

Final decision

Transgrid transmission determination
1 July 2023 to 30 June 2028

Attachment 9 – Capital expenditure sharing
scheme

April 2023

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9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards to 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. We first applied the CESS to Transgrid in the 2018–23 regulatory control period.

This attachment sets out our decision for both the determination of the revenue impacts as a result of the CESS applying in the 2018–23 regulatory control period, and the application of the CESS for Transgrid in the 2023–28 regulatory control period.

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. Under the CESS, a service provider retains 30% of an under-spend or over-spend, while consumers retain 70% of the under-spend or over-spend. 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.

The CESS works as follows:

1. We calculate the cumulative efficiency gains or losses for the current regulatory control period in net present value terms.
2. We apply a ratio of 30% to the cumulative under-spend or over-spend to work out the service provider's share of the under-spend or over-spend.
3. We calculate the CESS revenue increment/decrement taking into account the financing benefit, or cost, to the service provider of the under-spend or over-spend. We can also make a further adjustment to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB).

The CESS increment/decrement is added or subtracted to the service provider's regulated revenue as a separate building block in the next regulatory control period.

9.1 Final decision

9.1.1 Revenue impacts in the 2023–28 period from applying the CESS in the 2018–23 period

Our final decision is to apply a CESS revenue decrement of \$38.1 million (\$2022–23) from the application of the CESS in the 2018–23 regulatory control period and the corresponding CESS carryover true-up for 2017–18. This is \$36.3 million more than Transgrid's forecast decrement of \$1.8 million. The CESS revenue decrement arises as a result of an over-spend in capex against the forecast for the 2018–23 period, after accounting for deferrals and capitalisation changes. This revenue decrement is deducted from Transgrid's maximum allowed revenue across the 2023–28 regulatory control period. The primary reason for the difference in revenue decrement between our final decision and Transgrid's revised proposal is due to an increase in the deferral for *Project EnergyConnect* (PEC). There are also some slight adjustments due to updated inflation and weighted average cost of capital (WACC) inputs.

Our final decision on the revenue impact of the application of the CESS in the 2018–23 period and the corresponding CESS carryover true-up for 2017–18 is summarised in Table 1.

Table 1 AER's final decision on Transgrid's CESS

Revenue Adjustments	2023–24	2024–25	2025–26	2026–27	2027–28	Total
CESS revenue decrement as per NER 6A.5.4(a)(5)	-7.83	-7.83	-7.83	-7.83	-7.83	-39.15
CESS carryover true-up for 2017–18	0.22	0.22	0.22	0.22	0.22	1.08
Total CESS decrement	-7.61	-7.61	-7.61	-7.61	-7.61	-38.07

Note: Total may not add due to rounding.

Source: AER final decision CESS model

9.1.2 Application of the CESS in the 2023–28 period

Section 9.2.2 describes Transgrid's proposal to exclude the application of the CESS to PEC and other Integrated System Plan (ISP) projects in the 2023–28 period. As described in section 9.4.1.2, we do not accept that the CESS should not apply to PEC and ISP projects as Transgrid has not made a compelling case to not apply the CESS as part of the incentive-based ex ante regulatory framework. We will apply the CESS as set out in version 1 of the *Capital Expenditure Incentives Guideline* to Transgrid in the 2023–28 regulatory control period.¹ Consistent with the revised CESS guideline, we will consider the merits of any proposed application of the CESS for future large transmissions projects on a case-by-case basis at the time of the contingent project applications to ensure they are in the long-term interests of consumers. Our default position is to apply the CESS and we will be careful in making exclusions.

9.2 Transgrid's revised proposal

9.2.1 Revenue impacts in the 2023–28 period from applying the CESS in the 2018–23 period

Transgrid proposed a CESS revenue decrement of \$2.9 million (\$2022–23) for the 2023–28 regulatory control period, compared to a \$0.9 million CESS revenue increment from our draft decision.

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

In its revised proposal, Transgrid has:

- accepted our additional non-PEC deferrals from our draft decision
- increased capex under-spend for 2018–23 regulatory period from its initial estimates, including:
 - updated actual 2021–22 capex with a further \$270.0 million under-spend
 - reduced 2022–23 capex estimates by \$104.2 million
- increased PEC deferrals from \$532.8 million to \$989.3 million (\$2022–23) which has the effect of reducing Transgrid’s CESS benefit
- aligned the 2018–23 inflation assumptions to our draft decision.

