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Dear Arek,

AER's Capital Expenditure Incentive Guideline Review

Transgrid welcomes the opportunity to respond to the Australian Energy Regulator's (**AER's**) draft Capital Expenditure Incentive Guideline (**draft CEIG**), which follows the publication of the AER's consultation paper in February 2025.[1]

As explained in this submission, we support the direction taken by the AER in its draft CEIG, particularly in proposing changes to reduce Capital Expenditure Sharing Scheme (**CESS**) penalties following an ex post review. While these changes are positive, our view is that further guidance and clarity regarding the AER's approach is needed to promote investor confidence, which is critical for supporting timely investment in actionable ISP projects for the benefit of consumers.[2]

The key driver for the AER's guideline review is the AEMC's targeted ex post review Rule change[3], which now creates a situation in which:

- The AER's ex post review concludes that an overspend in respect of an actionable ISP project is prudent and efficient; and
- The AER's CESS imposes a financial penalty on the TNSP in relation to that overspend amount, even though it is prudent and efficient.

[1] For ease of reference, Transgrid's submission to the consultation paper is provided in this link: Transgrid's submission to the AER's consultation paper.

[2] As highlighted by the AEMC in its 2024 Rule determination, Accommodating financeability in the regulatory framework, Rule determination, p.7.

[3] AEMC, Final determination, Managing ISP project uncertainty through targeted ex post reviews, 1 August 2024.

The AEMC recognised that such an outcome would be inequitable and, therefore, required the AER to review its current guideline, as noted below:[4]

> *"To ensure the CESS and the ex post review arrangements do not conflict with each other, it is important that the AER has the ability to adjust how the CESS is applied depending on the outcomes of the ex post review."*

Transgrid's earlier submission to the AER's consultation paper highlighted the detrimental impact on incentives for efficient transmission investment and electricity consumers, if CESS penalties continued to apply following an ex post review, particularly given the current circumstances:

- In its role as the national transmission planner, AEMO has identified the urgent need for transmission investment of $16 billion[5] to meet the needs of electricity consumers and the target emission reductions at the lowest total cost.

- The regulated rate of return assumes a low-risk environment, which is inconsistent with imposing CESS penalties in circumstances where the actual expenditure is found to be prudent and efficient. Applying CESS penalties to efficient capital expenditure would also be contrary to the Revenue and Pricing Principles in the National Electricity Law, which include the requirement that a network service provider should be provided with a reasonable opportunity to recover at least the efficient costs of providing transmission services.[6] This principle supports efficient investment for the benefit of consumers.

- While transmission networks are natural monopolies, this does not mean that project funding is guaranteed. On the contrary, transmission projects in Australia must compete for funding with other investment opportunities, nationally and internationally. HumeLink and VNI West have required the support of concessional finance through the Rewiring the Nation fund to ensure that they can proceed as planned for the benefit of consumers. In the absence of concessional finance, it is highly doubtful that these projects could have achieved the headline return on equity required for a positive investment decision to be made. It would have a detrimental impact on consumers if these types of projects cannot proceed as regulated transmission projects.

- The CESS regime was developed at a time when the networks had a greater degree of control over the decisions on when and where to invest capital. Today, that degree of autonomy has been largely replaced by the actionable nature of the ISP projects.

Given this context, the best remedy to promote efficient investment on behalf of consumers is to remove the application of CESS penalties from actionable ISP projects and large transmission investments. This approach recognises that an appropriately applied ex post review alone provides

[4] AEMC, Final Determination - Managing ISP Project Uncertainty Through Targeted Ex Post Reviews, 1 August 2024, p.19.

[5] Ibid, p. 13.

[6] National Electricity Law, sections 7(2).

sufficiently strong incentives to drive efficient performance. In making this observation, it is worth emphasising that the ex post review exposes equity holders to a 100% loss of any expenditure that is found to be imprudent or inefficient. This risk exposure already provides a powerful incentive on the TNSP's management and Board to ensure that every dollar of project expenditure is incurred prudently and efficiently.

