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Friday, 5 February 2021

Mr Mark Feather
General Manager, Policy and Performance
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email: TIRreview@aer.gov.au

Dear Mr Feather

RE: AER's draft guidance note to support efficient delivery of actionable ISP projects

ERM Power Retail Pty Ltd (ERM Power) welcomes the opportunity to respond to the Australian Energy Regulator's (AER's) draft guidance note (draft guidance) on the regulation of actionable Integrated System Plan (ISP) projects.

About ERM Power

ERM Power (ERM) is a subsidiary of Shell Energy Australia Pty Ltd (Shell Energy). ERM is one of Australia's leading commercial and industrial electricity retailers, providing large businesses with end to end energy management, from electricity retailing to integrated solutions that improve energy productivity. Market-leading customer satisfaction has fuelled ERM Power's growth, and today the Company is the second largest electricity provider to commercial businesses and industrials in Australia by load[1]. ERM also operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, supporting the industry's transition to renewables.

http://www.ermpower.com.au
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General comments

ERM is generally supportive of Section 2 and Section 4 of the draft guidance, which provide useful information for TNSPs submitting a contingent project application (CPA) to the AER. In particular, the focus on undertaking activities to manage risks and increase cost certainty is sensible. However, we suggest that rather than 'encourage', the AER should 'expect' "the TNSP to adopt consistent cost categories across the RIT-T and CPA stages for the project, where possible"[2]. This would:

- assist stakeholders to compare costs between the two processes
- help to hold TNSPs accountable for cost increases
- potentially allow for a future assessment of the accuracy of RIT-T cost estimates, and the extent to which this resulted in projects being approved that wouldn't otherwise have been the preferred RIT-T option.

ERM generally supports the concept of multiple CPA stages as described in Section 3 of the draft guidance. However, as with many of the stakeholders who provided feedback in November 2020, ERM is concerned with

[1] Based on ERM Power analysis of latest published information.
[2] AER, *Draft guidance, Regulation of actionable ISP projects*, 20 December 2020, pp 5

significant cost increases from the finalised RIT-T to the CPA. ERM notes that "the cost forecasts developed for the ISP and RIT processes are out of scope for this guidance note, which focusses on the economic regulatory framework (e.g. the CPA process)"[3]. With this in mind, the remainder of this submission focuses on the checks and balances of a CPA being approved in the event of a large cost increase between the finalised RIT-T and progressive stages of CPAs.

The existing checks and balances are insufficient

As outlined in the attachment to the AER's covering letter and in Section 3.3 of the draft guidance, there are broadly two mechanisms to prevent an actionable ISP transmission project proceeding if there are excessive cost increases.

- The first mechanism is NER clause 5.16A.4(n), which requires a reapplication of the RIT-T if there is "a material change in circumstances which, in the reasonable opinion of the RIT-T proponent means that the preferred option identified in the project assessment conclusions report is no longer the preferred option". Because it is the proponent (i.e. the TNSP) that makes this assessment, there is a risk it is not objective – particularly when the TNSP would benefit from higher capital costs, which would translate into a larger regulated asset base. While beneficial for the TNSP, this increases costs for consumers. As a result, ERM does not believe clause 5.16A.4(n) can be relied upon to protect consumers from paying for inefficient transmission network upgrades.

  ERM is a co-signatory for a proposed rule change to address this issue. The rule change would do this by making the AER (not the project proponent) the entity that determines whether a significant increase in cost is a material change in circumstances.

- The second mechanism is the 'feedback loop' in NER clause 5.16A.5(b), which the AER explains in the context of CPA staging in Section 3.3 of the draft guidance.

  At best, the feedback loop has the potential to ensure that the total cost of an actionable ISP project remains below the maximum cost at which meeting the AEMO-identified need remains on the optimal ISP pathway. However, in the event of a large cost increase between the finalised RIT-T and the CPA, the feedback loop does not provide any assurance that the specific project being progressed in the CPA remains the most efficient way to meet the AEMO-identified need, or that the project itself continues to provide a net market benefit.

