Draft Decision

Endeavour Energy

Electricity Distribution Determination 2024 to 2029

(1 July 2024 to 30 June 2029)

Attachment 9

Capital expenditure sharing scheme

September 2023

AUSTRALIAN ENERGY REGULATOR

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9 Capital expenditure sharing scheme

The capital expenditure sharing scheme (CESS) provides financial rewards for network service providers (NSP) whose capital expenditures (capex) become more efficient and financial penalties for those that become less efficient. Customers benefit from improved efficiency through lower regulated prices. We first applied the CESS to Endeavour Energy in the 2014–19 regulatory control period.

This attachment sets out our decision for both the determination of the revenue impacts as a result of the CESS applying in the 2019–24 regulatory control period, and the application of the CESS for Endeavour Energy in the 2024–29 regulatory control period.

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 mechanism was recently updated in April 2023. The changes to the CESS only apply to its application in the 2024–29 period and onwards. In this attachment, our decision on the CESS revenue increments for the 2024–29 period uses the CESS mechanism before it was updated.[1]

For spending in the current period, the CESS applies as follows:

- We calculate the cumulative efficiency gains or losses for the current regulatory control period in net present value terms.
- We apply the sharing ratio of 30% 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.[2] We can also make further adjustments to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB).[3]
- 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.

9.1 Draft decision

9.1.1 Revenue impacts in the 2024–29 period

Our draft decision is to apply a CESS revenue increment amount of $12.61 million ($2023–24) to be paid across the 2024–29 regulatory control period. This is from the application of

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1 That is, for CESS revenue increments based on spending in the 2019–24 regulatory period, we follow this guideline: AER, *AER capital expenditure incentive guideline - November 2013*, November 2013. However, in applying the CESS in the 2024–29 period, we refer to this guideline: AER*, AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023.

2 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.

3 AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023, pp. 7–9.

the CESS in the 2019–24 regulatory control period and the corresponding CESS carryover true-up for 2018–19. This is $1.21 million less than Endeavour Energy's forecast of $13.82 million.

The CESS increment arises as a result of an underspend in capex against the forecast for the 2019–24 period. Our draft decision on the revenue impact of the application of the CESS in the 2019–24 period and the corresponding CESS carryover true-up 2018–19 is summarised in Table 9.1.

Table 9.1 CESS revenue increments in 2024–29 ($ million, 2023–24)

Revenue Adjustments	2024–25	2025–26	2026–27	2027–28	2028–29	Total
CESS revenue increment as per NER 6.4.3(a)(5)	3.59	3.59	3.59	3.59	3.59	17.94
CESS carryover true-up for 2018–19	-1.07	-1.07	-1.07	-1.07	-1.07	-5.33
AER draft decision CESS	**2.52**	**2.52**	**2.52**	**2.52**	**2.52**	**12.61**

Note: Numbers may not sum due to rounding.
Source: AER analysis. Endeavour Energy, *Endeavour Energy – 9.06 CESS Model*, 31 January 2023.

Given the timing of this draft decision, we calculated the CESS revenue increments in Table 9.1 using estimates of Endeavour Energy's capex for 2022–23 and 2023–24 regulatory years. The CESS revenue increment we calculated ($12.61 million) is different to the revenue increment that Endeavour Energy proposed ($13.82 million) because we applied updated modelling inputs, including inflation, rate of return and an adjustment for 2018–19 to reflect the difference between actual and estimated capex.

9.1.2 Application of CESS in the 2024–29 regulatory control period

We will apply the CESS as set out in the updated capital expenditure incentives guideline.[4] The reasons for adopting this updated CESS are set out in our final decision for the review of incentive schemes for networks, and the final decision for capital expenditure incentive guideline.[5] This is consistent with the proposed approach we set out in our framework and approach paper.[6]

4 AER, *AER - Final decision - Capital expenditure incentive guideline*, April 2023, pp. 3–9.

5 AER, *AER - Final decision - Review of incentive schemes for networks*, April 2023, pp. 14-22; AER, *AER - Final decision - Capital expenditure incentive guideline*, April 2023.

