DRAFT DECISION

Jemena
Distribution Determination
2021 to 2026

Attachment 9
Capital expenditure sharing scheme

September 2020

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Jemena for the 2021–26 regulatory control period. 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

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 incentive scheme and demand management innovation allowance mechanism

Attachment 12 – Not applicable to this distributor

Attachment 13 – Classification of services

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Attachment 17 – Negotiated services framework and criteria

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Attachment 19 – Tariff structure statement

Attachment A – Victorian f-factor incentive scheme

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9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers whose capital expenditures (capex) becomes more efficient and financial penalties for those that become less efficient. Customers benefit from improved efficiency through lower regulated prices.

The CESS approximates efficiency gains and efficiency losses by calculating the difference between forecast and actual capex. It shares these gains or losses between service providers and consumers.

The CESS works as follows:

- We calculate the cumulative efficiency gains or losses for the current regulatory control period in net present value terms.
- We apply the sharing ratio of 30 per cent to the cumulative underspend or overspend to work out what the service provider's share of the underspend or overspend should be.
- We calculate the CESS payments taking into account the financing benefit or cost to the service provider of the underspend or overspend.[1] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB).[2]
- 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.

This attachment sets out our draft decision for the determination of the revenue impacts as a result of the CESS applying from the 2016–20 regulatory control period and the application of the CESS for Jemena in the 2021–26 regulatory control period.

9.1 Draft decision

Revenue impact for the 2021–26 regulatory control period

Our draft decision is to apply a CESS revenue increment amount of $38.3 million ($2020–21) to be paid across the 2021–26 regulatory control period, from the application of the CESS in the 2016–20 regulatory control period.

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1 We calculate benefits as the benefits to the service provider of financing the underspend 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 overspend.

2 The capex incentive guideline outlines how we may exclude capex from the RAB and adjust the CESS payment for deferrals. AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers,* November 2013, pp. 9–13.

Consistent with our proposed interim measures,[3] the CESS will not apply over the 6 months between 1 January 2021 and 30 June 2021. As such, an increase (decrease) from the trended 6-months allowance is not included in our CESS revenue increment calculation.

The difference between our calculations and Jemena's proposal is due to our adoption of:

- more recent inflation figures
- an updated weighted average cost of capital (WACC) input information
- changes to actual capex for consistency with the roll forward model (RFM) discussed in Attachment 2. The initial proposal included an estimate of 2019 capex. We have updated this to reflect actual 2019 capex.

Given the timing of our draft decision, we will update our calculations in our final decision for updated inflation data, if available.

Application of scheme in the 2021–26 regulatory control period

We will apply the CESS, as set out in the capital expenditure incentives guideline to Jemena in the 2021–26 regulatory control period.[4] This is consistent with the proposed approach we set out in our framework and approach (F&A) paper.[5]

The reasons for adopting a CESS is set out in our capital expenditure incentive guideline.[6]

9.2 Jemena's proposal

Jemena initially proposed a CESS payment of $25.6 million ($2020–21) for the 2021–26 regulatory control period. This reflected an expected underspend of 20.8 per cent compared to the AER's regulatory allowance.

Jemena noted the primary reasons for its underspend are:

- lower than forecast activity volumes and the achievement of delivery and scope efficiencies for replacement expenditure (repex)
- lower than expected demand growth, reducing the need for demand-driven augmentation expenditure (augex) for the network
- recurrent ICT expenditure being lower than forecast due to the purchase of some hardware as part of larger non-recurrent upgrades.[7]

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3 AER, *Correspondence to Jemena - Victorian EDPR and the six-month extension*, 17 August 2020.

4 NER, cl 6.12.1(9); AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9.

5 AER, *Final framework and approach AusNet Services, CitiPower, Jemena, Powercor and United Energy Regulatory control period commencing 1 January 2021*, January 2019, pp. 84–85.

6 AER, *Better regulation explanatory statement capital expenditure incentive guideline for electricity network service providers*, November 2013.

After a subsequent information request, Jemena found an error in its calculations and re-forecast a new CESS payment of $30.2 million. Jemena considered its underspend should not give rise to an adjustment to the CESS as its deferrals have not led to a materially higher capex forecast in the 2021–26 regulatory control period.

