THE HON CHRIS BOWEN MP
MINISTER FOR CLIMATE CHANGE AND ENERGY

MS23-003135

Ms Anna Collyer
Chair
Australian Energy Market Commission
Level 15, 60 Castlereagh Street
SYDNEY NSW 2000

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Dear ~~Ms Collyer~~ Anna

Please find attached a rule change proposal to amend the National Electricity Rules to introduce a targeted ex post review mechanism for capital expenditure incurred on completed Integrated System Plan projects.

These necessary changes were recommended in the Australian Energy Market Commission's (AEMC) final report for Stage 3 of its Transmission Planning and Investment Review.

I endorse this rule change request and ask the AEMC progress with its initiation.

Yours sincerely

CHRIS BOWEN

Australian Government
Department of Climate Change, Energy, the Environment and Water

Rule Change Request

Managing Integrated System Plan project uncertainty through targeted ex post reviews

December 2023

1. Request to make a Rule

1.1. Name and address of the person making the request

The Honourable Chris Bowen MP
Minister for Climate Change and Energy
Parliament House
Canberra ACT 2600

2. Relevant background

2.1. AEMC Transmission Planning and Investment Review

The Australian Energy Market Commission (AEMC) established the Transmission Planning and Investment Review (TPIR or the Review) to consider how to ensure that the regulatory framework supports the timely and efficient delivery of major transmission projects, while ensuring investments in these projects are in the long-term interests of consumers.

Stage 3 of the Review, which focused on longer term solutions to support timely delivery of major transmission projects, included a recommendation to introduce a targeted ex post review mechanism of capital expenditure (capex) incurred on completed Integrated System Plan (ISP) projects.

The Commonwealth agrees with the AEMC's final position outlined in Stage 3 of the Review and considers that introducing a targeted ex post review of ISP project capex would serve to enhance the regulatory framework.

2.2. The role of ex post reviews of transmission network service providers' capital expenditures

At the beginning of each regulatory control period (5 years) a regulated transmission network service provider (TNSP) provides the Australian Energy Regulator (AER) with its capex proposal for the coming regulatory period. The AER must accept a regulated network business' capex proposal if it is satisfied that the total forecast capex is prudent, efficient, and reasonable, in line with National Electricity Rules (NER) requirements. Once approved, the proposed amount becomes the TNSP's capex allowance for that regulatory period. At the end of a regulatory period, the AER must produce a statement on the prudency and efficiency of all capex to be rolled into a TNSP's Regulatory Asset Base (RAB).

If total capex incurred by the TNSP over the regulatory control period exceeds its capex allowance, a capex overspend has occurred – triggering an ex post review. During an ex post review, the AER reviews whether to exclude the amount of the relevant capex overspend for the previous regulatory control period from being rolled into a TNSP's RAB. This process safeguards consumers against instances of capex inefficiency that may result in higher network tariffs.

3. Statement of Issue

As the size and complexity of transmission projects – specifically those identified in the ISP – grows, there is increased risk and uncertainty regarding costs.

In its TPIR Stage 3 draft report, the AEMC identified that the increased cost risks and uncertainty associated with large transmission projects are driven by:

- Supply chain risks,
- The line route being undetermined at the time of the revenue determination, and
- A lack of information on comparably large projects that makes forecasting costs difficult.[1]

To ensure consumers are adequately safeguarded from costs risks, it is important the current regulatory framework can review capex effectively. In submissions to the AEMC's TPIR Stage 3 draft report, stakeholders raised concerns with aspects of the NER's current overspending review arrangements.[2] These concerns stem from several key issues that impact the effectiveness of the regulatory review process for ISP project capex.

3.1. The NER does not explicitly specify overspending requirements for ISP projects

The current overspending requirement outlined in the NER applies to a TNSP's total capex on all projects within a regulatory control period. While there is no explicit prohibition on the AER reviewing individual project capex within a regulatory period, there is ambiguity regarding its ability to do this in practice.