6 AER, *AER - Final framework and approach for Ausgrid, Endeavour Energy and Essential Energy for the 2024-29 regulatory control period,* 29 July 2022, p. 47.

9.2 Endeavour Energy's proposal

9.2.1 CESS revenue increments from the 2019–24 regulatory control period

Endeavour Energy proposed a CESS increment of $18.67 million ($2023–24) for the 2024–29 regulatory control period. Endeavour Energy considered its underspend was predominantly due the impact of COVID-19 and natural disasters that limited activity to essential operations and maintenance work only. Endeavour Energy further cited higher than forecast disposals contributed to its proposed CESS increment, primarily due to the sale of its Huntingwood site as the main office was moved to Parramatta.[7]

Endeavour Energy proposed a CESS adjustment for the deferral of system capex totalling $54 million ($2023–24). This amount was derived from changes across Endeavour Energy's augex projects between the current and forecast period. Endeavour Energy noted that this deferral did not meet the AER criteria for CESS adjustments. However, following feedback from its Regulatory Reference Group and other stakeholders, Endeavour Energy decided it would be appropriate to include.[8]

9.2.2 Final year actual capex true-up for 2018–19

Using its true-up calculation method, Endeavour Energy proposed a true-up decrement of $4.85 million ($2023–24) to be added to its CESS revenue increments in the 2024–29 period.[9]

9.2.3 Application of CESS in the 2024–29 regulatory control period

Endeavour Energy proposed to apply the CESS in the 2024–29 regulatory period.[10]

Endeavour Energy also proposed $20 million ($2023–24) capex for its Innovation Fund which it proposed to exclude from its CESS calculation in the 2024–29 period, so Endeavour Energy is not rewarded for underspending the Fund.[11]

9.3 Assessment approach

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

- the revenue impacts on Endeavour Energy arising from applying the CESS in the 2019–24 regulatory control period;[12] and
- whether or not to apply the CESS to Endeavour Energy in the 2024–29 regulatory control period and how any applicable scheme will apply; [13]

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7 Endeavour Energy, *Endeavour Energy – 0_01 Regulatory Proposal*, January 2023, p. 130.

8 Endeavour Energy, *Endeavour Energy – 0_01 Regulatory Proposal*, January 2023, p. 131.

9 Endeavour Energy, *Endeavour Energy – 9.06 CESS Model*, January 2023.

10 Endeavour Energy, *Endeavour Energy – 0_01 Regulatory Proposal*, January 2023, p. 9.

11 Endeavour Energy, *Endeavour Energy – 0_01 Regulatory Proposal*, January 2023, p. 147.

12 NER, cl 6.4.3(a)(5).

13 NER, cl. 6.12.1(9).

We must determine the appropriate revenue increments or decrements (if any) for each year of the 2024–29 regulatory control period arising from the application of the CESS during the 2019–24 regulatory control period.[14]

In deciding whether to apply a CESS to Endeavour Energy for the 2024–29 regulatory control period, and the nature of the details of the scheme, we must: [15]

- make that decision in a manner that contributes to the capex incentive objective[16]
- take into account the CESS principles,[17] the capex objectives and, where relevant, the operating expenditure (opex) objectives,[18] the interaction with other incentive schemes,[19] and the circumstances of the service provider.[20]

Broadly, 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.

9.3.1 Interrelationships

The approval of CESS revenue increment determines the associated CESS building block as part of Endeavour Energy's overall forecast revenue requirement for the 2024–29 regulatory control period.

The CESS relates to other incentives Endeavour Energy faces to incur efficient opex, conduct demand management, and maintain or improve service levels. Related schemes include the efficiency benefit sharing scheme (EBSS) for opex, the service target performance incentive scheme (STPIS) for service levels and demand management incentive allowance mechanism (DMIAM). We aim to incentivise network service providers to make efficient decisions on when and what type of expenditure to incur and to balance expenditure efficiencies with service quality.

