MORRISON&CO

31 July 2019

Elizabeth Bowron
Senior Advisor
Australian Energy Market Commission
PO Box A2449, Sydney South NSW 1235
Via email: elizabeth.bowron@aemc.gov.au.
Reference Project: EPR0073

Dear Ms Bowron,

Introduction to HRL Morrison & Co ("Morrison & Co")

Morrison & Co is an investment manager with a 25-year track record in the Australian energy and infrastructure sector. Our clients are overwhelmingly Australian and New Zealand superannuation funds and institutional investors with our investments spanning the Australian energy sector, including generation, renewable energy, retailing and transmission networks. The value of the energy assets in which we have significant interests is over A$15 billion[1]. We consider ourselves active managers and our executives include a number of individuals with deep energy sector expertise. We therefore welcome the opportunity to participate in the AEMC's Coordination of Generation and Transmission Investment ('COGATI') process and look forward to involvement throughout its multiple stages.

Views on the COGATI process in terms of actioning the Integrated System Plan ('ISP')

Core objectives

We consider the core objectives of the present proposed reforms of the power system should be to:

- support 'Actioning the ISP'[2];
- deliver the reliability and system strength requirements of the power system;
- provide efficient consumer cost outcomes; and
- assist the transition to a power system with higher renewable energy penetration.

Achievement of these objectives requires high levels of investment from multiple market participants, notably including transmission network owners and participants in the generation market. An important consideration of this review should be to consider the potential impact of any proposed reforms on the ability of the power system to attract investment efficiently, in a timely manner that maximises total system and stakeholder benefits whilst ensuring a competitive market, all for the benefit of consumers.

Impact on investment environment and costs to consumers

It is essential that investment incentives are considered in any reforms to coordinate generation and transmission investment. Investment decision processes occur at the company, shareholder (equity provider) and lender levels with a particular focus on required return on investment, as influenced by a range of risk factors including market, counterparty, revenue, regulatory, construction and development risks. Companies and capital providers have a well-developed understanding of the

[1] Approximate full enterprise value of the unlisted businesses in which Morrison & Co has significant investments
[2] as per the Energy Security Board ('ESB')

present market design and function (including its weaknesses), developed over many years' experience of investing in the market and observing its operation. This degree of experience of the market's functioning is reflected in the required return sought by equity and debt financiers. Increased uncertainty or risk will be reflected in higher required returns or lower investment, and vice versa, either to the cost or to the benefit of consumers. The reforms proposed by the AEMC go to fundamental aspects of the market's operation and will fundamentally alter this balance. The reforms are being undertaken at a time of transformation of the energy sector, a time that necessarily involves a level of investment that far exceeds the 'normal' scale of investment in the power system. We encourage the AEMC to pay close attention to this aspect of the review, as fundamental changes to the market design and operation, no matter how well intentioned, have the potential to deter investment or materially increase the cost of investment at a time when consumers otherwise stand to gain a great deal from the implementation of the ISP and the renewable generation that it would facilitate.

We are pleased that the AEMC has engaged with investors in the generation and transmission sectors in its process to date, and we encourage more detailed and broader engagement with these groups as the process advances.

Cost-benefit analysis

Given the magnitude and importance of the proposed changes and the enormous impact they will have on the National Energy Market, efforts against climate change, and the security and cost of the power system, it is critical that detailed market modelling and a cost-benefit analysis is completed and made publicly available prior to the reform approach being decided. This type of analysis is critical to assessing the impact of proposed reforms and gaining relevant and actionable feedback from market participants. This stage of the review process should be viewed as paramount to the potential success of the reforms, and the timetable for the review should be set to allow a detailed analysis and comprehensive consultation with stakeholders on the results prior to final decisions being made.

Cost to consumers

The AEMC's paper contains statements about there being benefits in transferring the cost of transmission investment from consumers to generators. No such transfer is possible in practice because generators (indeed all market participants) ultimately recover their costs from consumers. Accordingly, we suggest the objective should be determine the allocation of risk that will have greatest benefit to consumers. For the various reasons that we outline below, we see a risk that several aspects of the AEMC's proposed design will lead to higher prices for consumers and a slowdown in much needed investment.

