FINAL DECISION
Ausgrid
Distribution Determination

2019 to 2024

Attachment 9
Capital expenditure sharing scheme

April 2019

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ausgrid for the 2019-2024 regulatory control period. It should be read with all other parts of the final decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The attachments have been numbered consistently with the equivalent attachments to our longer draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 7 – Corporate income tax

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

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Attachment 18 – Tariff structure statement

Attachment A – Negotiating framework

Attachment B – Pricing methodology

Contents

Shortened forms

Shortened form	Extended form
CESS	Capital expenditure sharing scheme
DNSP	Distribution network service provider
RAB	regulatory asset base
AER	Australian Energy Regulator
NER	National Electricity Rules
EBSS	Efficiency benefit sharing scheme
STPIS	Service target performance incentive scheme
WACC	Weighted average cost of capital
PTRM	Post tax revenue model
CPI	Consumer Price Index
RFM	Roll forward model
NPV	Net present value

9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides additional financial rewards to those distribution network service providers (DNSPs) that improve capex efficiency and additional financial penalties for those that become less efficient. Consumers benefit from improved efficiency through a lower RAB which results in lower regulated revenues.

The CESS approximates efficiency gains and efficiency losses by calculating the difference between approved forecast and actual capex. It shares these gains or losses between DNSPs and consumers. Under the CESS, a DNSP retains 30 per cent of an under-spend or over-spend. This means that for a one dollar saving in capex, the DNSP 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 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 RAB.[2]
4. The CESS payments will be added to or subtracted from the service provider's regulated revenue as a separate building block in the next regulatory control period.

This attachment sets out our final decision for the determination of the revenue increments or decrements as a result of the CESS applying from the 2014–19 regulatory control period and the application of the CESS for Ausgrid in the 2019–24 regulatory control period.

9.1 Final decision

Our final decision is to approve a CESS revenue increment amount of $87.61 million ($2018–19) from the application of the CESS in the 2014–19 regulatory control period.[3]

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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 and adjust the CESS payment for deferrals. AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 9, 13–20.

3 The CESS does not apply to 2014–15. NER, clause 11.56.3(a)(3).

The difference between our calculations and Ausgrid's proposal is due to:

- Updated inflation and discount rates
- A different approach to accounting for movement in provisions.

Our final decision on the revenue impact of the application of the CESS in the 2014–19 regulatory control period compared to Ausgrid's revised proposal is summarised in Table 1 below.

Table 1 AER's final decision on Ausgrid's CESS revenue increment ($ million, 2018–19)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Ausgrid's revised proposal						
Distribution	14.86	14.86	14.86	14.86	14.86	74.28
Transmission	2.66	2.66	2.66	2.66	2.66	13.29
Total	17.52	17.52	17.52	17.52	17.52	87.57
AER final decision						
AER final decision (distribution)	14.86	14.86	14.86	14.86	14.86	74.32
AER final decision (transmission)	2.66	2.66	2.66	2.66	2.66	13.28
Total	17.52	17.52	17.52	17.52	17.52	87.61

Application of scheme in 2019–24 regulatory control period

We will apply the CESS as set out in version one of the capital expenditure incentives guideline to Ausgrid in the 2019–24 regulatory control period.[4]

9.2 Ausgrid's revised proposal

Ausgrid adopted our draft decision for the 2014–19 CESS with the exception of our adjustment for the movement in provisions.[5] This approach is consistent with Ausgrid's approach to reporting the opening value of the regulatory asset base.

For the 2019–24 regulatory control period, Ausgrid proposed to exclude the following from the CESS:

- Network innovation program
- Advanced distribution management system

4 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9.

5 Ausgrid revised proposal p. 150.

- Additional cyber security.

9.3 Assessment approach

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

- the revenue effects on Ausgrid arising from applying the CESS in the 2014–19 regulatory control period;[6] and
- whether or not to apply the CESS to Ausgrid in the 2019–24 regulatory control period and how any applicable scheme will apply.[7]

Our assessment approach is set out below.

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2019–24 regulatory control period arising from the application of the CESS during the 2014–19 regulatory control period.[8]

The NER require that our final decision include a determination on how any applicable CESS is to apply to Ausgrid.[9] In deciding whether to apply a CESS to Ausgrid for the 2019–24 regulatory control period, and the nature of the details of the scheme, we must:

- make that decision in a manner that contributes to the capex incentive objective[10]
- take into account the CESS principles[11], the capex objectives[12], other incentive schemes[13], and, where relevant the opex objectives[14], as they apply to the particular service provider, and the circumstances of the service provider.