9.4 Reasons for draft decision

Our draft decision is to include an overall CESS revenue increment of $12.61 million ($2023–24). This is a $1.21 million decrease from Endeavour Energy's proposed CESS revenue increment of $13.82 million ($2023–24). We set out our reasons in the sections below.

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14 Increments or decrements arising from the application of applicable incentive mechanisms, including any capital expenditure sharing scheme, form one of the building blocks that must be used to determine the annual revenue requirement for distribution network service providers for each regulatory year of a regulatory control period: NER, cl. 6.4.3(a)(5).

15 NER cl. 6.5.8A(e).

16 NER, cl. 6.5.8A(e)(3); the capex incentive objective is set out in cl. 6.4A(a).

17 NER, cl. 6.5.8A(e)(4)(i); the CESS principles are set out in cl.6.5.8A(c).

18 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).

19 NER, cl 6.5.8A(d)(1).

20 NER, cl. 6.5.8A(e)(4)(ii).

9.4.1 CESS revenue increments from the 2019–24 regulatory control period

We are broadly satisfied with Endeavour Energy's calculation of CESS revenue increments for capex in the 2019–24 period. The difference between Endeavour Energy's proposal and our draft decision reflects adjustments for modelling inputs such as CPI and the WACC to reflect more up-to-date information. We will also update these inputs, where relevant, in our final decision.

We reviewed Endeavour Energy's proposed deferral of system capex. After engaging with Endeavour Energy, we accept its approach and have included the recalculated deferred total of $54 million ($2023–24) in our modelling.

The CESS requires the following three criteria must be satisfied before we apply a CESS adjustment:[21]

1. the amount of the estimated underspend in capex in the current regulatory control period is material
2. the amount of the deferred capex in the current regulatory control period is material
3. 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.

We have assessed Endeavour Energy's proposed deferral and, while we are satisfied with the proposed amount, we consider that the deferred total may still be subject to the AER criteria for CESS adjustments. We note that the difference in net capex across periods may not appear material. However, the efficiency gains from the deferral can contribute to a material underspend when compared to the forecast period. As part of our assessment, we engaged with Endeavour Energy and found its modelling approach to be reasonable. We are satisfied that Endeavour Energy has taken sufficient steps to inform its stakeholders of the proposed adjustments. Further, we consider it is appropriate and good practice for networks to identify deferrals so that customers share in the benefits from deferred capex.

9.4.2 Final year actual capex true-up for 2018–19

We consider that Endeavour Energy should receive a true-up adjustment of -$5.33 million ($2023–24). This is $0.48 million less than Endeavour Energy forecast true-up adjustment of -$4.85 million.

We have amended the calculation to take into account the difference in CESS payments between using estimated 2018–19 capex and actual 2018–19 capex. We then include the net present value of any CESS benefit or cost as a result of the difference between the estimate and actual capex, which we consider Endeavour Energy did not calculate correctly.

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21 AER, *Capital Expenditure Incentive Guideline for Electricity Networks Service Providers*, November 2013, p. 9.

9.4.3 Application of CESS in the 2024–29 regulatory control period

9.4.3.1 Updates to the CESS Guideline in April 2023

After Endeavour Energy submitted its initial proposal, the AER published its final decision on its review of incentive schemes for regulated networks in April 2023. This included an update to the workings of the CESS mechanism.[22]

The changes to the CESS mechanism will affect the application of the CESS to Endeavour Energy starting in the 2024–29 period.

The new guideline contains the following main changes to the CESS mechanism:

- application of a lower sharing factor of 20% to any underspend amount greater than 10% of the approved forecast capital expenditure allowance; and
- new transparency measures which require NSPs to explain variations between capital expenditure forecasts and outcomes.[23]

More information on the application of the updated CESS is available in our April 2023 capital expenditure incentive guideline.

