



# **Framework and Approach Murraylink**

**Regulatory control period  
commencing 1 July 2023**

July 2021

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Inquiries about this publication should be addressed to:

Australian Energy Regulator  
GPO Box 520  
Melbourne Vic 3001

Tel: 1300 585 165

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au)

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# About the framework and approach paper

The Australian Energy Regulator (AER) is responsible for the economic regulation of electricity transmission and distribution services in Australia's National Electricity Market (NEM). We are an independent statutory authority established by the Australian Government. Our relevant powers and functions are set out in the National Electricity Law (NEL) and National Electricity Rules (NER).

The framework and approach (F&A) paper is the first step in the process to determine efficient prices for the supply of electricity transmission services by Murraylink in NSW and the ACT, for the 2023–28 regulatory control period starting 1 July 2023 to 30 June 2028. It facilitates early consultation with consumers and assists Murraylink in preparing its revenue proposal.

Murraylink is a privately-owned transmission interconnector between South Australia and Victoria. It consists of a single high voltage direct current transmission line, approximately 176 kilometres long. Murraylink's current 2018–23 regulatory control period concludes on 30 June 2023.

This F&A paper sets out our proposed approach to the economic regulation of Murraylink's revenues for the 2023–28 period, including our proposed application of incentive schemes and allowances, as set out below:<sup>1</sup>

- service target performance incentive scheme (STPIS)
- efficiency benefit sharing scheme (EBSS)
- capital expenditure sharing scheme (CESS)
- small-scale incentive scheme (SSIS)
- demand management innovation allowance mechanism (DMIAM)
- expenditure forecast assessment guidelines
- whether depreciation will be based on forecast or actual capital expenditure (capex) in updating the regulatory asset base (RAB).

## Previous consultation

On 30 November 2020, we invited stakeholder submissions following our notice to amend or replace the current F&A for Murraylink for the 2023–28 period. We did not receive any submissions.<sup>2</sup>

On 30 December 2020, we decided to amend the current F&A for Murraylink for the 2023–28 period due to the introduction of the DMIAM.

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<sup>1</sup> In accordance with sub-clauses 6A.10.1A(a)(1) and (e) of the NER, our F&A paper for Murraylink for the 2023–28 period must be published by 31 July 2021.

<sup>2</sup> The stakeholder submissions period on our notice to amend or replace the current F&A for Murraylink ran from 30 November to 15 December 2020.

## Next steps

Following the release of this final F&A paper, Murraylink must submit its 2023–28 revenue proposal by 31 January 2022. Table 1 summarises the transmission revenue determination process.

**Table 1 Murraylink’s 2023–28 transmission revenue determination process**

Step	Indicative date
AER publishes F&A paper	30 July 2021
Murraylink submits revenue proposal to the AER	31 January 2022
AER publishes issues paper	March 2022*
AER holds public forum	April 2022*
Submissions on issues paper and revenue proposal close	May 2022*
AER publishes draft decision	September 2022*
AER holds public forum (predetermination conference)	October 2022*
Murraylink submits revised revenue proposal to the AER	December 2022*
Submissions on draft decision and revised revenue proposal close	January 2023*
AER publishes final decision	28 April 2023

Source: NER, Chapter 6A, Part E.

Notes: \* Dates are based on the AER receiving compliant proposals. The NER does not provide a specific timeframe for publishing a draft decision; only a final decision.

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# 1 Overview

The purpose of the F&A is to provide Murraylink and consumers with an indication of our likely position on matters that Murraylink is required to address in its upcoming 2023–28 revenue proposal. It provides a degree of regulatory predictability.

This F&A paper sets out how we propose to apply a range of incentive schemes and allowances and other guidelines to Murraylink’s 2023–28 revenue proposal, as well as our approach to calculating depreciation. The positions we set out in this paper are not binding on the AER or Murraylink.<sup>3</sup> This means that during the determination process, it is open to us to change our position, and for Murraylink to propose a different position, on matters set out in the F&A paper. If our position changes from the one set out in this paper, we will provide clear reasons.

