TRANSMISSION PLANNING AND INVESTMENT REVIEW

PUBLIC FORUM – STAGE 2 DRAFT REPORT (NEAR-TERM REFORMS)

23 JUNE 2022

AEMC

Agenda

1. Purpose of today's presentation
2. Overview of the Review
3. Stage 2 draft report - policy positions/recommendations (near-term reforms)
4. Q&A
5. Next steps

ACKNOWLEDGEMENT OF COUNTRY

INTRODUCTION AND WELCOME

Danielle Beinart– A/EGM Transmission and Distribution Networks

Purpose of today's presentation

AEMC staff will provide an update on the delivery of the Review and its key stages

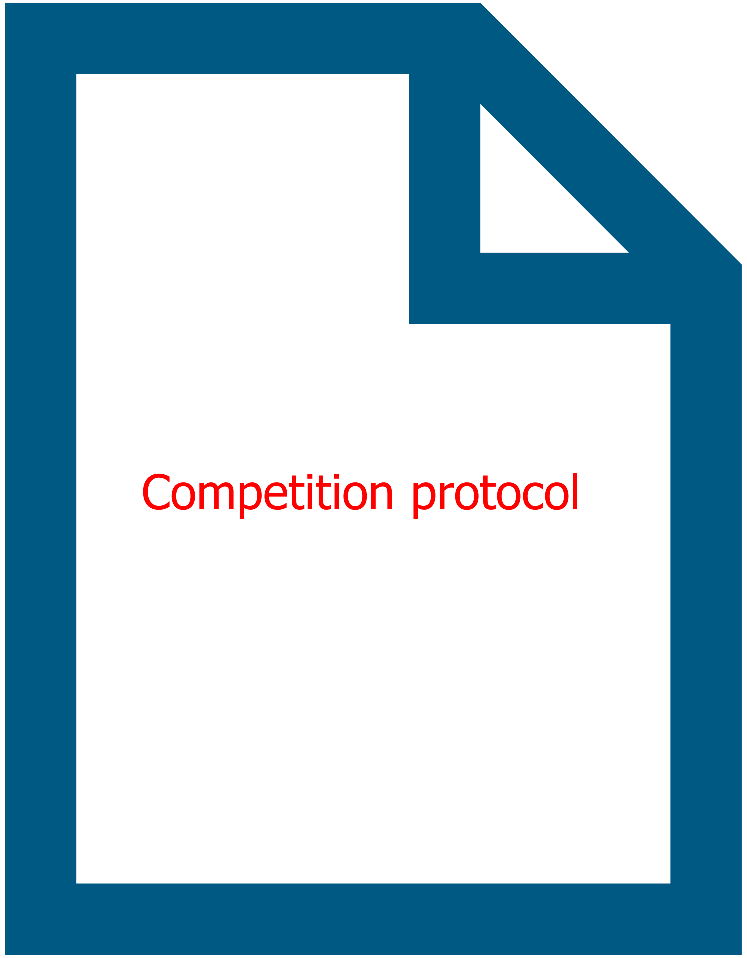
AEMC staff will provide an overview of the policy positions for Stage 2 of the Review

Forum participants are invited to ask questions

Housekeeping

- All participants are currently in ‘listen-only’ mode
  - Moderators can switch your mic/video on if you specifically request it.
- Asking questions
  - Use the Q&A button on the bottom of your screen
  - Questions will be answered at a dedicated Q&A session
  - We will try to answer all questions, but will prioritise questions with most ‘upvotes’ first
- Presentations from today will be posted on our website after the webinar, along with a recording of the forum

Before we start, an important notice: Compliance with Competition Law



Each entity must make an independent and unilateral decision about their commercial positions.

