

Review of incentives schemes: Options for the Capital Expenditure Sharing Scheme

Position paper

August 2022

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Contents

1	Introduction	2
2	About the CESS	3
2.1	Objective	3
2.2	Rule requirements	3
3	Stakeholder views on the CESS	5
4	Discussion	7
4.1	Genuine efficiency gains	7
4.2	The incentives provided by the CESS	10
4.3	Increased transparency	12
5	CESS options	14
5.1	20 per cent sharing ratio	14
5.2	Variable sharing ratio	14
6	Preliminary views and questions	16
7	Next steps	17

Request for submissions

We, the Australian Energy Regulator (AER) invite interested parties to make written submissions on this discussion paper for our review of expenditure incentive schemes for network service providers. Please provide submissions by 5pm AEST **9 September 2022**.

Submissions should be emailed to incentivereview@aer.gov.au. Alternatively, you may mail submissions to:

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We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. We will treat submissions as public documents unless otherwise requested. All non-confidential submissions will be placed on the AER's website. For further information regarding the AER's use and disclosure of information provided to it, see the ACCC/AER Information Policy.

We request parties wishing to submit confidential information:

- clearly identify the information that is the subject of the confidentiality claim
- provide a non-confidential version of the submission in a form suitable for publication.

1 Introduction

In December 2021, we commenced a review of the Capital Expenditure Sharing Scheme (CESS) and the Efficiency Benefit Sharing Scheme (EBSS) with a discussion paper. We received submissions in response to the discussion paper in March 2022.

Much of the focus of submissions has been on the CESS. To further develop our position on the CESS ahead of our draft decision, this position paper sets out our preliminary views on how the CESS may be changed. Our position on the EBSS will be outlined separately in the draft decision.

This position paper should be read together with our discussion paper and will be used as the basis for a workshop which we will convene in late August 2022. We invite comments either through submissions to this position paper and/or our workshop. All of this will contribute to a draft decision which we plan to release in October 2022.

Our preliminary views are:

- the CESS should not be abolished because it has been successful in providing incentives to NSPs to incur efficient capex
- to retain the CESS in its current form with a 30 per cent sharing ratio, however, we recognise that there may be a case to change the CESS to introduce a variable sharing ratio with a 30 per cent default rate that may be lowered to 20 per cent, to be assessed against certain criteria
- to require NSPs to be more transparent about the reasons for differences between actual capex incurred and our approved forecasts in preceding regulatory control periods and proposed forecasts in regulatory proposals.

Our review of incentive schemes is one part of our broader program to incrementally improve our approach to regulation. These are reflected in our 'tilt' priorities outlined in our Strategic Plan for 2020–25 and includes:

- Our *Better Resets Handbook Toward Consumer Centric Network Proposals* (the Better Resets Handbook). This is designed to strengthen the reputational and procedural incentives on electricity networks in preparing their regulatory proposals and engaging with customers.
- Our review of incentive arrangements for export services.

In addition, we continue to report annually on electricity network performance and benchmarking outcomes. The information in these reports helps inform our assessment of the performance of incentive schemes and in practice imposes reputational incentives on NSPs.

2 About the CESS

2.1 Objective

The objective of the CESS is to provide electricity distribution network service providers (DNSPs) and transmission network service providers (TNSPs) (collectively, NSPs) with an incentive to undertake efficient capex during a regulatory control period. It achieves this by rewarding NSPs that outperform their capex allowance and penalising NSPs that spend more than their capex allowance. The CESS also provides a mechanism to share efficiency gains and losses between NSPs and network users.

Without a CESS, a NSP will face incentives under the regulatory regime to achieve capex efficiencies, however, these incentives will decline over a regulatory control period. If a NSP makes an efficiency gain in the first year of a five-year regulatory control period any benefit will last for four more years before we update the RAB for actual capex. In the final year however, the benefit will be close to zero. This may lead to inefficient capex and inefficient substitution of opex for capex towards the end of a regulatory control period.

