FINAL DECISION

Ergon Energy
Distribution Determination
2020 to 2025

Attachment 9
Capital expenditure sharing scheme

June 2020

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ergon Energy for the 2020–25 regulatory control period. It should be read with all other parts of the final decision.

The final 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 12 – Classification of services

Attachment 13 – Control mechanisms

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Attachment 15 – Alternative control services

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Attachment A – Negotiating framework

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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 efficiency gains or losses for the current regulatory 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 or subtracted to 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 final 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 Ergon Energy 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 under-spend 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 Final decision

Revenue impact for the 2020–25 regulatory control period

Our final decision is to apply a CESS revenue increment amount of $48.4 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 Ergon Energy's proposal is due to adopting:

- 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 and the efficiency benefit sharing scheme (EBSS) discussed in attachment 2 and attachment 6 respectively.

Application of scheme in 2020–25 regulatory control period

We will apply the CESS, as set out in the capital expenditure incentives guideline to Ergon Energy in the 2020–25 regulatory control period.[3] This is consistent with the proposed approach we set out in our framework and approach paper.[4]

The reasons for applying a CESS are set out in our capital expenditure incentive guideline.[5]

We are also aware that the full effect of COVID-19 on our capital expenditure forecast cannot be determined at this time. We will consider this issue in more detail in our determination for the 2025–30 regulatory control period. We expect Ergon Energy to provide supporting evidence to identify the effect of COVID-19 on deferral of capex as part of its regulatory proposal.

9.2 Ergon Energy’s revised proposal

Ergon Energy proposed a $46.1 million CESS revenue increment for the 2020–25 regulatory control period. This is a departure from its initial proposal and our draft decision where it elected to forego its CESS payment. Ergon Energy noted the reason for changing its approach was due a reduction in interest rates and changes in regulatory tax approach resulting in a decrease in its revenue.

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

4 AER, *Final framework and approach Energex and Ergon Energy regulatory control period commencing 1 July 2020*, July 2018, p. 70.

5 AER, *Explanatory statement capital expenditure incentive guideline*, November 2013.

Consistent with its initial proposal, Ergon Energy included a $63.1 million ($ nominal) adjustment to actual capex to account for deferred capex.[6]

We received submissions from several stakeholders which considered Ergon Energy should not receive incentive payments or the payments should be reviewed.[7]

9.3 Assessment approach

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

- the revenue effects on Ergon Energy arising from applying the CESS in the 2015–20 regulatory control period; and
- whether or not to apply the CESS to Ergon Energy 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:

- the amount of the deferred capex in the current regulatory control period is material, and
- the amount of the estimated underspend in capex in the current regulatory control period is material, and
- 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 final decision includes a determination on how any applicable CESS should apply to Ergon Energy.[11] In deciding whether to apply a CESS

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6 Ergon Energy, *Application of incentive schemes 2020–25*, January 2019, p. 6.

7 CCIQ, *Submission to Australian Energy Regulatory 2020–25 Energy Queensland Price Determination*, January 2020, p. 3. AGL, *Energex electricity distribution network - 2020 to 2025: Draft decision*, 15 January 2019, p. 3. National Seniors Australia, *AER draft decision on the EQ regulatory proposal*, 15 January 2020, p. 4. Origin, *AER draft decision and revised regulatory proposals for Queensland electricity distributors 2020–25*, 15 January 2020, p. 2. ECA, *Energy Queensland revised revenue proposals 2020–25*, 22 January 2020, p. 4.

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).

to Ergon Energy for the 2020–25 regulatory control period, and the nature of the details of the scheme, we must:

- 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 final decision

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

In our draft decision, we noted that had Ergon Energy proposed a CESS in its initial proposal we would apply the CESS. We then undertook an assessment had a CESS been proposed.[17] Our final decision is consistent with that section of the draft decision.

We have not adjusted Ergon Energy's CESS revenue increment to account for material deferrals. We consider Ergon Energy has already adjusted its CESS payment for a majority of its deferrals. For other remaining deferrals, it has not materially increased our final 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. These adjustments reflect modelling updates to the roll forward model.

For us to make an adjustment to the CESS revenue increment, we must be satisfied that deferred capex meets the three materiality thresholds discussed in our assessment approach above.

Ergon Energy's initial proposal identified capex it deferred and reproposed.[18] Ergon Energy noted that as it was not clear what would be considered a material deferral, and it has identified all capex it has deferred and reproposed. We consider this

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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 AER, *Attachment 9: Capital expenditure sharing scheme - Draft decision - Ergon Energy 2020–25*, October 2019, p. 6.

18 Ergon Energy, *Application of incentive schemes 2020–25*, January 2019, p. 6.

approach is best practice as it allows us to assess materiality with all available information. As we do not define the materiality threshold in the CESS guideline, we consider the materiality on a case by case basis.

We have made no further adjustment to the CESS revenue increment for the deferred projects because we have not excluded these projects from our substitute capex. Had any of the identified projects been excluded from our forecast then we would have adjusted the CESS increment accordingly.

We also note that in response to an information request, Ergon Energy also identified that it reproposed property capex for its Maryborough project.[19] This reproposed capex was not accounted for in the deferrals section of Ergon Energy's proposed capex model.

However, as we have not included Maryborough in our substitute capex no further adjustment to the CESS is required.

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

We will apply the CESS to Ergon Energy 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 Ergon Energy with a continuous incentive to pursue efficiency gains. This approach is consistent with Ergon Energy's revised regulatory proposal.[20]

The reasons for adopting a CESS is set out in our capital expenditure incentive guideline.[21]

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19 Ergon Energy, *Response to information request 1*, 6 February 2019, p. 2.

20 Ergon Energy, *Revised regulatory proposal 2020–25*, December 2019, p. 49.

21 AER, *Better regulation explanatory statement capital expenditure incentive guideline for electricity network service providers*, November 2013.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
distributor	distribution network service provider
EBSS	efficiency benefit sharing scheme
NER	National Electricity Rules
opex	operating expenditure
RAB	regulatory asset base
WACC	weighted average cost of capital