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Submission to the *AER's Capital Expenditure Incentive Guideline Review Consultation Paper*

Thank you for the opportunity to make a submission to the Australian Energy Regulator's (**AER**) *Capital Expenditure Incentive Guideline Review Consultation Paper*.

The Clean Energy Finance Corporation (**CEFC**) is a specialist investor in Australia's transition to net zero emissions by 2050. With access to more than $30 billion from the Australian Government, we work with co-investors, industry and government to drive economy-wide investment in decarbonisation. The CEFC supports the development of a secure, reliable and affordable electricity system while lowering emissions through its investment activities. The Australian Government has allocated $19.65 billion to the CEFC under its Rewiring the Nation (**RTN**) program to help spearhead the necessary transformation of Australia's electricity grid infrastructure.

In making this submission we wish to advise the CEFC has and will continue to invest in electricity network projects that will be affected by this review. This submission has not been developed for the purpose or intent of de-risking existing CEFC investments that may be affected by the review's outcome but rather from the perspective of our role in delivering RTN fund objectives which are to:

- Increase renewables in the grid fast-track decarbonisation of the Australian economy.
- Ensure consumers benefit from the grid transformation.
- Build investor confidence in Australia's energy transition.

A. Summary of CEFC views

In summary, the CEFC considers:

- For Integrated System Plan (**ISP**) projects, the Capital Expenditure Sharing Scheme (**CESS**) should continue to apply to project cost overruns that have passed an ex post review and there should be a tightening of the circumstances in which the AER would exclude capex from a Transmission

Network Service Provider's (**TNSP**) Regulatory Assets Base (**RAB**) under an ex post review[1] in order to make projects more investable.

- For ISP projects, CESS rewards should not be available for abandoned projects because TNSPs already face CESS penalties on cost overruns; a natural brake on progressing inefficient projects. Further, in order to recover sunk costs of abandoned projects, we consider TNSPs should be required to demonstrate (to the AER's satisfaction) abandonment is in the long-term interests of consumers.
- For non-ISP projects, Network Service Providers (**NSP**) (including Distribution Network Service Providers (**DNSP**)) should continue to receive CESS rewards for abandoned projects given that forecasting across a portfolio of projects more than five years ahead comes with uncertainty of the network's future needs. However, recognising NSPs do often have flagship projects that have been consulted on with stakeholders, if such projects are abandoned, the CESS reward should only be applicable if the NSP can demonstrate:
    - they have delivered the project's outcomes by more efficient means; or
    - a material change in circumstances has meant the outcome is no longer appropriate to deliver.
- The AER should develop a definition of a 'completed project'. Additionally, TNSPs should have an onus to demonstrate that projects are either substantially complete *or* not substantially complete. If TNSPs are only required to alert the AER of projects they consider are substantially complete, they may be able to delay ex post reviews, which may not be in the interests of consumers.

B. Applying CESS penalties on overruns – ISP projects

In its *Managing ISP project uncertainty through targeted ex post reviews*, the Australian Energy Market Commission (**AEMC**) outlined it may be appropriate to reduce or remove a CESS penalty where capex overruns are considered efficient or outside of a TNSPs control during an ex post review. The AER is now considering changes to the CESS penalty applicable to a TNSP's cost overrun on an ISP project subject to an ex post review.

The CEFC considers:

1. The CESS should continue to apply to ISP project cost overruns.
2. The criteria for excluding assets from the RAB under an ex-post review should be tightened.

[1] Our submission limits the tightening of the ex-post review to circumstances where this is related to overspending only.

3. There may be merit in the AER re-visiting the application of the CESS to early ISP projects.

These considerations—which are made in the context of ISP projects that face an ex post review due to triggering the overspending requirement of the rules—are discussed below in turn.[2]

The CESS should continue to apply to ISP projects that are subject to an ex post review

The CESS is an effective tool for aligning TNSPs' and consumers' interests by allowing TNSPs to share in the benefits of delivering projects more efficiently than forecast and share in the disbenefits of cost overruns.

From an investor perspective, the CESS provides a clear framework with a certain outcome. That is, TNSPs and their investors know the consequences of cost overruns, which allows them to weigh this against the equity returns generated from the project's development. If TNSPs consider the standard 70/30 sharing ratio of the CESS does not deliver an appropriate risk adjusted return, they can apply to the AER for a different sharing ratio to be adopted.

