DRAFT DECISION

SA Power Networks Distribution Determination 2020 to 2025

Attachment 9 Capital expenditure sharing scheme

October 2019

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 SA Power Networks for the 2020–2025 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

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Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

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Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CCP14	Consumer Challenge Panel, sub-panel 14
CESS	capital expenditure sharing scheme
CPI	consumer price index
distributor	distribution network service provider
NER or the rules	national electricity rules
opex	operating expenditure
RAB	regulatory asset base
repex	replacement expenditure
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 capital expenditure (capex) becomes more efficient and financial penalties for those that become 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 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.[1] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB).[2]
- 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.

We consider in addition to greater incentives to improve capex efficiency, the CESS provides a consistent incentive to incur capex efficiently during a regulatory control period and encourages more efficient substitution between capex and operating expenditure (opex).

This attachment sets out our draft decision for the determination of the revenue impacts as a result of the CESS applying from the 2015–20 regulatory control period and the application of the CESS for SA Power Networks in the 2020–25 regulatory control period.

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1 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.

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.

9.1 Draft decision

Revenue impact for the 2020–25 regulatory control period

Our draft decision is to apply a CESS revenue increment amount of $69.0 million ($2019–20) to be paid across the 2020–25 regulatory control period, from the application of the CESS in the 2015–20 regulatory control period.

The difference between our calculations and SA Power Networks' proposal is due to adopting:

- a more recent inflation figures.
- an updated weighted average cost of capital (WACC) input information.
- changes to actual capex for consistency with the roll forward model discussed in Attachment 2.

Given the timing of our draft decision we will update our calculations in our final decision for the following:

- SA Power Networks' actual expenditure for 2018–19.[3]
- If available, updated inflation using actual data.

Application of scheme in 2020–25 regulatory control period

We will apply the CESS, as set out in the capital expenditure incentives guideline to SA Power Networks in the 2020–25 regulatory control period.[4] This is broadly consistent with the proposed approach we set out in our framework and approach paper.[5]

9.2 SA Power Networks' proposal

SA Power Networks proposed a CESS payment of $69.7 million ($2019–20) for the 2020–25 regulatory control period.

SA Power Networks noted the primary reasons for its underspend are:

- Actual customer demand was lower than forecast, which allowed prudent deferral of a number of augmentation projects.
- Delaying some work programs, in particular asset replacement work as a more asset management efficient approach was being developed and implemented.

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[3] Given the timing of when SA Power Networks submitted its initial proposal, SA Power Networks was only able to provide an estimate of its capex for the 2018–19 regulatory year. When we make our final decision we will be able to update the CESS payment calculation for the actual capex SA Power Networks incurred in 2018–19.

[4] NER, cl 6.12.1(9); AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9.

[5] AER, *Final framework and approach SA Power networks regulatory control period commencing 1 July 2020*, July 2018, p. 72.

- Storm events in 2016–17 resulted in a diversion of resources to repairing and reinstating the network, and away from implementing its capital program.[6]

SA Power Networks considered its underspend should not give rise to an adjustment to the CESS as its deferrals has not led to a materially higher capex forecast in the 2020–25 regulatory control period. In particular, its 'value-based replacement' approach results in forecasting less repex for the 2020–25 regulatory control period than it otherwise would have.[7]

9.3 Assessment approach

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

- the revenue effects on SA Power Networks arising from applying the CESS in the 2015–20 regulatory control period; and
- whether or not to apply the CESS to SA Power Networks in the 2020–25 regulatory control period and how any applicable scheme will apply.[8]

Our assessment approach is set out below.

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2020–25 regulatory control period arising from the application of the CESS during the 2015–20 regulatory control period.[9] This includes assessing whether any adjustments should be made to the CESS for deferred capex.

Consistent with the CESS guideline, we will make an adjustment to CESS payments where a distributor has deferred capex in the current regulatory control period and:

1. the amount of the deferred capex in the current regulatory control period is material, and
2. the amount of the estimated underspend in capex in the current regulatory control period is material, and
3. total approved capex in the next regulatory control period is materially higher than it is likely to have been if a material amount of capex was not deferred in the current regulatory control period.[10]

The NER requires that our draft decision include a determination on how any applicable CESS should apply to SA Power Networks.[11] In deciding whether to apply a CESS to SA Power Networks for the 2020–25 regulatory control period, and the nature of the details of the scheme, we must:

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6 SA Power Networks, *Attachment 9 Capital expenditure sharing scheme*, January 2019, p. 8.
7 SA Power Networks, *Attachment 9 Capital expenditure sharing scheme*, January 2019, p. 8.
8 NER, cl. 6.12.1(9).
9 NER, cl. 6.4.3(a).
10 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 9.
11 NER, cl. 6.12.1(9).

- make that decision in a manner that contributes to the capex incentive objective[12]
- take into account the CESS principles,[13] the capex objectives and if relevant the opex objectives[14], the interaction with other incentive schemes[15] as they apply to the particular service provider, and the circumstances of the service provider.[16]

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.

9.4 Reasons for draft decision

9.4.1 CESS revenue increments from the 2015–20 regulatory control period

We have not adjusted SA Power Networks' CESS revenue increment to account for its material deferrals as we do not consider its deferrals has materially increased our draft decision substitute of capex.

However, we have adjusted for modelling inputs such as CPI, reported capex and the WACC to reflect more up to date information.

