Energy Networks Australia

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Mr Arek Gulbenkoglu
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Australian Energy Regulator
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Melbourne, VIC, 3001

Email: AERenquiry@aer.gov.au

Dear Arek,

AER's Capital Expenditure Incentive Guideline Review – Draft Guideline

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

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

As explained in our earlier submission to the AER's consultation paper, we strongly support incentive based regulation as the best means of achieving outcomes that meet consumers' energy needs at the lowest total cost. A key aspect of incentive regulation is the establishment of incentive arrangements that are fit for purpose by ensuring that network service providers (NSPs) can respond to those incentives and reasonably expect to receive financial rewards for efficient performance and incur penalties if, and only if, expenditure is not prudent and efficient. This principle is reflected in the CESS design principles that are mandated in the National Electricity Rules (**the Rules**).[1] In this regard, we welcome the AER's recognition that:[2]

> *"…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."*

In particular, we strongly advocate that CESS penalties should not apply if capital expenditure is found to be prudent and efficient. The alternative outcome would reflect the outworkings of an incentive regime that is not fit for purpose, as efficient performance should not attract a financial penalty. While ENA welcomes the AER's commentary which acknowledges this issue, we are concerned that the draft CEIG does not commit the AER to remove CESS penalties in circumstances where the expenditure is found to be prudent and efficient.

In response to the draft Guideline, our focus remains on designing incentive arrangements that will promote the best outcome for consumers in accordance with the Rules requirements. With this consumer focus in mind, ENA's positions are as follows:

- The AER's discretion in its draft CEIG should be removed so that all stakeholders have clarity regarding the AER's approach to reducing CESS penalties following an ex post review. This observation applies to the proposed arrangements for TNSPs and DNSPs, and also for ISP and non-ISP expenditure.

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1 National Electricity Rules, Clause 6A.6.5A(c).

2 AER, Capital Expenditure Incentive Guidelines Review - Explanatory Statement, 16 May 2025, p.21.

- For reviewable ISP projects, the AER should only rely on the outcome of its ex post review to determine whether the CESS penalties should be reduced, and not the factors currently set out in the draft CEIG. Specifically, some of the factors and considerations in the draft CEIG, such as 'foreseeability', are not relevant to a TNSP's[3] efficiency performance which should be the sole focus of the AER's assessment approach.
- As a guiding principle, capital expenditure that is subject to an ex post review should not also be subject to CESS penalties. Applying this guiding principle, in relation to reviewable ISP projects, a TNSP should be able to propose arrangements for applying the CESS and ex post review so that each mechanism works together to complement each other. For example, the CESS could apply up to an overspend amount of 10% of the total project costs, with the ex post review only applying above that threshold. Under this approach each dollar of overspend is subject either to the CESS (up to 10%) or the ex post review (above 10%), but not both mechanisms. TNSPs should be able to propose how the CESS and ex post review should apply in combination for each ISP project, having regard to that project and feedback from consumers.
- In relation to CESS arrangements for DNSPs, the AER's proposed approach to adjusting the CESS payments for changes in connection volumes is too narrowly focused, as it does not account for capital contributions or the different types of connections (and associated costs), which include negotiated connection services that may vary significantly in size and cost. Given the likelihood that forecasting risk and economic conditions will vary significantly across DNSPs and regulatory periods, it is preferable for each DNSP to make its own proposal regarding the most appropriate ex ante adjustments and exclusions for the CESS (including in relation to connections), rather than the AER adopting its proposed default mechanism.
- In relation to ex post CESS exclusions for DNSPs, there needs to be a stronger commitment that the AER <u>will</u> (rather than <u>may</u>) make an adjustment to the CESS to account for large connections and other scope changes. ENA considers that incentive arrangements should be transparent, so that all stakeholders understand how bonuses and penalties will be calculated.
- We do not support adjustments to remove CESS bonuses that the AER considers were not achieved through management effort. Such an approach is likely to necessitate a forensic and bottom-up examination of the causes of those savings, which would be contrary to good regulatory practice and the effective and simple design of the CESS.

In addition to the above points, we note that the AER has proposed a number of other changes that improve the workability of the incentive arrangements including, for example, clarifying the definition of 'substantially completed' projects which will determine the timing of any ex post review. As explained in this attachment, in relation to these other matters we largely support the approach proposed by the AER in its draft CEIG. ENA also considers that the transitional arrangements should ensure that the new Guideline applies as soon as practicable to all TNSPs and DNSPs, so that the benefits of the improved approach are obtained by consumers without delay.

