AER's Capital Expenditure Incentive Guideline Review

Consultation Paper

February 2025

AUSTRALIAN ENERGY REGULATOR

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Request for submissions

We are undertaking a consultative process for amending the Capital Expenditure Incentive Guideline (Guideline), to take into account the Australian Energy Market Commission’s (AEMC) final rule for *Managing ISP project uncertainty through targeted ex post reviews*.

We are consulting in accordance with the standard rules consultation procedures set out in clause 8.9.2 of the National Electricity Rules.

We invite interested parties to make written submissions to us on the matters discussed in this consultation paper by close of business **21 March 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 place 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 Guideline.

1 Introduction

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. Consumers are at the heart of our work, and we focus on ensuring a secure, reliable, and affordable energy future for Australia as it transitions to net zero emissions. Our purpose is underpinned by our strategic objective to deliver efficient regulation of monopoly electricity and gas infrastructure while incentivising networks to become a platform for energy services.

Incentive schemes form an important part of our approach to regulating monopoly electricity and gas networks in Australia. We seek to incentivise network service providers to run an efficient business so that customers pay no more than necessary for services that they value the most. The framework is designed to mimic the outcomes from effectively competitive markets.

The Capital Expenditure Incentive Guideline (Guideline) outlines ex ante and ex post measures to incentivise efficient capital expenditure (capex). Capex refers to the money required to build, maintain or improve the physical assets needed to provide services.[1] Generally, these assets have long lives, and a network service provider will recover capex from customers over several regulatory control periods.

The Capital Expenditure Sharing Scheme (CESS) provides ex ante incentives for NSPs to undertake efficient capex during a regulatory control period. This is complemented by our ex post review mechanism to ensure only efficient capex is rolled into the regulatory asset base (RAB).

This consultation paper initiates our review of the Guideline to accommodate the Australian Energy Market Commission’s (AEMC) amending rule on *managing ISP project uncertainty through targeted ex post reviews* published in August 2024 (targeted ex post reviews rule change).[2] Giving effect to this we must update our Guideline to enable us to carry out separate targeted ex post review for Integrated System Plan (ISP) projects and non-ISP projects.

The AEMC’s targeted ex post reviews rule change, except for the transitional provisions,[3] will commence on 4 September 2025. In preparation for this, we are required to amend our Guideline by 4 September 2025.

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1 The basic service for distribution networks are standard control services and prescribed transmission services for the transmission network.

2 Australian Energy Market Commission (AEMC), *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, 01 August 2024.

3 The transitional provisions at clause 11.172 of the NER commenced on 5 September 2024.

1.1 Scope of review

This review of the Guideline 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).[4]

We note that the 2023 Incentives Review addressed a range of issues across the CESS, Efficiency Benefit Sharing Scheme (EBSS) and Service Target Performance Incentive Scheme (STPIS). We do not consider there is a need to revisit the issues we have addressed in the 2023 Incentives Review as we consider the circumstances have not changed since that review, with the exception of the issues identified by the AEMC's targeted ex post reviews rule change.[5]

In addition to the statutory changes, we have identified some potential further amendments to the Guideline based on stakeholder feedback we have received since our 2023 Incentives Review. We consider this is an appropriate time to raise these issues as these were not the subject of the 2023 Incentives Review.

This consultation paper focusses on incremental issues rather than the whole capital expenditure incentive framework.

In summary, the amendments to the National Electricity Rules (NER), as per the AEMC's targeted ex post reviews rule change will require us to:

- separate our targeted ex post reviews for ISP project expenditure and non-ISP project expenditure[6]
- accommodate the introduction of the "ISP review period", allowing the ex post review of ISP project to occur across multiple regulatory control periods[7]
- determine the matters we will take into account in determining whether a project is substantially completed for the purposes of being a reviewable ISP project[8]
- consider whether we should adjust TNSPs' CESS penalties following an ex post review of ISP project where we find TNSPs' overspend to be efficient.[9]

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4 AER, *Review of incentive schemes for regulated networks: Final Decision*, 28 April 2023.

5 For instance, in our 2023 Incentives Review we made a limited number of amendments to the CESS by introducing a bright-line tiered test for underspends, additional transparency measures and the ability to apply a separate CESS for contingent projects. We do not consider there is a need to revisit these issues.

6 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.12-13; NER, clause S6A2.2A(f).

7 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.14-15; NER, clause S6A2.2A(a1).

8 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.16-18; NER, clause S6A.5A(b)(2a).

9 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.19-22; NER, clauses 11.172.3 and S6A.5A(b)(2b)

Additional discretionary amendments we intend to consider in this review include:

- whether we should broaden the scope of exclusions in the CESS in certain circumstances
- whether any adjustments to the CESS are needed to accommodate abandonment of large projects.