Transgrid also notes the AER's statement that "the CESS provides NSPs with an ex ante incentive to spend only efficient and prudent capex".[7] In the presence of an ex post assessment of prudent and efficiency, however, such an incentive is duplicated which effectively makes the CESS redundant. Similarly, ex post reviews overcome information asymmetry that is sometimes cited as the reason for incentive mechanisms, such as the CESS. This raises a fundamental design question regarding how the CESS and ex post review should work together.

Transgrid, therefore, welcomes that AER's acknowledgment in its draft explanatory statement that there is an inequity in the current framework that needs to be addressed, as noted below:[8]

> "…*it may be unreasonable to apply a CESS penalty where we have undertaken an extensive ex post review of an individual project and found that project to be efficient*."

Transgrid is concerned, however, that the AER's explanatory statement does not discuss the importance of ensuring that the regulatory framework will attract project funding, which is essential to meeting the National Electricity Objective for the benefit of consumers. In particular, the investment case in actionable ISP projects, and other large transmission investments, will be undermined if investors believe that regulation may penalise, rather than reward, company performance that is found to be efficient. The AER does not appear to have recognised this risk because its draft position is that it <u>may</u> reduce CESS penalties in limited circumstance and at the AER's discretion:[9]

> *"…we may in limited circumstances, at our discretion, make an adjustment to the CESS penalty for a reviewable ISP project. This may include reducing the CESS penalty that we have applied, or would apply, to the TNSP under a CESS following an ex post review for the reviewable ISP project.*"

At present, the draft CEIG provides the AER with unbounded discretion as to whether to reduce the CESS penalty and, if so, by how much. Transgrid considers that this approach is contrary to the interests of consumers, as it creates regulatory risk that will undermine the investment case for actionable ISP projects or require higher prices to compensate TNSPs for that risk. Transgrid also notes that the AER's proposed approach only partially addresses the concerns raised by the AEMC by not fully resolving the conflict between the application of the CESS penalties and the ex post review.

[7] AER, Capital Expenditure Incentive Guidelines Review - Draft Guideline, 16 May 2025, section 5.1, p.24.

[8] AER, Capital Expenditure Incentive Guidelines Review - Explanatory Statement, 16 May 2025, p.21.

[9] AER, Capital Expenditure Incentive Guidelines Review - Draft Guideline, 16 May 2025, section 2.8.3, p.11.

As already noted, Transgrid's strong preference is not to apply CESS penalties to any large transmission project where the ex post review finds an overspend amount to be prudent and efficient. As the ex post review currently applies to any material overspend amount, it follows that no CESS penalties should apply. While Transgrid considers that approach best addresses the concerns raised by the AEMC, our earlier submission to the consultation paper identified alternative remedies that would substantially improve (but not eliminate) the problems with the current framework.

Specifically, Options 1 and 2 in that paper[10] examined ways of applying the CESS and ex post review in combination by creating a clear demarcation between the two mechanisms. Transgrid considers those alternative options, which are explained in further detail in the attachment, should be reconsidered by the AER alongside the better approach of not applying the CESS penalty in circumstances where expenditure has been found to be prudent and efficient. Each of these options has merit and the choice between them could be a matter for each TNSP in its Contingent Project Application or Revenue Proposal.[11]

Transgrid notes that the AER has raised a number of other issues in relation to the application of the ex post review to actionable ISP projects, which are also discussed in the attached submission. On these matters, Transgrid is also supportive of the direction taken by the AER which we consider will promote the interests of consumers and enable the mechanisms to operate effectively. Further details regarding Transgrid's position on these additional matters are set out in the attachment.

If you or your staff require any further information or clarification on this submission, please contact Joshua Everson, Senior Manager Regulation, Policy and Advocacy at joshua.everson@transgrid.com.au

Yours faithfully

Monika Moutos

General Manager – Regulation, Policy and Governance

[10] Option 1 adopts a percentage overspend amount, which sets a threshold. The CESS would apply below the threshold and the ex post review above it. Option 2 adopts the same approach but defines the threshold so that the CESS applies to the TNSP's own costs and the ex post review to other costs, including contracted services.

[11] Transitional arrangements would need to apply to existing ISP projects so that an option could be adopted as soon as practicable following the finalisation of the guideline.

