ABN 70 250 995 390
180 Thomas Street, Sydney
PO Box A1000 Sydney South
NSW 1235 Australia
T (02) 9284 3000
F (02) 9284 3456

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

By email: TIRreview@aer.gov.au
Cc: Mark.Feather@aer.gov.au

Dear Mr Feather

Re: Regulation of actionable Integrated System Plan (ISP) projects – Draft Guidance Note

Thank you for the opportunity to contribute to the AER's Guidance Note for actionable Integrated System Plan (ISP) projects.

We welcome the introduction of the Guidance Note to provide greater predictability and transparency on the AER's expectations for, and its approach to assessing, Contingent Project Applications (Applications) for Actionable ISP Projects under the National Electricity Rules (NER).

The Australian Energy Market Operator (AEMO) describes Actionable ISP Projects as 'critical to address cost, security and reliability issues'.

To date, we have submitted to the AER Applications for three Actionable ISP Projects:

> Queensland to New South Wales Interconnector (QNI) Minor Upgrade Project (QNI)

> Victoria to NSW Interconnector Minor Upgrade Project (VNI), and

> Project EnergyConnect (PEC).

These projects form part of the optimal development path in AEMO's 2020 ISP, which AEMO expects will deliver $11 billion in net benefits to the National Electricity Market (NEM)[1].

Delivering these ISP projects, and HumeLink, would require us to commit to more than $3 billion of capital expenditure over the next few years. This would be an unprecedented increase in capital expenditure on our network. To put this in context, the value of our regulatory asset base (RAB) was $6.4 billion (Nominal) at the start of our current 2018-23 regulatory period.

We are pleased that the AER has had regard for our Applications on PEC, QNI and VNI in the development of its Draft Guidance Note. We also endorse the Energy Network Association's (ENA) submission on the Draft Guidance Note and highlight the following matters:

> *Assessment of costs and the role of procurement* – We support the AER's draft position that competitive tendering is important to determine the efficient market-tested costs but we also agree that it may not be efficient or feasible to tender all project costs. The majority of our forecast expenditure for VNI, QNI and PEC is based on prices obtained through competitive tender processes with multiple bidders. We support a fit-for-purpose approach to tendering, such that the nature of the competitive tender process should reflect the scale, scope and other

[1] AEMO, 2020 ISP, p. 6. Found at Link

characteristics of the project. For example, given the brownfield nature and relatively small size and scale of QNI, we utilised our existing construction services' panel. In contrast, for PEC, which is a major greenfield project, we utilised both our existing panel and a range of new contractors in Australia and overseas. We agree with the AER that forecasting expenditure using competitive tendering ensures consumers are paying no more than they should be for the services that they will receive. It also encourages innovation in design and delivery.

> *Risks* – The AER[2] and its consultant HoustonKemp[3] recognise that cost risks for Actionable ISP Projects are greater than for business as usual (BAU) projects and therefore 'have a higher likelihood of being delivered over-budget and later than originally expected'. HoustonKemp notes that[4]:

> *significant uncertainty associated with both the benefits and costs of large, discrete projects…gives rise to additional challenges because:*
>
> - *much of this uncertainty appears to be intrinsic to individual projects and their interactions with existing regulatory processes; and*
> - *the regulatory process pre-supposes that these uncertainties will narrow as a project proceeds towards approval and construction, whereas there is evidence that this is not occurring for large, discrete projects.*

The AER's draft position is to maintain the risk cost framework set out in its contingent project determination for ElectraNet's Main Grid System Strength project. We applied this framework in our PEC Application. This approach involves:

- determining risk costs based on the expected cost of residual risks, having regard for the probability of occurrence and cost reductions arising from risk mitigation/management strategies, and
- transferring to third parties project risks that they are best placed to manage.

We consider that the AER's risk cost framework should efficiently compensate all risk costs, irrespective of which parties manage them. This is because:

- it may not always be possible for a network service provider (NSP) to transfer risk costs to a contractor or another third party. The willingness of a contractor to accept risk may vary, depending on factors such as their expertise, experience and risk appetite, and
- in some cases, it may be more cost efficient for certain risks to be retained by the NSP. In this case, the NSP should be appropriately compensated for these risks, otherwise it has an incentive to transfer these risks to contractors (subject to the contractor's willingness), which could result in higher overall prices for consumers.

