DRAFT DECISION
Evoenergy
Distribution Determination

2019 to 2024

Attachment 9
Capital expenditure sharing scheme

September 2018

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 Evoenergy for the 2019–2024 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

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
CESS	Capital expenditure sharing scheme
DNSP	Distribution network service provider
RAB	regulatory asset base
AER	Australian Energy Regulator
NER	National Electricity Rules
EBSS	Efficiency benefit sharing scheme
STPIS	Service target performance incentive scheme
WACC	Weighted average cost of capital
PTRM	Post tax revenue model
CPI	Consumer Price Index
RFM	Roll forward model
NPV	Net present value

9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides additional financial rewards to those distribution network service providers (DNSPs) that improve capex efficiency and additional financial penalties for those that become less efficient. Consumers benefit from improved efficiency through a lower RAB and regulated revenues.

The CESS approximates efficiency gains and efficiency losses by calculating the difference between approved forecast and actual capex. It shares these gains or losses between DNSPs and consumers. Under the CESS a DNSP retains 30 per cent of an under-spend or over-spend. This means that for a one dollar saving in capex the DNSP keeps 30 cents of the benefit while consumers keep 70 cents of the benefit.

The CESS works as follows:

1. We calculate the cumulative efficiency gains or losses for the current regulatory period in net present value terms.
2. We apply a ratio of 30 per cent to the cumulative under-spend or over-spend to work out what the service provider's share of the under-spend or over-spend should be.
3. We calculate the CESS payments taking into account the financing benefit or cost to the service provider of the under-spends or over-spends.[1] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the RAB.[2]
4. 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 2014–19 regulatory control period and the application of the CESS for Evoenergy in the 2019–24 regulatory control period.

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[1] We calculate benefits as the benefits to the service provider of financing the under-spend 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 over-spend.

[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

Revenue impact for the 2019–24 regulatory control period

Our draft decision is to approve a CESS revenue increment amount of $0.19 million ($2018–19) from the application of the CESS in the 2014–19 regulatory control period.[3]

The difference between our calculations and Evoenergy's proposal is due to:

- adoption of an updated CESS model that better reflects the relationship between the timing of revenue and changes in asset values used in the PTRM;
- different treatment of asset disposals in our 2014–19 capex allowance; and
- adoption of different discount rates.

Our draft decision on the revenue impact of the application of the CESS in the 2014–2019 regulatory control period compared to Evoenergy's proposal is summarised in Table 9.1 below.

Table 9.1 AER's draft decision on Evoenergy's CESS revenue increment ($ million, 2018–19)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Evoenergy's proposal	0.40					0.40
AER draft decision (distribution)	-0.71	-0.71	-0.71	-0.71	-0.71	-3.57
AER draft decision (transmission)	0.75	0.75	0.75	0.75	0.75	3.76
AER draft decision net	0.04	0.04	0.04	0.04	0.04	0.19

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

- Evoenergy's actual expenditure for 2017–18.[4]
- If available, updated inflation using actual data.
- Evoenergy's revised proposal to update capex figures to reflect the outcome of pass through applications. Evoenergy proposed a pass through related to costs incurred or expected to be incurred to comply with Power of Choice obligations

[3] The CESS does not apply to 2014–15. NER, clause 11.56.3(a)(3).

[4] Given the timing of when Evoenergy submitted its initial proposal, Evoenergy was only able to provide an estimate of its capex for the 2017–18 regulatory year. When we make our final decision we will be able to update the CESS payment calculation for the actual capex Evoenergy incurred in 2017–18.

related to the Expanding Competition in Metering and Related Services rule change.[5]

Application of scheme in 2019–24 regulatory control period

We will apply the CESS as set out in version one of the capital expenditure incentives guideline to Evoenergy in the 2019–24 regulatory control period.[6] This is consistent with the proposed approach we set out in our framework and approach paper.[7]

9.2 Evoenergy proposal

Revenue impact for the 2019–24 regulatory control period

Evoenergy proposed a $0.4 million ($2018–19) CESS revenue increment to its regulated revenue in the 2019–24 regulatory control period. This is split into $336,000 for distribution and $64,000 for transmission.[8]

Evoenergy also noted that it will adjust its revised proposal CESS calculation for pass through amounts. This includes $9.1 million for capex related to the Expanding Competition in Metering and Related Services Rule change.[9] This approach is consistent with section 2.3.1 of the Capital Expenditure Incentive Guideline.[10]

Application of scheme in 2019–24 regulatory control period

Evoenergy proposed to apply the CESS for the 2019–24 regulatory control period. This approach is broadly consistent with the AER's CESS guideline. Evoenergy also proposed that the CESS to apply to capex net of capital contributions and asset disposals, consistent with our response to CESS issues raised by Western Power as part of TransGrid's Framework and Approach consultation.[11]

9.3 Assessment approach

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

- the revenue effects on Evoenergy arising from applying the CESS in the 2014–19 regulatory control period; and

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5 Evoenergy, *Attachment 10 incentive schemes*, January 2018, p. 6.

