AEMC

REVIEW

Australian Energy Market Commission

FINAL REPORT

TRANSMISSION PLANNING AND INVESTMENT - STAGE 2

27 OCTOBER 2022

INQUIRIES

Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

E aemc@aemc.gov.au
T (02) 8296 7800

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ABOUT THE AEMC

The AEMC reports to the Energy Ministers' Meeting (formerly the Council of Australian Governments Energy Council). We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the Energy Ministers' Meeting.

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SUMMARY

1 Australia is undergoing a transformational shift to net zero. A key feature of this transformation is the replacement of centralised thermal generation with decentralised renewable generation.

2 There is broad consensus that transmission is a critical enabler for the transition to net zero, both in the national electricity market (NEM) and for the economy more broadly. This transition will require an unprecedented level of investment in, and build of, transmission infrastructure to deliver power from renewable generation and energy storage to consumers, and to deliver infrastrcuture quickly.

3 The scale of transmission investment required, coupled with the speed of the energy transition, presents unique opportunities and challenges for the existing regulatory framework. This framework was developed and has evolved over a period of incremental growth of the grid where the framework was weighted to minimise the risk of overbuilding, rather than the current required pace of step-change growth set out in the Australian Energy Market Operator's (AEMO) Integrated System Plan (ISP).

4 The AEMC's Transmission planning and investment review (the Review) was established to consider how to ensure that the regulatory framework supports the timely and efficient delivery of major transmission projects, while ensuring investment in these projects are in the long-term interests of consumers. This document is the final report on Stage 2 of the Review.

Stage 2 final recommendations are designed to help manage uncertainty in the near-term

5 The Commission has made recommendations on four issues to help manage uncertainty in the near-term to support the timely and efficient delivery of major transmission projects.

Introducing greater flexibility to mitigate the foreseeable risk that financeability concerns may arise for ISP projects

6 The Commission's final position is that the revenue setting framework would benefit from more flexibility to address the risk of financeability challenges that may arise for ISP projects. This flexibility should provide more confidence for investors while providing protections for consumers.

7 To enable this flexibility, the Commission's final recommendation is that the Australian Energy Regulator (AER) be given the explicit ability to vary the depreciation profile for actionable ISP projects to address financeability challenges, where it considers this would better meet the National Electricity Objective. This represents no change between the draft and the final report.

8 The Commission has adjusted its approach regarding how the recommendation should be implemented in response to stakeholder feedback. In particular, the Commission recommends that the rules be amended to include principles that the AER should have regard to when considering requests to amend depreciation to address financeability concerns. The inclusion

of principles would provide a level of certainty regarding the factors the AER will have regard to in its assessment. This approach also allows the AER to undertake an assessment without having first issued a guideline, allowing these reforms to be implemented more quickly.

Providing greater clarity around social licence outcomes in the national framework

9 The Commission recognises that TNSPs, local communities and other stakeholders affected by major transmission projects are critical partners in the delivery of major transmission projects.

10 Based on feedback received from stakeholders, the Commission considers there are several opportunities for additional guidance to be provided in the Rules and by the AER in its guidelines to assist in social licence being obtained and maintained. This additional guidance will clarify the arrangements that support transmission network service providers (TNSPs) in carrying out activities that build and maintain community acceptance of major transmission projects.

11 The Commission's final recommendations are:

- **Cost recovery** - that the AER provide additional guidance to stakeholders regarding how the costs associated with building and maintaining social licence for major transmission projects should be considered and assessed as part of the regulatory process.
- **Engagement** - that the AER provide additional guidance to stakeholders around its expectations on TNSPs regarding engagement and consultation with local communities and other stakeholders affected by major transmission projects at key stages in the planning process.

  The Commission also recommends changes be made to the national electricity rules (NER) to ensure that the expectations on TNSPs to engage and consult local communities and other affected stakeholders at key points in the planning process are consistent for all transmission projects identified through the ISP.

Improving certainty over the regulatory treatment of early works

12 The Commission considers that it is important for TNSPs to have certainty that they can recover at least their efficient costs for preparatory activities and early works. These activities help manage cost uncertainty and the risk of project delays in their delivery. Based on stakeholder feedback, the Commission has made changes to the draft recommendations, specifically to clarify the meaning of 'early works'. This will help provide certainty regarding what activities can be undertaken, and when and how costs are appropriately recovered.

13 The Commission recommends that the AER should describe early works in its guidance as: activities that are completed prior to the construction of the preferred option, to improve the accuracy of cost estimates, and to ensure that a project can be delivered within the time frames specified by the most recent ISP.

14 The Commission's final position is that the existing cost recovery arrangements to recover the costs of preparatory activities and early works are appropriate.

Improving workability of the feedback loop will enable it to work as a timely and effective consumer safeguard

15 The Commission's final position is that the feedback loop would benefit from changes to improve its workability. The Commission's specific recommendations regarding how to improve the workability of the feedback loop are largely unchanged between the draft and the final report, with one additional recommendation to amend the NER to include a timeframe for AEMO to complete the feedback loop assessment.

16 The Commission recommends the following changes to improve workability:

- Align the timing of the feedback loop assessment with the publication of a draft or final ISP through changes to the AER's Cost Benefit Analysis Guidelines to provide AEMO with the discretion to establish the timeframe for when the feedback loop assessment is to occur.
- Amend the NER to allow the contingent project application process and feedback loop assessment to proceed concurrently to manage potential bunching of the feedback loop assessments around the publication of a draft ISP.
- Amend the NER to require AEMO to complete the feedback loop assessment within 40 business days from the later of the date the request is submitted or additional information is received following an information request issued by AEMO, with a possible 60 business day extension if AEMO determines the assessment involves particular complexities or difficulties.

The recommendations in the Stage 2 final report should be implemented by rule changes and updated guidance from the AER

17 The Commission notes that the recommendations for financeability, social licence and the workability of the feedback loop are accompanied by proposed rules and could be progressed immediately if a rule change proponent submits a corresponding rule change request. Regarding the recommendation for early works, the proposed changes need to be given effect through the AER's guidelines and could therefore be progressed immediately following the publication of this report.

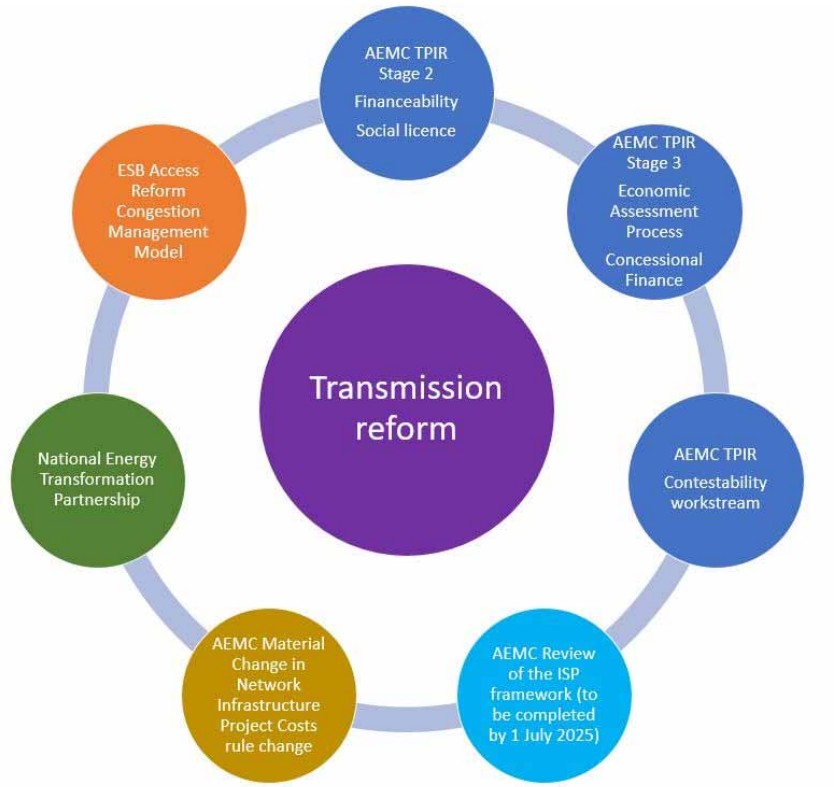
18 The Commission anticipates that the recommendations could be fully implemented by mid- to late-2023. The Commission has provided proposed rules to form a basis for the processes to follow. The Commission is strongly supportive of the expeditious implementation of these reforms.

The Stage 2 final report is part of a larger body of work to support the timely and efficient delivery of ISP transmission projects to support the transition to net zero

19 The Review is part of a larger program of work to make sure the national regulatory framework supports the transition to net zero. The program of work seeks to create a national regulatory framework for transmission that ensures major projects that are required are delivered in the most timely possible way with robust consumer protections in place.

20 The upcoming Review of the ISP process is also focused on these issues, while the Energy Security Board's access reform workstream seeks to address increasing congestion in the grid by considering approaches to facilitate efficient use of transmission, generation and storage assets and to assure that consumer processes are appropriate.

Figure 1: Stage 2 of the Transmission Review is part of a larger body of work on transmission reform



Source: AEMC.

21 The Commission's Review looks at multiple issues relating to the planning and delivery of transmission infrastructure. Many of these issues are complex and interlinked, but all go to the overarching objective of obtaining the right balance between time and efficiency to support the transition to net zero.

22 This Review is being delivered in stages. This recognises that some issues can be addressed more quickly, while others will require significant work due to their inherent complexity. These stages are:

- Stage 2 – near-term reforms: This stage focuses on recommendations to help manage uncertainty in the near-term, with solutions to these issues potentially being able to be implemented sooner.

- Stage 3 – longer-term reforms: This stage focuses on priority issues that are of considerable complexity, with further consideration required to establish the scope and source of issues prior to considering proportionate solutions.
- Contestability workstream: This workstream focuses on delivering a recommendation on whether contestability should be explored in more detail, and if so, in what form.

  As well as the complementary work in access reform and the upcoming ISP review, the Material change in network infrastructure project costs final rule determination considered similar issues relating to the economic assessment process, cost estimate accuracy and transparency.

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1 INTRODUCTION

This report is the AEMC's final report on Stage 2 of its Transmission planning and investment review (the Review). This chapter outlines:

- the purpose of the Review and the particular focus of Stage 2
- the other stages of the Review and the associated Material change in network infrastructure project costs rule change
- the assessment framework for the Review.

1.1 The Review's purpose is to explore options to support the timely and efficient delivery of ISP projects

Australia is undergoing a transformation to net zero. A key feature of this transformation is the replacement of centralised thermal generation with decentralised renewable generation. There is broad consensus that transmission is a critical enabler for the transition of both the national energy market (NEM) and the broader economy to net zero and that the speed and scale of decarbonisation of the NEM require substantial investment in and build of transmission infrastructure to bring power from renewable generation and storage to consumers.

The current regulatory framework was developed and has evolved over a period of incremental growth, not the current pace of step-change growth set out in the Integrated System Plan (ISP). The scale of this investment combined with the speed of the energy transition means that it is appropriate to consider whether the current regulatory framework is sufficiently flexible to support the timely and efficient delivery of ISP projects, while ensuring the right investments are made and that these are in the long-term interests of consumers. The objective of this Review is therefore to ensure that the regulatory framework strikes an appropriate balance between enabling timely investment in and delivery of ISP projects, at a time when significant growth is required to facilitate the transition to net zero, and ensuring that they deliver beneficial outcomes to consumers.

1.1.1 The priority issues to be addressed via the Review have been separated into several areas given their range and complexity

Drawing on the inputs of stakeholders, Stage 1 of the Review identified those issues that are most material in the context of major transmission projects and that could deliver the greatest prospective gains to consumers. Given the range and complexity of these issues, they are being considered in the Review in the following ways:

- Stage 2 – near-term reforms: This stage focuses on recommendations to help manage uncertainty in the near-term, with resolution of issues potentially being able to be implemented sooner.
- Stage 3 – longer-term reforms: This stage considers priority issues of considerable complexity which may take longer to implement .

- Contestability workstream: This workstream focuses on delivering a recommendation on whether contestability should be explored in more detail, and if so, in what form.
- Material change in network infrastructure project costs rule change: The final rule sets out amendments to the material change provisions in the national electricity rules (NER) to improve consumer confidence in the efficiency of network infrastructure projects.

1.1.2 The final recommendations in the Stage 2 draft report are designed to help manage uncertainty in the near-term and support the timely and efficient delivery of ISP projects

This report has drawn on stakeholder feedback to prioritise key issues we consider can be addressed in the near-term. A regulatory framework that is sufficiently clear and flexible to support the timely and efficient delivery of ISP projects is crucial given the large scale and significance of transmission investment required to facilitate the decarbonisation of the energy system. The Commission's final recommendations promote the timely and efficient delivery of ISP projects through:

- introducing greater flexibility to the regulatory framework to mitigate the foreseeable risk that **financeability** concerns may arise in the future. This is the focus of **Chapter 2** of this report.
- providing greater clarity and seeking feedback on if there are any changes which could improve how the regulatory framework supports **social licence** to facilitate community engagement and the acceptance of major transmission investments. This is the focus of **Chapter 3** of this report.
- providing greater clarity on what **early works** activities are, how they can be distinguished from preparatory activities, and how the associated costs are recovered. This is the focus of **Chapter 4** of this report.
- improving the **workability of the feedback loop** so that it can operate as an effective consumer safeguard and be completed in a timely manner. This is the focus of **Chapter 5** of this report.

The Commission notes that the recommendations for financeability, social licence and the workability of the feedback loop are accompanied by proposed rules and could be progressed immediately if a rule change proponent submits a corresponding rule change request. Regarding the recommendation for early works, the proposed changes need to be given effect through the Australian Energy Regulator's guidelines and could therefore be progressed immediately following the publication of this report.

1.2 The subsequent stages of the Review and the Material change in network infrastructure costs rule change request consider interrelated issues

1.2.1 Stage 3 focuses on several areas in the framework where the regulatory treatment of ISP projects can be simplified, made more timely, and provide more certainty

The Commission published the draft report for Stage 3 of the Review on 21 September 2022. Based on stakeholder feedback to the consultation paper, the Commission identified 5 key

issues for Stage 3 of the Review. These areas are of considerable complexity, relate primarily to longer-term reforms, and include consideration of:

- a spectrum of alternatives to the current **economic assessment process** for ISP projects and whether any of these options could better facilitate the timely transition to net zero while balancing rigour in the economic assessment process.
- the evolving policy landscape regarding **emissions abatement** and the role of transmission planning in the transition to net zero. This workstream considers how the current scenario planning approach underpinning the ISP factors emissions abatement into transmission planning, including in relation to detailed jurisdictional environmental and energy policies and broader emission abatement ambitions and/or targets.
- the regulatory treatment of **concessional finance** given the recent announcement of the Rewiring the Nation fund policy and that the NER does not explicitly recognise the treatment of concessional finance. This workstream considers what form of additional guidance is necessary to clarify the treatment of concessional finance and how the benefits can be allocated based on the intended purpose of the concessional finance.
- whether transmission network service providers (TNSPs) face **suitable incentives and obligations to invest** to encourage a timely investment decision in major transmission projects.
- whether the existing mechanisms to promote and assist management of cost risk and **uncertainty in the ex-ante regulatory framework** remain appropriate for major projects and where changes could be made to support TNSPs in the management of cost risk and uncertainty.

1.2.2 The Contestability workstream

The Commission initially intended to examine contestability as a potential solution to the risk that ISP projects are not delivered, given that TNSPs have an exclusive right but no corresponding obligation to invest. However, having considered the potential for contestability as a solution to multiple issues considered under the Review, the Commission concluded that an expanded scope for the contestability workstream is appropriate. The Commission is now examining the suitability of contestability in the provision of transmission services as an alternative approach to the existing regulation of ISP projects. This involves examining various potential models of contestability to assess their relative costs and benefits through a high-level analysis and comparison.