The CESS complements the rewards a NSP would already receive for an efficiency gain so the total benefit of an efficiency gain to a NSP will be the same in each year. The CESS also provides symmetric incentives in that the reward for an efficiency gain is equal to the penalty for an efficiency loss of the same quantum. The CESS was first implemented with a 30 per cent sharing ratio, which at the time, balanced the incentives between the CESS and the EBSS.

2.2 Rule requirements

How the CESS is currently applied is set out in the Capital Expenditure Incentive Guidelines.¹ The same framework that applied to us in developing the Capital Expenditure Incentive Guidelines applies to any changes that we may make to the CESS.

In summary, any changes we may make to the CESS must be:

- done so in a manner that will or is likely to contribute to the achievement of the National Electricity Objective
- consistent with the capital expenditure incentive objective, taking into account the capital expenditure criteria, the capital expenditure factors and the capital expenditure sharing scheme principles.²

In particular, we must take into account:

- that NSPs should be rewarded or penalised for improvements or declines in the efficiency of capex

¹ AER, *Better Regulation, Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013.

² NEL, s 16(1)(a); NER, cl 6.4A, 6.5.7, 6.5.8A, 6A.5A, 6A.6.7(c) and 6A.6.5A.

- that any rewards and penalties should be commensurate with the efficiencies or inefficiencies in capex, but rewards and penalties do not need to be the same
- the interaction of the CESS with any other incentives the NSP has to undertake efficient capex or opex
- the capital expenditure objectives, and if relevant, the operating expenditure objectives.³

³ NER, cll 6.5.8A(c), 6.5.8A(d), 6A.6.5A(c) and 6A.6.5A(d).

3 Stakeholder views on the CESS

In response to the discussion paper, we received submissions from network, consumer group and retail stakeholders. We have also sought views from Energy Consumers Australia and the Public Interest Advocacy Centre.

Generally, consumer groups remain sceptical about whether, and the extent to which, consumers have benefited from the efficiency gains that the CESS has rewarded. They have asked for more transparency about incentive payments and capex underspends, and for us to reconsider how the CESS is, or should be, applied.⁴ Specifically, consumer groups have submitted:⁵

- concerns about whether the capex underspends reported by networks represent genuine efficiency gains rather than the result of previous over-forecasting and capex deferrals
- more needs to be done to assess the results of the CESS (including by way of benchmarking against other countries where rate of return regulation is applied) and the networks should be required to explain, as part of their regulatory proposals, the difference between the previous forecast and actual expenditure in the previous regulatory control period
- we should encourage 'honest' forecast capex proposals, by reducing incentive payments to networks, or adjusting the sharing ratio between networks and consumers, in response to inaccurate forecasts
- we should consider not applying the CESS at all.

Retail stakeholders have also raised concerns about the extent to which capex underspends represent genuine efficiency gains. They have also encouraged us to continue to improve how we apply the CESS.⁶

Conversely, the networks do not support changing the CESS (including changing the incentive rate or applying a tiered sharing ratio).⁷ Rather, the networks have strongly supported retaining the CESS in its current form, for the following reasons:

- the HoustonKemp analysis estimates the CESS has delivered \$2.9 billion in benefits to consumers so far

⁴ Consumer Challenge Panel, *Submission to the AER on Review of Incentive Schemes Discussion Paper*, 11 March 2022 (CCP Submission); Network of Illawarra Consumers of Energy, *AER Review of Expenditure Incentives*, January 2022 (NICE Submission).

⁵ CCP Submission, pp 25-30; NICE Submission, p 13.

⁶ Origin Energy, 11 March 2022; Red Energy, 17 March 2022.

