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Dear Arek

Ausgrid welcomes the opportunity to provide this submission to the Australian Energy Regulator (**AER**) on the Draft Capital Expenditure Incentive Guidelines (**the Guidelines**) published in May 2025.

We generally support the AER's objective to review and update the Guidelines to ensure Network Service Providers (NSPs) remain incentivised to undertake efficient investments in the context of unprecedented challenges resulting from the energy transition. However, Ausgrid considers that the current draft proposal, while a positive step, requires a number of refinements to develop a more effective framework. Our submission offers the following key recommendations:

- **Establishing a symmetric and predictable CESS:** The draft Guidelines seeks to implement an imbalance in the CESS where the AER may ease penalties but will not recognise foregone rewards, and in some situations may even claw rewards back. A fair, symmetric framework gives networks the confidence to pursue efficiencies that ultimately benefit consumers.
- **Exclude large connection projects from CESS:** We strongly recommend that large, bespoke connection projects be entirely excluded from CESS calculations to uphold the 'beneficiary pays' principle and maintain the integrity of the incentive scheme.
- **Aligning the Regulatory Treatment of Major DNSP and TNSP Projects:** The Guidelines must extend the same regulatory flexibility and risk management tools proposed for TNSP ISP projects to DNSP-led projects of comparable scale, risk, and uncertainty.
- **Ex ante volumetric adjustments to a DNSP's standard connection capex:** the proposal is insufficiently defined about how it would treat the variety of connection circumstances and subsequent volumes and unit rates, creating ambiguity that will lead to adverse or suboptimal customer outcomes for new or upgrading connections. To address this, Ausgrid recommends the final Guidelines provide clear definitions and methodologies for volumetric adjustments and allow for a range of connection unit costs being used.

Further details are provided in our submission below. If you have any questions, please contact Philippe Laspeyres, Regulatory Modelling Manager, at [redacted].

Regards,

[redacted]

Timothy Jarratt
Group Executive, Market Development and Strategy

Submission

Ausgrid supports the principle objective of the CESS to provide Network Service Providers (**NSPs**) with a continuous incentive to pursue prudent and efficient investments in their networks. In a period of unprecedented transformation – characterised by the rapid electrification of the economy, the need to augment the network to support renewable energy generation, and the impact of large-scale connections such as data centres – a more sophisticated and flexible incentive framework is needed. While the AER's proposed amendments to the Guidelines are a welcome acknowledgement of these challenges, we believe they reduce the level of certainty required to facilitate efficient investments. This submission is structured in three parts to provide feedback on the key areas of the draft Guidelines that need further consideration:

- Part A focuses on the proposed ex post CESS exclusions.
- Part B addresses the need to align the Guidelines with the evolving role of DNSPs, in particular:
    - the treatment of ex ante CESS exclusions;
    - the interaction between a separate targeted ex post review and the CESS;
    - the treatment of project abandonment; and
    - incentive implications for substantially completed ISP projects.
- Part C addresses the AER's proposal regarding ex ante volumetric adjustments to a DNSP's standard connection capex.

Part A: Ex post CESS exclusions

This part of the submission focuses on the AER's proposed ex post CESS mechanism and its implications for managing data centre-driven investments. Data centres are a major bespoke connection that presents significant challenges for developing accurate ex ante forecasting and fair performance under the CESS. We have three key concerns with the AER's draft Guidelines, outlined below.

1. Asymmetric treatment of penalties and rewards

A foundational principle of effective incentive regulation is for the framework to be balanced and symmetrical, providing a clear and predictable link between a network's performance and the resulting reward or penalty. Ausgrid is concerned that the AER's proposed approach to ex post CESS adjustments, as articulated in the Explanatory Statement, introduces an asymmetry that risks creating a structurally imbalanced incentive scheme, to the detriment of networks. This asymmetry exacerbates existing imbalances in the CESS that provide for a lower sharing factor of 20% for underspends that exceed 10% of an ex ante capex allowance.

In the Explanatory Statement, the AER explicitly frames the proposed ex post adjustment mechanism as a tool for penalty relief:[1]

> "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 such a penalty on the relevant overspend (emphasis added)".

