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Australian Energy Regulator
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By email: aerinquiry@aer.gov.au

Dear Arek

Thank you for the opportunity to provide feedback on the Australian Energy Regulator (**AER**) on the review of the Capital Expenditure Incentive Regime Guideline (**the Guideline**) published in February 2025. The energy transition is creating unprecedented challenges for all network service providers (**NSPs**), with significant investments required to facilitate the integration of renewable energy and support federal and state emissions reduction targets.

As a Distribution Network Service Provider (**DNSP**), we acknowledge that the consultation paper primarily focuses on transmission level integrated system plan (**ISP**) projects. We are mindful of the AER's consideration to extend some of the proposed amendments to DNSPs' capital expenditure subject to the National Electricity Rules (**NER**). Our response focuses on the impact those proposed changes could have on DNSPs, with a particular consideration on Renewable Energy Zone (**REZ**) projects which fall under the Electricity Infrastructure Investment (**EII**) Act. This is because the non-contestable guidelines for REZ projects generally mirror the NER guidelines, meaning there could be a direct impact on these projects as well.

We generally support the AER's review of the Guideline and our submission offers the following key positions:

- We request greater clarity regarding ex-post reviews associated with cost overruns, particularly how these might apply to DNSPs involved in REZ-related infrastructure where a transmission network service provider (**TNSP**) licence is not required;

- We support multi-period CESS adjustments to accommodate projects that span multiple regulatory control periods;

- We support modifications to the CESS regime to allow lowering the sharing ratio for overspends found to be efficient;

- We endorse CESS exclusions for specific categories of expenditure where traditional incentive mechanisms may not be appropriate; and

- We support the development of more effective project abandonment incentives to ensure consumers are protected while maintaining appropriate investment signals.

If you have any questions, please contact Philippe Laspeyres, Regulatory Modelling Manager, at [redacted].

Regards,

Timothy Jarratt
Group Executive, Market Development and Strategy

**Application of the Guideline**

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

**Separate ex-post reviews**

While the proposal for a separate ex-post review for ISP and non-ISP projects appears not to be directly relevant to DNSPs, we note that large scale REZ projects may be carried out by DNSPs under the EII Act. As the guidelines under the EII Act generally follow the NER guidelines, it would be helpful for the AER to indicate whether the updated guideline would apply the ex-post review mechanism to non-contestable REZ investments.

Generally, we do not expect that the ex-post review modifications for ISP projects are necessary for individual non-contestable REZ projects as these projects are subject to a separate regulatory determination with (in most cases) a five year term. Most projects would be completed within that timeframe, and as the determination is dedicated to that project there is no non-REZ expenditure to be separated.

However, should the AER consider extending the updated ex-post review to individual DNSP-led large-scale capital investments like REZs, we suggest the AER:

- Develops clear materiality thresholds for triggering reviews of REZ-related investments or major capital investments that reflect their scale and risk profile;
- Considers how investments that span multiple regulatory control periods would be assessed; and
- Provide guidance on how the AER would assess the efficiency of REZ-related or other major capital investments, recognising their unique characteristics and policy drivers.

**Modifications to the CESS for multi-period projects**

We support the proposed amendments to refund NSPs for CESS penalties already incurred on capex that is subsequently excluded from the RAB following an ex-post review. This approach prevents double penalisation and ensures the incentive framework operates as intended.

We particularly support the AER's recognition that adjustments may need to be made for periods beyond the standard five-year ex-post review period. This is critical for large, multi-year projects that are increasingly common in the energy transition.

**Applying CESS penalties on efficient overspends**

We believe the current interaction between the CESS and ex-post review is not fully fit for purpose, particularly for large-scale investments such as ISP projects and REZ distribution investments. The current framework has several limitations:

- The CESS applies the same 30% penalty to all overspends, regardless of whether they are efficient or not. This can penalise NSPs for efficient overspends that are in the long-term interests of consumers.

- The framework does not adequately account for the unique characteristics of large, complex projects with higher inherent uncertainty. For larger projects, a 30% penalty on efficient overspends is not sustainable and may prevent critical projects from proceeding. We support modifications to the CESS regime to allow lowering the sharing ratio or excluding the overspend from CESS where appropriate.
- The framework may create incentives for NSPs to avoid necessary but uncertain investments.

Creating flexibility to reduce CESS penalties for efficient overspends following an ex-post review is in the long term interest of consumers. It provides an incentive to continue delivering projects without cutting corners if there is an event outside of their control that pushes cost over the allowance. The incentive to deliver efficiently remains because there is a risk that the overspend could be found to be inefficient, in which case the penalty would still apply. This flexibility should apply to all ex-post reviews, including for DNSPs, as well as ISP projects.

**CESS exclusions**

We support modifying the application of the CESS to allow for ex ante nominated exclusions of certain capex categories. For DNSPs, there are some categories of expenditure where the standard CESS may not provide appropriate incentives or may create perverse outcomes that are not in the long-term interests of consumers.

The consultation paper noted that Ausgrid had suggested a CESS exclusion for innovation expenditure. This was based on support from our customer representative panel that innovation expenditure can be uncertain and that if all of the allowance was not spent, it should not be counted as an “efficiency” for which customers should pay 30% reward. We agree with our panel on this matter and maintain that innovation should be considered for CESS exclusion.

Further to this, the need for CESS exclusions is particularly important in the context of the growing need for data centres and digital economy, where networks are required to provide significantly more capacity in certain locations.

Where augmentation is subject to Individually Calculated Tariffs, CESS may result in cross-subsidies if for example, an underspend on projects involving data centre connections, a CESS reward is passed on to all Ausgrid customers. In the case of data centres, the exclusion of such projects from the CESS would reduce the risk of any benefits (or penalties) being passed on to parties other than those requesting the service.

We agree that the factors for TNSP contingent projects provide a good starting point for considering whether expenditure should be excluded from CESS for DNSPs. We would welcome engaging with the AER to develop DNSPs specific principles that clearly set out the criteria the AER intends to use when assessing a DNSP’s CESS exclusions.

**Project abandonment incentives**

We acknowledge that the current incentive framework may not provide an appropriate balance of risk between NSPs and consumers for efficient project abandonment. However, any modifications to manage this issue requires more time and consideration. Any modifications to the CESS to better balance incentives between networks and consumers in cases of project abandonment should include development of clear criteria for when project (or parts thereof) abandonment would be considered efficient.

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