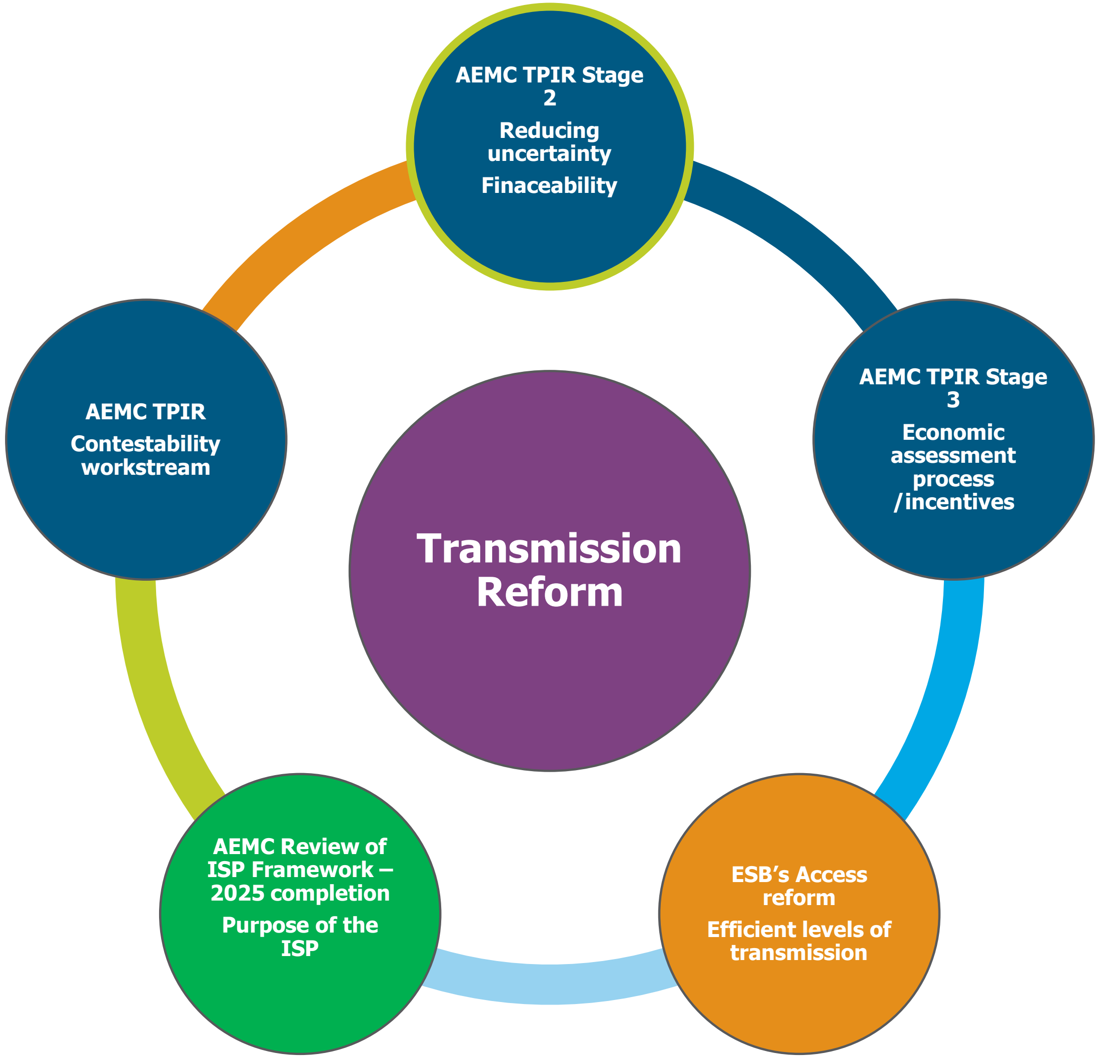
OPENING REMARKS

Charles Popple – Commissioner

OVERVIEW OF THE REVIEW

Alisa Toomey – Acting Director

The Stage 2 draft report is part of a larger body of work to support the efficient use of transmission infrastructure and the timely and efficient delivery of major projects



A different approach has been taken to this Review with work being delivered in stages

Timeline to progress the Review

Stage 1

COMPLETE
This stage identified and prioritised issues associated with the frameworks for planning, funding and delivering major transmission projects.

Stage 2

Stage 2: Near-term reform

This stage is exploring reform options that can be implemented in the near term to address issues relating to financeability, social licence, cost recovery of planning activities and the feedback loop.

Draft Report
Final Report

Stage 3

Stage 3: Long-term reform

This stage is exploring reform options that may require longer-term implementation timeframes. This stage will investigate issues relating to the economic assessment process and the exclusive right of TNSPs to build transmission projects.

Draft Report
Final Report

Contestability

Contestability

This workstream is exploring the potential of contestability to improve the timely and efficient delivery of major transmission projects.

