



Preliminary framework and approach AusNet Services

**Regulatory control period
commencing 1 July 2022**

December 2019

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About the framework and approach paper

The Australian Energy Regulator (AER) is responsible for the economic regulation of electricity transmission and distribution services in Australia's national electricity market. We are an independent statutory authority established by the Australian Government. Our powers and functions are set out in the National Electricity Law (NEL) and the National Electricity Rules (NER).

This preliminary Framework and Approach (F&A) paper is the first step in the process to determine efficient prices for AusNet Services' electricity transmission service business in Victoria. Following consultation on this preliminary F&A paper, we will publish a final F&A paper setting out our proposed approach to the economic regulation of AusNet Services' Victorian transmission revenues for the forthcoming regulatory control period. The final F&A paper will set out, amongst other things, the application of any incentive schemes. The F&A also facilitates early consultation with consumers and other stakeholders and will assist AusNet Services to prepare expenditure proposals.

AusNet Services is a licensed, regulated operator of the monopoly high voltage electricity transmission network in Victoria. The network comprises the poles, wires and transformers used for transporting high voltage electricity from remote generators to population centres. AusNet Services constructs, operates and maintains much of the transmission network for Victorian electricity consumers. The design and tendering for new construction of the Victorian transmission network is undertaken by the Australian Electricity Market Operator (AEMO) under arrangements that are unique to Victoria. The current five year Victorian transmission regulatory control period concludes on 30 March 2022. Our F&A paper for the 2022–27 regulatory control period must be published by 30 April 2020.¹

This preliminary F&A paper sets out our proposed approach for the 2022–27 regulatory control period concerning the application of the following:

- service target performance incentive scheme (STPIS)
- expenditure efficiency benefit sharing scheme (EBSS)
- capital expenditure sharing scheme (CESS)
- expenditure forecast assessment guidelines
- whether depreciation will be based on forecast or actual capital expenditure (capex) in updating the regulatory asset base (RAB).

Following the release of the final F&A paper, AusNet Services must submit a revenue proposal by 31 October 2020 for its next regulatory control period commencing on 1 April 2022.

Table 1 summarises the transmission determination process.

¹ NER, cl. 6A.10.1A(a)(i) and (e).

Table 1 AusNet Services' transmission determination process

Step	Date
AER publishes preliminary F&A for AusNet Services	20 December 2019
Submission on preliminary F&A for AusNet Services close	3 February 2020
AER publishes final F&A for AusNet Services	30 April 2020
AusNet Services submits regulatory proposal to AER	31 October 2020
AER publishes issues paper	December 2020*
AER holds public forum	January 2021*
Submissions on regulatory proposal close	February 2021*
AER publishes draft transmission determination	July 2021*
AER holds a predetermination conference	August 2021*
AusNet Services submits revised regulatory proposal to AER	September 2021
Submissions on draft determination and revised proposal close	November 2021*
AER publishes transmission determination for AusNet Services regulatory control period 2022–27	January 2022

Source: NER, Chapter 6A, Part E.

Notes: * The dates provided are based on the AER receiving compliant proposals. These dates may alter if the AER receives non-compliant proposals. The NER also does not provide specific timeframes in relation to publishing draft decisions.

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
capex	capital expenditure
CESS	capital expenditure sharing scheme
CSIS	customer service incentive scheme (small scale incentive scheme for customer service)
DMIAM	demand management innovation allowance mechanism
DNSP	distribution network service provider
EBSS	efficiency benefit sharing scheme
ENA	Energy Networks Australia
F&A	framework and approach
MAR	maximum allowed revenue
MIC	market impact component
NCC	network capability component
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
opex	operating expenditure
RAB	regulatory asset base
STPIS	service target performance incentive scheme
TNSP	transmission network service provider

1 Overview

This preliminary F&A paper sets out how we propose to apply a range of incentive schemes and other guidelines to AusNet Services as well as our approach to calculating depreciation. The positions we set out in this F&A paper are not binding on the AER or AusNet Services.²

Incentive schemes encourage transmission network service providers (TNSPs) to manage their businesses in a safe, reliable manner that benefits the long term interests of consumers. The schemes also provide TNSPs with incentives to spend efficiently and to meet or exceed service quality/reliability targets. In some instances, TNSPs may incur a financial penalty if they fail to meet set targets. The overall objectives of the schemes are to:

- encourage appropriate levels of service quality
- maintain network reliability as appropriate
- incentivise TNSPs to spend efficiently on capital and operating expenditure
- share efficiency gains and losses between TNSPs and consumers
- incentivise TNSPs to consider economically efficient alternatives to augmenting their networks.

