



FINAL DECISION

SA Power Networks
Distribution Determination
2020 to 2025

Attachment 9
Capital expenditure sharing
scheme

June 2020

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165

Email: SAPN2020@aer.gov.au

AER reference: 62729

Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to SA Power Networks 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

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 17 – Connection policy

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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 SA Power Networks in the 2020–25 regulatory control period.

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 \$76.4 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 SA Power Networks' proposal (\$76.3 million) is due to adopting:

- more recent inflation figures
- an updated weighted average cost of capital (WACC) input information.

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.³ This is consistent with the proposed approach we set out in our framework and approach paper⁴ and SA Power Networks' revised proposal.⁵

The reasons for adopting a CESS is set out in our capital expenditure incentive guideline.⁶

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 SA Power Networks to provide supporting evidence to identify the effect of COVID-19 on deferral of capex as part of its regulatory proposal.

9.2 SA Power Networks' revised proposal

SA Power Networks proposed a \$76.3 million (\$2019–20) CESS revenue increment for the 2020–25 regulatory control period. SA Power Networks updated its CESS revenue increment for actual capex in the 2018–19 regulatory year and the inflation forecast.

SA Power Networks considered its forecast capex was not materially higher than it would have been if no capex had been deferred.⁷

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 SA Power Networks regulatory control period commencing 1 July 2020*, July 2018, p. 72.

⁵ SA Power Networks, *Attachment 9 capital expenditure sharing scheme*, December 2019, p. 7.

⁶ AER, *Better regulation explanatory statement capital expenditure incentive guideline for electricity network service providers*, November 2013.

⁷ SA Power Networks, *Attachment 9 capital expenditure sharing scheme*, December 2019, p. 8.

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:

- 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 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:

- make that decision in a manner that contributes to the capex incentive objective¹²
- take into account the CESS principles,¹³ the capex objectives and if relevant the opex objectives,¹⁴ the interaction with other incentive schemes¹⁵ as they apply to the particular service provider, and the circumstances of the service provider.¹⁶

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).

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).

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

We have not adjusted SA Power Networks' CESS revenue increment to account for material deferrals. We are satisfied that our final decision forecast capex is not materially higher than it otherwise would have been had it not deferred capex.

However, we have adjusted the 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 (RFM).

In our draft decision, we identified that SA Power Networks had material capex underspend and deferrals. However, we noted that the amount of repropoed capex included in our draft decision substitute of capex was not material.¹⁷ Had all of SA Power Networks' repropoed capex been included in our substitute, then this may have been considered a material deferral.

We have updated our assessment of repropoed capex. In response to our information request, SA Power Networks identified \$43.8 million in deferred and repropoed capex. SA Power Networks stated that its Asset and Works program which it initially classified as a repropoed project is a separate program to the one it underspent in the current period.¹⁸

SA Power Networks also did not consider its repex underspend in the 2015–20 regulatory control period resulted in a materially higher revised proposal repex forecast for 2020–25.

We have assessed these deferrals against our substitute estimate for capex. We have accepted SA Power Networks' ICT programs. We have reduced SA Power Networks' forecast property, augex and repex by \$99.2 million.

We note our alternative property forecast is based on historical trend rather than adjusting for specific property projects. However, this has the same effect of reducing the amount of repropoed property capex from our substitute capex forecast.

¹⁷ AER, *Attachment 9: Capital expenditure sharing scheme – Draft decision – SA Power Networks 2020–25*, October 2019, p. 9.

¹⁸ SA Power Networks, *Information request 79 - capex deferrals*, January 2020, p. 3.

Based on this, we have included \$39.3 million in repropoed capex in our substitute capex forecast of \$1,594.2 million. This accounts for 2.5 per cent of our substitute capex forecast.

We also note that our forecast capex is broadly in line with SA Power Networks' average annual expenditure in the 2015–20 regulatory control period. Had we observed an increase in forecast capex relative to actual expenditure, then we would have concerns that consumers are paying for both incentive payments and increased capex.

Our CESS guideline does not define a materiality threshold and we consider the impact of deferrals on a case by case basis. In this circumstance, we do not consider forecast capex being 2.5 per cent as a result of repropoed capex is material given our substitute of forecast capex is not materially higher than actual capex in the current regulatory control period.

We received submissions expressing concern that the CESS payment did not reflect true efficiency gains but rather deferred capex or circumstances beyond SA Power Networks' control.¹⁹

South Australian Council of Social Service (SACOSS) noted that the criteria to assess the CESS is difficult and was concerned that we have not undertaken a separate assessment of the prudence of the deferral.²⁰

We acknowledge SACOSS' concerns that the CESS may be providing SA Power Networks with a reward that does not reflect true efficiency gains. One of the main objectives of the CESS is to provide a distributor with an incentive to undertake efficient capex during a regulatory control period.²¹

We consider inter-period deferral of capex is not a problem of itself. However, we have concerns if a customer, as a result of a deferral, has to pay more than once through an incentive payment and repropoed capex. If repropoed capex is not included in our substitute capex, then consumers will pay lower prices through a lower RAB.

This is why we must also consider our capex forecast in conjunction with the assessment of deferrals. Where appropriate, the CESS can reveal efficient capex through the distributors own actual capex profile. This can assist us in determining an efficient capex forecast. For example, we have used historical data to assist with our assessments of repex, property and ICT.

¹⁹ SACOSS, *Submission to Australian Energy Regulatory on SA Power Networks' 2020–25 revised regulatory proposal*, January 2020, pp. 52–65, CCP14, *Advice to the AER on the SA Power Networks' regulatory determination 2020–25 revised proposal*, February 2020, p. 15.

²⁰ SACOSS, *Submission to Australian Energy Regulatory on SA Power Networks' 2020–25 revised regulatory proposal*, January 2020, p. 54.

²¹ AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 5.

We also note that this is the first time we have adopted an incentive scheme for capex for SA Power Networks. Capex has long term implications and prices consumers pay and we consider at this stage it is still early to assess the effect on network investment decisions.

However, we consider more transparency is required to determine to what extent networks are underspending and reproposing the same projects. Ensuring that a distributor is not rewarded by increasing its forecast capex for projects it has deferred is a key factor in ensuring efficient capex.

To ensure this transparency, at some point in the future, we may review the CESS guideline to ensure that deferrals are adequately accounted for.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
augex	augmentation expenditure
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	National Electricity Rules
opex	operating expenditure
RAB	regulatory asset base
repex	replacement expenditure
RFM	roll forward model
WACC	weighted average cost of capital