21 March 2025

Mr Arek Gulbenkoglu

General Manager, Network Expenditure

Australian Energy Regulator

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Dear Arek,

AER's Capital Expenditure Incentive Guideline Review – Consultation Paper

Energy Networks Australia (ENA) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Capital Expenditure Incentive Guideline Review – Consultation Paper.

ENA represents Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

We reiterate our support for incentive arrangements for capital expenditure, working in tandem with schemes for operating expenditure and service outcomes to give NSPs incentives to make investments that are in the long term interests of electricity consumers. However, we think that changes to the CESS are required to ensure there is a better alignment between the penalties and rewards with changes in the efficiency of capex as the rules require. This issue is particularly significant for ISP projects given their size and the greater uncertainty associated with capex forecasts for greenfields projects.

In response to specific aspects of the Consultation paper, the ENA's positions are as follows:

- Any ex post review in relation to an ISP project should be conducted as soon as practical after the expenditure is made, which may require it to be conducted before the ISP project is fully complete. TNSPs should propose which ISP projects are ready for ex-post review in their revenue proposals for approval by the AER. A flexible approach guided by principles set out in the Capital Expenditure Incentive Guideline (CEIG) should be applied to determine whether an ISP project is deemed to be "substantially complete". There should be principles in the CEIG for guiding this decision.
- TNSPs should have the flexibility to propose measures within the CESS to better manage the uncertainty in capex forecasts and better reflect prevailing market conditions in relation to ISP projects. As part of this, **TNSPs should have the option of adopting the AEMC's proposal that CESS penalties be annulled where the AER has undertaken an ex post review and found the overspend to be efficient**. However, TNSPs should also have the flexibility to propose alternative measures to manage capex uncertainty that best meet the characteristics and context of their projects, such as excluding certain expenditure from the CESS (as applied in the context of HumeLink) or applying a cap to the potential penalty. The incentive rate for an ISP project should be appropriate for the context of that project, noting that the exposure to the asymmetric risk of ex post disallowance already provides a strong incentive for prudence and

efficiency. The AER should also allow TNSPs for existing ISP projects to have the option for CESS penalties to be annulled where the project is found to be efficient in an ex post review, as allowed for in the savings and transitional rule.[1]

- The CEIG should also include flexibility to propose measures within the CESS to better manage the uncertainty for the other capital expenditure of TNSPs and to DNSPs. In relation to the latter, connections expenditure present a key exposure for the DNSPs.
- Financial incentives are unlikely to play a material role in whether an ISP project is abandoned (this would be a major decision that would follow substantial analysis and consultation). However, where the decision was taken to efficiently abandon an ISP project, ENA would support the TNSP in question having the opportunity to recover the costs incurred, and for any CESS rewards that may be generated for the cancelled portion of the project to be annulled.

Further detail on key points is provided in the attachment.

ENA looks forward to working with the AER as it drafts amendments to the Guideline. In the meantime, if you would like to discuss this submission, please contact Verity Watson (vwatson@energynetworks.com.au) in the first instance.

Yours sincerely

Dominic Adams
General Manager - Networks

1 Rule 11.172.3.

Attachment:

AER's Capital Expenditure Incentive Guideline Review – Consultation Paper

1. Introduction

ENA welcomes the opportunity to respond to the AER's latest consultation paper on its review of the Capital Expenditure Incentive Guideline (CEIG).[2] ENA represents Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

The main topic for the consultation paper relates to how the CEIG needs to be amended to give effect to the AEMC's recent rule change[3] for targeted ex post review of ISP projects. We address these issues in section 2 below. However, the consultation paper also raises broader questions about whether further refinements should be introduced into the Capital Expenditure Efficiency Sharing Scheme (CESS) with a view to reducing the reliance of the CESS rewards / penalties on historical forecasts (regulatory allowances) of capital expenditure. We address these issues in section 3.

2. Measures required to enable the targeted review of ISP projects

The principal changes required to the CEIG are to give effect to the targeted review rule change are to:

- enable the ex post review to be undertaken separately for ISP projects from other projects, with reviews to occur during the revenue cap reviews
- require the ex post review to apply to the whole of the construction period for an ISP project (i.e., the whole of the period until the project is either complete or substantially complete)
- to permit potential CESS penalties associated with an overspend that may have been created in an earlier regulatory period to be offset in a situation where capex is disallowed as a consequence of the ex post review (i.e., to prevent a penalty exceeding 100% of the capex overspend), and
- to specify how the requirement for a project to be "substantially complete" will be applied in practice.

