Capital Expenditure Incentive Guideline Review

Explanatory Statement - Draft Guidelines

May 2025

AUSTRALIAN ENERGY REGULATOR

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Contents

Request for submissions

We are undertaking a consultation process for amending the Capital Expenditure Incentive Guidelines (Guidelines), to take into account the Australian Energy Market Commission's (AEMC) final rule for *Managing ISP project uncertainty through targeted ex post reviews* and the issues relating to exclusions from the application of the CESS.

We are consulting in accordance with the standard rules consultation procedures set out in clause 8.9.2 of the National Electricity Rules (NER), and the distribution and transmission consultation procedures set out in clauses 6.16 and 6A.20 of the NER respectively.

We invite interested parties to make written submissions to us on the matters discussed in the draft Guidelines and the accompanying explanatory statement by close of business **27 June 2025**.

We prefer electronic submissions to aerinquiry@aer.gov.au.

Alternatively, stakeholders can mail submissions to:

Mr Arek Gulbenkoglu
General Manager, Network Expenditure
Australian Energy Regulator
GPO Box 520
Melbourne, VIC, 3001

We prefer all submissions be publicly available to facilitate an informed and transparent consultation process. We will therefore treat submissions as public documents unless otherwise requested.

We request parties wishing to submit confidential information to:

- clearly identify the information that is the subject of the confidentiality claim, and reasons for the confidentiality claim
- provide a non-confidential version of the submission, in addition to a confidential one.

We will publish all non-confidential submissions on our website at www.aer.gov.au. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy, June 2014 available on our website.

Please direct enquiries about this paper to aerinquiry@aer.gov.au.

We look forward to engaging with all stakeholders on these important updates to our Guidelines.

1 Background

1.1 The AER's Capital Expenditure Incentive Guidelines

The Capital Expenditure Incentive Guidelines (Guidelines) outline the ex ante and ex post measures to incentivise prudent and efficient capital expenditure (capex). Capex refers to the money required to build, maintain or improve the physical assets needed to provide services. Generally, these assets have long lives, and a network service provider (NSP) will recover capex from customers over several regulatory control periods through network tariffs.

The Capital Expenditure Sharing Scheme (CESS) and the use of forecast depreciation on capex are ex ante measures that provide up front incentives for NSPs to pursue efficient capex. These ex ante measures are complemented by our ex post review, which allows us to assess the efficiency and prudency of capex after it is incurred. This helps to ensure we only use efficient and prudent capex to set regulated prices.

Taken together, the CESS and ex post review outlined in the Guidelines should contribute to achieving the capital expenditure incentive objective under clauses 6.4A and 6A.5A of the NER:

The capital expenditure incentive objective is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the Rules, then the only capital expenditure that is included in an adjustment that increase the value of that regulatory asset base is capital expenditure that reasonably reflects the capital expenditure criteria.[1]

In particular, the CESS provides NSPs with incentives to pursue efficiency gains throughout the regulatory control period. NSPs will have a constant incentive to reduce capex irrespective of the year of the regulatory control period and whether they have overspent or underspent in total.

The ex post measures complement the CESS to provide NSPs with an additional incentive to ensure that any overspends are efficient and prudent. Under the current CESS, NSPs bear 30% of the cost of an overspend whether it is efficient or not. If the overspend is found to be imprudent and inefficient, however, the NSP will bear 100% of the imprudent and inefficient overspend. In addition, we also may exclude inefficient related party margins and capitalised operating expenditure (opex) that does not benefit consumers.

These measures are intended to work in a way so that consumers pay only for efficient and prudent overspends and share in the benefits where an NSP is able to spend less than its capex forecast.

These measures also complement the incentive schemes for opex (Efficiency Benefit Sharing Scheme) and for service standards (Service Target Performance Incentive

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1 The capex criteria require we be satisfied that forecast capex reflects prudent and efficient costs and a realistic forecast of demand and cost inputs and other relevant inputs. See NER, clause 6A.6.7(c)(1)-(3) and clause 6.5.7(c)(1)-(3).

Schemes) and are designed to balance the incentives to reduce expenditure against maintaining service standards.

1.2 Scope of this Review

This Guidelines review will consider the statutory amendments made by the AEMC's targeted ex post reviews rule change. In addition, this review also considers additional matters that has been raised by stakeholders since our 2023 review of incentive schemes for regulated networks (2023 Incentives Review).[2] In particular, the objective of this Review is to accommodate the AEMC's rule change and address the matters of forecasting uncertainties via exclusions from the application of the CESS.

In August 2024, the AEMC published a final determination for its *managing ISP project uncertainty through targeted ex post reviews* (targeted ex post reviews) rule change. Giving effect to this we must update our Guidelines to enable us to carry out separate targeted ex post review for Integrated System Plan (ISP) projects and non-ISP projects.

We have also received a number of regulatory proposals requesting exclusions for the CESS, including from the Victorian distribution network service providers (DNSPs) for the 2026-31 regulatory period. The current Guidelines do not allow for any exclusions for DNSPs.[3]

NSPs state that there are a range of specific and new forecasting errors arising due to the energy transition. They contend that the current CESS approach will result in projects being inefficiently deferred or NSPs bearing the forecasting risk and likely being penalised via the CESS for efficient expenditure. NSPs consider this forecasting risk can be managed via ex ante CESS exclusions.

Against this context, this review consider:

- how we should undertake the separate targeted ex post reviews for ISP project capex and non-ISP project capex
- what factors we will take into account to conclude whether an actionable ISP project, or a stage of an actionable ISP project, is substantially complete
- how we would apply the CESS to reviewable ISP projects that span across multiple regulatory control periods
- whether we should allow certain categories to be excluded from application of the CESS to accommodate the uncertainties in forecasting
- whether we should reduce the CESS penalties incurred on an ex post basis
- how we should apply the CESS to projects that are efficiently abandoned.

1.3 Consultation process and next steps

We published our consultation paper on 21 February 2025, and received 19 submissions from networks, retailers, consumer groups and individual consumers. A summary of the issues raised in these submissions can be found in **Appendix A**.

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2 AER, *Review of incentive schemes for regulated networks: Final Decision*, 28 April 2023.
3 For TNSPs, we may vary the application of the CESS to allow for exclusions in contingent project assessments.

The draft Guidelines and this explanatory statement incorporate feedback from the written submissions we received in response to our consultation paper. We are seeking stakeholder views on amendments proposed in our draft Guidelines.

Table 1 sets out the next steps for this review before publication of the final Guidelines amendments on 4 September 2025 as required by the AEMC's targeted ex post review rule change.[4]

Table 1: Timeline

Milestone	Indicative Date
Draft Guidelines and Explanatory Statement for consultation	16 May 2025
Submissions close for draft Guidelines	27 June 2025
Final Guidelines and Explanatory Statement	1 September 2025

1.4 Structure of this Explanatory Statement

This explanatory statement is structured as follows:

- Chapter 2 discusses our proposed method for undertaking separate targeted ex post reviews for ISP project capex and non-ISP project capex
- Chapter 3 sets out the factors we will take into account to conclude whether an actionable ISP project, or a stage of an actionable ISP project, is substantially complete
- Chapter 4 discusses how we will modify the CESS to ensure a transmission network service provider (TNSP) is not being penalised more than 100% of overspend expenditure that is found to be inefficient following an ex post review on a reviewable ISP project spanning across multiple regulatory periods
- Chapter 5 discusses ex ante and ex post CESS exclusions, including CESS exclusions for ISP projects, and seek stakeholder views as to whether the proposed changes retain an appropriate balance of rewards and penalties under the CESS
- Chapter 6 discusses the interactions between the CESS and efficiently abandoned ISP project
- Chapter 7 discusses matters in relation to the transitional provision, and the application of the CESS for renewable energy zone projects (REZ) and businesses with single asset regulatory asset base (RAB)
- Appendix A provides a summary of the stakeholder submissions we received on the consultation paper for this review.
- Appendix B provides illustrative example on how we will consider the CESS exclusions.

[4] The AEMC's targeted ex post reviews rule change, except for the transitional provisions at clause 11.172 of the NER, will commence on 4 September 2025. In preparation for this, we are required to amend our Guideline by 4 September 2025. The transitional provisions at clause 11.172 of the NER commenced on 5 September 2024.