Incentive schemes and allowances encourage transmission network service providers (TNSPs) to manage their respective businesses in a safe and reliable manner that benefits the long term interests of consumers. Such schemes also provide TNSPs with incentives to spend efficiently and to meet or exceed service quality/reliability targets. In some instances, TNSPs may incur a financial penalty if they fail to meet set targets. The overall objectives of these schemes are to:

- encourage appropriate levels of service quality
- maintain network reliability as appropriate
- incentivise TNSPs to spend efficiently on capital expenditure (capex) and operating expenditure (opex)
- share efficiency gains and losses between TNSPs and consumers
- incentivise TNSPs to consider economically efficient alternatives to augmenting their networks.

We summarise the specific incentive schemes and allowances below, and also provide an overview of our expenditure forecast assessment guideline and approach to calculating depreciation.

## 1.1 Upcoming incentive scheme review

We are currently planning for a review of our incentive schemes to ensure that they remain relevant and fit-for-purpose. This will include the design and application of the CESS, EBSS and STPIS to transmission network service providers, and will consider stakeholder concerns and feedback.

We aim to finalise the review in the second half of 2022 providing scope to incorporate elements of the review in Murraylink’s revenue determination. However, our ability to

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<sup>3</sup> NER, cl. 6A.10.1A(f).

reflect changes in the draft determination depends on the issues raised by stakeholders and the nature of any changes to the schemes. The AER will work closely with all affected stakeholders throughout the incentive scheme review and this determination process.

Section 1.2 sets out how the AER intends to apply the schemes at present.

## 1.2 Summary of F&A paper final positions

Table 1 below sets out a summary of our F&A paper final positions in terms of the application of incentive schemes and allowances, expenditure forecast assessment guideline, and approach to calculating depreciation, to Murraylink's 2023–28 revenue determination.

**Table 1. Summary of AER position to Murraylink for the 2023–28 period**

Name of scheme or mechanism	Applied	Further information
Service target performance incentive scheme (STPIS) <sup>4</sup>	Version 5	Section 2 (pp. 8–10)
Efficiency benefit sharing scheme (EBSS) <sup>5</sup>	Version 2	Section 3 (pp. 11–13)
Capital expenditure sharing scheme (CESS) <sup>6</sup>	Version 1	Section 4 (pp. 14–15)
Small-scale incentive scheme (SSIS) <sup>7</sup>	Not applied	Section 5 (p. 16)
Demand management innovation allowance mechanism (DMIAM) <sup>8</sup>	Applied	Section 6 (p. 17)
Expenditure forecast assessment guideline	Tailored approach	Section 7 (pp. 18–19)
Depreciation	Applied forecast depreciation	Section 8 (pp. 20–22)

<sup>4</sup> STPIS provides a financial incentive to TNSPs to maintain and improve service performance.

<sup>5</sup> EBSS aims to provide a continuous incentive for TNSPs to pursue efficiency improvements in opex, and provide for sharing these efficiencies between TNSPs and network users.

<sup>6</sup> CESS provides financial rewards to TNSPs whose capex becomes more efficient and financial penalties to those whose capex becomes less efficient.

<sup>7</sup> Scheme would reward network service providers for improving their customer service, or penalise them if service deteriorates.

<sup>8</sup> DMIAM provides TNSPs with funding for research and development in demand management projects that have the potential to reduce long-term network costs.

## 1.3 Murraylink’s views on the existing F&A paper

On 29 October 2020, Murraylink advised it is not requesting a formal change to the existing F&A paper for the 2023–28 period.<sup>9</sup> In its letter, Murraylink set out its preliminary views on the matters requiring the AER’s consideration prior to finalising the F&A paper, as set out below.

### 1.3.1 Expenditure forecast assessment guideline

Murraylink notes that parts of the expenditure forecast assessment guideline is not suitable in forecasting its operating expenditure based on the difference in technology, size and role compared to other transmission networks. Murraylink suggests stakeholders would benefit from understanding why the AER adopts a different approach compared to other TNSPs.

The expenditure assessment guideline is flexible and recognises that a range of different estimating techniques may be employed to develop an expenditure forecast. As set out in section 7, our position is to tailor the approach given Murraylink’s size and nature of its network operations. This includes not applying the standardised benchmarking analysis or predictive modelling in assessing its capex and opex forecasts as well as tailoring the information required from Murraylink through the regulatory information notice process.

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<sup>9</sup> Murraylink, *Request for revised framework and approach paper*, 29 October 2020 available at <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/murraylink-determination-2023-28/initiation>.



