	0	
Carryover amount (Ct)						5	5	5	5	0	0 p.a.
Benefits to NSP (Ft – At +Ct)	0	0	0	5	5	5	5	5	5	0	0 p.a.
Benefits to consumers (F1 – (Ft +Ct))	0	0	0	0	0	0	0	0	0	5	5 p.a.
Discounted benefits to NSP**	0	0	0	5	4.7	4.5	4.2	4.0	3.7	0	0
Discounted benefits to consumers**	0	0	0	0	0	0	0	0	0	3.5	58.8***

Notes:

* At the time of forecasting opex for the second regulatory period we don't know actual opex for year 5. Consequently this is not reflected in forecast opex for the second period. That means an underspend in year 6 will reflect any efficiency gains made in both year 5 and year 6. To ensure the carryover rewards for year 6 only reflect incremental efficiency gains for that year we subtract the incremental efficiency gain in year 5 from the total underspend. In the example above, I6 = U6 – (U5 – U4).

** Assumes a real discount rate of 6 per cent.

*** As a result of the efficiency improvement, forecast opex is $5 million p.a. lower in nominal terms. The estimate of $58.7m is the net present value of $5 million p.a. delivered to consumers annually from year 11 onwards.

Table 3 sums the discounted benefits to NSPs and consumers from the bottom two rows of Table 2. As illustrated below, the benefits of the efficiency improvement are shared approximately 30:70 in perpetuity between the service provider and consumers.

Table 3 Sharing of efficiency gains—Year 4 forecasting approach, with EBSS

	NPV of benefits of efficiency improvement[1]	Percentage of total benefits
Benefits to service provider	$26.1 million	30 per cent
Benefits to consumers	$62.3 million	70 per cent
Total	$88.3 million	100 per cent

In implementing the EBSS we must also have regard to any incentives TNSPs may have to capitalise expenditure.[27] Where opex incentives are balanced with capex incentives, a TNSP does not have an incentive to favour opex over capex, or vice-versa. The CESS is a symmetric capex scheme with a 30 per cent incentive power. This is consistent with the incentive power for opex when we use an unadjusted base year approach in combination with an EBSS. During the regulatory control period when the CESS and EBSS are applied, incentives will be relatively balanced, and TNSPs should not have an incentive to favour opex over capex or vice versa. The CESS is discussed further in attachment 3.

We must also consider the possible effects of implementing the EBSS on incentives for non-network alternatives:[28]

- Expenditure on non-network alternatives generally takes the form of opex rather than capex. Successful non-network alternatives should result in the TNSP spending less on capex than it otherwise would have.
- We propose applying both the CESS and EBSS in future regulatory control periods. As a result a TNSP has an incentive to implement a non-network alternative if the increase in opex is less than the corresponding decrease in capex. In this way, the TNSP will receive a net reward for implementing the non-network alternative.[29] This is because the rewards and penalties under the EBSS and CESS are balanced and symmetric. In the past where the EBSS operated without a CESS, we excluded expenditure on non-network alternatives when calculating rewards and penalties under the scheme. This

27 NER, cl. 6A.6.5(b)(3).

28 NER, cl. 6A.6.5(b)(4).

29 When the TNSP spends more on opex it receives a 30 per cent penalty under the EBSS. However, when there is a corresponding decrease in capex the TNSP receives a 30 per cent reward under the CESS. So where the decrease in capex is larger than the increase in opex the TNSP receives a larger reward than penalty, a net reward.

was because TNSPs may otherwise receive a penalty for increasing opex without a corresponding reward for decreasing capex.[30]

30 Without a CESS the reward for capex declines over the regulatory period. If an increase in opex corresponded with a decrease in capex, the off-setting benefit of the decrease in capex depends on the year in which it occurs.

3 Capital expenditure sharing scheme

The CESS provides financial rewards for TNSPs whose capex becomes more efficient and financial penalties for those that become less efficient. Consumers benefit from improved efficiency through lower regulated prices in the future. This attachment sets out our proposed approach and reasons for how we intend to apply the relevant version of the CESS to Murraylink in future regulatory control periods.

The CESS approximates the efficiency gains and efficiency losses by calculating the difference between forecast and actual capex. It shares these gains or losses between TNSPs and network users.

The CESS works 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 the cumulative underspend or overspend to work out what the TNSP's share of the underspend or overspend should be.
- We calculate the CESS payments taking into account the financing benefit or cost to the TNSP of the underspend or overspend.[31]
- The CESS payments will be added or subtracted to the TNSP's regulated revenue as a separate building block in the next regulatory control period.

Under the CESS a TNSP retains 30 per cent of the benefit or cost of an underspend or overspend, while consumers retain 70 per cent of the benefit or cost of an underspend or overspend. This means that for a one dollar saving in capex the TNSP keeps 30 cents of the benefit while consumers keep 70 cents of the benefit. Conversely, in the case of an overspend, the TNSP pays for 30 cents of the cost while consumers bear 70 cents of the cost.

3.1 Proposed approach

We propose to apply the relevant version of the CESS as set out in our capex incentive guideline to Murraylink.