  Further, it is unclear if AEMO is required to engage in meaningful consultation when it adjusts its modelling as part of this feedback loop. If AEMO does not effectively consult before revising its modelling, followed by additional consultation on a published draft revised modelling report, stakeholders may question whether AEMO's feedback-loop analysis is valid. Maintaining transparency and effectively consulting with stakeholders is key to protecting consumers from inefficient costs.

Options to better-protect consumers from cost increases

Until one or both of the above mechanisms are improved, ERM believes that consumers are not adequately protected from unacceptable cost increases between the finalised RIT-T and the CPA. As stated above, ERM is already pursuing a rule change to improve the first mechanism. A potential improvement to the second mechanism could involve (for example) a parallel multi-step feedback loop:

- For actionable ISP projects over a certain cost threshold, require the TNSP to submit a 'preliminary works' CPA (CPA1), and subsequently undertake additional work to improve the RIT-T cost estimates to an Association for the Advancement of Cost Engineering (AACE) - Class 1 level.

[3] AER, *Re: AER's draft guidance note to support efficient delivery of actionable ISP projects—for consultation*, 18 December 2020, pp 11

- Before submitting a full-project CPA (CPA2), if there has been an increase in costs from the finalised RIT-T, require the TNSP to consult on and justify why the CPA project is still the most efficient outcome. This may involve the TNSP re-applying relevant parts of the RIT-T.
- When assessing CPA2, require the AER to assess the TNSP's justification of whether the CPA project is still the best option compared to the other options considered in the RIT-T. If it is, assess CPA2 as normal. If not, require the TNSP to conduct preliminary works on the next best RIT-T option.
- After conducting the relevant preliminary works for the next best RIT-T option, require the TNSP to re-submit a CPA2 for its preferred option, which includes a justification for why it is the most appropriate project compared with the other option for which it undertook preliminary works.
- When assessing this new CPA2, require the AER to assess the TNSP's justification of whether their proposed project is the best option compared with the other option taken to 'preliminary works'. The AER would then make a CPA2 determination based on the most efficient option.

The obvious drawback of this approach is the additional time and cost, which could potentially outweigh the benefits. It may also become superfluous if the first mechanism is improved. However, these issues should be balanced against the costs to consumers of inefficient transmission investment, which can be substantial.

ERM notes that the AEMO feedback loop has the potential to rule out an inefficient proposed project at each separate CPA stage if AEMO applies the provision diligently. If there are cost increases from the ISP to the RIT-T to the CPA (or if one of the two aforementioned protection mechanisms are strengthened), then there is an increased likelihood of this happening, which may cause delays to developments proposed in the ISP. This could be avoided if AEMO and TNSPs invested in more detailed cost estimates for transmission upgrades during the ISP development process. Similarly, requiring a more accurate cost estimate (e.g. a Class 1 or 2 estimate) during finalisation of the RIT-T process would help to more accurately assess the net benefit (or cost) of projects before they receive RIT-T approval. As it stands, it is unclear how a preferred option can be accurately determined or reasonably compared to non-network options (in either the ISP or RIT-T) if cost estimates are grossly inaccurate. To date, stakeholders have observed an underestimation of costs in the ISP and RIT-T process, followed by large cost increases when the project proponent applies for CPA funding. Revised calculated benefits to justify the project proceeding have then been provided with little if any consultation.

Ex-post capital expenditure review

The purpose of the ex-post review process is to protect consumers by ensuring only efficient and prudent capital expenditure (capex) is carried forward to subsequent regulatory periods. In practice, it is not clear that this process achieves its intent.

The AER only undertakes an ex-post review if a TNSP's actual total capex during a regulatory period exceeds its total capex allowance by a nominal threshold. This can be exploited, because TNSPs can manage actual capex during each regulatory period by cancelling or deferring capital projects for which a capex allowance has been included. TNSPs can then include the cancelled or deferred projects in their capex project lists for the subsequent regulatory period. This allows TNSPs to overspend on projects and/or claim incentive payments under the Capital Expenditure Sharing Scheme (CESS). If this occurs, consumers ultimately pay for the cost overruns, CESS incentive payments and the cancelled or deferred projects.