We discuss each of these areas in more detail in sections 3, 4 and 5 below.

1.2 Consultation process

The standard rules consultation procedures in the NER,[10] applicable for the purposes of this review,[11] set out a 3-stage process to amend the Guideline:

- Stage 1: Publish a consultation paper that:
  - explains particulars of the proposal, the issues involved and options to address them, if applicable
  - identifies the provision of the NER under which the consulting party is making the proposal; and
  - invites stakeholders to make written submissions, allowing no less than 20 business days.
- Stage 2: Publish draft decision or amended Guideline no later than 50 business days after the due date for submissions on the consultation paper, with an invitation for written submissions, allowing no less than 20 business days for stakeholder submissions.
- Stage 3: Publish final decision or amended Guideline no later than 50 business days after the due date for submissions on the draft decision.

All consultation procedures allow the AER, under specific circumstances, to extend the time on the final decision. Further details on these procedures are set out in the NER.[12]

1.3 Consultation timeline and next steps

This consultation paper is the first step of the 3-stage process stated above. The indicative timeline in Table 1 is designed to be in line with our statutory obligation to update and publish the Guideline by 4 September 2025 in accordance with clause 11.172.2(a) of the NER.

The indicative timeline also accommodates for the distribution and transmission consultation processes.[13] This enables us to propose the additional discretionary changes in this review.

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10 Standard rules consultation procedure is set out in NER, clause 8.9.2.

11 NER, clause 11.172.2(a).

12 NER, clause 8.9.2 for Rules Consultation Procedures; NER, Part H of Chapter 6A for Transmission consultation procedures and NER, Part G of Chapter 6 for distribution consultation procedures.

13 NER, clauses 6.16 and 6A.20.

Table 1: Indicative timeline for guideline review

Milestone	Indicative Date
AER consultation paper published	21 February 2025
Submissions close for our Consultation Paper	21 March 2025
Draft Decision	16 May 2025
Submissions close for our Draft Determination	27 June 2025
Final Decision	29 August 2025

While there are no public forums currently scheduled, we are open to further engagement to capture the full range of stakeholder views. Details and invitations of any such engagement will be published as a Communications Notice on our website.

2 Existing incentive framework for capital expenditure

The purpose of this section is to provide background context to the issues we are considering as part of this review.

2.1 Incentivising efficient capital expenditure

We use incentive-based regulation across all energy networks we regulate. Incentive-based regulation provides NSPs with financial incentives to improve their efficiency. This includes financial rewards where NSPs improve their efficiency and financial penalties where they become less efficient. Consumers benefit from improved efficiencies through lower regulated prices.

We apply incentive-based regulation through an approach known as the building block model. Under this approach, we forecast what revenue a NSP requires to cover its efficient and prudent costs over a regulatory control period. Regulated prices are based on the building blocks and the forecast demand for the regulated services during a regulatory control period.

Under the building block model we use to set regulated revenues, at the start of every regulatory control period we forecast the efficient and prudent capex that a NSP requires in that period. We add the forecast capex to the NSP's RAB. In each year of the regulatory control period, regulated network prices are set based on a return on the undepreciated value of the RAB (return on capital building block), and the depreciated value of the RAB (return of capital building block).

Prior to the start of the next regulatory control period, we then adjust the RAB to account for any difference between forecast and actual capex during the current regulatory control period and depreciation. This is known as rolling forward the RAB. The new rolled forward RAB is then used as the basis for setting the return on capital and depreciation building blocks in the next regulatory control period. This process is repeated in each regulatory control period.

Under this approach, if a NSP has underspent against the capex forecast during a regulatory control period, a NSP will retain benefits of financing the forecast capex during the regulatory control period. This is the NSP's reward for making efficiency improvements. Consumers will then benefit after the end of the period when the RAB is rolled forward to a lower amount than if the full amount of the capex forecast had been spent. This leads to lower regulated network prices into the future.

The ex ante and ex post measures, such as the CESS and ex post review process, outlined in the Guideline complement this existing incentive an NSP has to deliver efficient capex. These are explained below.

2.1.1 Capital Expenditure Sharing Scheme

Without a CESS, a NSP will face incentives that decline over a regulatory control period. If a NSP makes an efficiency gain in the first year of a five year regulatory control period any benefit will last for four more years before we update the RAB for actual capex. However, if the same efficiency gain occurred in the final year of the regulatory control period, the benefit to the NSP will be approximately zero. This may lead to inefficient capex and inefficient substitution of opex for capex towards the end of a regulatory control period.

