Framework and approach

Directlink

Regulatory control period commencing 1 July 2025

July 2023

AUSTRALIAN ENERGY REGULATOR

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1 Introduction

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. Consumers are at the heart of our work, and we focus on ensuring a secure, reliable, and affordable energy future for Australia. The regulatory framework governing electricity transmission and distribution networks is the National Electricity Law and Rules (NEL and NER). Our work is guided by the National Electricity Objective (NEO).

A regulated network business must periodically apply to us for a determination of the revenue it can recover from consumers using its network. Electricity transmission interconnector Directlink, which carries electricity between the New South Wales and Queensland transmission networks, is due to submit its next revenue proposal on 31 January 2024, for the period 1 July 2025 to 30 June 2030 (2025–30 period).

The Framework and Approach (F&A) process is the first step in a two-year regulatory process to determine efficient prices for Directlink's transmission services and sets the foundation for the regulatory reset and the revenue proposal. It sets out our proposed approach to key elements of the upcoming determination and facilitates early consultation on these before Directlink prepares and submits its revenue proposal. These elements include:

- the application of incentive schemes which encourage network service providers to manage their business in a safe, reliable manner that serves the long-term interests of consumers. The schemes provide network service providers with incentives to only incur efficient costs and to meet or exceed service quality targets.[1]
- our approach to setting efficient expenditure allowances[2] and the establishment of the opening regulatory asset base for the upcoming regulatory control period[3].

The F&A that applied to Directlink for the current (2020–25) regulatory control period was published in July 2018. Since then, we have seen significant transition in the energy market and the rules, schemes and guidelines under which we regulate electricity networks. In December 2022, we therefore confirmed that we would review and make an amended or replacement F&A for Directlink.

We published our preliminary positions on the F&A on our website in March 2023 and invited stakeholders to make written submissions. No submissions were received.

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1 NER, cl. 6A.10.1(b)(1), (2), (3), (4), (7)

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

3 NER, cl. 6A.10.1A(b)(6).

1.1 Next steps

The table below provides an indicative timeframe for the remaining stages of our transmission determination for Directlink. These are subject to change.

Table 1 Indicative timeline for Directlink electricity transmission determination

Milestone	Indicative date
Directlink submits revenue proposal to AER	January 2024
AER publishes issues paper and holds public forum	March/April 2024
Submissions on revenue proposal close	May 2024
AER to publish draft transmission determination	September 2024
AER to hold predetermination conference	October 2024
Directlink to submit revised revenue proposal to AER	December 2024
Submissions on revised revenue proposal and draft decision close	January 2025
AER to publish transmission determination for regulatory control period	April 2025

2 Incentive schemes

We propose to apply the following incentive schemes in our transmission determination for Directlink in the 2025–30 period:

- Efficiency benefit sharing scheme (EBSS), subject to the considerations set out below.[4] This provides a continuous incentive to pursue efficiency improvements in opex and provides for a fair sharing of these between Directlink and network users.
- Capital expenditure sharing scheme (CESS).[5] This incentivises efficient capex throughout the period by rewarding efficiency gains and penalising efficiency losses.
- Service target performance incentive scheme (STPIS).[6] This balances incentives to reduce expenditure with the need to maintain or improve service quality, by providing financial incentives to maintain and improve service performance where consumers are willing to pay for these improvements.

These schemes work together within a revenue determination to provide incentives for network service providers to invest efficiently and operate in the long-term interests of consumers.

Since we published Directlink's F&A for the current 2020–25 period, we have completed a review of the CESS and EBSS. That review concluded that revisions to the EBSS were not necessary.[7] Given this, and consistent with our general approach, we intend to apply the EBSS to Directlink in the 2025−30 regulatory control period if we are satisfied the scheme will fairly share efficiency gains and losses between the business and consumers.[8] This will occur only if the opex forecast for the following period is based on Directlink's revealed costs. Our transmission determination for Directlink for the 2025−30 regulatory control period will specify if and how we will apply the EBSS.

The final decision for the incentives review resulted in a number of changes to the CESS including:

- changes to the sharing ratios in the CESS to implement a tiered arrangement, with a 30% sharing ratio for any underspend up to 10% of the forecast capital expenditure allowance, a 20% for any underspend over 10% and a 30% sharing ratio for any overspend that will apply over the 2025-30 period.
- requiring network service providers to provide further information to better and transparently explain the reasons for differences between our expenditure forecasts and the actual capital expenditure occurred.

We will therefore apply the new version 2 of the CESS to Directlink in the 2025-30 period.