To manage the significant volume of work required to explore this issue, the Commission is progressing work on contestability separately (but in parallel) to the issues being examined as part of Stage 3 of the Review.

The Commission published an options paper on 7 July. Subsequently, the Commission will recommend whether contestability should be explored in more detail and, if so, what the preferred contestable model is.

1.2.3 The Material change in network infrastructure project costs rule change looked at issues that complement the Review including cost estimate accuracy and transparency

The *Material change in network infrastructure project costs* rule change looked at issues that complement the review including cost estimate accuracy and transparency. The rule change request was considered alongside the Review and is used the same assessment framework. The Commission published a more preferable final rule and final determination on 27 October 2022.[1]

The Commission's final determination was to make a more preferable final rule that seeks to add clarity to the process for determining whether a material change in circumstances has occurred by requiring certain regulatory investment test (RIT) proponents to develop reopening triggers which, if met, would require the RIT proponent to consider if and how to reconsider the extent to which the previously identified preferred option is likely to remain the most net beneficial option in light of the changed circumstances.

The final rule additionally seeks to improve cost estimate accuracy by clarifying the rules governing the guidelines for RITs in order to support strengthened guidelines for cost estimate development.

The final rule has been made in response to a rule change request submitted by the Energy Users Association of Australia (EUAA), Delta Electricity, Major Energy Users Inc, ERM Power Limited (now Shell Energy Operations) and AGL Energy (the proponents). The rule change request sought to improve stakeholder confidence in the RIT process by amending the NER to require a RIT proponent to reapply the RIT process if, following completion of the RIT, project costs were to increase by more than a fixed percentage, unless an exemption was granted by the Australian Energy Regulator (AER). The rule change request also sought to improve cost estimate robustness in the RIT used to identify the preferred option.

Under the current arrangements, the RIT-T must be reapplied where, in the reasonable opinion of the project proponent, there has been a material change in circumstances which means the preferred option identified in the final RIT-T report is no longer the preferred option. The rule change proponents considered that this did not adequately protect consumer interests.

1.3 Assessment framework

This section sets out the Commission's assessment framework for the Review and responds to stakeholder comments on the assessment framework proposed in the consultation paper. It discusses the overarching National Electricity Objective (NEO) that guides all of the Commission's work in relation to electricity, including this Review. It then outlines the criteria that we will use in testing whether reforms to the regulatory framework promote the NEO.

1 AEMC, *Material change in network infrastructure project costs*, Final determination, 27 October 2022, available online at https://www.aemc.gov.au/rule-changes/material-change-network-infrastructure-project-costs

1.3.1 National Electricity Objective

This Review is considering potential changes to the NER. As such, the national energy objective relevant to this Review is the NEO:[2]

> to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> a) price, quality, safety, reliability and security of supply of electricity and
>
> b) the reliability, safety and security of the national electricity system.

Consistent with the terms of reference for the Review, the Commission considers that the relevant aspects of the NEO are the promotion of efficient investment in, and efficient operation and use of electricity services for the long-term interests of consumers of electricity with respect to price, quality, safety, security and reliability.[3]

1.3.2 Assessment framework criteria

The assessment framework criteria summarised in Table 1.1 have been used to assessed whether the Stage 2 draft recommendations promote the NEO. The Commission notes two changes to the assessment criteria which have been made to reflect an internal strategic initiative to support decision-making in the assessment of issues and potential solutions in rule changes and/or reviews. The changes include reflecting the Commission's focus on 'outcomes for customers' as a key criterion and the inclusion of a specific criterion for 'decarbonisation'.

Table 1.1: **Assessment framework criteria**

CRITERIA	EXPLANATION
Outcomes for consumers	Assesses whether the regulatory arrangements promote and appropriately balance the timely and efficient delivery of major transmission projects.
Economic efficiency	• Assesses whether the solution promotes efficient investment in, and use of, electricity services in the long-term interests of consumers with regard to: 1. **Efficient risk allocation:** allocating risk (and costs) to parties best placed to manage them and who have the incentives to do so will support efficient decision-making. 2. **Effective price signals/incentives:** effective incentives are needed to support service providers in making efficient and timely investment decisions. 3.

2 Section 7 of the NEL.

3 For a detailed discussion on the Commission's approach to applying these overarching objectives to rule making processes and reviews, such as this one, refer to: AEMC, *How the National Energy Objectives Shape our Decisions,* October 2022, available on the AEMC's website www.aemc.gov.au.

CRITERIA	EXPLANATION
	3. **Information provision/transparency:** service providers require clear adequate information to inform decision-making in an evolving market. 4. **Clear, consistent, predictable rules:** a stable regulatory environment creates confidence in the market and will encourage investment and innovation through the transition and beyond. • Evaluates whether the solution provides service providers with a reasonable opportunity to recover at least their efficient costs.
Implementation	• Considers the complexity of implementing a solution, i.e. whether it will require law and rule changes or other jurisdictional legislative changes. • Assesses the costs of implementing a solution (practical implementation and compliance costs). • Evaluates the timing of costs and benefits.
Flexibility	• Assesses whether the solution is consistent with the long-term direction of energy market reform. • Evaluates whether the solution is flexible enough to accommodate uncertainty regarding unknown technological, policy and other changes that may eventuate.
Decarbonisation	Considers whether market arrangements will enable the decarbonisation of the energy market

Note: While a number of stakeholders proposed additional criteria be added to the assessment framework in response to the consultation paper for this Review, the Commission considers that the assessment framework adequately captures these.[4] For a more detailed response to stakeholder comments on the assessment framework see Appendix B of the consultation paper for this Review.

4 Submission to the consultation paper: Transgrid, p. 1; ENA, p. 1; PIAC, p. 4; EnergyAustralia, p. 3; Neoen, p. 5.

2 THE REVENUE FRAMEWORK REQUIRES SUFFICIENT FLEXIBILITY TO ADDRESS ANY FUTURE FINANCEABILITY CONCERNS

BOX 1: KEY RECOMMENDATIONS

The Commission's final recommendation is that the revenue-setting framework will benefit from explicit flexibility to address the risk that financeability challenges may prevent future actionable ISP projects from progressing in a timely manner. This represents no change between the draft and the final report.

The Commission has adjusted its approach regarding how the recommendation should be implemented in response to stakeholder feedback. In particular, the Commission recommends that the rules be amended to include principles that the AER should have regard to when considering requests to amend depreciation to address financeability concerns. The inclusion of principles would provide a level of certainty regarding the factors the AER will have regard to in their assessment. This approach also allows the AER to undertake an assessment without having first issued a guideline, allowing these reforms to be implemented more quickly.

The Commission's final recommendation is that:

- The AER should have explicit discretion to vary the depreciation profile for an actionable ISP project on a case-by-case basis following a request for amendment from a TNSP. This is to support the capacity of TNSPs to finance efficient capital expenditure associated with such major projects.
- The rules should include a set of principles to guide the AER's approach when determining requests to amend the depreciation profile for a specific actionable ISP project.

This chapter describes :

- why financeability challenges could arise in relation to future actionable ISP projects.
- why the regulatory framework should have more flexibility for the AER to vary depreciation to address financeability issues if they arise.
- why the AER should have regard to inter-generational equity and the capacity of the TNSP to finance ISP investments at the network business level when considering requests to vary depreciation.
- our recommendation on how these changes should be implemented.

2.1 There is a risk that financeability challenges could arise in relation to actionable ISP projects

2.1.1 TNSPs may face challenges in raising capital to proceed with ISP projects

Financeability refers to the ability of TNSPs to efficiently raise capital to finance their activities. In the draft report, the Commission concluded that there is currently no clear evidence of financeability concerns with specific projects or businesses. However, the Commission recognised that successive ISP iterations could see major transmission works moved forward or bunched in a way that creates a risk of financeability issues arising in the future. If TNSPs are unable to adapt their capital structures sufficiently quickly this could place pressure on cash-flows and by extension credit metrics. While this risk increases with the scale of transmission investment required, it does not mean that financeability challenges will necessarily arise in each case.

Stakeholder feedback on whether financeability challenges are likely to arise in the future was wide-ranging:

- Transgrid and ENA stated that financeability challenges are already evident with ISP projects, pointing to the experience of Project EnergyConnect.[5] ENA rejected the draft report's characterisation that financeability concerns are only likely to occur in 'exceptional circumstances'.
- Some stakeholders agreed that financeability challenges may arise under future ISP scenarios given the scale, immediacy and/or sequencing of ISP investments.[6]
- Other stakeholders did not consider that financeability challenges are likely to arise. In their view, the regulatory framework already adequately supports investment and there is insufficient evidence to conclude otherwise.[7] Another believed that caution should be taken before drawing definitive judgements around financeability, as in principle the RAB should serve as a sufficient guarantee of cashflows to allow any project to be financed, provided a TNSP receives its cost of capital.[8]

The Commission considers that 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. The business also starts receiving a return of the investment (depreciation) when the investment is commissioned. The overall allowed revenue from the building block for regulatory depreciation is determined both by the depreciation profile of assets, which typically occurs on a straight-line basis, and an adjustment for inflation indexation. Depending on the financing and capital structure adopted by the TNSP, the resulting cash flow profile may not match financing requirements. For example, in the absence of changes to the business' capital structure there may be short-term negative impacts to some of the financial metrics that are used to assess the creditworthiness of a business, alongside other

5 Submissions to the stage 2 draft report: Transgrid p. 1; ENA, p. 2.
6 Submissions to the stage 2 draft report: Re-alliance, p. 2; Tilt p. 2; AEMO, p. 3; CEFC p. 2.
7 Submissions to the stage 2 draft report: AEC p.1; AGL p.1; EUAA p.4.
8 ENGIE, submission to stage 2 draft report, p.2.

factors. The ratio of funds from operations (FFO) to net debt (or FFO/net debt) is one such metric.

Where new transmission projects are being developed with similar characteristics to the existing system, and the RAB has a diversity of assets with different lives, new transmission projects can be absorbed without a significant impact on these financial metrics. Accordingly, in the ordinary course of investing, there is little impact on the ability of a business to attract finance to support its activities. Even significant one-off investments may be absorbed, with appropriate changes to capital structure. Such changes may include shareholders (equity) supporting cash flow in earlier years, and receiving higher cash flow in later years.

Not all stakeholders shared the view that networks can adapt their capital structures to support cash flow in earlier years. Transgrid considered that networks cannot fund major new projects by reducing gearing below the benchmark efficient gearing level assumed in the rate of return instrument (currently 60 percent). Despite maintaining a net debt/RAB of around 90 percent as assessed by Moody's,[9] Transgrid proposed that financeability should only be assessed assuming the benchmark gearing of 60 percent.[10] The AER has previously pointed to evidence that gearing of network service providers is relatively volatile, suggesting that TNSPs are able to adjust their gearing to meet their financial needs despite the use of a 60 percent benchmark in the rate of return instrument.[11]

It is possible for network businessesto adapt their capital structures in order to be able to efficiently finance investment requirements. In periods of expansion it is likely that networks will need to rely more heavily on finance from equity investors, relative to less capital-intensive periods. In practice network companies may be constrained from adapting their capital structures quickly. These constraints are more likely to be tested due to the size, scale and sequencing of ISP projects.

2.1.2 The revenue framework is not sufficiently flexibility to address financeability challenges that may arise in future

In the draft report, the Commission established that the AER has some flexibility under current arrangements to adjust the profile of regulatory allowances, including through depreciation.[12] In response to the draft report, some stakeholders considered the AER's existing flexibility to adjust depreciation means that the changes proposed by the Commission are not required.[13] The Commission continues to consider that further clarity is required on how the AER should assess and, if necessary, adjust depreciation profiles for ISP projects to address cash-flow concerns.

In line with the draft report, the Commission recommends that the regulatory framework would benefit from explicit flexibility to address any financeability challenges that may arise in the future.

9 Moody's (2020), NSW Electricity Networks Finance Pty Limited – Update to credit analysis, p.3.
10 Transgrid, submission to the stage 2 draft report, p. 3.
11 AER (2018), Rate of Return Instrument – Explanatory Statement, p. 67.
12 AEMC, TPIR stage 2 draft report, p.13.
13 Submissions to the stage 2 draft report: EnergyAustralia p. 2; NICE p. 10.

2.2 The AER should have more flexibility to vary depreciation for actionable ISP projects if financeability issues arise

The Commission considers that changing the TNSP's cash flow profile through a net present value (NPV) neutral adjustment to depreciation is an appropriate solution to address financeability issues, should they arise in the future. This aligns with the Commission's position in the draft report that adjusting the rate of depreciation is more appropriate and proportionate for addressing short-term impacts from specific projects than changes to the rate of return. The Commission's considered that adjusting the rate of return is more appropriate to address systemic changes in costs or risks for all businesses.[14]

Of those stakeholders that considered financeability issues may arise in the future, the majority supported varying depreciation as the appropriate solution to these challenges.[15] However, some stakeholders raised reasons why depreciation should not be varied. These included potential consequences for inter-generational equity[16] and the view that varying depreciation may be a narrow solution, given that financeability issues may relate to a broader range of factors such as the rate of return.[17]

The Commission considers that it remains appropriate for the AER to exercise discretion and have flexibility when considering requests to vary depreciation profiles. This was consistent with feedback from the majority of stakeholders. Only Transgrid considered that a prescriptive approach would be more appropriate. Transgrid suggested that the AER should have limited flexibility both in terms of determining whether a financeability issue exists and how this should be addressed.[18] Other stakeholders pointed to alternatives to varying depreciation, including contestable procurement,[19] government funding of transmission projects through Rewiring the Nation or government underwriting the costs of early works.[20]

We consider it is important to ensure that the AER has sufficient flexibility to address the risk of financeability challenges on a case-by-case basis, including the ability to shape cash flows for specific projects in a manner that is appropriate to compensate a business for its efficient costs over time, as well as incentivise timely and efficient new transmission investment. Further, the Commission considers it is important that the overall regulatory framework is flexible enough to address financeability issues if they arise, regardless of whether concessional financing is available or not.

14 AEMC, TPIR stage 2 draft report, p. 16.

15 Submissions to the stage 2 draft report: AEMO p. 3; CIEG p. 2; ENGIE p. 2; EUAA p. 3; CEFC p. 2; ENA p. 2; Origin p. 1; Re Alliance p. 3; TasNetworks p. 1; Transgrid p. 4.

16 Submissions to the stage 2 draft report: EUAA p. 4; NICE p. 10; PIAC p. 6.

17 Transgrid, submission to the stage 2 draft report, p. 4 and p. 27.

18 Transgrid, submission to the stage 2 draft report, p. 4.

19 Submissions to the stage 2 draft report: CIEG p. 6; PIAC p. 6; AEC p. 2.

20 Submissions to the stage 2 draft report: CIEG p. 6, NICE p.2; PIAC p. 9; Snowy Hydro p. 3; TILT p. 2.

2.3 We recommend that the AER's approach to assessing requests to vary depreciation is based on a set of principles in the rules and supported by guidance

The Commission's final recommendation is that the rules are amended to introduce a set of principles that the AER will have regard to when developing its approach and assessing requests to amend depreciation on a case-by-case basis, i.e. in relation to a specific actionable ISP project.