This creates uncertainty for TNSPs in determining whether non-ISP capex could be subject to exclusion from their RAB if overspend has only occurred on an ISP project. The subsequent regulatory doubt and increased chance of capex overspend may result in inefficient outcomes for consumers as it creates risks outside of a TNSP's control.

3.2. Current high-level guidance on the approach to ex post reviews creates uncertainty for TNSPs

The NER currently requires the AER to provide an outline of how it will make a determination where the overspending requirement is met in its *Capital Expenditure Incentive Guidelines.*[3] However, the AER's proposed approach to an ex post review of ISP projects is currently only included in its *Regulation of actionable ISP projects* guidance note.[4]

The current arrangements make it challenging for stakeholders trying to understand how the AER would consider ISP projects as part of an ex post review. This is because guidance on the application of ex post review arrangements for ISP capex is not required by the NER, nor is the AER required to consult with stakeholders when amending the current regulation of actionable ISP projects guidance note.[5]

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[1] Australian Energy Market Commission, Transmission Planning and Investment Review Stage 3 Draft Report, Sydney, 21 September 2022, p.92-94.

[2] Submissions to the Australian Energy Market Commission's Transmission Planning and Investment Review Stage 3 Draft Report, Sydney, 21 September 2022: Energy Networks Australia, p.9-11; Transgrid, p.5.

[3] Australian Energy Regulator, Capital Expenditure Incentive Guidelines, April 2023, available here.

[4] Australian Energy Regulation, Guidance Note - Regulation of actionable ISP projects, March 2021, available here.

[5] NER clause 6A.20(b)

3.3. The current definition of a "review period" creates challenges for evaluating ISP project capex

Currently, when evaluating how a TNSP's actual capex compares to its forecast allowance when conducting an ex-post review, the AER is limited to looking back across the last five-year review period.

As a result, the AER is unable to effectively review the capex of a particular transmission project if it falls across multiple review periods. This limits the AER's ability to evaluate whether capex overspend has occurred during a major transmission project and, if so, whether this spending is sufficiently prudent and efficient. This undermines the ability for an ex post review to safeguard consumers from paying network costs that are beyond what is in their long-term interests.

While the issues resulting from the definition of "review period" exists for all projects, the nature of ISP projects increases the likelihood of a project spanning multiple review periods. The current inability for the AER to assess the efficiency of overspend on ISP projects increases the risks of overspend and, subsequently, can increase costs for consumers.

Cumulatively, these issues could impact the efficient delivery of ISP projects to the detriment of consumers.

4. Description of the proposed rule

The proposed rule would amend the NER to implement the rule change recommendations contained in the AEMC's TPIR Stage 3 final report. These are:

1. Establishing a separate ex post review of ISP project capex from non-ISP project capex, and
2. Amending the period over which the ISP project capex is reviewed by the AER.

The proposed amendments – which were prepared by the AEMC and accompanied the final report – are attached to this request.

The proposed amendments will improve the current arrangements by ensuring the AER can specifically review potential capex overspend on ISP projects, while also providing a clear and consistent regulatory framework that supports the efficient delivery of transmission projects.

4.1. A targeted ex post review of ISP project capex would reduce risk and promote economic efficiency

A targeted ex post review of ISP project capex would reduce uncertainty and provide a clear regulatory framework that safeguards consumers from paying for inefficient capex. This will be particularly important where large and complex ISP projects in a strained supply-chain environment creates increased risk of capex overspend—with some overspends potentially still reflecting efficient and prudent expenditure.

The amendments to the NER would see the implementation of the following:

- A targeted ex post review of ISP project capex triggered whenever capex incurred on a specific ISP project completed in the review period exceeds the project's forecasted capex,[6] and
- the amount of capex open for exclusion from a TNSP's RAB would be limited to the level of overspend on that project above the ISP project's forecast capex allowance that the AER determines does not meet the capex criteria under the NER.[7]

The AER would have access to complete information concerning project specific capex drivers, management practices and processes when undertaking a targeted ex post review of ISP project capex incurred over the review period. To implement these amendments, the AER would also need to update its *Capital Expenditure Incentives Guidelines* to align with the new process for targeted ex post reviews of ISP projects.