Options Paper
Draft Report
Final Report

Q1 Q2 Q3 Q4
COMPLETE
2022

Q1 Q2 Q3 Q4
2023

STAGE 2 DRAFT REPORT - POLICY POSITIONS/RECOMMENDATIONS

FINANCEABILITY

Rupert Doney – Senior Adviser

Financeability challenges may arise for TNSPs under future major ISP project investment scenarios

Financeability concerns for a TNSP may arise from the way that cash flow is impacted by major investments.

When a network business invests in a project, it starts receiving a return on the investment based on forecast capital expenditure. However, the business does not start receiving a return of the investment (depreciation) until the investment is commissioned.

This may lead to a mismatch in profile of cash flow available to meet the higher levels of debt in the early years.

While there is currently no clear evidence of financeability concerns with specific projects or businesses, the Commission considers it is possible that financeability issues could arise in the future under realistic development plans that may arise from the ISP planning framework

Upcoming major projects may be significant compared to the TNSPs current asset base and multiple large projects may overlap. While this could typically be absorbed ,for example, with changes to capital structure such as shareholders (equity) supporting cash flow in earlier years and receiving higher cash flow in later years, there are some factors that may lead to financeability concerns for some major transmission projects.

These include: (i) multiple large projects conducted concurrently or in sequence would make new investments a much larger proportion of the RAB, impacting short-term cashflow & (ii) capital chooses to go elsewhere

We welcome stakeholder views on this finding that financeability challenges could arise in the future under realistic future ISP development plans.

A proportionate response is to provide greater flexibility to vary the depreciation profiles for actionable ISP projects

Broadly speaking there are two options for adjusting cash flows: (1) adjust the return on capital (through the rate of return instrument), or (2) adjust the return of capital (through depreciation).

Option 1 - return on capital (through rate of return instrument)

This would apply across all network businesses, both TNSPs and DNSPs.

Would only be appropriate to address systemic costs or risks affecting all businesses.

Financeability concerns on the other hand are likely to arise only for specific projects or businesses and in each case will only persist for a limited time

This option is not recommended in the draft report.

Option 2 – return of capital (through deprecation)

A more proportionate approach for a single project or business is to adjust the return of capital through changes to the depreciation profile.

Shaping cashflow while keeping the asset life the same, increases cashflow in the short term, while tapering off longer term, and keeping changes NPV neutral for the TNSP.

This supports the financial metrics of the business, while ensuring consumers as a whole pay the same. Consumers would pay more in the near term and less later on.

This would only be applied in exceptional circumstances, where the consumer benefits of timely investment outweigh the short term negative impacts.

We welcome stakeholder views on this finding that financeability challenges could arise in the future under realistic future ISP development plans and that it is appropriate for the AER to have sufficient flexibility to address this issue.

Financeability solutions need to be targeted to projects where financeability might be an issue in future, not to all projects all of the time

There are broadly two options to implement a change to how depreciation could be applied:

1. Providing greater flexibility within existing arrangements for setting depreciation
2. Introducing a specific financeability or commercial viability test that can trigger the ability to shape depreciation

The AEMC's draft recommendation is option 1 as we consider creating and applying a specific test for all revenue determinations would impose disproportionate administrative burden on AER and businesses.

Defining metrics for a test would also be difficult, given ratings agencies take quantitative and qualitative factors into account, and there are company-specific factors that may also have an impact.

The changes proposed provide the AER with **greater flexibility within the existing arrangements**

They would allow the AER, on a case-by-case basis, to disapply straight-line deprecation profiles for actionable ISP projects where this meets the NEO and instead **apply an alternative depreciation profile**.

The **AER would develop guidelines** setting out how arrangements will be applied including the approach it will take when required to consider a different depreciation profile and information to be provided by the TNSP in support of the new profile.

The **TNSP revenue proposal or CPA would set out, for an actionable ISP project, the revenue profile** under a normal deprecation profile and the impact this will have on its financial metrics and credit rating. It would also set out a proposed deprecation profile and explain how this would meet the NEO.

We welcome stakeholder views on whether this draft recommendation to increase the AER's discretion to vary depreciation profiles for actionable ISP projects is an appropriate response to financeability challenges that may arise.