ENA looks forward to working with the AER as it finalises this important Guideline. In the meantime, if you would like to discuss this submission, please contact Verity Watson [redacted] in the first instance.

Yours sincerely,

[redacted]

Dominique van den Berg
Chief Executive

[3] ISP projects may also be undertaken by DNSPs and, therefore, the draft CEIG should be amended to refer to NSP, rather than TNSP. For the purpose of this submission, we have referred to TNSP to be consistent with the draft CEIG.

Attachment:

AER’s Capital Expenditure Incentive Guideline Review – Draft Guideline

1. Introduction

ENA welcomes the opportunity to respond to the AER’s draft Capital Expenditure Incentive Guideline (draft CEIG). ENA supports the application of financial incentives to drive efficiency improvements for the benefit of consumers. In responding to the draft CEIG, therefore, our focus is on how best to apply the incentive mechanisms to promote better outcomes for consumers.

The AER’s draft CEIG addresses several ‘housekeeping’ changes that are required to address the AEMC Rule change that introduced targeted ex post reviews for ISP projects.[4] For example, the AER provides guidance on the meaning of ‘substantially completed’ ISP projects, which will determine the timing of an ex post review if there is an overspend amount. ENA supports the AER’s approach to these housekeeping changes, subject to one clarification that we address later in this submission.

The draft CEIG also addresses the operation of the CESS and ex post review for TNSPs and DNSPs that raise issues regarding principles of good regulatory design. Specifically, a key issue raised by the AEMC is whether it is reasonable to apply a CESS penalty in relation to an overspend amount that is found to be prudent and efficient in an ex post review. As explained in this submission, our position is that it is not appropriate to apply financial penalties to efficient expenditure.

The remainder of this submission is structured as follows:

- Section 2 addresses exclusions from the CESS, including ex ante and ex post adjustments for TNSP and DNSPs; and
- Section 3 comments on the other issues raised in the draft CEIG.

For the avoidance of doubt, it should be noted that ISP projects may be undertaken by DNSPs, including in accordance with the NSW EII Act. This submission, therefore, also applies to those projects and the NSW framework, even if not explicitly stated in the discussion.

2. CESS exclusions

This section responds to the matters raised in section 5 of the AER’s draft explanatory statement. We first address the approach to CESS exclusions for TNSPs and then discuss the approach for DNSPs. ENA concurs with the AER’s view that the current arrangements for ex ante exclusions for TNSPs are ‘fit for purpose’, and therefore we focus on ex post exclusions for ISP[5] and non-ISP capital expenditure. For DNSPs, this submission also follows the AER’s explanatory statement by considering the arrangements for ex ante and ex post adjustments.

2.1. ISP projects

At present, CESS penalties would apply to an overspend amount for an ISP project even if the AER’s ex post review assesses that overspend amount as being prudent and efficient. The situation is contrary to good regulatory practice because it is not appropriate to apply financial penalties to efficient expenditure.

[4] AEMC, Final Determination - Managing ISP Project Uncertainty Through Targeted Ex Post Reviews, 1 August 2024, p.19.

[5] As already noted, ISP projects may be undertaken by DNSPs. For ease of exposition and avoid confusion, we refer to TNSP in this submission.

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Furthermore, such an outcome would be contrary to clause 6A.6.5A(c) of the National Electricity Rules (the Rules), which sets out the following design principles for the CESS:

> "In developing a *capital expenditure sharing scheme*, the *AER* must take into account the following principles (the *capital expenditure sharing scheme principles*):
>
> (1) *Transmission Network Service Providers* should be rewarded or penalised for improvements or declines in efficiency of capital expenditure; and
>
> (2) the rewards and penalties should be commensurate with the efficiencies or inefficiencies in capital expenditure, but a reward for efficient capital expenditure need not correspond in amount to a penalty for the same amount of inefficient capital expenditure."

ENA's position is that if the CESS results in financial penalties in relation to an efficient overspend, then the CESS fails to meet the design principles mandated by the Rules. Specifically, applying a financial penalty to efficient capital expenditure cannot be consistent with rewards and penalties being ***commensurate with the efficiencies or inefficiencies in capital expenditure***, as required by 6A.6.5A(c)(2). ENA also notes the following design requirements in clause 6A.6.5A(d)(1) of the Rules:

> "In developing a *capital expenditure sharing scheme*, the *AER* must also take into account:
>
> (1) the interaction of the scheme with other incentives that *Transmission Network Service Providers* may have in relation to undertaking efficient operating or capital expenditure"

The AEMC identified the ex post review as being the principal incentive mechanism that is relevant to the CESS design, as explained below:[6]

> "To ensure the CESS and the ex post review arrangements do not conflict with each other, it is important that the AER has the ability to adjust how the CESS is applied depending on the outcomes of the ex post review."

