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Dear Arek

Feedback on the Draft Capital Expenditure Incentive Guidelines

Jemena welcomes the opportunity to provide feedback on the Australian Energy Regulator's (**AER**) Draft Capital Expenditure Incentive Guidelines Review (**Draft Guideline**). The key objective of the Draft Guideline is to accommodate the Australian Energy Market Commission's (**AEMC**) ex-post review rule change and address the issue of forecasting uncertainties by way of exclusions from the application of the Capital Expenditure Sharing Scheme (**CESS**). We provide our feedback on the matter of exclusions below.

Connection capex

The AER has considered our submission to its consultation paper where we proposed excluding connection capex from CESS. Excluding connection capex from CESS would ensure Distribution Network Service Providers (**DNSP**) are not unfairly penalised for their necessary and unforeseen[1] investments and uphold the intent of the Revenue and Pricing Principles in the National Electricity Law (**NEL**).[2] We appreciate that the AER has acknowledged the issue and proposed a mechanism to address the uncertainty of forecasting the connection of customers to the electricity system, particularly, large customers.

In its Draft Guideline, the AER noted:[3]

> *The elements of DNSP's connections capex are influenced by volumes that can be difficult to accurately forecast. For this reason, we may apply a volumetric adjustment for a DNSP's standard connections capex.[2] In making the volumetric adjustment, we will consider changes in connections volume so that a DNSP is not rewarded or penalised for changes in the volume of*

[1] Unforeseen at the time a Regulatory Proposal is proposed to the AER for a forthcoming regulatory control period, and/or not included by the AER in its assessments when making a Price Reset determination.

[2] NEL 7A – Revenue and pricing principles (2) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in— (a) providing direct control network services; and (b) complying with a regulatory obligation or requirement or making a regulatory payment.

[3] AER, Capital Expenditure Incentive Guidelines for Electricity Network Service Providers, Draft Guidelines for consultation

work it needs to undertake. In this scenario, we will exclude a portion of the connection capex related to the increases or decreases in volumes from our CESS calculations. This is a symmetrical mechanism which responds to uncertainties in forecasting volumes.

We will determine whether or not to apply the volumetric adjustment for standard connections capex in response to a DNSP's proposal. Our default position is to apply the volumetric adjustments to a DNSP's standard connection capex.

We support the AER's intent to improve CESS's accuracy and fairness by recognising that DNSPs do not have control over connection volumes and the efficiency focus should be on costs under normal market conditions. Currently CESS applicable to DNSPs does not recognise the uncertainty around connection volumes. However, the proposal to adjust for actual connection volumes for standard connections has some challenges in its application:

- The proposal assumes that any connections that are not 'bespoke' large connections can be classified as standard connection capex. The AER's reference to standard connections and bespoke connections in the Draft Guideline is currently inconsistent with the connection definitions in chapter 5A of the National Electricity Rules (**NER**) and our Framework and Approach paper (**F&A**).[4] The AER needs to apply consistent definition of connections.

- The AER does not explain how it will consider differences in volume mix of simple/complex connection, connection size (such as above or below 10 MVA), location of connection or LV/HV/subtransmission connections. These differences can result in large variation in costs and there may not be an easy way to determine simplified unit costs. The proposed approach is only focussed on outturn volumes without consideration of nature, location and type of connection, the volume mix or their associated complexities.

- While the DNSPs largely have control over their costs in normal market conditions, the actual costs during the regulatory period may be significantly different when market conditions are volatile. For example, international economic conditions may result in unforeseen increase in material costs. In these circumstances the proposed approach would unnecessarily penalise the DNSP for meeting its obligation.

- CESS operates on net capital expenditure which means the connection capex incurred by a DNSP is also influenced by the capital contributions received, and not just connection volumes. On the other hand, the unit rates underlying capital expenditure allowances are established at gross capex level. For CESS to operate as intended there needs to be alignment in the volume mix (that is, the variance in volumes across different classes of connecting customers) used as part of DNSP allowance and the actual outturn volume mix. It is extremely unlikely that this alignment will occur. In our opinion, evaluating adjustments required for capital contributions is inherently difficult due to the variability in customer types, connection type and size, nature of project (one-off or business as usual), etc.

The AER's proposed approach could potentially penalise DNSP for differences between the outturn connection volume mix and that underlying capex allowance, and also result in a higher regulatory burden, as it would require in-depth comparisons of how the allowance for different types of connections was set and how the actual capex was incurred.

A simpler approach would be to exclude the entire connection capex similar to the approach used by the AER when calculating CESS for gas distribution businesses. The AER already has access to ex-

[4] AER - Framework and Approach for AusNet Services, CitiPower, Jemena, Powercor and United Energy 2026-31, July 2024

post review, in the event there are inefficiencies in DNSPs' costs, which already provides a powerful incentive for DNSPs to manage their costs.