9.2.2 Application of the CESS in the 2023–28 period

Transgrid’s revised proposal requested to exclude PEC and other ISP projects from the application of the CESS in the 2023–28 regulatory control period, a departure from its initial proposal, for the following reasons:²

- Transgrid’s input costs, including materials, labour and freight have increased. These cost increases have been driven by a range of factors (for example, supply change disruptions and the cost of fuel increasing due to the war in Ukraine) beyond Transgrid’s control.³ It is uncertain how long the existing inflationary pressures faced by major construction projects, including by PEC, will last.
- That these inflationary pressures could not have been anticipated, and are largely driven by supply-side factors that are beyond Transgrid’s control.
- The scale of PEC means that any resulting CESS penalties could have a material adverse impact on cash flows and financeability in future regulatory control periods.

9.3 Assessment approach

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

- the revenue impacts on Transgrid arising from applying the CESS in the 2018–23 regulatory control period
- whether or not to apply the CESS to Transgrid in the 2023–28 regulatory control period and how any applicable scheme will apply.⁴

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2023–28 period arising from the application of the CESS during the 2018–23 period.⁵

² Transgrid, *Suspension of CESS for Project EnergyConnect*, 2 December 2022, p. 8.

³ Transgrid, *Suspension of CESS for Project EnergyConnect*, 2 December 2022, p. 2.

⁴ NER, cl. 6A.14.1(5A).

⁵ NER, cl. 6A.5.4(a)(5).

We must also determine how any applicable CESS is to apply to Transgrid in the 2023–28 period.⁶ In deciding whether to apply a CESS to Transgrid for the 2023–28 period, and the nature and details of the scheme, we must:⁷

- make that decision in a manner that contributes to the capex incentive objective;⁸ and
- take into account the CESS principles,⁹ the capex objectives and, where relevant, the operating expenditure (opex) objectives,¹⁰ the interaction with other incentive schemes,¹¹ and the circumstances of the service provider.¹²

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 approval of CESS revenue increment/decrement determines the associated CESS building block as part of Transgrid’s overall forecast revenue requirement for the 2023–28 regulatory control period.

The CESS relates to other incentives Transgrid faces to incur efficient opex, conduct demand management, and maintain or improve service levels. Related schemes include the efficiency benefit sharing scheme (EBSS) for opex, and the service target performance incentive scheme (STPIS) for 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.

9.4 Reasons for final decision

Our final decision is to include a CESS revenue decrement of \$39.2 million. This is \$36.3 million more than Transgrid’s proposed CESS revenue decrement of \$2.9 million. We elaborate on each of the reasons previously set out in section 9.1.1 in the sections below.

9.4.1 Application of the CESS in the 2018–23 period

9.4.1.1 Assessment of deferred capex

Transgrid’s revised proposal included \$989.3 million of deferred capex for PEC, which is \$456.5 million higher than the \$532.8 million submitted in the initial proposal. Deferred capex forms part of the CESS calculation.

⁶ NER, cl. 6A.14.1(5A).

⁷ NER, cl. 6A.6.5A(e).

⁸ NER, cl. 6A.6.5A(e)(3); the capex incentive objective is set out in cl. 6A.5A(a).

⁹ NER, cl. 6A.6.5A(e)(4)(i); the CESS principles are set out in cl.6A.6.5A(c).

¹⁰ NER, cll. 6A.6.5A(e)(4)(i) and 6A.6.5A(d)(2); the capex objectives are set out in cl. 6A.6.7(a); the opex objectives are set out in cl. 6A.6.6(a).

¹¹ NER, cll. 6A.6.5A(e)(4)(i) and 6A.6.5A(d)(1).

¹² NER, cl. 6A.6.5A(e)(4)(ii).

We consulted with Transgrid about the proposed deferred capex for PEC, which involved Transgrid submitting a letter to us setting out how it calculated the \$989.3 million deferred PEC capex.¹³ We do not consider Transgrid has correctly calculated the remaining unspent capex for PEC because it has used an inflation series inconsistent with this determination, it has not updated the calculation of deferred capex for the inflation available at the time of the revised proposal, and it has excluded an unexplained residual amount from the deferred capex.¹⁴

As discussed in Attachment 5 – Capital expenditure, our final decision includes \$1,104.1 million for deferred PEC capex in our substitute estimate of total capex.¹⁵ This is \$114.8 million higher than the deferred PEC capex submitted in the revised proposal. The reason for this amendment is to ensure the remaining unspent portion of the total PEC capex requirement in the contingent project determination is included in Transgrid’s 2023–28 capex forecast.¹⁶ This is calculated on a common dollar basis (\$2022–23) to account for changes in inflation as consistent with the inflation series used in this final decision.¹⁷ Updating the deferred capex also ensures that the correct PEC capex forecast is included in the 2023–28 CESS calculation.

We have therefore increased the deferred PEC in the CESS calculation for 2018–23 associated with this change. This is the primary reason for the difference in CESS revenue decrement between the \$39.2 million in our final decision and the \$2.9 million in Transgrid’s revised proposal.