9.3 Assessment approach

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

- whether or not to apply the CESS to Jemena in the 2021–26 regulatory control period and how any applicable scheme will apply;[8] and
- the revenue effects on Jemena arising from applying the CESS in the 2016–20 regulatory control period.

Our assessment approach is set out below.

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2021–26 regulatory control period arising from the application of the CESS during the 2016–20 regulatory control period.[9] Next, we assess whether any adjustments should be made to the CESS for deferred capex in accordance with the capital expenditure incentive guideline. Finally, we make adjustments based on updated modelling inputs.

The NER requires that our draft decision includes a determination on how any applicable CESS should apply to Jemena.[10] In deciding whether to apply a CESS to Jemena for the 2021–26 regulatory control period, and the nature of the details of the scheme, we must:

- make that decision in a manner that contributes to the capex incentive objective[11]
- take into account the CESS principles,[12] the capex objectives and if relevant the operating expenditure (opex) objectives,[13] the interaction with other incentive schemes[14] as they apply to the particular service provider, and the circumstances of the service provider.[15]

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 Jemena, *2021–26 Electricity Distribution Price Review Regulatory Proposal Attachment 05-02*, pp. 1-12.

8 NER, cl. 6.12.1(9).

9 NER, cl. 6.4.3(a).

10 NER, cl. 6.12.1(9).

11 NER, cl. 6.5.8A(e)(3); the capex incentive objective is set out in cl. 6.4A(a) of the NER.

12 NER, cl. 6.5.8A(e)(4)(i); the CESS principles are set out in cl.6.5.8A(c)

13 NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(2); the capex objectives are set out in cl. 6.5.7(a); the opex objectives are set out in cl. 6.5.6(a).

14 NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(1).

15 NER, cl. 6.5.8A(e)(4)(ii)

9.4 Reasons for draft decision

9.4.1 CESS revenue increments from the 2016–20 regulatory control period

We have adjusted for modelling inputs such as CPI, reported capex and the WACC to reflect more up to date information. We will also update these inputs, where relevant, in our final decision.

We have also assessed whether an adjustment for deferred capex is required. In this instance, we have not adjusted Jemena's CESS revenue increment to account for material deferrals as we do not consider its deferrals have materially increased our draft decision substitute of capex.

We note that stakeholders have raised concerns in their submissions regarding the scheme's transparency, and the incentives for distributors to overestimate capex.

For example, Origin Energy,[16] EnergyAustralia,[17] ECA,[18] and the AER's Consumer Challenge Panel, sub-panel 17 (CCP17)[19] all commented on the lack of clarity as to whether under-expenditure during the current period was due to genuine efficiency gains, or due to a combination of happenstance, poor/over-forecasting or the inability to obtain project approvals. The stakeholders posit that the CESS is potentially not rewarding efficient behaviour but rather gaps between forecast effort and actual delivery.[20]

We consider underspending in and of itself is not necessarily a concern. The CESS can (and was intended to) reveal the efficient level of capex.

The CESS also helps consumers benefit through lower prices, relative to the prices they would have faced had Jemena spent its full capex allowance. Both distributor and users receive a share of this benefit through incentive payments.

On balance, we are satisfied by Jemena's explanations for its historical capex. We consider that stakeholders' concerns are less applicable to Jemena because its response to our information request on underspending,[21] its explanations of historical capex underspending in its proposal[22] and self-corrections to its CESS model to account for an administrative error, and $8.5 million of deferrals has been sufficiently transparent.

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16 Origin Energy, *Submission to Victorian electricity distributor's regulatory proposals,* June 2020, p. 6.

17 EnergyAustralia, *Victorian Electricity Distribution Determinations 2021–26 – regulatory proposals – 31 January 2020*, June 2020, p. 8.

18 ECA, *Victorian Electricity Distributors Regulatory Proposals 2021–26,* June 2020, Attachment 1, p. 32.

19 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 65.