In deciding whether to apply a CESS to a TNSP, and the nature and details of any CESS to apply to a TNSP, we must:[32]

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31 We calculate the benefits to the TNSP of financing the underspend since the amount of the underspend can be put to other income generating use during the period. Losses are similarly calculated as the financing cost to the TNSP of the overspend.

32 NER, cl. 6A.6.5A.

- make that decision in a manner that contributes to the capex incentive objective[33]
- consider the CESS principles,[34] capex objectives,[35] other incentive schemes and where relevant the opex objectives, as they apply to the particular TNSP and the circumstances of the TNSP.

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.

3.2 Reasons for proposed approach

We propose to apply the CESS to Murraylink as we consider this will contribute to the capex incentive objective.

As part of our Better Regulation program we consulted on and published version 1 of the capex incentive guideline which sets out the CESS.[36] The guideline specifies that in most circumstances we will apply a CESS, in conjunction with forecast depreciation.[37] We also propose to apply forecast depreciation, which is discussed further in attachment 5.

In developing the CESS we took into account the capex incentive objective, capex criteria, capex factors and the CESS principles. We also developed the CESS to work alongside other incentive schemes that apply to TNSPs including the EBSS and STPIS.

For capex, the sharing of underspends and overspends happens at the end of each regulatory control period when we update a TNSP's RAB to include new capex. If a TNSP spends less than its approved forecast during a regulatory control period, it will benefit within that period. Consumers benefit at the end of that regulatory control period when the RAB is updated to include less capex compared to if the TNSP had spent the full amount of the capex forecast. This leads to lower prices in the future.

Without a CESS the incentive for a TNSP to spend less than its forecast capex declines throughout the period.[38] Because of this a TNSP may choose to spend capex earlier, or on capex when it may otherwise have spent on opex, or less on capex at the expense of service quality—even if it may not be efficient to do so.

33 NER, cl. 6A.5A(a); the capex criteria are set out in cl. 6A.6.7(c)(1)−(3) of the NER.
34 NER, cl. 6A.6.5A(c).
35 NER, cl. 6A.6.7(a).
36 AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 5−9.
37 AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 10−11.
38 As the end of a regulatory control period approaches, the time available for the TNSP to retain any savings gets shorter. So the earlier a TNSP incurs an underspend in the regulatory control period, the greater its reward will be.

With the CESS a TNSP faces the same reward and penalty in each of a regulatory control period for capex underspends or overspends. The CESS will provide TNSPs with an ex ante incentive to spend only efficient capex. TNSPs that make efficiency gains will be rewarded through the CESS. Conversely, TNSPs that make efficiency losses will be penalised through the CESS. In this way, TNSPs will be more likely to incur only efficient capex when subject to a CESS, so any capex included in the RAB is more likely to reflect the capex criteria. In particular, if a TNSP is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent TNSP.

When the CESS, EBSS and STPIS apply to TNSPs the incentives for improvements in opex, capex and service outcomes are more balanced. This encourages businesses to make efficient decisions on when and what type of expenditure to incur, and to efficiently trade off expenditure reductions with service quality and reliability.

4 Expenditure forecast assessment guideline

This attachment sets out our intention to apply the expenditure forecast assessment guideline (guideline)[39] including the information requirements applicable to Murraylink at the commencement of the relevant regulatory control period. We propose applying the guideline as it sets out our expenditure assessment approach. The guideline outlines for TNSPs and interested stakeholders the types of assessments we will do to determine efficient expenditure allowances and the information we require from TNSPs to do so.

We were required to develop the guideline under the rules.[40] The guideline is based on a nationally consistent reporting framework allowing us to compare the relevant efficiencies of TNSPs and decide on efficient expenditure allowances. The rules require Murraylink to advise us by 30 June 2016 of the methodology it proposes to use to prepare forecasts.[41] In the final F&A we must set out our proposed approach to the application of the guideline.[42] This will provide clarity to Murraylink and assist it with the information it should include in its revenue proposal.

The guideline contains a suite of assessment/analytical tools and techniques to assist our review of revenue proposals submitted by TNSPs. We intend to apply some of the assessment techniques set out in the guideline. The techniques include:

- benchmarking (economic techniques and category analysis)
- methodology review
- governance and policy review
- predictive modelling
- trend analysis
- cost benefit analysis
- detailed project review (including engineering review).

We exercise our judgement in determining the extent to which we use a particular technique in assessing a revenue proposal. Our expenditure forecasting assessment guideline is flexible and recognises that a range of different estimating techniques may be employed to develop an expenditure forecast.

