



**PRELIMINARY DECISION**  
**United Energy distribution**  
**determination**  
**2016 to 2020**

**Attachment 10 – Capital**  
**expenditure sharing scheme**

October 2015

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## Note

This attachment forms part of the AER's preliminary decision on United Energy's revenue proposal 2016–20. It should be read with all other parts of the preliminary decision.

The preliminary 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

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
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
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure

Shortened form	Extended form
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 United Energy in the 2016–20 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 Preliminary decision

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to United Energy in the 2016–20 regulatory control period.<sup>1</sup> This is consistent with the proposed approach we set out in our framework and approach paper.<sup>2</sup>

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

<sup>2</sup> AER, *Final Framework and approach for the Victorian Electricity Distributors, Regulatory control period commencing 1 January 2016*, October 2014, p. 110.

## 10.2 United Energy's proposal

United Energy proposed that we apply the CESS as set out in the capex incentives guideline.<sup>3</sup>

## 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:<sup>4</sup>

- make that decision in a manner that contributes to the capex incentive objective<sup>5</sup>
- take into account the CESS principles,<sup>6</sup> the interaction of the CESS with any other incentives that the service provider may have to undertake efficient opex or capex, the capex objectives,<sup>7</sup> 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 United Energy faces to incur efficient opex, conduct demand management, and maintain or improve service levels.<sup>8</sup> 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 preliminary decision

We are satisfied with United Energy's proposal to apply the CESS as set out in the capex incentives 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.

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<sup>3</sup> United Energy, *Regulatory Proposal, 2016 to 2020*, April 2015, p. 135.

<sup>4</sup> NER, cl. 6.5.8A(e).

<sup>5</sup> NER, cl. 6.4A(a); the capex criteria are set out in cl. 6.5.7(c) of the NER.

<sup>6</sup> NER, cl. 6.5.8A(c).

<sup>7</sup> NER, cl. 6.5.7(a).

<sup>8</sup> 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.



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

The Victorian Department of Economic Development, Jobs, Transport & Resources raised concerns with the CESS potentially encouraging inefficient capex deferral and a pattern of underspending followed by overspending.<sup>9</sup> We addressed these issues in our explanatory statements to the capex incentive guideline.<sup>10</sup> As outlined above, the sharing of capex underspends and overspends between consumers and the distributor happens at the end of each regulatory control period when we update the RAB to include new capex. In the absence of the CESS the sharing ratio between consumers and the distributor will vary depending on the year in which the underspend or overspend occurs. Instead, under the CESS there will be a constant sharing ratio of 30:70. The CESS will also provide a continuous incentive for United Energy to incur efficient capex over the regulatory control period, rather than the declining incentive that is present without the CESS. We consider this continuous rather than declining incentive promotes more efficient decisions on when to incur capex, rather than encouraging deferrals or underspending. Further, we are able to make adjustments to the CESS reward or penalty to account for deferrals in some cases.<sup>11</sup>

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<sup>9</sup> The Victorian Department of Economic Development, Jobs, Transport & Resources, *Submission to Victorian electricity distribution pricing review – 2016 to 2020*, July 2015, pp. 12–13.

<sup>10</sup> 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.

<sup>11</sup> AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 9.