## 2 Service target performance incentive scheme

This section sets out our proposed approach and reasons on how we intend to apply the STPIS to Murraylink in the 2023–28 period.<sup>10</sup>

The AER creates, administers and maintains the STPIS in accordance with the requirements of the NER.<sup>11</sup> The STPIS is part of an incentive based regulation structure we use across all the electricity transmission networks we regulate.

The purpose of the STPIS is to provide incentives to TNSPs to provide greater transmission network reliability when network users place greatest value on reliability, and improve and maintain the reliability of the elements of the transmission network most important to determining spot prices.<sup>12</sup>

In developing the STPIS, the AER had regard to the requirements of the NER. Under an incentive based regulation framework, TNSPs have an incentive to reduce costs. Cost reductions are beneficial to TNSPs and customers where service performance is maintained or improved. However, cost efficiencies achieved at the expense of service performance standards are not desirable.

### 2.1 AER's position

Our position is to apply version 5 of the STPIS to Murraylink for the 2023–28 period. We also note the AER is currently scoping a broad review of incentive schemes to address any stakeholder concerns.

### 2.2 AER's assessment approach

The STPIS works as part of the 'building block' determination.<sup>13</sup> As part of a revenue determination, we make a decision on the application of the STPIS to a TNSP for the regulatory control period, as well as the values associated with the applicable STPIS parameters.<sup>14</sup> In each regulatory year, the TNSP's maximum allowed revenue (MAR) is adjusted based on its performance against the STPIS parameters in the previous calendar year.

We currently apply version 5 of the STPIS as follows:

- the parameters for each service component (SC) and the maximum revenue increment/decrement that a TNSP can receive for a given level of performance will be those prescribed in the scheme. The applicable parameter values will be set out

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<sup>10</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015 available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>11</sup> NER, cl. 6A.7.4(a).

<sup>12</sup> NER, cl. 6A.7.4(b)(1).

<sup>13</sup> NER, cll. 6A.5.4(a)(5) and 6A.5.4(b)(5).

<sup>14</sup> NER, cll. 6A.4.2(5) and 6A.14.1(1)(iii).

in the TNSP's transmission determination. The TNSP's MAR will be adjusted according to its performance against these parameter values, as assessed by us, in accordance with the scheme

- the market impact component (MIC) annual performance target<sup>15</sup> will be calculated in accordance with the scheme (see Appendix C, and example 2 in Appendix F)<sup>16</sup>

The network capability component (NCC) does not apply to Murraylink, as per clause 2.2(d) of the STPIS version 5.

In its 2023–28 revenue proposal, Murraylink must:

- submit proposed values for the SC parameters<sup>17</sup>
- submit data for its MIC for the preceding seven regulatory years.<sup>18</sup> Murraylink must submit a proposed value for a performance target, unplanned outage event limit, and dollar per dispatch interval incentive.<sup>19</sup>

We will accept Murraylink's proposed parameter values for the service and market impact if the proposed values comply with clauses 3.2 and 4.2, respectively, of version 5 of the STPIS.<sup>20</sup>

Version 5 of the STPIS can result in a maximum revenue increment/decrement of up to 2.25 per cent of the Murraylink's MAR.<sup>21</sup>

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<sup>15</sup> The market impact parameter is the number of dispatch intervals where an outage on the TNSP's prescribed transmission network results in a network outage constraint with a marginal value greater than \$10/MWh. For more information, see: AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015, Appendix C available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>16</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015, cl. 4.2(g) and Appendix F available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>17</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015, cl. 3.2 available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>18</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015, cl. 4.2(a) available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>19</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015, cl. 4.2(b) available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>20</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015 available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>.

<sup>21</sup> AER, *Transmission network service target performance incentive scheme, version 5 (corrected)*, October 2015 available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-version-5-september-2015-amendment/final-decision#step-40803>. Calculated as Service Component: max +/-1.25% MAR, Market Impact Component: max +/-1.00% MAR, and Network Capability

## 2.3 Reasons for AER's position

Version 5 of the STPIS seeks to ensure that cost reductions do not result in deterioration of service performance for customers. We consider it will provide appropriate incentives for Murraylink to:

- provide greater transmission system reliability
- improve and maintain the reliability of those elements of the transmission system that are most important to determining spot prices
- undertake relevant low cost projects to promote efficient levels of network capability from existing assets.

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Component: max +/-1.5% MAR, MAR, max decrement depends on allowance and number of projects not completed and their project range as per cl. 5.3(b)-(c).

