

Ms Michelle Groves
Chief Executive Officer
Australian Energy Regulator
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Dear Ms Groves

SOUTH AUSTRALIA – VICTORIA (HEYWOOD) INTERCONNECTOR UPGRADE

I am writing with regard to the proposed SA – Victoria (Heywood) Interconnector Upgrade. Macquarie Generation has several concerns with the analysis undertaken by AEMO and ElectraNet (together, the Proponents), that formed the basis for the *RIT-T: Project Assessment Conclusions Report for the proposed South Australia – Victoria (Heywood) Interconnector Upgrade*, published in January 2013 (the Heywood Upgrade RIT-T or PACR).

As you would be aware, the Heywood Upgrade RIT-T is the first assessment to be completed under the amended Rules and guidelines for the Regulated Investment Test for Transmission since changes were made in 2010, to combine the reliability and market benefit limbs of the former Regulatory Test. As the first assessment, the quality and robustness of the Heywood Upgrade PACR will effectively set a benchmark for all future studies.

The Rules place the responsibility for considering disputes regarding the application of the RIT-T, and, for determining whether an assessment satisfies the RIT-T requirements with the AER. Should either process be initiated, the AER has the final say as there is no further review or appeal process.

Given our concerns about the Proponents' analysis in the Heywood Upgrade PACR, as well as the role it will set as a precedent for future RIT-T assessments, Macquarie Generation considered initiating a formal dispute in relation to the PACR. However, we have chosen to write to the AER directly, noting that ElectraNet has stated publicly that it will seek a formal determination from the AER in the first half of 2013. We note that under the Rules the AER has 120 business days to make its determination and may have regard to any matter it considers relevant.

In our view, identifying, modelling and quantifying possible market benefits of an interconnector project is the most difficult and contentious part of any RIT-T assessment. It is in this area that Macquarie Generation has several concerns with the Heywood Upgrade assessment.

Magnitude of market benefits

The Proponents' PACR identifies Option 1b as the preferred option. Option 1b would increase Heywood interconnector flows by approximately 190MW in both directions from 2015/16 onwards. The modelling of this Option produced gross market benefits of approximately \$270 million (\$2011/12) in present value terms, weighted across the four modelled scenarios, at a present value cost of nearly \$80 million (\$2011/12). The corresponding weighted net market benefit was approximately \$191 million (\$2011/12) in present value terms.

Macquarie Generation has held concerns since the release of the Project Assessment Draft Report (PADR), that the magnitude of the modelled benefits for all of the options lacks robustness and credibility.

These concerns arise from two key sources – the nature of the scenarios modelled and the source of the gross market benefits.

Scenarios modelled

Of the four scenarios modelled by the Proponents, Macquarie Generation considers that the “revised central scenario” (Scenario 4), is the only realistic scenario. The first three scenarios rely on demand forecasts from the ESOO 2011 and carbon price projections from Treasury 2010 modelling. By mid-2012, prior to the completion of the PADR, it had been widely recognised in the marketplace that both of these sets of assumptions were obsolete.

The revised central scenario uses the NEFR 2012 medium growth demand forecasts, carbon prices starting at \$15/tonne in 2015/16, increasing steadily thereafter, and no forced closure of Hazelwood power station or fuel conversion at Playford power station. While it would have been appropriate for the Proponents to also consider a scenario with even lower demand growth and a lower (or nil from 2015/16) carbon price, the fact that the Proponents found higher net market benefits from Option 1b under the revised central scenario than under their central scenario suggests that adopting these changes may not have radically altered the results, at least under the Proponents' modelling methodology.

Source of gross market benefits

The PACR shows that more than 80% of the gross market benefits of Option 1b result from lower dispatch costs (fuel and carbon) relative to the no investment base case.¹ A breakdown of the differences in dispatched generation outcomes, in the revised central scenario with Option 1b compared to the base case, highlights the importance of a few key changes in output patterns, over the period to 2040, attributed to the upgrade:

- an additional 20,058 GWh of new biomass generation in South Australia;
- an additional 15,666 GWh of NSW black coal generation;
- 21,067 GWh less new biomass generation in NSW; and
- 20,301 GWh less gas generation in South Australia.

¹ AEMO & ElectraNet, Project Assessment Conclusions Report, Appendix I

Macquarie Generation has doubts about the credibility of the size and source of these changes in dispatch and hence in the modelled benefits reported by the Proponents. We are concerned that these results may be driven by a few key (inappropriate) modelling inputs (other than the assumptions noted above) and/or possibly a flawed modelling methodology.

Macquarie Generation has engaged an expert economic modelling firm to undertake a similar market modelling exercise. The preliminary results of that modelling show markedly lower gross market benefits from Option 1b than found by the Proponents.

Macquarie Generation's consultants are currently performing a more detailed analysis of the preferred Heywood upgrade option, including independent modelling of likely new generation build and forecast dispatch patterns. This modelling will, in the first instance, incorporate the same key demand, fuel cost and carbon price assumptions and data sets as those used by the Proponents in the "revised central scenario", as reported in the PACR.

Macquarie Generation anticipates that the consultants will finalise this modelling towards mid-March 2013. Once complete, Macquarie Generation will provide a summary report to the AER for its consideration and review. The independent modelling may or may not confirm the results of the modelling work undertaken by the Proponents.

Consultation process

Macquarie Generation has, through its membership of the National Generators Forum (NGF), participated in the various stages of the consultation process undertaken by the Proponents in applying the RIT-T. This has included submissions in response to early rounds of consultation and teleconferences with the Proponents. Macquarie Generation endorses the comments made by the NGF in its correspondence of 22 February 2013, to the AER.

Summary

The NEM Rules make the AER the ultimate arbiter of the manner in which the RIT-T has been applied where a dispute is raised or where a proponent seeks a determination on its assessment. In the case of any large scale interconnector project, the only certainty is that substantial costs will be incurred, customers will pay and the TNSPs will earn a guaranteed rate of return on the capital deployed.

Macquarie Generation encourages the AER to commit the time and effort to a thorough review of the Heywood Upgrade RIT-T PACR and modelling work. Our preliminary analysis indicates that the gross market benefits from the Proponents' modelling may substantially overstate the likely actual benefits. It is unclear whether the difference in benefits is driven by the modelling tools or by the use of a few critical, but unrealistic assumptions. In either case, further modelling work may identify problems or weaknesses with the Proponents' approach.

Macquarie Generation is of the view, given that this is the first application of the RIT-T, that a thorough external check on the Proponents' modelling is warranted. Macquarie Generation hopes to work co-operatively with the AER as it undertakes its determination of the Heywood Upgrade RIT-T.

Ms Michelle Groves
Chief Executive Officer
Australian Energy Regulator

We look forward to the AER's assessment of the Proposal. If you have any queries regarding Macquarie Generation's submission or modelling, please contact me on 02 9364 3123.

Yours sincerely

A handwritten signature in black ink that reads "leisl baumgartner". The signature is written in a cursive, lowercase style.

LEISL BAUMGARTNER
GENERAL MANAGER CORPORATE AFFAIRS

5 March 2013