ElectraNet

9 May 2022

Jim Cox
Deputy Chair
Australian Energy Regulator

By email: James.Cox@aer.gov.au

Dear Jim

RE: Revenue Proposal 2024-2028 - Capital Expenditure Sharing Scheme

In our Revenue Proposal (Attachment 9) we noted that the way ElectraNet applied the Capital Expenditure Sharing Scheme (CESS) in relation to the current regulatory period is not strictly correct or consistent with the AER objectives and requirements of the scheme, and that this should therefore be redressed during the AER assessment of the Revenue Proposal to ensure the objectives and requirements of the CESS are met.

The purpose of this letter is to address this outstanding matter and propose a way forward.

CESS Objectives

The CESS is one of the key incentive mechanisms in the national electricity regulatory framework. As the AER states in its CESS guideline:[1]

> *Incentive-based regulation provides NSPs with financial incentives to improve their efficiency. This includes financial rewards where NSPs improve their efficiency and financial penalties where they become less efficient. Consumers benefit from improved efficiencies through lower regulated prices.*

The AER further states that the CESS:[2]

> *…will provide additional financial rewards for a NSP that improves its efficiency and additional financial penalties for a NSP that becomes less efficient.*

Therefore, the CESS is intended to incentivise efficient capital expenditure by network businesses, and it does this by:

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[1] AER, "Better Regulation | Explanatory Statement | Capital Expenditure Incentive Guideline", p.8, available from www.aer.gov.au,

[2] Ibid, p.11.

- penalising TNSPs in circumstances where the total cost of delivering a given capital program exceeds the approved allowance; and
- rewarding TNSPs where the total cost of delivering a given capital program is less than the approved allowance.

It is possible for capital projects to be deferred and thereby give rise to a CESS bonus. However, this may not be in the interests of customers in all circumstances. The AER addresses the issue of deferrals in the CESS guideline, stating that:[3]

> *…if a NSP's capex forecast for the next regulatory control period materially increases because capex was deferred in the current regulatory control period, a NSP's reward from deferring capex through the CESS, will likely exceed the benefit to consumers from the deferral.*

In other words, if an NSP were to defer capex in one period and increase its capex correspondingly in the following period, with no adjustment to the CESS targets, a 'false efficiency' would be created. This 'false efficiency' would lead to the NSP receiving a windfall gain that would not be in the interests of customers.

Consequently, the AER provides in its CESS guideline that to prevent such windfall gains from occurring, it will adjust CESS payments where the following conditions are met[4]:

1. the amount of deferred capital expenditure is material;
2. the underspend in the current period is material; and
3. the total capital expenditure in the forthcoming period is materially higher than it is likely to have been without the deferral.

ElectraNet Revenue Proposal

The proposed application of the CESS to the current regulatory period is contained in Attachment 9 (ENET011) to ElectraNet's Revenue Proposal.

As the Revenue Proposal was being prepared it became evident that the completion of Project EnergyConnect (PEC) would be delayed by several months, with a consequential movement of approximately $60m of capital expenditure into the forthcoming regulatory period.

This was discussed with the Consumer Advisory Panel Working Group which had the view, shared by ElectraNet, that ElectraNet should not receive a 'windfall gain' from that movement in the application of the CESS, nor should it be penalised.

ElectraNet's Revenue Proposal treated the $60m in question as a deferral for the purposes of the CESS, and applied a corresponding adjustment. However, this treatment overlooks the fact that the final capital expenditure forecast for 2024-2028 involves a rebalancing of the capital program, including movement of capital expenditure into the current regulatory period that offsets the delay of PEC.

This rebalancing of the capital program to accommodate the deferral of PEC involved bringing forward capital works that had previously been deferred into the forthcoming period due to capital and resource constraints.

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[3] AER, op. cit. p.40.

[4] AER, "Better Regulation | Capital Expenditure Incentive Guideline", p 9, available from www.aer.gov.au.

This rebalancing 'filled the gap' created by the deferral of PEC. It means that, in net terms, there is no material change in our forward capital expenditure program due to the deferral of PEC, which minimises the impact on customers in the coming period.