Views on the AEMC's Directions Paper

Need for transmission access reform

Whilst a case for appropriate reform to 'Action the ISP' and incentivise efficient transmission investment exists, in making its case for reform the AEMC makes several statements about consumers being exposed to the risk of "roads to nowhere"[3] in transmission investment or bearing "overbuild or cost inefficiency"[4] and "the risk of transmission investment decisions being wrong". It is disappointing to see the AEMC include these arguments as core issues in its case for reform without providing

[3] AEMC Directions paper COGATI – Access reform, p10
[4] Ibid, p16

evidence that these risks are real or have eventuated historically. We would say no such evidence is available and indeed, statements such as these have been comprehensively disproven in other forums.

The reality is the present arrangements provide insufficient incentive for transmission network service providers (**TNSPs**) to develop transmission infrastructure, exacerbated by a low rate of return that is inconsistent with the extent and scale of risks that TNSPs are expected to bear. This is particularly stark in the case of the larger ISP projects which present significantly greater investment risks for TNSPs than it appears the AER mechanisms were designed to accommodate.

In relation to the argument about "the risk of transmission investment decisions being wrong", this goes to the effectiveness of the RIT-T process. It is hard to make the case that RIT-T has facilitated inefficient investment. If anything, the RIT-T process is in desperate need to reform so that manifestly necessary investments can proceed, and that heavy and costly administrative burdens (both on TNSPs and regulators) can be reduced. Reform of the RIT-T process is a critical component in the problems the AEMC is trying to address. An improved RIT-T process could incentivise TNSPs to undertake investment with efficient risk-return outcomes by removing regulatory and administrative hurdles where a clear need is shown to exist, such as in the case of the projects outlined in the ISP.

Dynamic regional pricing / local marginal pricing ('LMP')

LMP is a short-run measure addressing operational decision making that should not be expected to provide long-run price signals incentivising investment in long-life assets (such as generation and transmission infrastructure). In markets such as New Zealand where nodal pricing was introduced, LMP has not been shown to solve the issues of insufficient transmission investment. It is not clear how LMP will facilitate optimal transmission planning and investment, or what incremental information will be gleaned to help "Action the ISP" – the locations of grid constraints are already known from data available to market participants, and are clearly identified in the ISP itself.

We suggest that the market consequences of introducing LMP require careful consideration. We emphasise again that the AEMC should seek stakeholder feedback based on market modelling, cost benefit analysis and details of the proposed implementation approach. Without these details, it is possible to provide only high-level feedback that may not address important issues that may emerge in the design and modelling of an actual scheme.

Our major in-principle feedback on LMP covers two major topics: competition, and contractual implications for incumbent generators:

- **Competition**: As distinct from the main international market examples the AEMC might reference in its review, trading in the NEM is characterised by a lack of liquidity and an oligopoly of large integrated generator-retailers (**Major Gentailers**). Introduction of LMP in this context has the potential to exacerbate existing market power issues to the detriment of consumers. Independent generators would face new difficult-to-manage risks in a market context with only very few counterparties that would be capable of providing risk management solutions (i.e., principally, Major Gentailers through contractual arrangements such as PPAs and other more novel instruments that might be required to manage LMP risks). In this scenario, the market power of the Major Gentailers would be further entrenched, ultimately to the cost of consumers, and with material impacts on the ability to achieve the objectives outlined at the beginning of our submission.
- **Contractual implications for incumbent generators**: The AEMC has made reference to grandfathering provisions to shield incumbent generators from direct adverse economic impacts resulting from changes to market design. We endorse this approach. A failure to provide such protection would markedly increase the perceived risk of the NEM as an investment jurisdiction,

again having material cost implications for consumers. Nonetheless, even with grandfathering in place, such material reform of system design risks triggering contractual re-openers in PPAs and similar agreements widely across the market, creating cost and risk for all market participants – we emphasise again, these costs are ultimately born by consumers by virtue of creating a market with higher delivered energy costs.

Transmission hedges

Whilst we support the objective of providing generators with greater certainty of access to the network capacity that is critical to their ability to earn revenue, achieving this by the implementation of transmission hedges in the manner proposed by the AEMC presents a number of significant commercial concerns.

