Draft Decision

Transgrid Transmission Determination 2023 to 2028

(1 July 2023 to 30 June 2028)

Attachment 9
Capital expenditure sharing scheme

September 2022

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on Transgrid's 2023–28 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Maximum allowed revenue

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 11 – Demand management innovation allowance mechanism

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9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards to 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. We first applied the CESS to Transgrid in the 2018–23 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 2018–23 regulatory control period, and the application of the CESS for Transgrid in the 2023–28 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% of an under-spend or over-spend, while consumers retain 70% 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% to the cumulative under-spend or over-spend to work out the service provider's share of the under-spend or over-spend
3. we calculate the CESS revenue increment/decrement taking into account the financing benefit, or cost, to the service provider of the under-spend or over-spend. We can also make a further adjustment to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB)
4. the CESS increment/decrement is added or subtracted to the service provider's regulated revenue as a separate building block in the next regulatory control period.

9.1 Draft decision

9.1.1 Revenue impacts in the 2023–28 period from applying the CESS in the 2018–23 period

Our draft decision is to apply a CESS revenue increment of $0.9 million ($2022–23) from the application of the CESS in the 2018–23 regulatory control period. This is a reduction of $4.2 million from Transgrid’s forecast of $5.1 million. The CESS revenue increment arises as a result of an under-spend in capex against the forecast for the 2018–23 period, after accounting for deferrals and capitalisation changes. This is to be paid across the 2023–28 regulatory control period.

The key reasons for the differences between our calculations and Transgrid’s proposal are that our draft decision:

1. takes account of further deferred capex in addition to what was identified in Transgrid’s proposal
2. takes account of changes to the treatment for expenditure related to Software as a Service (SaaS) and leases

3. corrects for errors made by Transgrid in historical inflation rates and capex allowance figures
4. updates the actual inflation rate for the 2021–22 regulatory year
5. updates the weighted average cost of capital (WACC) for the 2022–23 regulatory year based on the most recent return on debt.

Our draft decision on the revenue impact of the application of the CESS in the 2018–23 period is summarised in Table 9.1.

Table 9.1 AER's draft decision on Transgrid's CESS

Revenue Adjustments	2023–24	2024–25	2025–26	2026–27	2027–28	Total
CESS revenue increment as per NER 6A.5.4(a)(5)	0.19	0.19	0.19	0.19	0.19	0.94

Note: Total may not add due to rounding.
Source: AER draft decision CESS model

9.1.2 Application of the CESS in the 2023–28 period

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to Transgrid in the 2023–28 regulatory control period.[1] This is broadly consistent with the proposed approach we set out in our *Framework and Approach* paper.[2]

9.2 Transgrid's proposal

9.2.1 Revenue impacts in the 2023–28 period from applying the CESS in the 2018–23 period

Transgrid proposed a CESS revenue increment of $5.11 million ($2022–23) for the 2023–28 regulatory control period.

Transgrid noted the CESS reward is a result of:

- reprioritisation of augmentation projects which could be cancelled without affecting network reliability (which are typically market benefit projects)
- deferring projects that Transgrid considered can be efficiently deferred into the 2023–28 regulatory control period
- an adjustment to account for deferred Project EnergyConnect (PEC) related capex. This has the effect of reducing Transgrid's CESS reward to ensure it receives no additional CESS benefit for this deferral.

9.2.2 Application of the CESS in the 2023–28 period

Transgrid proposed that the CESS for the 2023–28 regulatory control period is the same as that applied to the current regulatory control period.

[1] AER, *Capital Expenditure Incentive Guideline, November 2013*, pp. 5–9.

[2] AER, *Transgrid 2023-28 - Framework & Approach*, July 2021, p.7.

9.3 Assessment approach

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

- the revenue impacts on Transgrid arising from applying the CESS in the 2018–23 regulatory control period
- whether or not to apply the CESS to Transgrid in the 2023–28 regulatory control period and how any applicable scheme will apply.[3]

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2023–28 period arising from the application of the CESS during the 2018–23 period.[4]

We must also determine how any applicable CESS is to apply to Transgrid in the 2023–28 period.[5] In deciding whether to apply a CESS to Transgrid for the 2023–28 period, and the nature and details of the scheme, we must:[6]

- make that decision in a manner that contributes to the capex incentive objective;[7] and
- take into account the CESS principles,[8] the capex objectives and, where relevant, the operating expenditure (opex) objectives,[9] the interaction with other incentive schemes,[10] and the circumstances of the service provider.[11]

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.

9.3.1 Interrelationships

The approval of CESS revenue increment/decrement determines the associated CESS building block as part of Transgrid's overall forecast revenue requirement for the 2023–28 regulatory control period.

The CESS relates to other incentives Transgrid faces to incur efficient opex, conduct demand management, and maintain or improve service levels. Related schemes include the efficiency benefit sharing scheme (EBSS) for opex, and the service target performance incentive scheme (STPIS) for service levels. 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.

