DRAFT DECISION

Energex
Distribution Determination
2020 to 2025

Attachment 9
Capital expenditure sharing scheme

October 2019

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Energex for the 2020–25 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

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP14	Consumer Challenge Panel, sub-panel 14
CESS	capital expenditure sharing scheme
distributor	distribution network service provider
NER or the rules	national electricity rules
opex	operating expenditure
RAB	regulatory asset base
WACC	weighted average cost of capital

9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers whose capital expenditure (capex) becomes more efficient and financial penalties for those that become less efficient. Consumers 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 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 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.

We consider in addition to greater incentives to improve capex efficiency, the CESS provides a consistent incentive to incur capex efficiently during a regulatory control period and encourages more efficient substitution between capex and operating expenditure (opex).

This attachment sets out our draft decision for the determination of the revenue impacts as a result of the CESS applying from the 2015–20 regulatory control period and the application of the CESS for Energex in the 2020–25 regulatory control period.

[1] 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.

[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, 13–20.

9.1 Draft decision

Foregoing incentive payments and revenue impact for the 2020–25 regulatory control period

We accept Energex's proposal to forego its CESS increment of $107.0 million ($2019–20).[3] We note the CESS increment reflects the additional payment to Energex to ensure that it receives 30 per cent of the value of its capex underspend.

Energex still receives the financing benefit of its capex underspend throughout the 2015–20 regulatory control period. The financing benefit is 5.4 per cent of the capex underspend. This means the CESS adjustment Energex has elected to forego reflects the remaining 24.6 per cent of the 30 per cent value of the capex underspend.

As Energex has noted that it may revise its CESS position in its revised proposal, the section below reflects our position on Energex's CESS had it proposed the application of the CESS. [4]

Had Energex proposed the CESS, we would apply a CESS revenue of increment amount of $100.8 million ($2019–20) to be paid across the 2020–25 regulatory control period, from the application of the CESS in the 2015–20 regulatory control period.

The difference between our calculations and Energex's CESS model is due to adopting:

- more recent inflation figures.
- an updated weighted average cost of capital (WACC) information.
- changes to actual capex for consistency with the roll forward model discussed in Attachment 2.

Given the timing of our draft decision we will update our calculations in our final decision for the following:

- Energex's actual expenditure for 2018–19.[5]
- If available, updated inflation using actual data.

Application of scheme in 2020–25 regulatory control period

We will apply the CESS, as set out in the capital expenditure incentives guideline to Energex in the 2020–25 regulatory control period.[6] This is broadly consistent with the proposed approach we set out in our framework and approach paper.[7]

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[3] Energex, *11.002 Application of incentive schemes*, January 2019, p. 2.

[4] AER, *Capital expenditure incentive guideline explanatory statement*, November 2013, p. 21.

[5] Given the timing of when Energex submitted its initial proposal, Energex was only able to provide an estimate of its capex for the 2018–19 regulatory year. When we make our final decision we will be able to update the CESS payment calculation for the actual capex Energex incurred in 2018–19.

9.2 Energex's proposal

Energex proposed that it was entitled to a CESS payment of $107.0 million ($2019–20) for the 2020–25 regulatory control period. However, subject to our acceptance of its proposal, it is proposing to not claim this revenue. Energex noted it will reassess this position if we identify any concerns with its regulatory proposal in our draft decision.[8]

Energex also noted that it was not clear what constituted 'material' deferred capex and did not identify any material deferral in the 2015–20 regulatory control period. [9]

Energex noted that although its estimated underspend is material, it is forecasting to spend lower capex in the next regulatory control period which prima facie indicates that it has not materially deferred capex. [10]

9.3 Assessment approach

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

- the revenue effects on Energex arising from applying the CESS in the 2015–20 regulatory control period; and
- whether or not to apply the CESS to Energex in the 2020–25 regulatory control period and how any applicable scheme will apply.[11]

Our assessment approach is set out below.

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2020–25 regulatory control period arising from the application of the CESS during the 2015–20 regulatory control period.[12] This includes assessing whether any adjustments should be made to the CESS for deferred capex.

Consistent with the CESS guideline, we will make an adjustment to CESS payments where a distributor has deferred capex in the current regulatory control period and:

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

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

7 AER, *Final framework and approach Energex and Ergon Energy regulatory control period commencing 1 July 2020*, July 2018, p. 70.

