



Draft decision

Endeavour Energy distribution determination

2015–16 to 2018–19

Attachment 2: Regulatory asset base

November 2014

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Note

This attachment forms part of the AER's draft decision on Endeavour Energy's 2015–19 distribution determination. It should be read with other parts of the draft decision.

The draft 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 mechanisms

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
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
CPI-X	consumer price index minus X
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

Shortened form	Extended form
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
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue 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

2 Regulatory asset base

We are required to make a decision on Endeavour Energy's opening regulatory asset base (RAB) as at 1 July 2014.¹ We use the RAB at the start of each regulatory year to determine the return of capital (regulatory depreciation) and return on capital building block allowances. This attachment presents our draft decision on the opening RAB value as at 1 July 2014 for Endeavour Energy and roll forward of the forecast RAB over the 2014–19 period.

2.1 Draft decision

We do not accept Endeavour Energy's proposed opening RAB of \$5593.0 million (\$ nominal) as at 1 July 2014.² We instead determine an opening RAB value of \$5599.0 million (\$ nominal) as at 1 July 2014. This is because we have amended Endeavour Energy's proposed actual net capex values for 2009–14 to correct for errors in the value of disposals that were proposed.³ This amendment increased the opening RAB as at 1 July 2014 by \$6.0 million (or 0.1 per cent) compared to that proposed.

To determine the opening RAB as at 1 July 2014, we have rolled forward the RAB over the 2009–14 regulatory control period to determine a closing RAB value at 30 June 2014. This roll forward includes an adjustment at the end of the 2009–14 regulatory control period to account for the difference between actual 2008–09 capex and the estimate approved at the 2009 determination.⁴ From 1 July 2014 metering will be classified as an alternative control service and therefore metering assets are to be excluded from the standard control services RAB. The opening RAB value discussed in this attachment represents the closing RAB value at 30 June 2014 adjusted for the removal of these metering assets.

Table 2-1 sets out our draft decision on the roll forward of the RAB values for the 2009–14 regulatory control period.

We determine a forecast closing RAB value at 30 June 2019 of \$6343.1 million (\$ nominal). This is \$752.8million (or 10.6 per cent) lower than the amount of \$7095.9 million (\$ nominal) proposed by Endeavour Energy. Our draft decision on the forecast closing RAB reflects the amended opening RAB as at 1 July 2014, and our draft decision on forecast capex (attachment 6) and forecast regulatory depreciation (attachment 5).

Table 2-2 sets out our draft decision on the forecast RAB values for Endeavour Energy over the 2014–19 period.

We determine that the forecast depreciation approach is to be used to establish the opening RAB at the commencement of the 2019–24 regulatory control period for Endeavour Energy.⁵ This will apply to the full 2014–19 period, including the 2014–15 transitional regulatory control period. We consider this approach will provide sufficient incentives for Endeavour Energy to achieve capex efficiency gains over those periods. Endeavour Energy is not currently subject to a capital expenditure sharing scheme (CESS) but we will apply the CESS to Endeavour Energy over the subsequent (2015–19) regulatory control period.

¹ NER, cl 6.12.1(6).

² Endeavour Energy, *Regulatory proposal*, May 2014, Attachment 4.02.

³ Endeavour Energy, *Email response to information request AER 001*, RFM, 2 July 2014.

⁴ The end of period adjustment will be positive (negative) if actual capex is higher (lower) than the estimate approved at the 2009–14 determination.

⁵ NER, cl 6.12.1(18).

Table 2-1 AER's draft decision on Endeavour Energy's RAB for the 2009–14 regulatory control period (\$ million, nominal)

	2009–10	2010–11	2011–12	2012–13	2013–14 ^a
Opening RAB	3690.0	3940.3	4342.1	4910.3	5346.0
Capital expenditure ^b	423.1	509.4	647.9	581.7	564.0
Inflation indexation on opening RAB	67.2	112.1	147.2	86.6	131.0
Less: straight-line depreciation	239.9	219.7	226.8	232.6	231.5
Closing RAB	3940.3	4342.1	4910.3	5346.0	5809.5
Difference between estimated and actual capex (1 July 2008 to 30 June 2009)					–116.6
Return on difference for 2008–09 capex					–71.2
Closing RAB as at 30 June 2014					5621.7
Meters moved to alternative control services					–22.7
Opening RAB as at 1 July 2014					5599.0

Source: AER analysis.