The proposed rule would also clarify the function of non-ISP ex post reviews, including:

- Trigger of ex post review of non-ISP capex where capex incurred on non-ISP projects exceeds forecast capex for all non-ISP projects during the review period,
- The amount of capex open for exclusion from the RAB would be limited to the amount of overspend of non-ISP capex above the forecast capex allowance that the AER determines does not meet capex criteria under the NER,
- The review period for non-ISP ex post reviews would be the same 5-year period as currently specified in the NER.

4.2. Providing clarity around ex post review of ISP projects, including the review period, would increase certainty and transparency

Amending the NER to establish a review period for potential ISP project capex overspend will provide clarity and consistency in the regulatory process. The proposed amendments would introduce the concept of a 'reviewable ISP project' to enable the AER to consider all capex incurred on a completed ISP project and would be defined as:

- An actionable ISP project that has been commissioned and energised within a review period, or
- If AEMO has staged an actionable ISP project, each stage of that project which has been completed within a review period.[8]

To create a specific review period for 'reviewable ISP projects', the NER should also be amended to introduce a new definition of 'ISP project review period'. This definition is:

- the regulatory years, of one or more regulatory control periods, in which capex was incurred in relation to a *reviewable ISP project* – a project that has been completed in the five-year period since the previous ex post review window.[9]

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[6] Proposed clause S6A.2.2A(c1) of the NER.
[7] Proposed clause S6A.2.2A(f) of the NER.
[8] Proposed clause S6A.2.2A(a1) of the NER.
[9] Proposed clause S6A.2.2A(a1) of the NER.

The new review period would include all the years in which capex is incurred for that ISP project, including where the capex is incurred over multiple regulatory control periods or 'review periods' as currently outlined in the NER.

This would also change the AER's approach to RAB adjustments following a targeted review of ISP capex.

4.3. The AER should use the current approach to adjusting a TNSP's RAB following a targeted ex post review of ISP project capex

Under the proposed amendments, the AER may decide that all or part of an overspend on an ISP project is inefficient and should be excluded from the TNSP's RAB, following an ex post review of completed ISP project capex. Inefficient capex overspends occurring in the ISP project review period would not be rolled into the RAB at the end of the review period, and consumers would not fund any of this ISP project capex.

As such, under the proposed arrangements, the AER would make a net present value (NPV) adjustment to the RAB where an inefficient ISP project capex overspend has occurred in the previous regulatory control period. This is because the ISP project overspend incurred in a previous regulatory period would have already been rolled into the RAB at the end of that period – meaning consumers will have funded at least part of this overspend.

In line with its current approach, the AER would make an NPV adjustment to ensure the TNSP does not retain any revenue through the RAB from capex that does not meet the capex criteria. This would ensure consumers are compensated for the delay in the ex post review of overspends incurred in a previous regulatory control period.

Where the AER excludes ISP project capex from the RAB after an ex post review, the existing processes would apply as set out in the AER's *Capital Expenditure Incentives Guidelines.*[10]

There would be no change to how the AER adjusts a TNSP's RAB following ex post reviews of non-ISP capex.

4.4. There should be transitional arrangements to allow time for the amendments to take effect while not disrupting existing projects

As this rule may result in changes to the AER's and TNSP's existing processes, transitional arrangements should be developed to allow for smooth implementation.

The proposed transitional provisions would see:

- The AER to make relevant updates to its *Capital Expenditure Incentives Guidelines* to comply with the new process by the date the substantive changes to the Rules take effect.
- In amending the documents referred to in this rule change request, the AER would be required to follow the appropriate processes specified in the Rules, e.g., the transmission consultation procedure.

[10] New Chapter 11 – Transitional provisions of the NER.