## 3 Efficiency benefit sharing scheme

The EBSS is intended to provide a continuous incentive for TNSPs to pursue efficiency improvements in opex, and provide for a fair sharing of these between businesses and consumers. Consumers benefit from improved efficiencies through lower network prices in future regulatory control periods.

We address our position on the application of the EBSS in relationship to our proposed opex forecasting approach and benchmarking below. We also explain the rationale underpinning the scheme.

### 3.1 AER's position

We intend to apply the EBSS to Murraylink in the 2023–28 period if we are satisfied the scheme will fairly share efficiency gains and losses between the business and consumers.<sup>22</sup> This will occur only if the opex forecast for the following period is based on the businesses revealed costs. Our transmission determination for Murraylink for the 2023–28 period will specify if and how we will apply the EBSS.<sup>23</sup> We also note the AER is currently scoping a broad review of incentive schemes to address any stakeholder concerns.

### 3.2 AER's assessment approach

The EBSS must provide for a fair sharing of opex efficiency gains and efficiency losses between a network service provider and network users. We must also have regard to the following factors in developing and implementing the EBSS:

- the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme
- the need to provide service providers with a continuous incentive to reduce opex
- the desirability of both rewarding service providers for efficiency gains and penalising service providers for efficiency losses
- any incentives that service providers may have to capitalise expenditure
- the possible effects of the scheme on incentives for the implementation of non-network alternatives.

### 3.3 Reasons for AER's position

The EBSS applies to Murraylink in the current (2018–23) period.

The decision to apply the EBSS will depend on whether we expect to use Murraylink's revealed costs in the 2023–28 period to forecast opex in the 2028–33 period.

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<sup>22</sup> NER, cl. 6A.6.5(a).

<sup>23</sup> AER, *Efficiency benefit sharing scheme*, 29 November 2013.

### 3.3.1 Why we would apply the EBSS

We will only apply the EBSS in the 2023–28 period if we expect we will use a revealed cost forecasting approach to forecast opex for the 2028–33 period.

The EBSS is intrinsically linked to our revealed cost forecasting approach. This approach relies on identifying an efficient opex amount in the base year (the ‘revealed costs’ of the TNSP), which we use to develop a total opex forecast. When a business makes an incremental efficiency gain, it receives a reward through the EBSS, and consumers benefit through a lower revealed cost forecast for the subsequent period. This is how efficiency improvements are shared between consumers and the business.

Under a revealed cost approach without an EBSS, a TNSP has an incentive to spend more opex in the expected base year. Also, a TNSP has less incentive to reduce opex towards the end of the regulatory control period, where the benefit of any efficiency gain is retained for less time.

If we use a revealed cost forecasting approach, we apply the EBSS because:

- it reduces the incentive for a TNSP to inflate opex in the expected base year in order to gain a higher opex forecast for the next regulatory control period
- it provides a continuous incentive for a TNSP to pursue efficiency improvements across the regulatory control period. This is because the EBSS allows a business to retain efficiency gains for a total of six years, regardless of the year in which it was made.

In implementing the EBSS, we also consider any incentives a TNSP may have to inappropriately capitalise opex.<sup>24</sup> Where opex incentives are balanced with capex incentives, a TNSP does not have an incentive to favour opex over capex, or vice-versa. If the CESS and EBSS are both applied, these incentives will be relatively balanced. We discuss the CESS further in section 4.

### 3.3.2 Why we would not apply the EBSS

We will not apply the EBSS if it is likely we will *not* use a revealed cost forecasting approach to forecast opex for the 2028–33 period.

If we apply the EBSS but do not forecast opex using revealed costs, a TNSP could in theory receive an EBSS reward for efficiency gains (at a cost to consumers), but consumers would not benefit through a lower revealed cost forecast. If the TNSP expects this, it has an incentive to increase its EBSS carryover by reducing opex in its base year, knowing that it will not reduce its opex forecast.<sup>25</sup> Consumers would pay the

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<sup>24</sup> NER, cl. 6A.6.5(b)(3).

<sup>25</sup> In our explanatory statement to the EBSS, we detail why excluding the expenditure categories not forecast using a single year revealed cost forecasting method is in the best interest of network users. AER, *Explanatory statement - efficiency benefit sharing scheme*, November 2013, pp. 18–19.

