DRAFT DECISION

TasNetworks Distribution Determination 2019 to 2024

Attachment 9 Capital expenditure sharing scheme

September 2018

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on TasNetworks' 2019–24 distribution determination. It should be read with all other parts of the draft decision.

The draft 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

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Shortened forms

Shortened form	Extended form
ACS	alternative control services
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP 13	Consumer Challenge Panel, sub-panel 13
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIAM	demand management innovation allowance (mechanism)
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

Shortened form	Extended form
opex	operating expenditure
PPI	partial performance indicators
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
SCS	standard control services
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

9 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. We first applied the CESS to TasNetworks in the 2017–19 regulatory control period. This attachment sets out our decision for both the determination of the revenue impacts as a result of the CESS applying in the 2017–19 regulatory control period, and the application of the CESS for TasNetworks in the 2019–24 regulatory control period.

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. Under the CESS a service provider retains 30 per cent of an under-spend or over-spend, while consumers retain 70 per cent of the under-spend or over-spend. 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.

The CESS works as follows:

1. We calculate the cumulative efficiency gains or losses for the current regulatory control 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 or subtracted to the service provider's regulated revenue as a separate building block in the next regulatory control period.

[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. AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 13–20.

9.1 Draft decision

Revenue impacts in the 2019–24 regulatory control period from applying the CESS in the 2017–19 regulatory control period

Our draft decision is to apply a CESS revenue decrement of $1.2 million ($2018-19) in the 2019–24 regulatory control period.[3] CESS revenue decrements arise as a result of an over-spend in capex against the forecast for the relevant period (in this case, the 2017–19 regulatory control period).

Our draft decision on the revenue impact of the application of the CESS in the 2019–24 regulatory control period is summarised in Table 9.1.

Table 9.1 AER's draft decision on TasNetworks' CESS revenue decrement ($million, 2018–19)

	2019-20	2020-21	2021-22	2022-23	2023-24	Total
TasNetworks' proposal	-	-	-	-	-	-
AER draft decision	-0.24	-0.24	-0.24	-0.24	-0.24	-1.20

Note: Numbers may not add up due to rounding.

Given the timing of this draft decision, we calculated the CESS revenue decrements in Table 9.1 using estimates of TasNetworks' capex for the 2017-18 and 2018-19 regulatory years. When we make our final decision we will be able to update the CESS calculation for the actual capex TasNetworks incurred in 2017-18.

Application of scheme in the 2019–24 regulatory control period

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to TasNetworks in the 2019–24 regulatory control period.[4] This is consistent with the proposed approach we set out in our framework and approach paper.[5]

9.2 TasNetworks' proposal

Revenue impacts in the 2019–24 regulatory control period from applying the CESS in the 2017–19 regulatory control period

TasNetworks did not propose a CESS revenue increment or decrement to its regulated revenue in the 2019–24 regulatory control period.[6] TasNetworks considered that the

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3 NER, cl. 6.12.1(9).

4 AER, *Capital Expenditure Incentive Guideline*, November 2013, pp. 5–9.

5 AER, *Framework and approach, TasNetworks electricity transmission and distribution, Regulatory control period commencing 1 July 2019,* July 2017, pp. 59–60.

6 TasNetworks, *Post tax revenue model - Distribution*, January 2018.

reward or penalty for the operation of the CESS in the 2017–19 regulatory control period would not apply in the 2019–24 period, but rather would apply in the subsequent regulatory control period, because actual capex for 2017–19 is not known.[7]

Application of scheme in the 2019–24 regulatory control period

TasNetworks proposed that we apply the CESS as set out in the capital expenditure incentive guideline for the 2019–24 regulatory control period.[8]

9.3 AER's assessment approach

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

- the revenue impacts on TasNetworks arising from applying the CESS in the 2017–19 regulatory control period; and
- whether or not to apply the CESS to TasNetworks in the 2019–24 regulatory control period and how any applicable scheme will apply.[9]

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 2017–19 regulatory control period.[10]

We must also determine how any applicable capital expenditure sharing scheme is to apply to TasNetworks in the 2019–24 regulatory control period.[11] 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:[12]

- make that decision in a manner that contributes to the capex incentive objective[13]
- take into account the CESS principles,[14] the capex objectives and, where relevant, the opex objectives,[15] the interaction with other incentive schemes as they apply to the particular service provider,[16] and the circumstances of the service provider.[17]

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.