The CESS plays an important role in incentivising NSPs to undertake efficient capex throughout a regulatory control period. It achieves this by rewarding NSPs that outperform their approved capex forecast and penalising NSPs that spend more than their approved capex forecast on a consistent basis in each year of the regulatory control period. The CESS also provides a mechanism to share efficiency gains and losses between NSPs and consumers.

Box 1 illustrates how the CESS operates.

Box 1: Capital Expenditure Sharing Scheme

The CESS works as follows:

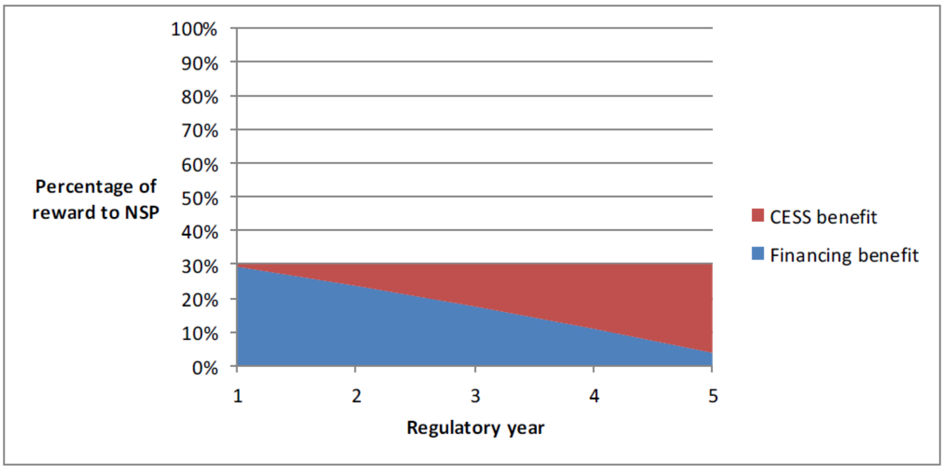
1) We calculate the cumulative underspend or overspend for the current regulatory control period (period n) in net present value (NPV) terms. We calculate the actual underspend or overspend in the first four years of the regulatory control period and an estimate of the underspend or overspend in the final year of the regulatory control period.[14]
2) We apply the sharing ratio of 30 per cent to the cumulative underspend or overspend to work out what the NSP's share of the underspend or overspend should be.[15]
3) To work out the CESS payments, we calculate the financing benefit or cost to the NSP to roll forward the RAB. We subtract this financing benefit or cost from the NSP's share of underspend or overspend. The financing benefit or cost received by the NSP declines over the regulatory control period. This means an underspend in year 1 of the regulatory control period will deliver a higher financing benefit to the NSP than an underspend in year 5 of the regulatory control period.
4) The CESS payments that relate to underspending or overspending in the current regulatory period will be added or subtracted to the NSP's regulated revenue as a separate building block in the next regulatory control period (period n+1).
5) Further adjustments to the CESS payments may need to be made where actual underspending or overspending in the final year of the regulatory control period differs from the estimate provided at the time of the initial calculation. These adjustments will be made when undertaking a revenue determination for the subsequent regulatory control period (period n+2).

14 An estimate is required as actual capex is not available at the time of making our determination.

15 Following our 2023 Incentives Review, the sharing ratio for underspend is asymmetric. If NSP's underspend is greater than 10% then the NSP's sharing ratio is reduced to 20%, rather than 30% as per default CESS.

Figure 1 below illustrates how the combination of the financing benefit and CESS payment provides a reward of exactly 30% of an underspend or overspend in each regulatory year. As shown, the financing benefit declines over the regulatory control period. This is because as the regulatory control period progresses, NSPs retain the value of their financing benefits/costs for a shorter period of time, approaching zero at the end of the five-year determination period.

Figure 1: CESS & Financing Benefits[16]



2.1.2 Ex post review

The NER requires us to produce an ex post statement on the efficiency and prudency on all capex that is to be rolled into the RAB.[17] The objective of the statement is to provide information about the efficiency and prudency, or otherwise, of capex to be included in the RAB.

We may also exclude certain types of capex from being included in the roll forward of the RAB.[18] This helps to ensure network users only pay for capex associated with providing network services which reasonably reflects the capex criteria.

The relevant period over which this assessment is to occur is the first three years of the regulatory control period just ending and the last two years of the preceding regulatory control period.

16 Assumes forecast depreciation is used to roll forward the RAB and an 8% WACC.

17 NER, clauses 6A.14.2(b) and 6.12.2(b).

18 NER, clauses S6.2.2A and S6A.2.2A.

The NER provides for three cases in which we may exclude capex from the RAB:[19]

1. when a NSP has overspent, the amount of capex above the allowance that does not reasonably reflect the capex criteria can be excluded from the RAB
2. where there is an inflated related party margin, the inflated portion of the margin can be excluded from the RAB
3. where a change to a NSP's capitalisation policy has led to opex being capitalised, the capitalised opex can be excluded from the RAB.