This transparency and certainty is conducive to making informed investment decisions and aligning TNSP and consumer interests, and the CEFC supports the CESS's ongoing application to ISP project overruns.

The criteria for conducting an ex post review

The rules allow the AER to reduce the value of a TNSP's RAB by the amount of a TNSP's capital expenditure that exceeds the forecast (if certain criteria are met) in an ex post review.

The AER's CESS guideline provides guidance on whether the AER will adjust the RAB, with the first assessment stage being:

- Has the NSP spent more than its allowance?
- Is the overspend significant?
- What is the NSP's history of capex?
- How does the NSP compare with similar NSPs?

In contrast to the CESS, the CEFC considers the presence of this ex post review introduces uncertainty and a material risk to TNSPs and their investors because the outcome is not known at the time the investment is made and TNSPs potentially stand to lose up to 100% of the overrun balance. To that end, it likely acts as a deterrent to the development of critical ISP transmission infrastructure. Therefore, the CEFC considers the criteria for making an ex post review RAB adjustment should be tightened to only capture egregious investment decisions or behaviour by TNSPs. We consider a definition or factors to consider in determining whether an

[2] National Electricity Rules, S6A.2.2A(c).

investment or behaviour is egregious could be developed in consultation with stakeholders during this CESS guideline consultation process.

Balancing consumer and TNSP interests and the need for ISP project delivery

In forming our view that the CESS should continue to apply and the ex post review criteria should be tightened, the CEFC has sought to balance consumer and TNSP risk. The following table outlines the CEFC's considerations in three scenarios representing different ways in which the CESS could be applied.

Table 1 Potential applications of the CESS

Options	Consumer risk	TNSP risk	Considerations
Option1 - Ex post review and no CESS Overruns that are not prudent or efficient are excluded from the RAB and remaining expenditure is included in the RAB without the CESS being applied	●	●	<u>Consumer protections</u> The AER's ex post review assesses whether expenditure is not inefficient or imprudent - which is a lower threshold than determining that it is prudent and efficient. Under this scenario, TNSPs would not face a financial penalty for cost overruns allowed to be included in a TNSP's RAB after facing the ex post review, meaning: • Consumers pay 100% of these cost overruns • Misalignment of TNSP and consumer interests on minimising costs • CESS becomes a one-sided reward only scheme <u>TNSP and investor risk</u> TNSP and investors face ex post review on overruns is less quantifiable and does not provide upfront certainty of their treatment. Potentially result in significant financial downside with up to 100% of overruns at risk of being unrecoverable.
Option 2 - Ex post review with CESS Overruns that are inefficient or imprudent are excluded from the RAB and remaining expenditure included in the RAB with a financial penalty	●	●	<u>Consumer protections</u> In theory, provides the highest level of consumer protection currently available, however, CEFC considers this may be an ineffective protection. The high level of TNSP and investor risk (below) may increase the propensity of TNSPs to abandon projects that are facing cost overruns, leading to unrealised project benefits and consumers potentially facing costs of sunk investments (discussed in section C). <u>TNSP and investor risk</u> TNSP and investors face ex post review on overruns which does not provide upfront certainty of their treatment and increasing the focus on revenue determination reopeners.[3] Potentially results in significant financial downside with: • Up to 100% of overruns at risk of being unrecoverable.

[3] National Electricity Rules, 6A.7.1

Options	Consumer risk	TNSP risk	Considerations
			• Remaining overruns—that are deemed not imprudent or inefficient—are penalised at the CESS rate.
Option 3 - Tightening the ex post review criteria with CESS Overruns only considered for RAB exclusion when linked to an egregious investment decision and otherwise they are included in the RAB with the CESS applying	●	●	_Consumer protections_ Consumers benefit from the application of the CESS on all overruns. Consumers are protected from egregious TNSP decisions via the application of an ex post review. _TNSP and investor risk_ TNSPs have a high degree of certainty upfront on the treatment of overruns i.e. unless they have made egregious decisions, the overruns will face the pre-determined CESS penalty rate but not an ex-post review.

