DRAFT DECISION

United Energy Distribution Determination 2021 to 2026

Attachment 9 Capital expenditure sharing scheme

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AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to United Energy 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 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 United Energy 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 $49.7 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 United Energy'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 2021–26 regulatory control period

We will apply the CESS, as set out in the capital expenditure incentives guideline to CitiPower 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 United Energy's proposal

United Energy proposed a CESS payment of $42.6 million ($2020–21) for the 2021–26 regulatory control period. This reflects an expected underspend of 20.4 per cent compared to the AER's regulatory allowance.

United Energy noted the primary reasons for its underspend are:

- deferral of augmentation expenditure (augex) due to a successful demand response program, see Attachment 11 for more details
- for categories of replacement expenditure (repex), lower than expected volumes of replacement for underground cables, lower unit rates for overhead conductors and

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3 AER, *Correspondence to United Energy - 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.

a new risk management model for pole top structures which reduced cross-arm incidents.[7]

United Energy 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 United Energy in the 2021–26 regulatory control period and how any applicable scheme will apply;[8] and
- the revenue effects on United Energy 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 United Energy.[10] In deciding whether to apply a CESS to United Energy 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]

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7 United Energy, *Information request 50 – Q1-2*, 20 July 2020, pp. 1-2.
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).

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.

9.4 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 United Energy'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 United Energy spent its full capex allowance. Both distributor and users receive a share of this benefit through incentive payments.

However, despite us not adjusting United Energy's CESS for capex, we recognise the serious concerns that stakeholders have on the operation of the CESS. For example,

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16 Origin Energy, *Submission to Victorian electricity distributors 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.

CCP17 submitted[21] that distributors are incentivised to overestimate their future network capacity. In this regard, we are currently scoping a broad review of incentive schemes that will look into the concerns raised by CCP17 and other stakeholders.

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.

Consistent with the capital expenditure incentive guideline, we can adjust the CESS in situations where material capex deferrals in the current regulatory period lead to a material increase in the total approved capex. As a result, we must be satisfied that all three of the following criteria are met:[22]

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.

9.4.2 Materiality assessment of adjustment mechanism

We are not satisfied that there is a material underspend, deferred and reproposed capex to adjust United Energy's proposed CESS payment.

While we consider certain projects in determining our substitute estimate, we do not determine which programs or projects a distributor should or should not undertake. Once we set a forecast, it is up to United Energy to prioritise its capex program within the total capex forecast given its circumstances, which are subject to change over the course of the regulatory control period. However, in the circumstances of a significant underspend compared to the final decision forecast, we have had regard to United Energy's performance against its 2016–20 forecast as key indicators to understand whether there is a material deferral.

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

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

Assessment of underspend

United Energy identified $199.8 million ($2020–21) in capex savings in the current regulatory control period.[23] United Energy's CESS applicable allowance for the current regulatory control period is $1023.2 million ($2020–21). We are satisfied that an underspend of $199.8 million is material relative to United Energy's allowance.

The purpose of assessing whether the underspend is material is to ensure that a network has the flexibility to respond to changing circumstances within a regulatory control period. This means that a network retains an incentive to efficiently defer some projects and to bring other projects forward. This ensures that we do not only examine the projects that United Energy has deferred without also considering whether United Energy has brought forward efficient capex.

We are satisfied that in this circumstance, given the size of the underspend relative to allowance, that United Energy has not rebalanced its capex. Rather, its underspend is a due to mixture of efficiency gains, exemptions from regulatory obligations and deferrals[24] which has resulted in a material underspend.

Assessment of deferral

We note the CESS guideline does not set a materiality threshold for an adjustment. To assess whether both deferrals and reproposed capex are material, we have considered materiality both in terms of quantity and the type of deferral.

United Energy's proposal identified $10.8 million in deferred and reproposed capex for repex.[25] In response to our information request on all deferrals, including those beyond the 2021–26 regulatory control period, United Energy did not identify any additional capex.[26]

Based on the limited information provided by United Energy and our total capex forecast approach which does not necessarily identify all approved projects in the current regulatory control period, it is unclear whether there has been a material deferral.

We note that United Energy's underspend is a mixture of deferred augex due to successful demand management, lower than forecast delivery of repex, and more efficient project delivery (e.g. lower unit costs, use of a new risk management model).[27]

However, we consider deferral to include capex that at some point is required to be undertaken. Deferral can be beyond the 2021–26 regulatory control period. We

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23 United Energy, *UE APP02 - What we have delivered*, January 2020, p. 5.
24 United Energy, *Information request 56 – Q1-3*, 20 July 2020.
25 United Energy, *Information request 10 – Q1-3*, 27 April 2020, p. 1.
26 United Energy, *Information request 10 – Q1-3*, 27 April 2020, p. 1.
27 United Energy, *Information request 50 – Q1-2*, 20 July 2020, pp. 1-2.

acknowledge that capex requirements may change during a regulatory control period and some capex may no longer be required.

When we examined United Energy's repex volumes for certain asset categories, United Energy's delivery was well below the provided allowance for the current period. Therefore, we consider lower than forecast delivery to be an important driver of itsunderspend.

Although United Energy attributes some of this underspend to efficiency improvement and efficient deferral, we are satisfied that due to the type of capex, reduced volumes are indicative of capex deferrals. Based on this, we are satisfied that United Energy's deferrals are material. As United Energy has not attributed all of its capex underspend to either efficiency improvements or reduced levels of regulatory obligations.

We note that although it is possible that there are additional capex deferrals, we have found no evidence of deferred capex in other categories based on the information provided by United Energy.

Assessment of reproposed capex

To adjust the CESS we must also be satisfied that the reproposed capex we have included in our forecast capex is material. We consider in this circumstance, we conclude that the reproposed capex included in our capex forecast is not material.

This is because we have reduced United Energy's forecast repex and augex by 28 per cent and 30 per cent respectively. Our assessment of these two categories includes trend analysis, demand forecasts and project specific analysis. We are satisfied that our assessment methodologies has mitigated the issue of including reproposed capex in our substitute capex forecast.

More information on our capex assessment is discussed in Attachment 5.

9.4.3 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 apply the CESS only where we can confidently correct for over-forecasting.[28] 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. [29] We have maintained this position.

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

[29] 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.

We consider that the CESS is needed to provide United Energy with a continuous incentive to pursue efficiency gains.[30] This approach is consistent with United Energy's proposal. [31] 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.[32] 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 United Energy in the 2021–26 regulatory control period.

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

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30 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.

31 United Energy, *Regulatory Proposal 2021–26*, January 2020, p. 174.

32 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
CCP17	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	National Electricity Rules
opex	operating expenditure
repex	replacement expenditure
RFM	roll forward model
WACC	weighted average cost of capital