2 Separate targeted ex post review of ISP projects and non-ISP projects

2.1 Issue

The amendments to the NER establish separate targeted ex post reviews for ISP project capex and non-ISP project capex.[5] This is a departure from the current Guidelines where we undertake an ex post review of total capex rather than individual capex projects.

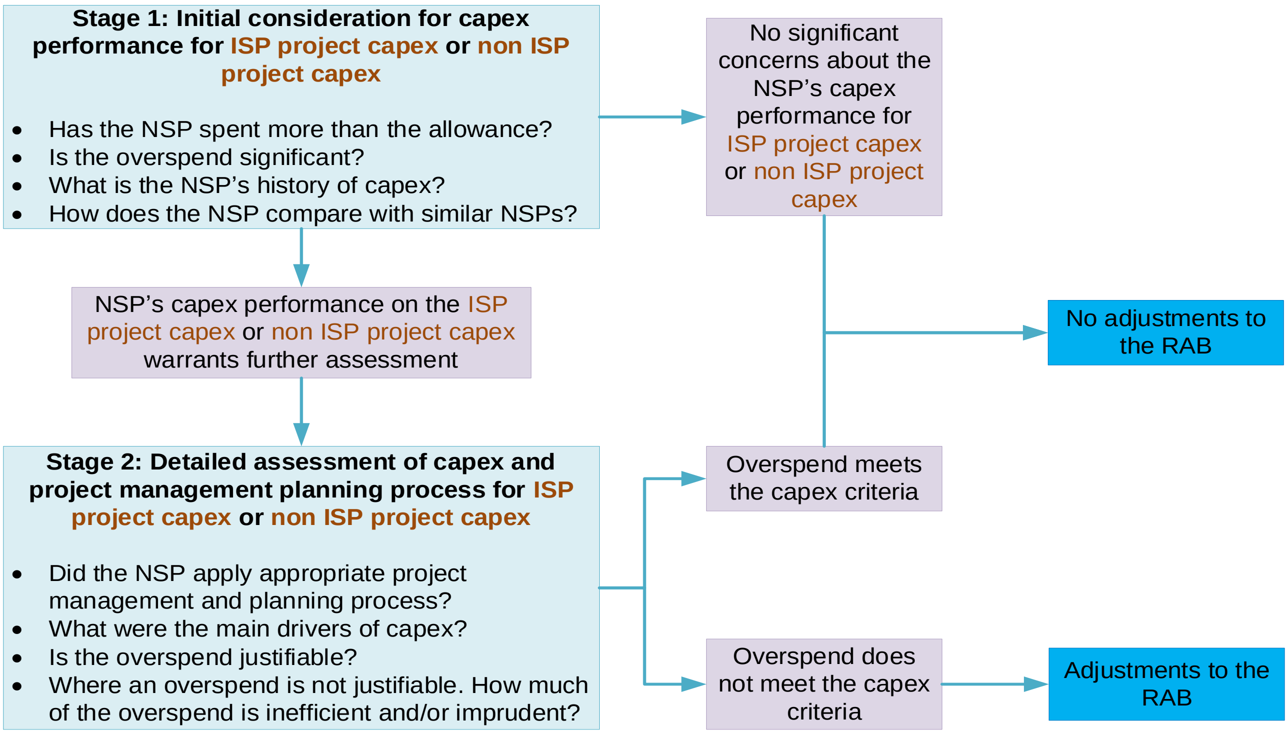
In giving effect to the rule change we are required to define how we would undertake the separate targeted ex post reviews of ISP project capex and non-ISP project capex.

The scope of the changes to our ex post review mechanism are limited to ISP projects.

2.2 Proposed amendments

The AEMC considers that minor amendments are required to our current ex post review process to reflect the rule change.[6] Our draft Guidelines reflects the AEMC's position. We have amended the draft Guidelines to apply our current ex post review approach to ISP project capex and the non-ISP capex separately, rather than a single ex post review on total capex. The figure below illustrates the 2 stage process we will undertake for ex post reviews. In stage 2, we will undertake a detailed assessment, and the factors listed in the diagram are not exhaustive.

Figure 1: Separate targeted ex post reviews



5 NER cl. S6A2.2A(f).
6 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, pp. 14-16.

Please see section 4.3 of the draft Guidelines.

2.3 Stakeholder views

We received a range of views from stakeholders:

- Most networks generally supported the amendments we proposed in the consultation paper to the existing ex post reviews[7]
- Energy Networks Australia (ENA) agreed with proposed amendments, but suggested that we should provide additional guidance that is specific to ISP projects on how the overspends would be judged[8]
- Clean Energy Finance Corporation (CEFC) submitted that there should be a greater weight placed on the ex ante incentives and the ex post review should only capture egregious investment decisions or behaviours by TNSPs[9]
- Individual consumers and Energy Australia submitted that the current ex post mechanism to be a fairly low hurdle in terms of justifying cost increases, and noted that there is a need to further scrutinise the ongoing costs of ISP projects to better protect consumers.[10]

2.4 Reasons for the proposed changes

In proposing the draft amendments to the Guidelines, we had regard to the mechanism for undertaking ex post reviews for ISP projects.

On balance, we consider that our existing 2 stage approach to ex post reviews is sufficiently flexible and fit for purpose for both ISP and non-ISP capex. This approach allows us to determine what level of analysis and examination is required on a case-by-case basis.

Stage 1 of our ex post review process considers whether the overspend is significant at the total cumulative forecast capex level. If we consider that the NSP's cumulative capex overspend warrants further assessment, then we undertake stage 2. Stage 2 involves a detailed assessment of the drivers of the NSP's capex and the NSP's management and planning tools and practices.

Therefore, by applying the 2 stage approach to ISP projects, we are able to use our discretion in determining whether it is necessary to conduct a detailed assessment where necessary. Section 4.3 of the existing Guidelines set out the principles and manner in which we will undertake ex post assessments. This guidance is sufficiently flexible to apply to ISP projects on a case-by-case basis.

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[7] Marinus Link, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025, pp. 3, AusNet, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025, pp. 3, Transgrid, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 2 April 2025, pp. 13 and ENA, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 26 March 2025, pp. 5.

[8] ENA, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025, pp. 5.

[9] CEFC, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 26 March 2025, pp. 2-4.

[10] Individual consumers, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper* email received on 21 March 2025; and Energy Australia, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025, pp. 1-3.

Finally, we consider ex post reviews to be a critical component in ensuring ISP project capex meets the capital expenditure incentive objective. The ex post review process is a key stage in identifying whether the capex to be rolled into the RAB is efficient and works in conjunction with the ex ante incentives.

3 Factors for establishing that an ISP project is substantially complete

3.1 Issue

The AEMC's rule change introduced the terms "ISP project review period" and "reviewable ISP project". Once a project has been substantially completed, it becomes a "reviewable ISP project" in which the AER can undertake an ex post review over the period in which the actionable ISP project, or a stage of the actionable ISP project, was constructed.[11] The ISP project review period encompasses the whole period in which a TNSP has incurred capex on the actionable ISP project, or a stage the actionable ISP project.[12]

We consider that a reviewable ISP project stage includes any predefined stage of an ISP project other than early works stage.

The AEMC identified that the AER should not have to wait for a project to be fully completed before commencing an ex post review. Rather, we can review an actionable ISP project, or a stage of an actionable ISP project, once it is substantially completed, and the overspending requirement is satisfied.

The AEMC expressed the view that for a project to be considered substantially completed:

- any future capex required to complete the project should be relatively minor, and
- estimates of this future capex should be reasonably certain,
- such that the risks of further cost overruns are low.[13]

The AEMC also considered that a substantially completed project would be one that is fully completed prior to our final determination. This means that we can complete an ex post review on a substantially complete ISP project as part of a draft determination and then 6 months later publish a final determination having reviewed all the capex overspend.[14]

We are required to specify in the Guidelines the matters we will take into account to conclude whether an actionable ISP project, or stage of an actionable ISP project, is substantially completed for the purposes of being a reviewable ISP project.[15]

Furthermore, in relation to staged actionable ISP projects, we can undertake ex post reviews for project stages separately.[16] This is to prevent a significant lag period between when a project is substantially completed and delivering benefits to consumers. However, under clause S6A.2.2(a1), stages that comprise only early works will not be considered reviewable

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[11] NER clause S6A.2.2A(a1); AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, pp. 14-16.

