AUSTRALIAN ENERGY REGULATOR

Level 25, 32 Turbot Street
Brisbane Qld 4000
GPO Box 3131
Canberra ACT 2601
tel: (07) 3835 4666
www.aer.gov.au

Our Ref: 16719855
Your Ref: ERC0381
Contact Officer: Sophia van der Zant
Contact Phone: (07) 3835 4637

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Anna Collyer
Chair
Australian Energy Market Commission
GPO Box 2603
SYDNEY, NSW, 2001

Dear Ms Collyer

**Re: Managing ISP project uncertainty through targeted ex post reviews**

The Australian Energy Regulator (AER) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) draft determination on Managing ISP project uncertainty through targeted ex post reviews.

The AER broadly supports the draft determination as a means to implement the recommendation from the Transmission Planning and Investment Review to enable the AER to undertake separate, targeted ex post reviews for Integrated System Plan (ISP) and non-ISP project capex.

The draft determination introduces a mechanism to improve the AER's ability to assess the efficiency of ISP and non-ISP projects. Under the current rules, our review is limited to a 5-year review period and ISP projects may cross over multiple review periods. Under the current framework, if there is a material overspend in the first half of an ISP project, we may be unable to distinguish if this is due to the TNSP prudently bringing forward planned work, or if there are material budget increases to the entirety of the project. The proposed new design will allow the AER to look at the entire ISP project period when undertaking an ex post review, therefore improving the AERs ability to assess the efficiency of projects more wholistically. We consider this will support better outcomes for consumers to prevent them from paying for inefficient capex and will create regulatory certainty around the treatment of ISP and non-ISP capex.

In this submission, we outline the current application of ex post reviews and the impacts on existing projects following the proposed rule. This includes the interactions of an ex post review with the Capital Expenditure Sharing Scheme (CESS). The AER recommends the

AEMC include a provision that enables the AER to adjust CESS penalties following an ex post review to ensure TNSPs are not penalised twice for inefficient capex. The submission also outlines AER support for the inclusion of a definition of a reviewable ISP project in the rules and the requirement for the AER to update the Capital Expenditure Incentive Guideline. These measures provide greater clarity and certainty to stakeholders.

**Use and application of ex post reviews**

*Current application of ex post reviews*

The transmission forecast capital expenditure criteria is set out in clause 6A.6.7 of the NER. These provisions guide the AER on how to assess the prudency and efficiency of capital expenditure. When undertaking an ex post review, we must abide by the Capital Expenditure Incentive Guideline to make any decisions on whether to exclude capex overspends from the Regulatory Asset Base (RAB). Section 4.2 of the Capital Expenditure Incentive Guideline states that we may exclude capex above the allowance that does not reasonably reflect the capital expenditure criteria.

*How the proposed rule would apply to existing projects on foot*

The draft determination proposes that the rule change will commence on 1 August 2025. This will mean that any project that has not been subject to an ex post review at that time, will be subject to the new arrangements once the rule commences. If this rule is made, the AER will undertake ex post reviews in accordance with the new rules after this date. Meaning, starting from the next scheduled ex post review, the AER will conduct ex post reviews on ISP and non ISP capex separately, and ISP project related capex will be assessed across the entirety of the ISP project - not just for the previous review period.

*Cost allocation*

In order to undertake these ex post reviews, NSPs will need to provide the AER with ISP and non-ISP related capex. As per the update to our Annual Information Orders, NSPs will be required to report capex as incurred on large projects[1]. As defined in the Orders, a large project is any project that has commenced, where the expected expenditure on the project exceeds a threshold value. This will enable the AER to assess capex related to large projects separately to non-large project capex covering the reporting periods 2024-25 to 2027-28. For any expenditure that has been incurred previously to this reporting period or does not meet the definition of large project, the AER has the ability to request the information through the revenue reset process. With these two mechanisms, the AER is able to adequately review ISP and non-ISP related capex for the purpose of ex post reviews.

**Interaction of an ex post review and the CESS**

As set out in section 2.8 of the Capital Expenditure Incentive Guideline, if the AER makes a determination to exclude capex from a TNSP's RAB after undertaking an ex post review, the AER would also need to adjust the CESS payments to ensure the TNSP is not penalised twice for the same inefficient capex. Currently, the AER may adjust the RAB and CESS payments in respect of the previous five years of any capex overspend (the first three years of the current regulatory control period and the last two years of the preceding regulatory control period). The draft rule will enable the ex post review to go beyond these five years and may include multiple regulatory control periods depending on the length of the ISP project.