⁷ Energy Queensland, 11 March 2022; CitiPower, Powercor, United Energy, Jemena and SAPN, 24 June 2022; CitiPower, Powercor, United Energy, 11 March 2022; TransGrid, 11 March 2022; TasNetworks, 10 March 2022; Jemena, 11 March 2022; Evoenergy, 11 March 2022; Essential Energy, 11 March 2022; Energy Networks Australia, *Review of incentive schemes, Response to AER Discussion Paper*, 15 March 2022; Endeavour Energy, 11 March 2022; Energy Networks Australia TNSP CEOs, 11 March 2022; AusNet Services, 11 March 2022; Ausgrid, 11 March 2022

- there is currently insufficient evidence to justify a change given the CESS has only been applied for one regulatory control period, and any changes should only be entertained after applying the CESS for another regulatory control period
- to better inform consumers, we should focus our existing information gathering powers (through the annual regulatory reporting process and during the regulatory determination process), together with how we apply the Better Resets Handbook
- the current CESS sharing ratio is required to maintain a balanced incentive framework and is required to motivate management effort to seek further efficiencies.

The networks have also submitted that changing the CESS does not appear to address the perception of over-forecasting that could not otherwise be addressed by our existing information gathering powers. The concern of networks is that changes to the CESS may instead lead to the unintended consequence of punishing high-performing networks and discourage underspending and ultimately delivering efficiencies.⁸

⁸ CitiPower, Powercor, United Energy, 11 March 2022, pp 5-7.

4 Discussion

There are two principal competing considerations concerning the CESS.

Firstly, by its design, the CESS has the potential to reward a NSP for an underspend that is not the result of genuine efficiency gains.

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

The key question before us now is whether CESS rewards for underspends that are not genuine efficiency gains outweighs the incentives the CESS has provided to date for NSPs to incur efficient capex. Or more pointedly, whether the CESS remains fit for purpose.

In considering this question, we have considered whether:

- the underspends the CESS rewards are genuine efficiency gains, or the result of forecast error, and accordingly how much consumers may have benefitted
- the NSPs are becoming more efficient over time
- the non-recurrent nature and lump nature of capex, which is more pronounced in transmission capex, has any implications about how the CESS should be applied differently to the EBSS.

4.1 Genuine efficiency gains

The CESS works well if all underspends represent genuine efficiency gains. However, the extent to which an underspend that results in a reward payment to a NSP under the CESS genuinely reflects an efficiency gain, or is the result of forecast error, can be difficult to ascertain.

This is due to the information asymmetry that exists between the regulator (us) and consumers on the one hand, and the regulated (the NSPs), on the other. However, the level of information asymmetry between us and the NSPs inevitably reduces over time as we progressively better understand how each NSP operates in practice. That said, we recognise that by definition, a forecast capex allowance that we determine is efficient for a NSP to incur can never be a fully accurate representation of what a NSP might need to incur during a regulatory control period. Nor can such an allowance ever be said to be completely devoid of any forecast error. In practice, this means that the CESS will reward a NSP for an underspend irrespective of whether that underspend is the result of genuine efficiency gains or forecast error on our part. If a NSP is rewarded because of forecast error, this erodes the benefits of the CESS for consumers. At one extreme, if the forecast errors are large enough, consumers may be worse off because of the CESS: the quantum of the CESS payments to an NSP may exceed the efficiency gains made.

Improvements in accuracy of forecasts

The extent to which forecast errors made on our part is a problem that must be viewed in light of the improving overall accuracy of our forecasts over time and the reduction of the information asymmetry between us and the NSPs. Lower forecast error is the corollary of

more accurate forecasts. This has been the result of our significant investment in the regulatory tools over the years that we use to assess and determine an NSP's capex and opex forecasts, which are now well-developed. This includes:

- applying our replacement capex (repex) model to forecast replacement costs by asset category based on the age profile of assets, revealed replacement rates and revealed unit costs which allows us to benchmark and compare unit costs and replacement rates across NSPs
- using revealed unit costs to forecast connections and augmentation expenditure
- adjusting CESS payments for deferrals that we identify
- similar to opex, applying a base, step and trend approach for IT and vehicles
- subjecting particular capex project to detailed engineering reviews
- our guidelines on Distributed Energy Resources Integration expenditure, actionable integrated system plan projects and replacement modelling for transmission that emphasises the need for economic risk-based planning
- relying on market tested outcomes for major projects where possible (for example, for TransGrid's component of the South Australia to New South Wales interconnector, we used tendered costs as the basis for our forecast).

