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30 September 2020

Ms Clare Savage
Chair
Australian Energy Regulator
Level 17, Casselden Place
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MELBOURNE VIC 3000

Email: Clare.Savage@aer.gov.au
Cc: Sebastian. Roberts@aer.gov.au

Dear Ms Savage

**Re: Contingent project application for Project EnergyConnect**

Thank you for your letter dated 23 July 2020, in response to our contingent project application (Application) for Project EnergyConnect (PEC)[1] that we submitted to the AER on 29 June 2020.

Your letter explains the AER's decision to defer its formal assessment of our Application for PEC until:

> we have submitted final expenditure forecasts based on our final tender outcomes, and

> ElectraNet completes its revised cost benefit analysis and submits its Application for its component of the Project with final expenditure forecasts.

We are writing to provide the additional information requested by the AER, which we understand will allow it to undertake its review of our Application. We understand the AER is working closely with ElectraNet on its revised cost benefit analysis and Application.

The AER's approval of PEC is critical to realise the benefits identified by the Australian Energy Market Operator (AEMO) in its Final 2020 Integrated System Plan (ISP)[2]. The Final 2020 ISP concludes that delivering the optimal development path, including PEC, will strengthen the National Electricity Market (NEM) and deliver gross market benefits of $11 billion in net present value (NPV) terms in its central scenario, with potentially higher benefits if the NEM moves quickly towards a renewable future.

***Updated capital expenditure (capex) forecast***

On 1 September 2020 we received tender proposals for the final stage of our procurement process, being the best and final offer (BAFO) stage. On 10 September 2020, we identified our preferred tenderer and on 18 September 2020 we finalised the BAFO Tender Evaluation Report.

Table 1 below sets out our total capex forecast of $1,910.9 million (Real 2017-18) based on the BAFO outcome for our component of PEC for the 2018-23 period. Our BAFO capex forecast is around 17 per cent lower than

[1] PEC involves the construction by mid-2023 of a high voltage interconnector between South Australia (SA) at Robertstown and New South Wales (NSW) at Wagga Wagga, with a transmission line linking to north-west Victoria

[2] Published on 30 July 2020

the capex forecast of $2,290.9 million ($Real, 2017-18) that we provided to the AER on 29 June 2020. This was based on the first phase of our procurement process, being the Request for Tender (RFT) Phase A.

This demonstrates that our competitive tender process resulted in an efficient outcome.

**Table 1 – Forecast capex for PEC for 2018-23 period ($M, Real 2017-18)**

| | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 | Total |
|---|---|---|---|---|---|---|
| Actual[1] | 3.4 | 22.4 | 2.0 | - | - | **27.8** |
| Forecast | 16.3 | 0.9 | 220.7 | 914.6 | 730.6 | **1,883.0** |
| Total forecast capex[2] | **19.7** | **23.3** | **222.7** | **914.6** | **730.6** | **1,910.9** |

Notes: 1. These are actual indirect costs that we have already incurred up to 31 July 2020. 2. Capex for 2018-19 includes equity raising costs of $16.2 million.

Attachment A sets out our capex forecast by category and overviews the methods we used to develop it.

Our capex forecast is explained and justified in the following supporting documents:

> Supplementary Capex Forecasting Methodology for PEC - BAFO

> Capex Forecasting Methodology for PEC - RFT Phase A

> Corporate and network overhead forecast for PEC - BAFO

> GHD's independent engineering capex verification and assessment, and

> HoustonKemp's independent economic capex verification and assessment.

### *Updated operating expenditure (opex) forecast*

We have updated our incremental opex forecast based on the outcomes of the BAFO. As detailed in Table 2, our incremental opex forecast is $2.6 million (Real 2017-18) for the 2018-23 period, which is $0.6 million ($Real 2017-18) lower than our opex forecast of $3.2 million ($Real 2017-18) provided to the AER on 29 June 2020. This reduction in our opex relates to our debt raising costs, which have reduced as a result of the reduction in our capex forecast since 29 June 2020.

**Table 2 – Incremental forecast opex for PEC for 2018-23 period ($M, Real 2017-18)**

| | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 | Total |
|---|---|---|---|---|---|---|
| Total incremental forecast opex | **-** | **>0** | **0.1** | **0.5** | **1.9** | **2.6** |

### *Forecast revenue*

As you are aware, we will shortly lodge a Rule change application with the Australian Energy Market Commission (AEMC) to appropriately align revenue and cost recovery for Major ISP Projects, including PEC (Financeability Rule change).