Bespoke connection projects

The AER considers that the volumetric adjustments to CESS do not address the issue of individual large bespoke connections as these are not developed in a price reset proposal using standardised unit rates. It has therefore proposed that it will only consider excluding these projects in circumstances where it undertakes an ex-post review, where the CESS outcome would be a penalty and the DNSP is able to demonstrate that the increase in large bespoke connections was not included in its capex allowance. Whilst a progressive step, this approach does not effectively manage the following situations:

- the CESS outcome is determined using the 5-year regulatory period capex while an ex-post review covers three years of capex of the regulatory period in consideration and two years of capex from the previous regulatory period. This 'phase offset' could result in situations where the ex-post review threshold has not been met by the capex overspend but DNSP incurs a CESS penalty
- there is an ex-post review but the CESS outcome is a small incentive payment and not a penalty
- there was a small allowance made for the bespoke project but change in scope resulted in higher costs.

These situations arise because, under the AER's proposal, it would only consider an ex-post exclusion of bespoke projects when it has undertaken an ex-post review. Additionally, ex-post reviews assess capex overspend at a gross capex level while the CESS operates at a net capex level. This means that if a DNSP is subject to an ex-post review but it has recovered just enough capital contributions to avoid a CESS penalty, it will still not receive any additional CESS benefit. We demonstrate the issues arising from AER's proposed approach in Table 1.

Table 1 – Illustration of impact of AER's proposed approach ($Million)

Description	DNSP A	DNSP B	DNSP C	Notes
Allowance				
Gross Capex	800	800	800	Total capex for five years
Net Capex	600	600	600	
Actual				
Gross Capex	1,000	1,000	800	Includes $200M bespoke project for each DNSP
Capital contributions	399	401	100	
Net Capex	601	599	700	
CESS incentive/penalty	**-0.3**	**0.3**	**-30**	Estimated as 30% of the difference between net capex allowance and actual
Ex-post review	Yes	Yes	No	Actual gross capex > Allowance gross capex
Change to CESS outcome	**60**	**0**	**0**	Estimated as bespoke project cost CESS impact if there is an ex-post review

Table 1 presents how AER's proposed approach may operate and result in unfair outcomes:

- Both DNSPs A and B overspent gross capex due to a large bespoke project, triggering an ex-post review. The only difference is DNSP B receives a slightly higher capital contributions which results in no CESS penalty but a small incentive payment. However, because DNSP B did not incur a CESS penalty the AER would not remove the bespoke project from CESS assessment. A $2M difference in capital contribution in this case results in a $60M difference in CESS outcome.

- In contrast, DNSP C managed the bespoke project within its capex allowance by deferring projects. However, it charges a lower contribution based on its connection policy which results in a CESS penalty of $30M. However, because DNSP C did not satisfy the ex-post review trigger it will need to incur the $30M CESS penalty as a result of the bespoke project. Comparing this to DNSP A which incurs $0.3M penalty but receives $60M uplift in the CESS outcome is an unfair outcome for DNSP C. The difference in outcome for DNSP A and C is $90M.

If CESS excluded all connection capex on ex-ante basis or if the ex-post trigger was not a relevant consideration, both DNSP 2 and DNSP 3 would have benefited similarly to DNSP 1 from exclusion of bespoke project capex exclusion and not be unfairly penalised. Applying ex-post adjustments only in circumstances where there is a penalty and where an ex-post review has been triggered will complicate CESS, as it fails to create a fair outcome by not accounting for connection policies of the DNSPs. In principle, CESS should apply universally to all DNSPs without creating unintended incentive to meet ex-post review requirement. A fairer, more equitable and low-cost approach would be allowing DNSPs to exclude all connection capex, including bespoke projects, on an ex-ante basis.

The AER has proposed significant discretion over whether or not to allow for ex-post adjustments which adds to regulatory uncertainty. We consider that an alternative approach would be to specify ex-ante principles or conditions, which when satisfied, allow automatic exclusion from CESS. For example, unforeseen negotiated connections above 10 MVA for which costs could materially vary from project to project are excluded from CESS.

If the bespoke projects were also excluded on an ex-ante basis, similar to standard connections, CESS would be simpler and these issues identified above would not arise. CESS will also be aligned to what already exists for gas network businesses. We do not support a separate treatment of standard and bespoke projects and propose that the AER include an ex-ante exclusion for all connection capex. This will help keep CESS simple, low cost and internally cohesive CESS.

Additional adjustments by the AER

The AER is seeking views on whether any additional changes are required to CESS to balance the proposed changes, to allow the AER to adjust CESS rewards in certain circumstances where the rewards do not reflect efficiency gains and may not provide a benefit to consumers. We strongly oppose any such amendments as CESS already adjusts for capex deferrals and asymmetrically lowers efficiency reward to 20% beyond 10% of underspend. Additionally, the STPIS ensures that the quality of supply is not deteriorated due to capex savings. Any adjustments by the AER would involve bottom-up examination of underlying capex savings, requiring significant effort, which would increase the regulatory burden on DNSPs and undermine the incentives provided by CESS.

Summary

We urge the AER to keep the CESS simple, cost-effective and easy to implement. Doing so would encourage investment in critical infrastructure and innovation, without penalising DNSPs for efficient spending that contributes to the long-term interests of consumers. We encourage the AER to refine its approach to ensure CESS delivers consistent, fair, and efficient outcomes. This can be achieved by removing all connection capex on an ex-ante basis from CESS to make it consistent with the AER's CESS for gas DNSPs.

Should the AER wish to discuss any part of this submission, please feel free to reach Jerrie Li on [redacted]

Yours sincerely

[redacted]

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