20 March 2025

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Submission to the AER's Capital Expenditure Incentive Guideline Review – Consultation Paper (REF: 17272948)

CitiPower, Powercor and United Energy welcome the opportunity to respond to the Australian Energy Regulator's (AER) consultation paper – Capital Expenditure Incentive Guideline Review.

We understand the AER is undertaking this review in light of new rule changes relating to targeted ex post reviews for ISP and non-ISP project expenditure, however have included additional discretionary amendments as part of the review. This submission focuses on one of these additional discretionary amendments; whether the scope of exclusions in the capital expenditure sharing scheme (CESS) should be broadened in certain circumstances.

In our 2022 submission to the AER's review of incentive schemes for networks, we agreed with the AER that the incentive scheme framework is generally fit-for-purpose and delivering positive outcomes for customers.[1] We continue to believe that the incentive schemes are functioning in the interests of customers and continue to provide network service providers (NSP) with incentives to incur efficient expenditure.

However, due to growing uncertainty relating to the energy transition, particularly around the pace and timing of electrification, the risk of under-forecasting capital expenditure is increasing (for both networks and importantly, the AER's determinations). This has the potential to lead to overspends from efficient investments, or inefficient deferrals, should the pace of the transition increase.[2] We consider minor adjustments to the CESS to allow for a broadened scope of exclusions is appropriate in light of these risks and potential customer impacts.

Applying exclusions to certain categories of capital expenditure, particularly where NSPs are required to incur expenditure regardless of incentives, will better align the intention of the CESS with its outcomes while also delivering better outcomes for customers.

High levels of uncertainty associated with the energy transition are making it harder to accurately forecast capital expenditure requirements

The pace of the energy transition is making it harder for businesses and the AER to have confidence that its forecasts and determinations respectively, will provide a reasonable opportunity for networks to recover efficient costs incurred in delivering network services.

For example, both Federal and State governments have ambitious emissions reduction targets, achieving these targets will require significant change in energy consumption. Similarly, increases in electricity consumption are

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[1] CPPALUE, Submission to AER review of incentive schemes discussion paper, 11 March 2022, p. 1.

[2] This is likely to be particularly relevant in Victoria, due to its comparatively heavy reliance on gas (~3 times more MJ consumed per annum than NSW and South Australia, ~7 times more than Queensland and ~1.5 times more than ACT and Tasmania combined).

being driven by the expansion of data centres that are required to meet growing digitalisation and automation needs.

A faster paced electrification will require NSPs to incur additional capital expenditure, however there are limited avenues for NSPs to alter their capital expenditure forecasts to account for this. While uncertainty mechanisms, such as cost pass throughs, contingent projects and capex reopeners are included in the regulatory framework to help manage general uncertainty, they are only able to be activated in specific circumstances and often have high thresholds. The majority of Victorian DNSPs have put forward electrification cost-pass through events in their regulatory proposals currently before the AER[3], however it is unclear whether the AER will accept these nominated events.

If additional capital expenditure associated with a faster paced energy transition is not able to be included through these mechanisms, it will result in either:

- inefficient deferral of expenditure to avoid CESS penalties potentially delaying the energy transition, or
- greater NSP overspends and therefore greater CESS penalties, even where that expenditure has been incurred efficiently and is not discretionary.

Both of the above scenarios are likely to lead to poorer customer outcomes.

Exclusion of certain types of capital expenditure from the CESS will better align the CESS with its intended purpose and produce better customer outcomes

While much of our capital expenditure program is discretionary and built up based on extensive stakeholder engagement, there are some categories of capital expenditure that NSPs have limited control over. This often occurs when NSPs have specific obligations that require us to undertake capital expenditure regardless of our allowance. One example of this is connections expenditure.

Connections expenditure is linked to the number of customers requesting connection to our network. The number of connection requests in any given regulatory period, both in terms of the nature and number of connections, is entirely outside of our control.

We must make an offer to any customer seeking a connection to our network, even when actual connection expenditure is already above our forecasts. This can place the overall capital program under significant pressure as week seek to balance our investment program by reducing expenditure in other areas.