The words "reduce an NSP's CESS penalties" suggest the AER's one-way discretion is focused on mitigating penalty risk for NSPs in cases of efficient but unexpected capex. However, later on in the document the AER signals it is also contemplating intervention on rewards, stating:[2]

[1] AER, Capital Expenditure Incentive Guidelines Review 2025 – Explanatory Statement, 17 June 2025, p. 14
[2] AER, Capital Expenditure Incentive Guidelines Review 2025 – Explanatory Statement, 17 June 2025, p. 24

> "We are keen to get further stakeholder views… 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**…"

Taken together, this suggests the AER is considering a framework with three new elements:

- **Discretionary penalty relief:** The AER may exclude penalties, but only at its discretion.
- **Exclusion of foregone rewards:** The AER will ignore foregone rewards because its ex post review is only triggered when a CESS penalty arises, meaning genuine efficiencies may go unrewarded.
- **Discretion to claw back rewards:** The AER may claw back rewards it considers do not reflect genuine efficiency gains.

This structure appears to offer networks a single discretionary adjustment on the penalty side but two separate avenues to remove or reduce rewards. In our view, this is an unbalanced approach. The AER's draft guideline acknowledges the difficulty in forecasting large, bespoke connections by proposing the potential exclusion of penalties, but it does not apply the same logic to foregone rewards. Instead, it proposes to ignore forgone rewards and, in addition, retain the ability to claw back other rewards where it considers efficiency has not been genuinely demonstrated.

This imbalance is exacerbated by the AER's focus on aggregate capital expenditure rather than isolating material changes driven by large, bespoke connection projects. These types of projects, particularly mid-period data centre connections, can significantly distort aggregate expenditure outcomes. For example, a DNSP may deliver strong efficiency improvements in its core operations but still face an overall penalty because a single large connection project dominates the expenditure profile. The current ex post review trigger, which relies on aggregate spend, is not well-suited to capture these situations.

Furthermore, we are concerned about the AER's lack of a clear approach with its proposal to "adjust CESS rewards in certain circumstances i.e. where the rewards do not reflect efficiency gains…". This could imply a level of forensic scrutiny into a DNSP's investment decision-making process that has not previously been undertaken as part of AER decision making. Clearer guidance is needed to ensure the CESS is applied in a fair and predictable way.

2. Over-reliance on discretion and lack of ex ante guidance

The AER's draft Guidelines states:[3]

> "We **may** reduce the CESS penalty arising from **large bespoke** connections that have not been included in forecast capex".

While the inclusion of such a provision is welcome, its discretionary nature offers no assurance. The key concerns in this context are:

- The language is highly discretionary ('may').
- There are no clear ex ante criteria or decision-making principles to guide how the AER will exercise this discretion.
- There is no definition of 'large' or 'bespoke' nor any quantitative threshold to inform businesses whether their investment might qualify.

[3] AER, Capital Expenditure Incentive Guidelines for Electricity Network Providers – Draft Guidelines for Consultation, 17 June 2025,, p. 12

Without thresholds or objective tests, this mechanism cannot serve its purpose as a risk management tool. In practice, DNSPs would be left investing in the dark, without knowing how efficient in-period investment will be treated at the end of the period.

3. Large bespoke investments that are funded through the RAB but paid for through ICTs

We support the principle that the CESS should provide balanced incentives. However, recent demand-side trends, for example data centres, are placing structural pressure on the CESS framework and challenging its neutrality as a starting point for determining rewards and penalties.

These step-change investments often arise mid-period and fall outside forecast allowances, placing networks in the difficult position of needing to invest efficiently without certainty about how those investments will be treated under the incentive framework.

Under the current CESS framework, this can trigger a penalty — even when the investment is efficient, customer-funded, and aligned with long-term consumer benefit. Further, these investments also deliver broader system benefits, including higher utilisation of existing infrastructure and downward pressure on average network costs. The regulatory framework should facilitate, not discourage, investment that enhances system efficiency and supports emerging digital industries.

Another aspect is that the CESS is designed to encourage efficient capital delivery by sharing the benefits of underspends between networks and customers. However, when applied to large customer funded connections delivered through ICTs, it can produce misaligned outcomes that run counter to core objectives of the scheme. The CESS is designed to share the benefits of efficiency gains (underspends) and the costs of losses (overspends) between the network business and the general body of customers who collectively fund the capex allowance. This linkage is broken when a project is funded entirely connecting customers through an ICT.

To illustrate this misalignment, consider the hypothetical scenario where a $50 million zone substation is required to connect a cluster of data centres. Under Ausgrid's approved Connection Policy and approved Tariff Structure Statement, a portion of the project would be RAB funded but fully paid for by the connecting customers via bespoke ICTs. The result is that the general customer base would pay nothing towards the cost of the new asset.

If the network in this hypothetical scenario delivers the zone substation efficiently for $47m, that is an underspend of $3m, the CESS would provide the DNSP a reward of 30%, or $0.9m that is funded by the general customer base. This outcome is not optimal given:

- The primary beneficiaries of the project (data centre customers) already fully fund the investment; and
- The general customer base receives only indirect benefits (e.g. improved network utilisation) but is required to fund the $0.9m reward.