We summarise the specific schemes below and provide an overview of our expenditure forecast assessment guideline and approach to calculating depreciation.

Service target performance incentive scheme

Our national service target performance incentive scheme provides a financial incentive to TNSPs to maintain and improve service performance. The STPIS aims to safeguard service quality for customers that may otherwise be affected as TNSPs seek out cost efficiencies. We propose to apply version 5 of the STPIS to AusNet Services for its 2022–27 regulatory control period.³

Efficiency benefit sharing scheme

The operating expenditure efficiency benefit sharing scheme aims to provide a continuous incentive for TNSPs to pursue efficiency improvements in opex, and provide for a fair sharing of these efficiencies between TNSPs and network users. Consumers benefit from improved efficiencies through lower regulated prices in the future. We propose to apply version 2 of the EBSS to AusNet Services for its 2022–27 regulatory control period.⁴

2 NER, cl. 6A.10.1A(f).

3 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015). STPIS version 5 is available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment>. The STPIS was last amended in September 2015 and corrected in October 2015.

4 AER, *Efficiency benefit sharing scheme*, 29 November 2013. EBSS version 2 is available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/efficiency-benefit-sharing-scheme-ebss-%E2%80%93-november-2013>.

Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards to TNSPs whose capex becomes more efficient and financial penalties for TNSPs whose capex become less efficient. Consumers benefit from improved efficiency through lower regulated prices in the future. We propose to apply version 1 of the CESS to AusNet Services for its 2022–27 regulatory control period.⁵

Small-scale incentive scheme

The NER provide that we may develop small-scale incentive schemes.⁶ The AER is currently considering whether to make an electricity distribution small scale incentive scheme for customer service, referred to as the customer service incentive scheme (CSIS). The scheme would reward electricity distribution network service providers (DNSPs) for improving their customer service, or penalise them if service deteriorates. AusNet Services transmission has not yet proposed a detailed incentive design developed in conjunction with its customers. As such, we do not propose to apply a small-scale incentive scheme to AusNet Services' transmission business.

Demand management incentive scheme/Demand management incentive allowance mechanism

The Demand Management Incentive Scheme (DMIS) provides the service operator with financial payments to implement efficient non-network options which are expected to lower costs to consumers. The Demand Management Innovation Allowance Mechanism (DMIAM) provides the service provider with funding for research and develop on demand management projects that have the potential to reduce long term network costs.

On 5 December 2019, the AEMC published its final determination for a rule change to apply the DMIAM, and not the DMIS, to transmission network service providers.⁷ The AER must develop and publish the first transmission DMIAM under the NER by 31 March 2021.⁸

At this stage we expect to develop and apply a DMIAM to AusNet Services for the 2022–27 regulatory control period in our final determination.

Expenditure forecast assessment guidelines

The expenditure forecast assessment guideline is based on a nationally consistent reporting framework allowing us to compare the relative efficiencies of TNSPs and decide on efficient expenditure allowances. Our proposed approach is to apply the expenditure assessment

5 AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013. CESS version 1 is available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/expenditure-incentives-guideline-2013/final-decision>.

6 NER, cl. 6A.7.5.

7 AEMC, *Demand management incentive scheme and innovation allowance for TNSPs*, Rule determination, 5 December 2019

8 NER, cl. 11.[118].2.

guideline, including the information requirements, to AusNet Services for its 2022–27 regulatory control period.⁹

The guideline outlines a suite of assessment/analytical tools and techniques to assist our review of AusNet Services' revenue proposal. We intend to apply the assessment techniques set out in the guideline to AusNet Services' revenue proposal.

Depreciation

As part of the roll forward methodology, when a TNSP's RAB is updated from forecast capex to actual capex at the end of a regulatory period, it is also adjusted for depreciation. The depreciation we use to roll forward the RAB can be based on either actual capex incurred during the regulatory control period, or the capex allowance forecast at the start of the regulatory control period. The choice of depreciation approach is one part of the overall capex incentive framework. The incentive based regulatory framework provides benefits to consumers from improved efficiencies through lower regulated prices.

We propose to use forecast depreciation to establish the RAB for the regulatory control period commencing in 2027 for AusNet Services.

Further details of our proposed approach and reasons for each aspect of the F&A are set out below.

2 Service target performance incentive scheme

This section sets out our proposed approach and reasons on how we intend to apply the STPIS¹⁰ to AusNet Services in the 2022–27 regulatory control period.

