



Hon Lily D'Ambrosio MP

Minister for Climate Action
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Dear Clare

Re: Issues Paper - Basslink Conversion Application and Electricity Transmission Determination - AER reference: 23007165

Thank you for the opportunity to make a submission to the AER's Issues paper on the proposed regulatory conversion of Basslink.

Since its operational commencement as a market network service provider (MNSP) in 2006, Basslink has provided benefits to consumers in both Victoria and Tasmania, by increasing security of supply, and decreasing consumer costs. It has also enabled Hydro Tasmania to access the Victorian retail market to sell its surplus energy and earn returns which have benefited Tasmanians.

It is not evident however that converting Basslink Pty Ltd to a transmission network service provider (TNSP) will provide benefits to consumers. Rather, the proposal indicates that the average Victorian residential consumer stands to pay an extra \$11 per year from this proposal (and the average Tasmanian \$8 per year) at a time when households are struggling with cost-of-living increases.

Furthermore, we believe any consideration of this proposal should be deferred pending resolution of critical related matters arising from the Marinus Link project, including:

- The Australian Energy Market Commission's (AEMC's) decision on a rule change proposal from the Commonwealth, Victorian and Tasmanian governments providing for interconnector cost-sharing through bilateral agreements;
- Completion of Marinus Link 1; and
- A decision to proceed with Tasmanian Renewable Energy Target (TRET) projects.

Consequently, Victoria does not support this proposal.

Should the AER proceed with the process to regulate Basslink immediately, Victoria would have objections to a number of elements in APA's proposal – in particular:

- the calculation of economic benefits that feeds into the calculation of an opening Regulatory Asset Base (RAB); and
- the jurisdictional cost allocation proposed by APA.

Our views are discussed in more detail below.

Unproven Benefits of Regulation

The Status Quo

For the majority of its operational life, Basslink Pty Ltd has had financial contracts with Hydro Tasmania. Initially this was the Basslink Service Agreement (BSA). This was later replaced by the current Network Service Agreement (NSA). These contracts had the following key effects:

- Hydro Tasmania was exposed to the Victorian regional reference price (RRP)
- Basslink Pty Ltd received a reliable stream of revenue.

These service agreements have provided Basslink Pty Ltd with income certainty in the form of an annual payment from Hydro Tasmania. In return Basslink Pty Ltd has assigned arbitrage revenue to Hydro Tasmania. This is sensible, as Hydro Tasmania controls the bidding of all Tasmanian hydroelectricity. Therefore, it should be given the incentive to maximise generation when the Victorian RRP peaks.

The Optimal Scenario

Monopoly power in most circumstances is contrary to consumer interest. In this particular case however, monopoly power by one party to set Tasmanian prices, coupled with monopoly power by another party to provide connectivity to the mainland, has incentivised both parties to align self-interest, with positive outcomes for consumers.

We believe an optimal scenario is achieved when Hydro Tasmania is exposed to the Victorian RRP. This incentivises Hydro Tasmania to use its stored water to generate power at those points when the Victorian RRP is highest. This gives Victorian consumers the dual benefit of increased security of supply, and lower wholesale costs. Conversely, Hydro Tasmania can import when the Victorian RRP is lower (typically during mid-day solar production) to avoid the need to use its stored water for generation (reserving it for higher value use). This produces benefits for Tasmanian consumers.

For most of the life of Basslink, Hydro Tasmania has been incentivised to employ this long-term strategy, due to the BSA and later the NSA. These contracts effectively exposed Hydro Tasmania to the Victorian RRP. It is not clear how a TNSP model will ensure a similar outcome.

TNSP Scenario

If Basslink Pty Ltd became a TNSP, all arbitrage revenue would be contained within Inter Regional Settlement Residues (IRSRs). Rights to these IRSRs would be auctioned by AEMO at Settlement Residue Auctions (SRAs) and any registered participant could bid for them (the usual process for regulated interconnectors).