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

7 AER, *Framework and approach ActewAGL regulatory control period commencing 1 July 2019*, July 2017, pp. 58–60.

8 Evoenergy, *Distribution Post Tax Revenue Model (PTRM).xlsx*, January 2018, and Evoenergy, *Transmission Post Tax Revenue Model (PTRM).xlsx*, January 2018.

9 Evoenergy, *Attachment 10: Incentive schemes*, January 2018, p. 6.

10 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 6.

11 Evoenergy, *Attachment 10: Incentive schemes*, January 2018, p. 6.

- whether or not to apply the CESS to Evoenergy in the 2019–24 regulatory control period and how any applicable scheme will apply.[12]

Our assessment approach is set out below.

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2019–24 regulatory control period arising from the application of the CESS during the 2014–19 regulatory control period.[13]

The NER require that our draft decision include a determination on how any applicable capital expenditure sharing scheme is to apply to Evoenergy.[14] In deciding whether to apply a CESS to Evoenergy for the 2019–24 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[17], other incentive schemes, and, where relevant the opex objectives, as they apply to the particular service provider, and the circumstances of the service provider.

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.

9.3.1 Interrelationships

The approval of CESS payments/penalties determines the associated CESS building block and therefore Evoenergy's overall forecast revenue requirement for the 2019–24 regulatory control period.

As set out in the AER's incentive guidelines, without applying a CESS for the 2019–24 regulatory control period, Evoenergy will face incentives that decline over the period.

That is, if Evoenergy makes an efficiency gain in the first year of the 2019–24 regulatory control period any benefit will last for four more years before the RAB is updated for actual capex. In the final year however, the benefit will be approximately zero. This may lead to inefficient capex and inefficient substitution of opex for capex towards the end of a regulatory control period.[18]

The CESS relates to other incentives Evoenergy faces to incur efficient opex, conduct demand management and maintain or improve service levels. Related schemes are

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12 NER cl. 6.12.1(9)

13 NER cl. 6.3.2(a)(3). Transitional arrangements in the NER excludes 2014–15.

14 NER cl. 6.12.1(9).

15 NER, cl. 6.5.8A(e)(3); the capex criteria are set out in cl. 6.5.7(c)(1)-(3) of the NER.

16 NER, cl. 6.5.8A(e)(4).

17 NER, cl. 6.5.7(a).

18 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 5.

the efficiency benefit sharing scheme (EBSS) for opex, the service target performance incentive scheme (STPIS) for service levels and the demand management incentive scheme and innovation allowance mechanism for non-network options relating to demand management. The AER aims 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 expenditure attachments.

9.4 Reasons for draft decision

9.4.1 CESS revenue increments from the 2014–19 regulatory control period

We consider Evoenergy should receive a CESS payment of $0.2 million ($2018–19) from the application of version one of the CESS during the 2014–19 regulatory control period. We note that the scheme operates only over the 2015–16, 2016–17, 2017–18 and 2018–19 regulatory years. This is because the 2014–15 transitional year of the determination was excluded when version one of the CESS was applied.[19]

The timing of our draft decision means that capex for the 2017–18 and 2018–19 regulatory years are estimates. The actual capex incurred by Evoenergy for the 2017–18 regulatory 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 2018–19 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 2018–19 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.[20]

In the 2014–19 regulatory control period, Evoenergy was subject to version one of the CESS Guideline. Our calculation of the CESS is in accordance with section 2.3 of this guideline.[21] Under the guideline the CESS revenue increments are to be based on the difference between:

- approved forecast capex which is set out in our determination for Evoenergy/ActewAGL for the 2015–19 regulatory control period
- actual capex for the regulatory years from 2015–16 to 2018–19, after the removal of any excluded cost categories.[22]

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19 NER, cl. 11.56.3(a)(3).

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

21 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 6.

22 An estimate of 2017–18 and 2018-19 capex will be used for the draft decision as actual capex for these years is not available

The formulas for calculating the revenue increments are set out in our determination CESS model.[23]

The CESS revenue that we calculated ($0.2 million) is different to the increment that Evoenergy proposed ($0.4 million) because of the following:

- We have used the updated CESS model, first adopted after Evoenergy's submission as part of the TransGrid final determination. This has a number of minor variations, set out below, to the original model used in Evoenergy's proposal.
- We have accounted for asset disposals in both forecast and actual net capex.
- We have applied the time varying WACC, consistent with the PTRM, to calculate the discount rate.
- We have used recently released actual inflation data for 2017-18.

