INCENTA
ECONOMIC CONSULTING

Memorandum

To:	Marinus Link Pty Ltd
From:	Jeff Balchin
Date:	19 December 2025
Subject:	CESS for Marinus Link construction – comment on the supplementary draft decision

1. Introduction and summary

1.1 Background

1. The AER has recently released a supplementary draft decision in relation to the Marinus Link project,[1] which addressed, amongst other things, the incentive rate that should be applied within the Capital Expenditure Sharing Scheme (CESS) during the construction period for the project. The AER's supplementary draft decision is to apply the following incentive rates within the CESS:

   a. an incentive rate of 30 per cent on under-spends or over-spends up to 10 per cent of the regulatory allowance, and

   b. an incentive rate of 10 per cent applying to under-spending or over-spending beyond this.

2. Marinus Link Pty Ltd (the project proponent, "MLPL") has asked me to make brief comments on the AER's proposal. I have provided two previous comments on this matter at the request of MLPL during this proceeding, which I refer to here where relevant.[2]

1.2 Summary of comments

3. In my view, the AER's proposed incentive rate is substantially higher than what is likely to be the optimal rate during the construction of a project like Marinus Link. The incentive rate the AER has proposed is likely to generate outcomes that are adverse to the long term interests of customers, both in relation to how Marinus Link is delivered, as well as by setting a precedent for future ISP projects and adversely affecting investment.

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1 AER (2025), Supplementary Draft Decision Marinus Link Stage 1, Part B (Construction costs) Electricity Transmission Determination 2025–30, November.

2 Incenta Economic Consulting (2025), Application of the capital expenditure sharing scheme to the Marinus Link project, July; Incenta Economic Consulting (2025), Memorandum - CESS incentive rate during the construction of Marinus Link, October.

4. In particular, I note that the AER's reasoning when arriving at its proposed incentive rates:

   a. references the "standard" incentive rate for energy networks, which is essentially an arbitrary value that is of no relevance to major greenfield transmission projects like Marinus Link

   b. reflects an underappreciation of the factors that distinguish Marinus Link (and similar ISP projects) from standard network projects, both in the costs and benefits of financial incentives and when assessing whether ex post review is likely to provide an effective discipline

   c. quotes customer views as justification for its positions, but without properly analysing and interpreting those views within the requirements of the National Electricity Rules.

5. In addition, whilst the supplementary draft decision states that the proposed incentive rate is consistent with the HumeLink decision, this is not correct. Whilst the proposed incentive rate is similar to the actual incentive rate that was foreshadowed in the HumeLink decision, it is materially higher than the incentive rate that is calculated using the method that was described in the HumeLink decision.[3]

6. Lastly, I noted in my earlier report that the AER's decision also appeared out of step with how similar projects were treated elsewhere, with an incentive rate of 15 per cent or lower being the norm for similar projects in other incentive regulation jurisdictions.[4] Since writing that report, I have become aware that Ofgem is proposing (for the next regulatory period, RIIO 3) to substantially reduce the incentive rate applicable for transmission projects to a level that is materially lower than the AER has proposed, and indeed not dissimilar to what I (and MLPL) proposed, in particular:[5]

   a. a 25 per cent incentive rate within a band of ± 5 per cent

   b. a 5 per cent incentive rate for the next ± 10 per cent (i.e., out to ± 15 per cent underspends or overspends), and

   c. zero incentive rate ("i.e., cost pass through"[6]) beyond ± 15 per cent underspends or overspends.

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3 I also note in the body of this memorandum that (i) the AER's benchmarking against HumeLink does not take into account the much lower risk allowance account the AER has proposed for Marinus Link (this is relevant because the risk allowance will affect the outcome that is expected from a given incentive rate), and (ii) the fact that Marinus Link will receive concessional equity finance, which in turn would likely increase its responsiveness to financial incentives (and make it less able to bear a penalty) than an otherwise equivalent project/firm.

4 Ofgem set an incentive rate of 15 per cent for the RIIO 2 regulatory period for projects for which Ofgem did not have high confidence in the cost estimate. In New Zealand, 15 per cent is the standard incentive rate for transmission projects and an application can be made for a lower incentive rate where appropriate.

5 Ofgem (2025), RIIO-3 Draft Determinations – Electricity Transmission, July, p.170.

6 Ofgem (2025), RIIO-3 Draft Determinations – Electricity Transmission, July, p.170.

7. Indeed, Ofgem's new proposals – and the reasoning underpinning them – deserve serious consideration by the AER and would in my view provide a materially better incentive scheme than the AER's proposal. I elaborate upon these below.