- **Auction system not appropriate to settle long-term contracts with highly diverse counterparties**: in order to support transmission investment, transmission hedges would need to be long-term (30+ years) firm revenue commitments from creditworthy counterparties (**Sponsors**) in favour of TNSPs. Failing this, TNSPs will be unwilling to invest in the transmission infrastructure necessary to provide firm transmission rights to those parties – or if willing, the cost of investment would be very high. The generation market in the NEM includes only a small handful of creditworthy counterparties. The smallest generation developers often have limited credit standing and the quality of projects proposed to be developed and connected to the network is equally diverse, ranging from those highly likely to proceed and perform a long-term important role in the electricity market, through to those with questionable future value. This diversity of counterparty and project quality is fundamentally unsuited to an auction market, where two bids at an equivalent *price* would necessarily be treated as equal, whereas their *value* could be substantially different.

  We further note that having AEMO as a counterparty to TNSPs enables consumers to benefit from a low rate of return on transmission investment (i.e., the AER's regulated rate of return). This low rate of return could not be offered under an auction system that would require TNSPs to accept higher counterparty risk, with materially higher long-term revenue risk than that provided by AER regulation.

- **Efficient reform of transmission access rights can be achieved without radical redesign of transmission charging:** The present system already allows for the costs for transmission investment to be allocated between generators (in the form of Contestable Services for network connections and Negotiated Services for direct network augmentation – each to be recovered from consumers at the generator's risk) and consumers (for deep network augmentation through TUOS charges regulated by the AER and recovered by AEMO). In our view, subject to appropriate reform of the RIT-T process, this system is adequate to facilitate the objectives of the NEM and recognises the complexity of attributing 'deep network' transmission upgrades to any particular generator or load.

  Thus, we suggest the issue of firmness of transmission rights should be separated from the issue of transmission charging. This can be achieved by the *allocation* of rights, rather than the *auctioning* of rights. Firm access can be delivered simply by 'locking down' the Marginal Loss Factor (**MLF**) and transmission access rights of generators on a first-come, first-served basis over the notional life of a generator. This would allow efficient investment decisions by generators without the arbitrary risk of material adverse changes due to 'crowding out' of access by future generators and/or driving large changes in MLF to occur. Such an approach would provide appropriate signals to generation developers as to the location and extent of network constraints, and the economic impact on that developer of connecting at a certain location (MLF, access

constraints and/or augmentation costs to alleviate the constraint). By contrast, the present system 'socialises' across existing generators and a new generator the impact of constraints created by that new generator connecting at a network location that is close to its capacity constraint. This revised approach would remove a substantial external (uncontrollable) risk factor for generation investors, which in turn would lower the overall cost of energy for consumers.

- **First mover disadvantage**: It is unclear to us how the proposed reforms will encourage a 'first-mover' generator to invest in transmission when the rational approach would be to wait until another party acts (and bears the diseconomies of supporting new investment). In our view, a more rational commercial outworking under this arrangement would be a substantial stalling of the type of major investment that will benefit the overall operation of the market (and therefore consumers) in favour of a multitude of small-scale investments designed to avoid the triggering of large transmission investment. These investments would be 'efficient' for the individual developers/generators because they would minimise connection costs for each asset, but would be inefficient in aggregate because they would not allow consumers to be benefit from the large economies of scale that are available in broader transmission investment, as well as its ability to improve the competitiveness of the wholesale electricity market.

Associated with these issues, we see the risk that the increased contracting costs and complexity of a market for transmission hedging would reduce competition in the market because only very large developers would be credible as counterparties to transmission hedges. This would risk eliminating the diversity of small and medium sized generation developers that inject much-needed competition into the market.

We value open engagement and constructive collaboration with the AEMC

We welcome the opportunity to engage with the AEMC as partners in delivering a sustainable and cost-efficient energy system for consumers, industry, regulators and investors. We recognise the significant challenges faced by the AEMC in conducting this review and implementing its findings. We encourage the AEMC to continue its dialogue with stakeholders, and importantly to include detailed market modelling and cost benefit analysis as part of that dialogue. We would be pleased to meet in person to discuss the issues we have raised. Please contact Michael Faulkner via email (michael.faulkner@hrlmorrison.com) or by phone on 0431 041 074 with any questions.

Yours sincerely

Paul Newfield
Chief Investment Officer
HRL Morrison & Co

Steven Fitzgerald
Head of Asset Management
HRL Morrison & Co