Our Better Resets Handbook further supplements these tools. The Better Resets Handbook provides reputational incentives for NSPs to improve their processes and regulatory proposals by establishing principles for good regulatory proposals and better consultation with consumers. In particular, the Better Resets Handbook sets out our clear expectations on the process, and what constitutes and is required, of a proper proposed capex forecast. Meeting these expectations is part of reducing the level of information asymmetry that exists between the NSPs and us.

The improvements in the accuracy of our forecasts over time is shown in Figure 1. Figure 1 compares the level of aggregate distribution and aggregate transmission capex under or overspending over the last two full regulatory control periods, and the current regulatory control period.⁹

⁹ For DNSPs, the current regulatory period is 2021-25 for VIC, QLD and SA, and 2020-24 for NSW and ACT. The previous regulatory control period is 2016-20 for VIC, QLD and SA, and 2015-19 for NSW and ACT. The second to last regulatory control period is 2011-15 for VIC, QLD and SA, and 2010-14 for NSW and ACT.

Figure 1: Actual capital expenditure compared to forecast

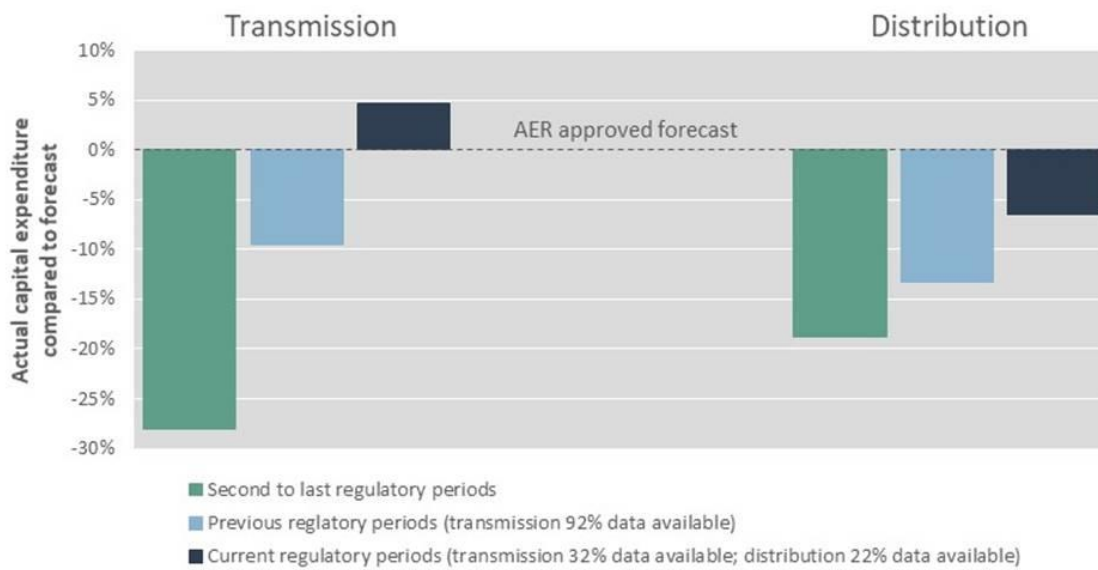


Figure 1 shows that NSPs underspending relative to our forecasts has reduced significantly over the three regulatory control periods. For DNSPs, the average underspend has fallen from around 18 per cent in the first regulatory control period to around 7 per cent now. For TNSPs, an underspend of some 28 per cent in the first regulatory control period is now an overspend of around 5 per cent (despite transmission being generally harder to forecast because it is less recurrent and has more project ‘lumpiness’ with significant major projects including new interconnectors).

However, whilst the accuracy of our forecasts has improved overall over time, this improvement has not been equally realised for each NSP. This can be seen in Table 1, which sets out each DNSP’s underspending:

- in the last full regulatory control period (column 2)
- compared to our final decision for the previous regulatory control period (column 3)
- compared to how much the network proposed in the following regulatory control period (column 4).

