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Sent by: email to TIRreview@aer.gov.au

**Regulation of actionable ISP projects
Draft guidance note**

The Major Energy Users Inc (MEU) welcomes the opportunity to provide its views to the AER draft guidance note relating to regulation of actionable ISP projects. The MEU has been a consistent respondent to the various AER consultations on other aspects for regulation of actionable ISP projects.

About the MEU

The MEU was established by very large energy using firms to represent their interests in the energy markets. With regard to all of the energy supplies they need to continue their operations and so supply to their customers, MEU members are vitally interested in four key aspects – the cost of the energy supplies, the reliability of delivery for those supplies, the quality of the delivered supplies and the long-term security for the continuation of those supplies.

Many of the MEU members, being regionally based, are heavily dependent on local staff, suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those interests of smaller power and gas users, and even at the residences used by their workforces that live in the regions where the members operate.

It is on this basis the MEU and its regional affiliates have been advocating in the interests of energy consumers for over 20 years and it has a high recognition as providing informed comment on energy issues from a consumer viewpoint with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

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The MEU stresses that the views expressed by the MEU in this response are based on looking at the issues from the perspective of consumers of electricity but it has not attempted to provide significant analysis on how the proposed changes might impact AEMO, generators, TNSPs and other stakeholders.

The MEU considers that this guidance note is an essential control needed to ensure that the interests of consumers (the focus of the National Electricity Objective – NEO) are maintained and that inefficient investment in the transmission network does not occur. Already consumers have seen that their interests have been threatened through inefficient practices by transmission network service providers (TNSPs) and AEMO where the anticipated cost of the proposed South Australia to NSW interconnector rose considerably from the TNSP proposed cost of \$1.3-1.5 Bn in its PADR, \$1.53 Bn in its PACR, AEMO proposed cost of \$1.9 Bn in its 2020 ISP and the contingent project application (CPA) citing a cost of \$2.4 Bn¹. That project costs could rise so much in such a short time is deeply concerning to consumers, especially as stakeholders have little formal ability to address their concerns about price escalations beyond responses to the PADR stage.

As a general observation, the MEU considers that the draft guidance note is well constructed and addresses most of the concerns of consumers with regard to appropriate regulation of actionable ISP projects. Despite the overall support and acceptance of the draft guidance note, the MEU does have some concerns about it.

While the MEU notes that the AER couches its draft note in terms of “encouraging” the TNSPs to follow the guidance note, the MEU considers that the AER should “expect” the TNSPs for follow the guidance and the wording should make this clear. The MEU considers that an “expectation of compliance” is greatly preferable to “encouragement to comply” and hopefully this will provide much greater certainty that the guidance note will be followed by TNSPs in both the aspirations of the note and the detail.

The MEU has three main concerns with the guidance note and these are detailed below.

The first concern is that the guidance note assumes there exist tools to ensure that cost increases over the various stages of project development are minimised and that there are adequate checks built into the review process which achieve this outcome. The MEU is also very concerned that the benefits claimed are properly identified and demonstrated to be real but recognises that this is not the focus of this guidance note.

There are two main checks embedded in the rules to assist in satisfying the NEO – that AEMO runs a “feedback” loop and that the TNSP is required to review the project if there is a material change.

¹ The AER finally approved the CPA with a value of \$2.15 Bn

The MEU does not consider that the AEMO “feedback” loop is as strong as it is thought to be. Firstly, all the “feedback” loop does is require AEMO to assess the new project costs (or benefits) by inserting these into its ISP model. If the outcome of this process is still net benefit positive, then AEMO considers the project is still in keeping with its ISP. Essentially, the feedback loop puts a cost cap on the project so that as long as the cost is below a certain level, and the project is considered to provide net benefits when considered with all of the other ISP projects. Placing a cap on the costs does not guarantee that the project is costed correctly.

What the “feedback” loop does not do is to assess whether the project fundamentals still deliver a net benefit at the project level. The MEU points out that the AER is required to assess each project in isolation, and not as a part of the overall transmission network. Therefore, even if a project assists in delivering a wider net benefit when included in the ISP model, then this negative net benefit project would receive approval from AEMO. On this basis, the MEU considers that “passing the feedback loop” test does not necessarily ensure that the project for which the CPA has been made meets the NEO or that this “proves” the project should proceed at consumer cost.

This concern is further compounded with the reality that the project for which the CPA has been made (presumably with the highest accuracy possible) is being integrated into an ISP model which has been populated with costs and benefits for future projects which have been based on much lower orders of accuracy. So, when these other projects reach the CPA stage there is no certainty that the future ISP benefits will still exist for the project under immediate consideration by the AER.