In undertaking our ex post review, we use a staged process for making any decisions on whether to exclude capex that meets the overspending requirement[20] from the RAB:

- Stage 1 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.

This approach is useful where a NSP is relatively unresponsive to financial ex ante incentives or where there is a significant project the NSP has undertaken which has not previously been subject to regulatory scrutiny. As we can exclude up to 100% of the cost of any inefficient or imprudent overspend from the RAB, this is potentially a very powerful deterrent against overspending.

2.1.3 How the measures work together

Taken together, the ex ante and ex post measures outlined in the Guideline 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[21].

The CESS provides NSPs with clear incentives to pursue efficiency gains throughout the regulatory control period. They 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.

[19] NER, clauses S6.2.2A and S6A.2.2A.

[20] The overspending requirement is satisfied where actual capex exceeds forecast capex during the review period.

[21] 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)

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 CESS, NSPs bear 30% of the cost of an overspend whether it is efficient or not. If the overspend is found to be inefficient, however, the NSP will bear 100% of the inefficient overspend.

These measures mean that consumers pay only for efficient and prudent overspends and that consumers share in the benefits where a 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 Schemes) and are designed to balance the incentives to reduce expenditure against maintaining service standards.

3 Requirements under the AEMC's Targeted ex post review of ISP project rule change

In August 2024, the AEMC published a final determination for its targeted ex post reviews rule change. This rule change included several amendments to support better outcomes for consumers by:

1. encouraging TNSP's to undertake efficient capex on ISP projects and better enable us to prevent TNSPs from charging customers for inefficient capex overspend, and
2. provide certainty for TNSPs on how capex overspends will be treated under the ex post review mechanism.[22]

Specifically, the transitional provision in NER clause 11.172.2(a) requires us to update the Guideline taking into account the targeted ex post reviews rule change. In updating our Guideline, we must also consider the amendments to clauses 6A.5A(b)(2) to 6A.5A(b)(2b) which specify the matters we must include in our Guideline.

The AEMC's targeted ex post reviews rule change, with the exception of transitional provisions, will commence on 4 September 2025.

The amendments to the NER under this rule change require us to:

- separate our targeted ex post reviews of capex for ISP projects and capex for non-ISP projects[23]
- accommodate the introduction of the "ISP review period", allowing the ex post review of ISP project to occur across multiple regulatory control periods[24]
- determine the matters we will take into account to conclude when a project is substantially completed for the purposes of being a reviewable ISP project[25]
- consider whether we should adjust TNSPs' CESS penalties following an ex post review of ISP project, where we find TNSPs' overspend to be efficient.[26]

We discuss each of these amendments below.

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

23 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.12-13; NER, clause S6A2.2A(f).

24 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.14-15; NER, clause S6A2.2A(a1).

25 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.16-18; NER, clause S6A.5A(b)(2a).

26 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, p.19-22; NER, clauses S6A.5A(b)(2b) and 11.172.3.

3.1 Separate targeted ex post review for ISP projects and non-ISP projects

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

Specifically, revisions to clauses 6A.5A(b)(2), S6A.2.2A(f)-(g), and the addition of clauses S6A.2.2A(b)(4), require us to separate our determinations for ISP and non-ISP projects, provided the relevant overspending requirement[27] has been satisfied. This means:

- For ISP projects, we may only reduce actual ISP capex in the RAB roll forward if the ISP overspending requirement is satisfied and we determine that all or part of the ISP capex overspend is not prudent and efficient.[28] The total amount determined by the AER as inefficient and to be reduced from the RAB cannot exceed the ISP overspent amount determined in the calculation of the ISP overspending requirement.[29]
- For non-ISP projects, we may only reduce actual capex excluding ISP capex in the RAB roll forward if the (non-ISP) overspending requirement is satisfied, and we determine that all or part of the capex overspend not related to ISP capex overspend is not prudent and efficient.[30] The total amount determined by the AER as inefficient and to be reduced from the RAB cannot exceed the overspent amount determined in the calculation of the overspending requirement which excludes ISP capex overspend.[31]

Under the current Guideline, we undertake a staged ex post review process for the purpose of the ex post statement and to make a decision on whether to exclude capex overspends from the RAB.[32]

Figure 2 below, shows the changes to the ex post review mechanism separating ISP capex and non-ISP capex if we maintain our existing ex post review process as set out in the AEMC's final decision.