We note that the AER's risk approach focuses on the management of known risks. We are concerned that there are currently no mechanisms to address unforeseeable and unquantifiable cost risks that are likely to arise in the delivery of Actionable ISP Projects, given their unique characteristics. These cost risks are heightened by the size and scale of Actionable ISP Projects. Currently, NSPs would need to fund the gap in financing the investment during the regulatory period and would be penalised under the Capital Expenditure Sharing Scheme (CESS) for any overspend, even when the higher levels of expenditure are necessary and efficient. This means

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[2] AER letter to stakeholder, Re: AER work program to support efficient delivery of actionable ISP projects —stakeholder views sought, 17 November 2020. Found at link

[3] HoustonKemp, Regulatory treatment of large, discrete electricity transmission investments, a report to the Australian Energy Regulator, 19 August 2020 (Regulatory Treatment of large transmission investments). Found at link. See page 1

[4] HoustonKemp, Regulatory Treatment of large transmission investments, 19 August 2020, page 2. Found at link.

that an NSP may therefore not have a reasonable opportunity to recover its efficient costs of delivering these projects.

We support:

- the AER examining options to reform the regulatory framework for the treatment of cost risks as part of its broader work program to ensure that an NSP has a reasonable opportunity to recover its efficient costs of delivering ISP projects. We would welcome the opportunity to participate in this regulatory reform process, and
- flexibility for an NSP to propose the most efficient approach to address cost risks based on the nature of risks associated with the Project. This could involve a mix of the following:
  (i) an ex ante allowance based on expected risk cost and likelihood of occurrence
  (ii) a pass-through mechanism for actual capex incurred for unforeseeable and unquantifiable cost risks, and
  (iii) a true-up for the variance between forecast and actual costs, for costs such as environmental offset costs, biodiversity costs and compulsory land acquisition costs. These costs are typically determined by a third party regulator or government agency based on the specific nature of the Actionable ISP Project. These costs can be material and uncontrollable, and are not known at the time of submitting an Application, however they become certain as the project proceeds.

  It is important that these arrangements ensure NSPs can recover the actual efficient costs that they incur.

> *Stakeholder engagement* – We support the AER's view that early and ongoing engagement with the AER and other stakeholders is important to promote consumer confidence and improve the quality of an Application and the accuracy of forecast expenditure. We note that the AER considers that our Stakeholder Engagement Overview Paper for PEC reflects good practice and is consistent with its expectations. Separately to engagement on the Application, we undertake extensive stakeholder and community engagement on ISP projects including:

- as part of the Regulatory Investment Test for Transmission (RIT-T) process. We agree with the AER that:
  - consultation on the RIT-T concludes once AEMO issues its Feedback Loop confirmation that the Project is on the optimal development path, and
  - the focus of engagement through the contingent project application process is limited to the costs of delivering the preferred option as determined through the RIT-T process.
- as part of the Environmental Impact Statement (EIS) process, which is overseen by a third party regulator, and
- throughout the project life-cycle to ensure that stakeholders and the community generally are informed about all aspects of the project and have ongoing opportunities to provide input throughout the project, including on key matters such a route selection.

> *Staging of Contingent Project Applications (CPA staging)* – We welcome the AER's clarification of CPA staging, which would involve the submission of multiple CPAs, such as CPA1 and CPA2, in order to reduce uncertainty associated with a projects costs and/or benefits. We note the AER has based its approach to CPA staging on our letters to the AER for staging HumeLink. We agree with the AER that in most cases two CPAs would be appropriate and the approach to CPA staging should be discussed and agreed with the AER in advance.

> *Ex post review* – The AER's draft position is to apply to ISP Projects its approach to conducting ex-post capex reviews set out in its Capital Expenditure Incentive Guideline. We do not consider this is appropriate or reasonable given the current treatment of cost risks. This is because, if we

significantly overspend our total capex allowance, we could be penalised through the ex-post capex review process by having actual capex incurred excluded from our RAB. We have previously raised our concerns about the application of the ex-post review with the AER and we encourage the AER to re-assess its position on this matter as part of its broader work program to ensure that we have a reasonable opportunity to recover our efficient costs of delivering Actionable ISP Projects.

- *Regulatory process* – We welcome the AER's initiative to publish its preliminary positions paper on our PEC Application. This is akin to a Draft Decision and provides us with an opportunity to respond to the AER's issues and reasoning before the AER finalises its decision. This process increases transparency and consultation for all stakeholders. We therefore consider this is a crucial step in the contingent project application process for Actionable ISP Projects given their value and critical role in the NEM. We welcome the AER formalising changes to the Application process to include a Draft Decision stage in its Guidance Note.

Next steps

We look forward to continuing to work with the AER to develop its Guidance Note for Actionable ISP Projects. If you have any questions on this letter, please contact our Head of Regulation, Stephanie McDougall, on (02) 9284 3874 or stephanie.mcdougall@transgrid.com.au.

Yours sincerely

Jason Conroy
Chief Financial Officer