FINAL DECISION
SA Power Networks determination 2015−16 to 2019−20

Attachment 10 − Capital expenditure sharing scheme

October 2015

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on SA Power Networks' 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

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Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

Contents

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 SA Power Networks 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 SA Power Networks in the 2015–20 regulatory control period without any further exclusions.[1]

10.2 SA Power Networks' revised proposal

SA Power Networks' proposed we apply the CESS as set out in the Capex Incentive Guideline in its initial proposal.[2] In its revised proposal SA Power Networks proposed

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

we exclude expenditure from the CESS that it will incur to implement systems and other changes to meet new regulatory requirements[3] imposed by Power of Choice and other Rule changes. It considered it may be unable to recover these costs through a pass through event mechanism because of the high materiality threshold, and so these costs should be excluded from the CESS.[4]

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:[5]

- make that decision in a manner that contributes to the capex incentive objective[6]
- take into account the CESS principles,[7] the interaction of the CESS with any other incentives that the service provider may have to undertake efficient opex or capex, the capex objectives,[8] 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 the incentives SA Power Networks faces to incur efficient opex, conduct demand management, and maintain or improve service levels.[9] 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.

10.4 Reasons for final decision

We do not accept SA Power Networks' proposal to modify the CESS to exclude capex associated with rule changes.

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

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2 SA Power Networks, *Regulatory Proposal, 2015–20*, October 2014, p. 279.

3 'Regulatory obligation or requirement is defined in s. 2D of the NEL.

4 SA Power Networks, *Revised Regulatory Proposal 2015–20*, July 2015, p. 307.

5 NER, cl. 6.5.8A(e).

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

7 NER, cl. 6.5.8A(c).

8 NER, cl. 6.5.7(a).

9 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.

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

The Energy Consumers Coalition of South Australia supports applying the CESS to SA Power Networks in the 2015–20 regulatory control period.[10]

10.4.1 Costs associated with rule changes

In developing the CESS in consultation with stakeholders, we considered a range of capex categories that we could exclude from the CESS. The Capex Incentive Guideline provides for a single exclusion related to the STPIS for transmission. Our reasoning for deciding to only allow this exclusion, and not any other categories of exclusions, is set out in the explanatory statement to the Capex Incentive Guideline.

We will apply the CESS to SA Power Networks as set out in the Capex Incentive Guideline without any further exclusions as SA Power Networks proposed. For the reasons we set out below, we are not satisfied SA Power Networks' has justified why we should exclude capex resulting from the uncontrollable event of a rule change. The issues SA Power Networks raised were not new to those we considered during our

[10] The Energy Consumers Coalition of South Australia, *Australian Energy Regulator, SA Electricity Distribution Revenue Reset, The AER preliminary decision, A response by Energy Consumers Coalition of South Australia,* June 2015, p. 36.

development of the Capex Incentive Guideline.[11] We have considered SA Power Networks' circumstances and the specific matters it raised in its revised proposal regarding the application of the CESS. We note we decided to apply the CESS as set out in the Guideline to all NSW, QLD, SA and VIC distributors. We are of the view that SA Power Networks has not provided sufficient evidence to demonstrate why its circumstances warrant a departure from our approach.

SA Power Networks stated its revised proposal included forecast expenditure associated with the Distribution Network Pricing Arrangements Rule.[12] However, it cited other new or draft rule changes where the outcomes are not yet known including:[13]

- Expanding Competition in Metering and Related Services Rule change
- Customer Access to Information about their Electricity Consumption Rule change
- Improving Demand Side Participation Information provided to AEMO by Registered Participants Rule change
- Demand management and embedded generation connection incentive scheme;
- Demand response mechanisms
- Embedded networks
- Multiple trading relationships.

SA Power Networks submitted that it was possible that many or all of these costs may not individually exceed the materiality threshold of a regulatory change pass through event in the rules. It considered it should not be penalised for incurring costs to implement imminent rule changes.[14]

In our explanatory statement to the Capex Incentive Guideline we explained that we did not consider there was a convincing reason to allow exclusions for capex resulting from uncontrollable events.[15] When included in the CESS, the cost of any capex increase or decrease from an uncontrollable event is shared between network service providers and consumers in the same way as any other capex efficiency gain or loss. That is, under the CESS a service provider retains 30 per cent of a capex underspend or overspend, while consumers retain the remaining 70 per cent.

If we excluded capex resulting from uncontrollable events from the CESS, the associated capex underspend or overspend will still be shared between the service provider and consumers. However, when excluded from the CESS the relative sharing

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[11] AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013*.

[12] http://www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements

[13] SA Power Networks, *Revised Regulatory Proposal 2015–20*, July 2015, p. 306.

[14] SA Power Networks, *Revised Regulatory Proposal 2015–20*, July 2015, p. 306.

[15] AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013*, pp. 38–39. (AER, *Explanatory Statement, Capex incentive guideline*, November 2013).

ratio between the service provider and consumers will depend on the year in which the overspend or underspend occurs, and will vary across the regulatory control period. We considered there was no reason why capex overspends or underspends resulting from uncontrollable events should be shared differently between service providers and consumers in each regulatory year, or shared differently to all other costs facing service providers.[16]

Capex is generally lumpy and non-recurrent and different capex categories have different drivers. The extent to which a distributor can influence capex drivers can vary. However, we assess forecast capex at an overall rather than component level. The purpose of the CESS is to provide a continuous incentive for a distributor to deliver efficient overall capex and to share the benefits of capex efficiency gains (or costs of capex efficiency losses) between the distributor and consumers. The incentives provided by the CESS are part of a package of measures to incentivise distributors to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality.

Further, SA Power Networks will not always be penalised or rewarded under the CESS for overspending or underspending specifically on capex resulting from rule changes. This is as the CESS rewards and penalties are determined relative to total forecast capex.

Finally, we are of the view that the risk borne by distributors for costs which would have qualified for a pass-through if not for the materiality threshold to be relatively immaterial. We see no reason why relatively immaterial costs should be excluded from the CESS.

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[16] AER, *Explanatory Statement, Capex incentive guideline*, November 2013, pp. 38–39.