In addition, the AER has also asked whether there are any additional considerations that it should take into account when giving effect to the targeted review of ISP projects.[4]

The first three of the requirements set out above appear to be largely mechanical in nature and not raise obvious issues of principle. Accordingly, we do not have any specific comments on these matters at this stage. However, we will comment on the AER's proposed amendments to the CEIG in due course.

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2 AER (2025), "AER's Capital Expenditure Incentive Guideline Review – Consultation Paper, February (AER 2025).
3 AEMC (2024), Rule determination – National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024, August (AEMC 2024).
4 AER 2025, p.17.

We address the other matters on which the AER is consulting in turn below, and also offer comment on two further changes to the CESS in relation to ISP projects that would be beneficial.

2.1. Definition of "substantially complete"

The new rules introduced as part of the ISP targeted review rule change require the ex post review of ISP projects to be undertaken during a periodic revenue cap review, with the ex post review for a specific ISP project to be undertaken at the next revenue cap review after the project is complete or "substantially complete". The AER proposes that, for a project to be deemed substantially complete, it would need to meet each of four mandatory factors:[5]

> *a) The completed works and costs incurred on the reviewable ISP project is a sufficient representation of the likely overall capex outcome. For example, if the substantially complete project is expected to not meet the overspending requirement, is this still likely to be the case once the whole project is completed.*
>
> *b) The TNSP does not expect to incur additional construction costs related to the ISP project or ISP project stage. The only remaining works are associated with commissioning and energising the assets for the relevant ISP project or ISP project stage.*
>
> *c) The estimated future capex of the remaining works for the relevant ISP project or ISP project stage, and any cost variations, will be immaterial. There could be a specific cost threshold for immateriality or be assessed on a case-by-case basis.*
>
> *d) The remaining works are expected to be completed, and the costs are expected to be incurred before the AER has completed its final determination.*

At the outset, we would observe that all stakeholders – and indeed the AER itself – would benefit from the ex post review in relation to an ISP project being undertaken as close to the completion of the ISP project as possible. As the AER's discussion correctly assumes, TNSPs benefit from earlier application of the ex post review because the prospect of having capex disallowed is a substantial risk to ISP projects and so an earlier review will minimize the period during which this uncertainty continues. An earlier application of the ex post review would coincide with greater familiarity of AER commissioners and staff with the project and potentially allow an earlier adjustment of the RAB should the AER decide any expenditure is not prudent and efficient, which will benefit consumers.

However, the mandatory factors the AER proposes would unduly limit the potential for an ISP project to be deemed to be "substantially complete". Whilst we support the first of the AER's proposed factors (that "the completed works is a sufficient representation of the likely overall capex outcome"), the remaining three mandatory requirements the AER proposes ((i) no remaining construction costs, (ii) any remaining expenditure be immaterial, and (iii) all expenditure – including testing and commissioning – be complete by the final determination) would set too high a bar for an ISP project to be deemed to be substantially complete.

Instead, the CEIG should set out guidelines for when a project is deemed to be "substantially complete", but to leave flexibility in their application to the context of a particular ISP project. As well as the "representative" principle discussed above, a principle that the remaining expenditure be "reasonably predictable" and so occur after major risk factors with the project have passed, would also be appropriate. Moreover, we would also support the CEIG providing quantitative guidance as to the proportion of work that had already occurred (such as more than 90 per cent complete), provided again that this was not applied as a "bright line" test. Lastly, given that all participants would benefit from an earlier application of ex post review to an ISP project, we think that, whilst TNSPs would

5 AER 2025, p.18.

present argument as to why an ISP project should be considered "substantially complete", it is inappropriate for TNSPs to bear a formal onus of proving this as the consultation paper proposes.[6]

ENA consider it is important to recognise that projects can involve a number of TNSPs with differing workloads and issues within each state's project. Flexibility is also needed to enable a TNSP that is substantially complete to undertake an ex post review if needed and not be delayed until the other TNSPs' project is also substantially complete.