1. Introduction

This submission responds to the AER's draft Capital Expenditure Incentive Guideline (**the draft CEIG**), which follows the AER's earlier consultation paper. Transgrid appreciates the significant work undertaken by the AER in developing the draft CEIG and welcomes the opportunity to make this further submission.

As explained in Transgrid's earlier submission to the AER's consultation paper, the key issue for Transgrid relates to the interplay between the CESS and the ex post review that was raised by the AEMC in its targeted ex post review Rule change. Specifically, TNSPs are exposed to penalty payments under the CESS in circumstances where the AER's ex post review has found the expenditure to be prudent and efficient. Transgrid's position is that this outcome is contrary to the long-term interests of consumers as it will undermine the incentives for efficient investment or require TNSPs to be compensated for the risk of expected losses, leading to increased costs for consumers.

It is helpful to reiterate the context for the draft CEIG, which is that there is an unprecedented, urgent need for investment in major transmission projects. In particular, AEMO's 2024 ISP has identified the need for transmission investments of $16 billion to achieve the transition to net zero by 2050 at the lowest cost to consumers. AEMO's analysis shows that these transmission projects will provide very substantial consumer benefits through net savings of $18.5 billion and emissions reductions valued at $3.3 billion.[12]

Transgrid is committed to delivering its share of this investment program, which is unprecedented in terms of scale and complexity, comprising the following major projects.

- VNI and QNI Minor (Delivered)
- EnergyConnect
- HumeLink Stage 1 and 2
- VNI West Stage 1
- VNI West Stage 2[13]
- Sydney Ring North (Hunter Transmission Project)
- Sydney Ring South, and

[12] AEMO, 2024 Integrated System Plan, June 2024, p. 73.
[13] VNI West Stage 2 and the next three projects below are subject to regulatory approvals; securing the necessary land access and environmental; cultural heritage approvals; and final investment decisions.

- QNI Connect.

The key point in our earlier submission is that these projects cannot proceed if the regulatory framework fails to attract project finance. Transgrid's concern is that the investment case for actionable ISP projects is finely balanced, which means that the expected benefits to consumers may not be achievable.

As explained in detail in our earlier submission, as large-scale, complex greenfield projects, the risks in delivering actionable ISP projects are substantially greater than brownfield replacement and augmentation 'business as usual' network projects. At present, there are significant uncompensated risks arising from actionable ISP projects that undermine the investment case. This point is illustrated by the fact that several actionable ISP projects have only been able to proceed with the support of concessional finance from the Rewiring the Nation fund.

The above points have been discussed in detail in our earlier submission and, therefore, are not revisited in the remainder of this attachment. However, we urge the AER to consider the context for the draft CEIG which includes an unprecedented, urgent need for major transmission projects. In particular, Transgrid's view is that the AER should ensure that the regulatory framework provides an environment that is conducive to delivering these major transmission projects, noting that the National Electricity Objective states that:

> "*The objective of this Law is to <u>promote efficient investment</u> in, and efficient operation and use of, electricity services <u>for the long term interests of consumers of electricity</u>…*" (emphasis added)

The remainder of this submission is structured as follows:

- Section 2 discusses the AER's proposal to reduce CESS penalties following an ex-post review, and explains why an alternative solution is required. This section concludes with Transgrid's proposed way forward

- Section 3 comments on the remaining issues that have been raised in the draft CEIG.

- Section 4 sets out Transgrid's concluding comments.

2. Incentives for actionable ISP projects

2.1. Summary of issue and the AER's proposed approach

In its Rule change that introduced targeted ex post reviews for actionable ISP projects, the AEMC concluded that the AER should review the interplay between the ex-post review and the CESS. The AEMC's concern is that:

- The AER's ex post review concludes that an overspend in respect of an actionable ISP project is prudent and efficient; <u>and</u>
- The AER's CESS could impose a financial penalty on the TNSP, despite a positive finding in the ex-post review.