[12] We note that TNSPs have the ability to define project stages for a large network project.

[13] AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p 16.

[14] AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p 16.

[15] NER, Clause 6A.5A(b)(2a). AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p 17.

[16] We consider that a reviewable ISP project stage includes any predefined stage of an ISP project stage other than early works stage.

ISP projects. We can only undertake our ex post review on ISP capex once the actionable ISP project or the stage of an actionable ISP project is substantially completed.

3.2 Proposed amendments

Our proposed amendment to the draft Guidelines introduces a new sub section 4.3.4 referring to ex post reviews for ISP projects. This section will place the onus on the NSP to propose that an actionable ISP project, or a stage of an actionable ISP project,[17] is substantially complete and hence eligible for a targeted ex post review. In putting forward a proposal, NSPs should seek to demonstrate that the project, or project stage, is substantially complete by reference to the following factors:

i) Whether the completed works and costs incurred on the actionable ISP project, or stage of an actionable ISP project are 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?

ii) Whether the TNSP expects to incur additional construction costs related to the actionable ISP project, or a stage of an actionable ISP project, or whether the only remaining works are associated with commissioning and energising the assets for the relevant actionable ISP project, or stage of an actionable ISP project.

iii) Whether the estimated future capex of the remaining works for the relevant actionable ISP project, or stage of an actionable ISP project, and any cost variations, will be immaterial (as assessed by the AER on a case by case basis).

iv) Whether the remaining works are expected to be completed, and the costs expected to be incurred, before the AER has completed its final determination.

However, in an event where a TNSP incurs materially higher capex after a project is substantially complete, the AER reserves the right to reassess the ex post review.

Please see section 4.3.4 of the draft Guidelines.

3.3 Stakeholder views

Network stakeholders submitted that:

- while a TNSP may propose arguments as to why an ISP project is substantially complete, TNSPs should not bear a formal onus to do so[18]
- factors proposed by the AER were too restrictive and the AER should allow greater flexibility[19]

17 Any predefined stage of a staged ISP project other than early works stage.

18 ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 4.

19 ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 4-5, AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 3, and Marinus Link, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 3-4.

- the Guidelines should provide quantitative guidance as to the proportion of work that is completed to be considered as a substantially complete (provided it not be used as a hard threshold)[20]
- the AER may be able to conduct an ex post review if any remaining construction and commissioning costs are not material and/or can be forecast with a reasonably high degree of confidence.[21]
- there should not be any time limitations for when the remaining works are expected to be completed, as any remaining costs should be immaterial, there should be no need to require a time limit on when the remaining works are to occur.[22]

CEFC submitted the AER should monitor and assess when an actionable ISP project or project stage is substantially completed and define where a project is "complete" as it may aid determining when a project is substantially complete.[23]

3.4 Reason for the proposed changes

Consistent with the propose-respond model under the NER, we consider that it is appropriate for a TNSP to put forward a case to why an ISP project is substantially completed, having regard to the factors set out above. Then, at the time of our draft regulatory determination, we will make a decision as to whether we agree that an actionable ISP project, or a stage of an actionable ISP project, is substantially complete.

We do not agree that there is need for the AER to define where a project is "completed" nor closely monitor the progress of the projects. In particular, the AER may be unable to access and accurately assess reliable information about the quantum of any remaining project costs. Instead, the NSP should be responsible for monitoring the progress of the project as it will have better access to information about the project's status. We also note the term for "complete" is well-established in practice and our statutory task is to specify matters we will take into account to conclude whether an actionable ISP project, or stage of an actionable ISP project, is substantially completed.[24]

We consider that the proposed factors are sufficiently flexible and there is no need to introduce additional flexibility. For instance, the wording of proposed factor (i) refers to the costs incurred being a "sufficient representation of the likely overall capex outcome" and factor (iii) referring to expected future costs being "immaterial" and the threshold for this being determined on a case-by-case basis. As ISP projects begin passing through the proposed ex post review process, we anticipate a common understanding will develop in this interpretation between the AER, NSPs and other stakeholders.

The purpose of the ex post review is to determine whether any imprudent and inefficient expenditure has been incurred. To align with the intent of ex post reviews, we consider it is

[20] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 4-5

[21] Marinus Link, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3.

[22] Marinus Link, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025 p. 4.

[23] CEFC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 26 March 2025, p 8.

[24] For instance, in the AEMC rule change process, it was originally proposed that project completion be defined in terms of being commissioned and energised.

necessary to take into account whether there are any remaining construction costs and timeframe of when the remaining costs would be reasonably incurred. Outstanding physical construction costs suggest the project is not close to completion by the end of the relevant regulatory period and may have a greater risk of unexpected overruns. Therefore, allowing greater flexibility with timeframes or allowing remaining construction costs may introduce unnecessary risk that the outstanding project costs may change from what is expected to be immaterial. Further, a longer timeframe for such costs and project works occurring may be inconsistent with the AEMC's policy intent that the introduction of the "substantially complete" element was to "prevent minor project delays from delaying an ex post review, until the next revenue reset."[25]

[25] AEMC, *Targeted ex post review final determination*, 1 August 2024, p iii.

4 Modification to the CESS to accommodate multi-period ISP projects

4.1 Issue

In relation to reviewable ISP projects that span across multiple regulatory periods, we are considering how we can ensure that an NSP does not face a penalty above 100% for an inefficient overspend.

The current Guidelines includes a mechanism to reverse any CESS penalty for capex that is subsequently found to be inefficient as part of an ex post review. This means that an NSP does not face a penalty above 100% of the inefficient overspend. However, this mechanism is limited to a 5 year ex post review period.

4.2 Proposed amendments

Our proposed amendment to the Guidelines adopts the current mechanism to reverse any CESS penalty for a reviewable ISP project capex that is subsequently found to be inefficient as part of an ex post review. We do this by introducing a new sub section to 2.8, which explicitly allows us to adjust the CESS penalties for ISP capex incurred during the ISP project review period that is later found to be inefficient as part of an ex post review.

We propose to extend this mechanism to apply for the whole ISP project review period (period in which capex was incurred in relation to an actionable ISP project, or a stage of an actionable ISP project, that is substantially completed).

Please see section 2.8.3 and section 4.4 of the draft Guidelines.

4.3 Stakeholder views

Stakeholders generally supported our approach presented in the consultation paper. This is the ability to reverse or adjust CESS penalties for inefficient capex from projects that span multiple regulatory periods and refunding penalties when capex is excluded from the RAB following an ex post review, taking the time value of money into account.[26]

TasNetworks also stated that the AER should separate the application of the CESS for ISP and non-ISP project capex and undertake an assessment of actual ISP project capex against the total allowance over multiple regulatory control periods for the purposes of the CESS.[27]

4.4 Reasons for the proposed changes

We consider our proposed approach maintains consistency with the existing mechanism and is generally accepted by stakeholders.

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[26] AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 4; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p 3; and ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 3-4.

[27] TasNetwork, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p 2.

In response to TasNetworks' comments, we do not consider any further changes are required. TasNetworks' suggested changes would create unnecessary complexities in the operation of the CESS scheme. Our revenue determination and the CESS is based on a 5 year regulatory control period and CESS payments are calculated based on the most up to date actual and estimated capex information.

5 Exclusions from the application of the CESS

5.1 Issue

The current Guidelines do not allow for general exclusions from the application of the CESS. However, for TNSPs,[28] we may vary the application of the CESS for transmission contingent project proposals. This allows for a bespoke CESS be applied to transmission contingent projects including ISP projects.

In our consultation paper, we sought stakeholder views on two types of changes to the CESS:

- whether there is a need to modify the application of the CESS generally to allow CESS exclusions on certain capex categories on an ex ante basis, and
- whether we should have the flexibility to adjust the application of the CESS after an ex post review.