8 Energex, *11.001 Application of incentive schemes*, January 2019, p. 2.

9 Energex, *11.001 Application of incentive schemes*, January 2019, p. 5.

10 Energex, *11.001 Application of incentive schemes*, January 2019, p. 5.

11 NER, cl. 6.12.1(9).

12 NER, cl. 6.4.3(a).

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.[13]

The NER requires that our draft decision include a determination on how any applicable CESS should apply to Energex.[14] In deciding whether to apply a CESS to Energex for the 2020–25 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[15]
- take into account the CESS principles,[16] the capex objectives and if relevant the opex objectives,[17] the interaction with other incentive schemes[18] as they apply to the particular service provider, and the circumstances of the service provider.[19]

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 2015–20 regulatory control period

As noted above, consistent with Energex's proposal, we have not applied a CESS revenue increment from the 2015–20 regulatory control period. However, had Energex proposed its CESS, we consider that Energex should receive a CESS payment of $100.8 million ($2019–20) from the application of the CESS during the 2015–20 regulatory control period.

Submissions were supportive of Energex foregoing its incentive payments. However, they also noted that the foregoing of incentive payments should be a separate issue to assessing efficient opex and capex.[20]

We have not excluded the CESS increment from our assessment of the overall revenue requirement in line with Energex’s submission. As the foregoing of incentive payments is at Energex’s discretion, this position may be subject to change.

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

[14] NER, cl. 6.12.1(9).

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

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

[17] 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 NER, cl. 6.5.6(a).

[18] NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(1).

[19] NER, cl. 6.5.8A(e)(4)(ii).

[20] CCP14, *Advice to the AER on the Energex and Ergon Energy 2020-25 regulatory proposals*, 31 May 2019, p. 12 and QCOSS, *QLD electricity distribution determinations – Energex and Ergon 2020 to 2025 submission: AER issues paper*, May 2019, p. 21.

We also note Energex's incentive payments are sensitive to estimated expenditure. The timing of our draft decision means that the 2018–19 and 2019–20 regulatory years are estimates. The actual capex incurred by Energex for the 2018–19 year will be known in time for the final decision. We will update the CESS revenue increment in the final determination to reflect this updated information.

Given that the 2019–20 regulatory year will be an estimate at the time of our final decision, we may need to make further adjustments to the revenue increment where actual underspending or overspending in the 2019–20 regulatory year is different to the estimate. Consistent with our incentive guideline, these adjustments will be made when undertaking a revenue determination for the subsequent regulatory control period.[21]

We have also updated the CESS payment to reflect more up to date model inputs.

Deferrals

We do not consider Energex's CESS payment should be adjusted for deferrals as it does not meet the materiality criteria set out in the CESS guidelines.

Energex indicated that it was not clear what constituted a material deferral and compared augmentation projects between 2015–20 and 2020–25. Energex did not identify any material deferrals.[22]

In response to our information request, identifying all capex deferrals, Energex identified an additional property deferral valued at $10.3 million that it had reproposed in the 2020–25 regulatory control period.

We do not have defined thresholds for material deferrals and assess them on a case by case basis. Although Energex's underspend of $361.8 million ($2019–20) is material, relative to its $2894.0 million capex allowance, we must be satisfied deferred capex has a material impact on our forecast capex before we make an adjustment to the CESS increment.

Of Energex's $10.3 million of reproposed capex, we have included $3.7 million for this project in our substitute capex forecast. We do not consider $3.7 million of reproposed capex materially increases our substitute capex forecast of $1799.1 million of net capex so an adjustment is not required.

9.4.2 Application of the CESS in the 2020–25 regulatory control period

We will apply the CESS to Energex in the 2020–25 regulatory control period. As we have set out in the framework and approach, we consider the CESS is needed to

21 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 8.

22 Energex, *11.001 Application of incentive schemes*, January 2019, p. 5.

provide Energex with a continuous incentive to pursue efficiency gains. This approach is consistent with Energex's regulatory proposal.[23]

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[24]

23 Energex, *11.001 Application of incentive schemes*, January 2019, p. 6.

24 AER, *Explanatory statement capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 19.