The AEMC commented on the importance of amending this situation so that the operation of the CESS and ex post review mechanisms do not conflict with one another:[14]

> *"To ensure the CESS and the ex post review arrangements do not conflict with each other, it is important that the AER has the ability to adjust how the CESS is applied depending on the outcomes of the ex post review."*

To address this issue, the AEMC introduced a new Rule with the expectation that it would avoid the prospect of TNSPs facing double penalties through the CESS and ex post review or CESS penalties for expenditure that is found to be efficient:[15]

> *"Effectively, the AER would apply a new CESS with a different penalty to ensure a TNSP is not double penalised for inefficient expenditure or penalised for efficient expenditure.*
>
> *Our final rule requires the AER to specify in the Guideline, how any CESS would apply when it makes an ex post review determination either to remove capex from the RAB or not."*

In its draft CEIG, the AER has also recognised that it would be unreasonable to apply a CESS penalty in cases where the expenditure is found to be efficient:

> *"…we recognise that it may be unreasonable to apply a CESS penalty where we have undertaken an extensive ex post review of an individual project and found that project to be efficient."*

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[14] AEMC, Final Determination - Managing ISP Project Uncertainty Through Targeted Ex Post Reviews, 1 August 2024, p.19.

[15] AEMC, Final Determination - Managing ISP Project Uncertainty Through Targeted Ex Post Reviews, 1 August 2024, p.20.

To address this issue, the AER proposes to adjust CESS penalties following an ex post review, but will only do so in limited circumstances and at its discretion, as explained below:

> *"…we consider that this ex post adjustment should be limited to where the overspend is genuinely beyond a network's control and based on unforeseeable factors.*
>
> *In making any adjustment, the AER would have regard to the following factors:*
>
> - *the form of CESS in place for the relevant project*
> - *our findings in the relevant ex post review period*
> - *whether the TNSP has demonstrated it has reasonably managed and prioritised its total capex*
> - *the degree to which the overspend was due to factors beyond the TNSP's control*
> - *other relevant factors.*
>
> *In assessing whether this adjustment should be discretionary, we consider that automatically removing the CESS penalty following an ex post review would not provide sufficient ex ante incentives for TNSPs to undertake efficient capex. As noted by JEC and CEFC, due to information asymmetry it is difficult for us to conclude with certainty the efficiency of all elements of capex overspends. Rather, the ex post review identifies material inefficiencies."*

2.2. Transgrid's comments on the AER's proposed remedy

Transgrid welcomes the AER's confirmation that it would be unreasonable to apply CESS penalties in circumstances where the overspend has been found to be prudent and efficient. This is an important development as it recognises the conflict between the CESS and ex post review that was highlighted by the AEMC's Rule change. Transgrid also notes that allowing CESS penalties to continue to apply in circumstances where the expenditure is prudent and efficient would be contrary to the following Revenue and Pricing Principle in the National Electricity Law, and the interests of consumers:[16]

> *"A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services."*

While the draft CEIG is a significant step forward, Transgrid is concerned that the AER stops short of committing to reduce CESS penalties to ensure that TNSPs are not penalised in relation to efficient expenditure. As a consequence, the 'conflict' that the AEMC highlighted between the

[16] National Electricity Law, sections 7(2).

operation of the CESS and the ex post review may persist in practice if the draft CEIG were adopted. Transgrid's key concerns are summarised below:

- The AER has proposed that it should have broad discretion in relation to the decision to reduce CESS penalties, which means that the conflict between the CESS and ex post review that was raised by the AEMC has not been fully addressed.

- The AER's explanatory statement suggests that a CESS penalty will only be reduced if the increase in costs was caused by 'unforeseeable factors'. It follows that prudent and efficient cost increases would continue to attract CESS penalties if the cost overrun was caused by an event that was foreseeable such as, for example, planning approval delays or bad weather. The concept of foreseeability, therefore, is not aligned with prudency and efficiency and would lead to unwarranted CESS penalties.

- The AER's list of considerations for reducing the CESS, as excerpted on the previous page, contains a test of whether an overspend was reasonably foreseeable or controllable. In applying such a test, the AER is going beyond the hurdles determined by the AEMC in the final rule. Transgrid does not consider this an appropriate course of action.