The AER creates, administers and maintains the STPIS in accordance with the requirements of the NER. The purpose of the STPIS is to provide incentives to TNSPs to provide greater transmission network reliability when network users place greatest value on reliability, and improve and maintain the reliability of the elements of the transmission network most important to determining spot prices.¹¹ The STPIS can result in a maximum revenue increment or decrement of up to five per cent of the TNSP's maximum allowable revenue (MAR) in a regulatory year.¹²

The STPIS works as part of the building block determination.¹³ As part of the revenue determination, we make a decision on the application of the STPIS to a TNSP for the regulatory control period as well as the values associated with the applicable STPIS parameters.¹⁴ In each regulatory year, the TNSP's MAR is adjusted based on its performance against the STPIS parameters in the previous calendar year.

⁹ We are continuously improving the economic benchmarking techniques that are captured in our Guideline. This includes reviewing and refining our analysis of operating environment factors. See section 7 for more detail.

¹⁰ AER, *Service target performance incentive scheme*, September 2015 (updated October 2015).

¹¹ NER, cl. 6A.7.4(b)(1).

¹² NER, cl. 6A.7.4(b)(3).

¹³ NER, cll. 6A.5.4(a)(5) and 6A.5.4(b)(5).

¹⁴ NER, cll. 6A.4.2(5) and 6A.14.1(1)(iii).

The STPIS is part of an incentive based regulation structure we use across all the energy networks we regulate. The incentives provided by the CESS and the EBSS are balanced with the incentive to improve service standards provided by the STPIS.

The STPIS must:

- provide incentives for each TNSP to:¹⁵
 - provide greater reliability of the transmission system that is owned, controlled or operated by it at all times when transmission network users place the greatest value on the reliability of the transmission system
 - improve and maintain the reliability of those elements of the transmission system that are most important to determining spot prices
- result in a potential adjustment to the revenue the TNSP may earn, from the provision of prescribed transmission services, in each regulatory year to which the STPIS applies
- ensure that the maximum revenue increment or decrement as a result of the operation of the STPIS will fall within a range that is between one per cent and five per cent of the MAR for the relevant regulatory year
- take into account the regulatory obligations or requirements with which TNSPs must comply
- take into account any other incentives provided for in the rules that create incentives for TNSPs to minimise capital or operating expenditure; and
- take into account the age and ratings of the assets comprising the relevant transmission system.

In developing the STPIS we had regard to the requirements of the NER, as set out in our final decision on the STPIS published in October 2015.¹⁶ Under an incentive based regulation framework, TNSPs have an incentive to reduce costs. Cost reductions are beneficial to TNSPs and customers where service performance is maintained or improved. However, cost efficiencies achieved at the expense of service performance standards are not desirable. Version 5 of the STPIS seeks to ensure that increased financial efficiency does not result in deterioration of service performance for customers.

2.1 Proposed approach

We propose to apply version 5 of the STPIS to AusNet Services for the 2022–27 regulatory control period as follows:

- the parameters for each service component and the maximum revenue increment or decrement that AusNet Services can receive for a given level of performance will be those prescribed in version 5 of the scheme. The applicable parameter values will be set out in AusNet Services' transmission determination. AusNet Services' MAR will be

¹⁵ NER, cl. 6A.7.4(b).

¹⁶ AER, *Service target performance incentive scheme*, September 2015 (updated October 2015).

adjusted according to its performance against these parameter values, as assessed by us, in accordance with the scheme

- the MIC annual performance target¹⁷ will be the rolling average of performance history over the three previous calendar years. Actual performance will be measured as a rolling average of the most recent two years of actual performance data¹⁸
- the network capability component of version 5 of the scheme will apply to AusNet Services.

In its revenue proposal, AusNet Services must:

- submit proposed values for the service component parameters¹⁹
- submit data for its market impact component for the preceding seven regulatory years.²⁰ AusNet Services must submit a proposed value for a performance target, unplanned outage event limit and dollar per dispatch interval incentive.²¹
- submit a network capability incentive parameter action plan.²²

We will accept AusNet Services' proposed parameter values for the service, market impact and network capability components if the proposed values comply with STPIS version 5 clauses 3.2, 4.2 and 5.2 respectively.²³

2.2 Reasons for proposed approach

We consider application of version 5 of the STPIS will provide appropriate incentives for AusNet Services to:

- provide greater transmission system reliability
- improve and maintain the reliability of those elements of the transmission system that are most important to determining spot prices
- undertake relevant low cost projects to promote efficient levels of network capability from existing assets.