27 NER, clause S6A.2.2A(c1). ISP overspending requirement is satisfied where the net capex relating to a reviewable ISP project, incurred during the ISP review period, exceeds the sum of forecast capex relating to a reviewable ISP project.

NER, clause S6A.2.2A(c). The non-ISP overspending requirement is satisfied where the net capex, not related to an actionable ISP project, incurred during the ex post period, exceeds the sum of forecast capex.

28 NER, clause S6A.2.2A(f)(2)

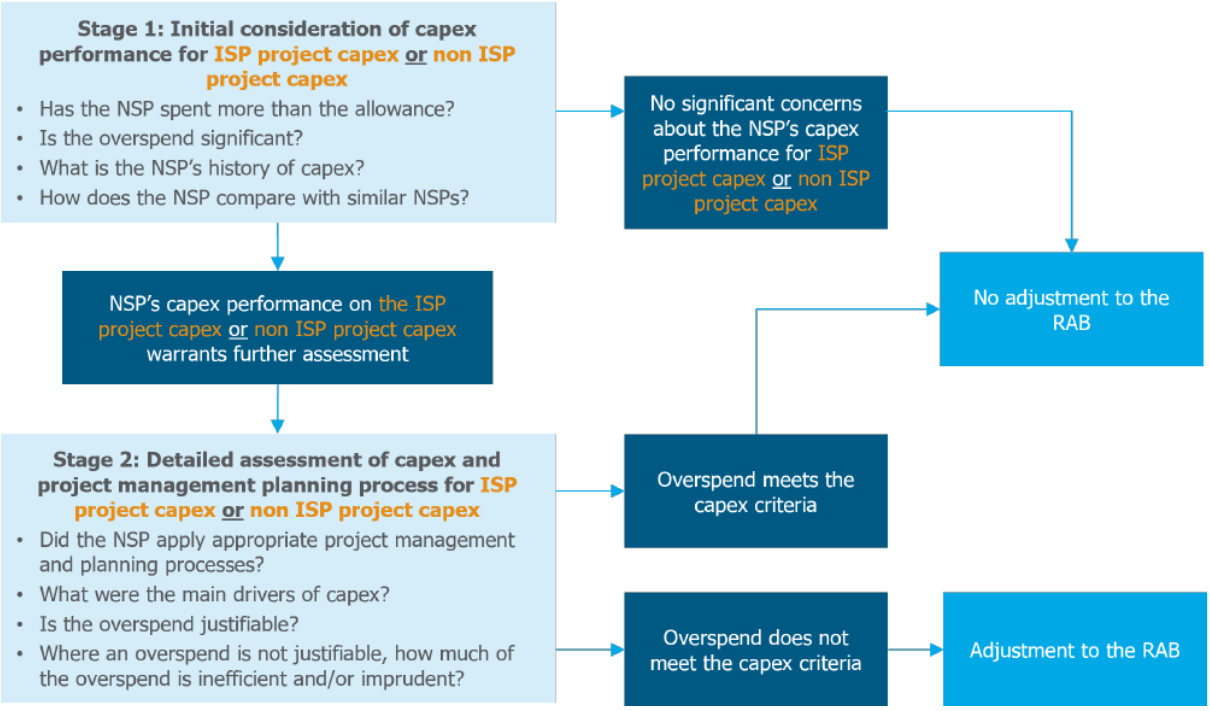
29 NER, clause S6A.2.2A(g)(1a).

30 NER, clause S6A.2.2(f)(1)

31 NER, clause S6A.2.2A(g)(1).

32 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, 30 July 2024, p. 13.

Figure 2: AEMC’s proposed amendments to our ex post review process[33]



Source: AEMC, *Managing ISP project uncertainty through targeted ex post reviews*, August 2024, p. 2. Changes to the existing ex post review mechanism are shown in orange.

We have illustrated an example of how the new process differs from the existing process in **Box 2** below**.**

Box 2: Example of separation of ISP and non-ISP ex post reviews

In this example consider a TNSP’s expenditure as per below:

- ISP forecast capex = $ 120 million
- Non-ISP forecast capex = $ 180 million
- ISP actual capex = $ 160 million
- Non-ISP actual capex = $ 140 million

Existing ex post mechanism

Under the current Guideline, we must consider the total capex when undertaking an ex post review. As the total of actual non-ISP and ISP capex is $300 million, which is equal to the forecast, the overspending requirement has not been met and no ex post review is undertaken.

Targeted ex post mechanism

Under the targeted ex post review rule change, we must consider the ISP project capex and non-ISP project capex separately. As per the scenario above, the ISP project actual capex is

33 We note that this staged approach to undertaking ex post reviews may be further amended as part of this Guideline consultation process.