2. Elaboration

2.1 Logic behind the incentive rate

8. As noted above, the AER's discussion links the incentive rate for Marinus Link during the construction period to the standard rate that is applied for electricity networks (30 per cent). However, as I have explained previously,[7] this rate is essentially arbitrary as it has no economic justification, especially in relation to Marinus Link.

   a. The rate itself was originally an estimate of the incentive rate that was the outcome of the incentive scheme for operating expenditure, with the objective being to align the incentive rates between operating and capital expenditure. However, the incentive rate under the operating expenditure scheme is now much lower given the fall in discount rates over the intervening period.

   b. In any event, as there is no operating expenditure during the construction period, neutrality of incentive rates is irrelevant.

9. In addition, while the AER identifies some of the features that distinguish ISP projects from standard transmission projects that are relevant to the incentive rate (namely the substantially higher cost uncertainty for ISP projects, and the absence of diversification benefits across a portfolio of projects), the AER omits consideration of several key factors, namely that:

   a. for standard transmission projects, TNSPs can manage the risk of a CESS penalty simply by deferring non-essential projects, whereas this risk management device is not available in relation to an ISP project – this benefit is substantial and additional to the diversification benefits that are available for standard transmission projects[8]

   b. the incentive scheme for ISP projects has a much narrower focus than the schemes that apply to standard transmission activities (i.e., encouraging the efficient administration and oversight of contracts for the delivery of the ISP project, rather than encouraging a step change in overall business performance) and can be achieved with a low incentive rate,[9] and

   c. the AER's view that ex post review will not provide an effective discipline on MLPL's cost management drew on the AER's previous conclusions in relation to standard transmission projects, and did not consider the factors (such as the much more narrow focus of MLPL's activities during construction) that mean ex post review will be far more feasible – and so effective at encouraging efficiency – in

7 Refer to Incenta 2, para.5.
8 Refer to Incenta 2, para.9.
9 Refer to Incenta 2, para.10 and Incenta 1, paras.52-53.

relation to ISP projects (and Marinus Link in particular) than for standard transmission projects.[10]

10. A fuller consideration of the factors that distinguish ISP projects (and Marinus Link in particular) from standard transmission projects should lead to a conclusion that a lower incentive rate than the AER has proposed is appropriate.

2.2 Potential for perverse incentives

11. The main detriment the AER identifies from an overly high incentive rate is that this may affect the incentive to invest. However, equally, it is possible that the AER does not believe that there is a material risk to Marinus Link being delivered given the government backing for the project, including concessional finance, and so has downweighted this concern. It is important for the AER to understand that the potential for an unduly high incentive rate to generate adverse outcomes for consumers is broader than the AER may appreciate.

    a. First, the AER's decision in relation to Marinus Link will influence expectations for other ISP projects, which would be within the context where ISP projects already face substantial issues (noting their size and profile of cash flows) in terms of obtaining finance. Thus, an excessive incentive rate in relation to Marinus Link has the potential to create an impediment to the energy transition.

    b. Secondly, even in relation to Marinus Link, an excessively high penalty for overspending may encourage MLPL to act in a manner that is not in the long term interests of consumers, for example by:

        i. closing its mind to value adding opportunities if they involve additional expenditures and/or

        ii. cutting back on expenditures that, whilst very important, may not be essential to the delivery of the project, such as stakeholder / community focussed expenditures.

2.3 Views of consumers

12. The AER's principal reasons for retaining a 30 per cent incentive rate for a band was because this was favoured by customers. However, it is important for the AER to analyse carefully the positions of consumers and ensure that their input is applied in a manner that is most consistent with the regulatory framework.

13. My reading of the customers' submissions was that their preference for a high incentive rate arose principally because:

[10] Refer to Incenta 2, para.10 and Incenta 1, para.61.

a. of a desire for the TNSP to share some of the risk that the efficient cost may be higher than forecast – which, as I explained in my earlier report, is not the purpose of the CESS as defined in the rules nor a sensible allocation of risks,[11] and

b. a view that it is more likely than not that the efficient cost of the project will be higher than forecast – which is more of a comment on the AER's expenditure allowances than the efficient incentive rate.[12]

2.4 Consistency with the Humelink decision

14. Part of the AER's reasoning was that the incentive rate it proposes outside of the high-powered zone (i.e., 10 per cent incentive rate for underspending or overspending beyond ± 10 per cent) is consistent with (or similar to) the HumeLink decision. The relevance of this would appear to be that its proposed rate should have been anticipated (rather than being well-founded in economic principles). I can confirm, however, that the incentive rate of 10 per cent is certainly not how I had interpreted the HumeLink precedent.

a. It is correct that the 10 per cent incentive rate is similar to (although slightly higher than) the 9.83 per cent incentive rate that was foreshadowed in the HumeLink decision.

b. However, the HumeLink decision set out a method for deriving the incentive rate that would differ across ISP projects (the method being to set the incentive rate at the average of the natural incentive rate experienced during a regulatory period from an equal increase in costs in each construction year). In one of my previous reports, I observed that the HumeLink method produced an incentive rate of 5.9 per cent for Marinus Link, with the lower rate reflecting MLPL's lower WACC than HumeLink and that construction is forecast to occur over the entire 5 years of the regulatory period.[13] This observation does not seem to have been considered by the AER in the supplementary draft decision.