9.4.3.2 Proposed exclusions from the CESS in the 2024–29 period

Endeavour Energy proposed its capex for the Innovation Fund should be excluded from the application of the CESS in the 2024–29 period.[24] We understand the intent of the exclusions is to avoid the risk that consumers pay for a CESS reward for an underspend on innovation expenditure.

For the following reasons, we do not consider that the proposed exclusion is consistent with the CESS principles and CESS Guideline:

- We make a decision on total capex and do not approve specific projects or programs. We assess the prudency and efficiency of specific projects/programs (amongst other things) to inform the prudency and efficiency of the total capex forecast. Businesses can spend more or less than the total capex forecast as circumstances change throughout the regulatory control period. Therefore, in this proposed instance, and for distribution determinations more generally, we consider it is inconsistent to pre-determine which projects or programs to exclude from the CESS when the forecast is determined at the total level.
- Our default position is to apply the CESS to all categories of capex, with only limited circumstances where we can apply exclusions after any inefficient or imprudent expenditure has occurred (ex-post exclusion) or expenditure has been delayed (in the case of deferred capex) as per the CESS Guideline. We note the distribution business is not limited in forgoing a part or full amount of CESS at the time of the CESS calculation, which could achieve the same result for consumers if the concern is with a distribution business underspending for certain capex programs.

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22 AER, *AER - Final decision - Capital expenditure incentive guideline*, 28 April 2023.

23 AER, *AER - Final decision - Capital expenditure incentive guideline*, 28 April 2023, p. 1.

24 Endeavour Energy, *Endeavour Energy – 0_01 Regulatory Proposal*, January 2023, p. 147

- There are incentives and outcomes that can arise from pre-determining exclusions that are inconsistent with our ex-ante regulatory framework and are not in the long term interest of consumers. By determining project/program level exclusions before the expenditure has occurred, this can result in the incentive to categorise or allocate investment to the excluded category so that it is not included in the CESS calculation. While the intent of the proposed exclusions for the 2024–29 period is to address underspending, we note there is an outcome that is not in the long term interest of consumers where an overspend would also be excluded and would result in a CESS increment.[25]

Endeavour Energy's proposal states that:[26]

> Any underspending will be returned to customers, and this will be excluded from the Capital Expenditure Sharing Scheme.
>
> Given the potentially more speculative nature of this investment, Endeavour Energy seeks exemptions for the proposed innovation investment fund from the Capital Efficiency (CESS) Mechanisms and will operate the innovation investment fund akin to the existing DMIA. This would provide for upfront funding, annual true-up and refund to the customers as Endeavour Energy would bear any overspend risk.

Our default approach is to apply the CESS to all capex categories, and we can only adjust this in certain limited circumstances as set out in the CESS Guideline. Based on the above description of Endeavour Energy's proposed approach, if Endeavour Energy and its customers agree that innovation should be excluded due to an underspend, then Endeavour Energy can propose a lower CESS amount than our default approach in the subsequent 2029–34 period when determining the CESS revenue adjustments. However, any exclusion from the CESS calculation should not result in a higher CESS than our default approach as this is not what is intended by the exclusion. Further, the calculation approach should be transparent and should be clearly explained to us and customers why this is aligned with the intent of the exclusion and why it is in the long term interest of consumers.

25 An overspend occurs when the actual spend exceeds the forecast. So, if the forecast and the actual spend for an overspent program are both excluded from the CESS calculation, then a larger number is subtracted from the total actual capex than from the total forecast capex. Therefore, at a total capex level, the gap between forecast and actual increases and consumers would pay a CESS increment for an overspend (all else equal). This is not in the interest of consumers.

26 Endeavour Energy, *2024–29 Innovation Investment Proposal*, December 2022, pp. 3, 16.

Shortened forms

Term	Definition
AER	Australian Energy Regulator
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIAM	demand management innovation allowance mechanism
EBSS	efficiency benefit sharing scheme
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RRG	Regulatory Reference Group
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital