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Dear Arek,

## **AER's Capital Expenditure Incentive Scheme Review - Consultation Paper**

AusNet welcomes the opportunity to provide this submission to the Australian Energy Regulator (AER) in response to the review on the Capital Expenditure Incentive Scheme and the implementation of the Australian Energy Market Commission's (AEMC) final rule<sup>1</sup> for managing ISP project uncertainty to amend the Capital Expenditure Incentive Guideline (Guideline).

We understand the primary goal of the guideline is to incentivise network service providers to run an efficient business so that customers do not have to pay more than necessary for an essential service and, in this case, deliver efficient and prudent capex outcomes.

Currently the CESS provides ex ante incentives for networks to undertake efficient capex during a regulatory period, which is complemented by the ex post review mechanism to ensure only efficient capex is rolled into the regulatory asset base (RAB). From an incentive perspective networks receive up to 30% of the benefit of any saving while the consumer receives 70%.

However, there are several potential refinements and changes to the CESS explored in the consultation paper, which should be considered further throughout this review to improve the operation of the Capital Efficiency Sharing Scheme (CESS). These include:

- Exclusions to the CESS, for example due to the uncertainty faced with new customer connections capex due to distribution networks having to incur capex as requests come through, this does not allow networks to have control over when capex is to be incurred. This has similarities to the Humelink biodiversity offset expenditure.
- Changes to ex post review framework to accommodate the inherent uncertainty to be faced by the energy transition given that efficient capex can significantly deviate from approved allowances over a regulatory period.

AusNet continues to strongly support the application of incentive regulation as driving better customer outcomes. However, at this early stage of the energy transition there is a case for additional flexibility in this incentive scheme, to deal with heightened uncertainty over the timing and magnitude of additional investment needed to achieve net zero targets. In lieu of any broad-based regulatory reforms in Australia, like we have seen in the UK for example, adding flexibility into this guideline is needed. Importantly, in adding flexibility we are not looking to undermine the operation of the CESS or make it an asymmetrical reward only scheme, but to correct some possible areas where it is not assisting efficient outcomes. This additional flexibility can be added without undermining the operation of the scheme.

Another challenge outside of the scope of the review of this guideline (as prescribed in the National Electricity Rules), but one that should be considered by the market bodies, is the definition of the overspending requirement in the ex post review framework being met when capital expenditure exceeds the relevant allowance by a single

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<sup>1</sup>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.

dollar. That is, if a network spends a dollar more than the AER set as an efficient allowance at the time of the price review, they are exposed to ex post review risk.

However, the high degree of uncertainty faced around the pace of the transition (associated with uncertainty regarding government policies and consumer behaviour) has increased the forecasting risk around demand growth and other aspects of network expenditure. Market-driven cost pressures will also continue to impact efficient capex levels as the transition gathers pace, and are challenging to forecast at the time of setting expenditure allowances (e.g. it is difficult to predict long-term changes in material prices). These increases, among other factors, are contributing to a ~20% overspend in the 2022-26 capex allowance approved for our electricity distribution network.

These factors mean it is increasingly likely that the true 'efficient' level of spend can significantly deviate in the years after the efficient allowance is set by the AER. The current ex post review arrangements very materially increase the financial risk for networks overspending the capital allowance over an ex post review period, even where this would be efficient and in customer interests. Options such as building in a buffer (i.e. +10%) into the overspending requirement (noting the CESS will still apply to overspends) will help to accommodate the uncertainties presented by the transition.

AusNet supports the submission made by ENA. We have provided further detail on some of the positions taken by ENA in this submission.

We look forward to engaging further with the AER once stakeholder feedback has been reviewed and working towards updating the guidelines, which will then govern capital expenditure incentive schemes for electricity and gas network businesses in the next regulatory periods.

Please do not hesitate to contact Astro Sakalis, Regulatory Economist ( [REDACTED] ) about this submission.

Sincerely,



Rob Ball  
Manager, Regulation (Electricity Distribution)  
**AusNet**

## Attachment – Response to AER’s Capital Expenditure Incentive Guideline Review – Consultation Paper

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

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

AusNet is supportive of the 2-stage approach taking into consideration ISP capex and non-ISP capex, this change will allow for more targeted assessment of efficient capex and positively reduce the need to undertake full ex-post reviews on all capex in the case of an overspend in one of the two categories as is the case under the existing ex post mechanism.

