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Dear Sebastian

Western Power's submission on TransGrid's draft Framework and Approach paper 2018-23

Thank you for the opportunity to comment on TransGrid's draft Framework and Approach paper for the 2018-23 regulatory control period. This submission concerns the Australian Energy Regulator's (AER's) proposed approach with respect to the application of the Capital Expenditure Sharing Scheme (CESS).

We note that the CESS is a foundational element of the current regulatory framework. It ensures that network businesses face continuous and symmetric incentives to undertake efficient capex throughout a regulatory period, and complements the Efficiency Benefit Sharing Scheme (EBSS) to address the trade-off between capex and opex. This is consistent with the National Electricity Objective by promoting the efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity.

However, we have identified several issues in relation to the current version of the scheme which has implications for its application to TransGrid and other network businesses. These issues fall into three categories: (a) the scheme's mechanics and formulation; (b) treatment of capital contributions; and (c) treatment of asset disposals. We discuss each of these issues in further detail below.

Western Power will join the National Electricity Market in November 2016. Our first revenue proposals under the National Electricity Rules (NER) for our transmission and distribution businesses are due by 1 April 2017. We were not involved in the development of the CESS, and TransGrid's Framework and Approach paper represents our first opportunity to comment on the formulation and application of the scheme.

In our opinion, we think the AER will be best served by addressing the issues raised in this submission through an industry-wide consultation to amend the CESS guideline. In the absence of this, we hope that the comments provided below will assist the AER in applying the current version of the CESS to TransGrid and other network businesses, and welcome further dialogue or clarification on any of the matters raised.

Scheme mechanics and formulation

(i) Accounting for benefits and costs already incurred

The CESS makes an adjustment to the value of incentive payments to account for any benefits and costs that have already accrued to a network business during the regulatory control period (the 'net financing benefit'). However, the approach adopted in the CESS to account for the return on capital for new capex differs from the revenue actually provided by the AER through its Post Tax Revenue Model (PTRM).

Specifically, the PTRM provides for a half year return on new capex to be capitalised and recovered over the life of the asset. This is calculated using the specific half vanilla WACC applying to the year in which the expenditure is incurred. This approach means that the return on new capex for the 6-month period before that capex is included in the RAB is not recovered immediately, but rather is recovered over the economic life of the asset through the network business' depreciation allowance.

In contrast, the CESS assumes that a network business will immediately receive the financing benefit of any capex underspend, and immediately incur the financing cost of any capex overspend, for the year in which the capex is incurred. This arises from the equation set out in section 2.3.3 of the CESS guideline (2013) to calculate the net financing benefit, which assumes that a network business recovers a half-year financing benefit on the portion of any unspent capex allowance, calculated as a half year return on the value of the underspend, in the year in which the underspend occurs (an equivalent calculation is applied to any overspend).

The difference in approach between the PTRM and the CESS means that the current formulation incorrectly calculates the net financing benefit (cost) received by a network business for under (over) spending its capex allowance over a regulatory control period.

Western Power supports amending the calculation of the net financing benefit in the CESS to align the treatment of the return on capital for new capex with the approach adopted in the PTRM.

(ii) Deferral of capex in the current regulatory period

The CESS allows the AER to make an adjustment to the incentive payment received by a network business when a material amount of capex is deferred from the current regulatory period to the next period. In our opinion, application of this adjustment will require the AER to undertake a project level assessment of a network business' capex profile, contrary to the intention of the NER.

Under the CESS guideline, if the AER determines that an adjustment for deferred capex should be made, it must: (a) identify capex in the current period that has deferred to the next period; (b) determine the value of this deferred capex in the next period; (c) discount this amount to present value terms; and (d) subtract this from the total efficiency gain calculated for the current period. To give effect to this, a network business would need to provide a list of all capex projects that it had intended to undertake in the current period, but which have instead been deferred to a later regulatory control period.

Under the NER, the AER is only required to determine a network business total forecast capex for the next regulatory control period. The AER is not required to approve the subcomponents of this budget, such as individual projects or programs. The prioritisation of particular capital investments during the regulatory control period remains in the hands of a network business, and it is open for the network to change its capex program during the course of a regulatory control period in response to actual circumstances. However, the adjustment for deferred capex in the CESS guideline creates a risk that the AER will be overly focussed on specific projects rather than an overall allowance.

Western Power seeks clarification from the AER on its approach to identifying deferred capex projects, and calculating the value of the CESS adjustment for deferred capex.

(iii) Bringing forward capex into the current regulatory period

The CESS guideline makes no provision for when capex is efficiently brought forward into the current regulatory period. Under the current version of the scheme, bringing forward capex may result in a CESS penalty if it results in the network business spending more than its forecast capex allowance in the current period. This provides a disincentive to bring forward capex, even when it would be efficient to do so (due to, for instance, unanticipated increases in network demand or connections).

As noted in the preceding section, the AER may adjust the efficiency benefit/loss for deferred capex. The impact of these provisions is that the efficiency calculations only reflect the benefit that a network business receives from deferring capex (the time value of money), as distinct from the full value of the deferred capex. In our view, an equivalent provision should be included to address the situation where capex is brought forward – that is, the cost of bringing forward capex should not reflect the full value of that capex, but only the time value of money associated with undertaking the expenditure earlier than expected.