- Amendments to any AER guidelines, etc. would take effect on and from the effective date or any earlier time as specified by the AER.[11]

5. How the proposed rule will address the issue

The proposed rule would create a project specific approach to better accommodate ISP project capex that increases certainty on the approach to the ex post review of TNSPs' capex.

Introducing a targeted ex post review for ISP projects will:

- clarify the ex post review arrangements for both non-ISP and ISP project capex and the time periods over which they occur,
- promote efficient delivery of major transmission projects while ensuring the regulatory framework is fit for purpose, and
- safeguard consumers by making sure they only pay the efficient costs for major transmission investment.

Providing clarity and certainty in the regulatory framework for the AER and TNSPs will also:

- enable the AER to rigorously assess and consider the overall efficiency of capex incurred on specific ISP projects where there has been an overspend, and
- decrease administrative burden for the AER and TNSPs by reducing the effort and time required to gather and assess information and evidence to determine the materiality or efficiency of potential overspend on ISP projects spanning multiple review periods.

6. How the proposed rule will or is likely to contribute to the achievement of the National Electricity Objective

The national electricity objective (NEO), as set out in section 7 of the National Electricity Law, is:

> "to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

(a) price, quality, safety, reliability, and security of supply of electricity; and
(b) the reliability, safety, and security of the national electricity system; and,
(c) the achievement of targets set by a participating jurisdiction –
  i. for reducing Australia's greenhouse gas emissions; or
  ii. that are likely to contribute to reducing Australia's greenhouse gas emissions."

The relevant aspect of the NEO for present purposes is the promotion of efficient investment in electricity services for the long-term interests of consumers of electricity with respect to price, quality, safety, reliability, and security of the supply of electricity.

The proposed amendments to the NER advance the NEO in the following ways:

1. Reviewing the performance of TNSPs on ISP project capex will ensure consumers do not pay unnecessarily high costs for transmission infrastructure due to capex overspend on ISP projects.

[11] New Chapter 11 – Transitional provisions of the NER.

2. Establishing separate review processes for capex on ISP and non-ISP capex will promote a clear, consistent, and predictable regulatory framework and provide transparency to TNSPs, the AER and other stakeholders by clarifying what is and is not subject to review.
3. Clarifying the period ISP project capex will be subject to potential review will provide regulatory clarity and predictability and address any current ambiguity.

7. Expected costs, benefits and impacts of the proposed rule

7.1. Expected benefits

The introduction of a targeted ex post review for ISP projects and associated amendments will improve the AER's ability to assess the capex efficiency of increasingly large and complex projects. The amendments will support a clear, predictable, and repeatable regulatory process for ensuring both ISP and non-ISP project capex is effectively assessed where overspend may have occurred. The amendments will also promote the efficient delivery of major transmission infrastructure by ensuring TNSPs can only recover the efficient costs of these projects.

Furthermore, this rule change will improve the ex post review's ability to effectively safeguard consumers while also reducing administrative burden for the AER and TNSPs when assessing potential overspends on ISP projects that span multiple regulatory control periods.

7.2. Expected costs

The proposed amendments are not expected to impose any significant new costs on TNSPs or consumers.

There may be resourcing implications for the AER during the initial implementation of the proposed amendments and to the extent that it would increase the number of ex-post reviews. However, any additional costs from implementation and additional review work will likely be offset by the benefit of improved review processes, improved consumer protection and minimised regulatory uncertainty.

7.3. Expected impacts

The proposed amendments will impact the AER's existing processes and review of TNSP capex. However, the benefits of a clear and consistent regulatory process are expected to outweigh the potential costs associated with implementation and additional review work. In particular, the benefits of these proposed changes for the protection of consumers are considerable in the context of increasingly large and complex transmission projects required to support the transition.

The proposed amendments may also impact TNSPs who may be subject to more reviews of their capex, where potential overspend has occurred on ISP projects. However, the clarity on how these reviews will work and what will be assessed provided by these amendments will exceed the additional regulatory burden or costs.