Essentially, there is a misalignment between who funds the investment and who pays the CESS incentive or penalty. To preserve the principle of beneficiary pays and avoid distorting incentives, the AER should exclude large ICT funded projects from the CESS, with certainty and not at the AER's discretion. This means any underspend or overspend on such projects would not generate a CESS reward or penalty. This is a simple, targeted solution that corrects a flaw in the current framework and ensures that incentives remain aligned with the customers who ultimately bear the costs.

Summary of Recommendations:

We make the following recommendations to the AER:

1. **Extend CESS exclusions to cover foregone rewards, not just penalties**

   Current language in the draft Guidelines allows the AER to exclude penalties but not address cases where an efficient, material investment is delivered under forecast capex without reward. The CESS should apply symmetrically to preserve balanced incentives.

2. **Make the exclusion for large bespoke connections a mandatory mechanism (subject to defined criteria)**

   Discretionary relief provides insufficient certainty for networks in making investment decisions. A mandatory exclusion framework — where defined criteria are met — would support efficient, customer-driven investment and reduce the risk of unintended penalties.

3. **Introduce clear ex ante criteria and definitions for when an exclusion applies**

   The AER should define what qualifies as a 'large bespoke connection', potentially through thresholds based on:

   - project value
   - customer contribution (e.g. ICTs)
   - connected load.

   These criteria should be consulted on before the final Guidelines are issued.

4. **Exclude large customer-funded projects under ICTs from the CESS**

   ICTs allocate cost to the customers who trigger and benefit from a project. If a project is delivered efficiently and customer-funded, any reward or penalty should not be borne by the general customer base. The CESS framework should recognise this and provide an exemption to avoid misalignments between who funds the investment and who bears the consequences.

Part B: Aligning the Guidelines with the Evolving Role of NSPs

While the AER's consultation paper primarily addresses transmission network issues regarding ISP projects, many of the same principles apply to DNSPs as they increasingly play a role in supporting REZ developments under regimes such as the NSW EII Act. The scale and complexity of these investments present similar challenges to those faced by TNSPs with ISP projects.

5. Ex post adjustments to the CESS for projects undertaken under the NSW EII Act

As noted previously, the energy transition is fundamentally reshaping the roles and responsibilities of network businesses. DNSPs are becoming active facilitators of a decentralised energy system, tasked with delivering large and complex projects. This is particularly true in NSW, where DNSPs like Ausgrid play a crucial role in delivering network infrastructure to support REZs under the NSW EII Act. As the distinction between the scale and complexity of major projects undertaken by TNSPs and DNSPs blurs, the regulatory framework should evolve in alignment to ensure consistent and efficient treatment.

It is therefore expected that DNSPs will eventually undertake works in the future which are of a similar nature to TNSP-led projects as outlined in Section 2.8.1 of the draft Guidelines. Accordingly, we would suggest that the whole section relating to TNSPs' ex post adjustments to the CESS be expanded so that it covers DNSP-led EII Act projects.

In addition, we also suggest that it remains a discretionary mechanism, but with clear ex ante criteria as to when it will apply.

6. Establishing Clear Principles for Efficient Project Abandonment

Ausgrid supports the AER's proposal to adjust the CESS calculation to remove any CESS rewards that a TNSP or DNSP might receive as a result of abandoning an ISP or EII Act project. It is consistent with the principles of the scheme that a reward should not be paid where an underspend is the result of a project not proceeding, rather than an efficiency in its delivery. We note that the majority of stakeholders' submissions agree with this position. However, this change must be balanced with the development of a clear framework that defines and protects "efficient" project abandonment. Any modification to the CESS to manage project abandonment may require the development of clear criteria that would define the triggers resulting in unviable projects to be excluded from the CESS. This will provide NSPs with the regulatory certainty needed to make difficult but correct decisions to abandon projects that are no longer viable.

Further, we reiterate the need for Section 2.8.3 to be expanded to include DNSP-led EII Act projects and not solely focusing on TNSP-led ISP projects.

7. Ensuring a Flexible Approach to 'Substantially Complete' Projects

Ausgrid supports the AEMC's policy intent to allow an ex post review to commence once a project is "substantially complete" rather than waiting for full completion and commissioning. This allows for earlier regulatory certainty for NSPs. Again, this should apply not only to TNSP ISP projects but also DNSP-led EII Act projects.