The first part of our assessment is to identify whether there has been a material deferral of capex. Although SAPN identified some drivers of its underspend in its regulatory proposal, it did not quantify its deferrals. In response to information requests[17] and our own analysis, we have identified $361.6 million ($2019–20) of capex projects that were not fully undertaken and included in its $1999.4 million ($2019–20) 2015–20 capex allowance.

Of these deferred projects, SA Power Networks incurred capex costs of $108.9 million ($2019–20) in the 2015–20 regulatory control period. This results in a net deferral of $252.7 million ($2019–20). In addition to the sources of deferrals identified in SA Power Networks regulatory proposal, there were also deferrals to ICT and property capex.

We do not have set thresholds for our materiality assessment. In this circumstance, both SA Power Networks' net deferrals of $252.7 million and its CESS applicable capex underspend of $309.5 million ($2019–20) is material as it is greater than 10 per cent of its current period capex allowance.

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12 NER, cl. 6.5.8A(e)(3); the capex incentive objective is set out in cl. 6.4A(a) of the NER

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

14 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).

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

16 NER, cl. 6.5.8A(e)(4)(ii).

17 SAPN, *Response to information request 32*, May 2019, p. 1.

However, for us to make a CESS adjustment, we must be satisfied that our substitute capex forecast is materially higher than it would have been had the 2015-20 capex not been deferred.

Based on our analysis from information request responses and business cases, we have identified at least $69.3 million in capex that has been included in SA Power Network's capex proposal.

We also note that of SA Power Networks' $65 million in repex deferrals, it estimates that the deferral will be longer than 10 years.[18] For the purposes of our CESS assessment, we have not included this capex as part of our reproposed calculations.

We have included one reproposed project, for CRM and Billing project ($9.5 million), in our substitute forecast net capex of $1276.7 million ($2019–20). As this accounts for less than 1 per cent of our substitute of forecast capex we do not consider the reproposed capex is material.

However, we note our substitute capex position may change in response to SA Power Networks' revised proposal. For example, in our assessment of property capex, we acknowledge that our substitute reflects a lack of information to support its forecast.

We note that had all of SA Power Networks' reproposed capex been included in our substitute forecast, this would increase our substitute capex by around 5 per cent which we would consider to be a material increase in forecast capex.

We received several submissions requesting that, due to a large capex underspend, we examine deferrals in more detail and query whether there are efficiency gains. These submissions also questioned whether consumers are receiving a benefit for capex underspends.[19]

We consider the CESS encourages distributors to pursue more efficient capex which in the long term reduce prices for consumers. As noted above, we consider deferrals are a significant driver of SA Power Networks' underspend. However, in this circumstance reproposed capex in our substitute forecast is not material and we have not adjusted the CESS payment.

We also note that this is the first iteration of the CESS, as discussed in the CESS guideline, other regulators have removed a CESS due to concerns around deferrals.[20] We will review the long term impact of the application of the CESS on prices after we have had the opportunity to review the CESS for Victorian distributors. Although we

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18 SA Power Networks, *Response to information request 11C*, p. 7, April 2019.

19 Business SA, *Submission to AER on SA Power Networks 2020–25 regulatory proposal*, May 2019, p. 7. CCP14, *Advice to the AER on the SA Power Networks 2020–25 regulatory proposal*, May 2019, p. 44, ECA, AER, *Issues paper: SA Power Networks Electricity distribution determination 2020 to 2025*, May 2019, p. 23. SACOSS, *Submission on SA Power Networks regulatory proposal 2020–25*, May 2019, pp. 5–7.

20 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers explanatory statement*, November 2013, p. 31.

intend to continue the application of the CESS for the 2020–25 regulatory control period, we can examine in further detail how we take into account deferrals.

SA Power Networks noted that the CESS payment should not be adjusted because of the drivers of the deferrals are reasonable and consumers are likely to face lower prices because of deferrals. [21]

We note that in our CESS guideline, we identified that customers would only be better off if deferred capex has no impact on forecast capex. In a situation where there is a short term deferral, the distributors reward from deferring capex is likely to exceed the benefit to customers from the short-term deferral. If this is the case, consumers will face higher prices after the deferral.[22] We also note that based on the amount of deferrals and the underspend, a majority of SA Power Networks' underspend is driven by deferrals. Although, SA Power Networks has identified efficiencies such as improvements in its repex approach, it is not clear how long this capex has been deferred. We discuss this issue in more detail in attachment 5.

As noted above, SA Power Networks included at least $65 million in reproposed capex. Had this been included in our forecast capex, customers would be paying higher prices than they otherwise would have had that capex been undertaken in the 2015–20 regulatory control period.

9.4.2 Application of CESS in the 2020–25 regulatory control period

We will apply the CESS to SA Power Networks in the 2020–25 regulatory control period. As we have set out in the framework and approach, we consider the CESS is needed to provide SA Power Networks with a continuous incentive to pursue efficiency gains.[23] This approach is consistent with SA Power Networks' regulatory proposal.[24]

The reasons for our preference for a CESS are set out in our capital expenditure incentive guideline.[25]

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21 SA Power Networks, *Attachment 9 Capital expenditure sharing scheme*, January 2019, p. 8.

22 AER, *Capital expenditure incentive scheme explanatory statement*, November 2013, p. 30.

23 AER, *Final framework and approach SA Power Networks regulatory control period commencing 1 July 2020*, July 2018, p. 72.

24 SA Power Networks, *Attachment 9 Capital expenditure sharing scheme*, January 2019, p. 9.

25 AER, *Explanatory statement capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 19.