#### **Reviewable ISP project**

In Victoria, ISP projects are unlikely to be delivered as regulated augmentation projects – as this is a process planned by AEMO Victoria today (and VicGrid from July 2025) and is typically delivered on a contestable basis. Therefore, CESS arrangements relating to ISP projects are unlikely to be applicable in Victoria and to AusNet.

Moreover, future Victorian augmentation projects are expected to follow a new Victorian framework (under the Victorian Transmission Investment Framework ‘VTIF’) rather than the ISP actionable framework.

Regardless, we support the ENA submission on this point, and add the following:

- To TNSPs for ISP projects which relates to the determination of whether an overspend is ‘significant’ and the triggering of an ex post review and support changes on how the CESS applies to ISP projects.
- Flexibility should be available around the CESS rewards associated with the initial ISP construction to be spread over the life of the assets rather than focused only on the next five-year regulatory period.

#### **2) Do stakeholders agree with the factors set out for determining when an ISP project is substantially complete?**

We agree with the ENA position that the AER’s factors are too restrictive.

#### **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?**

We support the ENA position on this matter.

#### **4) Are there any additional factors we should have regard to?**

We support the ENA position on this matter.

#### **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?**

We support the ENA position on this matter.

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

AusNet supports the points of change around the:

- Extension of review periods to handle long-term ISP projects.
- The ability to reverse or adjust CESS penalties for inefficient capex from projects that span multiple regulatory periods.
- Refunding penalties when capex is excluded from the RAB following an ex-post review, taking the time value of money into account.

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

Appears to be a necessary and sensible adjustment.

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

We support the ENA position on this matter.

## Applying CESS penalties on efficient overspends

### **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.**

We support the ENA position on this matter and note the importance of rewards and penalties aligning with the circumstances of the relevant network as required by rules (rules 6A.6.5A(c)(1) and 6A.6.5A(e)(4)(ii)). Comparing actual capex to regulatory allowances from up to seven years ago doesn't consider changes in capital expenditure needs. This has been highlighted in the past five years with several unforeseen events, like COVID-19 logistics issues, rising costs of materials and unit rates in delivering key projects, which can make regulatory allowances inaccurate. As a result of this the current capex efficiency calculation in the CESS can lead to inefficient project deferrals or unnecessary risk for networks, which ultimately impacts customers.

### **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.**

We consider this flexibility is appropriate to ensure that a TNSP is not unduly penalised for circumstances genuinely outside their control.

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

We support the ENA position on this matter.

### **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?**

We welcome the AEMC's rule change which will provide greater flexibility for networks to manage the uncertainty of large-scale Integrated System Plan (ISP) projects, such as renewable energy generation and transmission upgrades. Allowing for adjustments to capex during a regulatory period which will help networks manage uncertainties in costs without incurring a penalty. Likewise, the introduction of provisions around re-openers if a network's situation changes significantly is important to allow networks to fulfil their role in facilitating the

construction of critical infrastructure and adapting to the needs of the energy transition and market conditions and recovering the relevant costs.

AusNet supports this level of flexibility in the CESS applying more broadly by allowing efficient overspend from an ex post review to not be penalised under the CESS. While we recognise that the CESS plays a crucial role in ensuring DNSPs/TNSPs have an incentive for efficient capex expenditure, efficient overspending may be necessary due to material, unforeseen factors outside of a network's control, which may not necessarily meet the cost pass through or re-opener provisions in the Rules (e.g. changes in government policy that do not satisfy the definitions of the prescribed cost pass through events).

Recognising this risk, in our 2026-31 electricity distribution regulatory proposal, we have also proposed several new, nominated pass through events, including an Electrification Event. We consider more flexibility in the application of the CESS is complementary to cost pass through arrangements that are fit for purpose for the energy transition

Improving the clarity and expectations of the above will provide more detailed guidance on the types of capex that will be incentivised in a regulatory period and the wider expectations around demonstrating efficient capital expenditure.