Overall the CEFC considers Option 3 delivers the appropriate balance of risk by providing upfront certainty to TNSPs on the basis on which they invest, while retaining the CESS to align TNSP and consumer interests and the ex post review in circumstances where TNSPs have made egregious investment decision. In contrast, we:

- Consider Option 1 places too much risk onto consumers and still subjects TNSPs to uncertainty on the results of an ex post review.
- Acknowledge that Option 2 potentially offers the greatest consumer protection. However, we hold concerns that over the longer term more projects will experience cost overruns given the difficult conditions facing the Australian market, and that TNSPs will be less inclined to deliver ISP projects or will require higher equity returns to do so under this CESS application. In our view this would not be in the long term interest of consumers because actionable ISP projects are critical to transition to a decarbonised electricity sector, promote wholesale market competition, and ensure supply reliability.

Application of the CESS to early ISP projects

Notwithstanding our view that the CESS should apply to ISP project cost overruns, we note that determinations for ISP projects progressed prior to April 2023 were made under version 1 of CESS, which did not contain flexibility to depart from the default 70/30 sharing ratio.[4] In subsequent ISP project determinations, the AER has placed less risk from cost overruns on TNSPs.

There may be a case for the AER to vary the CESS's sharing ratio for ISP projects progressed under version 1 of the CESS because those decisions are not in line with the risk sharing positions subsequently approved by the AER. This could be

[4] AER, *Final decision Transgrid transmission determination 1 July 2023 to 30 June 2028 Attachment 9 – Capital expenditure sharing scheme* p. 5.

facilitated through this guideline review (e.g. by applying the CESS to only a portion of overruns) in accordance with the flexibility afforded to the AER by the new ex post review rules.

C. CESS and incentive to abandon projects

In our submission to the AEMC's *Bringing forward early works to improve transmission planning* rule change, we sought consumer protections in recognition of the additional risks borne by consumers where TNSPs procure early works equipment ahead of completing a RIT-T. A related issue being consulted on now, is ensuring the CESS does not inappropriately encourage NSPs to abandon efficient projects and ensure consumers do not pay incentive rewards to TNSPs in these circumstances. Currently, a NSP that abandons a project would be eligible for a CESS reward on the difference between the project's forecast cost and the expenditure incurred at the time of abandonment.

Application of the CESS to ISP abandoned projects

In general, we consider projects that have sufficiently large cost overruns (e.g. above the original net market benefits), are most likely to be those where the TNSP considers abandonment because there is a high risk for the TNSP incurring financial penalties from the CESS and ex post review.

CESS penalties

As outlined above, we consider it appropriate for the CESS to apply to overruns, which includes for abandoned projects. However, we note projects are more likely to be abandoned after these overruns are known but before they are incurred and so in practice a CESS penalty is unlikely to apply to abandoned projects.

CESS rewards

In our view, TNSPs should not be eligible for CESS rewards, nor the financing benefit associated with unspent capex, for abandoned ISP projects. Our reasoning is outlined in the table below that consider two cases; one where project abandonment is in the interest of consumers and one where it is not.

Table 2 CESS reward considerations

Scenario	Whether a CESS reward is justified
Expected future cost overruns where the project would still deliver net benefits	A TNSP may abandon this project to avoid future CESS penalties and/ or an ex post review. TNSP should not be incentivised (via a CESS reward) to abandon a project that would deliver net market benefits if completed. Additionally, abandoning this project would likely strand the assets already developed, the costs of which may be borne by consumers (discussed further below).
Expected future cost overruns where the project would not deliver net benefits	In this scenario, consumers would be better off from the TNSP abandoning the project. We nevertheless do not consider a CESS reward to encourage the abandonment is required. This is because a TNSP would already be encouraged to abandon the project to avoid facing a CESS penalty on the expected future overruns and / or an ex post review (potentially with tightened application criteria).

Other consumer protections

In addition to not receiving CESS rewards and facing CESS penalties for overruns on abandoned projects, we also consider consumers should be protected from having to pay for stranded assets incurred ahead of a decision to abandon where that decision was not in the interests of consumers.