SOCIAL LICENCE

Rupert Doney – Senior Adviser

Social licence is a significant issue that can have a major impact on the timely and efficient delivery of major transmission projects

Social licence is a broad term used to refer to a range of concepts and activities.

We are focusing on social licence activities that are (or could be) required under the NER, and which help to build a level of community acceptance for major transmission projects.

Several parties and regulatory frameworks (e.g. national and jurisdictional) shape social licence outcomes across the end-to-end process for major transmission projects.

Existing work in this area by jurisdictional governments and TNSPs remains critical to supporting the timely and efficient delivery of major transmission projects and enabling the energy transformation.

Among the issues raised by stakeholders to date, there are two key issues that build/maintain social licence and sit within the remit of the NER:

- cost recovery of a range of activities undertaken to build community acceptance such as stakeholder engagement or compensation (e.g. to landowners or communities) and
- stakeholder and community engagement activities.

We're seeking your feedback on whether the current cost recovery mechanisms are appropriate to recover the costs associated with social licence activities

Recovering the costs of activities that contribute to building community acceptance

The draft position is that existing cost recovery mechanisms in the NER are largely appropriate for TNSPs to recover efficient costs associated with social licence activities, such as compensation and stakeholder engagement. This is on the basis that revenue to fund the cost of some social licence activities can be:

- included in forecast expenditure for preparatory activities
- sought via the RIT-T and then recovered via the CPA process
- recovered via the cost pass-through mechanism when costs are unexpected.

We seek stakeholder views on whether:

- the current cost recovery mechanisms are appropriate and allow TNSPs to recover the costs associated with social licence activities?
- whether any social licence activities are not captured by the existing cost recovery arrangements?

We're seeking your feedback on whether current stakeholder engagement requirements in the NER provide sufficient flexibility or present barriers

Existing regulatory obligations for TNSPs to build and maintain social licence are largely appropriate

The draft position is that existing regulatory obligations for TNSPs to build and maintain social licence are largely appropriate. The NER places obligations on AEMO, TNSPs, and the AER to support stakeholder consultation as part of the identification and delivery of major transmission projects. For TNSPs, these are largely non-prescriptive so stakeholder engagement activities can be tailored to suit each individual project.

Further opportunities for TNSPs to improve stakeholder engagement outcomes

However, stakeholders provided feedback to the consultation paper on areas where they considered that stakeholder engagement activities could be improved. These include opportunities to:

- tailor engagement to meet community needs
- involve stakeholders more and provide greater transparency around decision
- improve the timing of stakeholder engagement, bringing it forward where possible so that stakeholders can engage more effectively.

We seek stakeholder views on whether the NER provides the right balance of flexibility and prescription in relation to stakeholder engagement, and whether there are any barriers to stakeholder engagement taking place earlier in the process?

Stakeholders raised other opportunities for improving community acceptance for major projects that fall within the remit of jurisdictional regulatory frameworks

Issues raised by stakeholders relating to jurisdictional frameworks generally fell within two key areas:

- Community benefit sharing and landowner compensation
- Planning, including land use and land access.

Stakeholders reflected that landowner and community expectations about compensation are changing and stakeholders suggested opportunities to adapt current approaches. Jurisdictions are encouraged to consider:

- reviewing jurisdictional frameworks to identify any barriers to faster settlement of land acquisitions, and
- the role of jurisdictions in helping build relationships between TNSPs and landowners.

Stakeholders also noted that better consideration of planning decisions and their impacts on landowners and communities may reduce the risk of land use conflicts and project delays. Jurisdictions are encouraged to consider:

- reviewing jurisdictional land access protocols to see if changes could be made to improve engagements between TNSPs and landowners
- whether coordination activities between energy, environment, and planning portfolios can help to progress the delivery of major transmission projects for the energy transition.

PLANNING ACTIVITIES

Dylan Frangos - Consultant

Preparatory activities and 'early works' are not clearly distinguishable in the regulatory framework

Under the actionable ISP framework, TNSPs incur expenditure related to two distinct types of project planning activities:

1. Activities to *identify* and *select* the preferred option to meet an identified need
2. Activities to further *refine* and *deliver* the preferred option

Under the NER, different cost recovery arrangements are intended to apply for different types of planning activity expenditure. Generally speaking:

- Costs associated with preparatory activities to identify and select preferred options are typically accommodated within TNSPs' expenditure allowances
- Costs associated with substantive project delivery activities are intended to be recovered through the CPA process.