The introduction of principles in the Rules is a change from our draft recommendation. In submissions to the draft report, some stakeholders suggested that embedding principles in the rules would provide greater certainty as to whether a TNSP's proposal was likely to be accepted by the AER.[21]

The Commission agrees that this change aligns with the assessment criteria for this Review. Specifically:

- outcomes for consumers – principles will provide greater clarity regarding the criteria against which the AER would assess the need to vary depreciation. This provides TNSPs with better information to develop their project plans and funding arrangements ahead of the AER's decision, supporting the timely delivery of transmission projects.
- flexibility – as discussed in section 2.4 defining principles in the rules allows this reform to be implemented more rapidly.

The scope for the AER to vary depreciation will be limited to actionable ISP projects only, consistent with the draft report position and the scope of the Review. When considering whether to vary the depreciation profile for a specific actionable ISP project, the Commission recommends the AER have regard to:

> **Principle 1:** the relative consumer benefits from the provision of network services over time
>
> **Principle 2:** the capacity of the network operator to efficiently finance its overall regulatory asset base, including efficient capital expenditure, and
>
> **Principle 3:** any other factors the AER considers relevant, having regard to Principles 1 and 2.

As set out in section 2.4.1, the Commission expects the AER to develop depreciation guidelines to provide further detail on the application of these principles, including in relation to any other factors identified under Principle 3. The remainder of this section explains the intention of these principles.

21 Submissions to the stage 2 draft report: ENA, p. 2; TasNetworks, p. 2.

2.3.1 Principle 1: The AER will have regard to any impact on inter-generational equity as a result of a decision to amend a depreciation profile

Principle 1 requires the AER to consider whether the impact of varying depreciation on the benefits/cost borne by present or future customers is appropriate. Accelerating depreciation in the early years of an investment, and slowing it down in later years, would have an intergenerational impact on customers. In practice, a change in the depreciation profile directly impacts the amount present customers pay compared to future customers. The Commission notes that the current approach to regulatory depreciation inherently delivers a revenue flow associated with the investment however this may not necessarily reflect the flow of costs and benefits for the project, particularly in the case of large new projects. As a consequence, this principle requires the AER to consider whether an alternative depreciation schedule may provide a better fit for the specific project.

The impact accelerated depreciation may have on inter-generational equity was a key point raised by stakeholders.[22] EUAA considered that it is not fair and equitable to ask electricity consumers to pay greater costs in the early years of an asset's life before the modelled benefits are expected to appear.[23] NICE argued that the current framework already tilts payments towards the early years of an asset's life and accelerating depreciation would exacerbate inter-generational equity impacts.[24] PIAC considered that bringing forward cost recovery increases bills and shifts costs to current consumers who will not receive the full benefits of the ISP project, effectively cross-subsidising future consumers.[25]

In some circumstances, outcomes for consumers may be worse if projects do not proceed or if they do not proceed in a timely manner due to financeability concerns. We consider the appropriate way of assessing inter-generational equity trade-offs is from the perspective of overall consumer benefits. A shift in depreciation will be net present value neutral from the perspective of the TNSP. This means that consumers overall will pay the same over the life of the asset. Near-term consumers will pay a larger share than later consumers, but in this in turn allows the project to proceed. If shifting of the depreciation profile allows the project to proceed in a timely manner then these consumer benefits from the delivery of the project can be unlocked. We expect the AER will have regard to this perspective when assessing requests to amend depreciation profiles.

This principle aligns with the assessment criterion for this Review in relation to outcomes for consumers, as consideration of inter-generational equity promotes an appropriate balance between timely and efficient delivery of transmission projects.

2.3.2 Principle 2: The AER will consider the capacity to finance the ISP investment at the network business level and not at the project level

When setting the revenue TNSPs can recover from their customers, the AER has regard to the network business as a whole rather than individual projects.[26] The core parts of the

22 Submissions to the stage 2 draft report: EUAA p. 4; NICE p. 12; PIAC p. 6.
23 EUAA, submission to the stage 2 draft report, p. 4.
24 NICE, submission to the stage 2 draft report, p. 12.
25 PIAC, submission to the stage 2 draft report, p. 6.
26 Clause 6A.1.1 of the NER.

regulatory framework reflect this focus. For example, the allowed rate of return is set for regulated network service providers and not individual projects.[27] The revenue and pricing principles also make it clear that it is the "regulated network service provider" that "should be provided with a reasonable opportunity to recover at least efficient costs".[28]

However, some stakeholders have challenged the existing frameworks and questioned the appropriateness of assessing financeability at the network business level. Transgrid argued that ISP projects must on a stand-alone basis have cash-flows which support a BBB+ credit rating, assuming a 60:40 debt to equity ratio.[29] Transgrid proposed that the likely credit rating should be assessed by testing forecast project cash-flows against Moody's quantitative financial metrics and any project that fails this test would be considered to have a financeability problem.[30]

The Commission considers that introducing a financeability or commercial viability test as suggested by Transgrid would be unlikely to promote the long-term interests of consumers in all cases. In particular, adopting specific metrics as the sole measure of businesses' financeability may not be appropriate. Moody's and other credit rating agencies combine an assessment of both qualitative and quantitative metrics to arrive at an overall rating. For example, while FFO/Net Debt is a key factor considered by Moody's, it is not appropriate for an assessment of financeability to rely so strongly on a single metric. Such an approach would also present the key issue of how an appropriate threshold for this credit metric should be determined. Further, there are a range of company-specific factors that contribute to credit ratings and credit metric thresholds, such as how a company has structured their balance sheet and the risks associated with non-regulated revenues. These factors may lead to a narrowly defined approach to assessing financeability producing unintended consequences.

A more targeted approach to considering financeability, only where this is raised by a business with respect to a specific actionable ISP project, would be more appropriate given the issue is likely only to arise in limited circumstances.

The Commission considers it appropriate that the AER will consider the capacity to finance the ISP investment at the network business level and not at the project level. As part of this assessment, consideration should also be given to how an investment in a particular project may impact the overall position of the business (including in relation to financial metrics) and where the TNSP will sit after the inclusion of the project.

This principle aligns with the economic efficiency assessment criterion for this Review because considering financeability at the network business level:

- provides service providers with a reasonable opportunity to recover at least their efficient costs, and
- is consistent with the current regulatory approach to setting revenues.

27 AER (2018), Rate of Return instrument.
28 Clause 7A(2) of the NEL.
29 Transgrid, submission to the stage 2 draft report, p. 3.
30 Ibid., p. 20.

2.3.3 Principle 3: The AER can incorporate other factors in their assessment which may not be captured by principles 1 and 2

The Commission is seeking to ensure the regulatory framework has a proportionate and flexible mechanism for addressing financeability concerns if they arise. Sufficient flexibility can be achieved by providing the AER with an appropriate level of discretion to incorporate other relevant factors into their assessment of a request to accelerate depreciation.

The intent of Principle 3 is to enable the AER to factor in a broader range of factors that may impact its assessment or decision for a particular project. This is necessary, given that Principles 1 and 2 are not exhaustive. As outlined in section 2.4.1 below, we expect the AER to issue a guideline to supplement these principles. Part of the guideline will provide clarity to stakeholders on the other factors that may be considered and the AER's reasoning for including these other factors in their assessment/decision. For example, other relevant factors could include the impact of any concessional financing, bill shock and the impact of ISP projects on affordability, or more detailed considerations of the TNSP's balance sheet.

This principle aligns with the flexibility assessment criterion for this Review, as it allows the AER's assessment to consider other relevant factors that may emerge.

2.4 These reforms can be implemented quickly

The Commission considers that these reforms can be implemented quickly and recommends that:

- the AER be able to make decisions to vary depreciation based on the depreciation principles in the NER, which can then be supplemented with more detailed information in a guidance note.
- a TNSP can make an application to amend the depreciation profile for a specific project no earlier than six months prior to the CPA application and no later than four months prior to CPA lodgement.

2.4.1 The AER will be able to make decisions based on the depreciation principles in the NER until such time that more detailed guidance is developed by the AER

The Commission's position in the draft report was that the AER would be required to issue a depreciation guideline setting out how the new arrangements would be applied. Based on the final recommendation to introduce depreciation principles in the rules, it is no longer considered necessary to include a binding requirement for the AER to issue a guideline. However, given the complexity of this issue and considerable stakeholder interest, it is expected that the AER will provide supplementary guidance setting out its detailed approach for assessing requests to vary the depreciation profile of an actionable ISP project.

We consider this approach aligns with the following assessment criteria underlying this Review:

- flexibility – a principles-based approach will provide the AER with a considerable degree of discretion, and

- economic efficiency – facilitating efficient investment in transmission infrastructure by providing transparency and certainty to TNSPs regarding how the AER will assess applications to vary the depreciation profile for a specific project.

The Commission considers that a principles-based approach is preferable from a timeliness perspective. Defining depreciation principles under the Rules will enable TNSPs to submit a request to the AER to vary depreciation as soon as a rule is made.[31] In contrast, a guideline-based approach as recommended under the draft report would take longer to implement given that TNSPs could only submit a request once the rules had been amended, and the AER had consulted on and published its depreciation guideline.

As mentioned above, the Commission nonetheless expects the AER to develop a depreciation guideline within a reasonable timeframe. The guideline would set out how the arrangements will be applied, including:

- the approach the AER proposes to take when assessing whether a different depreciation profile would better meet the NEO
- the information that should be provided by the TNSP in support of its proposal to vary the usual approach to depreciation for the relevant ISP project, and
- any other matters the AER considers appropriate to include in the guideline.

The Commission expects that the AER will publish its depreciation guideline nine months after the relevant changes to the NER, providing stakeholders with the opportunity to engage in the process of developing this guideline. However, this will not prevent TNSPs requesting a change in depreciation as soon as the new rules are published. This approach to implementation is consistent with stakeholder views, which emphasised the importance of giving effect to the reform quickly and the potential costs associated with delaying transmission projects.[32]

Consistent with our position in the draft report, the Commission's view is that any decision by the AER to vary depreciation profiles will also require the AER to amend the current post-tax revenue model (PTRM) and roll forward model (RFM). The AER has indicated that it would take nine to 12 months to implement the appropriate changes to these models. Modifications to these models can proceed in parallel with the AEMC considering a rule change request to introduce depreciation principles under the NER, following the publication of this final report. We anticipate that if needed the AER could apply temporary arrangements to vary depreciation profiles in the interim.[33]

31 The rule making process can be fast-tracked if the rule change request arises from an AEMC review. Under such a fast-track process there is an opportunity for written submissions only after publication of the draft rule determination. The AEMC can make a rule within approx. 85 business days under such a fast-track process. See AEMC, *The rule change process. A guide for stakeholders, 20 June 2017*, p. 5.

32 Submissions to the stage 2 draft report: ENA, p. 8; CEIG, p. 4.

33 AEMC, TPIR stage 2 draft report, p. 20.

2.4.2 Under the new framework TNSPs will be able to submit a request for accelerated depreciation prior to the CPA stage to facilitate investment certainty

Stakeholders expressed that it is important to have early visibility regarding the cash-flow profile for a project in responses to the draft report.[34] Transgrid highlighted that investors are required to make an 'in principle' commitment early and to do so requires a high level of confidence that financeability risks will be addressed. CEFC also stated that it was important to allow sufficient time for the TNSP to consider the impacts of the investment on their corporate strategy, engage with investors to raise debt and equity capital, and engage with credit rating agencies, if required.[35]

A level of visibility regarding potential variations to depreciation could be provided prior to the TNSP submitting a CPA. This needs to be balanced against the possibility that sufficient information to allow the AER to undertake an assessment may not be available substantially prior to the CPA. There is also a possibility that estimates, for example of total project costs, shift between the date at which the TNSP applies to vary depreciation and the CPA lodgement date.

To manage this balance, the Commission recommends a two-step process as shown in Figure 2.1 below. This would involve the AER undertaking an initial assessment in relation potential depreciation adjustments pre-CPA lodgement, with the final depreciation decision being made concurrently with the CPA decision. This process will provide TNSPs and investors with a degree of certainty regarding the bounds of any depreciation adjustment and early sight of the AER's thinking and potential stakeholder support. A two-stage process also provides additional time for the AER to consider the relevant issues and reduces the complexity of issues that the AER needs to consider during the limited time available to decide on a CPA application.

In the first step, the TNSP would submit an initial request to vary depreciation between four and six months prior to their intended CPA lodgement date. The request would need to include sufficient information for the AER to undertake an assessment of the impact of the relevant project on the TNSP's financeability. The AER would specify the information required in its depreciation guideline. This may include similar information to a CPA application, such as the impact of the project in question on the TNSP's cash flows. After reviewing the TNSP's submission, the AER would publish an issues paper for consultation to allow stakeholders to comment. This issues paper would provide an indication of the AER's thinking with a regard to a depreciation change. The AER would be required to publish the issues paper within two months of receiving the TNSP's submission.[36] If the AER requests further information from the TNSP following the initial submission, this request would 'stop the clock' until the relevant information is provided by the TNSP. Consultation on the issues paper would close prior to the CPA lodgement date.

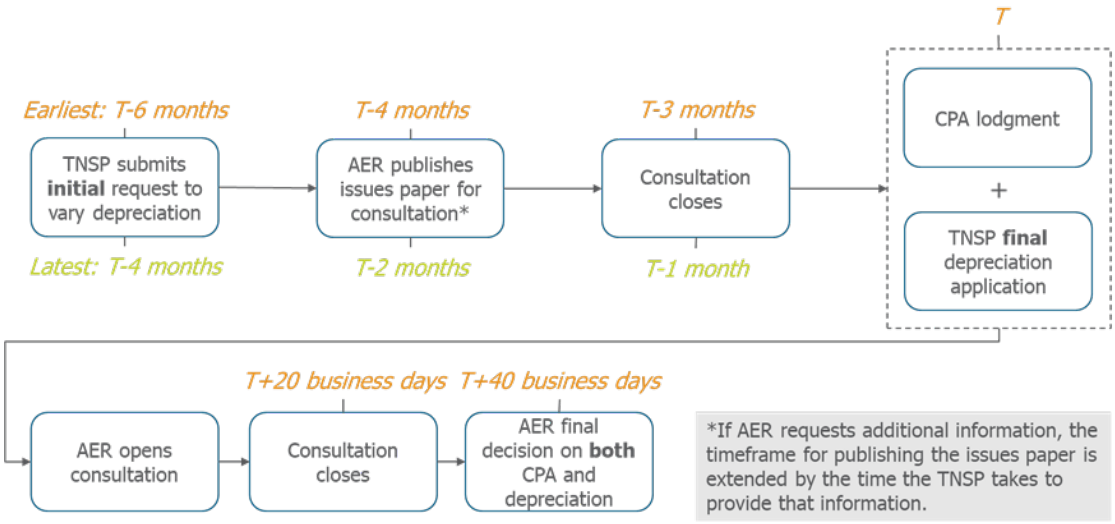
In the second step the TNSP would submit their CPA and a final request to vary depreciation. The process and timelines would follow the current standard CPA approval procedure. The

34 Submissions to the stage 2 draft report: Transgrid, p. 4; CEFC, p. 3.
35 CEFC, submission to the stage 2 draft report, p. 3.
36 See clause 6A.6.3(j) of the proposed rule.

AER would make its final decision on whether to vary depreciation on the basis of the information included in the CPA.

The Commission notes that TNSPs may submit more than one CPA to deliver an ISP project. This may occur when either AEMO (in the ISP) or the TNSP (in the RIT-T) determines that an ISP project should be developed in multiple stages, to manage uncertainty around the need for and optimal timing of the investment. TNSPs may also submit multiple CPAs for single-stage ISP projects, to seek approval of costs. The first CPA would typically seek an allowance for early works (which are undertaken to further scope and refine the project through more detailed cost estimates), while the second CPA would seek approval for the full cost to deliver the project. In this context, the Commission anticipates that the TNSP's request to vary depreciation would occur four to six months prior to the *second* CPA. The Commission considers it appropriate for the financeability assessment to occur at the second CPA stage when more accurate cost estimates will be available and when the bulk of the project expenditure will be assessed by the AER.