In other words, the AEMC is pointing to the need for change in order for the CESS to comply with the design principles specified in the Rules. In its draft CEIG, although the AER accepts that it may be unreasonable to apply CESS penalties to efficient capital expenditure[7], it does not accept that penalties should not apply, as explained below:[8]

> "…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

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6 AEMC, Final Determination - Managing ISP Project Uncertainty Through Targeted Ex Post Reviews, 1 August 2024, p.19.

7 AER, Capital Expenditure Incentive Guidelines Review - Explanatory Statement, 16 May 2025, p.23.

8 AER, Capital Expenditure Incentive Guidelines Review - Explanatory Statement, 16 May 2025, p.23.

asymmetry it is difficult for us to conclude with certainty the efficiency of all elements of capex overspends. Rather, the ex post review identifies material inefficiencies."

ENA does not support the extent of the discretion proposed by the AER in deciding whether to adjust CESS penalties following an ex post review. Instead, our strong preference is to develop a framework that provides transparency to all stakeholders regarding the circumstances in which CESS penalties will be reduced and by how much. At present, the draft CEIG does not provide sufficient transparency for stakeholders to understand how the AER's approach will be applied in practice, which creates significant uncertainty for TNSPs and consumers.

ENA also notes that some of the factors proposed by the AER in considering whether to reduce CESS penalties are not focused on efficiency considerations and, therefore, are also contrary to the CESS design principles specified in the Rules. In particular:

- The AER suggests that a CESS adjustment would only be made if the cost overrun were caused by "unforeseeable factors". ENA notes that expenditure overruns may be efficient even if the causes are foreseeable, such as delays in planning approvals or increases in materials costs. ENA does not consider it reasonable to continue to apply CESS penalties in circumstances where an overspend is efficient, but foreseeable.
- The AER proposes that a decision to reduce CESS penalties should have regard to whether the TNSP has reasonably managed and prioritised its total capital expenditure. This factor is contrary to the purpose of recent regulatory changes which have introduced the separate application of the CESS and ex post review to each ISP project. In this context, a factor that focuses on the TNSP's total capital expenditure appears at odds with those changes. In addition, this factor creates incentives that are contrary to the interests of consumers as it would encourage TNSPs to reduce non-ISP capital expenditure to compensate for cost overruns for ISP projects, even if those overruns are efficient. As a practical matter, this also ignores the size of ISP projects relative to ex ante capital programs.

In summary, while ENA welcomes the AER's acknowledgment that it may be unreasonable to apply CESS penalties to overspend amounts that are found to be prudent and efficient, the draft CEIG does not address this issue appropriately. ENA considers that consumers interests will be best served by either:

- Not applying CESS penalties to actionable ISP projects, and instead rely on the ex post review to ensure that expenditure is prudent and efficient; or
- Establish a clear demarcation between the CESS and ex post review so that expenditure is subject to one or other mechanism, but not both.

In relation to the first point, it is important to recognise that an ex post review provides a very powerful incentive to deliver projects efficiently. Specifically, the risk of losing 100% of any overspend amount can only be managed effectively by ensuring that the project is delivered efficiently. ENA therefore considers that the ex post review can be relied upon to provide strong incentives for ensuring that capital expenditure is efficient.

In relation to the second point, it would be reasonable for the CESS to apply to capital expenditure if the ex post review does not also apply to the same capital expenditure, and vice versa. For example, it would be reasonable to apply the CESS to, say, the first 10% of an overspend amount and then apply the ex post review to any additional overspend amount above that threshold. This approach would ensure that both mechanisms interact appropriately, in accordance with the Rules requirements, so that every dollar of overspend is subject <u>either</u> to the CESS <u>or</u> ex post review, not both mechanisms. As already explained, applying both mechanisms to the same expenditure means that CESS penalties may apply to expenditure that is found to be prudent and efficient through an ex post review.

ENA considers that there is value in allowing TNSPs to propose how the CESS and ex post reviews should apply in relation to each ISP project. Specifically, the incentive rate for the CESS and the threshold at which the application of the CESS ceases and the ex post review commences, are matters that should be proposed by the TNSP and determined by the AER as part of the revenue setting process. This approach provides the potential for innovation in how these mechanisms operate and would allow each TNSP to consult consumers in developing their proposals, having regard to the specific circumstances for each project.

