

Draft decision

TasNetworks transmission determination

2015-16 to 2018-19

Attachment 10: Capital expenditure sharing scheme (CESS)

November 2014

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1. AER reference: 53445
2. Note

This attachment forms part of the AER's draft decision on the transmission determination for TasNetworks' 2015–19 regulatory control period. It should be read in conjunction 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

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Attachment 12 – pricing methodology

Attachment 13 – pass through events

Attachment 14 – negotiated services

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1. Shortened forms

| 1. Shortened form | 1. Extended form |
| --- | --- |
| 1. AARR | 1. aggregate annual revenue requirement |
| 1. AASB | 1. Australian Accounting Standards Board |
| 1. ABS | 1. Australian Bureau of Statistics |
| 1. AEMC | 1. Australian Energy Market Commission |
| 1. AEMO | 1. Australian Energy Market Operator |
| 1. AER | 1. Australian Energy Regulator |
| 1. ARPC | 1. Australian Reinsurance Pool Corporation |
| 1. ASRR | 1. aggregate service revenue requirement |
| 1. AR | 1. allowed revenue |
| 1. ASX | 1. Australian Stock Exchange |
| 1. ATO | 1. Australian Tax Office |
| 1. augex | 1. augmentation expenditure |
| 1. Benchmarking report | 1. AER, Electricity transmission network service providers annual benchmarking report, November 2014 |
| 1. capex | 1. capital expenditure |
| 1. capex incentive guideline | 1. AER, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013 |
| 1. CCP | 1. Consumer Challenge Panel |
| 1. CEG | 1. Competition Economics Group |
| 1. CESS | 1. capital expenditure sharing scheme |
| 1. CPI | 1. consumer price index |
| 1. DAE | 1. Deloitte Access Economic |
| 1. DRP | 1. debt risk premium |
| 1. EBA | 1. enterprise bargaining agreement |
| 1. EBSS | 1. efficiency benefit sharing scheme |
| 1. EGWWS | 1. electricity, gas, water and waste services |
| 1. EMCa | 1. Energy Market Consulting associates |
| 1. EMRF | 1. Energy Market Reform Forum |
| 1. ERA | 1. Economic Regulation Authority of Western Australia |
| 1. ERP | 1. equity risk premium |
| 1. EUAA | 1. Energy Users Association of Australia |
| 1. Guideline | 1. AER, Expenditure forecast assessment guideline for electricity transmission, November 2013 |
| 1. ICT | 1. information and communications technology |
| 1. JGN | 1. Jemena Gas Networks |
| 1. LME | 1. London Metals Exchange |
| 1. MAR | 1. maximum allowed revenue |
| 1. MEU | 1. Major Energy Users |
| 1. MJA | 1. Marsden Jacob Associates |
| 1. MRP | 1. market risk premium |
| 1. MTFP | 1. multilateral total factor productivity |
| 1. MW | 1. megawatts |
| 1. NEFR | 1. national electricity forecasting report |
| 1. NEL | 1. national electricity law |
| 1. NEM | 1. national electricity market |
| 1. NEO | 1. national electricity objective |
| 1. NER | 1. national electricity rules |
| 1. NERA | 1. NERA Economic Consulting |
| 1. NPV | 1. net present value |
| 1. NSP | 1. network service provider |
| 1. NTNDP | 1. National Transmission Network Development Plan |
| 1. NTSC | 1. negotiated transmission service criteria |
| 1. NSW | 1. New South Wales |
| 1. opex | 1. operating expenditure |
| 1. OTTER | 1. Office of the Tasmanian Economic Regulator |
| 1. PFP | 1. partial factor productivity |
| 1. POE | 1. probability of exceedance |
| 1. PPI | 1. partial performance indicators |
| 1. PPI | 1. producer price index |
| 1. PTRM | 1. post-tax revenue model |
| 1. QCA | 1. Queensland Competition Authority |
| 1. RAB | 1. regulatory asset base |
| 1. RBA | 1. Reserve Bank of Australia |
| 1. repex | 1. replacement expenditure |
| 1. RFM | 1. roll forward model |
| 1. RIN | 1. regulatory information notice |
| 1. RPP | 1. revenue and pricing principles |
| 1. SFG | 1. SFG Consulting |
| 1. SLCAPM | 1. Sharpe-Lintner capital asset pricing model |
| 1. STPIS | 1. service target performance incentive scheme |
| 1. TAB | 1. tax asset base |
| 1. TFP | 1. total factor productivity |
| 1. TNSP | 1. transmission network service provider |
| 1. TSBC | 1. Tasmanian Small Business Council |
| 1. TUoS | 1. transmission use of system |
| 1. version one of the EBSS | 1. AER, Electricity transmission network service providers: Efficiency benefit sharing scheme, September 2007 |
| 1. version two of the EBSS | 1. AER, Efficiency benefit sharing scheme for electricity network service providers, November 2013 |
| 1. WACC | 1. weighted average cost of capital |
| 1. WPI | 1. wage price index |

# Capital expenditure sharing scheme

1. 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 TasNetworks in the 2015­–19 regulatory control period.
2. As part of the Better Regulation program we consulted on and published version 1 of the capex incentive guideline, which sets out the CESS.[[1]](#footnote-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.
3. 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]](#footnote-2) We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the RAB.[[3]](#footnote-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.

