

4 July 2024

Ms Anna Collyer
Chair
Australian Energy Market Commission (AEMC)

By online submission

Dear Ms Collyer,

ERC0380 – Bringing early works forward to improve transmission planning

The Australian Energy Market Operator (AEMO) welcomes the opportunity to comment on the AEMC's draft determination on bringing early works forward to improve transmission planning, in response to the rule change request submitted by The Honourable Chris Bowen, Minister for Climate Change and Energy.

AEMO agrees that improving cost recovery certainty for TNSPs to undertake early works activities concurrently with the regulatory investment test for transmission (RIT-T) has the potential to positively impact project costs and delivery timeframes. Earlier planning activities that better consider social, cultural, heritage and environmental factors and improve the accuracy of cost estimates should assist with delivering transmission projects on time.

It is critical that the proposed rule change enables early works activities that can make a meaningful impact on project delivery timeframes or cost estimate accuracy. AEMO's view is that the NER principles proposed in the draft determination would not serve their intended purpose and would not encourage more and earlier planning activities to be undertaken by TNSPs. The scope of early works activities that are likely to align with the principles is too narrow to have a material impact. Very few activities are likely to be common to all RIT-T credible options. Of more importance is the need for early works activities to be customised and tailored to the option, rather than being common across options. In order to achieve more timely transmission investment, a degree of risk must be accepted in the early works stage. The current principles do not do this.

AEMO's submission proposes some alternative NER principles that we believe strike an appropriate balance between minimising the risks to consumers of undertaking early works prior to the completion of the RIT-T and mitigating the risks to consumers of project delays and cost increases further down the track.

In the interests of prudent investment decisions, AEMO's view is that costs that have actually been incurred that are not able to be resold should be excluded from the RIT-T. This may be all, or a subset of costs included in an early works Contingent Project Application (CPA). Early works CPA approved costs that have not yet been incurred, or not reasonably expected to be incurred prior to the RIT-T concluding, should be included in the RIT-T. This approach is consistent with Infrastructure Australia's

guide to economic appraisals and ensures that decisions to further invest are based on the costs and associated benefits that are expected to be realised from that point forward.

This submission provides AEMO's perspectives on each of the recommendations in the draft determination in Appendix 1 below.

If you would like to discuss anything further, please contact Kevin Ly, AEMO Group Manager – Reform Development & Insights (kevin.ly@aemo.com.au).

Yours sincerely,

A handwritten signature in black ink, appearing to read "N. Falcon", is placed over a light blue horizontal line.

Nicola Falcon
Acting Executive General Manager
Reform Delivery

APPENDIX 1: AEMO'S VIEWS AND INSIGHTS ON THE DRAFT DETERMINATION

General comments

AEMO welcomes the intent of the draft determination. Enabling TNSPs to undertake early works to a greater extent and earlier in the process of transmission investment should improve cost estimate accuracy and the timely delivery of ISP projects. For the rule change to be effective in practice, the scope and types of activities allowed for cost recovery through an early works contingent project application (CPA) need to make a material contribution to progressing the delivery of the ISP project.

AEMO appreciates that the proposed rule change presents a trade-off between allowing meaningful early works activities to be undertaken by TNSPs and preserving the decision-making rigour of the RIT-T. AEMO considers that in order for expanded early works activities to make a real impact on the timeliness of project delivery, a greater level of risk needs to be accepted during the early works phase. This may include progressing early works for one or some RIT-T credible options prior to the completion of the RIT-T and the selection of a preferred option for the project. On-time delivery of ISP projects is likely to have far greater benefits for consumers than any potential misplaced early works effort. Further, earlier consideration of factors that impact on project costs is likely to result in decisions that avoid greater costs to consumers later.

Draft recommendation 1: A TNSP could seek cost recovery for early works after the ISP identifies a project as actionable.

AEMO agrees that enabling a TNSP to submit an early works CPA for an actionable ISP project before completing a RIT-T (and passing the feedback loop assessment) will encourage TNSPs to commence early works sooner and improve the information available to TNSPs during the identification and assessment of transmission investment options. It should also mitigate the risks to consumers due to supply chain delays and labour supply issues.