Service component

The service component of the STPIS incentivises TNSPs to maintain and improve network availability and reliability by measuring performance against certain parameters. Under this

17 The market impact parameter is the number of dispatch intervals where an outage on the TNSP's prescribed transmission network results in a network outage constraint with a marginal value greater than \$10/MWh. For more information see AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), Appendix C.

18 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 4.2(g) and Appendix F.

19 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 3.2.

20 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 4.2(a).

21 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 4.2(b).

22 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 5.2(b).

23 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015).

component of the scheme, a TNSP can receive a revenue increment or decrement of up to 1.25 per cent of its MAR for the relevant calendar year.²⁴

A TNSP receives a financial incentive (reward) in proportion to the extent its annual performance exceeds its performance target (calculated as the s-factor). If the TNSP fails to meet its performance target, it incurs a financial penalty in proportion to the extent its annual performance does not meet the performance target.

Version 5 of the STPIS amended the service component parameters to focus more on unplanned outages, including a new parameter focusing on proper operation of equipment. Performance against these parameters can be used as a lead indicator of a deterioration of network reliability.²⁵

The scheme contains definitions for each parameter. The definitions specify the applicable sub-parameters, unit of measure, source of performance data, the formula for measuring performance, definitions of relevant terms, inclusions (which specify particular equipment or events which are to be measured) and exclusions.

We will assess whether AusNet Services' proposed performance targets, caps and weightings comply with the version 5 STPIS requirements.²⁶

We must accept AusNet Services' proposed parameter values if they comply with the requirements of the STPIS.²⁷ We may reject them if they are inconsistent with the objectives of the STPIS.²⁸

Market impact component

The market impact component will be applied to AusNet Services to incentivise it to minimise the impact of its transmission outages that can affect NEM market outcomes.

In this component, AusNet Services will receive a financial incentive which falls within a range of minus one percent (penalty) and plus one per cent (reward) of its maximum allowed revenue.²⁹

We will assess AusNet Services' proposed parameter values using the methodology set out in section 4, appendix C and appendix F of version 5 of the STPIS.

Network capability component

The network capability component will be applied to AusNet Services to incentivise the identification and implementation of low cost one-off projects that will improve the capability of the transmission network at times most needed. AEMO will play a part in prioritising the projects to deliver best value for money for customers.

24 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 3.3(a)

25 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), pp. 7–8.

26 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 3.1.

27 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 3.2(a).

28 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 3.2(l).

29 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 4.3.

In this component, AusNet Services will receive an annual allowance of up to a total of 1.5 per cent of MAR, but we may reduce the final payment (up to) minus 2.5 per cent of MAR, depending on the extent to which AusNet Services achieves its priority project improvement targets.³⁰

We will assess AusNet Services' network capability incentive parameter action plan in accordance with section 5.2 of version 5 of the STPIS.

3 Efficiency benefit sharing scheme

The EBSS is intended to provide a continuous incentive for transmission businesses to pursue efficiency improvements in opex, and provide for a fair sharing of these between businesses and consumers. Consumers benefit from improved efficiencies through lower network prices in future regulatory control periods.

We address our position on the application of the EBSS in relationship to our proposed opex forecasting approach and benchmarking below. We also explain the rationale underpinning the scheme.

This section sets out our preliminary position and reasons on how we intend to apply the EBSS to AusNet Services in the 2022–27 regulatory control period.

3.1 AER's preliminary position

We intend to apply the EBSS to AusNet Services in the 2022–27 regulatory control period if we are satisfied the scheme will fairly share efficiency gains and losses between the business and consumers.³¹ This will occur only if the opex forecast for the following period is based on the businesses revealed costs. Our transmission determination for AusNet Services for the 2022–27 regulatory control period will specify if and how we will apply the EBSS.³²

3.2 AER's assessment approach

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between a network service provider and network users.³³ We must also have regard to the following factors in developing and implementing the EBSS:³⁴

- the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme
- the need to provide service providers with a continuous incentive to reduce opex

30 AER, *Service target performance incentive scheme*, September 2015 (updated October 2015), cl. 5.3(b).

31 NER, cl. 6A.6.5(a).

32 AER, *Efficiency benefit sharing scheme*, 29 November 2013.

33 NER, cl. 6A.6.5(a).

34 NER, cl. 6A.6.5(b).

- the desirability of both rewarding service providers for efficiency gains and penalising service providers for efficiency losses
- any incentives that service providers may have to capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

3.3 Reasons for AER’s preliminary position

The EBSS applies to AusNet Services in the 2017–22 regulatory control period.³⁵

The decision to apply the EBSS will depend on whether we expect to use AusNet Services’ revealed costs in the 2022–27 regulatory control period to forecast opex in the following period.