Proposed changes to the National Electricity Rules as recommended by the AEMC in Stage 3 of the Transmission Planning and Investment Review

Ex post ISP review mechanism

6A. Economic Regulation of Transmission Services

Part C Regulation of Revenue – Prescribed Transmission Services

6A.5A Capital expenditure incentive mechanisms

(a) The *capital expenditure incentive objective* is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the *Rules*, then the only capital expenditure that is included in an adjustment that increases the value of that regulatory asset base is capital expenditure that reasonably reflects the *capital expenditure criteria*.

(b) The AER must, in accordance with the transmission consultation procedures, make and publish guidelines (the *Capital Expenditure Incentive Guidelines*) that set out:

(1) any capital expenditure sharing schemes developed by the AER in accordance with clause 6A.6.5A, and how the *AER* has taken into account the *capital expenditure sharing scheme principles* in developing those schemes;

(2) the manner in which it proposes to make a determinations under clause S6A.2.2A(a) if the overspending requirement or the ISP overspending requirement is satisfied;

(3) the manner in which it proposes to determine whether depreciation for establishing a regulatory asset base as at the commencement of a regulatory control period is to be based on actual or forecast capital expenditure;

(4) the manner in which it proposed to make determinations under clause S6A.2.2A(i) if the margin requirement is satisfied;

(5) the manner in which it proposes to make determinations under clause S6A.2.2A(j) if the capitalisation requirement is satisfied; and

(6) how each scheme and proposal referred to in subparagraphs (1) to (5), and all of them taken together, are consistent with the capital expenditure incentive objective

(c) there must be *Capital Expenditure Incentive* Guidelines in force at all times after the date on which the AER first publishes the Capital Expenditure Incentive Guidelines under the Rules.

Schedule 6A.2 Regulatory Asset Base

6A.5A Capital expenditure incentive mechanisms

(a) Prior to making a decision on the regulatory asset base for a *transmission system* as required by clause 6A.14.1(5D), the AER may determine under this clause S6A.2.2A that the amount of capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced.

(a1) For the purposes of this clause S6A.2.2A,:

ISP project review period means the *regulatory years*, of one or more *regulatory control periods*, in which capital expenditure was incurred in relation to a reviewable ISP project.

reviewable ISP project means:

(1) unless paragraph (2) applies, an *actionable ISP project* that has been commissioned and *energised* within a review period; or

(2) if an *actionable ISP project* has been staged in accordance with clause 5.22.6(a)(6)(vi), each stage of that project which has been completed within a review period

"**review period**" means:

(1) the immediately previous *regulatory control period* (excluding the last two *regulatory years* of that ~~previous~~ *regulatory control period*); and

(2) the last two *regulatory years* of the *regulatory control period* preceding the immediately previous *regulatory control period*.

(b) The *AER* may only make a determination under paragraph (a) if any of the following requirements is satisfied:

(1) the requirement set out in paragraph (c) (the *overspending requirement*);

(2) the requirement set out in paragraph (d) (the *margin requirement*); or

(3) the requirement set out in paragraph (e) (the *capitalisation requirement*); or

(4) the requirement set out in paragraph (c1) (the *ISP overspending requirement*).

Definitions of overspending, ISP overspending, margin and capitalisation requirements

(c) The overspending requirement is satisfied where the sum of all capital expenditure that is not related to reviewable ISP projects, incurred during the review period, exceeds the sum of:

(1) the forecast capital expenditure accepted or substituted by the *AER* for the review period as such forecast capital expenditure has been adjusted in accordance with clauses 6A.7.1(f) and 6A.8.2(h); and

(2) any capital expenditure that is recovered by way of such part of an *approved pass through amount*, or of a *network support pass through amount*, as is permitted to be passed through to *Transmission Network Users* during the review period less any capital expenditure that is included in a negative pass through amount, or in a *network support pass through amount*, that is required to be passed through to *Transmission Network Users* during the review period.

