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Mr Arek Gulbenkoglu
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Australian Energy Regulator
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Melbourne, VIC, 3001
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Dear Arek,

Re: AER's Capital Expenditure Incentive Guideline Review

Marinus Link Pty Ltd (MLPL) welcomes the opportunity to make this submission in response to the AER's consultation paper on its review of its Capital Expenditure Incentive Guideline (the Guideline). The consultation paper discusses the changes that should be made to the Guideline following the AEMC's targeted ex post review rule change. The AER explains that it will also consider additional matters that have been raised by stakeholders since its 2023 review of incentive schemes for regulated networks.

In this submission, we briefly set out some background information on MLPL and other actionable ISP projects before addressing each of the topics raised in the consultation paper. As explained in this submission, MLPL's principal concern is that a default Capital Expenditure Sharing Scheme (CESS) penalty of 30% combined with a targeted ex post review for ISP projects imposes an inappropriately high incentive rate for any overspend amount.

MLPL's view is that the AEMC's targeted ex post review rule change provides the AER with an ideal opportunity to ensure that the incentives regime applying to actionable ISP projects is recalibrated so that it protects the interests of consumers <u>and</u> supports efficient investment. In making this observation, MLPL notes the essential role that actionable ISP projects will play in achieving Australia's transition to net zero by 2050. In this context, the design of the incentive arrangements for actionable ISP projects should have regard to the risks of undermining the investment case for these projects if shareholders are exposed to unacceptable risks.[1] As actionable ISP projects have access to concessional finance, the net benefit to consumers is further enhanced if these projects proceed as planned.

1. Background

As you know, Project Marinus comprises Marinus Link and the North West Transmission Developments[2], which will be progressed by MLPL and TasNetworks, respectively. Marinus Link involves approximately 255 kilometres of undersea HVDC cable and approximately 90 kilometres of underground HVDC cable in

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[1] Section 7A(6) of the National Electricity Law specifically requires the AER to consider this issue.

[2] This component of Project Marinus includes new and upgraded overhead transmission lines that will link Cressy, Burnie, Sheffield, Staverton, Hampshire, and East Cam in Tasmania.

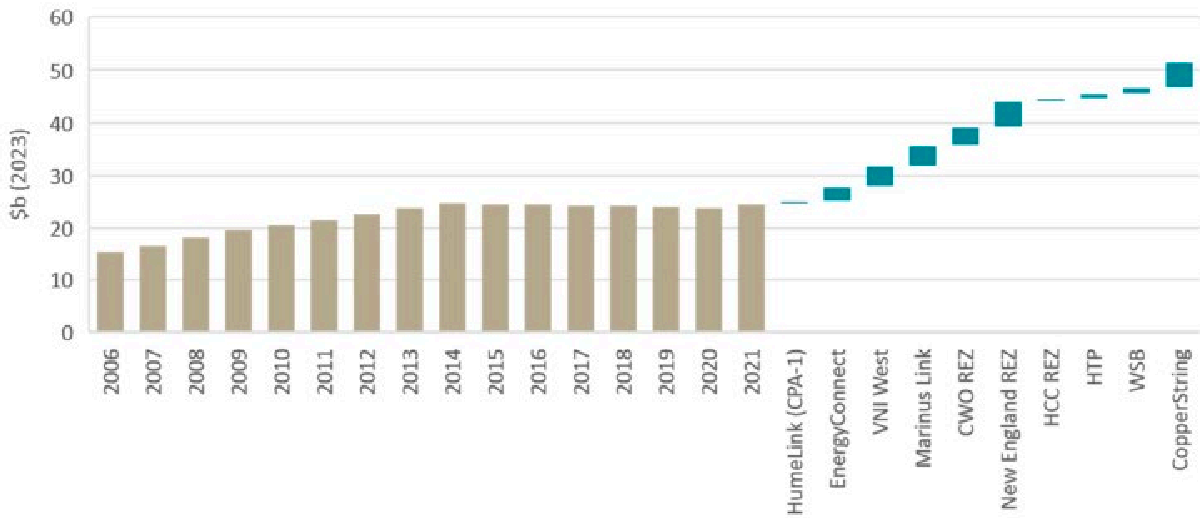
Victoria, converter stations and associated works. Marinus Link will be owned and operated by MLPL, which is owned by the Australian (49%), the Victorian (33.3%) and the Tasmanian (17.7%) Governments. MLPL has progressed its early works activities and recently submitted its Revenue Proposal for the construction of Marinus Link during the 2025-2030 regulatory period.