Because of this rebalancing, the capital program in the current regulatory period is expected to be delivered very close to the capex allowance, and the deferral of PEC has minimal net impact on the capex forecast for the coming regulatory period.

This means the CESS as applied by ElectraNet in the Revenue Proposal with a PEC deferral adjustment, results in a material penalty, rather than the intended removal of a windfall gain that would otherwise exist from the PEC deferral. This is summarised in Table 1.

Table 1 – Summary of current regulatory period capex and CESS adjustments ($m FY23)

	Capex forecast	Capex allowance	Underspend	CESS outcome
Preliminary Revenue Proposal	1393.1	1411.1	-18.0	7.4
Revenue Proposal – with deferral adjustment	1388.5	1411.1	-22.6	-11.1
Revenue Proposal – without deferral adjustment	1388.5	1411.1	-22.6	7.3

The key point is that the deferral adjustment made by ElectraNet in its Revenue Proposal is incorrect and should not be made because it penalises ElectraNet by seeking to remove a windfall gain that does not exist.

The windfall gain does not exist because none of the three conditions above requiring the deferral adjustment have been met. This is because:

- given the rebalancing of capex to offset the deferral of PEC, the amount of total capex deferred into the next regulatory period is not material;
- the level of forecast underspend in the current regulatory period is minimal (less than 1%); and
- total capex in the forthcoming period has not increased materially through the deferral.

Consequently, as presently applied, the CESS has not been implemented in a manner consistent with the requirements of the scheme. It is delivering an outcome that is not consistent with either the objectives of the CESS or the long-term interests of customers.

This inconsistency was identified at the time of submitting ElectraNet's Revenue Proposal to the AER, but time did not allow for it to be corrected prior to submission. For this reason, the issue was identified to be addressed during the AER's assessment of the Revenue Proposal.

Transgrid Approach

We note that our circumstances regarding a PEC capex deferral CESS adjustment are very different to those facing Transgrid in its Revenue Proposal.

The AER's Issues Paper for Transgrid's Revenue Proposal notes that Transgrid has deferred $540m in capex from the current regulatory period to the next due to the delay in delivering PEC.

The difference between Transgrid's approach and our own is that Transgrid has not offset the delay by rebalancing its capex program and bringing expenditure forward. In this circumstance, the three criteria for adjusting CESS payments are all met because:

- $540m in capex is deferred from this regulatory period to the next;
- Transgrid's capital expenditure underspend in the current regulatory period will be $540m; and
- Transgrid's total capital expenditure in the forthcoming regulatory period will be $540m more than it would have been had PEC not been deferred.

Consequently, the application of a deferral adjustment in these circumstances is appropriate as the above criteria are met. This avoids a potential windfall gain, and results in a close to neutral outcome under the CESS. This is consistent with the intent of the scheme.

The circumstances faced by ElectraNet and Transgrid are clearly very different. A deferral adjustment is not required and inappropriate in the case of ElectraNet as the relevant criteria are not met.

Proposed Way Forward

The application of the CESS in ElectraNet's Revenue Proposal penalises ElectraNet by seeking to remove a windfall gain that does not exist and is inconsistent with the objectives and requirements of the scheme.

The rebalancing of capex to offset the movement of PEC prevents us from obtaining a windfall gain under the CESS. However, if a deferral adjustment is also applied, a windfall loss will be imposed, which is inconsistent with the CESS and the long-term interests of customers.

We submit that the AER should amend the application of the CESS in respect of ElectraNet' capital expenditure for 2019-2023 by applying the CESS calculations without a PEC deferral adjustment. This removes the windfall loss that would otherwise be applied.

We enclose an updated CESS model in which this correct application of the CESS has been applied.

We look forward to the AER's consideration of this matter, and would be happy to provide any further information or to discuss any aspects as required.

Please call me on 08 8404 7983 or 0417 868 224 if you would like to discuss.

Yours sincerely

Rainer Korte
Interim Chief Executive