(c1) The *ISP overspending requirement* is satisfied where the sum of all capital expenditure relating to a reviewable ISP project, incurred during the ISP review period, exceeds the sum of:

(1) the forecast capital expenditure accepted or substituted by the *AER* for that reviewable ISP project as such forecast capital expenditure has been adjusted in accordance with clauses 6A.7.1(f) and 6A.8.2(h); and

(2) any capital expenditure for that reviewable ISP project, that is recovered by way of such part of an approved pass through amount, or of a *network support pass through amount*, as is permitted to be passed through to *Transmission Network Users* during the ISP project review period less any capital expenditure that is included in a negative pass through amount, or in a network support pass through amount, that is required to be passed through to *Transmission Network Users* during the ISP project review period

(d) the *margin requirement* is satisfied where the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) includes capital expenditure that represents a margin paid by the *Transmission Network Service Provider* in circumstances where the *margin* is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms.

Note

This paragraph also applies to capital expenditure relating to reviewable ISP projects.

(e) The *capitalisation requirement* is satisfied where the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) includes expenditure that, under the *Transmission Network Service Provider's* applicable capitalisation policy submitted to the *AER* as part of its *Revenue Proposal*, should have been treated as operating expenditure.

Determinations if overspending requirements or ISP overspending requirement are satisfied

(f) Where the *overspending requirement* is satisfied pursuant to paragraph (c), or the ISP overspending requirement is satisfied pursuant to paragraph (c1), and subject to paragraphs (g) and (h), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced by such amount as the *AER* is satisfied corresponds to ~~capital expenditure incurred~~:

(1) in respect of the overspending requirement - capital expenditure that is not related to reviewable ISP projects, incurred during the review period; or

(2) in respect of the ISP overspending requirement - capital expenditure relating to a reviewable ISP project, incurred during the *ISP project review period*,

that does not reasonably reflect the *capital expenditure criteria*.

(g) The amount determined by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

(2) must be determined in a manner that is consistent with the capital expenditure incentive objective, and

(3) must be determined taking into account the *Capital Expenditure Incentive Guidelines*.

(h) In making a determination under paragraph (f), the *AER* must:

(1) have regard to the capital expenditure factors; and

(2) only take into account information and analysis that the *Transmission Network Service Provider* could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure.

Determinations if margin requirement or capitalisation requirement are satisfied

(i) Where the *margin requirement* is satisfied, and subject to paragraph (k), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced by such of the margin referred to in paragraph (d) as the *AER* is reasonably satisfied would not have been paid if the arrangements to which the margin is referable had been on arm's length terms.

(j) Where the *capitalisation requirement* is satisfied, and subject to paragraph (k), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced by any or all of the amount of expenditure referred to in paragraph (e) which should have been treated as operating expenditure.

(k) A determination made under paragraph (i) or (j) must be consistent with the capital expenditure incentive objective and, in making such a determination, the AER must take into account the Capital Expenditure Incentive Guidelines.

AER may request information and conduct analysis

(l) Nothing in this clause S6A.2.2A is to be taken to preclude the *AER* from:

(1) requiring a *Transmission Network Service Provider* to provide such information; or

(2) from undertaking such analysis,

as the *AER* considers appropriate to enable it to make a statement, with supporting reasons, as referred to in clause 6A.14.2(a).

New Chapter 10 definition

ISP overspending requirement

The requirement set out in caluse S6A.2.2A(c1).

New Chapter 11 transitional provisions

(a) By the effective date, the *AER* must review and, where it considers it necessary or desirable, amend and publish procedures, guidelines and other documents published by the *AER* under the *Rules* to take into account the Amending Rule.

(b) In amending the documents referred to in paragraph (a), the *AER* must follow the process for amending those documents (if any) specified in the *Rules*.

(c) Amendments made in accordance with paragraph (a) must take effect on and from the effective date or any earlier time specified by the *AER*.