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4 NER, cl. 6A.10.1(b)(2)

5 NER, cl. 6A.10.1(b)(3)

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

7 AER, *Review of incentives schemes for networks, Final decision*, April 2023, p. 10.

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

We propose to continue to apply the transmission STPIS (version 5) to Directlink in the 2025–30 period. A review of the Market Impact Component of the transmission STPIS planned for the second half of 2023 may mean that a new version of the STPIS will apply to Directlink in 2025–30.

We released a new Demand management innovation allowance mechanism (DMIAM) for transmission network service providers in May 2021 that has not previously applied to Directlink.[9] The DMIAM funds research and development in demand management projects that have the potential to reduce long term network costs. As Directlink noted in opening correspondence on this review of its F&A, the application of the DMIAM to an interconnector may not deliver any benefit to consumers.[10] Our final decision on the 2023–28 revenue determination for the Murraylink interconnector was that the DMIAM would not apply, as we considered that there would be very limited utility to energy users were Murraylink to invest in researching demand management opportunities through the DMIAM. For the same reasons, we do not propose to apply the DMIAM to Directlink.[11]

9 AER - Demand management innovation allowance mechanism - Transmission - May 2021.

10 Directlink - Request for a revised Framework and Approach - October 2022.

11 NER, cl. 6A.10.1(b)(7).

3 Expenditure forecast assessment guidelines

We propose to apply our Expenditure Forecast Assessment Guideline[12] (the EFA guideline) to our review of Directlink's revenue proposal for the 2025-30 period.[13]

The EFA guideline contains a suite of assessment/analytical tools and techniques to assist our review of the expenditure forecasts submitted as part of regulatory proposals. We exercise judgement to determine the extent to which we use a particular technique to assess a regulatory proposal. We use the techniques we consider appropriate depending on the specific circumstances of the determination. The guideline is flexible and recognises that we may employ a range of different estimating techniques to assess an expenditure forecast.

Given the small scale of Directlink's assets and the nature of its network operations as a transmission interconnector only, our F&A for the current period confirmed that we would apply the EFA guideline, but that we did not intend to use standardised benchmarking analysis or predictive modelling in assessing its capital and operating expenditure forecasts. In assessing its forecast expenditure for the current period, we instead relied on our judgement to determine the extent to which we used particular techniques to assess regulatory proposals.

In its request that we amend or replace the framework and approach paper that applied for the 2020–25 period, Directlink did not request any change to how we apply the EFA guideline. Consistent with this, our position is we will apply the EFA guideline in our assessment of its proposal for the 2025–30 period as we did for the 2020–25 period.

We note that work is currently underway to incorporate emissions reductions into the NEO, which guides the AER and other market bodies in their decision making.[14] This change may impact the framework and guidelines we use to assess regulatory proposals. This is something that we, and Directlink, will need to be mindful of as we progress through the 2025–30 determination.

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12 We are required to develop the EFA guideline under clauses 6.4.5 and 11.53.4 of the NER. We published the current guideline on 29 November 2013. It can be located at www.aer.gov.au/node/18864

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

14 https://www.energy.gov.au/government-priorities/energy-and-climate-change-ministerial-council/priorities/national-energy-transformation-partnership/consultation-proposed-legislative-changes-incorporate-emissions-reduction-objective-national-energy-objectives

4 Depreciation to establish the opening RAB

As part of the roll forward methodology, when the RAB is updated from forecast capex to actual capex at the end of the regulatory control period, it is also adjusted for depreciation. The depreciation approach 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, 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.

Directlink is currently subject to the CESS and as set out in section 2 above, we propose to continue to apply the CESS in the 2025-30 period. We are satisfied that the incentive provided by the application of the CESS, in combination with the use of forecast depreciation and our other ex-post capex measures, would be sufficient to achieve the capex incentive objective.

Our final position is therefore to continue to use the forecast depreciation approach to establish Directlink's opening RAB at the commencement of the 2030–35 regulatory control period.[15]

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15 NER. cl. 6A.10.1A(b)(6).

Glossary

Term	Definition
AER	Australian Energy Regulator
Capex	Capital expenditure
CESS	Capital expenditure sharing scheme
DMIAM	Demand management innovation allowance mechanism
EBSS	Efficiency benefit sharing scheme
EFA	Expenditure Forecast Assessment
F&A	Framework and approach
NEL	National Electricity Laws
NEO	National Electricity Objectives
NER	National Electricity Rules
Opex	Operating expenditure
RAB	Regulated asset base
STPIS	Service target performance incentive scheme