Ex ante CESS exclusions enable certain capex to be excluded from the CESS calculation as identified at the time of when the AER makes its regulatory determination, so the excluded capex is identified ahead of time before an NSP undertakes the capex. In practice, this would mean that the excluded capex is removed from the forecast and the actual capex incurred when calculating a network's efficiency gain or losses. Therefore, a network will not receive a CESS reward or penalty for the excluded capex. However, the network will retain the financing benefit or cost they would receive within the period from the time value of money.

Ex post adjustments to the application of the CESS allows us to reduce an NSP's CESS penalties where we consider it is not reasonable to incur a such a penalty on the relevant overspend.[29] In other words, this allows us to vary the application of the CESS on retrospective basis if an NSP overspent its forecast capex. However, in the event of an underspend the network will retain the rewards under the CESS.

DNSPs generally preferred ex ante CESS exclusions on some capex categories they have limited control over. For instance, DNSPs considered that the energy transition is making it increasingly difficult to forecast connections expenditure due to the increased uncertainty in the number of connections (volumes) and the different types of connections.[30] Further,

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[28] For TNSPs, any capex incurred under the network capability component of the STPIS is not included in the capex calculation.

[29] The Guidelines already allows for CESS adjustments for capex that is found to be inefficient.

[30] CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 1-2; SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p 2-3; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 5; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p 4; EvoEnergy, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2.

DNSPs submitted that their consumers support CESS exclusions for innovation or reliability programs on a “use it or lose it” basis.[31]

TNSPs did not consider ex ante exclusions on specific categories as a viable solution to addressing concerns about the CESS.[32] TNSPs, for non-ISP capex, noted the need for additional projects that happen unforeseeably and potentially across all categories of capex.[33] TNSPs also noted that changes to capex forecasts due to factors outside their control, such as supply chain challenges and economic shocks.[34]

TNSPs also noted that for ISP projects, forecasting uncertainty arises out of the size and greenfield nature of the project. TNSPs suggested that as an ISP project is a single large project, they cannot reprioritise activities in order to manage their expenditure within the total forecast.[35]

5.2 Proposed amendments

Given the different sources of the uncertainties in forecasting identified by stakeholders, we have considered how to apply CESS exclusions in different scenarios.

Our draft Guidelines changes for ex post and ex ante CESS exclusions are set out in Table 2.

Table 2: Proposed amendments to specific sections in the Guidelines

Network	Exclusion Mechanism	Details
DNSP	Ex ante exclusion	We propose to amend section 2.6 of the draft Guidelines to accommodate ex ante exclusions for DNSPs for connections capex.[36] This exclusion mechanism applies a volumetric adjustment to a DNSP’s standard connections capex (excluding bespoke/emerging connection types). A volumetric adjustment is one that takes into account changes in volume so that a network is not rewarded

[31] AusNet, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8; CPU, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3.

[32] ElectraNet, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2.

[33] ElectraNet, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; Powerlink, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; Transgrid, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 2 April 2025, p. 10.

[34] ElectraNet, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; PowerLink, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; APA Group, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 2-3.

[35] Transgrid, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 2 April 2025, pp. 5-7; Marinus Link, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 5; TasNetworks, *Submission to the AER’s Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2

[36] In proposing this amendment, we note that we have the flexibility to vary or not apply the CESS for a TNSP’s contingent project application proposal. This is an ex ante mechanism that is already available for TNSPs.

<table>
<tr><th>Network</th><th>Exclusion Mechanism</th><th>Details</th></tr>
<tr><td></td><td></td><td>or penalised for changes in the volume of work they need to undertake.

No other types of capex can be excluded on an ex ante basis.

Please see section 2.6.1 of the draft Guidelines.</td></tr>
<tr><td>DNSP</td><td>Ex post exclusion</td><td>We propose to amend section 2.8 in the draft Guidelines to introduce a new sub section allowing CESS adjustments following an ex post review. This effectively introduces a mechanism to allow ex post CESS exclusions for large connection capex.

Please see section 2.8.1 of the draft Guidelines.</td></tr>
<tr><td>TNSP (non-ISP project capex)</td><td>Ex post exclusion</td><td>We propose to amend section 2.8 in the draft Guidelines to introduce a new sub section allowing CESS adjustments following an ex post review. This effectively introduces a mechanism to allow ex post CESS exclusions.

This mechanism applies where there is an efficient increase in an NSP’s scope of works, and the incurred capex is not accounted for in a contingent project application, cost pass through application or a reopener.

We will only consider allowing ex post exclusions in limited circumstances at our discretion. Our default position is to apply the CESS without any ex post exclusions.

Please see section 2.8.1 of the draft Guidelines.</td></tr>
<tr><td>TNSP (ISP project capex)

(These changes also relate to REZ and businesses with single asset RAB)</td><td>Ex post exclusion</td><td>In our draft Guidelines, we propose to amend section 2.8 to allow flexibility for us to reduce CESS penalties following an ex post review for reviewable ISP projects.[37] In deciding whether to exercise this flexibility, we will have regard to the following factors:
• the form of CESS in place for the relevant reviewable project
• our findings in the relevant ex post review period
• whether the TNSP has demonstrated it has reasonably managed and prioritised its capex
• the degree to which the overspend was due to factors beyond the TNSP’s control
• other relevant factors.

Please see section 2.8.3 of the draft Guidelines.</td></tr>
</table>

[37] As discussed below, we may also consider ex post CESS adjustments for NSW REZ and businesses with a single asset RAB.

5.3 Stakeholder submissions

We have observed that DNSPs and TNSPs have identified different drivers for why they prefer some capex be excluded from the CESS. However, in general, submissions from NSPs identified forecasting uncertainty and how this may affect incentives as reasons for amending the CESS.

DNSPs submitted that:

- symmetry of risk no longer holds in some instances and that there are significant uncertainties due to the energy transition, which especially impacts connections capex due to the increase in connection types and volumes[38]
- forecasting error will likely lead to inefficient deferrals of projects[39]
- uncertainty mechanisms, such as cost pass throughs, contingent projects and capex reopeners are not able to be accessed to correct forecasting uncertainty[40]
- lack of discretion over some capex programs means the CESS is not operating to provide efficiency gains[41]
- elevated risks for network resilience, posed by climate change are driving increasingly severe and more frequent extreme weather events[42]
- there are increasing cyber security threats, with increasingly sophisticated and varied sources of cyber-crime, and increasing exposure as networks transform and rely more on Information and Communications Technology (ICT) systems in their operations[43]
- certain types of capex should be excluded from the operation of CESS based on a set of principles[44]
- CESS exclusions should be allowed based on whether the capital expenditure has been approved on a use-it or lose-it basis[45]

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38 Evoenergy, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025, p. 2; SAPN, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025., p. 4; Ausgrid, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper*, 21 March 2025., p. 4.

39 SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2-3; CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2.

40 CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2

41 CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2-3; SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2-3; SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2.

42 SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8-9.

43 SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2.

44 CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3; SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 2-3; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8.

45 CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8.

- the CESS should not be varied for DNSPs as altering the sharing ratio would likely add unnecessary complexities[46]
- complementary regulatory mechanisms should also be considered.[47]

In addition, SAPN submitted that ex post CESS exclusions will more likely drive uncertainty, high administrative burden on the AER and networks, and present challenges given the timing issues involved in the current capex ex post review mechanism.[48] However, other DNSPs noted there may be a need for ex post CESS exclusions in some instances.[49] This is because while there are reopener clauses, reducing CESS penalties on an ex post basis would be a less administratively burdensome solution.[50]

TNSPs submitted that:

- over the course of the regulatory period, many operating environment factors may change that could impact the need for, as well as the timing and cost of investments[51] - ex ante exclusions cannot address this issue, so an ex post adjustment to the CESS is required[52]
- there may be overspends caused by unforeseeable external factors beyond networks' control - in these instances, networks should not incur CESS penalties on prudent and efficient overspends[53]
- applying a CESS penalty on an efficient overspend can lead to deferrals of efficient investments to a later regulatory period[54]
- the AER should have regard to the circumstances for any material over-spend in capex[55]

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[46] CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 3-4.

[47] SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 4.

[48] SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 4.

[49] AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 5; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 24 March 2025, p. 2; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3-4; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p, 8.

[50] AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 5.

[51] Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; APA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025.

[52] ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p.2.

[53] APA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 4-5; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8.

[54] ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 6.

[55] Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p 2.