AusNet considers that there should be flexibility to not apply a CESS penalty on a case-by-case basis and that the AER should develop a set of principles to address this. An example of where this may be appropriate is as an alternative to submitting a pass-through application. AusNet has recently submit a passthrough application to install PMUs on our transmission network as a result of a direction from AEMO. The total expenditure was ~\$7m in capex, which will mainly be incurred in the final year of the regulatory period. As this is for capex on long life assets, incurred at the end of the regulatory period, this has a minimal impact on our MAR (~\$62,000) and we would likely not spend time submitting a passthrough application except for two key factors:

1. This expenditure could become important in an ex-post assessment, by contributing to the magnitude of any aggregated overspend. Having the passthrough amount approved helps mitigate against this outcome.
2. This will generate a CESS penalty of ~\$2.5m which will be incurred in subsequent regulatory periods.

If this expenditure could be excluded from the CESS and ex post review, then both we and the AER could avoid the administrative burden of submitting and assessing a passthrough application which would be a better outcome for both customers and networks.

## General exclusions and modification of CESS

### **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.**

The current CESS guidelines apply to total net capex and, for distributors, do not explicitly provide for exclusions<sup>2</sup>. However, we believe the exclusions proposed in our 2026-31 electricity distribution regulatory proposal would promote better consumer outcomes, are consistent with the regulatory framework, and should be examined in more detail.

AusNet has proposed the exclusion of three categories as part of the EDPR 2026-31 regulatory proposal.

- Innovation program
- Regional Reliability Allowance

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<sup>2</sup> Notwithstanding this, we consider that, under the current guideline, the AER has discretion to exclude capex from the CESS for distributors, consistent with its 2021-26 determination for our electricity network where innovation capex was excluded. We also note that the AER's preference, as stated in the 2026-31 Framework and Approach, is "to apply the CESS to all categories of capex and to make exclusions only in exceptional cases."

- New connection types - Expenditure for new technology connections, to reflect uncertainty around the pace of the energy transition and the difficulty in accurately forecasting some connection types. The specific connection types proposed for exclusion are:
  - Community batteries.
  - Grid scale battery and renewable generator hybrids.
  - Public EV charging points.
  - Data centres

In respect of excluding new types of connections, we engaged on the growing level of uncertainty with our EDPR Coordination Group, and the possible ways to manage the risk to our customers, including through an exclusion.

The Coordination Group acknowledged the risk of uncertainty is growing and that some mechanism to address this issue would be of value. The exclusion of new technology connections would incentivise networks to propose their best forecast of expenditure. If new technology take-up exceeds expectations, and our cost estimates are materially higher than actuals, the CESS exclusion avoids our customers paying for efficiency rewards that were achieved not through efficiencies but through inaccurate forecasts. Conversely, if our estimates are materially lower than actuals, it eliminates the incentive provided by the CESS to find capex savings elsewhere, potentially at a cost to our customers in terms of service performance. The Coordination Group's view on the need for exclusions to address these issues is set out below:

*"The panel supports this approach as it is likely to have less impact on customers if investment is markedly different than expected."<sup>3</sup>*

The exclusion of connections capex should be considered in detail as part of the AER's CESS review and the overall assessment of the Victorian electricity distribution regulatory proposals. We acknowledge that exclusions should be made in exceptional cases, so as not to undermine the effectiveness of the capex incentive framework. However, we consider that these connection types that are linked to the energy transition and evolving technology (and therefore highly uncertain) should qualify as exceptional. This is because:

- The energy transition is the most significant change in the energy sector since the electrification of the state and while it is having a very significant impact on connections and other expenditure categories today it is unlikely to have this same degree of impact in the longer term.
- The potential magnitude of costs impacted by new technology connections can be very significant, as demonstrated by Jemena applying for a reopener due to data centre connections, using a regulatory mechanism that had never been used by electricity networks since the regulatory framework was established.

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<sup>3</sup> Coordination Group 2024, Independent Report on Draft Revenue Proposal 2026-2031, Report for AusNet Services, 22 October, p. 32

**Table 1: Impact and uncertainty with connection forecasts for new business types and associated uncertainty**

Connection new business type	Connections capex impact by July 2031	Source of uncertainty
Community battery connections	An estimated 30 community battery of various sizes (20kW/40kWh – 5MW/20MWh) but typically 60kW/200kWh	Forecasts do not include future government grants and incentives. New government initiatives during the 2026-31 regulatory period could significantly impact this forecast.
Grid scale battery and renewable generator hybrids	Increasing the number of grid scale battery and renewable generator hybrids by 511% with 10 new major projects	Risk and uncertainty that not all of our anticipated projects do not proceed, <sup>4</sup>
Connections of public EV charging points and EV bus depots	Increasing volumes and connections capex by 790% to 2,536	Policy changes and market forces vary from AEMO's 2023 modelling assumptions, and  EV charging station connection costs variations from historical averages.
Data centre connections	Two 66kV connected data centres projects expected	One project with strong interest from a data centre operator and one forecast data centre. Connection costs variations based on indicative cost estimates (based on similar connection projects) and customer contribution calculation.