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[1] AER, *Networks information requirements review final decision*, 5 April 2024, https://www.aer.gov.au/industry/registers/resources/reviews/networks-information-requirements-review/final-decision

The CESS for TNSPs is outlined in clause 6A.6.5A of the NER, with paragraph (a) providing the meaning of the CESS as a scheme that provides TNSPs with an incentive to undertake efficient capex during a regulatory control period. The use of the phrase “during a regulatory control period” is not explicit on what regulatory control period the capex would be limited to. Therefore, the language of clause 6A.6.5A provides the AER with broad discretion on the development of the CESS that allows for adjustments to capex incurred in multiple previous regulatory control periods, so long as it is consistent with the capex incentive objective defined in clause 6A.5A(a) of the NER.

In order to develop a CESS that will allow for adjustments over multiple regulatory control periods to align with the proposed rule change, the Capital Expenditure Incentive Guideline will need to be updated to set out the amended CESS. As part of the update to this Guideline to reflect the proposed changes to the ex post review, the AER intends to update the Guideline to reflect changes to the operation of the CESS.

However, the current CESS will continue to apply to each TNSP for the current regulatory control period. There is no provision in the NER or the draft rule which permits the AER to amend or remake each TNSP’s revenue determination for the current regulatory control period to apply any amended CESS developed by the AER. This means that for some TNSPs where the AER recently made a revenue determination this year, the AER cannot apply the amended CESS to that business for another 5 years even if the CESS was amended earlier. Further, if the draft rule comes into force, there may be circumstances where the AER may conduct an ex-post review on capex incurred on an ISP project across multiple regulatory control periods, but the AER will not be able to make adjustments to the CESS payments over the entire period in which a TNSP incurred capex on an ISP project. The AER would be limited to the previous five years (which includes the last two years of the preceding regulatory control period) under the current CESS.

In light of the above, the AER consider the AEMC should include a transitional provision that permits each TNSP’s revenue determination for the current and previous regulatory control periods to be amended to the extent necessary to apply any amended CESS developed by the AER for any projects that have not undergone an ex post review. This will enable the AER to have the ability to adjust CESS penalties following an ex post review and will ensure TNSPs are not penalised twice for the same inefficient capex.

We would also like to note that the AER relies more heavily on the overall incentive framework (including the CESS) to drive efficient spending and deter inefficient overspends. The ex post review is considered a last resort mechanism, especially considering these ex post review amendments will potentially occur many years after the capex is incurred, given how long ISP projects may take.

### Definition of a reviewable ISP project

The AER supports the AEMC’s inclusion of the definition of reviewable ISP project within the proposed NER clause S6A.2.2A. This definition clarifies what ISP projects are subject to a targeted ex post review. The terms ‘commissioned’ and ‘energised’ are useful inclusions to clearly identify that a project, or stages of a project, must be completed and can start delivering benefits to consumers. We would not consider staged projects as separate reviewable ISP projects if the staging was for cash flow purposes (for example, an early works project stage) as it would be difficult to assess the efficiency and prudency of a project when the capex attributable to that project would not be reflective of the entire capex on the project. As part of our guidance and guideline updates, we can provide further clarity to stakeholders on staging.

**Updating AER guidance**

The draft determination outlines that the AER must update the Capital Expenditure Incentive Guideline by 1 August 2025. The AER agrees that this is necessary to provide guidance and transparency to stakeholders about how we would undertake a targeted ex-post review within this Guideline. Currently, the AER also includes further guidance on ex post reviews for actionable ISP projects in our Regulation of actionable ISP projects guidance note. We will consider updating this guidance note to reflect the proposed changes made to the ex post review process to ensure our guidance remains consistent and up to date.

We appreciate the transitional provisions 11.XXX.2 that will allow the AER to commence consultation before the Rule Change Final Determination is published. This will provide us with flexibility to manage our processes against other priorities and assist us in updating the Capital Expenditure Incentive Guideline in the required time. We agree with the AEMC that the ongoing resourcing impacts on the AER will be relatively minimal and will fall under similar existing processes for ex post reviews, there will nevertheless be some additional resourcing requirements required across the short term to update the Guideline in line with the final rule change determination.

We thank the Commission for the opportunity to provide input to the draft determination. Should you have any questions about our submission, please contact Sophia van der Zant on 07 3835 4637.

Yours sincerely

K Funston

Dr Kris Funston
EGM Network Regulation

Sent by email on: 24.06.2024