- size and greenfield nature of ISP projects creates forecasting uncertainties which may result in significant overspends, and that TNSPs cannot reprioritise activities to manage their total forecasts as ISP projects are single projects.[56]

Transgrid also considered that the AER should remove the application of CESS penalties from actionable ISP projects. However, if the AER considers a CESS should apply, Transgrid considered various options for how the CESS could interact with ex post reviews. Transgrid's view was that the CESS should apply for costs within a TNSP's control, and the ex post review should only apply to costs other than the TNSP's own costs (as these costs would not be subject to the CESS).[57]

Some individual stakeholders considered that any attempt to exclude certain categories of capex from the CESS framework must be rejected outright.[58] They were concerned that exclusions from CESS would not sufficiently deter NSPs from poor decision-making and may result in inefficient costs being added to the RAB.

The Justice and Equity Centre (JEC), CEFC, and individual consumers did not support the reduction of CESS penalties following an ex post review. These stakeholders submitted that reducing CESS penalties on an ex post basis may undermine the design of the scheme.[59] This is because these changes would essentially make the CESS a reward only scheme.[60]

JEC and CEFC also noted the information asymmetry between the NSP and the AER and for this reason submitted that the AER cannot practically assess each element of overspending on a spectrum of efficiency.

5.4 Reason for the proposed changes

NSPs have raised concerns in relation to areas of capex that may have higher forecasting error than other types of capex. These NSPs did not consider it reasonable for the CESS to penalise for forecasting error.

Meanwhile non-NSP related submissions identified concerns that adding exclusions would decrease the incentive for NSPs to undertake efficient capex and that ex post exclusions could reduce the CESS to a reward only scheme.

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56 APA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 4-5; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8.

57 Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 2 April 2025, p.12.

58 Individual consumers, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper* email received on 21 March 2025.

59 Individual consumers, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper* email received on 21 March 2025. JEC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 20 March 2025, pp. 1-3 and CEFC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 26 March 2025, pp. 4-5.

60 Individual consumers, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper* email received on 21 March 2025.

We acknowledge that the CESS may reward or penalise NSPs for capex outcomes that may not solely relate to efficiency gains or losses. This is because any type of forecasting will include some element of forecasting error.

Our 2023 Review of incentive schemes for networks examined this issue in detail and noted that we have continued to develop our forecasting techniques over time and the introduction of the Better Resets Handbook has assisted in reducing forecast error.[61]

Overall, our 2023 Review found that the CESS should be retained but where underspends exceed 10%, then the sharing ratio would reduce to 20%. This Bright-Line Tiered Test introduced asymmetry to the CESS.[62]

The NSPs have raised various scenarios and types of capex where NSPs may incur additional capex that is beyond their control. However, the capex categories or projects identified in the submissions are different for DNSPs and TNSPs.

Overall, we have sought a balance in targeting areas where forecast error is the main driver of capex outcomes while retaining as much of the ex ante incentive framework as possible.

For this reason, we are proposing different amendments to the CESS for DNSPs and TNSPs.

5.4.1 CESS exclusions for DNSPs

DNSPs identified various categories that should be excluded from the CESS such as connections, resilience and innovation capex. However, some DNSPs also preferred to not make too many changes to the CESS to keep the complexity of the CESS low and reduce administrative burden.

We consider DNSPs have discretion over how they undertake their capex and which projects they prioritise over regulatory control periods. However, we note that the volume of connections is an area where forecasting error is likely to drive the differences in capex outcomes, rather than efficiency and this can have a material effect on capex outcomes. This is because DNSPs must respond to connection requests and have little control over the volume of such requests.

For this reason, we consider a volumetric adjustment to the CESS which takes into account the change in volumes of connections, so that a DNSP is not rewarded or penalised for changes in the volume of work it needs to undertake, is appropriate. We consider this is a targeted way to the address the effect of forecasting error on the CESS, while retaining an incentive for DNSPs to undertake connections works efficiently. We demonstrate how a volumetric adjustment can be applied in Appendix B.

We note that an ex ante volumetric adjustment to the CESS would not address the issue of forecasting error for individual large connections. These types of connections do not have standardised unit rates. For example, a data centre may have bespoke costs that could vary significantly based on a customer’s requirements. For this reason, we have also introduced the ability for us to reduce the CESS penalty arising from these types of connections that

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[61] AER, *Final decision Review of incentive schemes for networks*, p. 17
[62] AER, *Final decision Review of incentive schemes for networks*, pp. 15-16.

have not been included in forecast capex. We would make any ex post adjustments to the CESS for large connections only after we have conducted an ex post review.[63]

At this stage, we do not consider other capex categories require specific CESS exclusions. We note that some DNSPs submitted that capex projects that are supported by consumers should be excluded from the CESS on a 'use it or lose it' basis. We note that a DNSP can choose to not recover a portion of its CESS reward, so a 'use it or lose it' type of arrangement can be implemented without needing exclusions from the CESS. Thus, it may not be reasonable to exclude 'use it or lose it' projects from the CESS entirely as this would reduce the incentive to undertake these projects efficiently if they go ahead.

For other capex categories such as resilience and ICT, we consider it is important to retain an ex ante incentive based regulatory framework, consistent with the NER requirements and revenue and pricing principles. We provide a DNSP with a total capex forecast that reflects the prudent and efficient costs of managing a safe, reliable, and secure network and meetings its regulatory obligations. DNSPs have the flexibility to manage and prioritise their capex portfolio during the regulatory control period, having regard to new information.

However, we are open to receive further stakeholder views as to whether we should consider CESS exclusions for other capex categories, in addition to connections capex for DNSPs.

5.4.2 CESS exclusions for TNSPs' non ISP project capex

TNSPs did not identify specific types of capex that should be excluded from the CESS. Rather, TNSPs noted that it was unforeseen external factors beyond networks' control that could drive overspends. This could lead to deferrals of efficient capex investments.

TNSPs submitted that ex ante exclusions could not address this issue, therefore an ex post adjustment to the CESS was required.[64]

We agree that ex ante adjustments to the CESS that we have proposed for DNSPs above would not address the issues identified by TNSPs. The legitimate drivers for exclusions in the case of TNSPs, such as unforeseen external factors beyond networks' control, will be difficult to identify ahead of time.

We have proposed an amendment to the CESS that accounts for unforeseen projects and reflects an overall increase in the scope of works a TNSP undertakes during a regulatory control period. We consider that this situation could give rise to CESS penalties that may not reflect efficiency gains or losses, are beyond the control of the TNSP, and that this may have a material impact on the capex outcomes for the TNSP.

We propose to apply an ex post CESS adjustment where there is an efficient increase in an NSP's scope of works, and the incurred capex is not accounted for in a contingent project

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63 This means, the ex post adjustments to the CESS for large connections will only be done after we have undertaken an ex post review. We note the difference time between the regulatory control period and ex post review period. The ex post review period is the first 3 years of the relevant regulatory control period and the last 2 years of the regulatory control period preceding that.

64 ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 2.

application, cost pass through application or a reopener. We would make any ex post adjustments to the CESS only after we have conducted an ex post review.[65]

Our assessment would identify whether any overspend was a result of a TNSP undertaking additional projects that were not accounted for in the capex forecast at the time of the AER's final determination. The TNSP would need to demonstrate that it could not reprioritise its projects and that there was an increase in the overall amount volume of work it had to do. If we are satisfied that there was a material overall increase in work, then we would not apply a CESS penalty to the additional projects.

The TNSP would still be subject to a CESS penalty where there are increases in the costs of projects that were included in forecast capex, as these cost increases do not reflect an increase in the scope of works the TNSP had to undertake. We also note our ex post review is not limited to specific categories or projects were NSP overspent. We may assess all cost categories or projects to be satisfied if there is a genuine increase in TNSP's scope. This ensures that ex ante incentives would still apply to capex that is not a driver of the overspend. We have included the following factors we will take into account in determining whether there has been a change in scope:

- a comparison of the projects undertaken against projects forecasted for the relevant regulatory determination
- our findings in the relevant ex post review period
- whether the TNSP has demonstrated it has reasonably managed and prioritised its capex
- the degree to which the overspend was due to factors beyond the TNSP's control
- other relevant factors.