2.2. Application of ex post review – other considerations

The prospect of having actual capital expenditure disallowed ex post is a material risk for TNSPs. However, in relation to ISP projects, these risks are magnified: not only would ISP projects be considered in isolation rather than as a portfolio, the greenfield nature of the projects means that forecasts of expenditure are substantially more uncertain. Indeed, ex post disallowance is one of– if not the - key risk in relation to ISP projects.

Given this, the rules important guidance about the conduct of ex post reviews – most notably the requirement not to take advantage of hindsight – and why the AEMC describes the disallowance of capital expenditure under an ex post review as a "last resort."[7] The proper role for ex post review is to address clear and egregious failings in project selection and/or delivery, and for the AER to accept the onus of proof to demonstrate this.

In terms of whether a change to the CEIG is required as a consequence of the targeted review of ISP projects, we think the -two stage process for ex post review set out in the CEIG currently is pragmatic and equally applicable to the targeted review of ISP projects. Similarly, the focus (in stage 2) on the policies and practice of the TNSP, a detailed consideration of the context of the ISP projects and benchmarking against good industry practice are also appropriate. The one area where additional guidance that is specific to ISP projects would be appropriate is how the "significance" of the overspend would be judged, noting that ISP projects are at much greater risk of an overspend given that they will be assessed in isolation, and as they will typically be greenfields projects, as noted above. Community and landholder engagement and social licence present substantial risks in large greenfields projects, although brownfield projects are also not without risks.

2.3. Other suggested changes to the CESS for ISP projects

We address separately below the AER's questions about how capex uncertainty can be better managed within the CESS. However, there are two other changes to how the CESS applies in relation to ISP projects that we suggest the AER consider.

First, as with the conduct of the ex post review, applying the CESS part way through the construction of an ISP project does not make obvious sense, and may generate confusion amongst customers (for example, if CESS penalties are generated in one period and rewards in another). In addition to the changes the AEMC has made in the rule change to ensure that expenditure assessed as prudent and efficient does not trigger a CESS penalty, we propose that the CESS be applied over the entirety of the construction period once the ISP project is completed or substantially completed. This is how the AER has decided to treat the Humelink early works costs.

Second, we also propose adding flexibility to the CEIG as to how any CESS rewards or penalties associated with the construction of an ISP project if they arise are spread over time. The size of ISP projects, together with the inherent uncertainty in their forecast cost, means that material penalties or rewards could be created, and create material cash flow and price impacts if spread only over the first

6 AER 2025, p.18.
7 AEMC targeted review reasons for determination, pp.1, 10 and 37.

regulatory period after construction.[8] The preferable course would be for the CESS penalty or reward to be given effect via a direct change to the RAB for the ISP project or, equivalently, by spreading the penalty or reward over multiple regulatory periods.

3. Further refinements to the CESS

3.1. Lack of recognition of expenditure forecasting risk within the CESS

We strongly support the application of financial incentives to encourage efficiency in capital expenditure, working alongside incentives to minimise operating expenditure and incentives tied to service outcomes via the STPIS.

A critical feature of any incentive scheme is for the rewards or penalties that are created under the scheme to accurately reflect changes in efficiency. Indeed, ensuring that the rewards or penalties accurately reflect changes in capex efficiency is a formal requirement of the rules in relation to the CESS (rule 6A.6.5A(c)(1)). In addition, it is also important for the rewards and penalties to be reasonable and appropriate to the context of the project in question, which is also a formal requirement of the rules in relation to the CESS (rule 6A.6.5A(e)(4)(ii)).

However, the CESS derives efficiency gains or losses simply by comparing actual capex against the regulatory allowance that was determined in the previous revenue cap review (and so based on forecasts that may be up to seven years old). This may be a poor measure for changes in efficiency as it makes no allowance for how efficient capital expenditure needs may have changed during the interim period. Indeed, the experience over the last 5 years has shown the speed with which material, unforeseen events (such as the logistics issues associated with COVID-19, the subsequent unprecedented increase in equipment costs and the substantial increase in demand for certain connections at the distribution level) may cause regulatory allowances to become out of date and materially incorrect. This recent history also demonstrates that the risk of forecast errors in the regulatory allowances tends to be asymmetric.