9.4.1.2 Adjustments to modelling inputs

We have updated the inflation rate for actual 2022–23 inflation, forecast inflation for 2023–28, and the WACC for 2023–28 based on the most recent information in our calculation of the CESS revenue adjustment.

9.4.2 Application of the CESS in the 2023–28 period

We do not accept Transgrid’s proposal to exclude the application of the CESS to PEC and other ISP projects in 2023–28. As part of the incentive-based ex ante regulatory framework, our default position is that a network service provider (NSP) should have the appropriate incentives in place to spend efficiently and to share any costs or benefits with consumers. To depart from this approach, we require a compelling case to not apply the incentive schemes. As discussed below, we do not consider Transgrid has made a compelling case to not apply

¹³ Transgrid, [Letter to AER on PEC capex](#), 3 April 2023.

¹⁴ Transgrid states the \$989.3 million deferred PEC capex results in a total PEC capex that is \$144.7 million lower than total approved PEC capex requirement in the contingent project determination. Transgrid, [Letter to AER on PEC capex](#), 3 April 2023.

¹⁵ Using Transgrid’s revised proposal inflation (\$2022–23), the total PEC forecast capex requirement in the contingent project determination is \$2,120.5 million. Subtracting the actual/estimated capex of \$1,017.0 million in the 2018–23 period from the total capex requirement results in \$1,103.5 million remaining unspent PEC capex. The \$1,103.5 million is adjusted with the latest inflation inputs to determine the \$1,104.1 million.

¹⁶ NER cl. 6A.6.7(h).

¹⁷ The deferred PEC numbers (as incurred) that are set out in Transgrid’s letter use an inflation series that is not consistent with the series used in this determination. Our deferral estimate uses a consistent inflation series with this determination and updates for the latest inflation inputs.

the CESS at this time. In particular, Transgrid has not provided sufficient justification and supporting evidence for its claims.

We do not accept the proposed CESS exclusion because:

- Transgrid is already partially covered by price increases and inflationary pressures because the CESS calculation adjusts for inflation when determining the applicable forecast capex and actual capex. This ensures the NSP is neither worse off nor better off from fluctuations in inflation. We acknowledge that cost inputs may be below or above inflation levels at points in time.
- The risk of cost overruns is best managed by Transgrid, and any over-spends are best shared with customers, rather than being fully covered by customers. Transgrid’s announcement of capex savings of up to \$500 million in procurement, labour and avoided inflation costs across PEC, VNI West, and HumeLink exemplifies how the NSP is best placed to manage these risks.¹⁸
- The proposal appears asymmetric in that Transgrid is proposing to exclude the application of the CESS for projects where there is a possibility of a cost overrun,¹⁹ but is proposing for the CESS to remain in place for the remaining parts of its capex forecast where there is more potential for under-spends.
- It is unclear whether any CESS penalties could have a material adverse impact on cash flow and financeability because Transgrid has not provided analysis supporting its claims. We review a NSPs’ revenue proposal every 5 years which allows us to ‘reset’ and consider the market dynamics and circumstances at the time of future determinations of capex forecasts and CESS.

Consistent with the revised CESS guideline, we will consider the merits of any proposed application of the CESS for future large transmissions projects on a case-by-case basis at the time of the contingent project applications to ensure they are in the long-term interests of consumers. Our default position is to apply the CESS and we will be careful in making exclusions.

9.5 Final year actual capex true-up for 2017–18

Transgrid’s revised proposal includes an incremental CESS adjustment of \$1.1 million for the final year true-up. This compares to the \$1.0 million increment in our draft decision.

During the 2018–23 revenue reset, the capex for the final year (2017–18) for the 2014–18 regulatory control period was based on forecasts. This true-up calculation for the final year adjustment (2017–18) reflects the difference between actual and estimated capex.

¹⁸ Transgrid, [“Transgrid welcomes landmark transmission investment in NSW”](#), 21 December 2022; and Transgrid, *Response to information request 046*, January 2023, p. 1.

¹⁹ Though, we have not been provided evidence to demonstrate the likelihood of over-spending.

Glossary

Term	Definition
AER	Australian Energy Regulator
Augex	Augmentation expenditure
Capex	Capital expenditure
CESS	Capital expenditure sharing scheme
EBSS	Efficiency benefit sharing scheme
IFRS	International Financial Reporting Standards
NER	National Electricity Rules
NSP	Network service provider
Opex	Operating expenditure
PEC	Project EnergyConnect
RAB	Regulatory asset base
Repex	Replacement expenditure
SaaS	Software as a Service
STPIS	Service target performance incentive scheme
WACC	Weighted average cost of capital