AEMO made it clear in its 2022 ISP that consumers' interests are best served by the urgent delivery of actionable ISP projects, such as Project Marinus:[3]

> "The schedule of actionable projects lists the earliest practical delivery time AEMO has been advised by the project proponents. Earlier delivery would either be more optimal to deliver benefits to consumers or would provide valuable insurance and guard against other potential delays. All actionable projects should therefore progress as urgently as possible, and state and Commonwealth mechanisms which support earlier progression of projects could deliver earlier benefits or cost savings."

Importantly, actionable ISP projects have fundamentally different risk profiles compared to the capital expenditure ordinarily undertaken by TNSPs and DNSPs. In particular, as major transformation projects the extent of the required expenditure is an order of magnitude greater than routine projects and programs of work. Furthermore, the risk of error in forecasting the capital expenditure requirements is inherently greater for these types of projects. This forecasting risk is exacerbated by the combined effect of the growth in capital expenditure in transmission projects, as Australia transitions to net zero. This latter point is illustrated in the figure below.

Figure 1: Total RAB for TNSPs in the NEM and costs of new committed projects[4]



Given the fundamental differences between actionable ISP projects and routine capital expenditure, it is timely and appropriate for the AER to revisit the incentive framework applying to actionable ISP projects. Specifically, it should not be surprising that the ex post review and CESS mechanisms, which were designed for routine projects and programs of work for TNSPs and DNSPs, are not appropriately designed for actionable ISP projects. MLPL therefore supports change to the existing arrangements to ensure that the

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3 AEMO, 2022 Integrated System Plan June 2022, page 18.

4 Houston Kemp, Capital expenditure incentives applying to Humelink, 29 February 2024, Figure 3-2, page 10.

regulatory framework both protects the interests of consumers and supports the efficient delivery of actionable ISP projects without exposing shareholders to unacceptable and uncontrollable risks. In the remainder of this submission, we respond to each of the topics in the order presented in the consultation paper.

2. Application of the ex post review to actionable ISP projects

The AER's consultation paper discusses two issues that relate to the application of the ex post review to actionable ISP projects:

- Whether the detailed stage of an ex post review, referred to as 'Stage 2', should be modified for actionable ISP projects; and
- How 'substantially completed' should be interpreted in deciding when the ex post review for an ISP project should commence.

In relation to the first issue, MLPL considers that the existing ex post review process should apply to actionable ISP projects without amendment. Accordingly, the minor changes proposed by the AER which recognises that actionable ISP projects are subject to a separate ex post review are appropriate.

In relation to the second issue, the AER has suggested that it would consider a number of factors in deciding whether a project is 'substantially complete', which would trigger an ex post review. We set out below the AER's factors and our response, shown in blue.

(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?

MLPL supports the factor described, but not the example. If an overspend has not occurred, then the ex post review should not be undertaken. An ex post review should only be undertaken if there is evidence that an overspend has already been incurred and that the total capital expenditure for the project is expected to exceed the AER's total capital expenditure allowance.

(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.

MLPL does not support a strict requirement that the only remaining works should relate to commissioning and energisation. In particular, the AER may be able to conduct an ex post review if any remaining construction and commissioning costs are not material and/or can be forecast with a reasonably high degree of confidence.

(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.

MLPL supports this factor, applied 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.

MLPL does not support this factor, as it undermines the rationale for the concept of 'substantially complete'. As noted in response to factor (b), MLPL's view is that the ex post review should be conducted if any remaining construction and commissioning costs are not material and/or can be forecast with a reasonably high degree of confidence.

3. Modifications to the CESS to accommodate multi-period ISP projects

The consultation paper explains that 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. This ensures that a network service provider does not face a penalty above 100% of the inefficient overspend. However, this mechanism is limited to a 5 year ex post review period.

MLPL supports the AER's view that minor changes are required in the Guideline to allow CESS adjustments over multiple prior regulatory control periods following an ISP ex post review.

4. Applying CESS penalties on efficient overspends

In its targeted ex post review rule change, the AEMC highlighted the apparent inequity in applying a CESS penalty in circumstances where the AER finds through its ex post review that the overspend amount is prudent and efficient. Specifically, it seems unreasonable to penalise shareholders for incurring expenditure above the AER's capital expenditure allowance if that expenditure has been reviewed by the AER and found to be prudent and efficient. Furthermore, such an outcome would be even more unreasonable if the AER set an allowance below the TNSP's forecast expenditure, which is typically the case.