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 Ausgrid's overall forecast revenue requirement for the 2019–24 regulatory control period.

6 NER, cl. 6.4.3(a)(5).
7 NER cll. 6.3.2(a)(3); 6.12.1(9).
8 NER cl. 6.4.3(a)(5). Transitional arrangements in the NER excludes 2014–15.
9 NER cll. 6.3.2(a)(3); 6.12.1(9).
10 NER, cl. 6.5.8A(e)(3); the capex criteria are set out in cl. 6.5.7(c)(1)-(3) of the NER.
11 NER, cl. 6.5.8A(e)(4)(i).
12 NER, cll. 6.5.7(a); 6.5.8A(d)(2).
13 NER, cl. 6.5.8A(d)(1).
14 NER, cl. 6.5.8A(d)(2).

As set out in the AER's capex incentive guidelines, without applying a CESS for the 2019–24 regulatory control period, Ausgrid will face incentives that decline over the period.

That is, if Ausgrid makes an efficiency gain in the first year of the 2019–24 regulatory control period, any benefit will last for four more years before the RAB is updated for actual capex. In the final year however, the benefit will be approximately zero. This may lead to inefficient capex and inefficient substitution of opex for capex towards the end of a regulatory control period.[15]

The CESS relates to other incentives Ausgrid faces to incur efficient opex, conduct demand management and maintain or improve service levels. Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, the service target performance incentive scheme (STPIS) for service levels and the demand management incentive scheme and innovation allowance mechanism for non-network options relating to demand management. The AER aims 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. We discuss these interrelationships where relevant as part of our expenditure attachments.

9.4 Reasons for final decision

9.4.1 CESS revenue increments from the 2014–19 regulatory control period

We consider Ausgrid should receive a net CESS payment of $87.61 million ($2018–19) from the application of version one of the CESS during the 2014–19 regulatory control period across its distribution and transmission networks. We note that the scheme operates only over the 2015–16, 2016–17, 2017–18 and 2018–19 regulatory years. This is because the 2014–15 transitional year of the determination was excluded when version one of the CESS was applied.[16]

Ausgrid has generally accepted our draft decision with the exception of how we have accounted for the movement in provisions. For consistency, we have adopted the same approach to provisions as the roll forward model (RFM). We have discussed the treatment of provisions in Attachment 2.

We have also updated the model to reflect actual CPI data for 2017–18. This results in a $0.04 million increase relative to Ausgrid's revised proposal.

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[15] AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 5.

[16] NER, cl. 11.56.3(a)(3).

9.4.2 Application of the CESS for the 2019–24 regulatory control period

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[17] In developing the guideline, we took into account the capex incentive objective, capex criteria, capex objectives and the National Electricity Objective.

We will apply version one of the CESS[18], with the updated formulae set out in the TransGrid final determination[19], to Ausgrid in the 2019–24 regulatory control period. As we have set out in the framework and approach, we consider the CESS provides Ausgrid with a continuous incentive to pursue efficiency gains. This is consistent with Ausgrid's regulatory proposal.[20]

However, as noted above, Ausgrid proposed to exclude some categories of capex from its capex allowance application of the CESS for the 2019–24 regulatory control period.

Our CESS guideline explanatory statement notes that we do not exclude any capex from the CESS.[21] We acknowledge that the proposal to exclude some projects from the CESS is a result of a consultation process with customers.

This is to ensure that Ausgrid does not receive a CESS reward for any innovation funding not spent within the 2019–24 regulatory control period.[22]

We consider Ausgrid should still face an incentive to undertake these innovation projects efficiently. However, if the basis of any under-spend is due to deferral, Ausgrid may identify this under-spend as a deferral as part of its 2024–29 regulatory proposal. This will exclude these projects from the CESS.

We note that even if Ausgrid excludes some of this capex from the CESS, Ausgrid could still potentially receive the financing benefit from deferring a project. This is because the CESS adjustment only accounts for the difference between the financing benefit and the 30 per cent sharing ratio.

We will take into account any information from Ausgrid and the Network Innovation Advisory Committee in making our assessment of the revenue adjustment for the 2024–29 regulatory control period.

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

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

19 AER, *Final decision TransGrid transmission determination 2018 to 2023, Attachment 10 – Capital expenditure sharing scheme*, May 2018

20 Ausgrid, *Revised Regulatory Proposal*, January 2019, p. 150.

21 AER, Capital expenditure incentive guideline for electricity network service providers – explanatory statement, November 2013, p. 37.

22 Ausgrid, Revised regulatory proposal, January 2019, p. 34.