However, the draft determination and the draft rule seem to be unclear and inconsistent in how early works CPA costs should be treated. In the draft determination, the following statement refers to the treatment of costs across the RIT-T, feedback loop assessment and CPA:

“Our draft rule clarifies that when preparing a RIT-T, feedback loop assessment and CPA (to recover the total project costs), a TNSP must reflect the costs approved in any prior early works CPA for the specific actionable ISP project to accurately reflect the total cost of the project.” (Page 8)

In the draft rule (5.16.A.7(d)), this statement is applied only to RIT-T. The effect of this would be to introduce a requirement to include previously approved costs in the RIT-T analysis while leaving the requirements for the ISP and feedback loop assessments unchanged and uncertain. It is important to ensure consistency between the way incurred costs are treated across the ISP, feedback loop, CPA and RIT-T processes.

Also, in the draft rule (5.16.A.7(d)), it is unclear whether all costs approved in an early works CPA should be included in the RIT-T, including those that have been incurred. AEMO's view is that costs that have actually been incurred that are not able to be resold should be excluded from the RIT-T. This may be all, or a subset of costs included in an early works CPA. Early works CPA approved costs that have not yet been incurred, or not reasonably expected to be incurred prior to the RIT-T concluding, should be included in the RIT-T. This approach is consistent with Infrastructure Australia's guide to

economic appraisals and ensures that decisions to further invest are based on the costs and associated benefits that are expected to be realised from that point forward. In the submission to the AER’s Review of the Cost Benefit Analysis Guidelines and RIT Application Guidelines, AEMO proposed that RIT-T proponents should exclude sunk costs from the CBA (unless they can be resold) but should be required to transparently document these costs in the RIT-T.

Excluding incurred costs in the RIT-T assessment ensures that consumers gain the most benefit from costs that have already been incurred based on decisions already made. In general, including incurred costs from early works in the ranking of options runs the risk of consumers paying more than is necessary.

The hypothetical example below demonstrates that if incurred early works costs are excluded, Option A would be selected (at a total cost to consumers of \$8M). If incurred early works costs are included, Option B would be selected (at a total cost to consumers of \$8.5M). While, in hindsight, Option B may have been the better option to proceed with from the beginning, had costs been known with certainty at the time, under the proposed approach where early works costs are included, consumers will effectively now be asked to pay a further \$7.5M in order to realise the \$10M in benefits. A lower cost outcome for consumers would be to proceed with Option A as consumers would only need to pay a further \$7M to realise the \$10M in benefits. The \$1M in early works costs are sunk and therefore will be paid by consumers irrespective of whether Option A or Option B is now selected in the RIT-T.

RIT-T Option	Benefits	Incurred early works costs	Other Costs	Net benefit (excluding early works)	Net benefit (including early works)	Total costs to consumers
A	10,000,000	1,000,000	7,000,000	3,000,000	2,000,000	8,000,000
B	10,000,000	0	7,500,000	2,500,000	2,500,000	8,500,000

Certain costs approved in early works may be recoverable and should not be considered as sunk. For example, if electrical equipment is purchased during early works it may be able to be resold if it is not needed for the RIT-T preferred option.

Although AEMO proposes that RIT-T proponents exclude sunk costs from the CBA, they should be required to transparently document these costs in the RIT-T.

It is also important to ensure consistency between the approach to incurred costs and the existing approach to staged projects. The CBA Guidelines cite a specific example of a project staged in the ISP where ‘early works would be ‘Stage 1’ of a staged project and ‘Stage 2’ would be to build the interconnector’. In this example, once the AER has approved the CPA for stage 1 early works, AEMO would typically treat that project as ‘anticipated’ in subsequent ISPs as it is sufficiently advanced to meet the definition. In determining whether stage 2 is actionable, the stage 1 early works costs will not be included in this subsequent ISP cost benefit assessment, consistent with all other anticipated projects¹. The rule change proposed would create an inconsistency with this approach.

¹ The ISP Cost Benefit Analysis does not include the cost of commissioned, committed and anticipated projects given their stage of development.

Draft recommendation 2: Including a definition of early works and principles in the NER to guide the assessment of an early works CPA and protect consumers from inefficient expenditure.

AEMO supports the inclusion of a definition of early works in the NER and supports the definition as proposed in the draft determination, and shown below:

Early Works

Activities undertaken by a *Transmission Network Service Provider* in respect of an *actionable ISP project*:

- a) prior to construction of the *preferred option*; and
- b) which:
 - i) improve the accuracy of cost estimates for that project; or
 - ii) facilitate that project being delivered within the timeframes specified by the most recent *Integrated System Plan*.