Figure 2.1: Process for financeability assessment



Source: AEMC.

We consider this process aligns with the economic efficiency criterion for this Review:

- early visibility of the AER's initial assessment provides TNSPs with information to make efficient and timely investment decisions, and
- the process provides transparency around the AER's decision-making.

3 TNSPS, LOCAL COMMUNITIES AND OTHER STAKEHOLDERS AFFECTED BY MAJOR TRANSMISSION PROJECTS ARE CRITICAL PARTNERS IN THEIR DELIVERY

BOX 2: FINAL RECOMMENDATIONS

The Commission recognises that obtaining social licence for the delivery of major transmission projects in the NEM is a significant issue that can have a major impact on their timely and efficient delivery.

Based on feedback received from stakeholders to the questions posed in the stage 2 draft report, the Commission considers there are several opportunities for additional guidance to be provided in the Rules and by the AER in its guidelines. This additional guidance will clarify the arrangements that support TNSPs in carrying out activities that build and maintain community acceptance of major transmission projects.

The Commission has made the following recommendations in relation to social licence:

1. **Cost recovery** - the Commission recommends that the AER provide additional guidance to stakeholders regarding how the costs associated with building and maintaining social licence for major transmission projects should be considered and assessed as part of the regulatory process. This includes guidance on:
   - the consideration and assessment of costs associated with social licence activities in the RIT-T,
   - the AER's approach to the assessment of efficient costs under the different cost recovery avenues, and
   - the application of cost pass-throughs for unexpected and unavoidable costs, including those incurred under jurisdictional planning and environmental approval processes.
2. **Engagement** – the Commission recommends that the AER provide additional guidance to stakeholders around its expectations on TNSPs regarding engagement and consultation with local communities and other stakeholders affected by major transmission projects at key stages in the planning process. This includes guidance on:
   - the definition of "credible option" as it relates to the requirement for a credible option to be implemented in sufficient time to meet the identified need, and
   - the AER's expectations on TNSPs to engage and consult with local communities and other stakeholders affected by major transmission projects at key points in the planning process, including the RIT-T stage.

Further, the Commission recommends changes be made to the Rules to ensure that the

expectations on TNSPs to engage and consult local communities and other affected stakeholders at key points in the planning process are consistent for all major transmission projects identified through the ISP - that is, for renewable energy zones (REZs), future ISP projects and actionable ISP projects. These changes include:

- expanding the definition of "preparatory activities" to include engagement and consultation with local councils, local community members and other relevant community stakeholders,
- expanding the definition of "interested party" as it applies to the RIT-T consultation procedures for actionable ISP projects to include local councils, local community members and other relevant community stakeholders, and
- extending the expectations currently in place on jurisdictional planning bodies (JPBs) in respect of engagement and consultation for REZs to also apply to engagement and consultation undertaken by TNSPs in respect of future and actionable ISP projects.

This chapter sets out:

- a brief overview of what we mean by social licence and why it is important in the context of this Review,
- why clarity around the consideration and assessment of costs for activities required to build and maintain social licence is likely to be beneficial to stakeholders and the Commission's key recommendations regarding opportunities to increase clarity in this area, and
- why clarity around engagement and consultation expectations is likely to be beneficial to both TNSPs and these stakeholders and the Commission's key recommendations regarding opportunities to increase clarity in this area.

For the avoidance of doubt, in this chapter "local communities and other stakeholders affected by a major transmission project" includes local councils, local community members and other relevant community stakeholders wishing to express their views about the development of a major transmission project.

3.1 TNSPs, local communities and other stakeholders affected by major transmission projects are critical partners in the delivery of major transmission projects

Social licence is a broad term used to refer to a range of concepts and activities. For this review, we are focusing on social licence as it relates to the activities undertaken by TNSPs to build and maintain broad community acceptance of major transmission projects.

The Commission recognises that TNSPs, local communities and other stakeholders affected by major transmission projects are critical partners in the delivery of major transmission projects. Building and maintaining trust between these stakeholders is critical if TNSPs are to deliver major transmission projects efficiently and on time.

Major issues can arise where a community believes a major transmission project will cause disruption or other negative impacts within their community, or if the reasons for, and long-term benefits of, a major project are not adequately communicated. Extreme community opposition can result in delays and costly changes to the scope of a project.

Where the case for a major transmission project is adequately made and the benefits clearly articulated by TNSPs, a local community is much more likely to accept a project, including any short-term disruptions it may cause. Earning the trust of communities puts TNSPs in a stronger position to deliver major transmission projects on time and within budget. It also provides TNSPs with more flexibility to innovate, which creates benefits for all stakeholders, including consumers.

It is therefore critical that the regulatory arrangements support and incentivise TNSPs to undertake activities that help to build and maintain trust with local communities and other stakeholders affected by major transmission projects. Building trusting and productive relationships with local communities early can also create tangible value for TNSPs by assisting in the identification and management of key project risks before these have a material impact on the timely and efficient delivery of a project.

In the stage 2 draft report, the Commission set out its expectation that TNSPs continue to invest in social licence activities, recognising that securing social licence is vitally important in enabling the energy transition. The Commission notes the important work in this area by jurisdictional governments and other key bodies, including the Australian Energy Infrastructure Commissioner (AEIC), to identify key issues and promote best practice actions that will support TNSPs and communities to work together to deliver critical major transmission projects for the benefit of all consumers in the NEM.

3.2 We recommend the AER provide guidance to clarify the application of the various cost recovery mechanisms for activities associated with building and maintaining social licence

Based on feedback received from stakeholders to the stage 2 draft report, the Commission considers that although there are no barriers in the Rules to TNSPs being able to recover efficient costs associated with key activities undertaken to build and maintain social licence for major transmission projects, there are several opportunities for additional guidance to be provided by the AER regarding the application of these mechanisms.

3.2.1 The Rules provide various avenues for TNSPs to recover the costs associated with building and maintaining community acceptance for major transmission projects, but these are largely untested

As explained in the stage 2 draft report, the regulatory framework provides several avenues for TNSPs to recover their efficient costs associated with activities aimed at building and maintaining community acceptance of major transmission projects.[37] The suitability of the different mechanisms depends on whether these costs are known or reasonably foreseeable,

37 AEMC, Transmission planning and investment - stage 2, draft report, 02 June 2022, section 3.2.

unexpected or unavoidable, and when in the planning and delivery process the costs are known, discovered or incurred.

In submissions to the stage 2 draft report, stakeholders generally accepted that the current framework provides opportunities for TNSPs to recover the costs of social licence activities. However, most considered that additional guidance would be useful to clarify which costs should be considered, and how costs would be assessed, under each of the different cost recovery mechanisms.[38]

RE-Alliance, for example, expressed the view that the lack of clarity around the definition of efficient costs was at the heart of the cost recovery issue.[39] Transgrid noted the lack of codification within the Rules of the categories of social licence expenditure that TNSPs can recover, as well as what constitutes efficient expenditure within these categories.[40] More specifically, several stakeholders including Tilt and the CEIG, were of the view that the Rules do not support or provide adequate certainty regarding the consideration, assessment and recovery of costs associated with landholder compensation or benefit sharing arrangements.[41]

While a range of avenues for cost recovery exist, these are largely untested for the types and magnitude of social licence costs that are expected to be incurred by TNSPs in planning and delivering major transmission projects identified through the ISP. This means there is uncertainty around how these Rules should be applied by TNSPs, and will be applied by the AER, in practice. The three key avenues for cost recovery, and the potential issues associated with each, are as follows:

- **Forecast expenditure approved via the revenue determination process.**[42] Transgrid is the first TNSP to test this process for forecast costs associated with preparatory activities required to be undertaken for Transgrid's future ISP projects.[43] In its recent draft decision on Transgrid's revenue proposal, the AER did not approve Transgrid's proposed step change in its operating expenditure forecast for costs related to ISP preparatory activities. In making its draft decision, the AER noted that *"We observe that Transgrid's proposed costs associated with ISP preparatory activities form a small part of the overall opex, and we consider these costs should be considered business-as-usual (BAU) within Transgrid's total opex forecast."*[44] Importantly, there is currently no general guidance available regarding how the AER will approach an efficiency assessment of this

38 Submissions to the stage 2 draft report: Transgrid, p. 15; ENA, p. 3; AEMO, 5; RE-Alliance, pp. 5-6; TasNetworks, p. 2; Tilt, pp. 5-6; CEIG, p. 7.

39 RE-Alliance, submission to the stage 2 draft report, pp. 5-6.

40 Transgrid, submission to the stage 2 draft report, p. 15.

41 Submissions to the stage 2 draft report: Tilt, pp. 5-6; CEIG, p. 7.

42 See: AEMC, Transmission planning and investment - stage 2, draft report, 02 June 2022, section 3.2.1.

43 In its recent revenue proposal for the 2023-28 regulatory period, Transgrid included a step change in its operating expenditure forecast for costs related to ISP preparatory activities. See: Transgrid, Opex Step Change Overview Paper, 2023-28 Revenue Proposal, pp. 18-20. In the AER's draft decision, the AER did not approve the step change in TransGrid's opex forecast for ISP preparatory activity costs. See AER, Draft Decision Transgrid Transmission Determination 2023 to 2028, (1 July 2023 to 30 June 2028), Appendix 6, pp. 23-24.

44 *See AER, Draft Decision Transgrid Transmission Determination 2023 to 2028, (1 July 2023 to 30 June 2028), Appendix 6, pp. 23-24.*

nature, including on when it would consider a step change in operating expenditure would be appropriate for these costs.

- **Forecast costs of delivering a specific major transmission project approved via a CPA.**[45] The RIT-T application guidelines for actionable ISP projects provide guidance and worked examples on the types of costs that can be assessed as part of a RIT-T. However, there is no guidance around the types of social licence costs that can and should be considered and assessed in the RIT-T. The lack of clarity around whether community benefit-sharing arrangements are allowed and what level of landholder payments would be considered efficient (and would therefore be recoverable) was cited as a key deficiency in the arrangements by stakeholders.

  While the AER has provided some general guidance around expectations of TNSP cost estimates included within a CPA (eg that these are not overly conservative, based on evidence, trend based etc) there is little guidance available on what level of costs of social licence activities would be considered efficient for major transmission projects in the context of a CPA. Although the AER's recent CPA decision on HumeLink early works included an allowance for several activities related to building and maintaining social licence, there is no general guidance available to assist TNSP decision making.

- **Pass-through of costs incurred for certain types of events that are beyond a TNSP's reasonable control.**[46] The Commission does not anticipate that this avenue of cost recovery would be used by TNSPs for activities related to building and maintaining social licence, other than in very rare circumstances. However, there are some questions around how the mechanism would operate in practice.[47]

On this last point, we note the view put forward by Transgrid in its submission to the draft report that the costs associated with changes to route alignment due to state planning processes should be recoverable through a direct pass-through, on the basis that these costs cannot be managed through a staged CPA process.[48] In line with its draft position,[49] the Commission remains of the view that risks of this nature - that is, risks identified through jurisdictional planning processes - can be identified and quantified (for example, through earlier or improved engagement with affected communities), and so can be managed either as part of the risk allowance for major transmission projects, or through the staged CPA process.

45 See: AEMC, Transmission planning and investment - stage 2, draft report, 02 June 2022, section 3.2.2.

46 Ibid, section 3.2.3.

47 For example: what type of social licence related events would meet the definition of "regulatory change event"; will the AER agree to a new nominated pass-through event for unexpected and unavoidable material costs related to social licence activities; what evidence the AER would require for decisions on pass-through event applications or requests to include a nominated pass-through event in a TNSP's revenue determination; and what principles would the AER use when assessing the efficiency of these costs?

48 Transgrid, submission to the stage 2 draft report, p. 13.

49 This position was support by PIAC in its submission to the stage 2 draft report, p. 8.

3.2.2 Providing clarity around the consideration and assessment of costs associated with building and maintaining social licence will support the timely delivery of major transmission projects

We consider it is important that TNSPs have clarity around the operation and application of the Rules that enable TNSPs to recover the efficient costs incurred in undertaking activities to build and maintain social licence. Clear guidance that is specific to these activities and associated costs will:

- improve predictability around how the AER will approach its assessment of the efficient costs incurred by TNSPs to build and maintain community acceptance of major transmission projects
- increase confidence in TNSP forecasts of the costs associated with social licence activities so that consumers, who ultimately fund these activities, pay no more than necessary, and
- strengthen the incentive for TNSPs to undertake key activities to build and maintain community acceptance of major transmission projects at key points throughout the planning process by increasing certainty around cost recovery.

Clear guidance that increases transparency and predictability of the regulatory arrangements will support efficient decision making by TNSPs. This, in turn, will support the efficient and timely delivery of major transmission projects in the NEM, consistent with the NEO.

In submissions to the stage 2 draft report, stakeholders almost unanimously supported additional guidance on matters related to cost recovery, including on how social licence costs will be assessed within the regulatory framework and on what constitutes efficient costs to all transmission companies operating across the NEM.[50]

3.2.3 Additional AER guidance will increase clarity around recovery of costs associated with building and maintaining social licence for major transmission projects

The Commission considers there is an opportunity for the AER to provide additional guidance to stakeholders around:

- the consideration and assessment of costs associated with social licence activities in the RIT-T
- the AER's approach to the assessment of efficient costs under different cost recovery avenues, and
- the application of cost pass-throughs for unexpected and unavoidable costs, including those incurred under jurisdictional processes.

Each opportunity for additional guidance is discussed further below.

Guidance on how TNSPs should consider and assess the costs associated with building and maintaining social licence in the RIT-T

There is an opportunity for the AER to provide clear guidance to stakeholders on the treatment of costs associated with building and maintaining social licence in the RIT-T. Importantly, this should include guidance and worked examples on how the costs associated

50 Submissions to the stage 2 draft report: TasNetworks, p. 2; RE-Alliance, pp. 5-6; PIAC, p. 7; ENA, p. 3; Transgrid, p. 15.

with landholder compensation and benefit-sharing arrangements (where applicable) should be considered and assessed.

By providing clarity around consideration and assessment of costs for social licence activities in RIT-Ts, TNSPs will be in a good position to undertake a more robust and strategic assessment of the costs and benefits of major transmission projects. This will optimise decision-making and improve the timeliness and efficiency of the economic assessment process. Increased guidance on these issues will also assist local communities and other stakeholders affected by a major transmission project, and other stakeholders who engage in RIT-T processes.

This guidance could be provided in the AER's *Cost-benefit assessment guidelines*, which house the RIT-T application guidelines for actionable ISP projects. Alternatively, the AER could choose to publish this guidance in a standalone document dedicated to the assessment of social licence activities and costs in the regulatory framework.

This guidance will also be useful for AEMO when assessing social licence costs for potential transmission projects as part of the development of the ISP. The AER's *Cost-benefit analysis guidelines* also apply to AEMO in preparing the ISP.

We note Transgrid's submission which included a list of the categories of social licence costs that can be incurred by TNSPs in building and maintaining social licence.[51] Transgrid proposed that the Rules clarify the extent to which these costs can be recovered by TNSPs, subject to being prudent and efficient. While we do not propose that these categories of costs be included in the Rules, we encourage the AER to consider these categories when preparing guidance on these matters.

