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Capital Expenditure Incentive Guideline Review – Draft Guidelines for consultation

Endeavour Energy appreciates the opportunity to provide this response to the AER's draft Capital Expenditure Incentive Guideline (draft guideline or CEIG). Our response is focussed on the proposed amendments to manage the uncertainty associated with connections capex, rather than the transmission related changes.

The non-discretionary nature of facilitating connections may not align with the objectives of the CESS where the variance from forecast is material

The Capital Expenditure Sharing Scheme (CESS), a component of the CEIG, is designed to provide Distribution Network Service Providers (DNSPs) a continual incentive to improve capex efficiency. The AER has previously acknowledged that in setting an expenditure allowance a DNSP retains the discretion to manage changing circumstances, obligations and risks within the overall allowance and/or to spend above or below the allowance. We recognise the value of the CESS in providing a broad and continuous incentive to DNSPs to pursue efficiencies in the choice between capex and opex trade-offs and in the timing and delivery of capex.

DNSPs must respond to the evolving circumstances and demand for services that they face over the course of a five-year regulatory control period. In doing so, they must balance, and trade off, discretionary investments with non-discretionary investment drivers. For some of these investments, the DNSP may have a level of discretion in determining the optimal timing, level and/or method of achieving and/or maintaining the outcomes required, while other investments may have more prescriptive requirements.

Facilitating customer connections is an area of spend that generally falls into the latter category of non-discretionary expenditure. While there remains some ability to influence the size and timing of the spend, it is largely driven by the requirements of the connecting customer and initiated by them. DNSPs are therefore limited in the extent to which they can influence this spend and instead exposed to the risk of exogenous factors like population growth, housing demand and general economic activity within their network area. The NSW connections contestability framework amplifies this risk for NSW DNSPs as the customer engages an accredited service provider (ASP) who is then responsible for the design and construction of the connection or extension assets and subject to their own set of timing and commercial trade-offs that are distinct from our network considerations. This contestable framework (rightly) limits our ability to influence the timing and sizing of the connection works compared to other jurisdictions and means that our role in facilitating connections is focused more on HV shared network augmentation (i.e., "augex") rather than connection reticulation assets (i.e., "connection capex").

Currently, DNSPs must manage this forecasting risk by altering their spend in other categories (as they deem necessary) in responding to the incentives of the CESS. In circumstances where this variation is material, there is a risk that the CESS is rewarding or penalising forecasting accuracy, rather than efficiency, as intended. For Endeavour Energy we expect this risk to be pronounced given our constrained augex forecast for the 2024-29 period as we facilitate the establishment of the Western Sydney Airport and unprecedented level of connection activity and interest, we are observing from data centres and industrial customers in addition to the ongoing population growth across Western Sydney.

Caution should be taken in adjusting for exogenous factors while providing balanced incentives

As the CESS is not intended to be a perfect or precise scheme, it is important to recognise that any exogenous risk should be sufficiently material to warrant amendments to the CESS. Designed as a broad incentive to encourage DNSPs to apply their judgement efficiently in managing a range of expenditure drivers, the intent of the CESS is not to focus on specific categories of capex or make assessments of efficiency at a project level. Accordingly, any amendments must therefore be careful not to create imbalance in the scheme or dilute the discipline it imposes on a network to manage its entire capex portfolio efficiently, having regard to all relevant factors.

We understand that the AER is proposing to introduce a default volumetric adjustment when determining connections capex spend for CESS purposes in order to better achieve its intended purposes of rewarding/penalising management behaviour rather than exogenous factors. In addition, the AER notes it is considering excluding bespoke connections (i.e., large connection and greenfield augmentation spend) from capex for ex-post review purposes where an ex-post review has been triggered.

We agree that volatility in connection activity can undermine the objective of the CESS and so may warrant an adjustment where it is material, unforeseen, unavoidable and cannot reasonably be accommodated through reduced spend in other categories of capex without undermining service quality and/or safety. While we are supportive of providing the ability to manage this exogenous factor, we recommend that it is applied by exception rather than by default. We consider it would be preferable to not weaken the incentive provided by the CESS (as outlined earlier in this submission), and instead to vary its application in exceptional circumstances in accordance with an (ideally) ex-ante criteria such as that described above, to avoid its selective application.

If a default mechanism were to be implemented, further clarity would be required to define ‘connections capex’ and how any volumetric adjustment would be applied beyond the conceptual example currently provided in the draft guideline. As currently proposed, it is unclear whether the mechanism would produce proportionate results, given the fluctuations in annual data and the fact that some DNSPs may not use a unit rate and volume-based approach to forecasting connections related capex. For Endeavour Energy, our connections capex model derives a unit rate based on a historical average, to accommodate for the year-to-year volatility in reported figures.

In defining the scope of the adjustment, we consider connection activity impacts both the ‘connections’ and ‘augex’ categories of capex. In particular, greenfield augex makes up a substantive proportion of our capex and is driven by customer connection activity that triggers augmentation to shared network infrastructure (often for mixed industrial and residential use). Over the last three years, the augex category has averaged 22% of gross capex (including capital contributions) while connections capex has averaged 3% and capital contributions 17%. The variation that may occur within the category has been illustrated in recent years for Endeavour Energy with augex dropping to $42M ($m; FY24) at the height of the COVID-19 pandemic with a downturn in development activity while reaching $147M ($m; FY24) by FY23.

