



IR015

Third Response to AER Information request #15 – Capital expenditure

Company Information

ElectraNet Pty Ltd (ElectraNet) is the principal electricity transmission network service provider (TNSP) in South Australia.

For information about ElectraNet visit www.electranet.com.au.

Copyright and Disclaimer

Copyright in the material in this document is owned by or licensed to ElectraNet. ElectraNet reserves all rights in relation to this material. Permission to publish, modify, alter or use this material in any way must be sought in writing directly from ElectraNet.

ElectraNet, its officers and Shareholders disclaim any responsibility for the use of this document for a different purpose or in a different context.

Reasonable endeavours have been used to ensure that the information contained in this document is accurate at the time of writing. However, ElectraNet, its directors, officers and Shareholders give no warranty and accept no liability for any loss or damage incurred in reliance on this information. Forecasts, projections and forward looking statements included in this document are subject to change and amongst other things, reflect information, data, methodologies, legislation, judicial and tribunal decisions, regulatory guidance, assumptions, prevailing market estimates, assessments, standards, and factors current at the time of publication.

Contents

Information Request.....4

1. Follow up to additional question 10 – PEC deferral and capex movements.....4

Information Request

On 23 May 2022 the Australian Energy Regulator (AER) requested additional information in relation to ElectraNet's Revenue Proposal for the 2023-24 to 2027-28 regulatory period relating to ElectraNet's capital expenditure forecast.

ElectraNet responded in two parts on 3 and 20 June 2022. Question 10 asked ElectraNet to:

Provide information relating to capex movements between periods to offset PEC deferral

On 1 August 2022 the AER asked additional questions in relation to this. Specifically, the AER noted that ElectraNet's answer to question 10 referred to 'Other changes' totalling \$30.6m. The AER asked ElectraNet to specify:

- a) *the individual capex projects included in the Other changes project*
- b) *the capex value for each individual project included in the Other changes project, the total of which resulted in a reduction of \$30.6 million (\$2022-23) to ElectraNet's Regulatory Proposal capex allowance in comparison to its Preliminary Regulatory Proposal for the 2023-28 regulatory period; and*
- c) *for each individual capex projects included in the Other changes project, whether the project was included in ElectraNet's 2018-23 regulatory period capex allowance or has been deferred from the 2023-28 regulatory control period.*

1. Follow up to question 10 – PEC deferral and capex movements

Our Revenue Proposal noted that the way we applied the Capital Expenditure Sharing Scheme (CESS) in relation to the current regulatory period was neither strictly correct nor consistent with the AER objectives and requirements of the CESS. We have previously submitted that the AER should redress this in its draft determination by making the appropriate adjustments to ensure the objectives and requirements of the CESS are met.

We set out the correct application of the CESS in an open letter to the AER on 9 May 2022 which was published on the AER website. This matter was subsequently discussed with, and accepted by, ElectraNet's Consumer Advisory Panel at its meeting on 26 May 2022.

A summary of the requirements of the CESS and its correct application to ElectraNet's capital expenditure forecast is provided below.

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. It does this by:

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

It is also 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 was simply to defer capex from 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 from underspend in the first period, and 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 in circumstances where the following three conditions are met⁴:

1. the amount of deferred capital expenditure is material; and
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 background to the application of the CESS in ElectraNet's Revenue Proposal is as follows:

- 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 consequent

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

² Ibid, p.11.

³ AER, op. cit. p.40.

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

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, but nor should it be penalised. Therefore, 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 overlooked the fact that the final capital expenditure forecast for 2024-2028 involves a material movement of capital expenditure into the current regulatory period that more than offsets the delay of PEC, removing any potential windfall gain.

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

This rebalancing ‘filled the gap’ created by the deferral of PEC. Therefore, in net terms there is no material change in the capital expenditure forecast due to the deferral of PEC. The capital program in the current regulatory period is expected to be delivered very close to the capex allowance, minimising any impact on customers.

This means that the CESS applied with a deferral adjustment results in a material penalty, as it is seeking to correct for a material underspend that is not present. This is shown in Table 2.

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

Forecast	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

In ElectraNet’s case an adjustment to the CESS payment is not warranted as none of the three criteria that must each be satisfied are met. This is summarised in Table 2 below.

Table 2 – Conditions requiring a deferral adjustment in applying the CESS

Condition	Met?	Explanation
The amount of deferred capital expenditure is material	No	The amount of capital expenditure deferred into the 2023-2028 regulatory period (primarily the deferral of PEC) is more than offset by the movement of expenditure into the 2019-2023 regulatory period, resulting in no net deferral.
The underspend in the current period is material	No	The level of forecast underspend in the current regulatory period is minimal (around 1%).
The total capital expenditure in the forthcoming period is materially higher than it is likely to have been without the deferral	No	Total capital expenditure in the forthcoming regulatory period has fallen substantially and is no higher as a result of the deferral given the offsetting movement of expenditure into the current regulatory period.

Therefore, the deferral adjustment applied to the CESS in ElectraNet's Revenue Proposal is incorrect and should not be made because it penalises ElectraNet by seeking to remove a windfall gain that does not exist.

Expenditure Movements

Table 1 and Figure 1 in ElectraNet's previous response of 20 June 2022 provided an overview of the movements in the capital expenditure forecast for 2024-2028 between the indicative forecasts contained in ElectraNet's Preliminary Revenue Proposal (PRP) and the final forecasts contained in the Revenue Proposal (as per the capex model ENET197).

Table 3 below provides an update to the corresponding table from the earlier response, reflecting some minor refinements to the categorisation of individual project movements.

