FINAL DECISION

United Energy
Distribution Determination
2021 to 2026

Attachment 9
Capital expenditure sharing scheme

April 2021

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to United Energy for the 2021–26 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

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

Attachment 12 – Customer service incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

Attachment A – Negotiating framework

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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. Consumers 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 works as follows:

- We calculate the cumulative efficiency gains or losses 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 service provider's share of the underspend or overspend should be.
- We calculate the CESS payments taking into account the financing benefit or cost to the service provider of the underspend or overspend.[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]
- 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.

We consider in addition to 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).

This attachment sets out our final decision for the determination of the revenue impacts as a result of the CESS applying from the 2016–20 regulatory control period and the application of the CESS for United Energy in the 2021–26 regulatory control period.

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1 We calculate benefits as the benefits to the service provider of financing an 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.

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.

9.1 Final decision

Revenue impact for the 2021–26 regulatory control period

Our final decision is to apply a CESS revenue increment amount of $56.2 million ($2020–21) to be paid across the 2021–26 regulatory control period, from the application of the CESS in the 2016–20 regulatory control period.

The difference between our calculations and our draft decision ($49.7 million) is due to adopting:

- more recent inflation figures
- updated weighted average cost of capital (WACC) input information
- updated 2020 capex consistent with our roll forward model (RFM).

Application of scheme in 2021–26 regulatory control period

We will apply the CESS to United Energy in the 2021–26 regulatory control period, as set out in the capital expenditure incentives guideline.[3] This is consistent with the proposed approach we set out in our framework and approach paper.[4]

Our reasons for adopting the CESS are set out in our capital expenditure incentive guideline.[5]

9.2 United Energy's revised proposal

United Energy accepted our draft decision for the CESS.[6]

9.3 Assessment approach

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

- the effects on United Energy's revenue arising from applying the CESS in the 2016–20 regulatory control period; and
- whether to apply the CESS to United Energy in the 2021–26 regulatory control[7] period and how any applicable scheme will apply.[8]

Our assessment approach is set out below.

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3 NER, cl 6.12.1(9); AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9.

4 AER, *Final framework and approach AusNet Services, CitiPower, Jemena, Powercor and United Energy Regulatory control period commencing 1 January 202*1, January 2019, pp. 84–85.

5 AER, *Better regulation explanatory statement capital expenditure incentive guideline for electricity network service providers*, November 2013.

6 United Energy, United Energy revised proposal, December 2020, p. 134.

7 NER, cl. 6.5.8A(e).

8 NER, cl. 6.12.1(9).

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2021–26 regulatory control period arising from the application of the CESS during the 2016–20 regulatory control period.[9] This includes assessing whether any adjustments should be made to the CESS for deferred capex.

Consistent with the CESS, we will make an adjustment to CESS payments where a distributor has deferred capex in the current regulatory control period and:

- the amount of the deferred capex in the current regulatory control period is material; and
- the amount of the estimated underspend in capex in the current regulatory control period is material; and
- 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.[10]

The NER require that our final decision includes a determination concerning how any applicable CESS should apply to United Energy.[11] In deciding whether to apply a CESS to United Energy for the 2021–26 regulatory control period, and the nature of the details of the scheme that is to apply, we must:

- make that decision in a manner that contributes to the capex incentive objective;[12] and
- take into account the CESS principles,[13] the capex objectives and if relevant the opex objectives,[14] the interaction with other incentive schemes[15] as they apply to the particular service provider, and the circumstances of the service provider.[16]

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.

9.4 Reasons for final decision

Our final decision reflects mechanical adjustments to our draft decision to reflect updated actual capex, forecast capex, the Consumer Price Index and WACC.

In our draft decision, we were satisfied that there was no material reproposed capex included in our forecast capex.

9 NER, cl. 6.4.3(a).

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

11 NER, cl. 6.12.1(9).

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

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

14 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).

15 NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(1).

16 NER, cl. 6.5.8A(e)(4)(ii).

Our final decision is consistent with our draft decision. Although our updated 2020 capex included in the RFM is higher than our draft decision, we are satisfied that this has not resulted in deferred capex being included in our forecast capex.

We received several submissions regarding the CESS.

In its report to Energy Consumers Australia (ECA), Spencer&Co noted that the CESS must reward efficient behaviour only, not failure to deliver projects.[17]

The Consumer Challenge Panel, sub-panel 17 (CCP17) raised concerns with the outcomes of the CESS and strongly supported the incentive review in 2021.[18]

The Energy Users Association of Australia (EUAA) identified several limitations of the CESS scheme. In particular, the EUAA noted there was no incentive to overspend, so deferred projects are unlikely to be completed next period. The EUAA was not convinced that this reflects the original intent of the scheme, and considered that it is easy to game.[19]

The Victorian Community Organisations welcomed the incentive scheme review and identified several issues that should be considered as part of the review.[20]

We note that if a distributor can maintain its service standards without undertaking additional capex, consumers will benefit from this through a lower RAB. As long as deferred capex is not included in our forecast capex, then we are satisfied consumers are not paying additional costs for deferring projects. This means consumers pay lower prices than would have been the case in the absence of the CESS.

In our draft decision, we announced an incentive review to address stakeholder concerns regarding the CESS. We reaffirmed our plan to undertake an incentive review as part of our 2020–25 strategic plan. As part of our priorities to delivery efficient regulation of monopoly infrastructure, we will review and refine our incentive schemes to ensure they remain relevant and fit for purpose.[21]

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[17] ECA, Spencer&Co report, *Submission and attachment on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, p. 19.

[18] CCP17, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26,* January 2021, p. 68.

[19] EUAA, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, pp. 9–10.

[20] Victorian Community Organisations, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, p. 27; Victorian Community Organisations Headberry Partners*, Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26 – Report to Sponsoring Organisations*, January 2021, pp. 58–59.

[21] AER, *Strategic Plan 2020–25*, December 2020, p. 18.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
Capex	Capital expenditure
CCP17	Consumer Challenge Panel, sub-panel 17
CESS	Capital Expenditure Sharing Scheme
Distributor	Distribution Network Service Provider
ECA	Energy Consumers Australia
EUAA	Energy Users Association of Australia
NEO	National Electricity Objective
NER	National Electricity Rules
Opex	Operating expenditure
RAB	Regulatory Asset Base
RFM	Roll Forward Model
WACC	Weighted Average Cost of Capital