The simplistic calculation of changes in capex efficiency applied presently in the CESS will result in projects being inefficiently deferred (where reprioritisation of projects within the ex ante allowance is possible) or NSPs bearing unnecessary risk, both of which are ultimately to the detriment of customers. Indeed, the AEMC highlighted in its decision on the targeted review rule change that it appeared perverse that projects that had been subject to ex post review and found to be prudent and efficient (i.e., a source of new information about efficiency) could nonetheless be subject to a penalty as high as 30 per cent under the current incentive framework.[9]

We address how the CESS should be amended in light of these fundamental issues in the next two sections.

3.2. CESS applicable to ISP projects

As discussed earlier, how the CESS applies to ISP projects is a particular issue given their size, that their greenfields nature makes the expenditure forecasts subject to greater uncertainty, and because there is no opportunity to reprioritise expenditure in relation to ISP projects to remain within a regulatory allowance.

8 There is also a mismatch in the outcomes for customers arising from an overspend because the consequence of the overspend would endure (via a higher RAB) for the life of the assets, but the associated CESS penalty (which is intended to result in customers' bearing the target share of the overspend) would be concentrated over the first regulatory period after the ISP project commenced operation.

9 AEMC 2024, p.20.

The AER already has some flexibility under the current CEIG to alter the application of the CESS in relation to ISP projects (and other projects that are the subject of a Contingent Project Application), and modified certain aspects of the CESS in relation to HumeLink.[10] However, more clarity should be provided in the CEIG as to how ISP projects will be treated. More specifically, the CEIG should include:

- a process under which TNSPs were able to propose measures within the CESS to manage the uncertainty in capex forecasts (we would expect this to occur as part of the main contingent project application)[11]
- examples of measures that would be acceptable, and
- more relevant criteria should be provided to guide the assessment of such a proposal, namely that the objective is to ensure that CESS rewards or penalties are based on a better measure of changes in capex efficiency, and that an appropriate allocation of remaining capex risk is generated, both in the context of the particular ISP project.

As part of this flexibility, TNSPs should get the option of adopting the AEMC's suggestion that CESS penalties in relation to a capex overspend on an ISP project be cancelled where that overspend has been subject to the ex post review and deemed to be efficient, which the AEMC described as follows:[12]

> *For ISP projects already subject to a CESS, the AER may adjust a TNSP's future revenue allowance to offset the effect of any net CESS penalty attributable to an ISP project to prevent a TNSP from being double penalised or penalised for efficient overspends.*

As noted above, we agree with the AEMC that it is perverse for CESS penalties to be applied in relation to an ISP project where expenditure has been judged to be efficient.

However, TNSP's should also have the option of proposing alternative measures for managing the uncertainty in ISP project capex forecasts in the CESS that better meet the needs of a particular ISP project and the circumstances of the TNSP. Some of the alternative measures that the CEIG could contemplate include:

- an adjustment to the expenditure benchmarks against which CESS rewards or penalties are calculated under certain circumstances, for example, if a defined risk event or events occurred
    - in this case, before applying the CESS the AER would confirm that the risk event had occurred, and that the TNSP's response was prudent and efficient, mirroring the type of analysis that may be undertaken in an ex post review
- the exclusion of certain components of capex from the CESS, and/or
- a cap in relation to the total penalty that may be created.

A key component of the TNSP's proposed CESS in relation to an ISP project would be the sharing ratio that would apply to the deemed change in efficiency (i.e., after having applied the CESS capex uncertainty measures discussed above). We note that the AER's HumeLink decision has applied an

10 Specifically, a lower incentive rate applies for over- or under-spends in excess of 10 per cent, and one class of capex – biodiversity offset costs – were excluded from the scheme.
11 The AER to date has deferred its consideration of how the CESS should apply to an ISP project to the contingent project application for the main construction expenditure (i.e., it has not considered these issues in depth during early works applications), which is pragmatic and should continue.
12 AEMC, 2024, Managing ISP project uncertainty through targeted ex post reviews – information sheet, August, p.2.

incentive rate of 9.25 per cent,[13] which reflected HumeLink's expenditure profile, its WACC and the AER's view about the uncertainty in that project's expenditure forecasts.[14] For ISP projects, even a modest incentive rate could generate a substantial penalty in absolute terms from an overspend which, when combined with the enhanced exposure of ISP projects to the risk of ex post review, would be sufficient to motivate efficient behaviour.

