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Thursday, 19 September 2024

Ms Anna Collyer
Chair
Australian Energy Market Commission
Lodged online: www.aemc.gov.au

Dear Ms Collyer

Improving the cost recovery arrangements for non-network options

Transgrid welcomes the opportunity to respond to the *Improving the cost recovery arrangements for non-network options* consultation paper published by the Australian Energy Market Commission (AEMC) on 22 August 2024. This consultation initiates the rule change request submitted by Transgrid on 17 April 2024.

Transgrid operates and manages the high voltage electricity transmission network in NSW and the ACT, connecting generators, distributors and major end users. We have an important role in managing one of the key parts of the Australian energy system as it transitions to a higher renewables penetration.

Procuring and paying for services provided by non-network options or solutions can reduce, defer or replace the need for transmission network investment, delivering more timely and lower cost outcomes for consumers. As such, Transgrid is a strong advocate of non-network options and is continuing to progress several network support services with prospective providers. The purpose of our rule change request is to address regulatory barriers that are currently impeding the timely delivery of non-network options, and that result in delayed pass throughs to consumers.

In addition to the issues raised in our rule change request, Transgrid also notes it is currently working through the implementation of the AEMC's March 2024 Improving Security Frameworks (ISF) final rule and would like to discuss a fundamental implementation issue. This issue is driven by the potential for actual system strength payments to materially fluctuate each month in response to changing market conditions.

This fluctuation will result in a significant over or under recovery each month compared to the flat monthly recovery of forecast costs (received through annual transmission pricing). Where there is a significant under recovery, i.e. system strength payments are materially higher than forecast in a single month or quarter, this will have a material impact on Transgrid's credit metrics and debt covenant requirements.

Without a timely and effective solution to these issues, we expect material risks to the delivery of our non-network projects. We note these issues do not exist under the NSW Electricity Infrastructure Investment (EII) Act framework.

Next steps

Please see the attached submission with our detailed response to the AEMC's consultation paper. We have also contributed to and support Energy Networks Australia's submission to this consultation. We look

forward to working collaboratively with the AEMC as it develops its draft determination and, in particular, to discuss the challenges with implementing the ISF final rule.

Yours faithfully

Monika Moutos,
General Manager Policy & Regulation

Transgrid submission

As discussed in our rule change request, Transgrid is finding it increasingly difficult to manage the regulatory risks associated with the ex-post approval process as it seeks to negotiate high value, long term agreements with network support service providers. The expected growth in the number and the value of these agreements will increase the impact on consumers attributable to these regulatory risks.

Importantly, as we have communicated directly to the AEMC, without a timely and effective solution from this rule change process, some of our existing projects may be materially impacted. Our feedback across the key areas of the AEMC's consultation paper are provided in this attached submission.

1. Cost recovery uncertainty

Topic	Summary of AEMC consultation paper on cost recovery uncertainty
Issue	• Initial cost recovery uncertainty: If non-network opex is not included in a TNSP's revenue proposal, the AER assesses non-network expenditure after a TNSP has already entered a network support agreement. This results in higher cost recovery uncertainty for non-network than for network options. • Ongoing cost recovery uncertainty: The AER has an obligation to approve non-network opex if ongoing payment is required under an agreement between a TNSP and a non-network provider (which may span more than one regulatory period). However, there is a degree of uncertainty whether the AER will approve cost recovery in future revenue determination processes where non-network costs differ from expected levels, such as due to contractual terms.
Solution	• Initial cost recovery uncertainty: Introducing an upfront approval process that would enable a TNSP to seek AER approval of non-network expenditure before a TNSP enters a network support agreement. • Ongoing cost recovery uncertainty: In the upfront approval process prior to entering the network support agreement, a TNSP could seek AER approval of a 'methodology' for adjusting non-network payments over time. The methodology could include aspects of the agreement that could cause the payment profile to change in future regulatory control periods, such as early termination payments.
Benefit	• Support the non-network sector: Lower cost recovery risks would improve bankability and increase the attractiveness of non-network projects. Improvements in the competitiveness of non-network would support the development of a larger range of non-network projects more broadly. • Benefits for consumers: Increased revenue certainty may reduce the overall costs to consumers to the extent that revenue certainty reduces risk premiums and transaction costs for non-network projects.

