

5 February 2021

Australian Energy Regulator

By email: [TIRreview@aer.gov.au](mailto:TIRreview@aer.gov.au)

### **Re: AER's draft guidance note to support efficient delivery of Actionable ISP projects**

Spark Infrastructure welcomes the AER's draft guidance note to support efficient delivery of Actionable Integrated System Plan (ISP) projects. The guidance note is designed to improve transparency and predictability in how the AER will assess actionable ISP projects under the economic regulatory framework and improve the assessment tools and processes to ensure they remain fit-for-purpose for large Actionable ISP projects.

We support the approach taken in the Guidance Note and offer some further suggestions to the process and consideration of risk to recognise the impact of Actionable ISP projects on incentives under the regulatory framework. These include:

1. **Containing the scope of the pre-engagement matters** to issues and information (including new information on costs and benefits) that have not already been the subject of the Regulatory Investment Test for transmission (RIT-T) process or AEMOs ISP and feedback loop. This will reduce the potential for duplication and unhelpful delays.
2. **Including a draft decision** in the Contingent Project Application (CPA) process. This will provide additional transparency and enable stakeholders to engage with the AER's reasoning, address issues and provide additional relevant information.
3. **Providing access to a third-party review process** by an appointed expert or arbiter on CPA and ex-post review decisions for Actionable ISP projects. This will mitigate the risk that projects that would otherwise provide net benefits are not progressed due to the Transmission Network Service Provider (TNSP's) risk of incurring additional costs or penalties even if the investment is efficient. This would not guarantee recovery but would improve confidence in the process and outcome in the case where the AER forms a different view to the TNSP of the efficient costs and the TNSP expects to incur higher costs.
4. **Enable compensation for the higher risks** associated with Actionable ISP projects regardless of which party manages them. If it is the contractor, the tender process will ensure these are efficiently priced and should be included in the capital expenditure allowance. However, if retained by the TNSP, because to do so results in a lower cost of these risks than transferring them to contractors, these costs should also be able to be recovered. Otherwise, the TNSP has an incentive to transfer these risks to contractors which may result in a higher cost overall.
5. **Enable the TNSP to propose the appropriate cost recovery mechanism** for the higher risk based on the nature of the risk. For example, some risks may be able to be estimated based on probabilities, whereas others may be more uncertain. Options for recovery could include a specific allowance for the estimated cost of the risk, enabling variations (over or under) to be passed through or nominating particular risk costs for cost pass through.

## The risk allocation and sharing arrangements should be maintained for Actionable ISP projects

The incentive based regulatory framework provides strong incentives for the TNSP to incur no more than the efficient costs; the TNSP forgoes a return on any costs that are higher than the allowance in the regulatory period and incurs a 30% penalty on those higher costs even if those costs are efficient. These strong incentives ensure that customers benefit from efficiencies over time. Across the NEM, the incentive-based framework has delivered benefits to customers of between \$6 billion and \$11 billion over the 2006 to 2018 period.<sup>1</sup>

NSPs expect this risk, and to manage it, for ‘business as usual’ investment because they can manage variations within an overall envelope of projects and project costs. Some projects may be delivered for more, some less, some projects may be deferred, and others brought forward. However, for large Actionable ISP projects that represent a significant proportion of the investment program, overruns are less able to be absorbed within the ongoing program and, as they relate to a single project, the opportunity to reduce costs are limited. This was also the finding of HoustonKemp in its report on large discrete transmission projects:

*“The size of these projects also gives rise to significant additional risks to transmission network service providers (TNSPs). The Australian Energy Regulator (AER) operates a regulatory framework that provides TNSPs with incentives to outperform the forecast costs of undertaking investments. Although TNSPs have always faced the risk that they will under-perform against the cost of forecast capital expenditure, these risks have typically been mitigated since under-performance on any one project:*

- *is generally diluted within a portfolio of projects in which there might also be over-performance on other projects; and*
- *can be managed in the context of the five-yearly determination process since TNSPs’ performance is assessed in aggregate against a ‘bucket’ of approved capital expenditure.*