While MLPL considers that the AEMC raises an important concern regarding a potential inequity, MLPL supports a continuation of the CESS scheme for actionable ISP projects alongside the targeted ex post review. In reaching this position, MLPL's view is that:

- Capital expenditure should only be excluded from the regulatory asset base if it is obviously inefficient, i.e., the TNSP should be afforded the benefit of any doubt; and
- TNSPs are likely to be more efficient if they face rewards (penalties) for delivering projects at a cost which is lower (higher) than the forecast amount.

Taking these points together, the ex post review and the CESS scheme serve different purposes and should be applied differently. As such, MLPL considers that the CESS scheme has a role to play in relation to actionable ISP projects, even though the ex post review will also provide a powerful disincentive against any inefficient or imprudent expenditure.

The key question for MLPL is not whether the CESS should apply, but whether a default incentive rate of 30% is reasonable for actionable ISP projects that are subject to a targeted ex post review. Our view is that a 30% default incentive rate in these circumstances would not be reasonable, as shareholders would face a 30% penalty rate on any overspend amount that is found to be prudent and efficient.

MLPL's position is that a substantially lower default incentive rate would be more appropriate. Once a new default rate is set, each TNSP should also be able to propose a lower CESS rate in accordance with the current guidelines, having regard to:

- the size of the project;
- the benefit to customers;
- the degree of capital expenditure forecasting risk; and
- stakeholder views.

As described in MLPL's Revenue Proposal – Part B (Construction costs), we have explained why we regard the appropriate CESS incentive rate to be 5% for Marinus Link's construction costs. This proposal reflects the degree of forecasting risk as a single project TNSP without the benefit of any portfolio effect, in addition to the views of our Consumer Advisory Panel.

5. General exclusions and modification of CESS

MLPL notes that in addition to reducing the default incentive rate, it is appropriate that the CESS only applies to costs that are within the TNSP's control. Otherwise, the CESS scheme is likely to produce windfall gains or losses for consumers and TNSPs, as it penalises or rewards TNSPs for differences in forecasting error.

As a general principle, a CESS scheme that is more targeted to costs that are within the TNSP's control should have a more powerful incentive rate compared to a CESS that is less targeted. As noted in the consultation paper, biodiversity offset costs is one example where TNSPs are exposed to costs that are beyond their control. In addition, there may be other costs categories where a TNSP has some control over the outcome, but this degree of control is vastly outweighed by its exposure to forecasting risk. MLPL would prefer a more targeted CESS, and encourages the AER to give serious consideration to removing incentives on TNSPs in relation to costs that are either entirely or very substantially outside the TNSP's control. Rather than specifying which expenditure categories should be excluded from the CESS, the Guideline could instead set out criteria for a TNSP to apply in proposing particular exclusions in its Contingent Project Application or Revenue Proposal. MLPL's view is that it is preferable to provide this additional degree of flexibility in the regulatory framework to improve the overall effectiveness of the incentive arrangements.

6. Incentivising efficient abandonment

The consultation paper highlights a concern raised by the Clean Energy Finance Corporation (CEFC) about the risk to consumers bearing the cost of procuring early works where the project is cancelled. In addition, the AER notes that if a network company receives a CESS reward for abandoning the project, this may incentivise the company to inefficiently abandon a project and could result in a worse outcome for consumers.

In principle, MLPL does not consider that there is any difficulty in a network company receiving a CESS bonus if it completes the early works activities at a lower than expected cost. If a project is abandoned, however, it seems reasonable that the TNSP should not obtain a CESS bonus as a result of not completing the project. MLPL also notes that while there is a theoretical possibility that a TNSP would inefficiently abandon a project to obtain a CESS bonus, that outcome is extremely unlikely to occur in practice.

7. Closing

As noted earlier, MLPL welcomes the AER's review of its Guideline in light of the AEMC's rule change on the targeted ex post review for actionable ISP projects. MLPL supports the continuation of the CESS alongside the ex post review, but it is essential that the default incentive rate is recalibrated to address the interaction with the ex post review, as highlighted by the AEMC. An overarching consideration in relation to the new default rate is the importance of not undermining the incentives for investment in actionable ISP projects by exposing shareholders to unacceptable risks. This observation supports a more targeted CESS with a lower incentive rate. In making this submission, MLPL reiterates its commitment to deliver Marinus Link as prudently and efficiently as possible, for the benefit of consumers.

If you have any questions regarding this submission or would like to meet to discuss, please contact Prajit Parameswar by email [redacted] in the first instance.

Yours sincerely,

[redacted]

Collette Burke
Interim Chief Executive Officer