Table 1: Capex expenditure compared to AER forecast by distribution network

DNSP	Underspend in previous regulatory control period	Final decision compared to actuals in previous regulatory control period	Initial proposal compared to actuals in previous regulatory control period
AusNet Services	-15%	-18%	-14%
CitiPower	-32%	3%	49%
Jemena	-23%	9%	7%

Powercor	-14%	0%	24%
United Energy	-22%	17%	58%
SA Power Networks	-16%	-5%	2%
TasNetworks	7%		29%
Evoenergy	2%	-8%	-3%
Ausgrid	-16%	-5%	6%
Endeavour Energy	-6%	9%	8%
Essential Energy	-16%	-6%	-5%
Energex	-12%	-21%	-20%
Ergon Energy	-3%	-24%	-8%
All distribution networks	-13%	-18%	-14%

Notably, there is a wide disparity between networks in their initial proposals. Column 4 shows that some networks proposed a significant step up in capex compared to what they actually incurred in the previous regulatory control period, and similarly that our final decision was significantly lower than some of the networks' initial proposals (column 4).

For example, Powercor, United Energy and CitiPower, all underspent significantly in the previous regulatory period and then requested a significant step up in capex. In Powercor's case, it underspent against its pole replacement forecast, and then asked for a step up because of the poor condition of the remaining poles.¹⁰ In contrast, AusNet Services underspent its capex in the previous regulatory period and then proposed a further step down in spending. AusNet Services went through the NewReg trial and consulted heavily with its customers in forming its regulatory proposal. The end outcome was unambiguously positive for customers on its network.

Our experience in making the final decisions for Victorian DNSPs suggests that we have the tools available to provide reasonable capex forecasts. However, the Victorian experience also highlights variability in the quality of proposals and the level of consumer engagement undertaken in developing the proposals.

4.2 The incentives provided by the CESS

Consumers have benefited from reductions in network expenditures and revenues over time.

These reductions have occurred progressively as we have assumed responsibility for regulating distribution networks from 2008. We made our first regulatory determinations for New South Wales and the Australian Capital Territory in 2009, followed by Queensland and South Australia in 2010 and Victoria in 2011. As shown in Figure 2, there have been significant reductions in capex, opex and revenue per customer since 2011.

Figure 2: Revenue and expenditure electricity distribution networks, 2005-06 to 2020-21