Transgrid supports the AEMC's summary of the cost recovery issues, proposed solutions and its discussion of potential benefits, which is consistent with our rule change request.

The upfront approval needs to provide certainty to all stakeholders

To achieve the objective of the rule change in addressing barriers to the timely delivery of non-network options, the upfront approval process needs to be able to provide certainty to TNSPs and other stakeholders on cost recovery. The use of a methodology of payments within this upfront approval allows all stakeholders to transparently understand the risk sharing that the AER is approving of between consumers, TNSPs and the non-network proponents.

To ensure that the TNSP and non-network proponents can proceed with certainty over the length of a contract, approval of a methodology should be binding. The greater the reliance on the approved methodology in future AER pass through decisions (or revenue determinations) the greater the certainty provided and the more this avoidable regulatory risk is removed.

This approach to providing certainty should not be considered disproportionate to network expenditure related approvals. For network expenditure, if the TNSP delivers the solution consistent with an upfront approval, there would be no risk to cost recovery. Additionally, TNSPs are exposed to solely downside cost recovery risks for non-network expenditure. This contrasts starkly with TNSP capital and operational expenditure where relevant incentive sharing schemes reward a TNSP for out-performance (with consumers sharing these rewards). No such incentive scheme exists for transmission related non-network expenditure assessed in a pass though, which leaves a TNSP with only downside penalty risks.

The existence of these downside risks, especially where heightened due to the complexity, scale and scope of a non-network project, creates a structural difference between network and non-network expenditure. This heightens risks to the efficient delivery of non-network services.

Full cost recovery uncertainty

The AEMC's consultation paper noted that Transgrid's proposed solution also explicitly allows for TNSPs to incorporate the costs of obtaining the agreement (i.e. administrative and negotiation costs) in their network support payment allowance. The AEMC note that at present, clause 6A.7.2 of the NER does not explicitly make reference to recovery of these costs.

Regarding the existing clause 6A.7.2, the AER's guidelines related to this section of the NER (i.e. the Network Support Pass Through Guidelines) note that for pass through arrangements the AER will decide if directly related costs will be allowed for pass through on a case-by-case basis. This treatment creates uncertainty and is also inconsistent with the approach to capex where project related costs are capitalised.

Transgrid included this in our proposed solution as there is uncertainty regarding whether TNSPs are able to recover non-network costs, other than network support payments, through either upfront determinations or the pass-through process. Where there is uncertainty about cost recovery, or an expectation that costs cannot be recovered, it will provide an incentive to avoid this form of expenditure. Further, to the extent that these costs exist and are not explicitly recovered, TNSPs will incur a penalty under the EBSS.

Transgrid encourages the AEMC to consider this issue to ensure that there is a full pass through of all directly related costs. Importantly, pass through should only be provided for where the costs are not already accounted for in the TNSP's base opex allowance.

2. Cost recovery timing

Topic	Summary of AEMC consultation paper on cost recovery timing
Issue	• There is currently up to a two-year delay between non-network related costs being incurred and then recovered by TNSPs. This has the potential to cause balance sheet pressure for TNSPs and a more-uneven cost recovery profile from consumers.
Solution	• A TNSP's network support payment allowance would be updated at the time the AER assesses and approves expenditure towards a non-network project and also if the TNSP applies for the allowance to be updated. This would enable NNO costs to be recovered through prescribed transmission services in the same year in which they are incurred.
Benefit	• Aligning payment with cost recovery is likely to reduce balance sheet pressure on TNSPs to the extent this is, or will become, an issue. • There may be benefits in reduced compensation to TNSPs for the time value of money. However, consumers also have a time value of money so this is only a benefit to the extent consumers' time value is below the allowed rate of return at which TNSPs are compensated.

Transgrid supports the AEMC's description of the benefits of addressing the cost recovery timing issues. We would like to reiterate that our TAC consumer representatives are strongly supportive of reducing the risk of more volatile consumer prices.