Guidance on how the AER will approach its assessment of efficient costs under different cost recovery avenues, including forecast expenditure for preparatory activities, as part of the regulatory process

There is an opportunity for the AER to review, and update where necessary, its current guidance documents (for example, its *Expenditure forecast assessment guideline*) to ensure the processes, techniques and associated data requirements are appropriate for assessing and setting efficient allowances for activities associated with building and maintaining social licence.

More specifically, in light of the AER's recent draft decision on Transgrid's 2024-29 revenue determination, we consider there is benefit in the AER providing clarity regarding the circumstances in which TNSPs would be expected to manage the costs associated with ISP preparatory activities through BAU transmission planning expenditure, and the circumstances in which it would consider approving a step change in opex for ISP preparatory activities and other activities associated with building and maintaining social licence.

By providing clarity around the AER's approach to setting efficient allowances for social licence activities, TNSPs will have more confidence to invest in the activities critical to

51 Transgrid, submission to the stage 2 draft report, pp. 10-12. Categories include: easement compensation; neighbour compensation; community investment / benefit sharing / partnerships; visual impact mitigation; enhanced best practice community engagement; biodiversity offsets.

building and maintaining community acceptance of major transmission projects at key stages of the planning process. They will also be encouraged to invest in these activities at a level which ensures that consumers pay no more than is necessary to support these activities.

This guidance will also assist stakeholders who engage in revenue determination processes.

Guidance could be included within the AER's *Expenditure forecast assessment guidelines* and/or in an updated version of its guidance note on the *Regulation of actionable ISP projects 2021*. Alternatively, as noted above, the AER could choose to publish this guidance in a standalone document.

Guidance on how the arrangements for pass-through events would apply (if at all) to unexpected and unavoidable costs related to social licence activities

Finally, there is an opportunity for the AER to develop new guidance on the principles it will use, and the evidence it would require, to guide and inform decisions on cost pass-through event applications. This will provide regulatory certainty and transparency for TNSPs where unexpected and unavoidable costs related to social licence activities are incurred.

New guidance will also assist TNSPs and other stakeholders to better understand when, if ever, a pass through may be appropriate for social licence activities and when other regulatory tools should be used instead of pass-throughs. This will support better decision-making by TNSPs, and thus promote efficient investment in social licence activities, consistent with the NEO.

3.3 We recommend changes to the Rules and AER guidance to clarify the expectations on TNSPs to engage and consult with local communities at key stages of the planning process

The Commission considers there are several opportunities for additional guidance to be provided in the Rules, and by the AER in its guidelines, to clarify the expectations on TNSPs to engage and consult with local communities at key stages of the planning process.

3.3.1 The Rules provide many opportunities for stakeholders to engage, but it is unclear where TNSP engagement and consultation with local communities is most valuable

As outlined in the draft report, the Rules provide many opportunities for stakeholders to engage in the planning and regulatory processes.[52] However, different emphasis is given to different stakeholders at different points in the planning and delivery process. While there is nothing in the Rules that prevents TNSPs from engaging with local communities and other stakeholders who are critical to building and maintaining community acceptance for major transmission projects, the Rules and supporting guidelines do not proactively encourage engagement with this cohort, other than in the context of REZ Design Reports.

There are several issues driving the lack of clarity around whether and when TNSPs and local communities should engage on matters relevant to major transmission projects within the planning process:

52 See: AEMC, Transmission planning and investment - stage 2, draft report, 02 June 2022, section 3.3.

- the Rules do not explicitly recognise the value of early engagement with this cohort of stakeholder in the national planning process for major transmission projects, other than for REZs, and
- there is misalignment in and between the Rules and the AER's various guidelines regarding whether and when TNSPs should engage with this cohort of stakeholders.

Examples of both these issues are provided in Table 3.1 below.

Table 3.1: Areas where additional clarity may be useful

STAGE OF THE PLANNING PROCESS	ISSUE
REZ Design Reports	• The Rules for REZ Design Reports place significant emphasis on engagement and consultation by JPBs with local councils, local community members, members of the public and any other relevant stakeholders wishing to express their views about the development of projects within a REZ.[1] • The Rules for REZ Design Reports also include explicit expectations on JPBs regarding any public consultation and engagement undertaken for the purposes of preparing REZ Design Reports and undertaking preparatory activities for REZs.[2]
Preparatory activities	• The Rules regarding preparatory activities for future and actionable ISP projects (including REZs) require TNSP to engage with "a council and other stakeholders" as part of undertaking those activities.[3] • There are no equivalent expectations placed on TNSPs regarding any public consultation they may undertake with this group of stakeholders.
RIT-T for actionable ISP projects	• The Rules for RIT-T consultation for actionable ISP projects explicitly require TNSPs to consult with and seek feedback from *"AEMO, Registered Participants and interested parties"*.[4] However, local communities and other affected stakeholders are unlikely to meet the definition of "interested party" as it is defined for the purpose of the RIT-T. • The RIT-T application guidelines for actionable ISP projects set out expectations on TNSPs to consult with non-network providers, consumers and other stakeholders when undertaking a RIT-T for an actionable ISP project. However, they are silent on local communities and other stakeholders affected by major transmission projects.
CPA	

STAGE OF THE PLANNING PROCESS	ISSUE
	• The AER's *Guidance note: Regulation of actionable ISP projects* 2021 sets out a comprehensive list of expectations on TNSPs regarding CPA pre-lodgement engagement which includes engagement with local community and consumer representatives. This guidance relates to the preparation of CPAs and does not extend to engagement undertaken during the RIT-T consultation process.

Source: [1] Clause 5.24.1 of the NER; [2] Clause 5.24.1(e) of the NER; [3] Clauses 5.22.6 and 5.10.2 of the NER; [4] Clauses 5.16A.4(c), (f), (h) and (i) of the NER.

In addition, there is a disconnect between the RIT-T and jurisdictional planning and environmental approval processes, both in terms of the:

- factors that are considered in these project assessments, and
- scope of engagement and consultation that TNSPs are expected to undertake with local communities for the purpose of this those assessments.

The implications of this disconnect were explored by AusNet in its submission to the stage 2 draft report.[53]

This mix of obligations and expectations can be confusing for TNSPs in understanding what they are expected to do and when, and for the stakeholders who are asking for more clarity around when they will be heard and can participate in the process. In addition, there is a risk that TNSPs do not sufficiently or effectively engage with this cohort of stakeholder, and that this cohort of stakeholder does not participate in the process when it is of most value to all parties.

The consequence is that the delivery risks stemming from the location of a major transmission project within a community may not be identified and managed early before key decisions are made and may not be sufficiently or accurately priced into the overall cost of a project. This impacts both timely and efficient delivery.

3.3.2 Providing clarity around whether and when TNSPs should engage and consult with local communities is important

Meaningful, early, high quality engagement with local communities and other stakeholders has several benefits including:

- improves stakeholder and community understanding of the costs and risks of a major transmission project

53 AusNet explained that several years can lapse between when a RIT-T is completed and when a TNSP (as part of engaging with local communities as part of the jurisdictional planning process) subsequently discovers that a preferred solution is not socially or practically feasible. At this point, a TNSP's ability to address the concerns of consumer and community groups is significantly reduced, resulting in potentially costly scope revisions or project delays that may have been avoidable or mitigated by early engagement. Ausgrid considered that engagement with this group at the RIT-T stage would makes sense to uncover key risks to project delivery early. See: Ausnet Services, submission to the stage 2 draft report, pp. 5-7.

- facilitates understanding of any community concerns, including around route selection by affected stakeholders, which can inform the identification and management of risk
- provides opportunities to identify and assess whether project options (including credible options for assessment in the RIT-T) are likely to be able to be delivered in time to meet the need, particularly where there are community concerns
- provides opportunities for the preferred option to be designed with the benefit of local community input
- provides TNSPs with opportunities to address or manage concerns raised and demonstrate to communities how it has taken their concerns and feedback into account.

Early engagement can therefore improve the quality of planning undertaken by TNSPs for major transmission projects, including the identification of risks to timely delivery, and the quality of the regulatory process, including the accuracy of forecast costs of major transmission projects.

In this context, clear guidance that increases transparency around when engagement with local communities should be occurring will support efficient and robust decision-making by TNSPs. This, in turn, will support the efficient and timely delivery of major transmission projects in the NEM, consistent with the NEO.[54]

In general, stakeholders who submitted to the draft report viewed early and appropriately targeted engagement as promoting community acceptance and mitigating the risk of project delays.[55]

Stakeholders were, however, divided on whether additional obligations in the Rules are necessary to facilitate this. ENA noted that while there are opportunities to improve engagement outcomes and reduce social licence risks, prescribing additional requirements is unnecessary given TNSPs' evolving approaches to engagement, including bringing engagement forward to the RIT-T stage or earlier.[56] This view was supported by others who considered existing obligations are broadly appropriate.[57]

In contrast, several stakeholders considered there were opportunities for additional clarity to be provided around when community/consumer groups should engage to provide input into key decisions.[58] As outlined in section 3.4.2, the AEIC noted that, while early engagement with the community is encouraged, it cautioned against consulting too early, before key decisions are made.[59]

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54 The benefits of early engagement are currently recognised at a high level in the ISP Rules for REZ Design Reports and preparatory activities, and by the AER in its Guidance Note: Regulation of actionable ISP projects, which focuses on the CPA process, including expectations regarding pre-lodgement engagement. See: AER, Guidance Note: Regulation of actionable ISP projects 2021, p. 5.

55 Submissions to the stage draft report: ENA, p. 3; PIAC, p. 7; Energy Australia, pp. 1-2; AEMO, p. 5; Re-Alliance, pp. 7-8; CEIG, pp. 6-7; AusNet Services, pp. 5-7; Transgrid, pp. 9-10.

56 ENA, submission to the stage 2 draft report, p. 3.

57 Submissions to the stage 2 draft report: Engie, p.3; Origin, p.2; AGL, p.2; Tilt, p. 5.

58 Submissions to the stage 2 draft report: AusNet services, pp. 5-7; RE-Alliance, pp. 7-8; PIAC, p. 7; Transgrid, p. 9: Energy Australia, p. 2.

59 AEIC, submission to the stage 2 draft report, attachment: 2021 Annual Report of the Australian Energy Infrastructure Commissioner, Commonwealth of Australia 2022, pp. 47-48. This issue is discussed in more detail in section 3.4.2.

3.3.3 Amended rules and additional AER guidance will clarify the expectations on TNSPs to engage with and consult this cohort of stakeholders at key points in the planning process for major transmission projects

The Commission has identified several opportunities to increase clarity, and reduce uncertainty, around expectations on TNSPs to engage and consult local communities and other stakeholders affected by major transmission projects at key points in the planning process. Collectively, these recommendations aim to ensure that obligations and expectations are consistent for all major transmission projects identified through the ISP - that is, for REZs, future ISP projects and actionable ISP projects.

Importantly, the recommendations are not intended to impose material new obligations on TNSPs in terms of engaging with local communities and other affected stakeholders in the transmission planning process. The purpose is to remove uncertainty by providing additional clarity and consistency around when engagement between TNSPs and this cohort of stakeholder is likely to be most valuable to both parties and so should be undertaken. This will support efficient decision making by TNSPs, while helping to facilitate proactive and constructive relationships between TNSPs and local communities.

The Commission's recommendations are:

- AER to provide guidance on:
  - how TNSPs might ensure that a credible option can "be implemented in sufficient time to meet the identified need" as required by the definition of "credible option", and
  - the expectations on TNSPs regarding engagement with local communities and other stakeholders affected by major transmission projects during the RIT-T.
- Rule changes to:
  - Expand the definition of "preparatory activities" to include engagement and consultation with local councils, community representatives and other relevant community stakeholders.[60]
  - Expand the definition of "interested party" as it applies to the existing RIT-T consultation procedures for actionable ISP projects to include local councils, community representatives and other relevant community stakeholders.[61]
  - Extend the expectations regarding engaging and consultation by JPBs for REZs to include engagement and consultation undertaken by TNSPs in respect of future and actionable ISP projects.[62]

These recommendations are discussed in further detail below.

Additional AER guidance (non-Rules based recommendations)

Guidance on how TNSPs might ensure that a credible option can "be implemented in sufficient

60 See clause 5.10.2(e) of the proposed rule.
61 See clause 5.15.1(b) of the proposed rule.
62 See clause 5.24.1(e) of the proposed rule.

time to meet the identified need" as required by the definition of "credible option"

The purpose of the expanded definition is to require TNSPs to carry out activities, including community engagement and consultation, to satisfy themselves that a credible option is likely to be deliverable. Uncovering key risks to project delivery arising from communities at the RIT-T stage, rather than later, after key decisions on a project have been made, as part of the jurisdictional planning and environmental approvals processes, aims to ensure timely delivery of major transmission projects.

This is an alternative means of achieving the intent of the proposal put forward by AusNet to include a new limb in the definition of "credible option", requiring that a credible option is deliverable.[63] We agree with AusNet that there is benefit in TNSPs engaging and consulting local communities during the RIT-T (and earlier) as a means of uncovering key risks to the efficient and timely delivery of major transmission projects. However, our view is that the current definition of "credible option" already requires TNSPs to be satisfied that a credible option is deliverable as the current definition already requires that credible options "can be implemented in sufficient time to meet the identified need."[64]

While the AER's RIT-T application guidelines for actionable ISP projects expand on the meaning of the other limbs of the definition of credible option, the guidelines do not provide any guidance on how a TNSP might determine that a credible option can be implemented in sufficient time to meet an identified need.

The Commission, therefore, considers there is an opportunity for the AER to provide guidance on the meaning of this limb of the definition, and how it can be assessed. The Commission notes AusNet's suggestion that such guidance includes potential studies and analysis that TNSPs could undertake to demonstrate whether an option is likely to be deliverable.[65] More broadly, the Commission considers that the key point is that early engagement with affected communities is likely to be necessary for a TNSP to be comfortable that a project can be delivered in required timeframes.

This guidance is likely to be best placed in the RIT-T application guidelines for actionable ISP projects (which are housed in the AER's *Cost-benefit analysis guidelines*). The development of this guidance will therefore be subject to advice from RIT-T proponents and public consultation.

Guidance on the expectations on TNSPs regarding engagement with local communities and other stakeholders affected by major transmission projects during the RIT-T

The AER should review existing guidance regarding TNSP consultation and engagement with key stakeholders during the planning process to ensure these expectations are consistent with the Rules, including any new rules arising from this Review. This will further reduce uncertainty for TNSPs and local communities regarding whether and when engagement and consultation between these parties is expected. As noted in section 3.2.3:

63 Ausnet Services, submission to the stage 2 draft report, pp. 5-7.
64 Clause 5.15.2(a)(3) of the NER.
65 Ausnet Services, submission to the stage 2 draft report, pp. 5-7.

- the AER's *Cost benefit analysis guidelines* for actionable ISP projects sets out expectations on TNSPs to consult with non-network providers, consumers and other stakeholders when undertaking a RIT-T for an actionable ISP project.[66] The Commission encourages the AER to review this guidance in light of the recommended rule change to the "interested party" definition discussed below and consider whether changes are needed to recognise the importance and value of engagement with local communities and other stakeholders affected by major transmission projects at the RIT-T stage.
- the AER's *Guidance note: Regulation of actionable ISP projects 2021* sets out expectations on TNSPs regarding CPA pre-lodgement engagement, including engagement with local community and consumer representatives.[67] The Commission acknowledges the value that this guidance already provides in terms of supporting TNSPs to improve stakeholder engagement outcomes at the CPA stage. The Commission encourages the AER to review this guidance in light of the recommended rule changes set out in this report to ensure it remains consistent with and reflects the broader obligations and expectations in the Rules.