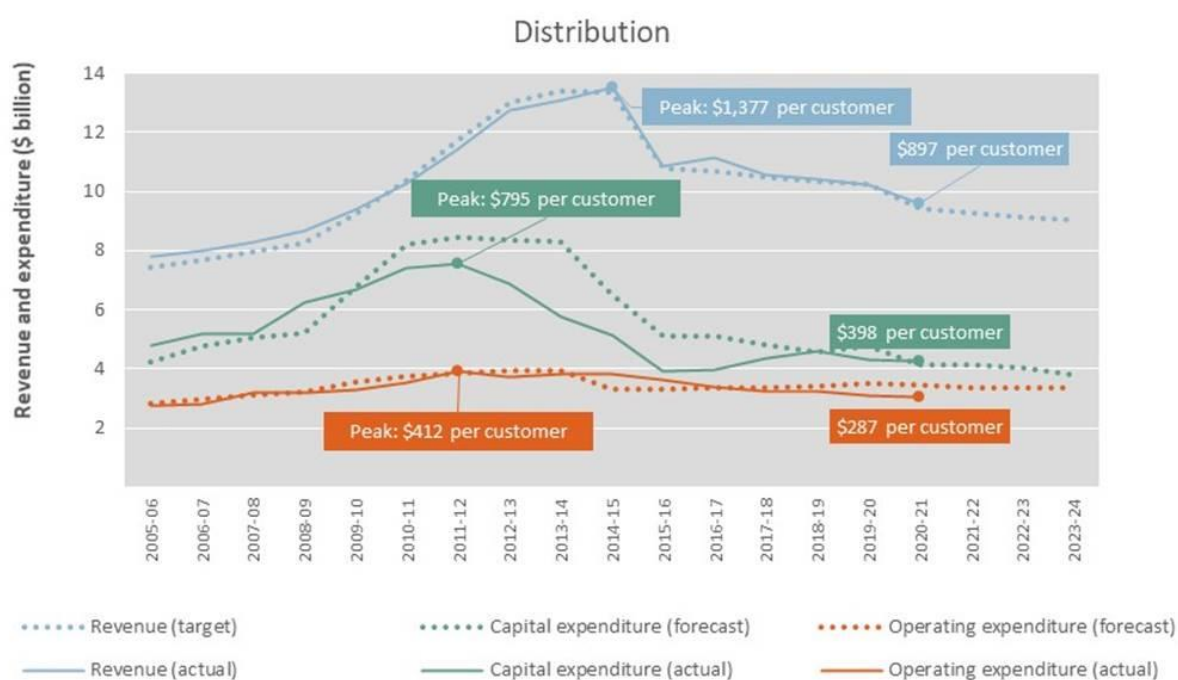
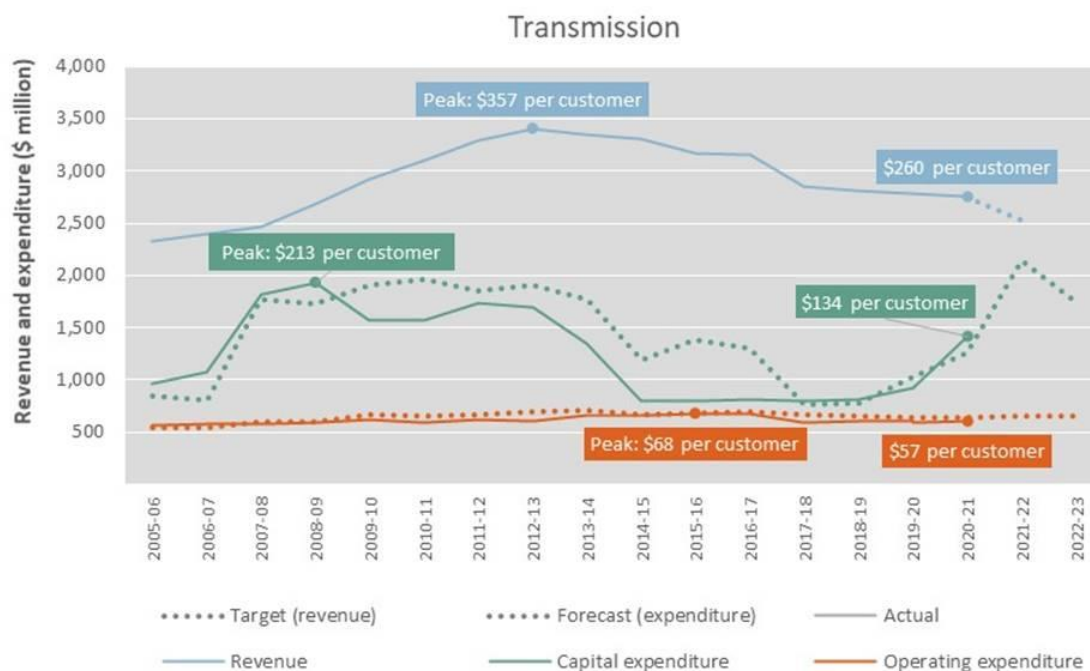


Figure 2 also shows that the capex incurred by DNSPs per customer has steadily reduced and was 50 per cent lower in 2020-21 in comparison to its peak in 2011. And before the capex peak in 2011, capex grew faster in New South Wales where there was no CESS or comparable incentive scheme at the time. By contrast, capex incentives schemes operated in Victoria and South Australia, and despite there being similar demand growth, capex in these states was much more stable.

A number of factors have contributed to the efficiency gains. This includes the application of the CESS, flattening demand growth (which has reduced augmentation requirements) and the privatisation of networks in New South Wales. Whilst we are unable to determinatively identify the extent to which these improvements over time can be attributed to the CESS, in our view, the CESS was a significant factor and has provided the NSPs with strong incentives to achieve efficiency gains.