(a): Based on estimated capex. We will update the RAB roll forward in the final decision.

(b): Net of disposals and capital contributions, and adjusted for CPI.

Table 2-2 AER's draft decision on Endeavour Energy's RAB for the 2014–19 period (\$ million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19
Opening RAB	5599.0	5828.8	5987.7	6102.2	6228.9
Capital expenditure ^a	293.2	231.9	197.8	214.4	207.0
Inflation indexation on opening RAB	140.0	145.7	149.7	152.6	155.7
Less: straight-line depreciation	203.4	218.7	233.0	240.3	248.5
Closing RAB	5828.8	5987.7	6102.2	6228.9	6343.1

Source: AER analysis.

(a): Net of forecast disposals and capital contributions.

2.2 Endeavour Energy's proposal

Endeavour Energy used our roll forward model (RFM) to establish an opening RAB as at 1 July 2014 and our post-tax revenue model (PTRM) to roll forward the RAB over the 2014–19 period.

Endeavour Energy proposed an opening RAB value as at 1 July 2009 of \$3690.0 million (\$ nominal). Rolling forward this RAB and using depreciation based on actual capex, Endeavour Energy proposed a closing RAB as at 30 June 2014 of \$5615.6 million (\$ nominal). Table 2-3 presents Endeavour Energy's proposed roll forward of its RAB during the 2009–14 regulatory control period. The removal

of metering assets from the RAB at 1 July 2014 resulted in a proposed opening RAB as at 1 July 2014 of \$5593.0 million (\$ nominal).⁶

Table 2-3 Endeavour Energy's proposed RAB for the 2009–14 regulatory control period (\$million, nominal)

	2009–10	2010–11	2011–12	2012–13	2013–14 ^a
Opening RAB	3690.0	3940.4	4340.2	4908.0	5343.9
Capital expenditure ^b	423.2	507.3	647.3	581.7	564.1
Inflation indexation on opening RAB	67.2	112.1	147.1	86.5	132.3
Less: straight-line depreciation	239.9	219.7	226.6	232.2	231.1
Closing RAB	3940.4	4340.2	4908.0	5343.9	5809.1
Difference between estimated and actual capex (1 July 2008 to 30 June 2009)					–120.1
Return on difference for 2008–09 capex					–73.3
Closing RAB as at 30 June 2014					5615.6
Meters moved to alternative control services					–22.7
Opening RAB as at 1 July 2014					5593.0

Source: Endeavour Energy, *Regulatory proposal*, May 2014, Attachment 4.01.

(a): Based on estimated capex

(b): Net of disposals and capital contributions, and adjusted for CPI.

Endeavour Energy proposed a closing forecast RAB as at 30 June 2019 of \$7095.9 million (\$ nominal). This value reflects its proposed opening RAB, forecast capex, forecast inflation and depreciation (based on forecast capex) over the 2014–19 period. Its projected RAB over the 2014–19 period is shown in Table 2-4.

Table 2-4 Endeavour Energy's proposed RAB for the 2014–19 period (\$million, nominal)

	2014–15	2015–16	2016–17	2017–18	2018–19
Opening RAB	5593.0	5982.3	6293.1	6553.7	6831.0
Capital expenditure ^a	452.0	383.2	343.7	365.4	358.2
Inflation indexation on opening RAB	139.8	149.6	157.3	163.8	170.8
Less: straight-line depreciation	202.5	221.9	240.5	251.9	264.1
Closing RAB	5982.3	6293.1	6553.7	6831.0	7095.9

Source: Endeavour Energy, *Regulatory proposal*, May 2014, Attachment 4.02.

(a): Net of disposals and capital contributions.