In consideration of the potential alignment with the ISF arrangements, we have suggested for consideration an alternative approach to addressing cost recovery timing. This is discussed in section 4 below.

Transgrid also notes it is currently working through the implementation of the ISF cost recovery approach and would like to discuss some potential unintended consequences. There is a potentially material impact on the financeability situation for TNSPs having to manage large volatile cashflows (estimated in the scale of 100's of millions annually), despite the ability to recover forecast costs annually.[1] This issue is driven by the potential for actual system strength payments to materially fluctuate each month in response to changing market conditions. This fluctuation will result in a significant over or under recovery each month compared to the flat monthly recovery of forecast costs (received through annual transmission pricing). Where there is a significant under recovery, i.e. system strength payments are materially higher than forecast in a single month or quarter, this will have a material impact on Transgrid's credit metrics and debt covenant requirements.

We are currently working through opportunities to mitigate these issues, however given the significant increase in financing costs that may be incurred to manage these risks, it may be appropriate to consider solutions through this rule change process. This is important given that increased risks to TNSPs being able to finance their functions, that are attributable to these cost recovery frameworks, will have flow on impacts to consumers. Importantly, the AEMC's recent final determination in relation to financeability has recognised the need to ensure that TNSPs are able to finance their functions. We would appreciate engagement with the AEMC on this issue.

[1] See Endgame Economics analysis prepared for Energy Networks Australia (ENA) – on the ENA's website here.

3. AEMC discussion of costs related to the proposed solution

Topic	Summary of AEMC consultation paper discussion on costs

Costs related to proposed solution	• Upfront assessment and approval of a cost adjustment 'methodology' could increase the level of financial risk borne by consumers as:
	  ○ limited information available to the AER regarding the likelihood/quantum of potential payments
	  ○ it could be challenging for the AER to make this assessment, if bespoke methodology or novel/unproven technology.
	• Approved methodologies could develop into an informal industry standard. Although this could reduce transaction costs, such an informal standard may be inappropriate for specific NNO projects and could increase the cost for specific NNO providers, to cover inefficiently assigned risk.

Transgrid considers that the risks discussed by the AEMC either already exist to a greater extent now or can be mitigated through design of improved cost recovery frameworks.

The AER already make similar upfront assessments during revenue determinations in approving the network support payment allowance. Given this, the AER should have the ability to make these determinations during the regulatory period, if the equivalent information is made available.

In relation to the AEMC's concerns around the risk of informal industry standards being developed, as noted in our rule change request, this is already an issue and reliance on an ex-post assessment exacerbates it. With an upfront assessment, there is greater ability to test out new approaches and concepts before parties commit to the project – supporting innovation in the interests of consumers.

How would a TNSP approach an upfront approval?

For each non-network service, a TNSP will typically consider - through the negotiations with the non-network proponent – pricing clauses to deal with costs associated with establishment, availability, activation and usage. The TNSP and non-network proponent would also consider how these service payments could change over time due to external factors and potential contingent events.

The pricing methodology of network support payments would reflect the negotiated arrangements on each of those elements and contingent events. Where a pricing element is a variable payment, i.e. where the exact amount of payments made will depend on the actual circumstances that unfold in the relevant future time period, the AER could request a forecast of these payments to support its decision making.

The main source of variability in these potential costs is likely to be in the usage of the service. Usage in an operational timeframe is largely outside of the TNSP's control as it will be driven by local electricity demand and supply, voltage, AEMO's scheduling engine (i.e. for system strength) or some other event (such as an unplanned outage).

Given the lack of active control a TNSP has in creating the real time need for the service, providing sign off on a methodology should not expose consumers to inefficient risks. The AER will review the risk sharing that has been developed in the contract in the upfront approval before consumers are exposed to these

risks. Importantly, the TNSP has nothing to gain from payments being higher or lower as they are all made on a pass-through basis.

How could an AER upfront approval work in the interests of consumers?