Figure 3 shows the revenue and expenditure over time for TNSPs. As is the case with DNSPs, capex incurred by TNSPs has fallen over time and is 37 per cent lower in 2020-21 than its peak in 2008-09. However, it must be kept in mind that transmission capex is more variable than distribution capex due to the lumpiness of major transmission projects. For example, the recent increase in transmission capex has been driven by large transmission projects including the \$2.3 billion South Australia to New South Wales interconnector.

Figure 3: Revenue and expenditure electricity transmission networks, 2005-06 to 2020-21



4.3 Increased transparency

As we discussed above, due to the information asymmetry between NSPs and us, a key issue is that the CESS rewards underspends irrespective of whether that underspend is the result of genuine efficiency gains or forecast error on our part. In our view, a clear case exists for NSPs to be more transparent about the reasons for any differences between actual capex incurred and our approved forecasts in a given regulatory control period. In addition to the criteria set out in the Better Resets Handbook about what we expect from a robust capex forecast in a regulatory proposal, there is also a clear case for NSPs to explain how actual capex outcomes in one regulatory control period relate to that any proposed forecasts in a regulatory proposal for the following regulatory control period.

In its submission, the CCP proposes new requirements for NSPs to explain the difference between forecasts and outcomes. It recommends:

Recommendation: Businesses should be required to provide a credible narrative to explain why their outturns differed from regulatory decisions. This would go some way towards giving stakeholders better information to support their understanding regarding whether and to what extent incentive payments are justified. We recommend that these narratives should be published as part of the networks' price submissions. They should be subject to public scrutiny, and should be used to judge the quality of the network's proposal for the next regulatory period.

A good narrative regarding what has happened in the current regulatory period and how that has informed what is being proposed for the upcoming regulatory period would confirm the network's commitment to customers, and its credibility as an efficient manager of network services.

Increased transparency will help consumers and the regulator assess efficiency performance and assist in understanding reset proposals. It may also support the reputational incentives faced by networks. Our preliminary position is to revisit how we better use our information gathering powers to solicit from NSPs:

- clear explanations for why actual expenditure incurred by a NSP departs from a forecast capex allowance we have determined in a given regulatory control period and how any such departure is to be explained in light of a capex proposal in a regulatory proposal for the following regulatory control period
- where capex projects or programs have been deferred from one regulatory control period to the next, the reasons why
- the extent to which changes beyond the control of a NSP, including regulatory obligations, customer demand, and environmental issues may be relevant.

Case to change the CESS

Taking into account our views on the matters discussed above, namely:

- the CESS will reward a NSP for an underspend irrespective of whether that underspend is the result of genuine efficiency gains or forecast error on our part
- despite the accuracy of our forecasts has improved overall over time and the reduction in forecast errors, this improvement has not been realised for each NSP
- consumers have benefited from reductions in network expenditures and revenues over time, in part due to the CESS
- a clear case exists for NSPs to be more transparent about the reasons for any differences between actual capex incurred and our approved forecasts and that proposed in a regulatory proposal,

as we further elaborate in the next section, there may be a case to change the CESS.

5 CESS options

Our preliminary position is to retain the CESS in its current form with a 30 per cent sharing ratio. However, for the reasons set out above, there may now be a case to revise the CESS. This section outlines the two options for how the CESS may be changed that we are considering:

- lowering the sharing ratio from 30 per cent to 20 per cent
- introducing a new variable sharing ratio with a 30 per cent default ratio that may be lowered to 20 per cent.

5.1 20 per cent sharing ratio

The CCP has suggested a lower 20 per cent sharing ratio because of forecasting error.¹¹

There is a trade-off for consumers if we lower the CESS rate. A lower CESS rate reduces incentives for efficiency and management effort devoted to reducing costs. Longer term this is likely to translate to higher capex and a higher regulatory asset base. On the flip side consumers won't pay as much in incentive payments. The trade-off may be a short versus longer term one where lower CESS payments reduce prices now at the cost of higher costs in future.

We do not have sufficient data to determine how much efficiency effort will change with lower sharing ratios and whether consumers will in aggregate be better off. However, the CESS, as it stands seems to have delivered significant efficiency gains and forecasting errors have fallen to relatively low levels. Accordingly, we see the 30 per cent sharing ratio as being effective so far.