15. In addition, the outcome of the CESS for any regulated business will depend upon both the incentive rate that is applied, as well as the adequacy of the expenditure allowance. To this end, I note for completeness that the risk allowance the AER has proposed for the construction of Marinus Link is materially less than that provided in relation to HumeLink (approximately 6 per cent of project cost for Marinus Link compared to approximately 10 per cent of project cost for HumeLink). All else constant, this difference in the expenditure allowance would imply that the same incentive rate across both projects would imply a higher likelihood (and expected magnitude) of a penalty under the CESS in relation to Marinus Link than it would for HumeLink.

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11 Refer to Incenta 1, paras.43-49.

12 This view would appear to be the mirror of the strong aversion that customer groups expressed to high incentive rates in the immediate post-privatisation era. In that case, efficiency gains were considered easy to make so that a reward would be almost guaranteed.

13 Refer to Incenta 1, para.89.

16. Lastly, any benchmarking of incentive schemes between HumeLink and Marinus Link assumes that the projects are otherwise equivalent in terms of their likely responses to financial incentives and capacities to absorb potential financial penalties. However, I observed in my previous report that Marinus Link is a special case in that it will receive concessional equity (i.e., as well as concessional debt).[14] The receipt of concessional equity means that Marinus Link will have less of a "buffer" in its cash flows (i.e., its return on equity will be lower), which would be expected to increase its responsiveness to financial incentives and lower its capacity to absorb financial penalties. Moreover, I also observed that Marinus Link's method of financing is different to that of ordinary firms (i.e., where the AER sensibly applies a benchmark approach) because customers will be the direct beneficiaries of Marinus Link's lower cost finance. I concluded that this factor would justify a lower incentive rate for Marinus Link than an otherwise equivalent project. This argument does not appear to have been responded to by the AER.

2.5 Precedent – the new Ofgem incentive rate

17. Lastly, I noted in my earlier report that the AER's decision also appeared out of step with how similar projects were treated elsewhere, with an incentive rate of 15 per cent or lower being the norm for similar projects in other incentive regulation jurisdictions.[15]

18. Since writing that report, I have become aware that Ofgem is proposing (for the next regulatory period, RIIO 3) to substantially reduce the incentive rate applicable for transmission projects, in particular:[16]

    a. a 25 per cent incentive rate within a band of ± 5 per cent

    b. a 5 per cent incentive rate for the next ± 10 per cent (i.e., out to ± 15 per cent underspends or overspends), and

    c. zero incentive rate ("i.e., cost pass through"[17]) beyond ± 15 per cent underspends or overspends.

19. This set of incentive rates that Ofgem proposes for the RIIO 3 regulatory period are materially lower than the AER has proposed, and indeed not dissimilar to what I (and MLPL) have proposed.

20. It is clear from Ofgem's reasoning that its proposal to set a lower incentive rate reflected the greater cost uncertainty over the next regulatory period (noting that the UK is also experiencing a substantial extension of its transmission network) and a resulting intention that the incentives would be intended to do less (i.e., have less of a focus on encouraging a step increase in business efficiency).

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14 Refer to Incenta 1, paras.63-66.

15 Ofgem set an incentive rate of 15 per cent for the RIIO 2 regulatory period for projects for which Ofgem did not have high confidence in the cost estimate. In New Zealand, 15 per cent is the standard incentive rate for transmission projects beyond a range and an application can be made for a lower incentive rate where appropriate. Within the range of the P30 to P70 costs the incentive rate is zero.

16 Ofgem (2025), RIIO-3 Draft Determinations – Electricity Transmission, July, p.170.

17 Ofgem (2025), RIIO-3 Draft Determinations – Electricity Transmission, July, p.170.

21. Similarly, Ofgem's view was also influenced by its finding that the transmission businesses would have much less control over costs than had been the case during previous regulatory periods (i.e., given the substantial expansion of the UK transmission network that is expected), which included a desire for each transmission business's risk exposure to be subject to a clear and transparent cap, much like I proposed:[18]

> *We consider that this stepped approach will ensure that TOs have an exposure to cost overruns that is commensurate with the risks that they are able to manage, whilst retaining a strong incentive to keep costs efficient when they are in control of those costs. It also provides for a capped and transparent level of exposure to cost overspends, providing investors with certainty of a worst-case scenario.*

22. In my view, Ofgem's new proposals deserve serious consideration by the AER and would in my view provide a materially better incentive scheme than the AER's proposal.

[18] Ofgem (2025), RIIO-3 Draft Determinations – Electricity Transmission, July, para.5.200.