$160 million against a forecast of $120 million. As the ISP project has met the ISP overspending requirement, we will undertake an ex post review on the ISP project.

As the non-ISP capex did not meet the overspending requirement, we will not undertake an ex post review on the non-ISP capex.

1) Are there any additional considerations we should take into account in incorporating ISP project capex into the 2 stage ex post review process?

3.2 Reviewable ISP project

The rule change will introduce 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 we can undertake an ex post review over the period in which the ISP project was constructed.[34] The ISP project review period encompasses the whole period in which a TNSP has incurred capex on the ISP project.

3.2.1 ISP project review period

We currently undertake an ex post review as part of our 5-year regulatory determination process. As noted in section 2.1.2, the relevant period over which this assessment is to occur is the first three years of the regulatory control period just ending and the last two years of the preceding regulatory control period.

However, this 5-year review period may not necessarily align with the period in which the actionable ISP project has been constructed. For example, if an actionable ISP project is only half constructed during the 5-year review period, it will be difficult for us to determine the efficiency of the capex as we cannot examine the capex holistically.

The ISP project review period extends the ex post review period to encompass the whole period in which a TNSP has incurred capex on an ISP project. This could be over multiple regulatory control periods.

3.2.2 Substantially complete

The AEMC also 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 ISP project once it is substantially completed, and the overspending requirement has been met.

[34] 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.

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.[35]

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.[36]

We are required to specify in the Guideline 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.[37]

Furthermore, in relation to staged actionable ISP projects, we can undertake the ex post review for project stages separately. This is to prevent a significant lag period between when an infrastructure 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 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.

At this point in time, we have identified the factors below that we consider could be appropriate. The onus would be on the NSP to demonstrate that an actionable ISP project, or a stage of an actionable ISP project, is substantially complete by demonstrating how it meets each of the factors.

a) The completed works and costs incurred on the reviewable ISP project is a sufficient representation of the likely overall capex outcome. For example, if the substantially complete project is expected to not meet the overspending requirement, is this still likely to be the case once the whole project is completed?

b) The TNSP does not expect to incur additional construction costs related to the ISP or ISP project stage. The only remaining works are associated with commissioning and energising the assets for the relevant ISP project or ISP project stage.

c) The estimated future capex of the remaining works for the relevant ISP project or ISP project stage, and any cost variations, will be immaterial. There could be a specific cost threshold for immateriality or be assessed on a case-by-case basis.

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

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

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

37 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.

2) Do stakeholders agree with the factors set out for determining when an ISP project is substantially complete?
3) Should there be a cost threshold specified in percentage terms for a project to be considered substantially complete? If so, what is the appropriate threshold?
4) Are there any additional factors we should have regard to?
5) How should we take into account any residual capex that has not been reviewed on an actual cost basis as part of our ex post review on a substantially completed project?

3.3 Modifications to the CESS to accommodate multi-period ISP projects

The introduction of the ISP project review period means that an ex post review period may extend further back than the 5 year ex post review period set out in the current Guideline.

The current Guideline includes a mechanism to reverse any CESS penalty for capex that is subsequently found to be inefficient as part of an ex post review.[38] This ensures that a 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.

If we found in our ex post review that there was inefficient capex from more than 5 years ago, we would not be able to reverse the CESS penalty for the inefficient capex that is about to be removed from the RAB.

To allow the CESS to continue to properly function if this scenario were to occur, the AEMC introduced a rule which will require us to specify in the Guideline how any CESS would apply when we make an ex post review determination either to remove capex from the RAB or not.[39]

We consider only minor changes are required in the Guideline to allow CESS adjustments over multiple prior regulatory control periods following an ISP ex post review. We can adopt a similar approach to that which we currently apply when making an adjustment for excluding capex from year 4 and 5 of the preceding regulatory control period. As set out in section 2.8 of the current Guideline, we refund the NSP the penalty it has already borne under CESS for capex that we have excluded from RAB.

Similar to this current approach, we can adjust a TNSP's revenues in the upcoming regulatory control period following an ex post review. This adjustment effectively refunds the TNSP, taking to account time value of money, what it has already borne under the CESS for the capex that we have excluded from the RAB.

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38 This ensures that a NSP is not penalized twice. That is for the removal of capex from the RAB and a CESS penalty.

39 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.

6) Are stakeholders satisfied with the proposed minor amendments to our existing framework to refund NSPs for any amount excluded from the RAB?

7) Are there any other factors we should consider in giving effect to this amendment?