2.2. Non-ISP projects

The draft CEIG proposes that adjustments to CESS penalties may be warranted where there is a change in the TNSP's scope of work. In determining whether to vary the application of CESS in response to a TNSP's proposal, the draft CEIG suggests that the following factors should be taken into account:

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

Similar to the comments made in relation to ISP projects, ENA is concerned that the AER proposes to retain a substantial degree of discretion in determining whether a CESS penalty should be reduced. In addition, the factors listed above are not necessarily relevant to whether the overspend amount is efficient, even though the CESS design principles mandated by the Rules require the rewards and penalties to be commensurate with efficiencies and inefficiencies, and nothing else.

ENA considers that the AER should commit to reduce the CESS penalty in relation to a non-ISP project where a TNSP is able to show that the overspend amount has been caused by a scope change. Furthermore, TNSPs may be exposed to substantial cost increases as a result of changed market conditions which are beyond the TNSPs control. ENA considers it important that TNSPs are not penalised for the increases that are beyond their control, whether the causes of that increase relate to scope changes, input costs or other factors.

2.3. Ex ante exclusions for DNSPs

The AER explains that the volume of connections is an area where forecasting error, rather than efficiency, is likely to drive differences in capital expenditure outcomes. This is because DNSPs must respond to connection requests and have little control over the volume of those requests. The AER therefore proposes a volumetric adjustment to the CESS, so that a DNSP is not rewarded or penalised for changes in the volume of work it is required to undertake for standard connections.

While ENA supports the principle that CESS adjustments should be made to account for changes in work volume, the AER's adjustment mechanism is overly narrow because:

- the proposed method does not account for variances in the size and cost of differing types of connections, including basic and standard connection services; and
- the adjustment does not account for the impact of capital contributions or differences in connection policies.

ENA notes that each DNSP may have different definitions of basic and standard connection services, and some connection categories may be subject to greater forecasting risk than others. Furthermore, forecasting risk may change over time, depending on market conditions and jurisdictional policy positions on matters such as solar subsidies and electric vehicle charging. As such, it is likely that the need for a volumetric adjustment will vary between DNSPs and over time. ENA therefore considers it appropriate for each DNSP to make their own proposals in relation to volumetric adjustments or other approaches to address forecasting risk, if any, as part of its regulatory proposal, rather than the AER mandating a volumetric adjustment in its Guideline.

In addition to DNSPs being able to propose bespoke volumetric adjustments for basic and standard connection services, the ENA considers that ex ante exclusions are likely to be warranted for some types of negotiated connection services that are difficult to forecast both in terms of volume and scope where technology, government policy and market conditions are highly uncertain, such as connections for data centres, community batteries and electric vehicle charging stations. It is preferable to address these exclusions on an ex ante basis, so that the CESS bonus or penalty payments are commensurate with efficiency performance rather than being affected by forecasting risk driven by market conditions that are beyond the DNSP's control.

By taking a more flexible approach to volumetric and risk adjustments for connections and ex ante exclusions, DNSPs will be able to tailor their proposals having regard to feedback from their consumers and prevailing uncertainties and forecasting risk that will change over time. ENA regards this approach as strongly preferable to the default adjustment mechanism proposed in the draft CEIG of only addressing large bespoke connections on an ex post basis, as a tailored, ex ante approach will likely achieve better outcomes for consumers.

2.4. Ex post exclusions for DNSPs

The draft CEIG proposes ex post adjustments to the CESS for large distribution connections only, following the conclusion of an ex post review. While ENA supports this proposal, it is appropriate to extend the approach to include:

- Adjustments for scope changes, in addition to large connections, that are beyond the DNSP's control. In seeking an ex post adjustment, the DNSP would be required to explain the reasons for the scope changes and the impact on its capital expenditure; and
- As noted in the previous section, some categories of negotiated connection services should be excluded from the CESS on an ex ante basis, rather than ex post. This approach will improve regulatory certainty and reduce the regulatory burden of examining a greater number of ex post exclusions. It would also provide a symmetrical approach of managing the uncertainty and forecasting risk associated with these connection types, which can lead to windfall gains and losses for both customers and networks, if not excluded from the CESS.

ENA notes that allowing ex post exclusions for scope changes and large connections will have the effect of allowing DNSPs to increase their capital expenditure programs where it is efficient to do so, without incurring higher CESS penalties or lower CESS bonuses. Consumers will benefit from these changes, which will sharpen the incentives provided by the CESS to achieve efficiency improvements.