We recommend the AEMC consider how to ensure the rules or AER guidelines set out the principles to be followed to ensure efficient outcomes for consumers are achieved in the process of procuring and negotiating non-network services. This will support the AER's upfront assessment and achievement of the lowest cost outcome for consumers.

To address the AEMC's stated concerns on information availability, the AER guidelines should detail the information required by the AER to make its decision on behalf of consumers. Where the AER cannot make a decision on the appropriateness of the arrangements, especially in regard to potential consumer risks, it should not provide the upfront approval for the project. It will be beneficial for consumers, the non-network proponent and the TNSP to know this before a network support agreement is entered into, rather than only finding this out after an agreement has been entered into and after network support payments have been made.

To support innovation, the guidelines should be flexible to allowing innovative approaches and cater for new technologies. For innovation, the AER's upfront assessment should also acknowledge that some projects may not pass this process. The concept of 'failing fast' should be welcomed as part of the upfront process to encourage innovation. This will allow the TNSP to amend the risk sharing arrangement with the project in response of the AER or pivot to a secondary option if required. This would allow innovation to flourish and avoid protracted and lengthy negotiations that inefficiently use resources.

If the AER has approved the payment methodology, then the AER's future review in either the annual true up process or future revenue determinations, should be focussed on confirming whether the payments were consistent with the methodology. If a TNSP proposes to do anything outside the bounds for the approved methodology, then it would need to seek specific approval and would risk not being allowed to pass through costs not based on the approved methodology.

Where payments are made that are inconsistent with an approved methodology, there should be an AER assessment of the TNSP's actions and decisions that contributed to those inconsistent payments. To avoid this occurring, it would be reasonable to allow for amendments to an upfront determination. This would ensure the AER can consider any proposed changes to a payment methodology before the payments are made (as is the case for other determinations).

In the case of an early termination payment, which may be necessary to underwrite a project, Transgrid considers the circumstances in which these payments would be made would be included in the methodology. Importantly these payments should only ever be paid where the solution is no longer needed.

4. Alignment with the Improving Security Framework rules

Transgrid substantially prepared our rule change request prior to the release of the AEMC's ISF Final Determination on 28 March 2024 which introduced largely similar arrangements for cost recovery of system security related non-network costs. In our rule change request, we noted that we would welcome the

opportunity to engage with the AEMC and other stakeholders on alignment of our proposed rule below with the largely similar arrangements introduced via the ISF Final Determination.

At a high level, we support aligned frameworks so that all parties involved in non-network solutions benefit from reduced complexity and administration in meeting the needs of the system. However, we note in aligning the AEMC should:

- avoid any negative impacts to system strength non-network solution implementation, which is already underway to achieve the required timelines, noting however that the cashflow volatility may be a material issue for implementation already (as discussed in section 2 above)
- maintain key elements of Transgrid's rule change request - i.e. addressing ongoing uncertainty
- avoid delays to the finalisation of this rule process – given potential impacts to existing projects.

We think this requires further engagement between the AEMC, AER and the ENA to establish the appropriate approach to alignment and transitioning of the existing ISF rules. We acknowledge that there may be differences inherent between types of non-network solutions that make one approach more suitable than the other – however consider it important that is weighed up against the benefits of a single aligned framework.

Our initial thinking on an aligned framework is set out in the table below.

Topic	Proposed aligned approach to cost recovery frameworks
Initial cost recovery uncertainty	• TNSPs are able to apply to the AER for an upfront approval of a proposed methodology for network support payments linked to any non-network solution. • In any subsequent year, the TNSP can seek AER upfront approval of any change to the proposed methodology of network support payments, to address situations in which there is a need to make a change to a network support arrangement that impacts the methodology.

Ongoing cost recovery uncertainty	• Any variation between the forecast costs that have been recovered and actual costs incurred will be recovered (or reimbursed) using the existing network support pass through mechanism. Where actuals are:
	  ○ consistent with an approved methodology, AER must accept pass through
	  ○ inconsistent with an approved methodology or the upfront approval was not used, the AER must make an assessment consistent with the existing network support pass through mechanism to determine whether the costs inconsistent with the methodology should be passed through to consumers.