We would only consider allowing ex post exclusions in limited circumstances and only make an ex post adjustment to the CESS after an ex post review.

5.4.3 CESS exclusions for TNSPs reviewable ISP project capex

TNSPs noted the size and greenfield nature of ISP projects creates forecasting uncertainties which may result in significant overspends, and that TNSPs cannot reprioritise activities to manage their total forecasts as ISP projects are single projects.[66]

In considering the stakeholder views, we acknowledge that for ISP projects there are elements of capex that may be harder to forecast than non-ISP capex. Given the size of large individual projects, there may be a limited ability for networks to reprioritise their capex.

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[65] This means, the ex post adjustments to the CESS will only be done after we have undertaken an ex post review. We note the difference time between the regulatory control period and ex post review period. The ex post review period is the first 3 years of the relevant regulatory control period and the last 2 years of the regulatory control period preceding that.

[66] APA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 4-5; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8.

Our existing Guidelines already takes into account forecasting uncertainties. The Guidelines provide us with flexibility to allow exclusions or prescribe any form of CESS on an ex ante basis. In addition, we may include a project risk allowance in an ISP project's contingent project determination. Our guidance note on the regulation of actionable ISP projects sets out our assessment approach and expectations on the supporting information accompanying a contingent project application.[67]

Overall, we consider our existing ex ante exclusion mechanism is fit for purpose. However, we recognise that it may be unreasonable to apply a CESS penalty where we have undertaken an extensive ex post review of an individual project and found that project to be efficient.

The current Guidelines do not include the ability to adjust the CESS payments on an ex post basis. We consider adding this flexibility will ensure that the CESS remains fit for purpose.[68] However, we consider that this ex post adjustment should be limited to where the overspend is genuinely beyond a network's control and based on unforeseeable factors. In making any adjustment, the AER would have regard to the following factors:

- the form of CESS in place for the relevant project
- our findings in the relevant ex post review period
- whether the TNSP has demonstrated it has reasonably managed and prioritised its total capex
- the degree to which the overspend was due to factors beyond the TNSP's control
- other relevant factors.

In assessing whether this adjustment should be discretionary, we consider that automatically removing the CESS penalty following an ex post review would not provide sufficient ex ante incentives for TNSPs to undertake efficient capex. As noted by JEC and CEFC, due to information asymmetry it is difficult for us to conclude with certainty the efficiency of all elements of capex overspends.[69] Rather, the ex post review identifies material inefficiencies.

We consider that this approach balances the need to have effective ex ante incentives for NSPs to pursue efficiencies and appropriately manage risk while recognising that there may be instances where it may be unreasonable or unfair to apply a CESS penalty for overspends.

5.5 Rebalancing the symmetry of the CESS

As noted in section 5.4, a key question before us now is whether the CESS framework penalises genuine losses in light of the increasing risk of forecasting uncertainties. In considering the stakeholder views, we have proposed to allow exclusions from the application of the CESS in limited circumstances, after an ex post review. We consider our

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67 AER, *Guidance note - Regulation of actionable ISP projects*, March 2021.

68 We would make any ex post adjustments to the CESS only after we have conducted an ex post review.

69 JEC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 20 March 2025, pp. 1-3 and CEFC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 26 March 2025, pp. 4-5.

proposed approach for allowing ex post exclusions would target the issue of under forecasting.

However, we acknowledge that non-network stakeholders have identified that ex post adjustments to the CESS may not be in the best interests of consumers.[70] We also note that some DNSPs consider that 'use-it' or 'lose-it' type arrangements would allow them to pass the benefits of an underspend (such as for innovation expenditure) to consumers.[71]

We recognise that there may be instances where the uncertainties in forecasting may benefit NSPs. If an NSP is rewarded because of forecasting error, this may lead to a windfall gain for the NSP, with no tangible benefits to consumers. In addition, the information asymmetry between the AER and NSPs will persist in the context of greater uncertainties in forecasting.

As part of the 2023 Guideline amendments, we introduced what we referred to as the Bright-Line Tiered Test. This applies:

- a 30 per cent sharing ratio for any underspend up to 10 per cent of the forecast capital expenditure allowance in the previous regulatory control period
- a 20 per cent sharing ratio for any underspend that exceeds 10 per cent of the forecast capital expenditure allowance in the previous regulatory control period
- a 30 per cent sharing ratio for any overspend of the forecast capital expenditure allowance in the previous regulatory control period.

The approach was designed to be asymmetric. We acknowledged that despite improvements in our assessment toolkit and stakeholder engagement, a level of information asymmetry between the AER, consumers and the NSPs remains. The changes to the CESS were supplemented by new transparency measures which required NSPs to better explain the reasons for variations between capex outcomes and forecasts. This would assist stakeholders to better understand the extent to which genuine efficiency gains have driven expenditure outcomes, and the value of incentive payments. These measures are in addition to the deferral mechanism which provides us with the ability to adjust the CESS rewards where there have been material deferrals between regulatory periods.

Despite these existing measures, we are keen to get further stakeholder views on whether any additional changes are required to balance the proposed changes in the draft Guideline that target overspends and related CESS penalties. For example, by introducing a means for the AER to adjust CESS rewards in certain circumstances i.e. where the rewards do not reflect efficiency gains and may not provide benefit to consumers.

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[70] Individual consumers, *Submission to AER Capital Expenditure Guideline Review 2025 – Consultation Paper* email received on 21 March 2025. JEC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 20 March 2025, pp. 1-3 and CEFC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 26 March 2025, pp. 4-5.

[71] CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 8.

6 Interaction with CESS and efficient abandonment

6.1 Issue

In its submission to the AEMC's bringing forward early works to improve transmission planning rule change (early works rule change),[72] the CEFC raised concerns about the risk of consumers bearing the cost of procuring early works assets where the project no longer needs them or is cancelled.

Currently, consumers bear the risk related to early works capex where projects are abandoned. Capex already incurred on early works cannot be recovered or removed from the RAB if the project is abandoned.

6.2 Proposed amendments

Our proposed amendment to our draft Guidelines gives the AER the flexibility to adjust the application of CESS for ISP projects that are abandoned. In practice, this is a CESS exclusion that would be applied after an ISP project is reported to be abandoned.

To allow us this flexibility, we propose to introduce a new sub-section for *CESS adjustments for ISP projects*. This sub-section gives the AER flexibility to adjust CESS rewards and penalties. We propose to explicitly state that we can remove any CESS rewards for an event where an ISP project is abandoned - please see section 2.8.3 of the draft Guidelines.

6.3 Submission summary

The majority of stakeholders agreed that TNSPs should not be eligible for CESS rewards for ISP projects that are efficiently abandoned.[73] For instance, TasNetworks submitted that *"receiving CESS rewards is inconsistent with the intent of the CESS insofar as the underspend is not a result of delivering the project more efficiently than forecast"*.[74]

6.4 Reasons for the proposed changes

Our proposed amendment to the Guidelines applies to all ISP projects that have been reported to be abandoned, at any stage of the project. Our proposed amendments give us the flexibility to adjust a TNSP's CESS for ISP projects in order to exclude allowable capex for abandoned ISP projects.

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72 AEMC, *National Electricity Amendment (Bringing early works forward to improve transmission planning) Rule 2024*, 5 September 2024.

73 CEFC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 26 March 2025, pp. 2, 6-8; Transgrid, CEFC, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 2 April 2025, p. 14, TasNetworks, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 3; AusNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 9; Marinus Link, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, p. 5; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 21 March 2025, pp. 2,8; Individual consumers, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, email received on 21 March 2025.

74 TasNetwork, *Submission to the AER's Capital Expenditure Incentive Guideline Review Consultation Paper*, 20 March 2025, p 8.

7 Other matters

7.1 Changes to accommodate the transitional provision

The AEMC rule change introduces a new transitional provision[75] which allows us to make a revenue adjustment to increase the maximum allowed revenue in the next period by an amount equivalent to (or less than) the penalties applied, or will be applied, under a CESS in relation to an ISP project already subject to a CESS. This includes Project Energy Connect (PEC), HumeLink and VNI-West.[76] Effectively, the transitional provision allows us to make future revenue adjustments to offset any CESS penalties following an ex post review for ISP projects.