AEMO acknowledges that the principles proposed in the draft determination are intended to mitigate the risk to consumers of bringing forward early works, namely, potential biasing of the assessment of options in the RIT-T and/or weakening the imperative for cost efficiency of these early works activities. At the same time, the rationale for bringing early works forward is to undertake more planning activities earlier in the process that mitigate the risk of later project cost increases and delays, and also mitigate the risk of additional costs or missed benefits to consumers due to supply chain delays and labour supply issues.

AEMO is aware of the inherent trade-off between undertaking meaningful, detailed planning activities early in the process, and preserving the decision-making rigour of the RIT-T. AEMO's view is that some level of risk must be taken during an expanded early works if the goal is to make a real impact on the timeliness of project delivery.

AEMO does not support the principles proposed in the draft determination. The proposed principles are too restrictive in that the AER will have regard to whether the costs of early works activities are "common to all ISP candidate options and any other options that would be identified in a regulatory investment test for transmission for the actionable ISP project." AEMO considers that TNSPs will not undertake early works to the scope and extent required to achieve more timely investment if there is an expectation that these activities must be common to all options. In fact, activities that have previously been accepted by the AER as early works activities would be unlikely to align with the proposed principles. Examples of activities that have previously been approved by the AER in an early works CPA that are unlikely to have applicability across 'all ISP candidate options and any other options that would be identified in a RIT-T' include undertaking pre-construction development for specific substations and transmission lines, valuing and acquiring land and easements for substations and lines, biodiversity offset costs for a particular corridor, land access consent payments, steel tower assembly design and prototype testing, detailed engagement with specific communities and environmental surveys for specific areas of interest.

The proposed principles are designed to ensure that the AER 'only approves a regulatory allowance for activities where the benefits to consumers outweigh the potential harms.' AEMO's view is that the benefits to consumers from on-time and efficient delivery of ISP projects is expected to outweigh any

potential misspent early works effort. Expecting all early works activities to be ‘no regrets’ and entirely unbiased towards credible options is unrealistic if the activities are also expected to meaningfully progress the project.

The AER should assess whether progressing early works on one or some of the RIT-T credible options would de-risk the future investment decision, taking consumer risk preferences into account. In making that assessment the AER should have regard to the magnitude of cost uncertainty for the project relative to potential benefits/avoided cost of delay. The early works activities should not need to be the same across options, as they should be customised to each option with the aim of improving cost accuracy or timely delivery, while avoiding disproportionate bias towards any particular RIT-T option or options prior to completion of the RIT-T.

As an alternative, AEMO proposes the following NER principles to be considered by the AEMC to be used to aid the AER’s assessment and a TNSP’s preparation of an early works CPA. The proposed alternative principles aim to minimise the risks to consumers of undertaking early works activities prior to the completion of the RIT-T while enabling TNSPs to undertake the early works activities that are most likely to have an impact on de-risking the investment decision.

Proposed alternative principles

In assessing whether to approve the costs of *early works* for an *actionable ISP project* where that project has not been the subject of a completed *regulatory investment test for transmission*, the AER may have regard to whether the:

- (a) early works activities are likely to reduce cost uncertainty for one or some *actionable ISP project* options identified by the TNSP (RIT-T credible options), and that improvements in cost accuracy could be material to the selection of the preferred option, or
- (b) early works activities are likely to reduce project lead times and deliver benefits to consumers within the timeframes in the most recent ISP, and
- (c) early works activities are sufficient to incorporate relevant activities for each RIT-T credible option to ensure delivery according to the optimal timing outlined in the most recent ISP.

Draft recommendation 3: Clarifying that AEMO can include examples of early works (and preparatory activities) in the ISP.

AEMO supports the proposed rule changes to clarify that AEMO can specify, in the ISP, early works activities (in addition to preparatory activities) that it considers beneficial for each actionable ISP project. AEMO also supports the AER having regard to the early works activities specified for actionable projects in the ISP in their assessment of early works CPAs.

Draft recommendation 4: The rule would commence on 29 August 2024 to ensure the framework can be used for actionable ISP projects in the 2024 ISP.

AEMO supports the intended commencement date.

Draft recommendation 5: Delaying the AEMC’s ISP review by two years would ensure alignment with recently completed and ongoing reforms.

AEMO supports the postponement of the AEMC’s ISP review by two years as described in the draft determination.