- In deciding whether a CESS penalty is reduced, the AER proposes to consider whether the TNSP has demonstrated it has reasonably managed and prioritised its total capital expenditure, i.e., including non-ISP capital expenditure. This approach appears to conflict with the AEMC's Rule change because:
    - It would mean that CESS penalties may apply to expenditure that is found to be prudent and efficient, and therefore allow the conflict identified by the AEMC to persist; and
    - The focus of the Rule change is to apply the CESS and the ex post review to each actionable ISP project, whereas this factor takes a contrary position by considering the TNSP's total capital expenditure, i.e. for ISP and non-ISP projects combined.

Transgrid notes that the AEMC has described predictability, stability and transparency as features of good regulatory practice and essential to building investor confidence.[17] The AEMC has also commented on the importance of investment certainty for consumers:[18]

> *"Greater investment certainty for transmission is in the interest of consumers because it supports essential transmission investment to transition to a net zero system."*

[17] AEMC, Accommodating financeability in the regulatory framework, Rule determination, March 2024, p.5 and p.7.

[18] AEMC, Final Determination - Managing ISP Project Uncertainty Through Targeted Ex Post Reviews, 1 August 2024, p.7.

Given the above observations, including the AEMC's statements in its Rule change that instigated the AER's review of the CEIG, Transgrid's view is that the draft CEIG should provide a framework that is more predictable and transparent in relation to the AER's likely approach to reducing CESS penalties. We discuss Transgrid's proposed way forward in the next section.

2.3. Proposed remedy

In Transgrid's submission to the AER's consultation paper, we explained that the best remedy to address the issues raised by the AEMC is to remove the application of CESS penalties from actionable ISP projects. In that submission, we explained that the ex post review provides powerful incentives to drive efficient performance and, therefore, removing CESS penalties following an ex post review would not lead to a detrimental outcome for consumers. In fact, consumers would benefit from this change because, for the reasons outlined by the AEMC, it would provide better incentives for efficient investment by removing the risk of unwarranted CESS penalties. Transgrid takes the view that CESS penalties should also not be applied to any project that is too large for a material overspend to be rebalanced across a TNSP's general capex portfolio within a regulatory period.

Transgrid notes that the AER's draft CEIG comments that:[19]

> *"…automatically removing the CESS penalty following an ex post review would not provide sufficient ex ante incentives for TNSPs to undertake efficient capex."*

As already explained, contrary to the AER's view, Transgrid's experience is that the application of an ex post review provides very powerful incentives to deliver capital expenditure efficiently. Transgrid therefore maintains its earlier position that the best remedy to address the concerns raised by the AEMC is not to apply CESS penalties where an overspend amount is found to be prudent and efficient. As the ex post review currently applies to any material overspend amount, Transgrid's position is that no CESS penalties should apply.

Transgrid also recognises, however, that the AER has thus far reached a different conclusion and, therefore, it is helpful to consider alternative options that would substantially improve (but not eliminate) the problems with the current framework. In particular, Transgrid proposed two options in its earlier submission, that would allow the CESS and ex post review mechanisms to work together without conflict. We recap briefly on those options below.

- **Option 1: A capped CESS combined with an ex post review**

Under this option, the CESS would operate up to the point where total project costs exceed the allowance by 10%. Beyond this point, the CESS would no longer apply. The ex-post review would only apply in relation to any overspend that exceeds the allowance by 10%. So, for a project that has a capital expenditure allowance of $500 million, the CESS would apply up to an overspend of $50 million (10% of the allowance) and the ex post review would only apply to

[19] AER, Capital Expenditure Incentive Guidelines Review - Explanatory Statement, 16 May 2025, p.23.

overspend amounts above that $50 million threshold, i.e., to $20 million if the total overspend amount is $70 million. If this $20 million amount is prudent and efficient, no CESS penalty will apply.

- **Option 2: A targeted CESS combined with an ex-post review**

This option is a variant on Option 1, where the CESS would only apply to costs that are within the TNSP's direct control, i.e. its own project costs. The ex-post review would apply to all other costs, including the contract costs for external service providers.