Western Power seeks clarification from the AER on its approach to calculating the efficiency benefit or loss in circumstances where a network business has efficiently brought forward capex into the current regulatory control period.

(iv) Deferral of capex in subsequent regulatory periods

The current CESS will only reward a network business if its actual level of capex in the current regulatory control period is less than its capex allowance approved by the AER for that period. The CESS does not reward network businesses for the deferment of capital expenditure in subsequent regulatory periods that occur as a result of actions taken by the network in the current regulatory period.

As such, a network business that implements minor capital works or a demand management program in the current regulatory period may not receive a reward under the CESS if that program defers network investment in a subsequent regulatory period, or results in a trigger for a contingent project being deferred to the next period. If the demand management program results in the network business overspending its opex allowance, the business will incur an EBSS penalty for the overspend, but will not receive a corresponding CESS reward since any deferred capex in the next regulatory period would be captured through a reduction in the network's capex allowance.

This omission may create incentives that are inconsistent with the NEO. For instance, a network business may be inclined to defer an efficient demand management program until the next regulatory period, if that program defers capex in the next regulatory period (or defers a larger amount of capex in the next period, vis-à-vis any capex that may be deferred in the current period). This outcome is more likely at the end of a regulatory period, where the implementation of demand management programs has a greater likelihood of deferring capex in the next regulatory period than in the current period.

Western Power supports amending the calculation of efficiency gains to account for the deferment of capex in subsequent regulatory periods that occur as a result of actions taken by a network business in the current regulatory period.

(v) The appropriate rate of return

The CESS assumes that a network business will earn a nominal rate of return on its capex. However, under the PTRM, a network's revenues only effectively include a real rate of return on assets, with the indexation of the RAB compensating the network for the effects of inflation.¹ In addition, the CESS does not stipulate whether the AER will adopt a pre- or post-tax rate of return. The PTRM calculates regulated

¹ The WACC is defined in section 2.3.1 of the CESS guideline (2013) as a nominal WACC applied in the regulatory period.

revenues using a vanilla WACC, and compensates networks for tax liabilities through the inclusion of a separate tax building block that feeds into the calculation of the annual revenue requirement.

Western Power seeks clarification from the AER on the rate of return that will be applied to calculate the incentive payments under the CESS. Western Power supports the use of a real vanilla WACC, which is consistent with the PTRM.

Treatment of capital contributions

The CESS guideline is silent on the treatment of capital contributions in the calculation of the efficiency gains or losses. We recognise that capital contributions have greater relevance for distribution business, which may require certain customers to contribute to the cost of connecting them to the distribution network, then for transmission businesses, which have no (or very limited) contributions in relation to regulated transmission services. Notwithstanding this, we have included this issue for completeness.

In our view, there are two key reasons to exclude capital contributions from the operation of the CESS:

- NSPs have little control over capital contributions – in the context of distribution connections, the AER's *Connection Charge Guideline* sets out when a distribution network may seek a capital contribution, and how the value of that capital contribution should be calculated. Fundamentally however, the application of these provisions is contingent on decisions made by connection applicants rather than the network business. The applicant's decision on the location and size of new connections will determine the network extension and augmentation costs that a distribution network will incur to accommodate the new connection, and consequently whether a capital contribution can be sought and the value of that contribution. There is little reason to provide efficiency incentives under the CESS for costs that are outside of the control of the network; and
- capital contributions reflect a shifting of costs between customers, rather than any intrinsic efficiency outcomes – capital contributions shift the recovery of network costs from tomorrow's customers, which benefit from contributed assets, to today's customers, which make the contribution. That is, capital contributions operate to allocate costs between different groups of customers, and have little reflection on the efficiency gains (losses) that are achieved (incurred) by a network. Capital contributions are therefore not required to achieve the overarching objective of the CESS, which is to promote efficient investment in the network.

Western Power seeks clarification from the AER on the treatment of capital contributions under the CESS. Western Power supports excluding the value of capital contributions from the calculation of efficiency gains or losses – that is, the CESS should be applied to capex net of capital contributions.

Treatment of asset disposals

The CESS guideline is silent on the treatment of asset disposals in the calculation of the efficiency gains or losses. In our view, applying the CESS on capex net of disposals is consistent with the objective of the scheme and the NEO. Specifically, including disposals within the CESS provides a strong incentive to network businesses to:

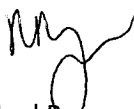
- optimise their capital stock, by providing an incentive to either dispose of regulated assets that are no longer necessary to provide controlled network services, or to efficiently relocate assets; and
- maximise the sale value of disposed assets, since the network will be entitled to retain 30 per cent of any realised value on disposed assets.

In addition, customers will directly benefit from including disposals within the CESS framework since it will lower the cost of controlled network services going forward (ie, the greater the disposal value, the lower the cost to network businesses of provided controlled services, and hence the lower the price of these services, assuming all else remains constant).

Western Power seeks clarification from the AER on the treatment of asset disposals under the CESS. Western Power supports including the value of asset disposals in the calculation of efficiency gains or losses – that is, the CESS should be applied to capex net of asset disposals.

If you have any questions with respect to this submission, please call me on 9326 4083 or Karyne Wong on 9326 6495.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Noel Ryan', with a stylized flourish at the end.

Noel Ryan
Economic Regulation Manager
Western Power