With these concerns in mind, the MEU considers that while the “feedback” loop might provide some support for accepting the CPA, the AER still needs to ensure that the project, in its standalone form and with accurate assessments of costs and benefits, still delivers a net benefit in its own right, exclusive of the outcome of the “feedback” loop. Further, if there have been significant cost rises between the PADR and CPA stage, stakeholders should have the opportunity to assess that the project still delivers a net benefit and provide input to the AER deliberations for the CPA.

The second issue that concerns the MEU is that it is the TNSP that determines if there is a material change when comparing the costs within the PACR to those with the CPA. While it might appear that this “check” should provide some support to ensuring the proposed option delivers a net benefit even if there is a significant cost increase, as the power to decide lies with the TNSP, there is no certainty that the project still delivers a net benefit. The MEU recognises that this responsibility lies within the purview of the TNSP is embedded in the rules, it also recognises that this rules requirement does not necessarily provide support for a preferred option. The MEU notes that this issue is the focus of a proposed rule change.

From the experience of the proposed SA to NSW interconnector project costings, it is clear that the accuracy of project costs is now a headline issue and that the wide band of project cost accuracy (usually to move to higher costs with each stage of the RIT-T and CPA processes) results in significant potential to generate uncertainty in whether any project delivers a net benefit. The MEU notes that a rule change proposal has been submitted to the AEMC to embed costing accuracy levels at each stage of the RIT-T and CPA processes based on the Association of Advancement of Cost Engineering (AACE) accuracy levels. At the CPA level, the MEU considers that the cost accuracy must be at the highest level (eg Class 1) as the project costs will get added to the Regulatory Asset Base (RAB) and consumers will have to bear the costs of the project for 40-60 years, so initiating a project where costs can still increase beyond the level where there are no net benefits but still be added to the RAB, exposes consumers to significant risk.

With this in mind, it is reasonable for consumers to expect a high level of accuracy in the expected costs – a process that applies with capital intensive industries exposed to competition. This issue could be managed by having a staged approach to the CPA process, where project cost accuracy can be affirmed along with the expected benefits before proceeding with the bulk of a project, allowing a project to be discontinued without too great a financial commitment.

The third issue relates to the allocation of risk. The guidance note discusses allocation of risk between the TNSP and its contractor and observes that the TNSP can clearly transfer much of the risk to the contractor with a resulting increase in contract price – the AER comments that such is a conservative approach to risk allocation. But what the guidance note does not address is that there are three parties to the project – the TNSP, the contractor and consumers who ultimately pay for the investment. The MEU considers that the guidance note needs to include consumers in the risk assessment. For example, the TNSP might have transferred completion time risk to the contractor with a fixed time-based contract. The contractor will increase its price to manage that risk, but consumer might be more prepared to accept some delay in the project completion date in preference to paying a premium. The guidance note needs to reflect this tri-partite arrangement and risk sharing.

However, what is still unclear is that as the cost side of the net benefit equation becomes more accurate, the same does not apply to the assessment of benefits. With this in mind, the MEU considers that at the CPA decision level, there must be a review of the assessed benefits to ensure that the project still delivers a net benefit to consumers.

The MEU is aware that AEMO is seeking to improve its capital costing processes and has initiated a Transmission Cost Database project with GHD Advisory to provide a source of data that will reflect current costs. The MEU supports this but considers that the AER can assist in improvement in forecasting costs by ensuring that the database does incorporate the data from completed projects where the AER carries out a detailed ex-post review of projects when the regulated capex allowance has been exceeded.

In a similar vein, the MEU also considers that the AER should carry out ex post reviews of the calculation of benefits over a number of regulatory periods. Such a review is commonplace in the competitive world as firms see that it is essential they can assess ex post whether the benefits they anticipated are achieving what underpinned the investment. Such an assessment is a critical part of competitive industry practices, allowing the firm to implement changes that could enhance the return on the investment which by that stage is effectively “sunk” or to discount the value of the investment.

The purpose of such an ex-post review of benefits by the AER is not to cause the value of an existing TNSP project to be optimised down, but to provide a database from which the accuracy of forecast benefits for new projects can be more accurately developed. The MEU is concerned that the current processes used by AEMO and other TNSPs can result in use of the same assumptions which might not be correct or appropriate when viewed ex post. Such an ex-post review would only be used to refine the accuracy of future benefits.

The MEU notes that there have been considerable amounts of energy market consultation in the current months and this has resulted in a response to the AER which not as expansive as the MEU would like. With this in mind, the MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at davidheadberry@bigpond.com or 0417 397 056.

Yours faithfully



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