In giving effect to this, the AER has proposed four factors it will take into account to determine if a project is substantially complete, and has placed the onus on the NSP to make this case. While we accept the principle of the NSP putting forward the case, we share the concerns raised by Energy Networks Australia (**ENA**) that the proposed factors, if applied as a rigid and mandatory checklist, are too restrictive and could defeat the purpose of the rule change by unduly delaying the ex post review.[4] For example, the requirement that a NSP "does not expect to incur additional construction costs" and that remaining works are limited to "commissioning and energising" may be too restrictive. In large, complex projects, minor construction or rectification works can often continue in parallel with commissioning activities.

Ausgrid advocates for a more flexible application of these factors. The key consideration should be whether the project has passed all major risk milestones and that the remaining costs and works are reasonably certain and immaterial relative to the total project cost. This approach, which focuses on the substantive completion and de-risking of the project, would better achieve the AEMC's objective of providing timely regulatory assessment, rather than a rigid, checklist-based approach that could be held up by minor, non-material outstanding works.

Summary of Recommendations:

We make the following recommendations to the AER:

5. Ex post adjustments to the CESS for projects undertaken under the EII Act

The AER should make it explicit which parts of the Guidelines apply to DNSP-led projects conducted under the NSW EII Act. In their current form, the draft Guidelines are unclear and create uncertainty.

[4] Energy Networks Australia, Submission to the AER's Capital Expenditure Incentive Guideline Review – Consultation Paper, 21 March 2025, p. 4.

6. **Establishing Clear Principles for Efficient Project Abandonment**

   The AER should develop clear criteria for when a decision to abandon a project is deemed efficient. This will provide NSPs with the regulatory certainty.

7. **Ensuring a Flexible Approach to 'Substantially Complete' Projects**

   We recommend that the AER adopt a more flexible approach than apply a rigid, restrictive and mandatory checklist.

Part C: Ex Ante CESS adjustments for DNSPs

The draft Guidelines propose an ex ante volumetric adjustment to a DNSP's standard connection capex (excluding bespoke/emerging connection types). Ausgrid is generally supportive of this principle. This mechanism correctly identifies that connection volumes are a significant source of forecasting uncertainty for DNSPs, largely driven by external economic factors rather than network management efficiency. However, for this mechanism to be effective, equitable, and administratively workable, the draft Guideline requires significant clarification and detail.

As currently drafted, the proposal is insufficiently defined, creating ambiguity that will lead to uncertainty during regulatory proposal processes. To address this, Ausgrid recommends the final Guidelines provide clear definitions and methodologies for the following elements:

- **Scope of "Standard Connections Capex":** The Guidelines should clarify what is included in this category. We propose that it should encompass not only 'standard connections' as defined in RIN reporting but also 'basic connections' that involve shared network augmentation and smaller 'negotiated connections'. DNSPs have limited or no control over the volume and location of these connections.
- **Calculation of Forecast Volumes:** While the Guidelines do not provide any guidance on the forecast volumes or level of stratification, to ensure simplicity and ease of administration, we recommend that the forecast volumes used for the basis of the adjustment be those submitted and approved as part of the DNSP's regulatory proposal. This will avoid introducing a separate, potentially contentious, forecasting process.
- **Criteria for Application:** The Guidelines should specify the criteria the AER will use when exercising its discretion to apply the volumetric adjustment. The default position should be to apply the adjustment, with clear and transparent reasons required for any deviation, ensuring the mechanism is applied fairly and consistently across all DNSPs.

With regards to deriving unit rates, the concept of a "standardised unit rate" is complex, as costs vary significantly depending on connection type, existing available capacity, network topology and location (e.g., heavily loaded urban underground network vs. Lightly loaded, high CER rural overhead network). Ausgrid strongly cautions against standardising unit rates, without stratification and across different network businesses, as connection costs are intrinsically linked to the specific characteristics of each network and connection policy. We propose that a materiality threshold be applied in conjunction with a series of standard unit rates for the volumetric adjustment be agreed as part of the regulatory reset using a DNSP's own connection costs for that particular circumstance to provide a transparent, consistent and network-specific basis for their calculation. Ultimately, the methodology to be adopted should be left to the DNSP to decide.

Summary of Recommendations:

We make the following recommendations to the AER:

8. Ex Ante CESS exclusions for DNSPs

We recommend the final Guideline provide clear definitions and methodologies for the calculation of the forecast volumes at each type of materially different unit costs and the criteria the AER intends to apply for ex ante volumetric exclusions.

With regards to the standardised unit rates, the AER should allow DNSPs to develop a set of their own specific unit rates that reflect the connection circumstances and the characteristics of their network and connection policy.