If Hydro Tasmania failed to secure full or majority rights to IRSRs at an SRA, it would only earn the Tasmanian RRP. This would not provide Hydro Tasmania with an incentive to maximise exports when the Victorian RRP peaks. This will, in turn, drive up wholesale prices in Victoria.

As a consequence of losing exposure to the Victorian RRP, Hydro Tasmania would also lose the incentive to sell cap contracts into the Victorian market. Victorian retailers and consumers would lose a key source of cap contracts, at a time when firming capacity in the NEM is diminishing. Hydro Tasmania and its shareholders would lose revenue from the sale of cap contracts to Victorian retailers.

Hydro Tasmania is in a unique position in Tasmania, as the supplier of virtually all dispatchable generation in the state. Under a TNSP scenario in which Hydro Tasmania has not secured all the Victoria-Tasmania IRSR rights, it would only have an incentive to maximise generation whenever the Tasmanian RRP peaks. However, Victoria benefits from Hydro Tasmania having a long-term incentive to reserve water in its dams to meet peak spot prices in Victoria. This is also the optimal scenario for the NEM, as it maximises revenue derived from energy flow over Basslink.

The increase in both wholesale prices and retail prices noted above is in addition to the proposed cost increases from the allocation of Basslink costs to Victorian consumers via TUOS. This additional cost increase will occur without corresponding benefits to Victorian consumers and would be inconsistent with the long-term interests of electricity consumers in the NEM, thus conflicting with the National Electricity Objective.

Counterfactual

As explained above, because of the mutual interests of Basslink Pty Ltd and Hydro Tasmania, the appropriate counterfactual against which to assess the proposal for Basslink regulation is one in which Basslink Pty Ltd signs a contract with Hydro Tasmania, equivalent to the previous BSA or current NSA.

If Basslink Pty Ltd were to remain an MNSP without a service agreement in place, it would be incentivised to restrict the flow of energy over the link, to increase the difference between the Tasmanian and Victorian RRs. This strategy could, at times, generate more arbitrage revenue for Basslink Pty Ltd, but at the expense of Hydro Tasmania's profits and at the expense of Victorian consumers (who would face higher wholesale prices). We agree with APA that this would be sub-optimal. However, we don't agree that this is an appropriate counterfactual for this assessment as there is a compelling financial case for both parties to sign a service agreement.

Any opposition to a future agreement between Basslink Pty Ltd and Hydro Tasmania is likely to be transient. APA's views on a future contract, expressed in its submission, may reflect its preferred way of managing risk, and a negotiating strategy, designed to encourage its preferred regulatory outcome. However, APA may not be the owner of the link for the remainder of its service life.

Past behaviour confirms that both parties are likely to maintain an agreement akin to the current one. Since April 2006 Basslink Pty Ltd has been subject to a service agreement with Hydro Tasmania for all but ten months in 2022. This ten-month period was the result of a disruption to Basslink's service and a subsequent legal dispute between the parties. Both events are anomalies and should not be the basis of a business-as-usual case. It is noted that the current contract between Hydro Tasmania and Basslink Pty Ltd provides Basslink Pty Ltd the option for 3 by 3-year extensions, subject to mutual agreement between the parties regarding adjustment to the fee arrangements.

Barring some fundamental change to the dual monopoly situation described previously, Victoria expects both parties will continue to be incentivised to employ such service agreements as an effective way to reduce market risk and smooth revenue. Victoria expects consumers in both Victoria and Tasmania will continue to benefit from this scenario.

The case for deferring consideration

The Commonwealth, Tasmanian and Victorian governments jointly submitted a rule change request to the AEMC on 8 December 2023 (AEMC Reference ERC0383). The proposed rule change would address the current opacity of the National Electricity Rules (NER) in dealing with cost-sharing arrangements for interconnectors. The following is an outline of the proposed rule change:

- Allow State governments, for jurisdictions which an interconnector passes through, to agree to the allocation of the interconnector's aggregate annual revenue requirement (AARR) that would be recovered from the consumers of each State. The proposed rule would allow the agreed allocations to be reflected in each relevant TNSP's transmission determination to give effect to the States' agreement.
- In addition to overall project costs, the allocation of ongoing transmission costs would also be determined in the agreements between two jurisdictions. To ensure the intent of this rule change is consistent throughout the NER there would also need to be the ability for the allocation of other transmission costs to be changed according to jurisdictional agreements.