For clarity, the new transitional clause set out in the NER is limited to ISP projects and does not extend to non-ISP projects.

In our draft Guidelines we propose to amend section 2.8 to allow flexibility for us to reduce CESS penalties following an ex post review for reviewable ISP projects that are already subject to a CESS at the time of release of version of our Guidelines. In deciding whether to exercise this flexibility, it will be determined on a case by case basis using the factors set out above for reviewable ISP projects.

Please see section 2.8.3 and 2.8.4 of the draft Guidelines.

7.2 CESS Exclusions for REZ and single asset RAB

As mentioned above, section 2.6 of the current Guidelines provides flexibility to allow exclusions or prescribe any form of CESS on an ex ante basis for large transmission projects.

We note that the CESS also has a role in NSW REZ non-contestable revenue determinations made under the *Electricity Infrastructure Investment Act 2020 (NSW)* (EII Act). We state in our *Transmission Efficiency Test and revenue determination guideline for NSW non-contestable network infrastructure projects* (non-contestable guideline) that when NER guidelines are updated, we will direct EII stakeholders to these consultation processes to avoid duplication of consultation processes under the NER and EII frameworks.[77]

While not raised during the consultation process, we consider that NSW REZ non-contestable projects may face forecasting risks as transmission contingent projects. Similarly, a business with a single asset in its RAB might also face similar forecasting risks and a limited ability to manage and reprioritise its total capex forecast.

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[75] AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination, 01 August 2024, p 20*; NER, clause 11.172.3.

[76] AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination, 01 August 2024, p 20*.

[77] AER, *TET & revenue determination guideline for non-contestable network infrastructure projects*, July 2024, p. 13.

Therefore, we have amended section 2.6 of the proposed Guidelines to clarify that the flexibility to modify the application of the CESS may be extended to NSW REZ non-contestable projects[78] or a business with a single asset in its RAB.

In our draft Guidelines we propose to amend section 2.8 to allow flexibility for us to reduce CESS penalties following an ex post review for NSW REZ and businesses with a single asset RAB. In deciding whether to exercise this flexibility, it will be determined on a case by case basis using the factors set out above for reviewable ISP projects.

Please see sections 2.6.2 and 2.8.3 of the draft Guidelines.

[78] We also consider there are differences between the NER and EII Act frameworks and that there may be additional factors to consider on a case-by-case basis for REZ projects. NSW REZ non-contestable projects may have additional considerations that are specific to the EII framework. For example, the EII framework includes several adjustment mechanisms that are not included in the NER which could help the business manage its cost variation risk.

Glossary

Term	Definition
AER	Australian Energy Regulator
AEMC	Australian Energy Market Commission
Augex	Augmentation expenditure
Capex	Capital expenditure
CEFC	Clean Energy Finance Corporation
CESS	Capital Expenditure Sharing Scheme
DNSP	Distribution network service provider
ENA	Energy Networks Australia
Guidelines	Capital Expenditure Incentive Guidelines
ICT	Information and Communications Technology
ISP	Integrated system plan
ISP review period	Has the meaning prescribed in S6A.2.2A(a1) of the National Electricity Rules.
JEC	Justice and Equity Centre
NER	The National Electricity Rules as defined in the National Electricity Law.
NSP	Network service provider
Opex	Operating Expenditure
PEC	Project EnergyConnect
RAB	Regulatory asset base
Reviewable ISP project	Has the meaning prescribed in S6A.2.2A(a1) of the National Electricity Rules
Reviewable ISP project stage	Reviewable ISP project stage includes any predefined stage of a reviewable ISP project other than early works stage.
REZ	Renewable energy zone
TNSP	Transmission network service provider

Appendix A – Stakeholder Summary

Topics	Comments
Separate targeted ex post review / Ex post review for ISP projects	Marinus Link, TasNetworks, ENA, Transgrid, and AusNet submit the minor amendments proposed in our consultation paper are sufficient to undertake separate targeted ex post reviews. ENA and Transgrid also submit that the AER should provide additional guidance that is specific to ISP projects on how the overspends would be judged. CEFC submitted that that the presence of an ex post review introduces uncertainty to an extent that likely acts as a deterrent to the development of critical ISP transmission infrastructure. There should be a greater weight placed on the ex ante incentives and the ex post review should only capture egregious investment decisions or behaviours by TNSPs. This mechanism would deliver an appropriate balance of risk by providing upfront certainty to TNSPs. Individual consumers, submit that a failure to properly scrutinise the ongoing costs of ISP projects disregards the consumers concerns. They submit that consumer interests are completely ignored and there is lack of genuine accountability for cost overruns, resulting in consumers bearing the cost via increased network charges. Energy Australia considers the current ex post mechanism to be a “fairly low hurdle in terms of justifying cost increase”. It also submitted that overspending on ISP projects may exceed the approved costs in the Regulatory Investment Test (RIT-T), thereby, diminishing the net benefits delivered to the consumers. For instance, Project EnergyConnect double its amount only 20 months prior to its completion which means this project no longer meets the net benefits to customers which were estimated to be only $201 million in the final (updated) RIT. Therefore, in conducting the ex post review Energy Australia recommend considering more specific factors.
Substantially complete	CEFC, ENA and Marinus Link generally supported the AER’s approach to provide principles in the Guidelines. ENA and Marinus Link suggested that factors proposed by the AER were too restrictive and suggested greater flexibility be allowed. For instance, Marinus Link proposed the AER may be able to conduct an ex post review if any remaining construction and commissioning costs are not material and/or can be forecast with a reasonably high degree of confidence. ENA also stated the AER could provide quantitative guidance as to the proportion of work that had already occurred provided it is not used as a hard threshold. ENA stated that while a TNSP may provide arguments why an ISP project should be considered substantially complete, they did not support TNSPs bearing a formal onus to do so. CEFC suggested TNSPs be required to prove when they consider projects that are nearing completion are not substantially complete and hence should not yet be subject to an ex post review. CEFC stated that the AER monitors and assesses when an actionable ISP project or stage of an actionable ISP project is substantially complete. CEFC suggested the AER define where a project is “complete” as it may aid determining when a project is substantially complete in relation to this.

Topics	Comments
Interaction of CESS across multiple regulatory periods	TasNetworks, AusNet, Ausgrid and ENA support the proposed minor amendments as per consultation paper. TasNetworks also stated that we should separate the application of the CESS for ISP and non-ISP project capex and could undertake an assessment of actual ISP project capex against allowance over multiple regulatory control periods for the purposes of the CESS.
General CESS Exclusions	**Reason for exclusion** All DNSPs and ENA submitted that the symmetry of the risk no longer holds and significant uncertainties in forecasting due to the energy transition. This leads to under forecasting or inefficient deferrals of projects. DNSPs submitted that that we should amend the Guidelines to allow distribution networks to propose the exclusion as this would provide an opportunity for the AER to assess whether or not excluding the expenditure category, would better align with the CESS principles and promote customers long term interests. Evoenergy and Ausgrid considered that for DNSPs there are some categories where standard CESS may not provide appropriate incentive or may create perverse outcomes. CPU, AusNet and SAPN suggested that the CESS exclusions should be nominated ex ante. ENA, CPU, AusNet, Ausgrid and Marinus Link considered that the AER should develop a set of specific principles that clearly set out the criteria for assessing an NSP's CESS exclusions. CPU considered that altering the CESS sharing ratio would likely add unnecessary complexity creating uncertainty and confusion to NSPs and consumers. CPU submitted that reopener and contingent projects and cost pass throughs can only be activated in specific circumstances and often have high thresholds. ElectraNet submitted that for TNSPs, category specific exclusions will not address the problem. This is because, forecasting uncertainty and overspend occurs where changes to the appropriate capex allowance happen unforeseeably and potentially across all categories of capex, for example due to an economic shock affecting the cost of capex projects. Individual consumers consider that any attempt to exclude certain categories of capex from the CESS framework must be rejected outright. The exclusions from the CESS will not sufficiently deter NSPs from poor decision-making and may result in inefficient costs being added to the RAB. **Exclusion for connections expenditure** Most DNSPs have stated that lack of discretion over these capex programs means the CESS is not operating to provide efficiency gains. Therefore, they considered that it would be more appropriate to exclude such expenditure from the CESS. Ausgrid, AusNet, CPU, ENA, Jemena and Evo Energy have emphasised the non-discretionary and uncertain nature of connections capex. They submitted that, with the emergence of large, new connection types such as data centres, it is difficult to forecast capex and customer contribution, hence this has made the CESS apply unfair penalties for expenditure outside of an NSP's control. Ausgrid stated that in the case of data centres, the exclusion of such projects from the CESS would reduce the risk of any benefits (or penalties) being passed on to parties other than those requesting the service.

