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Mr Sebastian Roberts
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Email: incentivereview@aer.gov.au

Dear Mr Roberts

Position Paper – Options for the Capital Expenditure Sharing Scheme (CESS)

Thank you for the opportunity to comment on the AER's Position Paper (Position Paper) published on 11 August 2022[1] as part of its incentive schemes review and contribute to the broader review process.

As noted in our submission on the AER's Discussion Paper,[2] we support incentive schemes that reward genuine efficiencies and improvements in service quality. The AER's position paper demonstrates that its incentive schemes have delivered significant benefits to consumers. A key objective of the AER's review should therefore be to maintain strong incentives for transmission network service providers (TNSPs) to continue to deliver efficient outcomes for customers.

We strongly support the AER's views in its Position Paper to:

- **Maintain the CESS** for business-as-usual capex, which has driven efficiency and provided significant benefits to consumers[3]
- **Retain the CESS in its current form with a 30% sharing ratio** as a default, and
- **Require increased transparency** about the differences between actual capex incurred and allowances.

[1] AER, Review of incentive schemes: Options for the Capital Expenditure Sharing Scheme, Position Paper, August 2022.
[2] AER, Review of incentive scheme for networks - Discussion Paper, December 2021.
[3] BAU capex includes all capex other than that required to deliver the Australian Energy Market Operator's (AEMO) Actionable Integrated System Plan (ISP) projects including Project EnergyConnect, HumeLink and Victoria to New South Wales Interconnector West (VNI West). As explained in our Contingent Project Application for Project EnergyConnect, we consider that Actionable ISP projects should not be subject to the CESS given the difficulty in accurately forecasting their costs. This of particular concern in the current inflationary environment. The scale of these projects means that any resulting CESS penalties could have a material adverse impact on cash flows and financeability in future regulatory control periods.

We do not, however, support the introduction of a variable CESS sharing ratio for business-as-usual capex, noting that:

- the principles-based approach would introduce significant uncertainty, which would undermine the incentive power of the CESS, and
- the 'bright line' tests are likely to penalise efficient outcomes and reduce efficiency-related savings passed on to consumers.

We encourage the AER to have specific regard to the circumstances of TNSPs in finalising its position on this proposal. As outlined in our submission to the AER's Discussion Paper there is no evidence that TNSPs are over-forecasting and underspending capex in order to secure CESS rewards.

Further, transmission capex is characterised by large, identifiable project components, which can be reviewed through the enhanced ex-post assessment of CESS benefits that the AER has proposed. This allows for the exclusion of the Australian Energy Market Operator's (AEMO) Actionable Integrated System Plan (ISP) projects from the CESS.[4]

We note that the Position Paper focuses exclusively on the CESS. We encourage the AER to consider any implications arising from its review for Efficiency Benefit Sharing Scheme (EBSS) noting the interaction between the EBSS and CESS. We would also appreciate the opportunity to engage with the AER on our proposed amendments to the EBSS, which are outlined in our submission on the Discussion Paper, and to participate in its future review the STPIS.

We endorse Energy Networks Australia's (ENA's) submission on the Position Paper, which explains why a variable CESS sharing ratio for BAU capex will reduce consumer benefits and is therefore not in the long term interests of consumers. We support the ENA's view that the AER should address the true underlying concerns about the CESS (i.e., information asymmetry between the AER and NSPs) directly, and to recognise that these concerns would not be resolved by weakening the efficiency incentives.

Attachment A provides detailed comments on the AER's proposals for a variable CESS sharing ratio.

We would welcome the opportunity to discuss our submission with the AER.

Yours sincerely

Stephanie McDougall
General Manager of Regulation

[4] These projects include Project EnergyConnect, HumeLink and VNI West.

