FINAL DECISION
TransGrid transmission determination
2015−16 to 2017−18

Attachment 10 – Capital expenditure sharing scheme (CESS)

April 2015

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457

Email: AERInquiry@aer.gov.au

AER reference: 53444

Note

This attachment forms part of the AER's final decision on TransGrid’s revenue proposal 2015–18. It should be read with other parts of the final decision.

The final 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

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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
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual 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

Shortened form	Extended form
NTSC	negotiated transmission service criteria
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 and 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 TransGrid in the 2015–18 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.

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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.

10.1 Final decision

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to TransGrid in the 2015–18 regulatory control period.[4] This is consistent with the proposed approach we set out in our framework and approach paper.[5] We will apply 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.[6] We will not apply any further exclusions as proposed by TransGrid.

10.2 TransGrid's revised proposal

TransGrid accepted our draft decision to apply the CESS as set out in the guideline. TransGrid also accepted our draft decision to not exclude employee entitlements from the CESS. However, TransGrid did not accept our draft decision to not exclude equity raising costs and capital expenditure under the demand management innovation allowance from the CESS.[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 other incentives TransGrid faces to incur efficient opex, conduct demand management and maintain or improve service levels.[12] We aim to incentivise

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

5 AER, *Framework and approach paper, TransGrid*, January 2014, p. 24.

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

7 TransGrid, *Revised revenue proposal, 2014/15 – 2017/18*, January 2015, pp. 144–145 (TransGrid, *Revised revenue proposal*, January 2015).

8 NER, cl. 6A.6.5A.

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

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

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

12 Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, and the service target performance incentive scheme (STPIS) for service levels.

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 our capex attachment.

10.4 Reasons for final decision

We maintain our draft decision to apply the CESS to TransGrid as set out in the capex incentive guideline.

We will apply the exclusion from the CESS set out in the guideline 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.[13]

We will not apply further exclusions. We are not satisfied that TransGrid has justified further exclusions.[14]

10.4.1 Equity raising costs

In our draft decision we outlined that we did not consider equity raising costs should be excluded ex ante from the CESS on the basis that we may exclude debt raising costs ex post from the EBSS. This was because the reason for excluding debt raising costs from the EBSS does not correspond to excluding equity raising costs from the CESS.

In its revised proposal TransGrid submitted that equity raising costs should be excluded from the CESS for two reasons:[15]

- Equity raising costs are determined with reference to a benchmark efficient firm. These costs are already subject to the incentive to source capital at a more competitive rate than the benchmark rate of return, and do not require additional incentives.
- As equity raising costs are not included in forecast capital expenditure, they are not included in the CESS targets. Therefore, they should not be included in the actual expenditure measured under the CESS. For the avoidance of doubt, TransGrid proposed that equity raising costs be excluded from the CESS.

We maintain our view from the draft decision that equity raising costs should not be excluded ex ante from the CESS. We explained in our draft decision that while we may

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

14 In developing the CESS in consultation with stakeholders, we considered a range of capex categories that we could exclude from the CESS. The capex incentive guideline provides for a single exclusion related to the STPIS for transmission. Our reasoning for deciding to only allow this exclusion, and not any other categories of exclusions, is set out in the explanatory statement to the capex incentive guideline.

15 TransGrid, *Revised revenue proposal*, January 2015, pp. 145–146.

exclude debt raising costs from the EBSS, the reasons for doing this under the EBSS do not correspond to excluding equity raising costs from the CESS. [16]

Regarding the further arguments TransGrid submitted in its revised proposal, we do not consider we should exclude a category of expenditure from the CESS on the basis that it is already subject to incentives for efficiency. We assess forecast capex at an overall rather than component level. The purpose of the CESS is to provide a continuous incentive to deliver efficient overall capex and to share the benefits of capex efficiency gains (or costs of capex efficiency losses) between the service provider and consumers. If the CESS did not apply to a particular type of capex the relative sharing ratio between the distributor and consumers would instead depend on the year in which the overspend or underspend occurs, and will vary across the regulatory control period. We recognise TranGrid's point that equity raising costs are not included in forecast capex and would therefore not be included in the CESS targets. However, the CESS rewards and penalties will ultimately be determined relative to total forecast capex. We will apply the CESS as set out in the guideline. We are not satisfied there is a satisfactory reason to depart from the guideline by specifying further exclusions.

10.4.2 Demand management

TransGrid proposed to exclude capital expenditure under the demand management innovation allowance from the CESS. In its revised proposal TransGrid stated that the purpose of the demand management innovation allowance is to undertake initiatives of a research and development nature to develop the demand management market. It indicated consumers have generally supported demand management innovation and a desire for TransGrid to proactively pursue developments in this area. TransGrid agreed that much of this expenditure is likely to be opex, but noted that some of the initiatives may involve some minor capital expenditure. TransGrid was of the view that the inclusion of the demand management innovation allowance in the CESS would provide an incentive that is contrary to the value consumers have expressed for development of the demand management market. That is, this would reduce expenditure on demand management innovation.[17]

We disagree that inclusion of demand management in the CESS would discourage TransGrid from pursuing demand management opportunities. As stated in our draft decision, successful demand management should result in the network service provider spending less on capex than it otherwise would have. Both the CESS and EBSS will apply to TransGrid in the subsequent regulatory control period. As a result TransGrid has an incentive to implement a demand management solution if the increase in opex is less than the corresponding decrease in capex. In this way, it will

16 AER, Draft decision, *TransGrid transmission determination, 2015–16 to 2017–18, Attachment 10: Capital expenditure sharing scheme*, November 2014, p. 11.

17 TransGrid, *Revised revenue proposal*, January 2015, p. 146.

receive a net reward for implementing demand management.[18] This is because the rewards and penalties under the EBSS and CESS are balanced and symmetric. In the past, when a CESS did not apply, service providers could have received a penalty for increasing opex without a corresponding reward for decreasing capex.

[18] When the service provider spends more on opex it receives a 30 per cent penalty under the EBSS. However, when there is a corresponding decrease in capex the service provider receives a 30 per cent reward under the CESS. So where the decrease in capex is larger than the increase in opex the service provider receives a larger reward than penalty, a net reward.