20 ECA, *Victorian Electricity Distributors Regulatory Proposals 2021–26,* June 2020, pp. 16-17.

21 Jemena, *Information request 12 – Q1-3*, 11 May 2020, pp. 1-6.

22 Jemena, *2021–26 Electricity Distribution Price Review Regulatory Proposal - Attachment 05-02*, January 2020.

Because we consider that Jemena has not met all three limbs of the adjustment for deferrals mechanism, we do not make the adjustment to its CESS payments based on deferrals.

However, we recognise the serious concerns that stakeholders have on the operation of the CESS. For example, the CCP17 submitted[23] that distributors are incentivised to overestimate their future network capacity. We note that in the event of overestimating capex, we do not have an explicit adjustment mechanism in the CESS guideline to account for this. The CESS guideline notes that we will address any over forecasting issues as part of our capex assessment.

In this regard, we are currently scoping a broad review of incentive schemes that will look into the concerns raised by the CCP17 and other stakeholders. We also note that our substitute forecast, which largely reflects Jemena's proposed capex with the exception of a COVID-19 adjustment, is not materially higher. This is because forecast is similar to historical capex for the areas where Jemena has identified deferrals or it has any increase in forecast capex is due to other drivers.

According to the capital expenditure incentive guideline, we can adjust the CESS in situations where capex deferrals in the current regulatory control period lead to distributor's materially increasing their capex forecasts. As a result, we must be satisfied that all three of the following criteria are met:[24]

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

In other words, we need to be satisfied that there is material underspend, deferred and reproposed capex to make the adjustment.

More information on our capex assessment is in Attachment 5.

9.4.2 Application of CESS in the 2021–26 regulatory control period

The Victorian Government (DELWP) submitted, as part of our F&A consultation, that the CESS should be not applied for the 2021–26 regulatory control period, or that we

23 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 68.

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

apply the CESS only where we can confidently correct for over-forecasting.[25] DELWP's submission reflected similar concerns by the aforementioned stakeholders.

In our F&A paper, we noted that we would continue to apply the CESS for the 2021–26 regulatory control period. [26] We have maintained this position.

We consider that the CESS is needed to provide Jemena with a continuous incentive to pursue efficiency gains.[27] This approach is consistent with Jemena's proposal. [28] We also note that ex ante measures are the primary means to reveal efficient costs over time. The CESS provides a relatively strong incentive to reveal this expenditure and provides a good indicator of future costs.[29] Given the greater incentive to incur efficient capex, we consider actual capex spent is a key indicator of identifying and over-forecasting bias. This is reflected in both our top down and bottom-up category specific analysis which we discuss in further detail in attachment 5. We consider our draft decision addresses over-forecasting of capex and we consider future capex outcomes under a CESS are an important source of information to assist with capex assessments in future regulatory control periods.

Therefore, we will apply the CESS to Jemena in the 2021–26 regulatory control period.

However, as noted above, we consider the operation of the CESS can be improved through a future review of CESS guideline as part of the broader incentive review, currently being scoped.

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25 DELWP, *Submission on Victorian Preliminary Framework and Approach 2021–25,* 29 October 2019, p. 2.

26 AER, *Final framework and approach AusNet Services, CitiPower, Jemena, Powercor and United Energy Regulatory control period commencing 1 January 2021,* January 2019, pp. 83-86.

27 AER, *Final framework and approach AusNet Services, CitiPower, Jemena, Powercor and United Energy Regulatory control period commencing 1 January 2021,* January 2019, pp. 83-86.

28 Jemena, *Jemena Electriciy Networks 2021–26 Regulatory Proposal - Overview,* January 2020, p. 69.

29 AER, *Better regulation explanatory statement capital expenditure incentive guideline for electricity network service providers*, November 2013, p. 13, p. 50.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP 17	Consumer Challenge Panel, sub-panel 17
CESS	capital expenditure sharing scheme
CPI	consumer price index
distributor	distribution network service provider
ECA	Energy Consumers Australia
F&A	framework and approach
NER or the rules	National Electricity Rules
opex	operating expenditure
RAB	regulatory asset base
repex	replacement expenditure
RFM	roll forward model
WACC	weighted average cost of capital