Cost recovery timing	• The TNSP can estimate all network support payments for the upcoming year on an annual basis and recover through an additive adjustment to prescribed transmission prices. • Expanding this ISF arrangement approach to all non-network options would reduce the administrative burden on the AER and ensure consumers can avoid more volatile price paths – without increasing risks for consumers as all costs will be assessed in the network support pass through mechanism.

	• Noting that for system strength non-network solutions, as discussed earlier, this approach is expected to have material unintended consequences. So, another solution may be required to address cost recovery timing specifically for system strength non-network solutions.

5. Other issues

Materiality thresholds

Transgrid does not consider it appropriate to include a materiality threshold for a network support upfront approval or cost recovery timing solution. Consistent with the network support pass through arrangements which have no materiality threshold – it is important that all non-network solution projects (of which there are only a limited number) should be able to proceed with certainty. Without this:

- consumers would be impacted by smaller projects having higher transaction costs or delays due to the TNSP and network support provider negotiations having to consider this avoidable regulatory risk
- TNSPs may experience balance sheet pressure given multiple smaller projects could easily create the same financial impacts as a single 'material' project – these financial impacts are likely to flow on to consumers in some form.

We do not consider that this creates a significant new administrative burden on the AER given under the current framework the AER already manage annual network support pass through applications. For example, for a project with payments made over a five-year period, instead of five AER reviews in the annual network support pass through there is six, with the one additional upfront review.

Assessment frameworks

Considering the National Electricity Objective and the issues raised by Transgrid, the AEMC proposes to assess this rule change request against three assessment criteria including principles of market efficiency, innovation and flexibility, and principles of good regulatory practice.

Transgrid strongly recommends that the AEMC should consider the addition of emissions reduction as an assessment criterion. The timely delivery of non-network options (including but not limited to battery energy storage systems), has the potential to contribute to a reduction in Australia's greenhouse gas emissions which is aligned with the emissions reduction objective.

Links to the RIT-T

The AEMC note in the consultation paper that the process for selecting the preferred option (the RIT-T) is not within scope for this rule change project unless identified issues are directly relevant to the cost recovery framework. Transgrid agrees that the RIT-T is not the focus of the rule change process, however we note it may be relevant to consider how any potential upfront assessment process established via the rule could be considered by the TNSP during the RIT-T. Considering how any upfront assessment works effectively alongside the RIT-T process will ensure cost recovery frameworks are driving lower costs for consumers.

This could be relevant as currently the RIT-T process does not provide an explicit means to assess the prudency and efficiency of potential network support payments and they have no bearing in the economic analysis used to select the preferred option. This could lead to inefficient outcomes where a non-network project is identified as the preferred option in the RIT-T, only to be rejected in the upfront assessment by the AER due to the scale of payments subsequently being assessed as too high.

Application of proposed solution

Transgrid considers that it would be appropriate to allow all non-network solutions to benefit from the solutions considered in this rule change process. We are interested in working this through with the AEMC to identify any issues with non-RIT-T related non-network solutions using these potential improved cost recovery frameworks. Importantly pass through of non-network related costs shouldn't be available where the costs are already funded via another mechanism.

6. Case study examples

Waratah Super Battery – Upfront approval with adjustment mechanisms

The AEMC should have regard to the approach taken under the EII Act related to the successful and timely regulatory approvals provided to the Waratah Super Battery project. This example shows clearly how the AER can provide upfront and ongoing cost recovery certainty for a non-network solution project.

Transgrid was directed to undertake the Waratah Super Battery (WSB) project by the NSW Minister for Energy on 14 October 2022. The WSB project was planned to address the anticipated shortfall in electricity supply caused by the potential early closure of the Origin Energy Eraring power station, by increasing the capacity of the existing transmission network and allowing existing generators in NSW to increase output.