Endeavour Energy proposed to apply a forecast depreciation approach to establish the RAB at the commencement of 2019–24 regulatory control period, consistent with the approach set out in our Stage 2 framework and approach paper.⁷

⁶ From 1 July 2014 metering will be treated as an alternative control service and therefore metering assets are to be excluded from the standard control services RAB.

2.3 AER's assessment approach

We are required to roll forward the service provider's RAB during the 2009–14 regulatory control period to establish the opening RAB at 1 July 2014. This value can be adjusted for any differences in the forecast and actual capex, disposals and capital contributions. It may also be adjusted to reflect any changes in the use of the assets, with only assets used in the provision of standard control services to be included in the RAB.⁸

To determine the opening RAB, we developed an asset base RFM in accordance with the requirements of the NER.⁹ A service provider must use the RFM in preparing its regulatory proposal. The RFM rolls forward the RAB from the beginning of the final year of the 2004–09 regulatory control period, through the 2009–14 regulatory control period, to the beginning of the next period. The five regulatory years between 2014–19 are split over two regulatory control periods (a transitional regulatory control period from 2014–15 and then a subsequent regulatory control period from 2015–19). However, the NER expressly provides that when we determine the opening value of the regulatory asset base for this five year period we should do so as if the two periods were combined.¹⁰ The roll forward occurs for each year by:

- Adding an inflation (indexation) adjustment to the opening RAB for the relevant year. This adjustment must be consistent with the inflation factor used in the control mechanism.¹¹
- Adding capex to the RAB for the relevant year.¹² In future determinations, the NER allows us to review a service provider's past capex and exclude inefficient past capex from being rolled into the RAB.¹³ We note that under the transitional rules, the review of past capex does not apply to Endeavour Energy prior to 1 July 2015.¹⁴ Therefore, for the purposes of this draft decision, we will add Endeavour Energy's actual or estimated capex in the 2009–14 regulatory control period to the RAB. We check actual capex amounts against audited annual reporting regulatory information notice (RIN) data and generally accept the capex reported in those RINs in rolling forward the RAB. However, there may be instances where adjustments are required to the annual reporting RIN data because it is not fit for purpose due to a particular issue.
- Subtracting depreciation from the RAB for the relevant year, calculated in accordance with the relevant distribution determination for that year.¹⁵ Depreciation based on forecast or actual capex can be used to roll forward the RAB.¹⁶ By default the RFM applies the depreciation approach based on actual capex, although this can be modified to apply a depreciation approach based on forecast capex if necessary. For this draft decision, we use depreciation based on actual capex for rolling forward Endeavour Energy's RAB values over the 2009–14 regulatory control period.¹⁷
- Subtracting any disposals and capital contributions from the RAB for the relevant year.¹⁸ We check these amounts against audited annual reporting RIN data.

⁷ Endeavour Energy, *Regulatory proposal*, May 2014, p. 31.

⁸ NER, cl S6.2.1 and 11.56.4(f).

⁹ NER, cl 6.5.1 and 11.56.4(c) and (f).

¹⁰ NER, cl 11.56.4(c)(4)-(6) and (f).

¹¹ NER, cl 6.5.1(e)(3) and 11.56.4(f).

¹² NER, cl S6.2.1(e)(4).

¹³ NER, cl S6.2.2A.

¹⁴ NER, cls 11.56.5 and 11.62.

¹⁵ NER, cl S6.2.1(e)(5).

¹⁶ NER, cl 6.12.1(18).

¹⁷ The use of actual depreciation is consistent with the depreciation approach established in the 2009 distribution determinations for NSW service providers.

¹⁸ NER, cl S6.2.1(e)(6).

These annual adjustments give the closing RAB for any particular year, which then becomes the opening RAB for the following year. Through this process the RFM rolls forward the RAB to the end of the 2009–14 regulatory control period. The PTRM used to calculate the annual revenue requirement for the 2014–19 period generally adopts the same RAB roll forward approach as the RFM, although the annual adjustments to the RAB are based on forecasts, rather than actual amounts.