ENA also notes that the ex post review should only apply to material overspends, where materiality could be informed by the DNSP's proposed application of the CESS. In particular, as materiality is likely to vary by project, ENA considers it appropriate for the DNSP to consider this issue in proposing how the CESS and ex post reviews should work together.

2.5. Rebalancing the symmetry of the CESS

The AER's explanatory statement seeks 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, the AER asks whether it should be able to adjust CESS rewards in certain circumstances i.e. where the rewards do not reflect efficiency gains and may not provide benefit to consumers.

ENA strongly opposes any CESS reductions that the AER considers, after the event, to be unrelated to efficiency gains. Such an approach will inevitably lead to a forensic examination of the reasons for cost savings, which will involve considerable effort and significantly undermine the incentives provided by the

CESS. As such, it would be contrary to the interest of consumers and the principles of incentive regulation to reduce bonuses after the event.

ENA also notes that there are already safeguards in place that address issues relating to information asymmetry and inefficient deferrals. For example, the revenue setting process involves a detailed examination of the NSP's expenditure forecasts and applies a Service Target Performance Incentive Scheme that results in penalties if service levels deteriorate. These aspects of the regulatory framework substantially reduce the scope for cost savings that are not attributable to management effort. In addition to these measures, the CESS provides for the removal of benefits arising from deferrals. These observations reinforce ENA's position that a forensic examination of the causes of cost savings is not warranted and contrary to good regulatory practice.

3. Other issues

The other 'housekeeping' issues that are addressed in the draft CEIG cover the following matters:

- Separate targeted ex post review for ISP projects and non-ISP projects;
- Factors for establishing that an ISP project is substantially complete;
- Modifications to the CESS to accommodate multi-period ISP projects;
- Incentivising efficient abandonment; and
- Transitional arrangements, including:
  - Applying the Guideline to reviewable ISP projects that are already subject to a CESS
  - CESS Exclusions for REZ and single asset RAB.

ENA supports the approach adopted in the draft CEIG in relation to each of these topics, subject to the following qualifications in relation to:

- The definition of 'substantially completed' ISP projects; and
- Ensuring that the transitional arrangements enable the changes to be introduced as soon as practicable for the benefit of consumers.

We address each of these points in turn.

3.1 Substantially completed ISP projects

ENA notes that the factors that will guide the assessment in the draft CEIG are unchanged from those presented in the consultation paper. As noted in our submission to the consultation paper, while we support the first of the AER's proposed factors (that "the completed works is a sufficient representation of the likely overall capex outcome"), the remaining three mandatory requirements the AER proposes ((i) no remaining construction costs, (ii) any remaining expenditure be immaterial, and (iii) all expenditure – including testing and commissioning – be complete by the final determination) would set too high a bar for an ISP project to be deemed to be substantially complete.

In the draft CEIG, it appears that the AER has introduced flexibility in how these factors are applied to determine whether a project is substantially complete, as noted in the AER's draft explanatory statement[9]:

> "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

[9] AER, Capital Expenditure Incentive Guidelines Review - Explanatory Statement, 16 May 2025, p.10.

as to whether we agree that an actionable ISP project, or a stage of an actionable ISP project, is substantially complete."

ENA supports this approach as it allows the TNSP to explain how the factors should be applied in relation to each specific ISP project. However, the draft CEIG does not include commentary that is aligned with the draft explanatory statement and instead focuses on the AER's assessment of the above factors. ENA would welcome amendments to the draft CEIG to better reflect the AER's position in the draft explanatory statement, which allows the relevant factors to be applied flexibly by the TNSP in its regulatory proposal.

3.2 Transitional arrangements

The AER has confirmed that the new Guideline will apply to actionable ISP projects that are already underway, as contemplated by the AEMC's Rule change. ENA supports that approach as it ensures that all actionable ISP projects will be treated consistently, whether or not works have already commenced.

ENA considers that the transitional arrangements should also ensure that the new Guideline applies as soon as practicable to all TNSPs and DNSPs, so that the benefits of the improved approach are obtained by consumers without delay. In particular, the transitional arrangements should provide for the Guidelines to apply to existing determinations, as far as practicable. In particular, ex post exclusions should apply to existing determinations, while transitional arrangements should be considered to allow ex ante exclusions to be introduced early in a DNSP's regulatory determination. This approach will ensure that the CESS operates as effectively as possible, without delaying the introduction of the new Guideline.