This highlights the key challenges of introducing a default adjustment mechanism focused on standard connection capex, specifically, that:

- it may increase the complexity of the scheme or produce unreasonable CESS outcomes across DNSPs; and
- for some networks, the impacts of volatility in network growth assumptions may instead be more pronounced in other categories of capex such as augex.

For these reasons, we support maintaining the simplicity of the CESS and instead allowing DNSPs to propose adjustments that reflect their individual and exceptional circumstances for the AER to consider where connection-related volatility may undermine the objectives of the CEIG.

Unexpected bespoke connection capex should be treated equally to deferred capex rather than limited to ex-post assessment

The draft guideline delineates between bespoke connections and connection capex, on the basis that DNSPs have greater discretion in managing the timing, cost and scale of connection headworks on the shared network. Endeavour Energy has extensive experience in this category of spend (i.e., greenfield augex) as one of the fastest growing networks in Australia over the last decade with the continued expansion of Western Sydney. In managing this category of spend, we engage extensively with the connecting customer, test for non-network solutions and seek to defer and size the ultimate investment as efficiently as possible. While DNSPs should be incentivised and required to investigate these opportunities, we note the discretion DNSPs have is limited, and that network augmentation is ultimately unavoidable given the scale of the required demand to be supplied.

The AER suggests that bespoke connections capex may be considered in the circumstance of an ex-post review. While we welcome this approach, we recommend a more balanced approach is taken, and that it allows DNSPs to propose adjustments. Currently, capex deferred from one period to the next must be adjusted so that the CESS does not reward a DNSP for capex that is added to the RAB on a delayed basis due to circumstances outside of its control (as opposed to the deployment of efficient deferral solutions). In contrast, 'unexpected' capex can only be considered in the context of deferred capex (i.e., where accommodating unforeseen capex created the need to defer other capex spend between periods).

We propose that a more balanced approach would be to allow for unexpected capex and deferred capex to be considered independently, instead of limiting unexpected capex to being considered only in circumstances where there is deferred capex and, per the draft guideline, where an ex-post review has been triggered. To prevent the need for frequent and detailed assessments that would increase the regulatory burden (both for DNSPs and the AER), the circumstances in which unexpected capex for bespoke connections could be considered could be limited to strict assessment criteria (e.g., like that currently applied to the capex re-opener provisions).

Additional regulatory mechanisms already exist to manage uncertainty

As noted above, we appreciate the need to maintain a simple, balanced and effective set of incentives under the CEIG. However, it is also clear that DNSPs are managing an unprecedented level of uncertainty as population growth continues to accelerate in conjunction with the effects of electrification and the energy transition.

In addition to the CEIG, we note that there exist other regulatory mechanisms which may be relied upon to better address this uncertainty. We consider the pass-through, contingent project and capex re-opener provisions are narrow in scope and (perhaps consequently) currently under-utilised. Specifically:

- **Pass-Throughs**: The Rules prescribe some pass-through events while allowing additional events to be nominated at the time of a determination for each individual DNSP. However, in practice the nominated events have converged across the NEM and rarely differ in their type or definitions[1]. We consider the risks associated with managing a distribution network have evolved since these events became commonplace from our 2014-19 determination.
- **Contingent projects**: These have a materiality threshold that is becoming prohibitively high for DNSPs with larger revenue allowances. For DNSPs, their use has been narrow with only eight applications to date with seven of these relating to bushfire-related obligations compared to 21 applications from TNSPs across a broader range of investment triggers. While we would expect TNSPs to make greater use of this mechanism, we consider the materiality threshold and level of project specificity required makes them ineffective for DNSPs who do have large connection projects of uncertain timing (e.g., data centre connections) but also face broader investment pressures across several network locations (e.g., EV take-up rates).

[1] These nominated events being; insurance coverage, insurer credit risk, terrorism an natural disaster.

- **Capex re-opener:** Similarly, this provision has only been subject to one (ongoing) application, noting that the materiality threshold virtually disqualifies any network with a larger RAB from accessing it.

We accept that these uncertainty provisions should be relied upon only in exceptional circumstances and that DNSPs should generally manage risks and unexpected events within their allowance. However, we consider these existing mechanisms could be better utilised and expanded, in a targeted manner, to manage increasing uncertainty in addition to allowing for with greater flexibility within the CEIG. We acknowledge that DNSPs appropriately face incentives to limit RAB growth to only that which is necessary; however, is equally important to ensure that DNSPs are not penalised (or rewarded) for forecasting error in a time of unprecedented change.

We would be happy to discuss the matters in our submission further. If that would be of assistance, please contact Patrick Duffy, Manager Regulatory Transformation and Policy via email at [redacted]

Yours sincerely

[redacted]

Francoise Merit
Chief Financial Officer