We are required to decide whether depreciation for establishing the service provider's RAB as at the commencement of the 2019–24 regulatory control period is to be based on actual or forecast capex.¹⁹

The opening RAB for the 2019–24 regulatory control period can be determined using depreciation based either on forecast or actual capex incurred during the 2014–19 period. To roll forward the RAB using depreciation based on forecast capex, we would use the forecast depreciation contained in the PTRM for the 2014–19 period, adjusted for actual inflation. If the approach to roll forward the RAB using depreciation based on actual capex was adopted, we would recalculate the depreciation based on actual capex incurred during the 2014–19 period.

Our decision on whether to use actual or forecast depreciation must be consistent with the capex incentive objective. We must have regard to:²⁰

- any other incentives the service provider has to undertake efficient capex
- substitution possibilities between assets with different lives
- the extent of overspending and inefficient overspending relative to the allowed forecast
- the capex incentive guideline
- the capital expenditure factors.

2.3.1 Interrelationships

The RAB is an input into the determination of the return on capital and depreciation (return of capital) building block allowances.²¹ Factors that influence the RAB will therefore flow through to these building block components and the annual revenue requirement. Other things being equal, a higher RAB increases both the return on capital and depreciation allowances.

The RAB is determined by various factors, including;

- the opening RAB (meaning the value of existing assets at the beginning of the regulatory control period)
- net capex²²
- depreciation
- indexation adjustment – so the RAB is presented in nominal terms, consistent with the rate of return.

¹⁹ NER, cl S6.2.2B.

²⁰ NER, cl S6.2.2B(c).

²¹ The size of the RAB also impacts the benchmark debt raising cost allowance. However, this amount is usually relatively small and therefore not a significant determinant of revenues overall.

²² Net capex is gross capex less disposals and capital contributions. The rate of return or WACC also influences the size of the capex. This is because the capex is not depreciated in the year it is first incurred, but added to the RAB at the end of the year. Instead, the capex amount is escalated by half a WACC to arrive at an end of year value. It then begins depreciating the following year.

The opening RAB depends on the value of existing assets and will depend on actual net capex, actual inflation outcomes and depreciation in the past.

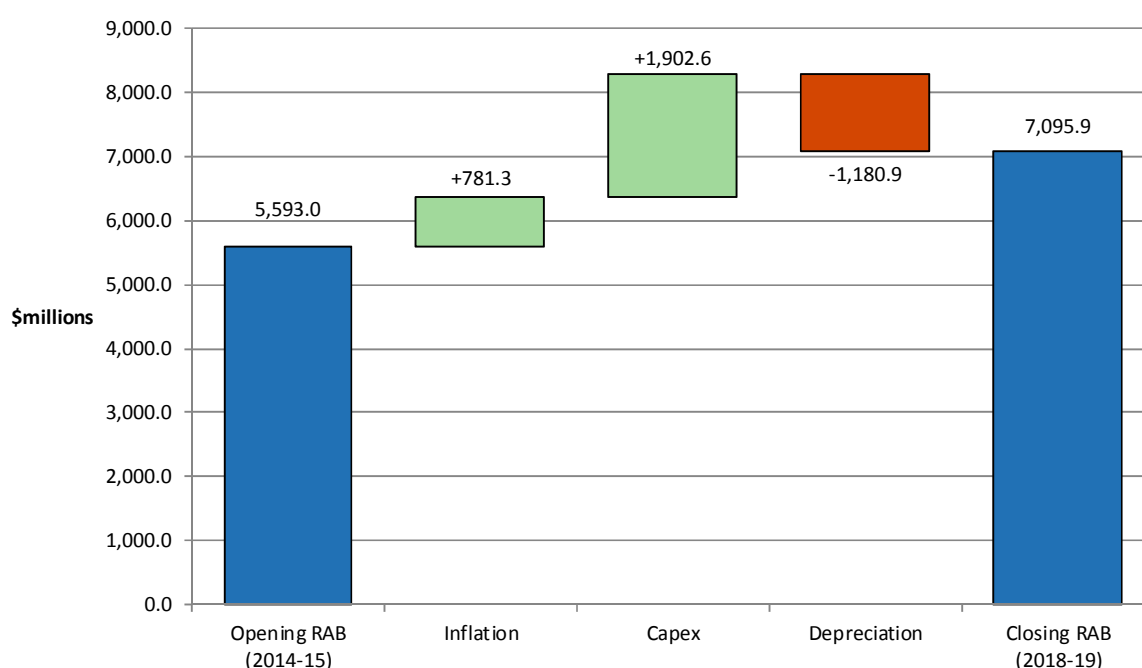
The RAB when projected to the end of the regulatory control period increases due to both forecast new capex and the indexation adjustment. The size of the indexation adjustment depends on expected inflation (which also affects the nominal rate of return or WACC) and the size of the RAB at the start of each year.