3.4 Applying CESS penalties on efficient overspends

The AEMC noted that the current Guideline does not permit us to adjust the CESS where, through an ex post review, we find the capex overspend is efficient. The AEMC also noted that there may be cases where we may consider it appropriate to adjust the CESS to prevent a TNSP from being penalised for efficient capex overspend or overspends that are due to factors outside of the TNSP's control.[40]

To facilitate this change, the AEMC rule change introduces a new transitional clause,[41] which allows us to reduce or remove CESS rewards and penalties applied to an ISP project if there is an overspend on the ISP project and the overspend is found to be efficient.

The transitional arrangement is necessary because the updated Guideline cannot be applied to TNSPs until their next revenue determination. The transitional provision therefore allows us to make a revenue adjustment to offset the effect of any CESS penalty applied under the current CESS framework. In order to give effect to this, we must update our Guideline to allow us to make such an adjustment, and the TNSP must have provided written consent.

We consider adding flexibility to adjust the CESS penalty following an ex post review is a significant change to the design of capex incentive framework.

In developing the CESS, the NER requires us to take into account the following:

- NSPs should be rewarded or penalised for improvements or declines in the efficiency of capex
- these rewards and penalties should be commensurate with the efficiencies or inefficiencies in capex, but rewards and penalties do not need to be the same.[42]
- the interaction of the CESS with any other incentives the NSP has to undertake efficient capex or opex
- the capital expenditure objectives[43] and, if relevant, the operating expenditure objectives.[44]

We consider these factors will be relevant in considering any amendments to the CESS.

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

41 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.

42 NER, clauses 6.5.8A(c) and 6A.6.7(e)

43 Outlined in NER, clauses 6.5.7(a) and 6A.6.7(a)

44 Outlined in NER, clauses 6.5.6(a) and 6A.6.6(a)

Under clause 6A.5A(b)(2b), we are required to specify in the Guideline, the manner in which we propose to apply the CESS when we make an ex post review determination.

We are seeking stakeholder views on whether we should amend the Guideline to allow us to modify any CESS penalties for efficient overspends following an ex post review for ISP projects.

We are also interested in stakeholder views on whether the Guideline should only consider ISP project related CESS adjustments for efficient overspends following an ex post review or whether this should be extended to non-ISP projects for all NSPs.

Box 3 provides an example of how efficient overspends could be treated in an updated Guideline.

Box 3: CESS penalties for efficient overspend

A TNSP has overspent its actionable ISP project capex by $500 million. Following an ex post review, we have identified that the $500 million overspend is efficient and no adjustment to the RAB is made.

Existing CESS mechanism

Under the existing CESS mechanism, the $500 million would be subject to a CESS penalty. The TNSP would be penalised 30% of the $500 million less any financing costs they have incurred.

Possible amended CESS mechanism

Following consultation, if we have decided to add flexibility to how we will apply the CESS to efficient overspends to our final Guideline, a possible scenario could be the following.

We have identified that the $500 million overspend is efficient. We will apply the newly introduced efficient overspend factors to consider as part of the Guideline. This may result in us choosing from a range of CESS outcomes such as applying:

- the full 30% CESS penalty
- no CESS penalty (in the absence of a CESS, the NSP would still incur financing costs)
- a partial CESS that could have a modified sharing ratio or specific exclusions.

8) Is the current interaction between the CESS and ex post reviews fit for purpose? If not, please explain why with reference to the overall impact on the long term interest of consumers and the factors we must consider in developing the CESS under the NER noted above.

9) Should we have the flexibility to reduce CESS penalties, through not applying any CESS penalty or applying a lower sharing ratio than 30%, for ISP projects after an ex post review for efficient overspends? If this flexibility is introduced, please identify any examples of any potential benefits and adverse outcomes that may occur as a result of this change.

10) What factors should we consider in reducing or not applying the CESS penalty to efficient overspends? Please provide the reasoning for each factor.

11) Should the flexibility to reduce CESS penalties, through not applying any CESS penalty or applying a lower sharing ratio than 30%, after an ex post review for efficient overspends be restricted to ISP projects, or should it apply more generally; e.g. for non-ISP projects and DNSPs? What factors should we consider in making these adjustments for non-ISP cases? What do you consider would be the implications if it was applied generally?

4 General exclusions and modification of CESS

The current Guideline allows for exclusions from the CESS in specific circumstances. It does not allow for any exclusions for DNSPs. For TNSPs,[45] we may vary the application of the CESS for transmission contingent project proposals.

Recently, we have received proposals from electricity distribution networks requesting some capex be excluded from the CESS. For example, Ausgrid in its 2024-29 electricity distribution determination proposed CESS to be excluded for network innovation programs.[46] Similarly, the Victorian DNSPs, as part of their 2026-2031 revenue determinations, are proposing CESS exclusions for connections-related expenditure.[47]

We consider there is a need to consult broadly with all stakeholders on whether it is appropriate for the CESS to be applied differently based on the category or type of capex as part of this consultation process.