This Rule change is required because the current regulatory arrangements result in a misalignment between when a network service provider (NSP) incurs costs and when it recovers revenues, particularly in the early years of projects. For Major ISP Projects, this means that an NSP cannot achieve the benchmark credit rating and gearing assumptions in the AER's 2018 Rate of Return Instrument, which are used by the AER to calculate the rate of return. This in turn undermines an NSP's ability to access efficient debt finance and therefore the financeability of these projects.

Our Financeability Rule change proposal requests the following changes for Major ISP Projects:

> remove the requirement to index the regulatory asset base (RAB) by CPI over the regulatory period, and

> calculate regulatory depreciation on as-incurred capex.

We reasonably expect that these changes will enable us to maintain our current credit rating[3] and so make PEC and other Major ISP Projects financeable, while maintaining the same total long-term cost to consumers (i.e. NPV neutral). However, these changes will not allow us to achieve the benchmark credit rating and gearing assumptions in the AER's 2018 Rate of Return Instrument. We will seek changes to the rate of return through the AER's pathway to the 2022 Rate of Return Instrument to achieve this longer term outcome for Major Projects. Our Financeability Rule change proposal is being made in good faith, ahead of the changes to 2022 Rate of Return Instrument, to facilitate the delivery of PEC in line with the timing set out in the Final 2020 ISP and to meet Government and other stakeholders' timing expectations.

We consider that investment in PEC, and other Major ISP Projects – and therefore our Rule change proposal – is in the long-term interests of consumers because it is integral to achieving AEMO's optimal development path.

The acceptance of our Financeability Rule change application by the AEMC would enable the AER to reflect the revenue profile (Maximum Allowable Revenue (MAR)) and prices set out in Table 3 in its Final Decision for PEC.

**Table 3 – Impact of PEC – MAR (smoothed) – based on Financeability Rule Change proposal ($M, Nominal)**

| | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 | Total |
|---|---|---|---|---|---|---|
| Smoothed MAR - based on Financeability Rule Change proposal | - | - | - | 41.2 | 105.5 | **146.7** |

Table 4 below shows that the same revenue outcome can be achieved by adding, as a revenue adjustment in the building blocks, the change to smoothed revenue for the 2021-22 and 2022-23 regulatory years from applying the Financeability Rule Change proposal to PEC capex.[4] To maintain an NPV neutral revenue outcome a corresponding negative adjustment would need to be made to future revenue, either to building blocks revenue or to the RAB.

**Table 4 Impact of PEC – MAR (smoothed) – based on a revenue adjustment to PTRM ($M, Nominal)**

| | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 | Total |
|---|---|---|---|---|---|---|
| Smoothed MAR - based on Revenue adjustment to PTRM | - | - | - | 41.2 | 105.5 | **146.7** |

### *Forecast prices*

FTI Consulting has estimated that PEC will reduce the total average annual residential electricity bill by up to $64 per year in NSW[5] over the 2020 to 2040 period. FTI's assessment reinforces that PEC will deliver positive benefits to consumers and will play a vital role in reducing electricity costs, improving system security and reliability and supporting the transition to renewable energy sources.

Table 5 shows the indicative impact of PEC on the transmission component of customers' bills. This assumes that a typical customer consumes 4.22 MWh per year and is based on revenue in set out in Table 3. This price increase will be more than off-set by a reduction in the wholesale component of customers' bills over the 2020 to 2040 period resulting in an overall bill reduction as calculated by FTI.

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[3] Our current credit rating is Baa2, which is equivalent to an S&P credit rating of BBB

[4] The revenue adjustments are calculated by comparing, in Real 2017-18 dollars, the smoothed revenue if the Financeability Rule Change proposal *is applied* to the smoothed revenue if it *is not applied*. Both smoothed revenue forecasts were calculated using the AER's Post-Tax Revenue Model (PTRM). The difference between them was added as a revenue adjustment in the PTRM.

[5] FTI Consulting, Assessing the benefits of interconnectors, a report for TransGrid (Wider Benefits Report), September 2020, p. 13. Calculated using the 2020 Final ISP assumptions.

**Table 5 – Impact of PEC on the transmission component of customers' bills – based on Financeability Rule Change proposal ($M, Nominal)**

| | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 | Total |
|---|---|---|---|---|---|---|
| Customer price increase - based on Financeability Rule Change proposal ($pa Nominal) | - | - | - | 2.7 | 6.4 | - |

***Compliance***

We would like to set out our views on the status of our Application in response to your letter. Clause 6A.8.2(a1) of the Rules gives us an express obligation to submit a contingent project application 'as soon as practicable after the occurrence of the trigger event'. TransGrid takes its obligations to comply with the Rules seriously. In particular, the trigger event for our Application was satisfied on 26 June 2020 and we worked diligently to finalise and lodge our Application as soon as practicable thereafter. The Application included robust, but not final, estimates of the likely capital and operating costs for PEC. Clause 6A.8.2(b) of the Rules requires estimates of capital and operating expenditure (amongst other things) to be included in a contingent project application. The Rules do not specify that final estimates are required. In particular, the Rules expressly contemplate contingent project applications being subject to a process of investigation, with the AER permitted to request further and updated information in relation to a contingent project application under clause 6A.8.2(h1) with the closing date for the AER to determine the application not being set until such information has been provided under clause 6A.8.2(d). This letter is providing further information in support of the Application and should not be treated as a fresh application for PEC.