EBSS reward, but not receive a share of the underspend and would be worse off. This outcome is contrary to the NER, which requires that the EBSS must provide for a fair sharing of efficiency gains and losses between a transmission business and consumers.<sup>26</sup>

If a TNSP's revealed costs in the current (2018–23) period are materially higher than the opex incurred by a benchmark efficient TNSP, we will be unlikely to use revealed costs to forecast opex for the 2023–28 period. In which case, we will be unlikely to apply the EBSS. Where we allow forecast opex that is materially lower than revealed costs, even in the absence of the EBSS the TNSP would have an incentive to reduce opex and therefore may have an incentive to capitalise expenditure it would have previously expensed. Given these incentives to reduce opex (and therefore to substitute opex with capex), we consider that applying the CESS would likely provide more balanced incentives between incurring capex and opex than not applying the CESS.<sup>27</sup>

Appendix A of the explanatory statement to the EBSS provides a detailed example of how the EBSS works with a revealed cost forecasting approach.<sup>28</sup>

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<sup>26</sup> NER, cl.6A.6.5(a).

<sup>27</sup> For example, we chose to apply the CESS and not the EBSS to Northern Territory electricity distributor, Power and Water in its 2019–24 distribution determination. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/power-and-water-corporation-determination-2019-24/draft-decision>.

<sup>28</sup> AER, *Explanatory statement – Efficiency benefit sharing scheme*, November 2013, pp. 25–26. <https://www.aer.gov.au/system/files/AERexplanatorystatement-efficiencybenefitsharingschemeNovember2013.docx>.

## 4 Capital expenditure sharing scheme

The CESS provides financial rewards to TNSPs whose capex becomes more efficient, and financial penalties for TNSPs whose capex becomes 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 TNSPs and network users.

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 the TNSP's share of the underspend/overspend
- CESS payments are calculated taking into account the financing benefit or cost to the TNSP of the underspend/overspend.<sup>29</sup> Further adjustments can also be made to account for deferral of capex and ex post exclusions of capex from the RAB
- CESS payments are added or subtracted to the TNSP's regulated revenue as a separate building block in the next regulatory control period.

Under the CESS, a TNSP retains 30 per cent of an underspend/overspend, while consumers retain the other 70 per cent. This means that for every one dollar saving in capex, the TNSP keeps 30 cents while consumers gain 70 cents.

### 4.1 AER's position

The CESS applies to Murraylink in the current 2018–23 period. Our position is to continue to apply the CESS, as set out in our capex incentives guideline, to Murraylink in the 2023–28 period.<sup>30</sup> We consider this will contribute to the capex incentive objective.<sup>31</sup> We also note the AER is currently scoping a broad review of incentive schemes to address any stakeholder concerns.

### 4.2 AER's assessment approach

In deciding whether to apply the CESS to a TNSP, including the nature and details of the applied CESS, we must:

- make that decision in a manner that contributes to the capex incentive objective

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<sup>29</sup> We calculate benefits as the benefits to the TNSP 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 TNSP of the overspend.

<sup>30</sup> AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 5–9.

<sup>31</sup> NER, cl. 6A.5A(a) and 6A.6.7(c).

- consider the CESS principles, capex objectives, other incentive schemes, and (where relevant) the opex objectives, as they apply to the particular TNSP, and the circumstances of the TNSP.

Broadly, the capex incentive objective is to ensure that only capex that meets the capex criteria enters the RAB (where the RAB is used to set prices). Consumers, therefore, only fund capex that is efficient and prudent.

### 4.3 Reasons for AER's position

In developing the CESS, we took into account the capex incentive objective, capex criteria, capex objectives and the CESS principles. The CESS is designed to work alongside other incentive schemes that apply to TNSPs, including the EBSS and STPIS.

If a TNSP spends less than its approved forecast capex during a regulatory control period, that TNSP will benefit within that period. At the end of the regulatory control period, the TNSP's RAB will be updated to include new capex. The RAB will include a lower capex amount than would be the case if the TNSP had spent the full forecast capex amount. This is where any sharing of capex underspends (or overspends) with consumers occurs. Thus consumers will also benefit from a capex underspend, but this will occur at the end of the regulatory control period as the result of lower future prices.

As the end of the regulatory control period approaches, the time available for the TNSP to retain any savings gets shorter. The earlier in the period that a TNSP incurs an underspend, the greater is its reward. Without a CESS, the TNSP may choose to spend earlier on capex, spend less on capex (at the expense of service quality), or displace opex with capex. The TNSP may make these choices when it is not efficient to do so. The CESS maintains the TNSP's incentive to spend less than its forecast capex as the TNSP approaches the end of its regulatory period.