The purpose of each of these options is to provide a clear demarcation or threshold which defines when each of the CESS and ex post review mechanisms should apply. This approach reduces but does not eliminate the existing conflict between the two mechanisms, where a CESS penalty continues to apply even though the expenditure incurred is prudent and efficient. Under these alternative mechanisms, the clear demarcation between the operation of the two mechanisms means that a CESS penalty only applies in relation to capital expenditure that has not been subject to an ex post review.

This approach adheres to the principle that CESS penalties should not apply to expenditure that is found to be prudent and efficient in an ex post review. Options 1 and 2 also maintain a role for the CESS by imposing a clear demarcation between when the CESS and ex post review should apply. The choice between Options 1 and 2 for future ISP projects should be a matter for each TNSP to propose in its Contingent Project Application or Revenue Proposal.

To give effect to Transgrid's proposed approach, the AER's draft CEIG could be amended as follows:

- The AER's guideline should rely only on the outcome of its ex post review to determine whether the CESS penalties should be reduced, and not the factors currently set out in the draft CEIG.

- The CESS should only apply up to the following threshold, and the ex post review should apply above that threshold:

    - **Option 1**: 10% of the AER's total capital expenditure allowance**; or**

    - **Option 2**: The AER's allowance in relation a TNSP's own project costs, excluding the contract costs and costs beyond the TNSP's control, such as biodiversity costs.

- For each ISP project, the TNSP should propose either Option 1 or 2 as part of its Contingent Project Application or Revenue Proposal, explaining its preference having regard to the interests of consumers. Transgrid would expect to have a preference for Option 2, given its greater alignment to the principle that penalties and rewards should be linked to costs that are within the TNSP's reasonable control.

- In relation to existing ISP projects, transitional arrangements would be required to allow a TNSP to propose either Option 1 or 2 as soon as practicable following the finalisation of the AER's guideline, including for current projects such as PEC. In its proposal, the TNSP would have regard to the particular circumstances of each project, the views of consumers, and the purpose of the CESS as set out in the Rules. The Guideline could require the AER to make a decision in relation to the TNSP's proposal within, say, 60 business days which would allow sufficient time for stakeholder consultation.

Transgrid considers that this approach would provide certainty, predictability and transparency to the incentive arrangements. Transgrid would welcome the AER's further consideration of this approach, particularly noting the challenges identified in relation to the draft CEIG which creates significant uncertainty for all stakeholders regarding its practical application.

3. Other matters raised in the consultation paper

The AER has outlined several other changes in the draft CEIG to align it with the new arrangements for applying ex post reviews to each actionable ISP project, including:

- Separate targeted ex post review for ISP projects and non-ISP projects;
- Reviewable ISP project;
- Modifications to the CESS to accommodate multi-period ISP projects;
- Ex post exclusions for non-ISP projects;
- Incentivising efficient abandonment; and
- Rebalancing the symmetry of the CESS.

We address each of these topics in turn.

3.1. Separate targeted ex post review for ISP projects and non-ISP projects

The draft CEIG explains how it intends to separate targeted ex post review for ISP projects and non-ISP projects, which is a requirement of the AEMC's Rule change. The AER has not provided any further guidance on how it will assess prudency and efficiency for actionable ISP projects, as suggested by Transgrid in its submission to the consultation paper.

While Transgrid would welcome further guidance from the AER on its approach to assessing prudency and efficiency, Transgrid supports the AER's proposed approach to separately applying ex post reviews to ISP and non-ISP projects.

3.2. Reviewable ISP project

In relation to the timing of ex post reviews for actionable ISP projects, the AER has provided guidance on the factors that it will consider in assessing whether a project has been 'substantially completed'. These factors include whether the completed works and costs incurred on the actionable ISP project, or stage of an actionable ISP project, are a sufficient representation of the likely overall capex outcome. The AER explains that the TNSP will be responsible for proposing whether a project should be treated as 'substantially completed', and therefore subject to an ex post review if there has been a material overspend.

Transgrid supports the AER's proposed approach. In particular, by relying on the TNSP to make a proposal regarding each project, it allows the particular circumstances to be considered in assessing whether the project is substantially completed.