Topics	Comments
	Other capex CESS exclusion SAPN, ENA and AusNet also proposed exclusions for reliability capex such as network resilience. ENA, CPU, SAPN, AusNet, and Ausgrid suggested that innovation expenditure can be uncertain and that if all of the allowance was not spent, it should not be counted as an "efficiency" for which customers should pay 30% reward. AusNet and CPU also stated that innovation expenditure should be able to be proposed on a "use it or lose it basis". SAPN submitted that CESS exclusions should also be considered for exclusions for Information Communications Technology (ICT) due to increasing cyber security threats and continual changes in compliance objectives.
Ex post adjustment to CESS penalties	**Reason for adjustment** All TNSP submissions submitted that CESS penalties imposed are not due to inefficiency but outside of TNSP's control discouraging innovative solutions for customers' long-term interests. Applying CESS penalty on an efficient overspend can lead to deferrals of efficient investments to a later regulatory period. The adjustments to the CESS penalties will provide additional flexibility to TNSPs. Thus, the AER should amend the Guidelines to have the flexibility to reduce CESS penalties for efficient overspend. Majority of NSPs and ENA considered that any efficient overspend should not be penalised under the CESS for ISP projects and should extend to non-ISP capex. AusNet and Ausgrid submitted that the CESS and ex post review does not adequately account for the unique characteristics of large, complex projects with higher inherent uncertainty. For larger projects, a 30% penalty on efficient overspends is not sustainable and may prevent critical projects from proceeding. CPU note that current guidelines reduce the "reward' from deferrals. However, no mechanism reduces the penalties where additional capex is efficient and required. Most TNSPs submitted that the size and greenfield nature of ISP project creates forecasting uncertainties which may result in significant overspend. And being a single project, TNSPs cannot reprioritise activities to manage its total forecast. In such, TNSPs incur CESS penalties, even if they find the overspend to be efficient in our ex post review. JEC, CEFC, and consumers do not support the reduction of CESS penalties following an ex post review. The general sentiment from these stakeholders is that by reducing CESS penalties on an ex post basis it may undermine the design of the scheme. Consumers pay 100% of these cost overruns in the scenario where efficient overspends are not penalised under the CESS. Therefore, they submitted that by allowing ex post exclusions, the CESS may become a reward only scheme. JEC and CEFC submitted that the information asymmetry between the NSP and the AER and for this reason submit that we can't practically assess each element of overspending on a spectrum of efficiency. JEC considered that networks can stage spending on discrete categories, and the AER could conduct limited an ex post reviews, assessing the efficiency and prudency of the capex on these items in isolation. This would have the effect of increasing certainty for NSPs by reducing the materiality of risk associated with each ex post regulatory decision. **Mechanism for ex post CESS adjustment** APA group stated that to provide certainty for both NSPs and customers, the Guideline could include a set of principles where we allow a particular capex overspend to be

Topics	Comments
	removed from the application of the CESS. The principle could include the capex project must be material (5% of maximum allowed revenue, consistent with the threshold for contingent project applications), and the overspend is demonstrably outside the NSP's control. ElectraNet submitted that that while there are reopener clauses, by reducing CESS penalties on ex post basis it would be a less administrative burdensome solution. To do this, the capex allowance could be varied within a regulatory period for the purposes of the CESS, where a TNSP can reasonably satisfy the AER that the ex ante allowance is no longer appropriate for the regulatory period in question. ElectraNet also stated that this option would retain the integrity of the CESS within a regulatory period. AusNet considers that there should be flexibility to not apply a CESS penalty on a case-by-case basis and that the AER should develop a set of principles to address this. This can be applied instead of a cost pass through application. Ausgrid and the CEFC support the view that lowering the sharing ratio for efficient overspends is a viable solution. Evoenergy submitted that we should ensure that any changes to the penalty rate applying to overspends are transparent, predictable, set on an ex ante basis, preserve the incentive-based intent of the scheme, and keep administrative costs low. ENA submitted that further clarification is required in the Guideline, specifically including a process under which TNSPs can propose a modified CESS, examples of variations of CESS we can apply, and criteria to guide assessment. ENA stated that TNSPs should have an alternative measure to manage uncertainties, other than modifying CESS for ISP projects. Some of the alternative measures should be included in the Guidelines. Transgrid suggested that the AER should remove the application of CESS penalties from actionable ISP projects. Transgrid also proposed 3 alternate options to resolve the CESS treatment of efficient overspends. This is via a capped CESS combined with an ex post review, targeted CESS combined with the ex post review or a modified CESS with no ex post review. SAPN stated that there is a preference towards ex ante incentives as ex post options for CESS exclusions "will more likely drive uncertainty, high administrative burden on the AER and networks, and present challenges given the timing issues involved in the current capex ex post review mechanism".
Efficient Abandonment	CEFC, AusNet, Ausgrid, ENA, Marinus Link and TasNetworks support the view that a TNSP should not receive any CESS reward for an efficiently abandoned project. Transgrid, and ENA notes that for projects efficiently abandoned TNSPs should recover the incurred costs. CEFC submitted that that for non-ISP projects that are abandoned the CESS should apply, as NSPs need the flexibility to reprioritise projects. Energy Australia stated that the designation of projects as "Actionable" should not mean they be executed at any cost and as fast as possible.
REZ	Ausgrid submitted that that we should consider updating ex post review to individual DNSP-led large-scale capital investments like REZs.

Topics	Comments
	Ausgrid also stated that for REZ projects we should considering lowering the sharing ratio or excluding the overspend from CESS where appropriate.
Other	SAPN sought for a greater flexibility of the pass through and reopener clauses in light of new sources of forecasting uncertainty. SAPN also stated that there can be many large unanticipated costs that are material in aggregate (even if it is not individually material). Evoenergy submitted that we should consider applying any modified CESS to regulatory determinations currently underway, on a retrospective basis. Individual consumers considered that the cost assumptions for major transmission and generation projects have been consistently underestimated. There is a general lack of transparency and accountability of costing ISP projects. Individual consumers stated that there is lack of consultation for ISP projects in rural and regional communities. Transgrid submitted that either the rate of return should be increased to reflect those obtained by greenfield infrastructure projects in the competitive sector, or the risk exposure should be reduced from current levels.

Appendix B – Illustrative example

This section sets out an illustrate example how we will consider the CESS exclusions.

Volumetric adjustment to the CESS takes into account the change in volumes of connections, so that a DNSP is not rewarded or penalised for changes in the volume of work it needs to undertake.

Assume that an NSP's forecast volumes and unit rates and its actual volumes for its residential connections capex are as shown in Table 3 below. The table also shows the change in volume and the resulting volume adjustment under two different scenarios.

First, we compare a change in volume by subtracting the actual volume from the forecast volume. Then, we calculate the volumetric adjustment by multiplying the change in volume by the forecast unit rate that was deemed to be efficient in the relevant regulatory period.

Table 3: Volumetric adjustment scenarios

Description	Scenario 1	Scenario 2
Forecast volume	400	500
Forecast unit rate ($ million per connection)[79]	0.25	0.25
Actual volume	600	200
Change in volume	200	-300
Volumetric adjustment formula	= (200*0.25)	= (-300*0.25)
Volumetric adjustment ($ million)	50	-75

In scenario 1, the calculated volumetric adjustment is positive $50 million. This is the amount that will be excluded from the actual capex when calculating the CESS payments.

In scenario 2, the calculated volumetric adjustment is negative $75 million. This amount will be included in the actual capex, to correct for the reduced volumes delivered.

[79] For simplicity, please assume the forecast unit rates are presented in $ real dollars for the relevant regulatory control period. In practice, we will need to adjust the unit rates to correct $ real terms.