***Next steps***

We agree to the AER publishing this letter, together with our Principal Application document, which we submitted on 29 June 2020. This is re-attached at Attachment C.

Attachment B lists the documents that support our Application. These can be made available to the AER and we would be pleased to provide any further information the AER may require to assess our Application.

We look forward to hearing from you and I am available to discuss it at your convenience.

Yours sincerely

Paul Italiano

**Chief Executive Officer**

*Attachments:*

*A. PEC BAFO forecast capex by category*

*B. Further available documents to support our Application*

*C. PEC Principal Application document – 29 June 2020*

### Attachment A – PEC BAFO forecast capex by category

Table 6 below sets out our capex forecast by category and overviews the methods we used to develop it.

**Table 6 – Forecast capex, by category, for PEC for 2018-23 period ($M, Real 2017-18)**

| Category of PEC capex | Description | Basis of capex forecast | Forecast capex | % of total capex |
|---|---|---|---|---|
| **Tendered works** | Substations and transmission lines, including access tracks | Forecast capex based on BAFO outcome (the successful tenderer's bid price) with minor top down adjustments | 1,270.2 | 66.5 |
| | Large specialist equipment | | 140.2 | 7.3 |
| | Other construction costs[1] | Forecast capex is based on tender information (i.e. rates from the successful tenderer's BAFO response) where available, third party information or historical experience | 58.2[2] | 3.0 |
| **Property and easements** | Property and easement acquisition and costs | Forecast capex based on project land prices and other costs associated with acquiring easements, including the cost of offsetting biodiversity and species loss | 121.5 | 6.4 |
| | Environmental 'offset' costs | | 127.4 | 6.7 |
| **Indirect costs** | Actual costs | Actual indirect costs incurred up to July 2020 | 27.8 | 1.5 |
| | Corporate and Network overheads | Forecast capex based on a bottom up-build of our indirect costs, which have been determined using current available market rates and recent historical data. | 108.0 | 5.7 |
| **Risks** | Biodiversity risk cost | Forecast capex calculated using the AER's risk cost methodology (detailed probabilistic risk assessment) | 38.2 | 2.0 |
| **Real input escalators** | Real labour cost escalation | Forecast capex calculated by multiplying the projected labour components of forecast capex for tendered works, property and easements and indirect costs, by the real labour cost escalators approved in the AER's 2018- | 3.2 | 0.2 |

| Category of PEC capex | Description | Basis of capex forecast | Forecast capex | % of total capex |
|---|---|---|---|---|
| | | 23 Revenue Determination for TransGrid. | | |
| **Equity raising costs** | Equity raising costs | Forecast capex calculated using the AER's Post Tax Revenue Model | 16.2 | 0.8 |
| **Total capex** | | | **1,910.9** | **100%** |

Notes: 1. These activities are not in the successful tenderer's bid price but relate to the tendered works. The BAFO stage of our tender process revealed that these are activities with risks that the tenderer is not willing to accept or it is more cost effective for us to undertake. 2. Minor adjustments of $2.9 million ($ Real 2017-18) relate to baseline planning conditions, track possessions, micrositing risk, which relate to departures risk not accepted by the successful bidder.