1. 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 every dollar saving in capex, the service provider keeps 30 cents of the benefit while consumers keep 70 cents of the benefit.

## Draft decision

1. We will apply version 1 of the CESS as set out in the capital expenditure incentives guideline to TasNetworks in the 2015–19 regulatory control period.[[4]](#footnote-4) The guideline provides for the exclusion from the CESS of capex the service provider incurs in delivering a priority project approved under the network capability component of the Service Target Performance Incentive Scheme (STPIS) for transmission network service providers.[[5]](#footnote-5) This is consistent with the proposed approach we set out in our framework and approach paper.[[6]](#footnote-6)

## TasNetworks' proposal

TasNetworks proposed that we apply the CESS as set out in the capex incentive guideline.[[7]](#footnote-7)

## AER's assessment approach

1. 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:[[8]](#footnote-8)

* make that decision in a manner that contributes to the capex incentive objective[[9]](#footnote-9)
* take into account the CESS principles,[[10]](#footnote-10) the capex objectives,[[11]](#footnote-11) other incentive schemes and, where relevant, the opex objectives as they apply to the particular service provider, and the circumstances of the service provider.

1. 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.

### Interrelationships

1. The CESS relates to the incentives TasNetworks faces to incur efficient opex, conduct demand management, and maintain or improve service levels.[[12]](#footnote-12) 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 of this draft decision (capex).

## Reasons for draft decision

1. We are satisfied with TasNetworks' proposal to apply the CESS as set out in the capex incentive guideline. This includes the exclusion provided for under the CESS of capex the service provider incurs in delivering a priority project approved under the network capability component of the transmission STPIS.
2. 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.
3. 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.
4. In developing the CESS we took into account the capex incentive objective, capex criteria, capex objectives, and the CESS principles. With the CESS, TasNetworks will face the same reward and penalty in each year of a regulatory control period for capex underspends or overspends. The CESS will provide TasNetworks with an ex ante incentive to spend only efficient capex. TasNetworks will be rewarded through the CESS for making capex efficiency gains. Conversely, TasNetworks will be penalised through the CESS for making capex efficiency losses. In this way, TasNetworks 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 TasNetworks is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent service provider.
5. The Energy Users Association of Australia raised the issue of windfall gains under the CESS and the importance of forecasting a prudent and efficient amount of total capex.[[13]](#footnote-13) We addressed each of these issues in our explanatory statements to the capex incentive guideline.[[14]](#footnote-14)
6. When the CESS, EBSS and STPIS apply to TasNetworks, then incentives for opex, capex and service are relatively balanced. This encourages TasNetworks to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality.

1. AER, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013, pp. 5–9. [↑](#footnote-ref-1)
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. [↑](#footnote-ref-2)
3. The capex incentive guideline outlines how we may exclude capex from the RAB: AER, Capex incentive guideline, November 2013, pp. 13–20. [↑](#footnote-ref-3)
4. AER, Capex incentive guideline, November 2013, pp. 5–9. [↑](#footnote-ref-4)
5. AER, Capex incentive guideline, November 2013, p. 6. [↑](#footnote-ref-5)
6. AER, Framework and approach paper, Transend, January 2014, p. 24. [↑](#footnote-ref-6)
7. TasNetworks, Tasmanian Transmission Revenue Proposal, Regulatory control period 1 July 2014–30 June 2019, May 2014, pp. 98–99. [↑](#footnote-ref-7)
8. NER, clause 6A.6.5A. [↑](#footnote-ref-8)
9. NER, clause 6A.5A(a); the capex criteria are set out in clause 6A.6.7(c)(1)-(3) of the NER. [↑](#footnote-ref-9)
10. NER, clause 6A.6.5A(c). [↑](#footnote-ref-10)
11. NER, clause 6A.6.7(a). [↑](#footnote-ref-11)
12. Related schemes are the EBSS for opex and the STPIS for service levels. [↑](#footnote-ref-12)
13. Energy Users Association of Australia, EUAA Submission on Transend’s Revenue Proposal 2014–19, p. 15. [↑](#footnote-ref-13)
14. AER, Explanatory Statement, Draft Capital Expenditure Incentive Guideline for Electricity Network Service Providers, August 2013; AER, Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013. [↑](#footnote-ref-14)