The application of these cost recovery arrangements relies on how categories of planning activities are distinguished.

However, planning activities are referred to in different ways in the NER and in regulatory documents. The NER explicitly defines 'preparatory activities' while early work is only described in AER and AEMO documents.

Clarity around how to distinguish types of planning activities is therefore necessary.

The draft recommendation is that planning activities should be clearly distinguished based on whether they relate to the selection or delivery of a preferred option

The Commission assessed two potential options to distinguish between various planning activities and to clarify the cost recovery arrangements for these activities in the context of major transmission projects. These are:
- Option 1: Distinction based on cost magnitude, the approach implicit in the AER's CBA Guidelines
- Option 2: Distinction based on the purpose of the expenditure.

The Commission's draft recommendation is to make changes to distinguish between planning activities for actionable ISP projects based on whether they relate to the *selection* or *delivery* of a preferred option to meet an identified need- ie the purpose

The changes will clarify that costs to select a preferred option are recovered through the regulatory allowance, while expenditure to deliver a preferred option is to be recovered through the CPA process. This approach clearly demarcates when cost recovery risk should be transferred from TNSPs to consumers

This approach would be given effect through:

1. amending the definition of 'preparatory activities' in the NER to further clarify that their purpose is to inform the selection of a preferred option.

2. removing the term 'early works' from AER and AEMO documentation and replacing it with consistent language that characterises activities as either preparatory or not, based on their purpose.

Stage 3 of the Review will consider how the proposed approach to distinguish project planning activities interacts with project staging. In particular, it is necessary to consider which planning activities appropriately comprise a project stage and the relevant cost recovery arrangements.

The draft position is that existing framework has the appropriate tools to manage uncertainty in cost recovery for preparatory activities

It may be difficult for TNSPs to accurately forecast the expenditure for all preparatory activities that will be required over a regulatory period as some costs may be unforeseen at the time.

As such, TNSPs bear most of the risk of overspending if the opex allowance is insufficient to accommodate any unforeseen obligations to complete preparatory activities.

While material unforeseen obligations are unlikely to arise given the ISP joint planning process where TNSPs work closely with AEMO to develop the ISP, consideration has been given to whether existing cost recovery arrangements are sufficiently robust and flexible to manage any uncertainty.

The Commission considers that existing tools within the framework remain appropriate and adequate to manage any uncertainty in the required level preparatory activities. The Commission notes that:

- preparatory activities may be nominated as a cost pass-through event under existing arrangements, and

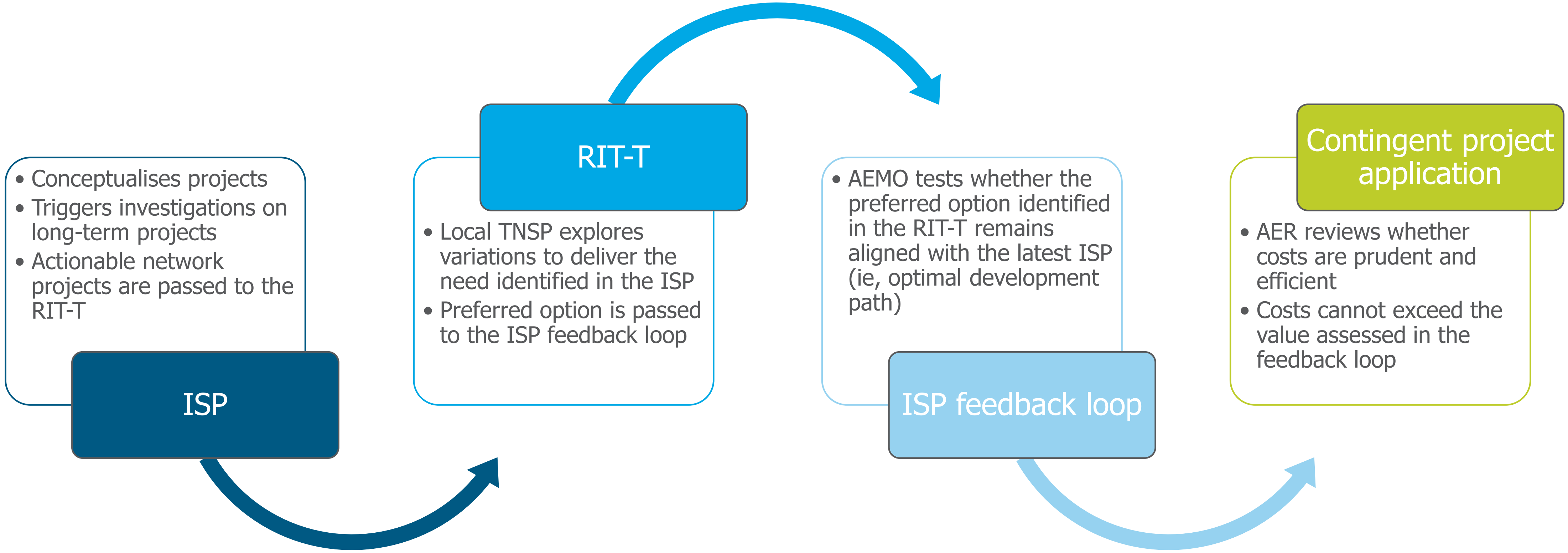
- the staged CPA process appropriately manages cost recovery uncertainty for actionable ISP projects and will be more effective as the process matures