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

The current CESS Guideline includes a mechanism to reverse any CESS penalty for capital expenditure that is subsequently found to be inefficient as part of an ex post review. This ensures that a TNSP does not face a penalty above 100% of the inefficient overspend amount. This mechanism, however, is limited to a five-year ex post review period. The AER's draft CEIG includes amendments to allow CESS adjustments over multiple prior regulatory control periods following an ex post review for an ISP project.

Transgrid supports the proposed approach, and welcomes the AER's clarification that the calculation of the CESS benefit reversal will be calculated to account for the time value of money. Transgrid also supports the AER's proposal to only conduct ex post reviews where the project capex overspend is significant.

3.4. Ex post exclusions for non-ISP projects

In relation to non-ISP projects, the AER explains that TNSPs may be penalised for undertaking more projects than forecast in its Revenue Proposal, even where the AER may ultimately find these projects to be prudent and efficient in an ex post review. To address this issue, a CESS exclusion will apply where there is an efficient increase in the TNSP's scope of works, and the incurred capex is not accounted for in a contingent project application, cost pass through application or a reopener.

However, the AER's draft position is that it will only consider allowing ex post exclusions in limited circumstances at its discretion, and sets out a number of factors that it will consider in exercising that discretion. For the reasons outlined in section 2 of this submission, Transgrid considers that the AER should commit to reducing the CESS penalty in circumstances where the overspend is shown to be prudent and efficient. While Transgrid accepts that the AER will need to examine each case on its merits, there is no reason for the AER to apply CESS penalties in circumstances where cost increases have arisen from scope changes.

3.5. Incentivising efficient abandonment

Under the AER's current CESS framework, if a TNSP chooses to not undertake a project, the TNSP would receive a CESS reward. Transgrid supports the AER's approach, which corrects this potential anomaly.

3.6. Rebalancing the symmetry of the CESS

The AER's explanatory statement raises the possibility that CESS bonuses should be removed if they are found not to reflect efficiency savings. Specifically, the AER comments that there may be instances where the uncertainties in forecasting may benefit network service providers. If a network service is rewarded because of forecasting error, the AER notes that this may lead to a windfall gain for the network service provider, with no tangible benefits to consumers.

These observations lead the AER to seek views on whether any additional changes are required to balance the proposed changes in the draft CEIG that target overspends and related CESS penalties. For example, by introducing a means for the AER to adjust CESS rewards in certain circumstances i.e. where the rewards do not reflect efficiency gains and may not provide benefit to consumers.

Transgrid does not support adjustments to CESS bonuses to remove benefits that the AER considers, after the event, to be unrelated to efficiency gains. Such an approach will undermine the incentive arrangements, contrary to the interests of consumers, by casting doubt on whether the network company will be able to retain bonus payments for achieving cost savings. It will also increase the regulatory burden as it will inevitably lead to a forensic examination of the reasons for cost savings.

In Transgrid's view, the better approach is to design the CESS scheme so that it is unlikely to produce windfall gains or losses. An approach that allows bonuses to be removed will undermine incentives to achieve efficiency improvements, as network service providers will have less confidence that it will be able to retain cost savings.

4. Concluding comments

The most significant issue to be considered by the AER under the current scope of the review is the interplay between the ex-post review and the CESS. Transgrid's fundamental position is that TNSPs should not be subject to CESS penalties for capex overspends that are found to be prudent and efficient in an ex post review. As explained in this submission, while Transgrid welcomes the AER's confirmation that it would be unreasonable to apply CESS penalties, further guidance and clarity regarding the AER's approach is needed to promote investor confidence, which is critical for supporting timely investment in actionable ISP projects for the benefit of consumers.

Transgrid therefore urges the AER to reconsider Options 1 and 2, as detailed in our earlier submission to the AER's consultation paper, which will ensure that each incentive mechanism operates in a way that can be understood by investors, stakeholders and consumers. These options also adhere to the principle that CESS penalties should not apply where capital expenditure has been assessed as being prudent and efficient. On that basis, the CESS should only apply to overspend amounts that are not subject to the ex post review.