The AEMC included a transition and savings provision in the rules that would permit the AER to cancel CESS penalties in relation to existing ISP projects that otherwise would have arisen under the applicable CESS to that project, where overspends are found to be efficient.[15] The AER should provide any relevant TNSP with the same choice to have CESS penalties cancelled where an overspend has been found to be efficient for existing ISP projects as we propose above in relation to new ISP projects.

3.3. Non ISP expenditure

The imprecision with which the existing CESS measures changes in capex efficiency applies equally to a TNSP's ex ante capex. The one difference between ISP and non ISP- capex is that the TNSPs can reduce their risk of overspending by re-prioritising projects; however, re-prioritising may create direct costs to customers where this leads to projects being deferred.

Accordingly, the same flexibility should also exist for TNSPs or DNSPs to propose CESS capex uncertainty measures in relation to non ISP capex, with the uncertainty measures proposed by the NSP to be assessed by the AER taking into account the circumstances and risks at the time.

A particular issues facing DNSPs is the uncertainty associated with customer connection capex. This is capex that DNSPs must incur when requested, but whose timing and quantity is determined by actual connection demand and hence is uncertain (and where that uncertainty has increased).

3.4. Abandonment of projects and the CESS

The comments in relation to how abandoned projects are treated were raised in the context of ISP projects, and changes that are made to the CESS to address the potential abandonment of projects should be restricted to ISP projects. In relation to other capex, NSPs receive an overall allowance for capex, and are provided with the flexibility to reprioritise projects as necessary to seek to work within the allowance. Any effort therefore to seek to identify specific abandoned projects (or, in reality, re-timed) and apply a different treatment in the CESS projects would be inconsistent with the intended flexibility in the overall allowance.

In relation to ISP projects, we note that any decision to abandon a project would have impacts across a range of stakeholders and so would not be made lightly by the TNSP, but rather would only occur after fulsome and transparent analysis and consultation. The financial incentives present in the regime are unlikely to have a material impact on the decision of whether or not an ISP project is to be abandoned.

However, where the decision is taken for an ISP project to be efficiently abandoned, then it would be reasonable for:

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13 However, we do not think the AER's decision to apply a 30 per cent incentive rate for over or under-spending of less than 10 per cent is appropriate for a large ISP project (a 30 per cent penalty for a 10 per cent overspend on a $4 billion project would imply a penalty of $120 million, which is a very substantial penalty, particularly when it may arise for reasons that were beyond the control of the TNSP.

14 The incentive rate of 9.25 per cent was calculated as the average of the "natural" incentive rate that would occur due to the revenue cap over the regulatory period, assuming the same proportionate over- or underspend in each year. Where a project has a different expenditure forecast uncertainty, an incentive rate that differs to the natural incentive rate may be seen as appropriate.

15 Rule 11.172.3.

- the TNSP to recover the costs incurred to date via being rolled into the RAB (less any transfer of assets that are able to be used elsewhere), but
- for any CESS rewards that may be created by a mechanistic comparison of the regulatory allowance to the actual expenditure for the abandoned component of the project be disapplied.

3.5. Exclusions and modification of CESS for DNSPs

Energy network businesses support the amendment the CESS Guideline to flexibly enable the modification of the CESS or the exclusion of the CESS for specific types of capital expenditure undertaken by DNSPs.

During this critical phase of the energy transition there are a range of specific and new forecasting risks arising, from rapidly evolving patterns of demand, connection trends, and community and consumer expectations around climate resilience.

Any potential modifications or exclusions need to ensure that the incentive framework remains strong, driving efficient delivery of outcomes consumer value.

Recognising this, ENA considers that in some limited cases forecasting risk could be efficiently mitigated to the benefit of consumers by allowing DNSPs to propose relevant exclusions which are customised to their specific circumstances. These could be transparently assessed by the AER against a pre-established set of criteria in the CESS Guideline. This would be an approach which promoted certainty and simplicity of approach, while also providing the AER with flexibility to respond to individual network proposals.

Such an approach would represent a balanced way, for example, to flexibly permit the AER to consider CESS exclusions for connections-related or network innovation programs, as proposed in recent network determinations in New South Wales and Victoria.

ENA considers movement in this direction would be a positive step towards ensuring the regulatory framework adequately responds to the greater levels of demand and cost uncertainty through the energy transition.