FINAL DECISION
Essential Energy
Distribution Determination

2019 to 2024

Attachment 9
Capital expenditure sharing scheme

April 2019

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Essential Energy for the 2019-2024 regulatory control period. It should be read with all other parts of the final decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The attachments have been numbered consistently with the equivalent attachments to our longer draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 7 – Corporate income tax

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 15 – Alternative control services

Attachment 18 – Tariff structure statement

Attachment A – Negotiating framework

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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 which results in lower 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 to or subtracted from the service provider's regulated revenue as a separate building block in the next regulatory control period.

This attachment sets out our final decision for the determination of the revenue increments or decrements as a result of the CESS applying from the 2014–19 regulatory control period and the application of the CESS for Essential in the 2019–24 regulatory control period.

9.1 Final decision

Our final decision is to approve a CESS revenue increment of $69.1 million ($2018–19) from the application of the CESS in the 2014–19 regulatory control period. [3]

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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.

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

This amount is consistent with our draft decision and Essential's revised proposal.

Our final decision on the revenue impact of the application of the CESS in the 2014–19 regulatory control period compared to Essential's revised proposal is summarised in Table 1 below.

Table 1 AER's final decision on Essential's CESS revenue increment ($ million, 2018–19)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Final decision	13.82	13.82	13.82	13.82	13.82	69.09

9.2 Essential Energy's revised proposal

Essential accepted our draft decision CESS revenue increment of $69.1 million. Essential did not update its CESS revenue increment to reflect actual capex as this would have resulted in an increase in the CESS reward. Essential considered the lower CESS reward aligned with the value its customers' place on affordability.[4]

9.3 Assessment approach

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

- the revenue effects on Essential arising from applying the CESS in the 2014–19 regulatory control period[5]; and
- whether or not to apply the CESS to Essential in the 2019–24 regulatory control period and how any applicable scheme will apply.[6]

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.[7]

The NER require that our final decision include a determination on how any applicable CESS is to apply to Essential.[8] In deciding whether to apply a CESS to Essential 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[9]

4 Essential Energy, Revised proposal, January 2019, p. 27.

5 NER, cl. 6.4.3(a)(5).

6 NER cll. 6.3.2(a)(3); 6.12.1(9).

7 NER cl. 6.4.3(a)(5). Transitional arrangements in the NER excludes 2014–15.

8 NER cll. 6.3.2(a)(3); 6.12.1(9).

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

- take into account the CESS principles[10], the capex objectives[11], other incentive schemes[12], and, where relevant the opex objectives[13], 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 Essential's overall forecast revenue requirement for the 2019–24 regulatory control period.

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

That is, if Essential 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.[14]

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

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

We consider Essential should receive a net CESS payment of $69.1 million ($2018–19) from the application of version one of the CESS during the 2014–19 regulatory

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10 NER, cl. 6.5.8A(e)(4)(i).

11 NER, cll. 6.5.7(a); 6.5.8A(d)(2).

12 NER, cl. 6.5.8A(d)(1).

13 NER, cl. 6.5.8A(d)(2).

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

control period across its distribution and transmission networks. 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.[15]

Essential did not update its CESS adjustment to reflect 2017–18 actual capex. Had Essential updated its CESS adjustment, it would have been entitled to a CESS revenue adjustment of $86.6 million.

We note that although Essential is entitled to the greater revenue, we accept Essential's proposal to forego this additional revenue. However, this is contingent on there being no material impact on the CESS adjustment following an update for 2018–19 actual capex in our determination for the 2024–29 regulatory control period.

9.4.2 Application of the CESS for the 2019–24 regulatory control period

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[16] In developing the guideline, we took into account the capex incentive objective, capex criteria, capex objectives and the National Electricity Objective.

We will apply version one of the CESS,[17] with the updated formulae set out in the TransGrid final determination,[18] to Essential in the 2019–24 regulatory control period. As we have set out in the framework and approach, we consider this provides Essential with a continuous incentive to pursue efficiency gains.

[15] NER, cl. 11.56.3(a)(3).

[16] AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013,

[17] AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013,

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