Rule change recommendations

Expand the definition of "preparatory activities" to include engagement and consultation with local councils, community representatives and other relevant community stakeholders

This recommendation will expand the current definition of preparatory activities in clause 5.22.6 of the NER to clarify that the existing obligation on TNSPs to engage with "a council and other stakeholders" as part of undertaking preparatory activities includes engagement with local councils, local community members, members of the public and any other relevant stakeholders wishing to express their views about the development of future and actionable ISP projects.[68]

The new rule would largely be consistent with the current definition of preparatory activities but would explicitly capture the list of stakeholders that JPBs are required to consult with for REZ Design Reports under clause 5.24(1)(d)(1) of the NER.

The objective of this change is to increase transparency and reduce uncertainty for local communities and other affected stakeholders around when they can first expect to be contacted by TNSPs to participate in the planning process for major transmission projects affecting them. It also provides clarity to TNSPs around what engagement with "councils and other stakeholders" should involve at this point in the planning process.

Given that this engagement and consultation will be undertaken as a "preparatory activity", cost recovery will occur through a TNSP's revenue determination process, consistent with other costs incurred for undertaking preparatory activities.

Expand the definition of "interested party" as it applies to the existing RIT-T consultation procedures for actionable ISP projects to include local councils, community representatives and

66 AER's Cost benefit analysis guidelines 2020.
67 AER: Guidance note: Regulation of actionable ISP projects 2021.
68 See clause 5.10.2(e) of the proposed rule.

other relevant community stakeholders[69]

This recommended change will explicitly recognise the value that this cohort can provide in helping TNSPs to identify and manage specific risks associated with located a major transmission project within a community.

Like the change to the definition of preparatory activities, this change will provide clarity to local communities and other stakeholders that their input is critical to TNSP planning. It also provides clarity to TNSPs regarding expectations on them to continue to engage with this cohort of stakeholder once preparatory activities have ceased and project options and their associated risks and costs are refined and further assessed at the RIT-T stage.

Expanding the definition of interested party will have the effect of requiring TNSPs to:

- make the PADR and PACR available to local communities and other stakeholders critical to building and maintaining social licence,[70]
- seek submissions from local communities and other stakeholders critical to building and maintaining social licence on the proposed preferred option presented and the issues addressed in the PADR, and[71]
- meet with a local community or other stakeholder critical to building and maintaining social licence if a TNSP, acting reasonably, considers that the meeting is necessary.[72]

The costs associated with undertaking a RIT-T are currently recovered through forecast operating expenditure in the revenue determination process and/or through the CPA process.[73] Any additional activities undertaken by TNSPs to consult with local communities and other stakeholders critical to building and maintaining social licence will also be recoverable through these avenues.

Extend the expectations regarding engagement and consultation by JPBs for REZs to engagement and consultation undertaken by TNSPs in respect of future and actionable ISP projects

This recommended change will extend existing expectations on JPBs regarding engagement and consultation with local communities and other affected stakeholders undertaken in the context of REZ Design Reports and preparatory activities for REZs, to TNSPs when engaging with and consulting this group of stakeholders for actionable and future ISP projects.

Currently, JPBs must ensure that:[74]

- stakeholders receive information that is clear, accurate, relevant and timely,
- stakeholders have sufficient opportunity to consider and respond to the information provided,

69 See clause 5.15.1(b) of the proposed rule.

70 See clause 5.16A.4(c) and (i) of the NER.

71 See clause 5.16A.4(f) of the NER.

72 See clause 5.16A.4(h) of the NER.

73 For example, Transgrid's proposed forecast capex for HumeLink set out in its CPA included a component for RIT-T analysis and documentation. See: Transgrid, HumeLink – Stage 1 (Early Works) Contingent Project Application Principal Application document, 5 April 2022.

74 Clause 5.24.1(e) of the NER.

- targeted consultation materials, and methods of communication tailored to the needs of different stakeholders are used, and
- stakeholders' role in the engagement process is clearly explained to them, including how their input will be taken into account.

In effect, this proposed rule change would extend the application of these expectations to TNSPs when undertaking engagement and consultation for the purposes of:[75]

- preparing a RIT-T for an actionable ISP project, and
- engaging with local communities and other stakeholders as part of preparatory activities for future and actionable ISP projects.

Importantly, this change will create consistency in the Rules regarding the obligations and expectations on TNSPs and JPBs regarding engagement and consultation with local communities and other stakeholders critical to building and maintaining social licence for all ISP projects - that is, REZs, actionable ISP projects and future ISP projects.

3.4 Other key bodies, including jurisdictions, are concurrently undertaking important work in this space

Existing work by jurisdictional governments and the AEIC in considering social licence issues and promoting best practice actions remains critical to supporting the timely and efficient delivery of major transmission projects. An update on this work is provided below.

3.4.1 Jurisdictions are progressing opportunities for improving community acceptance of major transmission projects as part of the National Energy Transformation Partnership and within their jurisdictions

On 12 August 2022, Commonwealth, state and territory Energy Ministers agreed to establish a new National Energy Transformation Partnership.[76] Through the partnership, governments will work together on priority actions to support the energy transformation. This work includes several coordinated initiatives and joint guidance to support TNSPs, local communities and other stakeholders critical to building and maintaining social licence to work together to support the timely and efficient delivery of major transmission projects.

Importantly, actions under this partnership and the recommendations made by the Commission in this stage 2 final report are complementary in supporting and valuing meaningful, early, high-quality community engagement and consultation by TNSPs.

In developing additional guidance as recommended by the Commission, the AER is encouraged to work closely with the National Energy Transformation Partnership to develop and articulate clear and consistent guidance and expectations for TNSP engagement and consultation with local communities throughout the transmission planning and investment process.

75 See clause 5.24.1(e) of the proposed rule.

76 See here.

In addition to the National Energy Transformation Partnership, several jurisdictions are carrying out important work to improve community acceptance of projects within identified REZs. An overview of the initiatives being taken forward in New South Wales and Victoria is provided below.

New South Wales Electricity Infrastructure Roadmap[77]

The Electricity Infrastructure Roadmap is the New South Wales Government's plan to facilitate the development of REZs and new network infrastructure to meet NSW's future energy needs. A number of community-related and social obligations are embedded in its Electricity Infrastructure Investment Act 2020 (EII Act). The responsibilities of the statutory authority, Energy Corporation of NSW (EnergyCo), include:

- leading community and stakeholder engagement activities to support REZ delivery
- delivering tangible benefits for First Nations people and communities, and
- promoting local development opportunities, through engagement with local communities and industry.

Key areas of focus for EnergyCo include the following:

- **First Nations Consultation Guidelines.** The Minister for Energy issued guidelines in August 2022 on consultation and negotiation with First Nations communities for energy infrastructure delivered under the Roadmap.
- **Regional Energy Strategy.** EnergyCo is currently engaging with local stakeholders in regional communities on developing a Regional Energy Strategy to support the delivery of REZs which aims to ensure end-users in communities in each REZ will benefit via improved and enhanced energy outcomes (reliability, access and affordability) at the distribution network level.
- **REZ community benefit sharing**. EnergyCo, with the NSW Consumer Trustee, are currently working with generation and storage proponents, and local communities, to ensure the economic benefits of REZs are equitably shared across the community through community benefit-sharing schemes funded through the collection of network infrastructure access fees.

Victoria's new Victorian Transmission Investment Framework

The Victorian Government recently released a preliminary design of the Victorian Transmission Investment Framework (VTIF) which sets out the proposed approach to develop Victoria's REZs.[78] A key focus of the VTIF is on improved processes and outcomes for critical stakeholders including Traditional Owners, local communities, agriculture and farm businesses, individual landowners and other regional stakeholders and industries. As the body established to coordinate the planning and development of REZs in Victoria, the intention is that VicGrid will take on a wider role in delivering improved engagement outcomes and benefits for these critical stakeholders.

77 See here.

78 See Victorian Government, *Victorian Transmission Investment Framework, Preliminary Design Summary for Communities*, July 2022.

Victorian Government is currently considering ways to adequately capture local views and issues throughout the decision-making process. The proposed high-level engagement process is outlined in Figure 3.1.

Figure 3.1: High-level engagement approach under the proposed VTIF to deliver REZ transmission projects

Source: *Victorian Government, Victorian Transmission Investment Framework, Preliminary Design Summary for Communities, July 2022, Figure 5.*

Other key areas of focus for the VTIF are building and maintaining community acceptance of major transmission projects and include the following:

- **New strategic land use assessment tool** to proactively identify the most appropriate areas to site transmission, generation and storage infrastructure in Victoria's REZs, taking into account community values, priorities and concerns.
- **Community benefit sharing** models are being explored to identify: the most appropriate model for REZs, who should be eligible to receive benefits and how these methods should be governed and implemented.
- **Traditional Owner engagement and benefit delivery** including specific opportunities for Traditional Owners to partner in decision-making, such as during the Strategic Land Use Assessment. VicGrid would also work with Aboriginal businesses to support their involvement and feedback in REZ development projects and would facilitate and enable economic and other benefits as identified by Traditional Owners.

3.4.2 AEIC observations and recommendations on community engagement for major transmission projects

In its submission to the AEMC on the Review, the AEIC notes that effective community consultation and engagement is essential for large-scale transmission projects to gain the support and 'social licence' to operate.[79] However, while early engagement with the community is encouraged, the AEIC cautioned against going public too early, before key decisions are made, as doing can inflame cross-sections of the community and create animosity and division between community members as they lobby to eliminate candidate routes that affect them. The AEIC suggests an alternative approach whereby TNSPs engage with communities and landholders to help finalise the actual route design and details with their insights. This approach would allow that subset of the broader community to be focussed on optimising the solution, rather than the whole, broader community group being focussed on stopping the project altogether.

Regarding recommendations specific to transmission, the AEIC recommends that:[80]

> *"3.2.17. Transmission project proponents should carefully consider minimising the number of route options that it announces for public review and consultation. Too many route options may generate widespread opposition to the project, much of which may be unnecessary if, in fact, there is ultimately only one viable route and design to pursue."*

It is important to note that the recommendations put forward in this chapter do not seek to prescribe the content and detail of any engagement and consultation undertaken by TNSPs with local communities and other affected stakeholders at key points in the planning process. The Commission's recommendations are intended to recognise the value that local communities and other stakeholders critical to building and maintaining community acceptance of major transmission projects can provide by participating in the planning process for these projects.

In line with the view of AusNet put forward in its submission, we consider it is important that TNSPs retain the flexibility to tailor their engagement activities to suit the individual project and its operating environment.[81] This recognises that some of the challenges that can emerge from engaging early with communities - for example, those identified by the AEIC - can be overcome by giving TNSPs the ability to decide what level of detail is required to be communicated and when.

We encourage TNSPs to have regard to the recommendations made by the AEIC in its annual report in relation to transmission, and to incorporate these recommendations into their engagement and consultation approaches, as appropriate.

79 2021 Annual Report of the Australian Energy Infrastructure Commissioner, Commonwealth of Australia 2022, pp. 47-48.
80 Ibid, p. 50.
81 Ausnet Services, submission to the stage 2 draft report, p. 6.

4 IMPROVING CERTAINTY OVER THE REGULATORY TREATMENT OF EARLY WORKS

BOX 3: **KEY RECOMMENDATIONS**

Early works help manage cost uncertainty and the risk of project delays in the delivery of major transmission investments. Based on stakeholder feedback, the Commission has made changes to the draft recommendations on planning activities, specifically to clarify the meaning of 'early works'. This will help stakeholders distinguish early works from preparatory activities, understand the types of activities TNSPs are able to complete when the ISP recommends completing early works, and what to include in an early works CPA.

Clarifying the meaning of early works will also clarify what preparatory activities are

- The Commission recommends that the AER should provide additional guidance to stakeholders regarding the term early works and the activities it encompasses. AEMO's use of the term in the publication of the ISP and other relevant documents should be consistent with the description and guidance provided by the AER. The Commission recommends that the AER should describe early works in its guidance as: activities that are completed prior to the construction of the preferred option, to improve the accuracy of cost estimates, and/or to ensure that a project can be delivered within the time frames specified by the most recent ISP.
- The Commission no longer recommends any changes to the definition of preparatory activities other than changes proposed regarding social licence in chapter 3 of this report. This change in position is due to stakeholders being comfortable with the existing definition, and we consider additional guidance on early works will improve clarity on the meaning of preparatory activities.

Cost recovery arrangements for planning activities remain appropriate

Consistent with the draft report, the Commission's final position is that the existing cost recovery arrangements to recover the costs of preparatory activities and early works are appropriate.

The Commission considers that the existing arrangements give TNSPs the opportunity to recover at least their efficient costs by:

- forecasting expenditure for preparatory activities in TNSPs' revenue proposals and nominating preparatory activities as a cost pass-through event in TNSPs' revenue proposals where there is a risk of material unforeseen increases to the cost of preparatory activities.

- submitting a separate CPA for early works expenditure, prior to receiving regulatory approval for the total costs of the project.

This chapter sets out:

- why it is important that the meaning and respective cost recovery mechanisms of preparatory activities and early works are clarified, and
- the Commission's recommendation to improve clarity over the meaning of preparatory activities and early works and the relevant cost recovery mechanisms.

4.1 A lack of clarity over terminology leads to uncertainty regarding what activities can be undertaken, and when and how costs are appropriately recovered

The Commission considers that it is important for TNSPs to have certainty that they can recover at least their efficient costs for preparatory activities and early works.

Completing preparatory activities and early works are likely to lead to better outcomes for consumers because these activities reduce uncertainty in the delivery of major transmission projects by improving the reliability of expenditure forecasts, managing the risk of project delays, and promoting innovative and cost-effective design.

The Commission considers that existing cost recovery uncertainty results from a lack of clarity on the meaning of early works. Preparatory activities and 'early works' are not clearly distinguishable in the regulatory framework. These activities are referred to in different ways in the NER and in regulatory documents produced by the AER and AEMO. In particular, the NER refer to 'preparatory activities' while AER and AEMO documents refer to 'early works'. The existing distinction between the two concepts appears to be one of magnitude (that is, the cost) and the extent to which the activities are project specific. However, as explained further in Box 4 below, there are overlaps between the descriptions of these activities. This creates confusion over whether certain planning activities fall into the category of preparatory activities or early works, or both.

As discussed further in section 4.3, the costs of preparatory activities and early works are recovered using different cost recovery mechanisms. Cost recovery uncertainty is created where TNSPs are unable to distinguish between different planning activities because it becomes difficult to identify which costs should be recovered under each cost recovery mechanism.

The Commission has considered how clarity around preparatory activities and early works could be improved.

BOX 4: EXISTING GUIDANCE ON PREPARATORY ACTIVITIES AND EARLY WORKS

Preparatory activities

TNSPs have an obligation under the NER to undertake preparatory activities for all actionable ISP projects, as well as for future ISP projects, where specified in the ISP.[1] Preparatory activities refer to actions taken to investigate the costs and benefits of actionable ISP projects and, if applicable, future ISP projects to support ongoing improvements to the ISP through the TNSP and AEMO joint planning process.[2] Preparatory activities are defined in the NER as follows:[3]

"preparatory activities means activities to design and investigate the costs and benefits of actionable ISP projects, future ISP projects and REZ stages (as applicable), including:

a) detailed engineering design;

b) route selection and easement assessment work;

c) cost estimation based on engineering design and route selection;

d) preliminary assessment of environmental and planning approvals; and

e) council and stakeholder engagement."