The energy transition is also making it increasingly difficult to forecast connections expenditure due to:

- increased uncertainty of the number and nature of future connections
- recent emergence of new types of large connections such as data centres, batteries and EV charging stations
- difficulty of forecasting customer contributions.

Incentives are only effective when the parties to the incentive scheme are able to adapt their behaviour. Where NSPs do not have discretion over expenditure it would be more appropriate to exclude such expenditure from the CESS. The NER states NSPs '*should be rewarded or penalised for improvements or declines in the efficiency of capital expenditure'*.[4] Including non-discretionary expenditure in the CESS, even when it has been incurred

3 For example: Powercor, PAL ATT 11.01 – Managing Uncertainty – Jan2025, pp. 22-23; Ausnet, Electricity Distribution Price Review – 2026-31 Regulatory proposal, pp.334-335

4 NER, Clause 6.5.8(c)(1)

efficiently, has the potential to generate CESS penalties. This outcome does not align with the principles of the CESS as set out in the NER.[5]

A process to exclude expenditure from the CESS where NSPs are not able to respond to incentives would also provide a better balance between under and overspends within the CESS framework. The AER's Capital Expenditure Incentive Guideline for Electricity Network Service Providers allows the AER to adjust capital expenditure included in the CESS where capital expenditure has been deferred and an NSP underspends its allowance.[6] This reduces the 'reward' an NSP receives for that regulatory period. However no such mechanism within the Capital Expenditure Incentive Guideline exists to reduce penalties where additional expenditure is required.

Excluding specific categories of capital expenditure will provide NSPs with certainty to undertake investments to maintain the network without fear of incurring CESS penalties for efficiently incurred expenditure. Large CESS penalties have the effect of reducing revenue available to NSPs to deliver services customers want at the standard they expect, as they require NSPs to reduce capital expenditure investments in some areas of the business to cover these additional penalties.

The following factors should be considered in determining whether specific capital expenditure should be excluded from the CESS

The factors we consider should be used to inform whether specific capital expenditure should be excluded from the CESS include:

- **whether the NSP has the ability to control whether the cost is incurred**: there are situations where NSPs have obligations that require them to undertake capital expenditure even if it will lead to a capital expenditure overspend. In this situation NSPs have no ability to respond to a capital expenditure incentive as we must incur these costs
- **whether the capital expenditure has been incurred efficiently:** if expenditure has been deemed to be efficient then the incentive scheme should not impose penalties on that expenditure. Imposing a penalty in this scenario is inconsistent with the intention of the CESS which is meant to incentivise NSPs to undertake efficient capital expenditure
- **whether the capital expenditure has been approved on a use-it or lose-it basis:** where capital expenditure has been proposed on a use-it or lose-it basis, for example in relation to innovation funds/allowances as have been proposed by a number of distribution businesses in their most recent proposals, then this expenditure should be excluded from the CESS. Excluding this expenditure will ensure that any unspent expenditure can be returned to customers in full at the end of the regulatory period, rather than part of this underspend being shared with NSPs.

Flexibility in the application of CESS penalties should be limited to considerations of whether capital expenditure should or should not be included in the CESS

We consider the inclusion or exclusion of expenditure from the CESS likely provides enough flexibility to incentivise efficient capital expenditure, without the need to alter the sharing ratio for specific circumstances. Having additional sharing ratios is only likely to add complexity to the scheme and create uncertainty and confusion for NSPs and stakeholders.

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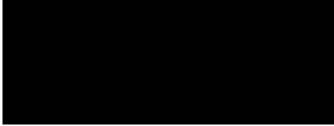
[5] Clause 6.5.8A(a) - A capital expenditure sharing scheme is a scheme that provides Distribution Network Service Providers with an incentive to undertake efficient capital expenditure during a regulatory control period.

[6] AER, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, April 2023, p.8

To promote consistency across outcomes, the AER should develop clear and transparent guidelines setting out the types of capital expenditure that can be excluded from the CESS and the process to have new types of capital expenditure considered for exclusion. This will ensure NSPs have certainty regarding the application of the capital expenditure incentive framework.

Yours sincerely,



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