Why we would apply the EBSS

We will only apply the EBSS in the 2022–27 regulatory control period if we expect we will use a revealed cost forecasting approach to forecast opex for the 2027–32 regulatory control period.

The EBSS is intrinsically linked to our revealed cost forecasting approach. This approach relies on identifying an efficient opex amount in the base year (the ‘revealed costs’ of the transmission business), which we use to develop a total opex forecast. When a business makes an incremental efficiency gain, it receives a reward through the EBSS, and consumers benefit through a lower revealed cost forecast for the subsequent period. This is how efficiency improvements are shared between consumers and the business.

Under a revealed cost approach without an EBSS, a transmission business has an incentive to spend more opex in the expected base year. Also, a transmission business has less incentive to reduce opex towards the end of the regulatory control period, where the benefit of any efficiency gain is retained for less time.

If we use a revealed cost forecasting approach we apply the EBSS because:

- it reduces the incentive for a transmission business to inflate opex in the expected base year in order to gain a higher opex forecast for the next regulatory control period
- it provides a continuous incentive for a transmission business to pursue efficiency improvements across the regulatory control period. This is because the EBSS allows a business to retain efficiency gains for a total of six years, regardless of the year in which it was made.

In implementing the EBSS we also consider any incentives a transmission business may have to capitalise operating expenditure.³⁶ Where opex incentives are balanced with capex incentives, a transmission business does not have an incentive to favour opex over capex, or

³⁵ AER, *Efficiency benefit sharing scheme*, 29 November 2013.

³⁶ NER, cl. 6A.6.5(b)(3).

vice-versa. If the CESS and EBSS are both applied, these incentives will be relatively balanced. We discuss the CESS further in section 4.

Why we would not apply the EBSS

We will not apply the EBSS if it is likely we will *not* use a revealed cost forecasting approach to forecast opex for the 2027–32 regulatory control period.

If we apply the EBSS but do not forecast opex using revealed costs, a transmission business could in theory receive an EBSS reward for efficiency gains (at a cost to consumers), but consumers would not benefit through a lower revealed cost forecast. If the transmission business expects this, it has an incentive to increase its EBSS carryover by underspending in its base year, knowing the underspend will not reduce its opex forecast.³⁷ Consumers would pay the EBSS reward but not receive a share of the underspend and would be worse off. This outcome is contrary to the NER which requires that the EBSS must provide for a fair sharing of efficiency gains and losses between a transmission business and consumers.³⁸

If a transmission business's revealed costs in the 2017–22 regulatory control period are materially higher than the opex incurred by a benchmark efficient transmission business, we will be unlikely to use revealed costs to forecast opex for the 2022–27 regulatory control period. In which case, we will be unlikely to apply the EBSS. Where we allow forecast opex that is materially lower than revealed costs, even in the absence of the EBSS the TNSP would have an incentive to reduce opex and therefore may have an incentive to capitalise expenditure it would have previously expensed. Given these incentives to reduce opex (and therefore to substitute opex with capex), we consider that applying the CESS would likely provide more balanced incentives between incurring capex and opex than not applying the CESS.³⁹ We discuss the CESS further in section 4.

For a detailed example of how the EBSS works with a revealed cost forecasting approach, see appendix A of the explanatory statement to the EBSS.⁴⁰

4 Capital expenditure sharing scheme

The CESS applies to AusNet Services in the 2017–22 regulatory control period.⁴¹

The CESS provides financial rewards to TNSPs whose capex becomes more efficient and financial penalties for TNSPs whose capex becomes less efficient. Consumers benefit from improved efficiency through lower regulated prices. The CESS approximates efficiency gains

37 In our explanatory statement to the EBSS, we detail why excluding the expenditure categories not forecast using a single year revealed cost forecasting method is in the best interest of network users. AER, *Explanatory statement - efficiency benefit sharing scheme*, November 2013, pp. 18–19.

38 NER, cl.6A.6.5(a).

39 For example, we chose to apply the CESS and not the EBSS to Northern Territory electricity distributor, Power and Water in its 2019–24 distribution determination. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/power-and-water-corporation-determination-2019-24/draft-decision>.