Depreciation reduces the RAB. The depreciation allowance depends on the size of the opening RAB and the forecast net capex. By convention, the indexation adjustment is also offset against depreciation to prevent double counting of inflation in the RAB and rate of return, which are both presented in nominal terms. This reduces the apparent depreciation building block that feeds into the annual revenue requirement.

Figure 2-1 shows the key drivers of the change in the RAB over the 2014–19 period as proposed by Endeavour Energy. Overall, the closing RAB at the end of the 2014–19 period would be 27 per cent higher than the opening RAB at the start of that period based on the proposal, in nominal terms. The proposed forecast net capex increases the RAB by about 34 per cent, while inflation increases it by about 14 per cent. Forecast depreciation, on the other hand, reduces the RAB by about 21 per cent.

The RAB would rise in real terms over the 2014–19 period based on Endeavour Energy's proposal. We consider the depreciation amount to be generally reasonable and satisfy the requirements of the NER in terms of the assigned asset lives. The depreciation amount also largely depends on the opening RAB (which in turn depends on capex in the past). However, we do have concerns with the size of the forecast net capex. Figure 2-1 shows forecast net capex is the largest driver of the increase in the RAB and we have considered whether it is appropriate that the forecast net capex exceeds depreciation as Endeavour Energy has proposed. Refer to attachment 6 for the discussion on forecast capex.

Figure 2-1 Key drivers of changes in the RAB (\$m, nominal)



A ten per cent increase in the opening RAB causes revenues to increase by about 6.2 per cent.

However, the impact on revenues of the annual change in RAB depends on the source of the RAB change, as some drivers affect more than one building block cost.²³

2.4 Reasons for draft decision

We have determined an opening RAB value for Endeavour Energy of \$5599.0 million (\$ nominal) as at 1 July 2014, an increase of \$6.0 million (\$ million) or 0.1 per cent from the proposed value. We forecast a closing RAB value of \$6343.1 million by 30 June 2019. This represents a reduction of 752.8 million, or 10.6 per cent compared to the proposal. The reasons for our decision are discussed below.

2.4.1 Opening RAB as at 1 July 2014

To determine the opening RAB as at 1 July 2014 we have rolled forward the RAB over the 2009–14 regulatory control period to determine a closing RAB value at 30 June 2014. As metering is to be classified as alternative control services from 1 July 2014, the metering assets must be removed from the closing RAB as at 30 June 2014 to determine the standard control services opening RAB as at 1 July 2014.

We do not accept Endeavour Energy's proposed opening RAB value as at 1 July 2014 of \$5593.0 million. Instead we have determined an opening RAB value of \$5599.0 million (\$ nominal) as at 1 July 2014, an increase of \$6.0 million (\$ million) or 0.1 per cent from Endeavour Energy's proposal.²⁴ This is because we have amended Endeavour Energy's proposed disposal values from 2008–13 in the RFM to reflect the gross proceeds from the disposal of standard control service assets. Endeavour Energy's proposed disposal values included some asset values not allocated to standard control services as well as some written down asset values. In reviewing this matter, we asked questions of Endeavour Energy and took account of its responses in forming our view on the appropriate disposal values for RAB roll forward purposes.²⁵ We consider that the revised disposal values satisfy the requirements of the NER.²⁶

We also reviewed the other key inputs into Endeavour Energy's proposed RFM, such as CPI, rate of return, asset lives and gross capex values. We found these were correct and they reconcile with relevant data sources such as ABS data, annual reporting RIN data and the 2009–14 decision models. For the 2013–14 CPI input, we have updated the RFM with the actual value of 2.45 per cent.