Attachment A: Comment on variable CESS sharing ratio options

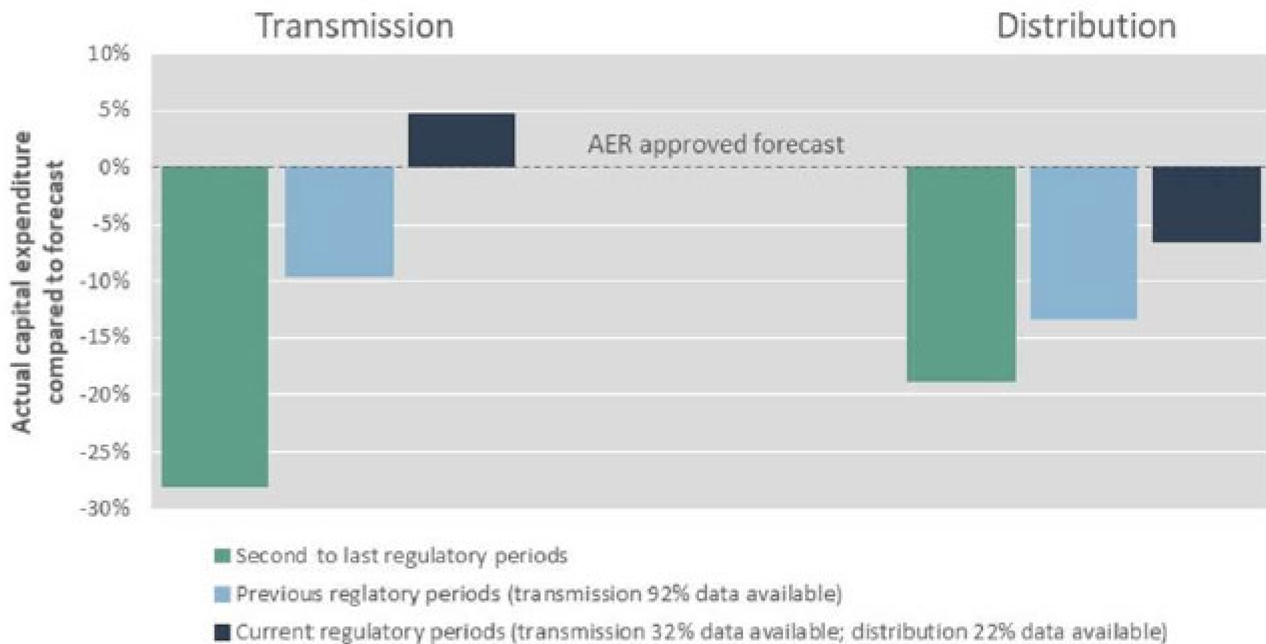
This attachment provides our comments on:

- Whether the case has been made for the introduction of a variable CESS sharing ratio, and
- The variable sharing ratio options that the AER has proposed.

The case has not been made for the introduction of a variable CESS sharing ratio

The Position Paper does not provide substantial new evidence that would support the case for introducing variable CESS sharing ratios. Rather, it shows the narrowing gap between TNSPs allowed and actual capex and that more recently, TNSPs are over-spending their allowances as they are required to deliver major transmission projects.

Figure 1: Actual capital expenditure compared to forecast



Source: AER, Review of incentive schemes: Options for the Capital Expenditure Sharing Scheme, Position Paper, August 2022, Figure 1, p. 9.

The AER Position Paper acknowledges that there is compelling evidence that consumers have benefited from the CESS:

> *…since its introduction in 2013, the data we have collected so far strongly suggests that the CESS has worked well to provide incentives for NSPs to incur efficient capex.*[5]

[5] Position Paper, p. 7.

Further, the Position Paper does not present any clear evidence of widespread 'gaming' of the CESS—for instance, by securing over-inflated capex proposals, in order to generate CESS rewards that do not relate to genuine efficiency gains.

We agree with the AER however, that:

- it is important to identify and isolate capex efficiency savings for the purposes of applying the CESS, and
- inefficient deferrals and exogenous events are excluded from the CESS, noting that the proposed enhanced reporting will further support these arrangements. We do not, however, agree that capex-opex switching is inefficient as this may be the most efficient decision in light of new information and options.

Variable sharing ratio options introduce uncertainty and will reduce consumer efficiency benefits

The Position Paper provides options to apply variable CESS sharing ratios. Under these options, the default CESS sharing ratio of 30% would be reduced to 20% for regulatory proposal of 'concern'. Two possible approaches for determining when the lower sharing ratio would apply are proposed in the Position Paper:

1. **Principles based approach:** This would apply the principles and criteria to determine if a regulatory proposal is of concern. A 20% sharing ratio would then be applied to these proposals.

2. **Bright line test:** This is based on a default 30% sharing ratio. A 20% sharing ratio would apply if the underspend in current period is more than 10% and the capex forecast for the next period is 10% higher than the current period actual, and

We consider that there are significant problems with both of these proposed approaches including the uncertainty that would arise from the principles based approach and the diminished consumer benefits that would result from the bright line test. Given that the AER's fundamental concern is information asymmetry, we note that:

- The variable sharing ratio CESS options do not address this problem and do not represent a proportionate response
- The AER should directly address the information asymmetry problem by applying the Better Resets Handbook, including by seeking more detailed ex post information on capex underspends. If the AER can, through improved transparency, establish that a certain proportion of underspend was not due to genuine efficiency gains, that portion of the underspend could be excluded from the application of the CESS. This would be preferable to applying a lower incentive rate to the whole of the efficiency saving; and
- The application of variable CESS rate options would substantially reduce the incentive power of the CESS and risks penalising NSPs that identify and then realise large efficiency gains. This would in turn incentivise NSPs to moderate savings so as to remain below the 10% threshold.