40 AER, *Explanatory statement – Efficiency benefit sharing scheme*, November 2013, pp. 25–26. <https://www.aer.gov.au/system/files/AERexplanatorystatement-efficiencybenefitsharingschemeNovember2013.docx>.

41 AER, Capital expenditure sharing scheme, November 2013.

and efficiency losses by calculating the difference between forecast and actual capex. It shares these gains or losses between TNSPs and network users.

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 the TNSP's share of the underspend or overspend
- CESS payments are calculated taking into account the financing benefit or cost to the TNSP of the underspend or overspend.⁴² Further adjustments can also be made to account for deferral of capex and ex post exclusions of capex from the RAB; and
- CESS payments are added or subtracted to the TNSP's regulated revenue as a separate building block in the next regulatory control period.

Under the CESS, a TNSP retains 30 per cent of an underspend or overspend, while consumers retain the other 70 per cent. This means for every one dollar saving in capex, the TNSP keeps 30 cents while consumers gain 70 cents.

4.1 Proposed approach

We propose to apply the CESS as set out in our capex incentives guideline to AusNet Services in its 2022–27 regulatory control period.⁴³

In deciding whether to apply the CESS to a TNSP, including the nature and details of the applied CESS, we must:⁴⁴

- make that decision in a manner that contributes to the capex incentive objective;⁴⁵ and
- consider the CESS principles,⁴⁶ capex objectives,⁴⁷ other incentive schemes, and (where relevant) the opex objectives, as they apply to the particular TNSP, and the circumstances of the TNSP.

Broadly, the capex incentive objective is to ensure that only capex that meets the capex criteria enters the RAB (where the RAB is used to set prices). Consumers therefore only fund capex that is efficient and prudent.

42 We calculate benefits as the benefits to the TNSP of financing the underspend since the amount of the underspend can be put to some other income generating use during the period. Losses are similarly calculated as the financing cost to the TNSP of the overspend.

43 AER, Capital expenditure incentive guideline for electricity network service providers, November 2013, pp. 5–9.

44 NER, cl. 6A.6.5A.

45 NER, cll. 6A.5A(a) and 6A.6.7(c)(1)-(3).

46 NER, cl. 6A.6.5A(c).

47 NER, cl. 6A.6.7(a).

4.2 Reasons for proposed approach

We propose the CESS continues to apply to AusNet Services in the 2022–27 regulatory control period. We consider this will contribute to the capex incentive objective.⁴⁸

In developing the CESS we took into account the capex incentive objective, capex criteria, capex objectives and the CESS principles. The CESS is designed to work alongside other incentive schemes that apply to TNSPs including the EBSS and STPIS.

If a TNSP spends less than its approved forecast capex during a regulatory period, that TNSP will benefit within that regulatory control period. At the end of the regulatory control period, the TNSP's RAB will be updated to include new capex. The RAB will include a lower capex amount than would be the case if the TNSP had spent the full forecast capex amount. This is where any sharing of capex underspends (or overspends) with consumers occurs. Thus consumers will also benefit from a capex underspend but this will occur at the end of the regulatory control period as the result of lower future prices.

As the end of the regulatory control period approaches, the time available for the TNSP to retain any savings gets shorter. The earlier in the regulatory control period a TNSP incurs an underspend, the greater is its reward. Without a CESS the TNSP may choose to spend earlier on capex, spend less on capex (at the expense of service quality), or displace opex with capex. The TNSP may make these choices when it is not efficient to do so. The CESS maintains the TNSP's incentive to spend less than its forecast capex as the TNSP approaches the end of its regulatory period.

The CESS means the TNSP faces the same reward and penalty for capex underspends or overspends in every year of the regulatory control period. The CESS provides TNSPs with an ex ante incentive to spend only efficient capex. TNSPs that make efficiency gains will be rewarded through the CESS. Conversely, TNSPs that make efficiency losses will be penalised through the CESS. In this way, TNSPs will be more likely to incur only efficient capex when subject to a CESS, increasing the likelihood that capex included in the TNSP's RAB reflects the capex criteria. Specifically, if a TNSP is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent TNSP.

When the CESS, EBSS and STPIS apply to a TNSP the incentives for improvements in opex, capex and service outcomes are balanced. This encourages businesses to make efficient decisions concerning when and what type of expenditure to incur. Businesses are incentivised to efficiently balance expenditure reductions against service quality and reliability.

⁴⁸ NER, cl. 6A.5A(a) and 6A.6.7(c).

