



**PRELIMINARY DECISION**  
**Ergon Energy determination**  
**2015–16 to 2019–20**

**Attachment 10 – Capital**  
**expenditure sharing scheme**

April 2015

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## Note

This attachment forms part of the AER's preliminary decision on Ergon Energy's 2015–20 distribution determination. It should be read with all other parts of the preliminary decision.

The preliminary 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

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
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

Shortened form	Extended form
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
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 Ergon Energy in the 2015–20 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 Preliminary decision

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to Ergon Energy in the 2015–20 regulatory control period.<sup>1</sup> This is consistent with the proposed approach we set out in our framework and approach paper.<sup>2</sup>

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<sup>1</sup> AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9.

<sup>2</sup> AER, *Preliminary positions paper, Framework and approach for Energex and Ergon Energy, Regulatory control period commencing 1 July 2015*, December 2013, p. 67.

## 10.2 Ergon Energy's proposal

Ergon Energy supported the AER's proposed approach to the application of the CESS as set out in the capex incentives guideline.<sup>3</sup> However, Ergon Energy suggested that in applying the CESS, the AER should consider the potential impacts on the operation of the CESS that may be generated by:<sup>4</sup>

- expenditure on customer connection initiated capital works being above or below the expected AER allowances or forecasts
- decisions by a distributor to not apply for a pass through for events that may meet the materiality threshold but generate capex that could contribute to over-expenditure of allowances.

## 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:<sup>5</sup>

- make that decision in a manner that contributes to the capex incentive objective<sup>6</sup>
- take into account the CESS principles,<sup>7</sup> the interaction of the CESS with any other incentives that the service provider may have to undertake efficient opex or capex, the capex objectives,<sup>8</sup> 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 Ergon Energy faces to incur efficient opex, conduct demand management, and maintain or improve service levels.<sup>9</sup> 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.

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<sup>3</sup> Ergon Energy, *Ergon Energy, Regulatory Proposal, 2015 to 2020*, October 2014, p. 29.

<sup>4</sup> Ergon Energy, *Ergon Energy, Regulatory Proposal, 2015 to 2020*, October 2014, p. 29. Ergon Energy, *03.01.03 Application of Incentive Schemes*, October 2014, pp 2–3.

<sup>5</sup> NER, cl. 6.5.8A(e).

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

<sup>7</sup> NER, cl. 6.5.8A(c).

<sup>8</sup> NER, cl. 6.5.7(a).

<sup>9</sup> 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.



## 10.4 Reasons for preliminary decision

We are satisfied that the CESS, as set out in the capex incentives guideline, should apply to Ergon Energy.

For capex, the sharing of underspends and overspends happens at the end of each regulatory control period when we update a network service provider's RAB to include new capex. If a network service provider spends less than its approved forecast during a period, it will benefit within that period. Consumers benefit at the end of that period when the RAB is updated to include less capex compared to if the service provider had spent the full amount of the capex forecast.

Without a CESS the incentive for a service provider to spend less than its forecast capex declines throughout the period. This is because as the end of the regulatory control period approaches, the time available for the service provider to retain any savings gets shorter. So the earlier a service provider incurs a capex underspend in the regulatory period, the greater its reward will be. As a result, the incentive for a service provider to spend less than its capex forecast declines throughout the period. Because of this, a service provider may choose to spend capex earlier than necessary, spend on capex when it may otherwise have spent on opex, or spend less on capex at the expense of service quality—even if it may not be efficient to do so.

In developing the CESS we took into account the capex incentive objective, capex criteria, capex objectives, and the CESS principles. With the CESS, Ergon Energy will face the same reward and penalty in each year of a regulatory control period for capex underspends or overspends. The CESS will provide Ergon Energy with an ex ante incentive to spend only efficient capex. Ergon Energy will be rewarded through the CESS for making capex efficiency gains. Conversely, Ergon Energy will be penalised through the CESS for making capex efficiency losses. In this way, Ergon Energy 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. In particular, if Ergon Energy is subject to the CESS, its capex is more likely to be efficient and to reflect the costs of a prudent service provider.

The Queensland Council of Social Services (QCOSS) noted the importance of forecasting a prudent and efficient amount of total capex. QCOSS considered the application of the CESS should not reward service providers for becoming more efficient from what may be an inefficient base.<sup>10</sup> The Alliance of Electricity Consumers was similarly concerned that the CESS may reward Ergon Energy for inefficient capex.<sup>11</sup> We addressed these issues in our explanatory statements to the capex

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<sup>10</sup> Queensland Council of Social Services, *Submission to the AER's Queensland electricity distribution determination 2015-2020*, January 2015, pp. 93–94.

<sup>11</sup> The Alliance of Electricity Consumers, *Submission on Ergon Energy's Regulatory Proposal 2015-2020*, January 2015, p. 29.

incentive guideline.<sup>12</sup> As outlined above, the sharing of capex underspends and overspends between consumers and the distributor happens at the end of each regulatory control period when we update the RAB to include new capex. In the absence of the CESS the sharing ratio between consumers and the distributor will vary depending on the year in which the underspend or overspend occurs. Instead, under the CESS there will be a constant sharing ratio of 30:70. The CESS will also provide a continuous incentive for Ergon Energy to incur efficient capex over the regulatory control period, rather than the declining incentive that is present without the CESS.

#### 10.4.1 Considerations in how we apply the CESS

As noted above, Ergon Energy supported the application of the CESS but raised issues about:<sup>13</sup>

- expenditure on customer connection initiated capital works being above or below the expected AER allowances or forecasts
- decisions by a distributor to not apply for a pass through for events that may meet the materiality threshold but generate capex that could contribute to over-expenditure of allowances.