**Attachment B – Documents comprising our Application**

| Document / model number | Name | Content/ purpose |
|---|---|---|
| A.1 | PEC Principal Application document | Seeks the AER's approval to amend the revenue requirements and MAR in the 2018-23 Revenue Determination for PEC.<br>This is unchanged from the document provided to the AER on 29 June 2020. |
| A.2 | Stakeholder engagement overview | Describes pre-lodgement consultation undertaken to 30 September 2020.<br>This supersedes the document provided to the AER on 29 June 2020. |
| A.3A | PEC Post-Tax Revenue Model – (BAFO outcome) | Demonstrates the calculations of our incremental revenue requirements and MAR, based on the BAFO outcomes in accordance with the NER.<br>This supersedes the model provided to the AER on 29 June 2020. |
| A.3B | PEC Post-Tax Revenue Model – (Financeability Rule change) | Demonstrates the calculations of our incremental revenue requirements and MAR, based on the BAFO outcomes by applying changes to the NER to support the financeability of PEC as set out in our Financeability Rule change proposal.<br>These changes include removing indexation and calculating depreciation using as-incurred capex - they do not change the amount of revenue we will recover for PEC but rather the timing of when we recover revenue (i.e. they are NPV neutral).<br>This is a new model since 29 June 2020. |
| A.3C | PEC Post-Tax Revenue Model – (Revenue adjustment) | Demonstrates the calculations of our incremental revenue requirements and MAR, based on the BAFO outcomes in accordance with the NER. This includes a revenue adjustment to achieve the same revenue outcome that would result from the Financeability Rule change proposal.<br>This is a new model since 29 June 2020. |
| A.4 | Specification and scope for PEC | Explains the development and refinement of the project specification and scope between the Project Assessment Conclusions Report (PACR), and the BAFO.<br>This supersedes the document provided to the AER on 29 June 2020. |

| Document / model number | Name | Content/ purpose |
|---|---|---|
| A.5A | Supplementary Capex forecasting methodology for PEC (BAFO capex forecast) | Explains and justifies the tendered works component of our BAFO capex forecast, as well as the differences between our RFT Phase A and BAFO capex forecasts for all categories of capex.<br>This document:<br>> supersedes the information relating to tendered works in our Capex Forecasting Methodology (i.e. document A.5B), and<br>> supplements document A.5B for all other categories of capex. |
| A.5B | Capex Forecasting Methodology for PEC (RFT Phase A capex forecast) | Explains and justifies our RFT Phase A capex forecast and presents the basis on which the works have been efficiently scheduled.<br>This now includes redactions for tendered works, because they are addressed in Document A.5A. |
| A.6 | Capex Model for Project EnergyConnect | Calculates our BAFO capex forecast.<br>This supersedes the model provided to the AER on 29 June 2020. |
| A.7 | Corporate and network overhead forecast for Project EnergyConnect | Explains the bottom-up forecast of overheads, which are a component of our total capex forecast. It explains our actual cost to 31 July 2020.<br>This supersedes the document provided to the AER on 29 June 2020. |
| A.8 | Corporate and network overhead spreadsheets for Project EnergyConnect | Calculates the corporate and network overhead forecast for the Project and reflects actual costs to 31 July 2020.<br>This supersedes the spreadsheets provided to the AER on 29 June 2020. |
| A.9 | GHD, Independent capex Assessment for the BAFO Outcomes, September 2020 | This is an independent engineering assessment of the scope, procurement process and BAFO forecast capex for the Project.<br>This supersedes GHD's June 2020 independent assessment provided to the AER on 29 June 2020. |
| A.10 | HoustonKemp, Independent capex Assessment for the BAFO Outcomes, September 2020 | This is an independent economic assessment of the scope, procurement process and BAFO forecast capex for the Project, based on the NER.<br>This is a new document since 29 June 2020. |

| Document / model number | Name | Content/ purpose |
|---|---|---|
| A.11A | FTI Consulting, Assessing the Benefits of interconnectors, September 2020 | This is an independent assessment of:<br>> the impact of PEC on wholesale electricity prices[6], and<br>> the wider benefits of PEC that are not currently captured by the RIT-T framework, but which were raised in its June 2020 report.<br>This report is based on AEMO's Final 2020 ISP assumptions.<br>This supplements FTI's June report at document A.11B. |
| A.11B | FTI Consulting, Benefits of PEC, June 2020 report | This is an independent view of the gross benefits of PEC under the RIT-T approach, having regard for the AER's feedback, as well as other wider benefits of PEC currently not captured by the RIT-T framework.<br>This report is based on AEMO's draft 2020 ISP assumptions. |
| A.12 | Opex forecasting methodology for Project EnergyConnect | This explains key steps to develop and validate our opex forecast.<br>This supersedes the document provided to the AER on 29 June 2020. |
| A.13 | Opex model for PEC | Calculates our opex forecast.<br>This supersedes our model provided to the AER on 29 June 2020. |
| A.14 | Insurance for Project EnergyConnect | Independent insurance report.<br>This supersedes the report provided to the AER on 29 June 2020. |
| A.15 | Demand forecast model | Calculates our incremental energy delivered forecast.<br>This is unchanged from the model provided to the AER on 29 June 2020. |
| A.16 | Model changes | Describes the changes made to the models and spreadsheets provided to the AER on 29 June 2020 that are now included as, and superseded by, those included as Attachments A.3A, A.3B, A.3C, A.6, A.8, A.13, and A.15. |

[6] Using updated modelling assumptions released by AEMO as part of Final ISP 2020

**Attachment C – PEC Principal Application document – 29 June 2020**