Draft decision

Directlink transmission determination

2015-16 to 2019-20

Attachment 10: Capital expenditure sharing scheme

November 2014

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Note

This attachment forms part of the AER's draft decision on Directlink's revenue proposal 2015–20. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – maximum allowed revenue

Attachment 2 – regulatory asset base

Attachment 3 – rate of return

Attachment 4 – 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 – pricing methodology and negotiated services

Attachment 13 – pass through events

Contents

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
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria

Shortened form	Extended form
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
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

10 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers whose capex becomes more efficient and financial penalties for those that become less efficient. Consumers benefit from improved efficiency through lower regulated prices. This attachment sets out how we will apply the CESS to Directlink in the 2015–20 regulatory control period.

As part of the Better Regulation program we consulted on and published version 1 of the capital expenditure incentive guideline (capex incentive guideline), which sets out the CESS.[1] 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 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 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 underspends or overspends.[2] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the RAB.[3]
- 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.

Under the CESS a service provider retains 30 per cent of an underspend or overspend, while consumers retain 70 per cent of the underspend on overspend. This means that for a one dollar saving in capex the service provider keeps 30 cents of the benefit while consumers keep 70 cents of the benefit.

10.1 Draft decision

We will apply version 1 of the CESS as set out in the capital expenditure incentive guideline to Directlink in the 2015–20 regulatory control period.[4]

10.2 Directlink's proposal

Directlink proposed that we apply the CESS as set out in the capex incentives guideline.[5]

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1 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9. (AER, *Capex incentive guideline*, November 2013).

2 We calculate benefits as the benefits to the service provider 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 service provider of the overspend.

3 The capex incentive guideline outlines how we may exclude capex from the RAB. AER, *Capex incentive guideline*, November 2013, pp. 13–20.

4 AER, *Capex incentive guideline*, November 2013, pp. 5–9.

5 Directlink, *Directlink Joint Venture, Directlink Revenue Proposal, Effective July 2015 to June 2020*, May 2014, p. 93.

10.3 AER's assessment approach

In deciding whether to apply a CESS to a network service provider, and the nature and details of any CESS to apply to a service provider, we must:[6]

- make that decision in a manner that contributes to the capex incentive objective[7]
- take into account the CESS principles,[8] the capex objectives,[9] other incentive schemes, and, where relevant the opex objectives, as they apply to the particular service provider, and the circumstances of the service provider.

Broadly, the capex incentive objective is to ensure that only capex that meets the capex criteria enters the RAB used to set prices. Therefore, consumers only fund capex that is efficient and prudent.

10.3.1 Interrelationships

The CESS relates to the incentives Directlink faces to incur efficient opex, conduct demand management, and maintain or improve service levels.[10] We aim to incentivise network service providers to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality. We discuss these interrelationships where relevant as part of our reasons below and in attachment 6 (capex).

10.4 Reasons for draft decision

We are satisfied with Directlink's proposal to apply the CESS as set out in the capex incentives guideline.

For capex, the sharing of underspends and overspends happens at the end of each regulatory control period when we update a network service provider's RAB to include new capex. If a network service provider spends less than its approved forecast during a period, it will benefit within that period. Consumers benefit at the end of that period when the RAB is updated to include less capex compared to if the service provider had spent the full amount of the capex forecast.

Without a CESS the incentive for a service provider to spend less than its forecast capex declines throughout the period. This is because as the end of the regulatory control period approaches, the time available for the service provider to retain any savings gets shorter. So the earlier a service provider incurs a capex underspend in the regulatory period, the greater its reward will be. As a result, the incentive for a service provider to spend less than its capex forecast declines throughout the period. Because of this, a service provider may choose to spend capex earlier than necessary, spend on capex when it may otherwise have spent on opex, or spend less on capex at the expense of service quality—even if it may not be efficient to do so.

In developing the CESS we took into account the capex incentive objective, capex criteria, capex objectives, and the CESS principles. With the CESS, Directlink will face the same reward and penalty in each year of a regulatory control period for capex underspends or overspends. The CESS will provide Directlink with an ex ante incentive to spend only efficient capex. Directlink will be rewarded

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6 NER, clause 6A.6.5A.
7 NER, clause 6A.5A(a); the capex criteria are set out in clause 6A.6.7(c)(1)-(3) of the NER.
8 NER, clause 6A.6.5A(c).
9 NER, clause 6A.6.7(a).
10 Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, and the service target performance incentive scheme (STPIS) for service levels.

through the CESS for making capex efficiency gains. Conversely, Directlink will be penalised through the CESS for making capex efficiency losses. In this way, Directlink will be more likely to incur only efficient capex when subject to a CESS, so any capex included in the RAB is more likely to reflect the capex criteria. In particular, if Directlink is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent service provider.

When the CESS, EBSS and STPIS apply to Directlink then incentives for opex, capex and service are relatively balanced. This encourages Directlink to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality.