# FINAL DECISION
# Jemena distribution determination 2016 to 2020

# Attachment 10 – Capital expenditure sharing scheme

May 2016

AUSTRALIAN ENERGY REGULATOR

© Commonwealth of Australia 2016

This work is copyright. In addition to any use permitted under the Copyright Act 1968, all material contained within this work is provided under a Creative Commons Attributions 3.0 Australia licence, with the exception of:

- the Commonwealth Coat of Arms
- the ACCC and AER logos
- any illustration, diagram, photograph or graphic over which the Australian Competition and Consumer Commission does not hold copyright, but which may be part of or contained within this publication. The details of the relevant licence conditions are available on the Creative Commons website, as is the full legal code for the CC BY 3.0 AU licence.

Requests and inquiries concerning reproduction and rights should be addressed to the:

Director, Corporate Communications
Australian Competition and Consumer Commission
GPO Box 4141, Canberra ACT 2601

or publishing.unit@accc.gov.au.

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

# Note

This attachment forms part of the AER's final decision on Jemena's distribution determination for 2016–20. It should be read with all other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

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 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – f-factor scheme

# Contents

Note ........................................................................................................10-2

Contents ....................................................................................................10-3

Shortened forms .......................................................................................10-4

10 Capital expenditure sharing scheme ..................................................10-6

10.1 Final decision ...................................................................................10-6

10.2 Jemena's revised proposal ..............................................................10-6

10.3 Assessment approach .....................................................................10-7

10.3.1 Interrelationships ....................................................................... 10-7

10.4 Reasons for final decision ................................................................10-7

# Shortened forms

| Shortened form | Extended form |
|---|---|
| AEMC | Australian Energy Market Commission |
| AEMO | Australian Energy Market Operator |
| AER | Australian Energy Regulator |
| AMI | Advanced metering infrastructure |
| augex | augmentation expenditure |
| capex | capital expenditure |
| CCP | Consumer Challenge Panel |
| CESS | capital expenditure sharing scheme |
| CPI | consumer price index |
| DRP | debt risk premium |
| DMIA | demand management innovation allowance |
| DMIS | demand management incentive scheme |
| distributor | distribution network service provider |
| DUoS | distribution use of system |
| EBSS | efficiency benefit sharing scheme |
| ERP | equity risk premium |
| Expenditure Assessment Guideline | Expenditure Forecast Assessment Guideline for Electricity Distribution |
| F&A | framework and approach |
| MRP | market risk premium |
| NEL | national electricity law |
| NEM | national electricity market |
| NEO | national electricity objective |
| NER | national electricity rules |
| NSP | network service provider |
| opex | operating expenditure |
| PPI | partial performance indicators |
| PTRM | post-tax revenue model |
| RAB | regulatory asset base |
| RBA | Reserve Bank of Australia |

| Shortened form | Extended form |
|---|---|
| repex | replacement expenditure |
| RFM | roll forward model |
| RIN | regulatory information notice |
| RPP | revenue and pricing principles |
| SAIDI | system average interruption duration index |
| SAIFI | system average interruption frequency index |
| SLCAPM | Sharpe-Lintner capital asset pricing model |
| STPIS | service target performance incentive scheme |
| 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 Jemena in the 2016–20 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. 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. We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the RAB.
- 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 or 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.

## 10.1 Final decision

We will apply the CESS as set out in version 1 of the Capex Incentive Guideline to Jemena in the 2016–20 regulatory control period.[1]

## 10.2 Jemena's revised proposal

Jemena did not accept our preliminary decision to apply the CESS as set out in the Guideline for the 2016–20 regulatory control period.[2]

---

[1] AER, *Capital Expenditure Incentive Guideline for Network Service Providers*, November 2013.

[2] Jemena, *Revised Regulatory Proposal*, Attachment 3-1, January 2016, p. 13.

Jemena maintained that we should exclude reliability improvement capex from the CESS, considering the STPIS and CESS would be in conflict.[3]

Jemena accepted our preliminary decision not to modify the CESS so that rewards and penalties are amortised over the regulatory control period. [4] The guideline specifies we will treat the CESS as a separate building block which is then smoothed throughout the next period.

## 10.3 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:[5]

- make that decision in a manner that contributes to the capex incentive objective[6]
- take into account the CESS principles,[7] the interaction of the CESS with any other incentives that the service provider may have to undertake efficient opex or capex, the capex objectives[8] and, if relevant, the opex objectives, as they apply to the particular service provider, as well as 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 Jemena faces to incur efficient opex, conduct demand management, and maintain or improve service levels.[9] 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 our capex attachment (attachment 6).

## 10.4 Reasons for final decision

We maintain our preliminary decision to apply the CESS to Jemena as set out in the capex incentive guideline without any further exclusions. We are not satisfied Jemena's reasons in its revised proposal justify excluding reliability improvement capex.