Source: AusNet

We expect unprecedented growth in the new customer types and emerging technologies, including:

- Dozens of dedicated grid or community scale batteries.
- Embedded generation and hybrid connections that support our renewable future. These new renewable energy embedded generation projects include energy storage is classified as hybrid or bi-directional connections.
- Hundreds of new public EV charging stations per year to meet the growing need for more charging locations.
- Several new data centres that keep data secure and provide new AI services with large continuous load requirements. These are often paired with contracted renewable energy generation projects.
- Bus depots electrifying their fleets for around-the-clock operations.

We have observed a rapid uplift in project specific enquiries from potential applicants. This trend is expected to continue, despite uncertainty around its pace, and it is important that incentive schemes allow for flexibility as the renewable energy transition progresses and technology and consumer behaviour evolve.

<sup>4</sup> Based on expressions of interest from credible renewable energy proponents, we reasonably anticipate 7 hybrid projects at the start of the 2026-31 regulatory period.

### 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?

We note the following factors identified by the AER as being relevant to whether modifications to the CESS are warranted. The table below assesses our proposed exclusion for new connections against these factors, demonstrating the merits of this proposal.

**Table 2: Assessment of proposed exclusion with AER factors**

CESS Guideline Factor	Assessment of proposed exclusion
<b>The network's CESS and capital expenditure proposals</b>	<ul style="list-style-type: none"> <li>Assessing the whole proposal in light of the energy transition, overall capital expenditure proposal and consumer views.</li> </ul>
<b>Benefits to consumers from the exemption</b>	<ul style="list-style-type: none"> <li>Removes incentive for networks taking a conservatively high approach to forecasting capex for connections.</li> <li>If actual spend is less than forecast, avoids customers paying for efficiency rewards that were achieved not through efficiencies but through inaccurate forecasts.</li> <li>If actual spend is greater than forecast, eliminates the incentive provided by the CESS to find capex savings elsewhere, potentially at a cost to customers in terms of service performance.</li> </ul>
<b>The size of the project</b>	<ul style="list-style-type: none"> <li>New technology connections account for \$87M of our 2026-31 electricity distribution capex forecast (approx. 2.5%) and therefore have potential to generate material CESS penalties or rewards if actual spend differs to forecast.</li> </ul>
<b>The degree of capital expenditure forecasting risk</b>	<ul style="list-style-type: none"> <li>High forecasting risk, as established above, with the risk being worn by both AusNet and customers on the network.</li> </ul>
<b>Stakeholder views</b>	<ul style="list-style-type: none"> <li>Our Coordination Group in its draft report said, "the panel supports this approach as it is likely to have less impact on customers if investment is markedly different than expected."</li> </ul>

Source: AusNet

### Innovation and Regional Reliability Allowance ('Use it or lose it' allowances)

- Our customers would like to ensure that, if we were to receive innovation or regional reliability allowance funding, we could not profit if we didn't deliver any of the projects and therefore underspent the allowance. As such, these allowances would be provided on a use-it-or-lose it basis.<sup>5</sup>
- There was general support from the Coordination Group and Availability Panel for the exclusion of innovation and RRA expenditure, respectively, from the CESS, on the grounds that these allowances

<sup>5</sup> Coordination Group 2024, Independent Report on Draft Revenue Proposal 2026-2031, Report for AusNet Services, 22 October, p. 19



should be provided on a 'use it or lose it' basis and in the case of not carrying these out not being subject to expenditure incentives<sup>5</sup>

These modifications would ensure that the CESS mechanism can effectively handle the complexities and uncertainties of capex spend, while continuing to provide incentives for efficient investment and development in the energy sector especially given the changes in the energy landscape and the need to incorporate evolving customer expectations, environmental considerations, and technological advancements and will improve the function of this incentive scheme.

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

**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?**

For the above questions we support the ENA position on this matter given networks receive an allowance for capex and have the discretion to reprioritise projects to work within that allowance. Changes to the CESS on potential abandonment should be restricted to ISP projects at this point in time.