Draft decision

TasNetworks transmission determination

2015-16 to 2018-19

Attachment 10: Capital expenditure sharing scheme (CESS)

November 2014

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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

Attachment 11 – service target performance incentive scheme

Attachment 12 – pricing methodology

Attachment 13 – pass through events

Attachment 14 – negotiated services

Contents

Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AASB	Australian Accounting Standards Board
ABS	Australian Bureau of Statistics
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ARPC	Australian Reinsurance Pool Corporation
ASRR	aggregate service revenue requirement
AR	allowed revenue
ASX	Australian Stock Exchange
ATO	Australian Tax Office
augex	augmentation expenditure
Benchmarking report	AER, *Electricity transmission network service providers annual benchmarking report*, November 2014
capex	capital expenditure
capex incentive guideline	AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013
CCP	Consumer Challenge Panel
CEG	Competition Economics Group
CESS	capital expenditure sharing scheme
CPI	consumer price index
DAE	Deloitte Access Economic

Shortened form	Extended form
DRP	debt risk premium
EBA	enterprise bargaining agreement
EBSS	efficiency benefit sharing scheme
EGWWS	electricity, gas, water and waste services
EMCa	Energy Market Consulting associates
EMRF	Energy Market Reform Forum
ERA	Economic Regulation Authority of Western Australia
ERP	equity risk premium
EUAA	Energy Users Association of Australia
Guideline	AER, *Expenditure forecast assessment guideline for electricity transmission*, November 2013
ICT	information and communications technology
JGN	Jemena Gas Networks
LME	London Metals Exchange
MAR	maximum allowed revenue
MEU	Major Energy Users
MJA	Marsden Jacob Associates
MRP	market risk premium
MTFP	multilateral total factor productivity
MW	megawatts
NEFR	national electricity forecasting report
NEL	national electricity law
NEM	national electricity market

Shortened form	Extended form
NEO	national electricity objective
NER	national electricity rules
NERA	NERA Economic Consulting
NPV	net present value
NSP	network service provider
NTNDP	National Transmission Network Development Plan
NTSC	negotiated transmission service criteria
NSW	New South Wales
opex	operating expenditure
OTTER	Office of the Tasmanian Economic Regulator
PFP	partial factor productivity
POE	probability of exceedance
PPI	partial performance indicators
PPI	producer price index
PTRM	post-tax revenue model
QCA	Queensland Competition Authority
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SFG	SFG Consulting

Shortened form	Extended form
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TAB	tax asset base
TFP	total factor productivity
TNSP	transmission network service provider
TSBC	Tasmanian Small Business Council
TUoS	transmission use of system
version one of the EBSS	AER, *Electricity transmission network service providers: Efficiency benefit sharing scheme*, September 2007
version two of the EBSS	AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013
WACC	weighted average cost of capital
WPI	wage price index

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 TasNetworks in the 2015–19 regulatory control period.

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] 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 every 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 incentives guideline to TasNetworks in the 2015–19 regulatory control period.[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] This is consistent with the proposed approach we set out in our framework and approach paper.[6]

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

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 AER, *Capex incentive guideline*, November 2013, p. 6.

6 AER, *Framework and approach paper, Transend*, January 2014, p. 24.

10.2 TasNetworks' proposal

TasNetworks proposed that we apply the CESS as set out in the capex incentive guideline.[7]

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:[8]

- make that decision in a manner that contributes to the capex incentive objective[9]
- take into account the CESS principles,[10] the capex objectives,[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.

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 TasNetworks faces to incur efficient opex, conduct demand management, and maintain or improve service levels.[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).

10.4 Reasons for draft decision

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.

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

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7 TasNetworks, *Tasmanian Transmission Revenue Proposal, Regulatory control period 1 July 2014–30 June 2019*, May 2014, pp. 98–99.

8 NER, clause 6A.6.5A.

9 NER, clause 6A.5A(a); the capex criteria are set out in clause 6A.6.7(c)(1)-(3) of the NER.

10 NER, clause 6A.6.5A(c).

11 NER, clause 6A.6.7(a).

12 Related schemes are the EBSS for opex and the STPIS for service levels.

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, 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.

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] We addressed each of these issues in our explanatory statements to the capex incentive guideline.[14]

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.

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13 Energy Users Association of Australia, *EUAA Submission on Transend's Revenue Proposal 2014–19*, p. 15.

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*.