---

3 Jemena, *Revised Regulatory Proposal*, Attachment 3-1, January 2016, p. 14.

4 Jemena, *Revised Regulatory Proposal*, Attachment 3-1, January 2016, p. 15.

5 NER, cl. 6.5.8A(e).

6 NER, cl. 6.4A(a); the capex criteria are set out in cl. 6.5.7(c) of the NER.

7 NER, cl. 6.5.8A(c).

8 NER, cl. 6.5.7(a).

9 Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, the demand management innovation allowance (DMIA), and the service target performance incentive scheme (STPIS) for service levels.

Jemena argued that where it assesses a reliability improvement project would be efficient under the STPIS because it costs less to deliver the benefits to consumers than the consumers value those benefits, the CESS should not penalise Jemena. It considered if the improvements were not made, distributors risk being penalised under the STPIS. Therefore, the STPIS provides a clear incentive for distributors to undertake the improvements. Jemena considered including reliability improvement capex in the CESS may mean undertaking those improvements may result in the distributor being penalised under the CESS. Jemena considered the STPIS and CESS would therefore be in conflict as each option could involve a penalty; it considered this would be an undesirable outcome.[10]

Jemena noted our reasoning that it was unclear whether applying a different sharing ratio for investments in reliability would lead to better outcomes for consumers. It considered this was not a compelling reason to not exclude reliability capex as there were detriments of failing to do so.[11]

Jemena also submitted that incentive schemes including the CESS must operate in a clear, consistent and co-ordinated manner to encourage efficient expenditure, ensure a decline in service standards is not incentivised and allow distributors to plan their activities with certainty as to the outcome of their investment and operational decisions.[12]

In our explanatory statement to the Capex Incentive Guideline we explained that we did not consider there was a convincing reason to allow exclusions for reliability improvement capex.[13] When included in the CESS, the cost of any capex increase or decrease from a reliability improvement is shared between network service providers and consumers in the same way as any other capex efficiency gain or loss. That is, under the CESS a service provider retains 30 per cent of a capex underspend or overspend, while consumers retain the remaining 70 per cent.

When deciding whether to undertake reliability improvement capex, Jemena will always face the need to balance incentives from the STPIS against the way capex is shared between the distributor and consumers. Applying the CESS alters the way capex resulting from reliability improvements is shared between the distributor and consumers. We do not agree with the characterisation that the CESS will excessively reward or penalise distributors. This is because a capex underspend or overspend from a reliability improvement is still shared between the service provider and consumers regardless of how the CESS applies. If we excluded capex spent on reliability improvements, the relative sharing ratio between the service provider and consumers will instead depend on the year in which the overspend or underspend occurs, and will vary across the regulatory control period. We do not consider there is a

---

[10] Jemena, *Revised Regulatory Proposal*, Attachment 3-1, January 2016, p. 14.

[11] Jemena, *Revised Regulatory Proposal*, Attachment 3-1, January 2016, p. 15.

[12] Jemena, *Revised Regulatory Proposal*, Attachment 3-1, January 2016, January 2016, p. 13.

[13] AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013*, pp. 39–40.

reason why capex overspends or underspends on reliability improvements should be shared differently between service providers and consumers in each regulatory year, or shared differently to all other costs facing service providers.

Applying a symmetric CESS means that overs and unders will be treated equally. If the CESS did not apply, the amount to be borne by the distributor and consumers would depend on the year in which the underspend or overspend (expected or not) occurs, and declines over the period. We view a continuous 30 per cent retention of underspends or overspends as a fair sharing of these risks between distributors and their customers. We consider having a sharing ratio of capex underspends and overspends that is constant across the period provides a clear and consistent incentive compared to a sharing ratio which declines over the period. In this way distributors will not face a varying incentive for decisions on when to incur capex in a way that balances expenditure efficiencies with service quality.

It is unclear whether applying a different sharing ratio for investments in reliability would lead to better outcomes for consumers. Excluding reliability capex from the CESS does not mean that a distributor's incentives to achieve efficiencies in capex will be balanced with its incentives to invest in reliability. If capex is not included in the CESS it will mean that the distributor will face a declining penalty from undertaking such expenditure within a regulatory control period. As there would be a smaller penalty if a distributor undertakes capex at the end of the regulatory control period, it would still be strongly incentivised to undertake reliability improving investments towards the end of a period rather than at the start. This may lead to investments in reliability not valued by consumers. In some cases it may also be difficult to identify and verify the discrete capex projects designed to improve reliability.

Importantly, Jemena will not always be penalised or rewarded under the CESS for overspending or underspending specifically on reliability improvement capex. This is because CESS rewards and penalties are determined relative to total forecast capex.