FEEDBACK LOOP

Dylan Frangos - Consultant

The feedback loop provides an important safeguard for consumers

- The feedback loop was introduced as part of the actionable ISP reforms and provides an important safeguard for consumers
- It's role is to ensure that only investments that are in their long term interests are eligible for regulatory funding, and that the level of regulatory funding does not exceed the efficient investment level



Practical application difficulties undermine the ability of the feedback loop to operate as an effective safeguard for consumers

Feedback loops must be assessed against the most recent optimal development path, which under the actionable ISP framework refers to the latest final ISP or ISP update (if relevant)

However, the optimal development paths in the latest ISP and future ISPs will be underpinned by different inputs, assumptions and scenarios. The feedback loop may therefore not take into account the latest available information

This approach creates a number of practical difficulties:

- The value of the outcome of the feedback loop assessment may be undermined if the latest information is not used, as it may significantly change the optimal development path & the outcome of the assessment
- Inconsistencies between the inputs underpinning the RIT-T preferred option and feedback loop assessment may be created (due to the requirement for RIT-T proponents to use the latest IASR)
- AEMO’s development of the next ISP may be complicated by having to simultaneously draw on modelling from the previous and next ISP – affecting the timeliness of the feedback loop assessment.

The Commission's draft position is that the workability of the feedback loop could be improved by aligning it with the publication of a draft or final ISP

Aligning feedback loop assessments with a draft ISP (or final ISP once published) will improve workability because:

- The assessment can be incorporated into the development of the draft ISP
- The scope for misalignment between the RIT-T and ISP is narrower

Aligning the feedback loop with a draft or final ISP also enables AEMO to consider the latest available information from the latest IASR in its assessment – ensuring the feedback loop operates as an effective safeguard for consumers. Running the CPA and feedback loop processes concurrently could address any delays due to bunching

Practically, alignment will be achieved through a PACR exclusion window between the final IASR and draft ISP – the period where the feedback loop is least workable for AEMO

We seek stakeholder views on:

- whether a PACR exclusion window between the final IASR and draft ISP will improve the workability of the feedback loop?
- If permitting the CPA and feedback loop processes to run concurrently is an appropriate means of addressing any potential delays?

The exclusion window would be given effect through the AER's Cost Benefit Analysis Guidelines

The AER's CBA Guidelines already contain guidance on the application of the feedback loop by AEMO. They are therefore a natural place to give effect to the Commission's draft position

The Commission expects that the amendments to the guidelines will provide AEMO with the discretion to time feedback loop assessment to when it is most appropriate given the circumstances of the particular investment (including during the exclusion window if appropriate)