The CESS means the TNSP faces the same reward and penalty for capex underspends/overspends in every year of the regulatory control period. The CESS provides TNSPs with an ex ante incentive to spend only efficient capex. TNSPs that make efficiency gains will be rewarded through the CESS. Conversely, TNSPs that make efficiency losses will be penalised through the CESS. In this way, TNSPs will be more likely to incur only efficient capex when subject to a CESS, increasing the likelihood that capex included in the TNSP's RAB reflects the capex criteria. Specifically, if a TNSP is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent TNSP.

When the CESS, EBSS and STPIS apply to a TNSP the incentives for improvements in opex, capex and service outcomes are balanced. This encourages businesses to make efficient decisions concerning when and what type of expenditure to incur. Businesses are incentivised to efficiently balance expenditure reductions against service quality and reliability.



## 5 Small-scale incentive scheme

The NER provide that we may develop a SSIS.<sup>32</sup> On 21 July 2020, we published an electricity distribution SSIS for customer service, referred to as the ‘customer service incentive scheme’ (CSIS).<sup>33</sup> Development of the CSIS was a collaborative effort between networks, consumers and market bodies. It was driven by a proposal to apply customer service incentives coming out of AusNet Service’s trial of ‘New Reg’ – a joint initiative between the AER, Energy Networks Australia (ENA) and Energy Consumers Australia (ECA) to explore ways to improve sector engagement and identify opportunities for regulatory innovation. The scheme rewards electricity distribution network service providers for improving their customer service, or penalise them if service deteriorates.

AusNet Services trialled New Reg in developing its 2021–26 electricity distribution regulatory proposal. As part of the negotiations, AusNet Services negotiated the customer service incentives with its Customer Forum and proposed to apply these incentives in its regulatory proposal. Under these CSIS incentives, AusNet Services will be penalised or rewarded based on how its customers rate its communication concerning planned and unplanned outages, its customer service for connections and complaints.

The relationship between TNSPs and their customers may be different to the relationship DNSPs have with their customers. As such, the development of a transmission CSIS warrants its own, separate consultation.

Murraylink has not proposed a detailed transmission incentive scheme design developed in conjunction with its customers. In the absence of a detailed scheme design, our position is to not apply a SSIS to Murraylink for the 2023–28 period.

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<sup>32</sup> NER, cl. 6A.7.5.

<sup>33</sup> AER, *Explanatory statement – customer service incentive scheme*, 21 July 2020.

## 6 Demand management innovation allowance mechanism

On 1 March 2019, Energy Networks Australia (ENA) submitted a rule change request to the AEMC proposing amendments to the NER that would require the AER to develop a demand management incentive scheme (DMIS) and a DMIAM to apply to TNSPs.<sup>34</sup> On 5 December 2019, the AEMC published a final rule determination to apply the DMIAM – but not the DMIS – to TNSPs.<sup>35</sup>

Introducing a DMIAM for transmission is expected to encourage transmission businesses to expand and share their knowledge and understanding of innovative demand management projects that may reduce long-term network costs and, consequently, lower prices for consumers. The AEMC was not satisfied that the benefits of applying the DMIS to transmission businesses would outweigh the upfront costs to consumers.<sup>36</sup>

In accordance with the NER<sup>37</sup> and following stakeholder consultation on a draft DMIAM, the AER published the final DMIAM on 27 May 2021.<sup>38</sup> The DMIAM provides TNSPs with funding for research and development in demand management projects that have the potential to reduce long-term network costs.

Our position is to apply the DMIAM to Murraylink for the 2023–28 period.

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<sup>34</sup> AEMC, *Demand management incentive scheme and innovation allowance for TNSPs, Rule determination*, December 2019.

<sup>35</sup> AEMC, *Demand management incentive scheme and innovation allowance for TNSPs, Rule determination*, December 2019.

<sup>36</sup> AEMC, *Demand management incentive scheme and innovation allowance for TNSPs, Rule determination*, December 2019.

<sup>37</sup> NER, cl. 6A.7.6.

<sup>38</sup> AER, *Demand management innovation allowance mechanism, Electricity transmission network service providers*, May 2021 available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/demand-management-innovation-allowance-mechanism-transmission/final-decision>.