Ergon Energy did not propose these categories of expenditure be automatically excluded from the CESS. But it proposed that in assessing the operation of the scheme we consider any overspend or underspend of capex in these categories against the capital objectives, criteria and factors under the Rules in assessing whether the overspend or under spend is efficient or inefficient.<sup>14</sup> Ergon Energy noted that not all categories of capex were subject to distortions and forms of 'gaming', in particular, those capex categories driven by circumstances beyond the distributor's control. Ergon Energy considered we should take this into account so our incentive schemes minimise the possibility of windfall gains or losses driven by factors unconnected to a distributors' performance.<sup>15</sup>

For the reasons we set out below, we are not satisfied the issues Ergon Energy raised regarding application of the CESS warrant modifying how we apply the CESS in the 2015–20 regulatory control period. The issues Ergon Energy raised were not new to those we considered during our development of the capex incentive guideline.<sup>16</sup> We have considered Ergon Energy's circumstances and the specific matters it raised in its proposal regarding the application of the CESS. We note we decided to apply the

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<sup>12</sup> AER, *Explanatory Statement, Draft Capital Expenditure Incentive Guideline for Electricity Network Service Providers, August 2013*; AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013*.

<sup>13</sup> Ergon Energy, *Ergon Energy, Regulatory Proposal, 2015 to 2020*, October 2014, p. 29. Ergon Energy, *03.01.03 Application of Incentive Schemes*, October 2014, pp 2–3.

<sup>14</sup> Ergon Energy, *03.01.03 Application of Incentive Schemes*, October 2014, p. 10.

<sup>15</sup> Ergon Energy, *03.01.03 Application of Incentive Schemes*, October 2014, p. 8.

<sup>16</sup> AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013*, p. 30, 37–39.

CESS as set out in the guideline to all NSW, QLD and SA distributors. We are of the view that Ergon Energy has not provided sufficient evidence to demonstrate why its circumstances warrant a departure from this approach.

## Uncontrollable capex categories

Ergon Energy submitted that a distributor has limited ability to improve its efficiency in relation to uncontrollable categories of capex such as customer initiated capex. To the extent a distributor can improve efficiency Ergon Energy considers it will continue to be rewarded or penalised by reference to the difference between the forecast customer initiated capex allowance and actual expenditure in a given year. However, it submitted that this effect should not be exacerbated by the additional reward or penalty associated with the CESS.<sup>17</sup>

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 capex resulting from uncontrollable events. When included in the CESS, the cost of any capex increase or decrease from an uncontrollable event 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.<sup>18</sup>

If we excluded capex resulting from uncontrollable events from the CESS, the associated capex underspend or overspend will still be shared between the service provider and consumers. However, when excluded from the CESS the relative sharing ratio between the service provider and consumers will depend on the year in which the overspend or underspend occurs, and will vary across the regulatory control period. We considered there was no reason why capex overspends or underspends resulting from uncontrollable events should be shared differently between service providers and consumers in each regulatory year, or shared differently to all other costs facing service providers.<sup>19</sup>

Ergon Energy's forecast of customer initiated capex, as with all forecasts, is not precise. 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.

Finally, capex is generally lumpy and non-recurrent and different capex categories have different drivers. The extent to which a distributor can influence capex drivers can

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<sup>17</sup> Ergon Energy, *03.01.03 Application of Incentive Schemes*, October 2014, p. 9.

<sup>18</sup> AER, *Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 38–39. (AER, *Explanatory Statement, Capex incentive guideline*, November 2013).

<sup>19</sup> AER, *Explanatory Statement, Capex incentive guideline*, November 2013, 38–39.

vary. However, we assess forecast capex at an overall rather than component level. Ergon Energy will not always be penalised or rewarded under the CESS for spending more or less on customer initiated capex than its forecast for that category of expenditure. This is as the CESS rewards and penalties are determined relative to total forecast capex.

The purpose of the CESS is to provide a continuous incentive for a distributor to deliver efficient overall capex and to share the benefits of capex efficiency gains (or costs of capex efficiency losses) between the distributor and consumers. The incentives provided by the CESS are part of a package of measures to incentivise distributors to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality.

## Pass through events

In our explanatory statement to the CESS we considered that a distributor could seek approval for additional material capex not included in its total forecast capex via the contingent projects and pass-through mechanisms.<sup>20</sup>

Ergon Energy noted that a distributor may decide to absorb the cost of capex events that might otherwise qualify for a pass through during the period to avoid price increases. However, a distributor may then be penalised later on if economic conditions, network demand or customer requirements necessitate over-expenditure of allowances later on in the same period. Ergon Energy also noted a distributor had several additional issues to consider when applying for a pass through such as administrative costs. Additionally, a pass through event affects not only CESS calculations but the distributor's return on capital and depreciation during the period. Finally, a pass through arms the distributor with the ability to pass those costs through to consumers, whether or not it had intended to do so when it made the pass through application.<sup>21</sup>

We consider these are issues for a distributor to take into account when making its expenditure decisions. The CESS provides a distributor with up front incentives for it to factor into its expenditure decisions. In order to avoid or reduce a capex overspend a distributor may decide to apply for a pass through for additional material capex not included in its total forecast capex. Or it may seek to reduce spending in other capex categories. Or it may decide to do nothing and receive the CESS penalty.

As outlined above, the purpose of the CESS is to provide a continuous incentive for a distributor to deliver efficient overall capex and to share the benefits of capex efficiency gains (or costs of capex efficiency losses) between the distributor and consumers. This is as part of the package of measures to incentivise distributors to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality.

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<sup>20</sup> AER, *Explanatory Statement, Capex incentive guideline*, November 2013, pp. 38–39.

<sup>21</sup> Ergon Energy, *03.01.03 Application of Incentive Schemes*, October 2014, p. 9.