Consistent with this rule change proposal, the issue of cost allocation should be determined by the jurisdictions themselves (Victoria and Tasmania) through a negotiated process. This should precede the AER conversion and revenue determination process.

In addition, confirmation of other Marinus-related matters – including the commencement of the first link, a decision to build a second link, and the related decision to proceed with TRET – should all precede any further consideration of a Basslink conversion proposal.

If Regulation Proceeds

If the conversion and revenue determination process were to proceed, Victoria would have objections to a number of elements of APA's proposal – in particular:

- The calculation of economic benefits that feeds into the calculation of an opening RAB; and
- The jurisdictional cost allocation proposed by APA.

Opening RAB value

The Victorian Government believes that, in its estimation of the future economic benefits of Basslink, APA has included projects forming part of TRET. The business case for TRET projects is questionable however and is dependent on some combination of the following:

- Increased interconnector capacity between Tasmania and Victoria (i.e. Marinus Link Stages 1 and 2)
- The Battery of the Nation project (specifically the 20hr storage component of the Cethana pumped hydro scheme)
- Increased demand in Tasmania.

Currently there is a lack of certainty around all the above. Therefore, including TRET projects in the base case for a benefits test for Basslink serves to exaggerate the benefits estimate. This occurs because the benefits test shows that Basslink offsets the need to build wind generation in Victoria. This is underpinned by the extra generation in Tasmania, provided by TRET projects. The cost savings from avoided Victorian wind projects have been included as a benefit however the costs of building TRET projects have not been included.

The Marinus Link proposal is a key variable in estimating Basslink's benefits. In their 15 September 2023 revenue proposal, APA assume a January 2029 start date for Marinus Link. However the draft 2024 ISP cites a 1 December 2030 delivery date. APA have already acknowledged the need for further sensitivity modelling of scenarios in which Marinus Link Stage 1 is delayed. The correct start date should be used and the appropriate sensitivity modelling should be completed before APA's Revenue Proposal is fully considered.

Cost allocation

As noted above, Victorian consumers should not pay any additional costs without conclusive evidence of additional benefits of regulation over the status quo. Should the proposal proceed, cost allocation should consider the beneficiaries of Basslink, including Hydro Tasmania. It is apparent that Hydro Tasmania benefits from the revenue earned through selling over Basslink, but also realises drought risk management benefits and energy security benefits.

In the event that Basslink Pty Ltd becomes a TNSP, we are opposed to APA's proposed cost allocation. APA have not justified why the cost share should deviate from the roughly 50/50 share, applied previously to both Murraylink and Directlink, when they converted. We note also that, if the cost share were based on geography, it would not result in a 50/50 split. For some regulatory purposes, Victoria has a maritime border with Tasmania running along 39 degrees 12 minutes south (passing immediately south of Wilson's Promontory). Based on this, the majority of the cable would sit in Tasmanian waters.

Conclusion

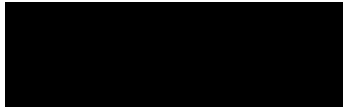
In summary:

1. Victoria opposes the conversion of Basslink to a TNSP at present, on the basis that there are unlikely to be net benefits for consumers.

2. Victoria believes that the conversion and revenue determination process should be delayed pending the resolution of related matters – principally, the Marinus Link project and related rule change.
3. In the event of regulation, Victoria opposes a number of elements in APA's proposal including:
 - a. the inclusion of any TRET projects when estimating the future economic benefits of Basslink
 - b. APA's allocation of costs to Victorian consumers

If you would like to discuss these matters further, please contact the Victorian Government's Energy Transition and Strategy Division at the Department of Energy, Environment and Climate Action.

Yours sincerely



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29 February 2024