The AER is a regulator under the EII Act and has the function of determining the revenue a Network Operator may collect for undertaking a project, either under a contestable or non-contestable process. Under either process, the revenue an entity may collect from undertaking the project is regulated by the AER and specified in a revenue determination. The Scheme Financial Vehicle (SFV) pays the Network Operator the amounts set out in a revenue determination. The SFV recovers these costs from consumers via Distribution Network Service Providers.

We strongly encourage the AEMC to consider these NSW frameworks in how they provide cost recovery certainty through the upfront revenue determination approval process and allow for ongoing revenue certainty through adjustment mechanisms. The adjustment mechanisms allow for the adjustment of any amount in the schedule of payments, including the timing or circumstances of when an adjustment must be carried out. These adjustment mechanisms are the equivalent to the payment methodology proposed by Transgrid in this rule change request.

Under the NSW EII framework, the AER has been able to make multiple revenue determinations for the non-network solutions that form part of the WSB project. It has made these determinations using the information made available by the Network Operators. This includes revenue determinations that provided upfront approval of 16 different adjustment mechanisms for the paired generation services and 12

adjustment mechanisms for the system integrity protection service to be provided by the battery system, which included payments related to early termination.

The process of making an adjustment during a contractual period, as per the AER's guidelines, is:

1. Network Operator submits to the AER proposed revenue adjustments, adjusted revenue and an adjusted payment schedule for the concession period.
2. Network Operator's revenue adjustment proposal must include evidence supporting the proposed adjustments.
3. AER undertakes compliance check, against the relevant adjustment provisions in the contractual arrangement and the determination, and notifies the Network Operator whether it agrees with the proposed revenue adjustments.

Importantly the process for making an adjustment following the upfront approval does not involve the AER reviewing its upfront decision-making, which would create the avoidable regulatory risk that exists in the existing NER framework. Transgrid would be happy to provide more details to support the AEMC understanding these arrangements.

Powering Sydney's Future

In Transgrid's 2018-23 Revenue Determination, the AER approved a total network support allowance of $19.13 million ($ June 2018) for Transgrid's Powering Sydney's Future (PSF) project. The PSF network support allowance was intended to enable Transgrid to use non-network solutions to manage the risk of supply outages in the inner Sydney and CBD area, before a new 330kV cable was operational in 2022–23.

The Powering Sydney's Future project can be considered a good historical case study of a demand management non-network project. In this case, the non-network solution was part of the RIT-T preferred option and used to defer the timing of capital expenditure of the network option component. It did not replace the need for the project however, instead it deferred it.

A summary of the non-network component taken from the PACR of this RIT-T project is provided below.

The first stage will seek approximately 40-60 MW of non-network capacity over a four-year program (based on the preferred Option 8) from 2018/19 summer to 2021/22 summer, and include binding contracts for the provision of non-network solutions that will be entered into. This RFT will be released after the AER provides certainty that funding is available to Transgrid to pursue non-network solutions, which is expected to align with the timing of its final determination on the revenue proposal in April 2018.[2]

Key insights from this experience are discussed below:

- As noted in the PACR excerpt above, Transgrid did not have the certainty to commit to the project until the outcome of the revenue determination. This meant the tender process could not begin until after the revenue determination which resulted in the network support payment allowance being based on the expression of interest responses rather than firmer draft contracts.

[2] See the RIT-T PACR for the 'Powering Sydney's Future' project here for more detail.

- There was a significant impact from the reduction in demand attributable to the covid-19 pandemic and related changes in electricity demand in areas linked to the project.
- Setting an allowance with no flexibility to update meant actual payments were significantly different to forecast in every year. Across the period there was less than ~$5 million in network support payments, compared to the allowance which was set at $19.13m. This meant consumers were refunded significant amounts through network support pass through mechanism.
- The demand response services had payments related to establishment, availability and dispatch. Across the four-year period there were no dispatch events, related in later years due to the reduction in peak demand attributable to covid-19.

Demand response services are not currently expected to play a major role going forward in any upcoming RIT-Ts for Transgrid. However, the learnings above do indicate that there would be benefits from a more flexible cost recovery framework that allows for upfront approval and more flexible forecasting of the costs to be recovered from consumers.

END OF SUBMISSION