Early works

The term 'early works' is not defined or explicitly referred to in the NER, but is referenced in several regulatory documents including the ISP, the AER's *Cost Benefit Analysis Guideline* and the AER's *Guidance Note on the Regulation of Actionable ISP projects.*

The AER guidelines describe early works as activities that are more substantial and distinct from preparatory activities.[4] AEMO has also used the term early works to describe the actionable first stage of the VNI West and HumeLink projects in the 2022 Draft ISP.[5] The activities comprising early works for these projects include:[6]

- project initiation, including the planning and design activities required to accurately define the projects such as pre-contracting activities for engineering, procurement and construction contracts
- stakeholder engagement with local communities, landowners and other stakeholders
- land-use planning to identify and obtain all primary planning and environmental approvals, route identification, field surveys, geotechnical investigations, substation site selection, easement acquisition and preparation of option agreements with landholders
- detailed engineering design
- cost estimation.

Source: [1]Clauses 5.22.6(c)-(d) of the NER; [2]Clause 5.14.4(a) of the NER; [3]Clause 5.10.2 of the NER; [4]AER, Guidance note - regulation of actionable ISP projects, March 2021, p. 26; [5]AEMO, Draft 2022 Integrated System Plan, December 2021, p. 13; [6]Ibid, p. 66 and p. 69.

4.2 Additional guidance on early works will improve clarity over the meanings of preparatory activities and early works

4.2.1 Additional guidance on what constitutes early works is a simple way to clarify its meaning

The Commission's draft recommendation was to amend the definition of preparatory activities to explicitly highlight its purpose, by clarifying that preparatory activities occur prior to the identification of the preferred option.[82] However, based on stakeholder feedback we consider clarifying the difference between preparatory activities and early works can be better achieved through changes in AER and AEMO regulatory documents. As such, the Commission is no longer recommending changes to the existing definition of preparatory activities as proposed in the draft report.

Some stakeholders considered that the proposed amendment would not materially help to distinguish preparatory activities from early works activities and considered that the existing definition is necessarily flexible to capture a wide range of activities.[83] Further, these stakeholders suggested that given early works is already a well-established term, it may instead be more suitable to provide additional guidance on the meaning of early works to reduce uncertainty and distinguish it from preparatory activities.[84]

The Commission considers that providing clarity on the use of the term 'early works' in AER and AEMO regulatory documents will improve clarity and consistency regarding the types of activities associated with early works. The following section provides more detail on this final recommendation.

4.2.2 We recommend the AER update their guidance on the term early works and AEMO's use of the term in following ISPs is consistent with that guidance

As noted above, the Commission considers that the term 'early works' will benefit from further guidance regarding its meaning.[85]

Based on stakeholder submissions and further discussions with stakeholders, the Commission considers that early works is appropriately described as:

> activities that commence prior to the construction of the preferred option, which are undertaken to improve the accuracy of cost estimates, and/or to ensure that a project can be delivered within the time frames specified by the most recent ISP.

The most recent ISP refers to the latest ISP publication available at the time a CPA is submitted. This could be either a draft ISP, ISP update or final ISP.

The Commission recommends that the AER update any references to early works in its guidelines[86] to be consistent with the above description. Following this, AEMO's use of early works in the publication of the ISP and other documents should be consistent with the

82 AEMC, TPIR stage 2 draft report, p. 40.
83 Submissions to the stage 2 draft report: Transgrid, p. 14; ENA, pp. 3-4.
84 Submissions to the stage 2 draft report: ENA, p. 8; Transgrid, p. 14.
85 AEMC, TPIR stage 2 draft report, pp. 39 - 40.
86 AER, *Cost benefit analysis guidelines*, August 2020; and AER, *Guidance note – Regulation of actionable ISP projects*, March 2021.

updated AER guidelines. Importantly, this will improve certainty around what activities TNSPs are expected to complete as early works by AEMO and what expenditure TNSPs can include as early works in a CPA.

The Commission's description recognises the dual-purpose of early works by acknowledging the broad range of activities that may be required as part of early works. Any activity which commences prior to the construction of the preferred option can be considered early works if the activity can be justified as being necessary to:

- improve the accuracy of project cost estimates, and
- ensure that a project will be delivered within the time frames specified by the most recent ISP.

Early works are activities that help TNSPs prepare to construct the physical asset and not the actual construction of the asset.

This is consistent with example of activities that can be considered as early works provided by AEMO in the 2022 final ISP:[87]

- activities to build social licence, including works to provide community benefits[88]
- completion of environmental approvals,
- construction works to test engineering design,[89] and
- purchasing easements and equipment.

4.3 The existing regulatory arrangements appropriately manage uncertainty regarding cost recovery for preparatory activities and early works

Consistent with our draft recommendation, the Commission considers that the existing regulatory framework consists of appropriate cost recovery mechanisms which effectively enable TNSPs to manage uncertainty and recover at least their efficient costs for preparatory activities and early works. TNSPs can:

- include forecast expenditure for preparatory activities in TNSPs' revenue proposals
- nominate preparatory activities as a cost pass-through event in TNSPs' revenue proposals where there is a risk of material unforeseen increases to the cost of preparatory activities
- submit a separate CPA for early works to bring forward cost recovery certainty over early works expenditure.

The Commission notes that the existing set of actionable ISP projects did not have the opportunity to apply the existing framework given that it is relatively new and as a result, had transitional rules applied to them. We consider that the application of the existing framework, clarified through recommendations and associated rule changes in this Stage 2

87 AEMO, *2022 Integrated System Plan*, June 2022, pp. 68-70 & pp.74-75.

88 See chapter 3 for examples of social licence activities

89 for example, the construction of steel tower prototypes as part of Humelink which need to be built test steel and other design elements. See Transgrid, *HumeLink – Stage 1 (early works) contingent project application*, 5 April 2022, p. 25.

final report will largely provide clarity on the appropriate cost recovery pathways for future ISP projects that become actionable.

4.3.1 TNSPs can include forecast expenditure for preparatory activities in TNSPs' revenue proposals

Consistent with our draft recommendation, we consider that TNSPs can include forecast expenditure for preparatory activities in their revenue allowances.[90]

Costs for known preparatory activities, at the time of submitting a revenue determination, are managed through TNSPs' regulatory expenditure allowances that are set as part of the revenue determination process at the outset of their regulatory control period.[91] These costs, as Transgrid noted, may be capitalised when the relevant contingent project is delivered.[92]

Forecasting expenditure as part of a TNSPs revenue determination subjects these costs to incentive regulation and incentivises TNSPs to improve cost efficiency, thereby facilitating economically efficient outcomes. This also puts the risk of cost increases on TNSPs, who are best placed to manage it. Stakeholders did not raise any concerns with the Commission's draft recommendation.

4.3.2 TNSPs can nominate preparatory activities as a cost pass-through event in TNSPs' revenue proposals where there is a risk of material unforeseen increases to the cost of preparatory activities

Consistent with the Commission's draft recommendation,[93] we consider that the existing cost pass-through mechanism can be applied to recover the costs of preparatory activities,[94] where there is a risk of material unforeseen increases to the cost of preparatory activities. Using the cost pass through mechanism to recover unforeseen costs of preparatory activities is consistent with the revenue and pricing principles as it gives TNSPs certainty that TNSPs have a reasonable opportunity to recover at least their efficient costs for preparatory activities.

The Commission agrees with stakeholders that the cost pass-through mechanism would not be used frequently, given TNSPs involvement in the ISP planning processes which reduces the likelihood of material and unforeseen increases to the cost of preparatory activities.[95]

Further, the Commission agrees with stakeholders that the materiality threshold is appropriate.[96] TNSPs can group the costs of multiple preparatory activities across multiple projects into a single cost pass through application to satisfy this threshold.

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90 AEMC, TPIR stage 2 draft report, pp. 41-42.

91 As discussed in section 3.2.1, based on the AER's recent draft decision on Transgrid's proposed step change for preparatory activities, we consider there is benefit in the AER providing clarity regarding the circumstances in which TNSPs would be expected to manage the costs associated with ISP preparatory activities through BAU transmission planning expenditure, and the circumstances in which it would consider approving a step change in opex for ISP preparatory activities.

92 Transgrid, submission to the stage 2 draft report, p. 14.

93 AEMC, TPIR stage 2 draft report, pp. 41-42.

94 Clause 6A.7.3 (a1)(5) of the NER.

95 ENGIE, submission to the stage 2 draft report, p. 5.

96 EUAA, submission to the stage 2 draft report, p. 9.

The Commission does not consider that further prescription or principles in the Rules, as suggested by ENA, is needed to guide the AER's discretion in accepting a nominated pass-through event relating to preparatory activities.[97] We consider that the existing arrangements clearly allow the AER to approve a pass through for material increases to the costs of preparatory activities.

4.3.3 CPA and project staging enables TNSPs to recover the costs of early works sooner

Consistent with the Commission's draft recommendation, we consider the existing CPA process is appropriate to recover costs for early works. Stakeholders agreed that the existing CPA framework is appropriate and should be given an opportunity to work.[98]

A TNSP may submit a separate CPA for early works costs, prior to submitting a CPA for the total costs of a project.[99] This provides TNSPs with appropriate cost recovery certainty to engage in early works activities prior to submitting a final CPA. Where it is beneficial for a TNSP to complete early works even sooner, such as when recommended by the ISP to complete early works, a TNSP can submit a CPA for stage 1 to recover the costs of early works.[100]

Some stakeholders consider that despite early cost recovery enabled by submitting a separate CPA for early works, there is benefit in bringing cost recovery for early works expenditure further forward to incentivise the completion of early works even sooner in the planning process.[101]

The Commission considers that bringing the cost recovery process for early works forward will involve amendments to the existing economic assessment process. Stage 3 of the Review is considering options to improve the economic assessment process to support the timely delivery of projects, including the benefit of any potential changes in this regard.

4.3.4 Additional guidance on the meaning of early works provides greater certainty over the CPA process

The AER assesses whether early works expenditure, included in a CPA, is prudent and efficient to ensure that consumers are protected against the risk of inefficient expenditure.

The existing lack of certainty around the meaning of early works and the novelty of assessing the costs of early works separately from the total costs of a project creates uncertainty when submitting a CPA to recover the costs of early works. For example, around what can be considered as efficient early works expenditure.

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97 ENA, submission to the stage 2 draft report, p. 8.

98 Submissions to the stage 2 draft report: ENA, p. 9; AGL, p. 2; TasNetworks, p. 2; ENGIE, p.5; CEIG, p. 10; EUAA, p. 9.

99 AER, *Guidance note – Regulation of actionable ISP projects*, March 2021, p. 26.

100 The ISP introduced a new form of staging where a TNSP may complete early works as a separate project stage before completing the second stage to construct the project (which could occur years later). Previously a project was staged when an upgrade to an asset might be needed some years later, for example, a first stage could be building a 330kV line and the second stage could be increasing its capacity when it is net beneficial to consumers to do so.

101 Submissions to the stage 2 draft report: SnowHydro, p. 10; Transgrid, p. 8; AEMO pp. 6-7.

The additional guidance provided by our description of early works clarifies that for the AER to consider expenditure as early works, TNSPs should justify in the CPA application why it is necessary to engage in expenditure which:

- improves the accuracy of project costs and,
- ensures a project can be delivered in the time frames specified in the most recent ISP.

TNSPs should demonstrate how the proposed early works expenditure achieves the above objectives.

In addition to updating the AER guidelines to be consistent with the description of early works in section 5.2.2, it may be beneficial for the AER to provide further guidance on how it balances efficiency and timeliness in its assessment of early works expenditure and what information TNSPs should provide to help the AER assess proposed early works expenditure.

5 IMPROVING THE WORKABILITY OF THE FEEDBACK LOOP WILL ENABLE IT TO OPERATE AS A TIMELY AND EFFECTIVE CONSUMER SAFEGUARD

BOX 5: FINAL RECOMMENDATIONS

The Commission's final position is that the feedback loop would benefit from changes to improve its workability. The Commission's specific recommendations regarding how to improve the workability of the feedback loop are largely unchanged between the draft and the final report, with one additional recommendation to amend the NER to include a timeframe for AEMO to complete the feedback loop assessment. Incorporating a timeframe for AEMO to complete the feedback loop in the NER will promote a clear, consistent and predictable regulatory framework because it provides clarity and transparency to stakeholders regarding when the outcome of the feedback loop will be known.

The Commission recommends the following changes:

- Align the timing of the feedback loop assessment with the publication of a draft or final ISP
  - Amend the AER's CBA Guidelines to provide AEMO with the discretion to establish the timeframe for when the feedback loop assessment is to occur, which can be tailored to the circumstances of a particular investment
  - This guidance establishes a feedback loop and PACR exclusion window between the final IASR and draft ISP – the period where undertaking the feedback loop is least workable for AEMO – with discretion for AEMO to undertake the feedback loop during the exclusion window where appropriate
  - Alignment with a draft or final ISP promotes timely completion of the feedback loop, while ensuring it draws on the latest available information to operate as an effective consumer safeguard – facilitating timely and efficient investment
- Amend the NER to allow the CPA process and feedback loop assessment to proceed concurrently to manage potential bunching of the feedback loop assessments around the publication of a draft ISP
- Amend the NER to require AEMO to complete the feedback loop assessment within 40 business days from the later of the date the request is submitted or additional information is received following an information request issued by AEMO, with a possible 60 business day extension if AEMO determines the assessment involves particular complexities or difficulties.

A rule change should be submitted to give effect to the Commission's recommendations to run the feedback loop and CPA processes concurrently, as well as placing a timeframe on

AEMO to complete the feedback loop. The AER should amend its CBA Guidelines to provide guidance on the timing of the feedback loop assessment consistent with the Commission's final recommendation.

This chapter describes the:

- difficulties with applying the feedback loop under current arrangements and the need to improve the workability of the feedback loop assessment
- Commission's recommended approach to improve the workability of the feedback loop by:
  - aligning the feedback loop assessment with the publication of a draft or final ISP through changes to the AER's CBA Guidelines
  - allowing the CPA process and the feedback loop to occur concurrently, and
  - specifying a timeframe for AEMO to complete its feedback loop assessment.

5.1 Practical application difficulties that undermine the ability of the feedback loop to operate as an effective safeguard for consumers should be addressed

5.1.1 The feedback loop ensures that the RIT-T preferred option is consistent with the optimal development path in the ISP

The feedback loop was introduced as part of the actionable ISP reforms and is designed as a safeguard for consumers. It requires the RIT-T proponent to obtain written confirmation from AEMO that:[102]

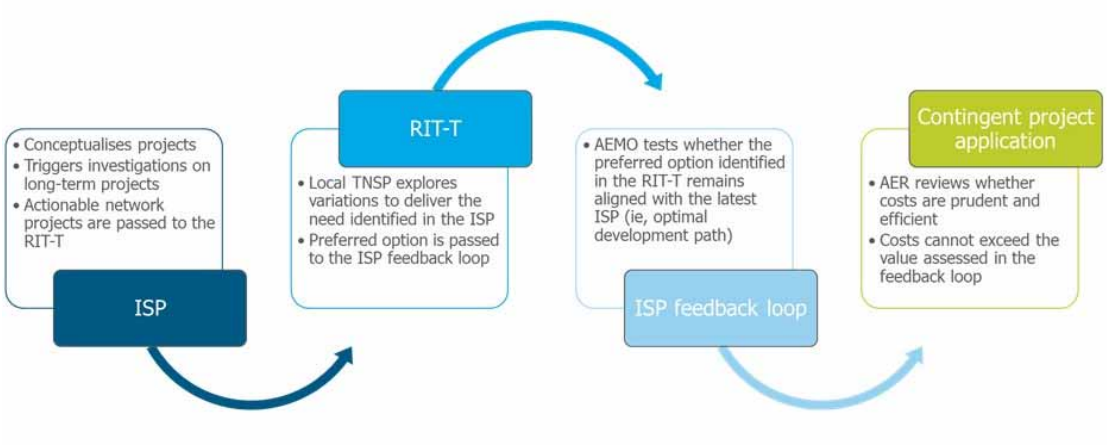
- the preferred option addresses the relevant identified need specified in the most recent ISP and aligns with the optimal development path (ODP) referred to in the most recent ISP, and
- the cost of the preferred option does not change the status of the actionable ISP project as part of the ODP as updated in accordance with an ISP update.[103]

The feedback loop also caps the costs that can be sought by a RIT-T proponent in the CPA. It provides an important safeguard for consumers by ensuring 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. The role of the feedback loop in the broader regulatory process is summarised in Figure 5.1.

