DRAFT DECISION

Power and Water Corporation 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 Power and Water Corporation 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 attachments:

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
ACS	alternative control services
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP 13	Consumer Challenge Panel, sub-panel 13
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIAM	demand management innovation allowance (mechanism)
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
NT NER or the rules	National Electricity Rules As in force in the Northern Territory

Shortened form	Extended form
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
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
SCS	standard control services
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

9 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 Power and Water in the 2018–23 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 NT NER provides that the CESS that was applicable in other jurisdictions as at 1 July 2016 is taken as the scheme applicable to Power and Water.[2]

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 underspend or overspend.[3] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the RAB.[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.

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.

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1 AER, *Capital Expenditure Incentive Guideline*, November 2013, pp. 5–9.

2 NT NER, cl. 6.5.8A(ea).

3 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.

4 The capex incentive guideline outlines how we may exclude capex from the RAB. AER, *Capital expenditure incentive guideline*, November 2013, pp. 13–20.

9.1 Draft decision

Our draft decision is to apply the CESS as set out in version 1 of the capital expenditure incentive guideline to Power and Water in the 2019–24 regulatory control period.[5] This is consistent with the proposed approach we set out in our framework and approach paper.[6]

9.2 Power and Water's proposal

Power and Water supported the application of version 1 of the CESS as set out in the capex incentive guideline from 1 July 2019.[7]

9.3 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:

- make that decision in a manner that contributes to the capex incentive objective
- take into account the CESS principles,[8] the capex objectives and, if relevant, the opex objectives,[9] the interaction with other incentive schemes as they apply to the particular service provider,[10] and the circumstances of the service provider.[11]

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.

9.3.1 Interrelationships

The CESS relates to the incentives Power and Water faces to incur efficient opex, conduct demand management and maintain or improve service levels. 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.

As set out in attachment 8 of this draft decision, we have determined not to apply the Efficiency Benefit Sharing Scheme (EBSS) to Power and Water in the 2019–24 regulatory control period. This is because we consider Power and Water already has strong incentives to reduce opex, as we have found that Power and Water's revealed

5 NT NER, cl. 6.12.1(9).

6 AER, *Final framework and approach, Power and Water Corporation (NT), Regulatory control period commencing 1 July 2019*, July 2017, p. 47.

7 Power and Water, *Regulatory proposal 2019–24*, 16 March 2018, p. 117.

8 NT NER, cl. 6.5.8A(e)(4)(i); the CESS principles are set out in cl.6.5.8A(c).

9 NT NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(2); the capex objectives are set out in cl. 6.5.7(a); the opex objectives are set out in cl.6.5.6(a).

10 NT NER, cll. 6.5.8A(e)(4)(i) and 6.5.8A(d)(1).

11 NT NER, cl. 6.5.8A(e)(4)(ii).

costs do not reflect efficient costs. Given these incentives to reduce opex (and therefore to substitute opex with capex), we consider that applying the CESS would provide more balanced incentives between incurring capex and opex than not applying the CESS.

9.4 Reasons for draft decision

We are satisfied with Power and Water's proposal to apply the CESS as set out in the capex incentive guideline.

As we set out in the framework and approach paper, distributors will be more likely to incur only efficient capex when subject to a CESS, so any capex included in the RAB is more likely to reflect the capex criteria. Without a CESS the incentive for a distributor to spend less than its forecast capex declines throughout the period. With the CESS a distributor faces the same reward and penalty in each year of a regulatory control period for capex underspends or overspends.[12] The CESS will therefore provide Power with a continuous incentive to pursue capex efficiency gains in the 2019–24 regulatory control period.

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[13] In developing the guideline we took into account the capex incentive objective, capex criteria, capex objectives and the NEO.

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12 AER, *Final framework and approach, Power and Water Corporation (NT), Regulatory control period commencing 1 July 2019*, July 2017, pp. 48-49.

13 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013.