2.4.2 Forecast closing RAB as at 30 June 2019

We forecast a closing RAB value of \$6343.1million by 30 June 2019 for Endeavour Energy. This represents a reduction of 752.8 million, or 10.6 per cent to Endeavour Energy's proposal. This reduction reflects our draft decision on the required inputs for determining the forecast RAB in the PTRM. To determine the forecast RAB value, we amended the following PTRM inputs:

- We increased Endeavour Energy's proposed opening RAB as at 1 July 2014 by \$6.0 million or 0.1 per cent (section 2.4.1).

²³ If capex causes the RAB increase, return on capital, depreciation, and debt raising costs all increase too. If a reduction in depreciation causes the RAB increase, revenue could increase or decrease. In this case, the higher return on capital is offset (perhaps more than offset) by the reduction in depreciation allowance. Inflation naturally increases the RAB in nominal terms. However, the real impact from changing the inflation forecast is inconsequential as revenues are updated annually by actual inflation and the X factor, which is generally unaffected by the assumed forecast inflation rate.

²⁴ At the time of this draft decision, the roll forward of Endeavour Energy's RAB includes estimated capex values for 2013–14. We will update the 2013–14 estimated capex values with the actual values for the final decision.

²⁵ Endeavour Energy, *Email response to information request AER 001*, 2 July 2014.

²⁶ NER, cl S6.2.1(e)(6).

- We reduced Endeavour Energy's proposed forecast capex for the 2014–19 period by \$758.2 million or 39.9 per cent (attachment 6).
- We increased Endeavour Energy's proposed forecast regulatory depreciation allowance by \$0.7 million or 0.2 per cent (attachment 5).

2.4.3 Application of depreciation approach in RAB roll forward for next reset

Consistent with our Stage 2 framework and approach paper and Endeavour Energy's proposal, we determine that the forecast depreciation approach is to be used to establish the RAB at the commencement of Endeavour Energy's 2019–24 regulatory control period.²⁷ This approach will apply to both the transitional and subsequent regulatory control periods for Endeavour Energy.²⁸ We consider this approach will provide sufficient incentives for Endeavour Energy to achieve capex efficiency gains over the relevant regulatory control periods.

We had regard to the relevant factors in the NER in developing the approach to choosing the depreciation approach set out in our capex incentives guideline.²⁹ Our approach is to apply forecast depreciation except where:

- there is no CESS in place and therefore the power of the capex incentive may need to be strengthened, or
- a service provider's past capex performance demonstrates evidence of persistent overspending or inefficiency, thus requiring a higher powered incentive.

In making our decision on whether to use actual depreciation in either of these circumstances we have considered:

- the substitutability between capex and opex and the balance of incentives between these
- the balance of incentives with service outcomes
- the substitutability of assets of different asset lives.

We have chosen forecast depreciation because, in combination with the CESS, it will provide a 30 per cent reward for capex underspends and 30 per cent penalty for capex overspends, which is consistent for all asset classes. In developing our capex incentives guideline, we considered this to be a sufficient incentive for a service provider to achieve efficiency gains over the regulatory control period in most circumstances.

As discussed in attachment 10, Endeavour Energy is not currently subject to a CESS but we will apply the CESS to Endeavour Energy from 1 July 2015. The CESS does not apply to Endeavour Energy for the 2014–15 transitional regulatory control period.³⁰ We consider the use of a forecast depreciation approach in combination with the application of the CESS and our other ex post capex measures are sufficient to achieve the capex incentive objective.³¹

²⁷ AER, *Stage 2 framework and approach paper*, January 2014, p. 37.

²⁸ The transitional regulatory control period for Endeavour Energy is 2014–15. Endeavour Energy's subsequent regulatory control period is from 2015–16 to 2017–19.

²⁹ AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, p. 12.

³⁰ NER, cl 11.56.3(a)(3).

³¹ Our ex post capex measures are set out in the capex incentives guideline, AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 13–19, 20–21. The guideline also sets out how all our capex incentive measures are consistent with the capex incentive objective.