A change to the CESS to allow to more general exclusions would be a significant change to the operation of the CESS. Our approach to considering more general exclusions to the CESS would be similar to the considerations set out in section 3.4 for efficient overspends.

We consider the framework set out in section 2.6 of the current Guideline may serve as a useful starting point for consultation on this issue. The Guideline sets out the following factors in determining whether or not to exclude, or vary, the application of the CESS to transmission contingent projects:

- the TNSP's CESS and capital expenditure proposals
- benefits to consumers from the exemption
- the size of the project
- the degree of capital expenditure forecasting risk
- stakeholder views.

We applied these factors for the first time in our assessment of Transgrid's HumeLink Stage 2 Contingent Project Application. As detailed in our HumeLink decision, we decided to modify the CESS to exclude biodiversity offset costs.[48] We noted that there was a significant amount of uncertainty in the forecast which would shift significantly as new information became

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

46 Ausgrid, *Ausgrid's Regulatory Proposal 2024-29*, 31 January 2023, section 7.2, p. 146.

47 CitiPower, *Regulatory Proposal 2026-31 – Part B Explanatory Statement*, 31 January 2025, p. 84; Powercor, *Regulatory Proposal 2026-31 – Part B Explanatory Statement*, 31 January 2025, p. 100; United Energy, *Regulatory Proposal 2026-31 – Part B Explanatory Statement*, 31 January 2025, p. 85; AusNet, *Electricity Distribution Price Review Regulatory Proposal 2026-31*, 31 January 2025, p. 313; Jemena Electricity Network, *Regulatory Proposal 2026-31*, 31 January 2025, p. 91.

48 AER, *AER Determination – Transgrid HumeLink Stage 2 Contingent Project*, 02 August 2024, pp. 50-57.

available. Due to the nature of Transgrid’s regulatory obligations relating to biodiversity, these costs were also largely out of Transgrid’s control. Further, these costs were not a part of its core work in managing the network. Based on these factors in combination with the size of the $353.6 million biodiversity forecast, we considered it was reasonable to exclude HumeLink biodiversity costs from the CESS.

We are seeking stakeholder views on whether the Guideline should be amended to extend the ability to modify the CESS or exclude the CESS entirely for specific types of capex to DNSPs.

12) Do stakeholders consider there is need to modify the application of the CESS generally to allow CESS exclusions on certain capex categories? Please explain why with reference to the overall impact on the long term interest of consumers and the factors we must consider in developing the CESS under the NER.
13) If we were to modify the application of CESS, what factors should we consider in determining whether specific capex should be excluded from the CESS?

5 Does the CESS sufficiently incentivise efficient abandonment and result in consumers being better off?

The Clean Energy Finance Corporation (CEFC) in its submission to the AEMC's bringing forward early works to improve transmission planning rule change (early works rule change),[49] raised concerns about the risk to 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.

Under our current CESS framework, if an NSP chooses to not undertake a project, the NSP may receive a CESS reward for not undertaking expenditure. The current Guideline acknowledges the potential benefits to consumers from NSPs reprioritising its capex which may result in some projects not going ahead.[50] However, we may adjust the CESS reward if a NSP defers a material amount of capex and includes it in subsequent forecasts as part of our deferral adjustment mechanism.[51]

However, the issue the CEFC raises extends beyond reprioritising within an existing portfolio of capex, instead it relates to projects which have been approved as part of an early works contingent project application.

In this situation, after receiving additional capex for an early works contingent project, a NSP could decide if the project should proceed. We note that if a NSP receives a CESS reward for abandoning the project, this may instead incentivise the NSP to inefficiently abandon a project and could result in worse outcomes for consumers.

While there is no statutory requirement, the Guideline review process allows us to seek stakeholder views on if the CESS should be modified to try to lessen incentives to not abandon efficient projects and to protect consumers from being worse off in the case of abandonment.

We acknowledge that the issue of project abandonment is an area that requires further work and consideration by us and stakeholders. The application of the CESS is only one part of this issue.

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

50 AER, *Explanatory statement - capital expenditure incentive guideline for electricity network service providers*, 29 November 2013, p. 32.

51 AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, 30 July 2024, pp. 7-8.

14) While we consider there is a need to incentivise efficient abandonment of projects, are the rewards sufficiently balanced between NSPs and consumers?

15) Should our consideration of the interaction of the CESS and project abandonment apply to all projects or only projects of a specific type such as actionable ISP projects?

16) If not, how should we apply CESS to an abandoned project or project stage?