5 Small-scale incentive scheme

The NER provide that we may develop small-scale incentive schemes.⁴⁹ The AER is currently considering whether to make an electricity distribution small scale incentive scheme for customer service, referred to as the CSIS. The scheme would reward DNSPs for improving their customer service, or penalise them if service deteriorates. We consider that this could improve the incentives available for DNSPs to recognise the value of customer service.

The relationship between TNSPs and their customers may be different to the relationship DNSPs have with their customers. As such, the development of a transmission CSIS warrants its own, separate consultation. The impetus for the development of our distribution CSIS was a detailed incentive design proposed by AusNet Services distribution. This incentive design was developed after a lengthy consultation with AusNet Services' distribution customers. AusNet Services transmission has not yet proposed a detailed incentive design developed in conjunction with its customers. As such, we do not propose to apply a small-scale incentive scheme to AusNet Services' transmission business.

6 Demand management incentive scheme/Demand management incentive allowance mechanism

On 1 March 2019, Energy Networks Australia (ENA) submitted a rule change request proposing amendments to the NER that would require the AER to develop a DMIS and DMIAM to apply to transmission network service providers.⁵⁰

On 5 December 2019, the AEMC published its rule determination to apply the DMIAM, and not the DMIS, to transmission network service providers.⁵¹

Introducing a DMIAM for transmission is expected to encourage transmission businesses to expand and share their knowledge and understanding of innovative demand management projects that may reduce long term network costs and, consequently, lower prices for consumers. The AEMC was not satisfied that the benefits of applying the DMIS to transmission businesses would outweigh the upfront costs to consumers.⁵²

The AER must develop and publish, by 31 March 2021, the first demand management innovation allowance mechanism required under new clause 6A.7.6.⁵³

49 NER, cl. 6A.7.5.

50 AEMC, Demand management incentive scheme and innovation allowance for TNSPs, Rule determination, 5 December 2019.

51 AEMC, Demand management incentive scheme and innovation allowance for TNSPs, Rule determination, 5 December 2019.

52 AEMC, Demand management incentive scheme and innovation allowance for TNSPs, Rule determination, 5 December 2019.

53 AEMC, Demand management incentive scheme and innovation allowance for TNSPs, Rule determination, 5 December 2019, NER cl. 11.[118].2.

The development of a DMIAM guideline will involve a process of consultation with our stakeholders.⁵⁴ We will consider applying the DMIAM to AusNet Services for the 2022–27 regulatory control period in our draft determination, expected in July 2021.

7 Expenditure forecast assessment guideline

The expenditure forecast assessment guideline (EFA guideline) sets out our expenditure forecast assessment approach as developed and consulted upon during the Better Regulation program.⁵⁵ It outlines the assessment techniques we will use to assess a transmission business's proposed expenditure forecasts, and the information we require from the business. This section sets out our intention to apply the EFA guideline to AusNet Services for the 2022–27 regulatory control period.

The EFA guideline uses a nationally consistent reporting framework that allows us to compare the relative efficiencies of transmission businesses and decide on efficient expenditure forecasts. The NER requires AusNet Services to advise us of the methodology they propose to use to prepare their forecasts by 31 March 2020.⁵⁶

In the final F&A we must set out our proposed approach to application of the guideline.⁵⁷ This will provide AusNet Services with clarity regarding the information they should include in their revenue proposal. This contributes to an open and transparent process and makes our assessment of expenditure forecasts more predictable.

The EFA guideline contains a suite of assessment/analytical tools and techniques to assist our review of the expenditure forecasts that transmission businesses include in their regulatory proposals. We intend to have regard to the assessment tools set out in the guideline. The tool kit includes:

- models for assessing proposed replacement and augmentation capex
- benchmarking (including broad economic techniques and more specific analysis of expenditure categories)
- methodology, governance and policy reviews
- predictive modelling and trend analysis
- cost benefit analysis and detailed project reviews.⁵⁸

We exercise judgement to determine the extent to which we use a particular technique to assess a regulatory proposal. We use the techniques we consider appropriate depending on the specific circumstances of the determination. The guideline is flexible and recognises that

54 The AER is required to follow the transmission consultation procedures in making, developing or amending guidelines, models or schemes or in reviewing methodologies. These procedures are set out in Part H of Chapter 6A of the NER, cl. 6A.20.

55 We were required to develop the EFA guideline under clauses 6.4.5 and 11.53.4 of the NER. We published the guideline on 29 November 2013. It can be located at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/expenditure-forecast-assessment-guideline-2013>.