*However, such forms of risk mitigation are either unavailable or ineffective for large, discrete transmission projects.”<sup>2</sup>*

The AER and HoustonKemp have recognised that the risk of a cost overrun is greater with Actionable ISP projects compared to ‘business as usual’ projects. The AER states: <sup>3</sup>

*“There is some evidence that these types of projects have a higher likelihood of being delivered over-budget and later than originally expected.”*

*“This can mean that these large actionable ISP projects may be more prone to cost overruns than ‘business as usual’ projects. Under the current framework, cost overruns may lead to over-spends that trigger penalties and ex-post measures (if the expenditure is inefficient). This is because any overruns on these projects will likely be larger in magnitude and more difficult to manage through unders and overs that would occur across projects in a capital expenditure portfolio.”*

The higher likelihood of incurring cost overruns fundamentally changes the risk allocation and benefit sharing under the existing capital expenditure financial incentive mechanism. We consider that the AER’s Guidance Note should recognise this shift, and the process and considerations of Actionable ISP projects should seek to ensure this risk allocation and sharing arrangement is maintained to be consistent with ‘business as usual’ expenditure. This can be achieved by:

- Enabling the recovery of this higher risk in the capital allowance regardless of whether the risk is transferred to the contractor or retained by the TNSP if the cost of this risk is efficient.
- Enabling the TNSP to propose, and the AER consider, options for recovering these costs that are appropriate to the nature of the risk and the estimation process. For example, included as an explicit allowance, enabling variations to be passed through or nominated as a cost pass through.

<sup>1</sup> Energy Networks Australia, Rewarding performance, July 2019.

<sup>2</sup> HoustonKemp, Regulatory treatment of large, discrete electricity transmission investments, 19 August 2020, p. 1-2.

<sup>3</sup> AER, Letter outlining the work program to support efficient delivery of large transmission projects, 17 November 2020, Attachment, page 5.

## Providing assurance and improving confidence in the regulatory process

However, in addition, the TSNP also faces the risk that the AER forms a different view to the TNSP on the efficient costs ex-ante and ex-post. If the higher costs are determined to be inefficient ex-post, the TNSP also forgoes a return on and of those higher costs for the life of the asset whilst continuing to incur financing costs.

For Actionable ISP projects, the costs are more likely to be greater than the ex-ante forecast, and where they are, the magnitude of the cost overrun can be significantly greater.

Therefore, if the TNSP cannot deliver the project for the ex-ante cost determined by the AER, the TNSP (and its investors) must weigh up the value of the investment taking in to account the regulated return and probability of 1) forgoing a return and incurring penalties (30%) on efficient overruns and 2) not earning a return at all on some or all the overrun (on the major project as well as the total capital expenditure program whilst continuing to pay financing costs) that the AER determines is not efficient. This assessment of probabilities increases the hurdle rate for investment.

If this risk is not addressed, it may put at risk an investment that would otherwise deliver net benefits to consumers (even at the higher cost) because the TNSP bears too much risk. This can be mitigated by:

- Including a draft decision to enable the TNSP (and other stakeholders) to address issues raised by the AER; and
- Providing access to a third-party review process so that the TNSP (and other stakeholders) can have additional confidence in the decision process and outcome.

Given the AER review processes, the AEMOs ISP process and feedback loop, asymmetrical risks and financial penalties, there is almost no likelihood that consumers will pay for investment that is ex-ante inefficient or costs that are ex-post inefficient. Whereas there is a much greater likelihood that the TNSP wears costs and does not access any rewards under the financial incentive scheme. The risk allocation (and sharing) is, therefore, not maintained for Actionable ISP projects.

We consider that the AER should take this into account when considering the starting point for assessing risk allocation and the efficient approach to managing these risks.

We also consider that the requirements on TNSP's to engage with customers prior to lodging the CPA should be contained to issues and new information that have not already been considered as part of the ISP and AEMO feedback loop process. This will avoid re-inserting duplication and delays that were intended to be removed under the Actionable ISP rules.

I would be happy to discuss these matters further and can be contacted on [REDACTED].

Yours sincerely,

[REDACTED]

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