3 NER, cl. 6A.14.1(5A).

4 NER, cl. 6A.5.4(a)(5).

5 NER, cl. 6A.14.1(5A).

6 NER, cl. 6A.6.5A(e).

7 NER, cl. 6A.6.5A(e)(3); the capex incentive objective is set out in cl. 6A.5A(a).

8 NER, cl. 6A.6.5A(e)(4)(i); the CESS principles are set out in cl.6A.6.5A(c).

9 NER, cll. 6A.6.5A(e)(4)(i) and 6A.6.5A(d)(2); the capex objectives are set out in cl. 6A.6.7(a); the opex objectives are set out in cl. 6A.6.6(a).

10 NER, cll. 6A.6.5A(e)(4)(i) and 6A.6.5A(d)(1).

11 NER, cl. 6A.6.5A(e)(4)(ii).

9.4 Reasons for draft decision

Our draft decision is to include a CESS revenue increment of $0.9 million. This is a $4.2 million reduction from Transgrid's proposed CESS revenue increment of $5.1 million. We elaborate each of the reasons set out in section 9.1.1 in the sections below.

9.4.1 Application of the CESS in the 2018–23 period

9.4.1.1 Assessment of deferred capex

In its initial proposal, Transgrid identified a $532.8 million PEC under-spend as the deferred capex to the 2023–28 regulatory control period. It considered this deferral to be a material deferral as a capex adjustment. We are satisfied with this adjustment. However, Transgrid identified that it had deferred other capex in its supporting augmentation expenditure (augex) and replacement expenditure (repex) documents[12].

In response to our information requests, Transgrid disclosed additional deferred capex ($27.9 million in real $2022–23) which was not included in its initial proposal. Transgrid submitted that after adjusting for PEC, the remaining under-spend and deferred capex is not material.

We consider the additional deferred capex is material. This is because we undertake the assessment of materiality on a total capex basis, rather than on a project-by-project basis. Otherwise, this may bias deferral to only be material for larger projects when in some cases deferral or multiple smaller projects can also be material. Therefore, we consider it is best practice for networks to identify all deferrals rather than only projects it considers are material.

Although the proposed deferral of PEC alone is material, we must assess the total amount of deferred capex that has been included in the 2023–28 regulatory control period.

The CESS requires the following three criteria must be satisfied before we apply a CESS adjustment:[13]

1. the amount of the estimated underspend in capex in the current regulatory control period is material
2. the amount of the deferred capex in the current regulatory control period is material
3. 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.

We consider all three criteria have been satisfied in this case.

[12] Transgrid, *Repex Overview Paper, 2023-28 Revenue Proposal*, 31 January 2022, p.26, Transgrid, *Augex Overview Paper, 2023-28 Revenue Proposal*, 31 January 2022, p.22.

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

9.4.1.2 Accounting changes for SaaS and Leases during the 2018–23 period

We have also updated the CESS to reflect our decision on regulatory treatment for SaaS and leases following two accounting policy changes which have changed the classification of some of Transgrid's capex reporting in the 2018–23 regulatory control period. These are:

- SaaS, which was previously classified as capex and accounted for as such in our forecast capex for the 2018–23 period. Some of this is now classified as opex under the new International Financial Reporting Standards (IFRS) guidance published in April 2021
- Leases, which were included in approved opex for the 2018–23 period, but are now considered as capex under AASB 16 which came into effect 1 July 2019.

Our decision is to treat SaaS expenditure as capex and lease expenditure as opex for the 2018–23 period.

This reduces Transgrid's CESS revenue adjustment by $9.9 million because higher actual capex has been accounted for resulting from SaaS being treated as capex for the entire 2018–23 period. We note there is a corresponding adjustment to the EBSS (see Attachment 8).

9.4.1.3 Adjustments to modelling inputs

We have updated the inflation rate for 2021–22 and WACC for 2022–23 based on the most recent information.

We have also made amendments to Transgrid's historical inflation rates and 2018–23 forecast capex figures to reflect more accurate information.

9.4.2 Updates for final decision

We note the adjustment reflects our draft decision capex forecast. Any changes to our final decision capex forecast for deferred and reproposed capex would be reflected in our final decision CESS assessment.

9.5 Final year actual capex true-up for 2017–18

We have made an incremental CESS adjustment of $1.0 million for the final year true-up.

During the 2018–23 revenue reset, the capex for the final year (2017–18) for the 2014–18 regulatory control period was based on forecasts. We have undertaken an update to the calculation for the final year adjustment (2017–18) to reflect the difference between actual and estimated capex.

Transgrid did not propose a final year true-up in the proposal. In response to our information request, Transgrid reported that its estimate of capex was higher than its actual capex for 2017–18. We have reviewed the calculations and consider Transgrid received $1.1 million less in CESS than it should have. Our draft decision accounts for the difference in 2017–18. We have also updated Transgrid's calculation to reflect the financing benefit over the current period.

Glossary

Term	Definition
AER	Australian Energy Regulator
Augex	Augmentation expenditure
Capex	Capital expenditure
CESS	Capital expenditure sharing scheme
EBSS	Efficiency benefit sharing scheme
IFRS	International Financial Reporting Standards
NER	National Electricity Rules
Opex	Operating expenditure
PEC	Project EnergyConnect
RAB	Regulatory asset base
Repex	Replacement expenditure
SaaS	Software as a Service
STPIS	Service target performance incentive scheme
WACC	Weighted average cost of capital