Table 3 – Summary of movements in the capital expenditure forecast 2024-2028 (\$m FY23)

Category	Projects (No.)	PRP (\$m)	RP (\$m)	Movement (\$m)
Deferred into 2024-2028	8	0	60	60
Brought Forward into 2019-2023	27	127	64	-64
Net reductions in scope / cost	99	658	551	-107
Cloud projects	21	57	11	-46
New projects	5	-	11	11
Total movement				-144
Movement net of IFRS step change				-99

The table shows that there was a \$99m net reduction in forecast capex from the PRP to the Revenue Proposal (net of IFRS accounting treatment changes of approximately \$46m). This remains unchanged from the earlier response.

Table 3 also shows that the value of expenditure deferred into the 2024-2028 period totalled \$60m across 8 projects. The bulk of this relates to the deferral in PEC of \$59m.

This deferred expenditure was more than offset by the movement of expenditure of \$64m from 2024-2028 into the 2019-2023 period across some 27 projects, most of which were originally scheduled to be delivered in the current regulatory period but which had been deferred into 2024-2028 at the time of the PRP due to cost and delivery pressures. Further information on these projects was provided in the previous response in the form of Table 4 below (reproduced in its original form).

Table 4 – Projects brought forward into 2019-2023 which offset PEC deferral into 2024-2028

Project name	PRP Value	RP Value	Reduction
	\$m real FY'23		
Protection Systems Unit Asset Replacement 2018-23	16.7	8.3	-8.4
Brinkworth-Waterloo Bearer Replacement	18.3	11.9	-6.4
Isolator Unit Asset Replacement 2018-23	9.8	3.9	-5.9
Substation and Building Security System Replacement	6.3	1.9	-4.5
AC Board Unit Asset Replacement 2018-23	17.4	12.9	-4.5
Substation Improvements for System Black Conditions	5.1	1.7	-3.4
Port Pirie and Bungama 11kV RMU and Aux Transformer Replacement	2.5	-	-2.5
Distribution Centre Fire System Upgrade 2024-25	1.6	-	-1.6

Project name	PRP Value	RP Value	Reduction
Surge Arrestor Unit Asset Replacement 2018-23	1.3	0.4	-0.9
East Terrace 275 kV GIS Gas Monitoring System Upgrade	0.8	-	-0.8
Other changes	53.3	22.7	-30.6
Total	133.2	63.7	-68.0

This table has been reproduced and updated in Table 5 below, consistent with the refinements to the categorisation of project movements summarised in Table 3 above. It has also been expanded as requested to provide a breakdown of the 'Other changes' item.

The 'Other changes' item above consisted of both further minor project movements and several larger project deferrals that were assumed at the time of the PRP reflecting expectations that certain projects would be delayed. In two instances, these further deferrals effectively increase the assumed value of these projects that was built into the PRP capex forecast 2024-2028 where indicated (*).

Table 5 - Projects brought forward into 2019-2023 which offset PEC deferral into 2024-2028 - expanded

Name	PRP value	RP value	Brought forward	2018-23 allowance
Protection Systems Unit Asset Replacement 2018-23*	19.8	8.3	-11.4	Yes
Line Insulator Systems Refurbishment 2018-23	10.1	-	-10.1	Yes
AC Board Unit Asset Replacement 2018-23*	20.4	12.9	-7.5	Yes
Brinkworth-Waterloo Bearer Replacement	18.3	11.9	-6.4	Yes
Isolator Unit Asset Replacement 2018-23	9.8	3.9	-5.9	Yes
Substation and Building Security System Replacement	6.3	1.9	-4.5	No
Substation Improvements for System Black Conditions	5.1	1.7	-3.4	Yes
Instrument Transformer Unit Asset Replacement 2018-23	3.0	-	-3.0	Yes
Port Pirie and Bungama 11kV RMU and Aux Transformer Replacement	2.5	-	-2.5	No
GE Harris D25 RTU Replacement	2.0	-	-2.0	No
Distribution Centre Fire System Upgrade	1.6	-	-1.6	No
Inventory Purchases 2022-23	1.0	-	-1.0	Yes
Surge Arrestor Unit Asset Replacement 2018-23	1.3	0.4	-0.9	Yes
East Terrace 275 kV GIS Gas Monitoring System Upgrade	0.8	-	-0.8	Yes (2013-18)
Fire Services Pirie Street	0.7	-	-0.7	No
Eyre Peninsula and Upper North Voltage Control Scheme	1.9	1.3	-0.6	Yes
Mechanical Pirie Street West	0.4	-	-0.4	No
EOJ Amenities Rymill 2023-24	0.3	-	-0.3	No
Spencer Gulf Emergency Bypass Preparation	2.5	2.2	-0.2	Yes
Project and Portfolio Mgmt Systems Refresh 21-22	0.2	-	-0.2	Yes
Other minor project movements	19.4	19.1	-0.3	
Total	127	64	-64	

This summary shows that the majority of the expenditure brought forward represents capital projects that had been deferred due to cost and delivery pressures, which were brought back into the 2018-2023 regulatory period to rebalance the capital program, fully offsetting the deferral of PEC. The overwhelming majority of this expenditure (over 80% by value) was also directly related to projects that were originally identified in the regulatory period capex allowance for 2018-2023 as noted above.

Again, this demonstrates that there was no net deferral of expenditure between periods as a consequence of the delay in PEC, reinforcing the need for the CESS to be correctly applied without a deferral adjustment to deliver the outcomes intended under the Scheme.