To address this, ERM suggests the ex-post expenditure review process is adjusted as follows.

- Each capex project should be allocated a unique identification code. The AER should require TNSPs to report all cancelled or deferred projects for which a capex allocation has been made. The AER would then adjust down the capex allowance for the regulatory period by the value of these projects. Actual capex

would then be assessed against this adjusted capex allowance to determine both the need for and extent of an ex-post review.

- All individual capital projects with a cost exceeding a pre-determined threshold should be automatically subject to an ex-post review. This threshold amount would be calculated for each individual region to reflect different consumption levels acting as a proxy for relative cost increases to consumers from transmission investment.

ERM believes these changes will improve consumer confidence that only prudent and efficient expenditure is carried forward to subsequent regulatory determinations. This is relevant to all regulatory determinations, including for the actionable ISP projects that are the subject of the AER's draft guidance.

Ex-post benefits review

To ensure only efficient investments are made in new transmission infrastructure projects, both the ISP and the RIT-T rely on the calculation of a net market benefit (i.e. benefits should exceed recovered costs). TNSPs have a high degree of certainty that they will recover their costs and earn a return, regardless of whether the infrastructure delivers the intended benefits. However, consumers ultimately pay for regulated assets. Therefore, it is consumers who bear the risks of the assumed benefits not occurring, despite there being far less certainty that the forecast benefits will actually occur.

Currently, there is no process to review and confirm that benefits as set out in a RIT-T or the ISP actually occur. This is a significant gap in the framework for network investment, which could be resolved with an ex-post benefits review. The purpose of such a review would be to provide learnings that could feed into assumptions used in future ISPs and RIT-Ts. This would ensure that forecasting assumptions more accurately reflect actual outcomes (as opposed to the theoretical assumption currently used). This in turn would promote consumer confidence that ISP and RIT-T processes are acting in consumers' best interests.

To commence this process of feedback to improve the understanding of actual benefits delivered, ERM recommends that the AER reviews the most recently completed large transmission infrastructure project, the Victorian to South Australia Heywood interconnector upgrade. The Heywood interconnector upgrade was the first project for which an independent entity reviewed the RIT-T's claimed benefits. This review, completed by Frontier Economics in 2013, raised significant questions with regards to the level of benefits claimed in the RIT-T[4]. It is unclear to ERM if the benefits claimed during the RIT-T process have actually occurred.

Similarly, the AER reviewed the benefits claimed in the Project EnergyConnect RIT-T Project Assessment Conclusions Report. The AER found that the proponents had substantially overestimated the project's net benefits, revising them down from $924M to $269M[5]. Both of these reviews cast doubt on whether consumers will ever see the benefits set out during the RIT-T or ISP processes.

ERM acknowledges that some network project benefits are only expected to accrue in future years. However, this should not prevent the AER from undertaking ex-post benefit reviews of major transmission projects at every regulatory reset period – particularly given the small number of projects.

[4] Frontier Economics, *Market benefits of Heywood upgrade – a report prepared for Macquarie generation*, May 2013. Accessed from: https://www.aer.gov.au/system/files/Market%20benefits%20of%20Heywood%20upgrade%20-%20Final%20Report.pdf

[5] AER, *Decision – South Australian Energy Transformation – Determination that the preferred option satisfies the regulatory investment test for transmission*, January 2020, pp7. Accessed from: https://www.aer.gov.au/system/files/AER%20-%20Determination%20-%20SAET%20RIT-T%20-%2024%20January%202020.pdf

If you would like to discuss this submission further, please contact Matthew Ladewig, Policy Adviser at mladewig@ermpower.com.au or on 03 9214 9397.

Yours sincerely,

[signed]

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