



FINAL DECISION
Energex determination 2015–16
to 2019–20

Attachment 10 – Capital
expenditure sharing scheme

October 2015

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Note

This attachment forms part of the AER's final decision on Energex's 2015–20 distribution determination. It should be read with all other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanism

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators

Shortened form	Extended form
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

10 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers whose capex becomes more efficient and financial penalties for those that become less efficient. Consumers benefit from improved efficiency through lower regulated prices. This attachment sets out how we will apply the CESS to Energex in the 2015–20 regulatory control period.

As part of the Better Regulation program we consulted on and published version 1 of the Capital Expenditure Incentive Guideline (Capex Incentive Guideline), which sets out the CESS. 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 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 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 underspends or overspends. We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the RAB.
- 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.

Under the CESS a service provider retains 30 per cent of an underspend or overspend, while consumers retain 70 per cent of the underspend or overspend. 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.

10.1 Final decision

We will apply the CESS as set out in version 1 of the Capex Incentive Guideline to Energex in the 2015–20 regulatory control period.¹

10.2 Energex's revised proposal

Energex accepted our preliminary decision to apply the CESS as set out in the Guideline for the 2015–20 regulatory control period.²

¹ AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9.

² Energex, *Energex 2015-20 revised regulatory proposal*, July 2015, p. 131.

10.3 AER's assessment approach

In deciding whether to apply a CESS to a network service provider, and the nature and details of any CESS to apply to a service provider, we must:³

- make that decision in a manner that contributes to the capex incentive objective⁴
- take into account the CESS principles,⁵ the interaction of the CESS with any other incentives that the service provider may have to undertake efficient opex or capex, the capex objectives,⁶ and, if relevant, the opex objectives, as they apply to the particular service provider, as well as the circumstances of the service provider.

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.

10.3.1 Interrelationships

The CESS relates to other incentives Energex faces to incur efficient opex, conduct demand management, and maintain or improve service levels.⁷ 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. We discuss these interrelationships where relevant as part of our reasons below and in our capex attachment (attachment 6).

10.4 Reasons for final decision

We are satisfied with Energex's proposal to apply the CESS as set out in the Capex Incentive Guideline.

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

Without a CESS the incentive for a service provider to spend less than its forecast capex declines throughout the period. This is because, as the end of the regulatory control period approaches, the time available for the service provider to retain any savings gets shorter. So the earlier a service provider incurs a capex underspend in

³ NER, cl. 6.5.8A(e).

⁴ NER, cl. 6.4A(a); the capex criteria are set out in cl. 6.5.7(c) of the NER.

⁵ NER, cl. 6.5.8A(c).

⁶ NER, cl. 6.5.7(a).

⁷ Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, the demand management innovation allowance (DMIA), and the service target performance incentive scheme (STPIS) for service levels.

the regulatory period, the greater its reward will be. As a result, the incentive for a service provider to spend less than its capex forecast declines throughout the period. Because of this, a service provider may choose to spend capex earlier than necessary, spend on capex when it may otherwise have spent on opex, or spend less on capex at the expense of service quality—even if it may not be efficient to do so.

In developing the CESS we took into account the capex incentive objective, capex criteria, capex objectives, and the CESS principles. With the CESS, Energex will face the same reward and penalty in each year of a regulatory control period for capex underspends or overspends. The CESS will provide Energex with an ex ante incentive to spend only efficient capex. Energex will be rewarded through the CESS for making capex efficiency gains. Conversely, Energex will be penalised through the CESS for making capex efficiency losses. In this way, Energex 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 Energex is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent service provider.

The Total Environment Centre disagreed with a reliance on incentive schemes to drive demand management activity. It considered there was strong evidence that the regulatory framework has failed to incentivise demand management to date, and exhibits an unreasonable level of faith in newly introduced incentives that remain untested.⁸

We addressed these issues in our explanatory statements to the Capex Incentive Guideline.⁹ Expenditure on demand management generally takes the form of opex rather than capex. Successful demand management should result in the network service provider spending less on capex than it otherwise would have. Both the CESS and EBSS will apply to Energex in the subsequent regulatory control period. As a result Energex has an incentive to implement a demand management solution if the increase in opex is less than the corresponding decrease in capex. In this way, it will receive a net reward for implementing demand management.¹⁰ 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 demand management when calculating rewards and penalties under the scheme. This was

⁸ Total Environment Centre, *Submission to the AER on the Preliminary Decisions on the QLD DBs' Regulatory Proposals 2015-20*, July 2015, p. 4.

⁹ AER, *Explanatory Statement, Draft Capital Expenditure Incentive Guideline for Electricity Network Service Providers, August 2013*; AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013.

¹⁰ When the service provider spends more on opex it receives a 30 per cent penalty under the EBSS. However, when there is a corresponding decrease in capex the service provider receives a 30 per cent reward under the CESS. So where the decrease in capex is larger than the increase in opex the service provider receives a larger reward than penalty, a net reward.

because service providers may otherwise receive a penalty for increasing opex without a corresponding reward for decreasing capex.¹¹

Additionally, the Australian Energy Market Commission finalised its demand management rule change in August 2015. Under the new rules we must develop and publish a demand management incentive scheme and innovation allowance by December 2016. The new incentive scheme and innovation allowance can be applied from the next round of regulatory determinations, preparation for which commences in early 2017. The AEMC did not consider it was appropriate to provide for the application of the new incentive scheme or innovation allowance midway through a regulatory control period.¹²

We will apply the CESS as set out in the capex incentives guideline and develop and implement other demand management incentives in accordance with the new rules.

¹¹ 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.

¹² AEMC, *Rule Determination, National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015*, August 2015, p. 78.