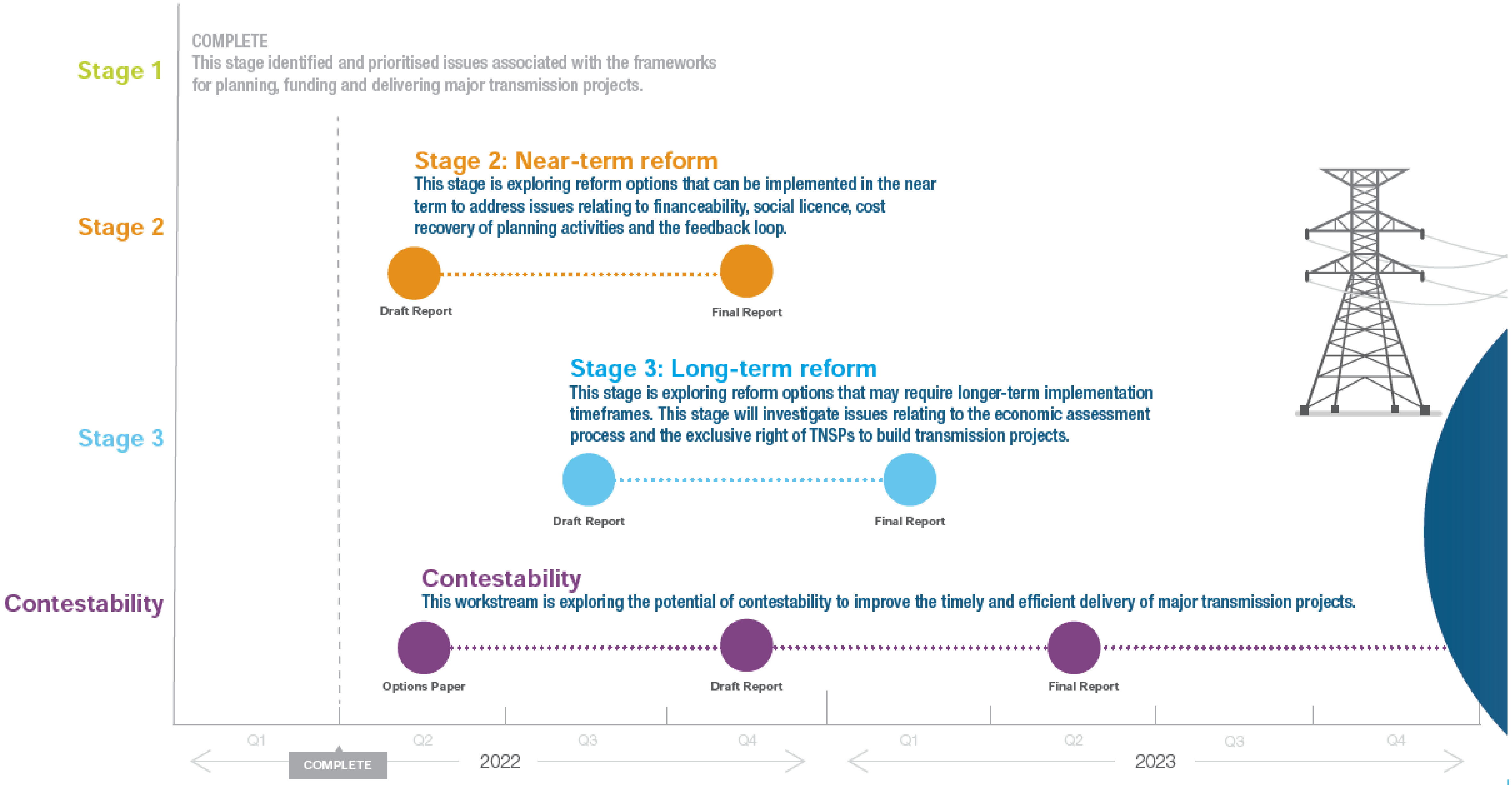
The Commission considers this to be an effective approach because it promotes the feedback loop as an effective consumer safeguard while not unduly delaying investment. It also provides the necessary flexibility to navigate the challenges of the energy transition, while providing clarity regarding the operation of the feedback loop

We seek stakeholders feedback on whether AER's CBA Guidelines the most appropriate way to give effect to the Commission's draft position?

QUESTIONS?

CLOSE AND NEXT STEPS

Timeline to progress the Review



AEMC

Office address
Level 15, 60 Castlereagh Street
Sydney NSW 2000

ABN: 49 236 270 144

Postal address
GPO Box 2603
Sydney NSW 2001

T (02) 8296 7800