56 NER, cl. 6A.10.1B.

57 NER, cl. 6A.10.1A(b)(5).

58 AER, *Explanatory statement: Expenditure assessment guideline for electricity transmission and distribution*, 29 November 2013.

we may employ a range of different estimating techniques to assess an expenditure forecast. As such, some customisation of the data requirements contained in the guideline might be required. While we do not anticipate any such requirements at present, any data customisation issues would be addressed through the RIN that we will issue to AusNet Services for the next regulatory control period.

8 Depreciation

As part of the roll forward methodology, when the RAB is updated from forecast capex to actual capex at the end of a regulatory control period, it is also adjusted for depreciation.

This section sets out our proposed approach to calculating depreciation when the RAB is rolled forward to the commencement of the 2027–2032 regulatory control period.

The depreciation we use to roll forward the RAB can be based on either:

- actual capex incurred during the regulatory control period (actual depreciation). We roll forward the RAB based on actual capex less the depreciation on the actual capex incurred by the TNSP; or
- the capex allowance forecast at the start of the regulatory control period (forecast depreciation). We roll forward the RAB based on actual capex less the depreciation on the forecast capex approved for the regulatory control period.

The choice of depreciation approach is one part of the overall capex incentive framework.

Consumers benefit from improved efficiencies through lower regulated prices. Where a CESS is applied, using forecast depreciation maintains the incentives for TNSPs to pursue capex efficiencies, whereas using actual depreciation would increase these incentives. There is more information on depreciation as part of the overall capex incentive framework in our capex incentives guideline.⁵⁹ In summary:

- If there is a capex overspend, actual depreciation will be higher than forecast depreciation. This means that the RAB will increase by a lesser amount than if forecast depreciation were used. So, the TNSP will earn less revenue into the future (i.e. it will bear more of the cost of the overspend into the future) than if forecast depreciation had been used to roll forward the RAB
- If there is a capex underspend, actual depreciation will be lower than forecast depreciation. This means that the RAB will increase by a greater amount than if forecast depreciation were used. Hence, the TNSP will earn greater revenue into the future (i.e. it will retain more of the benefit of an underspend into the future) than if forecast depreciation had been used to roll forward the RAB.

The incentive from using actual depreciation to roll forward the RAB also varies with the life of the asset. Using actual depreciation will provide a stronger incentive for the TNSP to underspend capex on shorter lived assets compared to longer lived assets as this will lead to a relatively larger increase in the RAB. Use of forecast depreciation, on the other hand, leads to the same incentive for capex regardless of asset lives. This is because using forecast

⁵⁹ AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 10–11.

depreciation does not affect the TNSP's incentive on capex as the TNSP does not lose the full cost of any overspend and is not able to keep all the benefits of any underspend. To this end, using forecast depreciation means the capex incentive is focussed on the return on capital.

8.1 Proposed approach

We must set out our proposed approach as to whether we will use actual or forecast depreciation to establish a TNSP's RAB at the commencement of the following regulatory control period.⁶⁰ Our decision must be consistent with the capex incentive objective.⁶¹ We must have regard to:⁶²

- 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.

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 TNSP'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 will consider:

- 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.

8.2 Reasons for proposed approach

We propose to use the forecast depreciation approach to establish the RAB at the commencement of the 2027–2032 regulatory control period for AusNet Services.

The opening RAB at the commencement of the 2022–27 regulatory control period will be established using forecast depreciation, as stated in our previous determination that applies to AusNet Services for the 2017–22 regulatory control period. The use of forecast depreciation to establish the opening RAB for the commencement of the 2027–32 regulatory control period therefore maintains the current approach. AusNet Services is currently subject

60 NER, cll S6A.2.2B and 6A.5A(b)(3).

61 NER, cl 6A.5A(b)(3).

62 NER, cl S6A.2.2B.

to version 1 of the CESS. We propose to continue to apply version 1 of the CESS in the 2022–27 regulatory control period as discussed in section 4 above.

We consider the incentive provided by the application of the CESS in combination with the use of forecast depreciation and our other ex post capex measures should be sufficient to achieve the capex incentive objective.⁶³ This approach, in combination with the CESS, will provide a 30 per cent reward for capex underspends and 30 per cent penalty for capex overspends. This is consistent for all asset classes. In developing our capex incentives guideline, we considered this to be a sufficient incentive for a TNSP to achieve efficiency gains over the regulatory control period in most circumstances.

⁶³ AER, Capital expenditure incentive guideline for electricity network service providers, November 2013, pp. 13–19 and pp. 20–21.