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7 TasNetworks, *Response to AER information request #036*, 6 August 2018.
8 TasNetworks, *Transmission Revenue and Distribution Regulatory Proposal 2019–2024*, 31 January 2018, p. 178.
9 NER, cl. 6.12.1(9).
10 NER, cl. 6.4.3(a)(5).
11 NER, cl. 6.12.1(9).
12 NER, cl. 6.5.8A(e).
13 NER, cl. 6.5.8A(e)(3); the capex incentive objective is set out in cl. 6.4A(a) of the NER.
14 NER, cl. 6.5.8A(c).
15 NER, cl. 6.5.7(a).
16 NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(1).
17 NER, cl. 6.5.8A(e)(4)(ii).

9.3.1 Interrelationships

The approval of CESS payments/penalties determines the associated CESS building block and therefore TasNetworks' overall forecast revenue requirement for the 2019–24 regulatory control period.

The CESS relates to the incentives TasNetworks faces to incur efficient opex, conduct demand management and maintain or improve service levels.[18] 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.

9.4 Reasons for draft decision

9.4.1 CESS revenue impacts from application of the CESS in the 2017–19 regulatory control period

We consider that TasNetworks should receive a CESS revenue decrement of $1.2 million ($2018-19) from the application of version 1 of the CESS during the 2017–19 regulatory control period. This means that total revenue to be recovered from customers in the 2019–24 regulatory control period is $1.2 million less than it would otherwise have been due to the application of the CESS to TasNetworks in the 2017–19 regulatory control period.

The timing of our draft decision means that the 2017-18 and 2018-19 regulatory year incurred capex figures used to calculate the CESS revenue decrements are estimates. Our capital expenditure incentive guideline provides for the calculation of CESS revenue amounts to use both actual and estimated capex for all years of the current period to determine the CESS revenues in the forecast period.[19]

The actual capex incurred by TasNetworks for the 2017–18 regulatory year will be known when we make our final decision. We will update the CESS revenue amount in our final decision to reflect this updated information. Given that the 2018-19 regulatory year capex will be an estimate at the time of our final decision we may need to make further adjustments to the revenue amount where actual underspending or overspending in the 2018-19 regulatory year is different to the estimate. These adjustments will be made when we undertake our regulatory determination for the subsequent regulatory control period.[20]

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[18] Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, the demand management incentive scheme (DMIS) for demand management, and the service target performance incentive scheme (STPIS) for service levels.

[19] AER, *Capital Expenditure Incentive Guideline*, November 2013, pp. 7–8.

[20] AER*, Explanatory Statement - Capital Expenditure Incentive Guideline*, November 2013, p. 21.

Our calculation of the CESS is in accordance with section 2.3 of version 1 of the capital expenditure incentive guideline.[21]

In the 2017–19 regulatory control period, TasNetworks was subject to version 1 of the CESS. Under this scheme the CESS revenue increments are to be based on the difference between:

- approved forecast capex set out in our determination for TasNetworks for the 2017–19 regulatory control period; and
- actual capex for the 2017–19 regulatory control period.[22]

The formulas for calculating the revenue decrements are set out in our draft determination CESS model.[23]

We have used the CESS model that we applied in our recent final determination for TransGrid (the first NSP to have operated under the CESS) to determine the revenue decrements for TasNetworks. This is consistent with TasNetworks' proposal, which noted TasNetworks' expectation that CESS calculation modifications made by the AER through the TransGrid determination process would be applied consistently to all service providers over time.[24] We have also updated the model to reflect the number of years in the relevant regulatory period (2017–19), and the modelling inputs to reflect the latest inflation and WACC data.

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

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[25] In developing the guideline we took into account the capex incentive objective, capex criteria, capex objectives and the NEO.

We will apply version 1 of the CESS to TasNetworks in the 2019–24 regulatory control period.[26] As we have set out in the framework and approach, we consider the CESS is needed to provide TasNetworks with a continuous incentive to pursue efficiency gains. This approach is consistent with TasNetworks' regulatory proposal.[27]

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21 AER, *Capital Expenditure Incentive Guideline*, November 2013, p. 6.

22 An estimate of capex for both years of the current period has been used for the draft decision. Actual capex for 2017–18 will be available for the final decision.

23 AER, *TasNetworks distribution draft decision 2019–24 CESS model*, September 2018.

24 TasNetworks, *Transmission Revenue and Distribution Regulatory Proposal 2019–2024*, 31 January 2018, p. 178.

25 AER, *Capital Expenditure Incentive Guideline*, November 2013.

26 AER, *Capital Expenditure Incentive Guideline*, November 2013.

27 TasNetworks, *Transmission Revenue and Distribution Regulatory Proposal 2019–2024*, 31 January 2018, p. 178.