## 7 Expenditure forecast assessment guideline

The expenditure forecast assessment guideline (guideline) sets out our expenditure forecast assessment approach as developed, and consulted upon, during the Better Regulation program.<sup>39</sup> It outlines the assessment techniques we will use to assess a transmission business's proposed expenditure forecasts, and the information we require from the business. This section sets out our intention to apply the guideline to Murraylink for the 2023–28 period.

The guideline uses a nationally consistent reporting framework that allows us to compare the relative efficiencies of transmission businesses and decide on efficient expenditure forecasts. The NER requires Murraylink to advise us of the methodology it proposes to use to prepare its forecasts by 30 June 2021.<sup>40</sup>

The F&A paper must set out our proposed approach to application of the guideline.<sup>41</sup> This will provide Murraylink with clarity regarding the information it should include in its revenue proposal. This contributes to an open and transparent process and makes our assessment of expenditure forecasts more predictable.

The guideline contains a suite of assessment/analytical tools and techniques to assist our review of the expenditure forecasts that transmission businesses include in their regulatory proposals. We intend to have regard to the assessment tools set out in the guideline. The tool kit includes:

- benchmarking (including broad economic techniques and more specific analysis of expenditure categories)
- methodology, governance and policy reviews
- predictive modelling and trend analysis
- cost benefit analysis and detailed project reviews.<sup>42</sup>

We exercise judgement to determine the extent to which we use a particular technique to assess a regulatory proposal. We use the techniques we consider appropriate depending on the specific circumstances of the determination. The guideline is flexible and recognises that we may employ a range of different estimating techniques to assess an expenditure forecast.

We developed the expenditure forecast assessment guideline to apply broadly to all electricity transmission and distribution businesses. Given Murraylink's smaller scale of

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<sup>39</sup> We were required to develop the EFA guideline under clauses 6.4.5 and 11.53.4 of the NER. We published the guideline on 29 November 2013. It can be located at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/expenditure-forecast-assessment-guideline-2013>.

<sup>40</sup> NER, cl. 6A.10.1B.

<sup>41</sup> NER, cl. 6A.10.1A(b)(5).

<sup>42</sup> AER, *Explanatory statement: Expenditure assessment guideline for electricity transmission and distribution*, 29 November 2013.

assets and nature of its network operations we do not intend applying standardised benchmarking analysis (including top down economic benchmarking or driver-based benchmarks) or predictive modelling in assessing its capex and opex forecasts. Our proposed approach for opex will involve consideration of revealed costs and the 'base-step-trend' approach. For capex, our proposed approach will involve detailed reviews of Murraylink's asset management practices and specified projects. Consequently, the information we will seek from Murraylink through the regulatory information notice may not include the same standardised data on expenditures and related benchmarking measures that are set out in the guideline.

## 8 Depreciation

This section sets out our proposed approach to calculating depreciation when the RAB is rolled forward to the commencement of the 2028–33 period.

As part of the roll forward methodology, when the RAB is updated from forecast capex to actual capex at the end of a regulatory control period, it is also adjusted for depreciation. The depreciation we use to roll forward the RAB can be based on either:

- actual capex commissioned during the regulatory control period (actual depreciation). We roll forward the RAB based on actual capex less the depreciation on the actual capex commissioned by the TNSP; or
- the capex allowance forecast at the start of the regulatory control period (forecast depreciation). We roll forward the RAB based on actual capex less the depreciation on the forecast capex approved for the regulatory control period.

For TNSPs, the recognition of capex in our regulatory models is based on a partially as incurred approach.<sup>43</sup> Under this approach, the return on capital is calculated based on as incurred forecast capex and the return of capital (depreciation) is calculated based on as commissioned forecast capex.<sup>44</sup>

The choice of depreciation approach is one part of the overall capex incentive framework.

Where a CESS is applied, using forecast depreciation maintains the incentives for TNSPs to pursue capex efficiencies, whereas using actual depreciation would increase these incentives. There is more information on depreciation as part of the overall capex incentive framework in our capex incentives guideline.<sup>45</sup> In summary:

- if there is a capex overspend, actual depreciation will be higher than forecast depreciation. This means that the RAB will increase by a lesser amount than if forecast depreciation were used. So, the TNSP will earn less revenue into the future (i.e. it will bear more of the cost of the overspend into the future) than if forecast depreciation had been used to roll forward the RAB
- if there is a capex underspend, actual depreciation will be lower than forecast depreciation. This means that the RAB will increase by a greater amount than if forecast depreciation were used. Hence, the TNSP will earn greater revenue into the future (i.e. it will retain more of the benefit of an underspend into the future) than if forecast depreciation had been used to roll forward the RAB.