Where an ISP project is abandoned, the TNSP should be required to demonstrate it was abandoned because the project is no longer in the long term interests of consumers, which should be assessed by the AER. We expect in most cases this would require the TNSP to update the cost benefit analysis performed as part of its original RIT-T. In the absence of this, a TNSP may abandon a project to avoid the CESS penalty it would face from a cost overrun that would be incurred to complete the project. We consider this inappropriate because:

- Consumers would bear costs for a partially completed project that does not provide them with a service or benefit, and yet which remains beneficial if completed.
- TNSPs invested in the project with the upfront knowledge that they faced the CESS risk on overruns and a tightened ex post review which limits their risk. They should be taking the risk of cost overruns (and the measurable impact of a CESS penalty) as a downside sensitivity to their expected project return.

We consider the AER should explore an appropriate complementary measure such as options for excluding part or all of the incurred capex from a TNSPs RAB if the TNSP is unable to demonstrate that project abandonment was in the long term interest of consumers. Alternatively, and if possible preferably, TNSPs could be required to hand over project assets (i.e. long-lead equipment) and intellectual property to another party willing to complete the project and at no more than cost price so that consumers still have an opportunity to benefit from the assets paid for by them, consistent with our submission to the AEMC's *Bringing early works forward to improve transmission planning rule change*.[5]

Application of the CESS to non ISP abandoned projects

A NSP's regular capex program (part of its regulatory determination) differs from ISP projects insofar as it is consists of multiple, smaller projects. During the determination process, NSPs consult with a wide range of stakeholders and seek their views on and support for the flagship projects. The different characteristics of a NSP's regular capex program means, in our view, the CESS does not need be applied in the same way as for ISP projects.

For non-ISP projects, the CEFC considers it remains prudent to have incentives in place for TNSPs to revisit the appropriateness and selection of forecasted projects because forecasting a portfolio of projects more than five years ahead comes with uncertainty of the network's future needs. However, we also consider there are

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[5] CEFC, Submission to the Bringing early works forward to improve transmission planning draft rule change, July 2024

circumstances in which receiving CESS rewards is not appropriate, in particular, where a NSP fails to deliver the outcomes associated with major flagship projects.

Currently, there is not a direct link between stakeholder feedback / support for projects and the outcomes delivered by the NSP. Negative stakeholder sentiment exists in circumstances where the NSP engages on project outcomes, does not deliver the outcomes of the project and then is rewarded for doing so. We consider that NSPs should not receive CESS reward when:

- A flagship or material project, which has been consulted on with stakeholders, is abandoned unless the NSP can demonstrate:
  - The outcomes have been delivered by another (more efficient) means; or
  - A market or rules / regulation change has meant that those outcomes are no longer appropriate to deliver (e.g. a material change in circumstances).

This will:

- Encourage NSPs to deliver the outcomes of projects that have been consulted on with stakeholders and approved by AER.
- Addresses stakeholders' concerns that there is no mechanism to encourage NSPs to deliver the agreed outcomes.
- Continue to encourage NSPs to deliver their overall capex program efficiently and share in the cost savings.

D. Whether a project is substantially complete

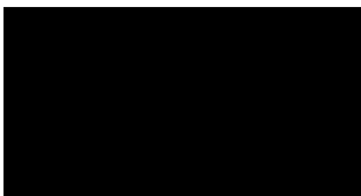
When a project is substantially complete, an ex-post review of the project will be conducted in the next regulatory determination process. The AER is consulting on the characteristics that identify a project as 'substantially complete'.

In addition to considering what constitutes a substantially complete project, the CEFC considers it is appropriate to define when a project is 'complete'. It is not always clear when major ISP projects are complete because of the substantial testing and commissioning requirements that ISP projects undergo, where capacity can be released incrementally over a period. Having a definition of 'complete' is relevant because 'substantially complete' must occur not long before a project is complete.

The AER notes that a TNSP should be required to demonstrate when it considers an actionable ISP project is substantially complete. We consider TNSPs should also be required to substantiate when they consider projects (that are nearing completion) are *not* substantially complete. This will help ensure consumers are not left waiting an additional 5 years for an ex post review to be conducted on a project which was actually substantially complete, but where the TNSP did not make this representation to the AER in order to avoid capex being excluded from its RAB at that time.

We value the opportunity to provide input into this process and look forward to the opportunity to engage further with the AER. Should you wish to discuss this submission further, please contact Frans Jungerth, Associate Director - RTN,

Your sincerely,



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