102 Clause 5.16A.5(b) of the NER.

103 ISP updates are set out in clause 5.22.15 of the NER.

Figure 5.1: The role of the feedback loop in the actionable ISP framework



Source: AEMC.

A clear, consistent and predictable regulatory framework is critical to the timely and efficient delivery of major projects. However, stakeholders have raised concerns that a lack of clarity and practical application difficulties undermine the ability of the feedback loop to operate as an effective safeguard for consumers. For instance, AEMO's experience of the feedback loop to date is that it is poorly defined and unworkable.[104] This unworkability may prevent timely regulatory approval of major strategic projects. ENA expressed the view that the feedback loop was extending the regulatory approval process by up to six months.[105]

The Commission considers that it is important to address these workability issues in the near term so that the feedback loop can be applied as intended and operate as an effective safeguard for consumers. Addressing this issue now will help to ensure that the significant expenditure expected to be incurred in the short term is in the long term interests of consumers. However, we note that the broader role of the feedback loop in the economic assessment process is being considered as part of our holistic review of that process during Stage 3 of the Review.

5.1.2 The factors AEMO must consider when performing the feedback loop drive workability issues

The present workability problem, due to practical application issues, arises as a result of the factors that must be considered by AEMO when performing the feedback loop. If the preferred option, or its cost, differs from the ISP candidate option then AEMO must consider:[106]

104 AEMO, submission to the consultation paper, p. 4.

105 ENA, submission to the consultation paper, p. 3.

106 These factors are set out in the AER's CBA Guidelines: AER, *Cost benefit analysis guidelines | Guidelines to make the Integrated System Plan actionable,* August 2020.

- removing the ISP candidate option from all development paths where it is featured, and replace these with the RIT-T preferred option (and associated cost)
- re-running the cost benefit analysis modelling and scenario analysis if practicable, to test whether the ODP referred to in the most recent ISP:
  - still has a positive net economic benefit in the most likely scenario with the RIT-T preferred option, and
  - is still optimal with the RIT-T preferred option under the same decision-making approach, or that any difference is immaterial
- adapting the extent to which AEMO re-runs the CBA modelling and scenario analysis to the size of the difference between the costs and/or market benefits of the ISP candidate option and the RIT-T preferred option.

The requirement for the feedback loop to be assessed against the ODP identified in the most recent ISP is a key driver of workability issues. Under the actionable ISP framework, the most recent ISP refers to the latest final ISP, or an ISP update if one has been published.[107] This means that the assessment focuses on the current ODP as opposed to the ODPs that will be included in the publication of the next ISP.

The ODPs in the current and future ISPs will likely be underpinned by different inputs, assumptions and scenarios (as detailed in AEMO's IASR).[108] This means that the feedback loop assessment may not be taking into account the latest available information and may be using outdated inputs, assumptions and scenarios.

This approach can create several practical difficulties for the feedback loop assessment, including:[109]

- undermining the value of the result of the assessment due to AEMO using inputs and assumptions underpinning the most recent ISP, because the latest version of the IASR may contain new government policies or changes to inputs that could materially affect the optimal development path of the next ISP and therefore the outcome of the feedback loop
- creating inconsistencies between the inputs underpinning the RIT-T preferred option and the feedback loop assessment, due to the requirement on RIT-T proponents to use the most recent ISP parameters, i.e. the latest IASR (which will likely differ from those underpinning the most recent ISP which uses the previous IASR), and
- complicating AEMO's development of the next ISP due to the need to simultaneously draw on modelling from the previous and next ISP, which can affect the timeliness of completing the feedback loop assessment.

The Commission considers that enabling the feedback loop to use inputs that will underpin the optimal development path in the next ISP, particularly where there are significant

107 The ISP is defined in Chapter 10 of the NER as "a plan developed and published by AEMO under rule 5.22 as amended by an ISP update from time to time".

108 The IASR is developed in consultation with stakeholders and sets out how AEMO will model the future in its forecasting and planning publications (including the ISP). It is updated in each ISP cycle.

109 Submissions to the consultation paper: AEMO, pp. 4-5; AER, pp. 9-10.

differences between the ISP candidate option and RIT-T preferred option, is important for the feedback loop to be an effective consumer safeguard. Providing clarity will also promote timely completion of AEMO's assessment by enabling the feedback loop assessment to be tailored to the circumstances of a particular project.

5.2 An exclusion window is recommended to align feedback loops with the publication of a draft or final ISP and improve workability

The Commission's final recommendation is to implement a feedback loop and PACR exclusion window between the final IASR and draft ISP to facilitate alignment with a draft ISP (or final ISP once published). This recommendation is unchanged from the draft report and received broad support from stakeholders.[110] Tilt Renewables submitted that the recommendation would not materially impact the delay caused by having the feedback loop in place,[111] while SnowyHydro emphasised the importance of not having delays associated with waiting for the next ISP to complete the feedback loop.[112]

The workability of the feedback loop will be improved under this recommendation because:

- the assessment can be incorporated into the development of the draft ISP, i.e. AEMO would not be required to draw on modelling from both previous and next ISPs, and
- the scope for misalignment between the RIT-T and ISP is narrower, reflecting the fact that the RIT-T will have likely used the inputs and assumptions underpinning the next ISP.

Aligning the feedback loop with a draft or final ISP 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.

As a result, TNSPs cannot publish PACRs and AEMO cannot undertake feedback loop assessments during the window between the final IASR and draft ISP. However, AEMO would retain the discretion to undertake the feedback loop during the exclusion window where appropriate. The purpose of this discretion is to ensure the exclusion window does not delay regulatory approval in particular circumstances, such as where the feedback loop request:

- is submitted shortly before the exclusion window commences, or
- would be unlikely to involve significant re-modelling (such as where the extent of difference between the ISP candidate option and RIT-T preferred option is minimal).

The recommended exclusion window would result in a four-to-six month period of the two-year ISP cycle where feedback loops would generally not occur (subject to AEMO's discretion described above).[113] Outside of this designated window, RIT-T proponents could submit requests for a feedback loop assessment to be carried out.

110 Submissions to the stage 2 draft report: AEMO, p. 8; CEIG, p. 11; EUAA, p. 4; ENA, p. 4; EnergyAustralia, p. 1; Origin, p. 2; PIAC, p. 5; RE-Alliance, p. 12; TasNetworks, p. 2; Transgrid, p. 3.

111 Tilt Renewables, submission to the stage 2 draft report, p. 2

112 SnowyHydro, submission to the stage 2 draft report, p. 2.

113 For example, in the recently completed ISP cycle, the final IASR was published on 30 July 2021 and the draft ISP on 10 December 2021. This would have resulted in an exclusion window of approximately four months.

Figure 5.2 shows an example of how aligning the feedback loop with a draft or final ISP through an exclusion window between the final ISP and draft ISP would work for the 2024 ISP cycle.

Figure 5.2: Aligning the feedback loop with a draft or final ISP through an exclusion window between the final IASR and draft ISP

Source: AEMC.

Prohibiting the publication of PACRs during this period minimises misalignment between the ISP and RIT-T, as this period is when the latest assumptions have been developed in the IASR but are not yet reflected in the ISP for assessment in the feedback loop.

The final recommendation facilitates alignment between the inputs, assumptions and scenarios used in both the RIT-T and ISP. It also provides RIT-T proponents with greater flexibility because outside of the exclusion window RIT-T proponents retain the ability to carry out the necessary analysis required to progress their project.

5.3 The AER's CBA Guidelines should be amended to give effect to the feedback loop and PACR exclusion window

Consistent with its draft position, the Commission's final recommendation is to amend the AER's CBA Guidelines to give effect to aligning the feedback loop with a draft or final ISP. Stakeholders broadly supported the Commission's draft position in terms of amending the AER's CBA Guidelines to give effect to aligning the feedback loop with a draft or final ISP.[114]

114 Submissions to the stage 2 draft report: AEMO, p. 8; EUAA, p. 4; ENA, p. 10; PIAC, p. 5; RE Alliance, p. 12; TasNetworks, p. 2.

The AER's CBA Guidelines should be amended to provide AEMO with the discretion to time the feedback loop assessment to when it is most appropriate given the circumstances of the particular investment. This will provide AEMO with the flexibility to undertake the feedback loop assessment during the exclusion window if it considers it appropriate to do so (consistent with the circumstances described above). For instance, AEMO may issue guidance that it will not undertake feedback loops during the period between the final IASR and draft ISP when there are material differences between the RIT-T preferred option and ISP candidate option.

The Commission recommends this approach because it promotes the feedback loop operating as an effective safeguard for consumers while not unduly delaying the progression of major strategic investments through the regulatory process. This approach also provides the necessary flexibility to manage the challenges of the energy transition in approving regulated investments, while providing additional clarity regarding the operation of the regulatory framework with respect to the feedback loop.

The Commission notes that other final recommendations for Stage 2 of this Review involve amendments to the AER's CBA Guidelines. In light of the scale of required changes, the Commission considers that a holistic approach to amending the CBA Guidelines is appropriate to avoid multiple consultation periods for the recommended changes.

5.4 A rule change is recommended to permit feedback loops and CPAs to run concurrently to address potential delays due to bunching

The Commission's final recommendation to align the feedback loop assessment with a draft or final ISP may lead to a bunching of feedback loop assessments around the publication of a draft ISP. This may lead to delays in the regulatory process as RIT-T proponents may wait for the feedback loop window to open.

In the stage 2 draft report we highlighted that one approach to managing this delay could be to amend the NER to allow the CPA process and feedback loop assessment to proceed concurrently. The submissions that responded to this aspect of the Stage 2 draft report broadly supported our proposal to allow the CPA process and feedback loop assessment to proceed concurrently.[115] ENGIE submitted that the exclusion window should be manageable because TNSPs and the AER should be able to plan their resourcing accordingly.[116]

The Commission's final recommendation is to permit the feedback loop and CPA processes to run concurrently.[117] A rule change should be submitted to give effect to this recommendation.

Running these processes concurrently is unlikely to result in a regulatory burden because the costs sought in the CPA are capped at those examined in the feedback loop. It follows that RIT-T proponents will have likely developed their cost estimates to the standard required for a CPA prior to seeking the feedback loop assessment from AEMO. This recommendation will

115 Submissions to the stage 2 draft report: AEMO, p. 8; CEFC, p.4; ENA, p. 4; RE Alliance, p. 12; TasNetworks, p. 3; Transgrid, p. 15.

116 ENGIE, submission to the stage 2 draft report, p. 6.

117 Clause 6A.8.2(e)(1D) of the proposed rule.

promote timeliness of investment by enabling TNSPs to submit CPAs without having to wait for the outcome of the feedback loop assessment.

Additionally, the final recommendation would not mandate that the two processes run concurrently. Rather, it provides TNSPs with the opportunity to do so. As noted by AEMO in its submission, stakeholders in the CPA process value the assurance given by the feedback loop assessment that the RIT-T preferred option is aligned with the ODP.[118] Accordingly, there may be some circumstances where a TNSP still prefers to complete the feedback loop prior to submitting a CPA.

5.5 A rule change is recommended to place a timeframe on AEMO to complete the feedback loop assessment

In response to the Stage 2 draft report, stakeholders – specifically TNSPs and ENA – suggested that placing a two-month timeframe on AEMO to complete the feedback loop would further promote its timely completion.[119] The Commission considers that there is merit in placing a timeframe on AEMO to complete the feedback loop assessment. A clear, consistent and predictable regulatory framework is critical to the timely and efficient delivery of major projects. Incorporating a timeframe for AEMO to complete the feedback loop will promote this objective by providing clarity and transparency to stakeholders regarding when the outcome of the feedback loop will be known.

Clarity around the timing of the feedback loop outcome is particularly important in light of the Commission's recommendation to permit the feedback loop and CPA processes to run concurrently. The NER currently contains provisions that require the AER to make a CPA determination within 40 business days of receipt of an application (accounting for any further information requests), with the possibility of a 60 business day extension if the AER considers the assessment is particularly complex or difficult.[120]

The Commission's final recommendation is to place a timeframe in the NER on AEMO to complete the feedback loop assessment.[121]A rule change should be submitted to give effect to this recommendation. For consistency it is recommended that the timeframe placed on AEMO to complete the feedback loop assessment be analogous to the timeframe applying to the AER with respect to assessing contingent project applications. Specifically:

- AEMO should have 40 business days to complete the feedback loop assessment from the later of the date the request is submitted or additional information is received following an information request issued by AEMO
- AEMO should be able to extend the period by up to a further 60 business days if the feedback loop assessment is particularly complex or difficult (such as if re-modelling is required).

118 AEMO, submission to the stage 2 draft report, p. 8.
119 Submissions to the stage 2 draft report: ENA, p. 4; TasNetworks, p. 3; Transgrid, p. 15.
120 Clauses 6A.8.2(d) and 6A.8.2(i) of the NER.
121 Clause 5.16A.5A of the proposed rule.

ABBREVIATIONS

ACCC	Australian Competition and Consumer Commission
AEIC	Australian Energy Infrastructure Commissioner
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
BAU	Business-as-usual
Capex	Capital expenditure
CBA	Cost-benefit analysis
CEC	Clean Energy Council
CEFC	Clean Energy Finance Corporation
CEIG	Clean Energy Investor Group
CEPA	Cambridge Economic Policy Associates
CESS	Capital Expenditure Sharing Scheme
Commission	See AEMC
CO2	Carbon dioxide
CPA	Contingent project application
DER	Distributed energy resources
DMIS	Demand management incentive scheme
DNSP	Distribution network service provider
EIOG	Emissions intensity of generation
ENA	Energy Networks Australia
ESB	Energy Security Board
EUAA	Energy Users Association of Australia
FFO	Funds from operation
IASR	Inputs, assumptions and scenarios report
IEA	International Energy Agency
IPCC	International Panel on Climate Change
ISP	Integrated System plan
MCE	Ministerial Council on Energy
MEU	Major Energy Users Inc.
MWh	Megawatt-hour
NEL	National Electricity Law
NEM	National Energy Market
NEO	National electricity objective
NER	National Electricity Rules
NICE	Network of Illawarra Consumers of Energy
NPV	Net present value

NSW	New South Wales
NTNDP	National transmission network development plan
ODP	Optimal development path
Opex	Operating expenditure
PACR	Project assessment conclusions report
PADR	Project assessment draft report
PEC	Project EnergyConnect
PIAC	Public Interest Advocacy Centre
PSCR	Project specification consultation report
PTRM	Post-tax revenue model
RAB	Regulated asset base
RCP	Representative Concentration Pathway
REZ	Renewable energy zone
RFM	Roll-forward model
RORI	Rate of return instrument
RIT-D	Regulatory investment test for distribution
RIT-T	Regulatory investment test for transmission
SRMC	Short-run marginal cost
SSP	Shared Socio-economic Pathway
TAPR	Transmission Annual Planning Report
TNSP	Transmission network service provider
WACC	Weighted average cost of capital