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<sup>43</sup> AER, *Final decision: Electricity transmission network service providers – Roll forward model handbook*, April 2020, p. 13; AER, *Final decision: Electricity transmission network service providers – Post-tax revenue handbook*, April 2021, p. 22.

<sup>44</sup> Forecast capex is net of asset disposals.

<sup>45</sup> AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 11–12.

The incentive from using actual depreciation to roll forward the RAB also varies with the life of the asset. Using actual depreciation will provide a stronger incentive for the TNSP to underspend capex on shorter lived assets compared to longer lived assets as this will lead to a relatively larger increase in the RAB. Use of forecast depreciation, on the other hand, leads to the same incentive for capex regardless of asset lives. This is because using forecast depreciation does not affect the TNSP's incentive on capex as the TNSP does not lose the full cost of any overspend and is not able to keep all the benefits of any underspend. To this end, using forecast depreciation means the capex incentive is focussed on the return on capital.

## 8.1 AER's position

Our position is to use the forecast depreciation approach to establish the RAB at the commencement of the 2028–33 period for Murraylink.<sup>46</sup>

## 8.2 AER's assessment approach

We must set out our proposed approach as to whether we will use actual or forecast depreciation to establish a TNSP's RAB at the commencement of the following regulatory control period.<sup>47</sup> Our decision must be consistent with the capex incentive objective.<sup>48</sup> We must have regard to:<sup>49</sup>

- any other incentives the service provider has to undertake efficient capex
- substitution possibilities between assets with different lives
- the extent of overspending and inefficient overspending relative to the allowed forecast
- the capex incentive guidelines
- the capital expenditure factors.

Our approach is to apply forecast depreciation except where:

- there is no CESS in place and therefore the power of the capex incentive may need to be strengthened, or
- a TNSP's past capex performance demonstrates evidence of persistent overspending or inefficiency, thus requiring a higher powered incentive.

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<sup>46</sup> NER, cl. 6A.10.1A(b)(6).

<sup>47</sup> NER, cl S6A.2.2B and 6A.5A(b)(3).

<sup>48</sup> NER, cl S6A.2.2B(b).

<sup>49</sup> NER, cl S6A.2.2B.

In making our decision on whether to use actual depreciation in either of these circumstances we will consider:

- the substitutability between capex and opex and the balance of incentives between these
- the balance of incentives with service outcomes
- the substitutability of assets of different asset lives.

### 8.3 Reasons for AER's position

The opening RAB at the commencement of the 2023–28 period will be established using forecast depreciation, as stated in our previous determination that applies to Murraylink for the current 2018–23 period.

The use of forecast depreciation to establish the opening RAB for the commencement of the 2028–33 period, therefore, maintains the current approach. Murraylink is currently subject to version 1 of the CESS and, as set out in section 4 above, we propose to continue applying version 1 of the CESS in the 2023–28 period. We consider that the CESS will provide sufficient incentives for Murraylink to achieve capex efficiency gains over that period.

We are satisfied that the incentive provided by the application of the CESS, in combination with the use of forecast depreciation and our other ex post capex measures, would be sufficient to achieve the capex incentive objective.<sup>50</sup>

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<sup>50</sup> AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 13–20 and pp. 21–22.

## A Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
Capex	Capital expenditure
CESS	Capital expenditure sharing scheme
CSIS	Customer service incentive scheme (small-scale incentive scheme for customer service)
DMIAM	Demand management innovation allowance mechanism
DMIS	Demand management incentive scheme
DNSP	Distribution network service provider
EBSS	Efficiency benefit sharing scheme
F&A	Framework and approach
ISP	Integrated System Plan
MAR	Maximum allowed revenue
MIC	Market impact component
NCC	Network capability component
NEM	National Electricity Market
NER	National Electricity Rules
Opex	Operating expenditure
RAB	Regulatory asset base
SC	Service component
SSIS	Small-scale incentive scheme
STPIS	Service target performance incentive scheme
TNSP	Transmission network service provider