5.2 Variable sharing ratio

Another option is to introduce a new variable sharing ratio. By default, we would apply the CESS to a NSP with a 30 per cent sharing ratio. However, in circumstances where the expenditure behaviour of a NSP in a previous regulatory control period compared to that which it proposes in its regulatory proposal raises concerns for us (regulatory proposal of concern), we would apply the CESS with a 20 per cent sharing ratio. This would encourage these NSPs to improve the quality of their regulatory proposals.

We note the CCP's concerns about forecast errors and suggest addressing this by adopting variable incentive rates which targets regulatory proposals of concern. The reason for suggesting a 20 per cent sharing ratio for regulatory proposals of concern is that it is materially lower than the 30 per cent sharing ratio but still high enough to provide meaningful incentives. In nominating the 20 per cent sharing ratio we have drawn on the CCP's submission.

11

A key question here is how we would identify which NSPs should be subject to a lower sharing factor as part of applying the CESS in their regulatory determination. We could either adopt a principles-based approach or a 'bright line' test.

Principles-based approach

A principles-based approach would involve assessing a NSP against certain principles and criteria to determine whether we should apply a 20 per cent sharing ratio. These principles and criteria could draw on the Better Resets Handbook. In particular, the capital expenditure expectations set out in the Better Resets Handbook, including:

- Top-down assessments which compare capex forecasts with actuals in the current reset period.
- Evidence of rigorous decision making, for example cost benefit assessments, capex/opex trade-offs and application of risk management standards.
- Genuine consumer engagement on capex proposals.

We would then exercise our judgement to assess whether a regulatory proposal against the principles to determine whether it is a regulatory proposal of concern. Those networks that are on the early signal pathway are more likely to satisfy the capex expectations.

For completeness we have other tools to address regulatory proposals of concern, including our ex-post assessment of CESS benefits and more intensive scrutiny of capex forecasts. We would use these tools in conjunction with adjustments to the sharing ratio.

Bright line test

An alternative approach is to use a 'bright line' test to determine when we should apply a 20 per cent sharing ratio. Two examples of a bright line test are:

- a 20 per cent sharing ratio would apply where a NSP underspent by more than 10 per cent in the previous regulatory control period and in its regulatory proposal sought an increase of more than 10 per cent compared to its actual expenditure in the previous regulatory control period, or
- a 30 per cent sharing ratio would apply for underspending up to 10 per cent in the previous regulatory control period and a 20 per cent sharing ratio rate would apply to any underspending in excess of 10 per cent.

A variation on the second of these examples has been proposed by some NSPs in discussions with us.

A bright line test in this context is necessarily arbitrary. However, it has the advantage of transparency and predictability.

6 Preliminary views and questions

For the reasons discussed above in this position paper, our preliminary views are:

- to require NSPs to be more transparent about the reasons for differences between actual capex incurred and our approved forecasts in preceding regulatory control periods and proposed forecasts in regulatory proposals.
- the CESS should not be abolished because it has been successful in providing incentives to NSPs to incur efficient capex
- to retain the CESS in its current form with a 30 per cent sharing ratio, however, we recognise that there may be a case to change the CESS to introduce a variable sharing ratio with a 30 per cent default rate that may be lowered to 20 per cent, to be assessed against certain criteria.

Questions:

- Do you think the case has been made out to change the CESS by introducing a variable sharing ratio?
- If you consider a variable sharing ratio should be introduced:
 - (1) should we adopt a principles-based approach or bright line test for determining when a 20 per cent sharing ratio would apply?
 - (2) are there any other alternative bright-line tests that may be appropriate?
 - (3) what other criteria would be appropriate if we apply a principles-based approach?

7 Next steps

The AER is running a workshop on the CESS on 26 August. We invite stakeholders to attend and participate.

We invite submissions in response to this paper by 9 September 2022. We will take submissions into account in our Draft Decision which we plan to release in October.

Following another round of submissions we will release a final decision by April 2023.