These issues are discussed below.

Updated CESS model

We have applied the updated CESS model, first adopted as part of the TransGrid final determination, to better take into account the timing of revenue recovery and changes to asset values. We noted that the updated model used for the TransGrid final decision would serve as the basis for subsequent regulatory determinations that will also use the same template.[24]

Evoenergy's CESS model, which is based on the CESS guideline model, does not reflect our updated CESS model. We note that the updated model was published after Evoenergy submitted its regulatory proposal.

The revised model adopts a different approach to calculating revenue over multiple regulatory control periods. The original CESS model did not fully account for the distribution of the financing benefit across regulatory control periods.[25]

This is illustrated by how the six-month WACC adjustment is calculated. In the original model, the financing benefit from the six-month WACC adjustment was included as a direct cash flow received for the underspend or overspend. The updated model instead adjusts the asset values, in effect capitalising the changes. This approach is consistent with the capitalisation approach applied in the PTRM.

More detail on the specific modifications and the reasons for the modifications to the model are discussed in attachment 10 of our TransGrid final decision.[26]

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[23] AER, *Evoenergy Dx 2019–24 - CESS model.xlsx*, October 2018 and AER, *Evoenergy Tx 2019–24 - CESS model.xlsx*, October 2018

[24] AER, *Final decision TransGrid transmission determination 2018 to 2023, Attachment 10 – Capital expenditure sharing scheme*, May 2018, p. 8.

[25] The financing benefit is the return on the underspend the distributor has already recovered during the regulatory control period.

In applying the updated model we have made the following changes to Evoenergy's proposed inputs:

- The financing benefit and the CESS payment to be made in the 2019–24 regulatory control period has been calculated based on the real WACC rather the nominal WACC. This has the effect of decreasing the financing benefit of any underspends and subsequently increasing the CESS payment.
- We have adopted an unlagged CPI, instead of a lagged CPI for our inflation figure. The six-month WACC adjustment inflation figures must be consistent with the nominal vanilla WACC. As the roll forward model (RFM) uses unlagged inflation in calculating the six-month WACC adjustment we consider the CESS model should also use the same inflation figure.
- We have annualised Evoenergy's CESS payment, consistent with our updated CESS model. Evoenergy's CESS payment is reflected as a payment in the PTRM in 2019–20 only. In the CESS guideline explanatory statement, we stated our intention that the CESS payments would be recovered equally over the regulatory control period, subject to any smoothing of revenues over the period.[27]

Asset disposals

Our CESS calculation applies to capex net of asset disposals. Evoenergy's CESS model adjusted actual net capex for disposals. However, it did not adjust forecast net capex for forecast asset disposals.

In our TransGrid framework and approach paper, we noted that we wanted to remove any distortions for business to inefficiently defer asset disposals and maximise the value of disposed assets. This affects the RAB and flows through to customers. Absent a CESS, a service provider may have an incentive to defer disposal of assets across regulatory periods, which may not be an efficient outcome.[28]

Discount rate

We have applied the time varying vanilla WACC to calculate the discount rate to calculate the NPV, which is consistent with the approach taken in the RFM. Evoenergy applied a nominal vanilla WACC without the time varying component.

We note that consistency between the CESS model and the RFM ensures that all calculations are NPV neutral. This is consistent with our position on using unlagged CPI discussed above.

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[26] AER, *Final decision TransGrid transmission determination 2018 to 2023, Attachment 10 – Capital expenditure sharing scheme*, May 2018, pp. 6–10.

[27] AER, *Explanatory Statement - Capital Expenditure Incentive Guideline for Electricity Network Service Providers* , November 2013, p. 40.

[28] AER, *Framework and approach for TransGrid for regulatory control period commencing 1 July 2018*, July 2016, p. 22

More information on the WACC is available in attachment 3.

Updated inflation

We have applied updated inflation figures to calculate the discount rate. As noted above, Evoenergy adopted a lagged CPI figure, so that 2017–18 CPI applies to 2018–19 inflation. Actual inflation data for 2017-18 was not available at the time of the proposal. We have updated the CESS model to use actual inflation for 2017–18.

This also means that the inflation figure for 2018–19 will need to be updated to reflect actual inflation in the final decision.

Adjustment for pass through

We will take into account adjustments for pass throughs. This approach is consistent with section 2.3.1 of the Capital Expenditure Incentive Guideline.[29]

Evoenergy noted that following the AER's assessment of Evoenergy's pass through application, it will adjust the CESS calculations as part of its revised proposal.[30]

We will assess Evoenergy's revised proposal CESS calculations for adjustments to take into account pass throughs as part of our final decision.

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[29] AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 6.

[30] Evoenergy, *Attachment 10: Incentive schemes*, January 2018, p. 6.