39 The first version of the guideline was published on 29 November 2013. It can be located at www.aer.gov.au/node/18864.

40 NER, cll. 6.4.5, 6A.5.6, 11.53.4 and 11.54.4.

41 NER, cl. 6A.10.1B(b)(1).

42 NER, cl. 6A.10.1A(b)(5).

We developed the guideline to apply broadly to all electricity transmission and distribution businesses. However, given the smaller scale of Murraylink's assets and nature of its network operations we do not intend applying standardised benchmarking analysis (including top down economic benchmarking or driver-based benchmarks) or predictive modelling in assessing its capex and opex forecasts. Our proposed approach for opex will involve consideration of revealed costs and the 'base-step-trend' approach. For capex, our proposed approach will involve detailed reviews of Murraylink's asset management practices and specified projects. Consequently, the information we will seek from Murraylink through the regulatory information notice will not include the same standardised data on expenditures and related benchmarking measures that are set out in the guideline.

5 Depreciation

As part of the roll forward methodology, when the RAB is updated from forecast capex to actual capex at the end of a regulatory control period, it is also adjusted for depreciation. This attachment sets out our proposed approach to calculating depreciation when the RAB is rolled forward.

The depreciation we use to roll forward the RAB can be based on either:

- actual capex incurred during the regulatory control period (actual depreciation). We roll forward the RAB based on actual capex less the depreciation on the actual capex incurred by the TNSP, or
- the capex allowance forecast at the start of the regulatory control period (forecast depreciation). We roll forward the RAB based on actual capex less the depreciation on the forecast capex approved for the regulatory control period.

The choice of depreciation approach is one part of the overall capex incentive framework.

Consumers benefit from improved efficiencies through lower regulated prices. Where a CESS is applied, using forecast depreciation provides the incentives for TNSPs to pursue continuous capex efficiencies. Using actual depreciation increases these incentives. There is more information on depreciation as part of the overall capex incentive framework in our capex incentive guideline.[43] In summary:

- If there is a capex overspend, actual depreciation will be higher than forecast depreciation. This means that the RAB will increase by a lesser amount than if forecast depreciation were used. So, the TNSP will earn less revenue into the future (i.e. it will bear more of the cost of the overspend in the future) than if forecast depreciation had been used to roll forward the RAB.
- If there is a capex underspend, actual depreciation will be lower than forecast depreciation. This means that the RAB will increase by a greater amount than if forecast depreciation were used. Hence, the TNSP will earn greater revenue into the future (i.e. it will retain more of the benefit of an underspend into the future) than if forecast depreciation had been used to roll forward the RAB.

The incentive from using actual depreciation to roll forward the RAB also varies with the life of the asset. Using actual depreciation will provide a stronger incentive for shorter lived assets compared to longer lived assets. Forecast depreciation, on the other hand, leads to the same incentive for all assets.

5.1 Proposed approach

43 AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 10−11.

We propose to use the forecast depreciation approach to establish Murraylink's RAB at the commencement of the 2023–28 regulatory control period. We consider this approach will provide sufficient incentives for Murraylink to achieve capex efficiency gains over the 2018–23 regulatory control period.

In the final F&A, we must set out our proposed approach as to whether we will use actual or forecast depreciation to establish a TNSP's RAB at the commencement of the following regulatory control period.[44]

Specifically, we are required to set out in our capex incentive guideline our process for determining which form of depreciation we propose to use in the RAB roll forward process.[45] Our decision on whether to use actual or forecast depreciation must be consistent with the capex incentive objective. We must have regard to:[46]

- any other incentives the service provider has to undertake efficient capex
- substitution possibilities between assets with different lives
- the extent of overspending and inefficient overspending relative to the allowed forecast
- the capex incentive guideline
- the capex factors.

5.2 Reasons for proposed approach

Consistent with our capex incentive guideline, we propose to use the forecast depreciation approach to establish Murraylink's RAB at the commencement of the 2023–28 regulatory control period.

We had regard to the relevant factors in the rules in developing the approach to choosing depreciation set out in the capex incentive guideline.

Our approach is to apply forecast depreciation except where:

- there is no CESS in place and therefore the power of the capex incentive may need to be strengthened, or
- a TNSP's past capex performance demonstrates evidence of persistent overspending or inefficiency, thus requiring a higher powered incentive.

In making our decision on whether to use actual depreciation in either of these circumstances we will consider:

44 NER, cl. S6A.2.2B.
45 NER, cl. 6A.5A(b)(3).
46 NER, cl. S6A.2.2B.

- the substitutability between capex and opex and the balance of incentives between these
- the balance of incentives with service outcomes
- the substitutability of assets of different asset lives.

We have chosen forecast depreciation as our proposed approach because, in combination with the CESS, it will provide a 30 per cent reward for capex underspends and 30 per cent penalty for capex overspends, which is consistent for all asset classes. In developing our capex incentive guideline, we considered this to be a sufficient incentive for a TNSP to achieve efficiency gains over the regulatory control period in most circumstances.

As discussed in attachment 3, we propose to apply the CESS to Murraylink for the regulatory control period commencing 1 July 2018.

For Murraylink, we consider the incentive provided by the application of the CESS in combination with the use of forecast depreciation and our other ex post capex measures should be sufficient to achieve the capex incentive objective.[47]

47 Our ex post capex measures are set out in the capex incentive guideline, AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 13−19. The guideline also sets out how all our capex incentive measures are consistent with the capex incentive objective. See pp. 20−21.