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Tasmanian Government

31 January 2025

Dr Kris Funston
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Dear Dr Funston

Basslink – Conversion Draft Decsion

I am writing on behalf of the Tasmanian government in response to the AER's call for submission on the December 2024 Draft Decision on the Basslink Conversion Application.

The Tasmanian government is very concerned with the AER's "finely balanced" decision against conversion of Basslink to a regulated asset. The case for regulation is made out in the AER's analysis, and there are good reasons for the 'fine balance' to fall in favour of conversion.

The principal matters the Tasmanian Government argues the AER should consider in moving to its final decision on Basslink's conversion are:

- the appropriateness of the 'precautionary approach' that the AER has taken in the draft decision;
- the undue weight being applied to the possibility of an enduring agreement between Hydro Tasmania and APA in relation to Basslink, particularly one that delivers the benefit of regulation (i.e. open flows) but without any direct costs to customers;
- the weight that should be given to the modelled customer benefits of conversion, relative to the modelled market benefits of conversion, given that these make the case for conversion;
- the lack of engagement in the draft decision on the very real possibility of Project Marinus eroding the commercial model for a MNSP; and
- the lack of weight in the draft decision given to known considerations, relative to modelled outcomes.

The draft decision frames a determination by the AER to approve regulation now as irreversible - hence the need for caution, because it can't be unwound.

The inference is that a decision to refuse conversion now is a reversible decision. This may not be the case, because only APA can submit a future application for regulation.

If APA is forced to establish a merchant trading position because its application for conversion is rejected by the AER, and that business model delivers outcomes that are value accretive for APA, but which other stakeholders do not like, there is no path for the jurisdictions or market participants to seek Basslink's conversion to ameliorate such impacts. There is no reason to doubt that APA will seek to maximise the commercial value of Basslink to its shareholders.

The fact is that Tasmania, Victoria and the wider NEM have no lived experience of how a merchant MNSP might maximise its value through strategic bidding. Rejecting Basslink's conversion will force this outcome. It is highly questionable whether the mid-2020s, with the national energy transition well underway, is the time to be taking such a step.

The ACIL Allen modelling shows the benefits to customers from regulation against the MNSP merchant counterfactual. A decision to refuse conversion at this time that forces the asset to become a merchant trader may well prove to be an irreversible decision also. Accordingly, the Tasmanian Government calls on the AER to be equally cautious is its consideration of refusing conversion.

Yours sincerely

Hon Nick Duigan MLC
Minister Energy and Renewables

Basslink Conversion Application and Electricity Transmission Determination

Draft Decision December 2024

Tasmanian Government Submission

January 2025

Tasmanian Government

1. Overview

Basslink is the only market network service provider (MNSP) in the National Electricity Market (NEM)[1]. Despite this, since its commissioning in 2006, Basslink has been generally available at its full export and import capabilities, with flows northward and southwards being determined by spot prices in Victoria and Tasmania, rather than flows being determined by those factors plus capacity bids from the link. In this context, Basslink has provided material benefits to both Tasmanian and Victorian customers, and the NEM more widely, in the same way it would have as a regulated interconnector, but without direct costs to Victorian and Tasmanian customers through transmission charges.

APA's application for conversion of Basslink from a MNSP to a TNSP would result in uniformity in the operation and commercial models for all interconnectors (existing and planned) in the NEM. This is particularly relevant in light of the planned development of Project Marinus, because of the very real risk that it will erode the unique commercial model of a MNSP.

The Tasmanian Government remains of the view that Basslink's conversion is in the best interest of Tasmania and Tasmanian electricity customers, and continues to support APA's application for Basslink's conversion. Moreover, Basslink's conversion to become a TNSP is of strategic importance to all NEM customers.

The work undertaken by the AER in considering the conversion proposition makes the case for this outcome, particularly the modelling of consumer outcomes. This is well canvassed in the APA and ReCFIT submissions on the Consultation Paper.

The principal matters the Tasmanian Government argues the AER should consider in moving to its final decision on Basslink's conversion are:

- the appropriateness of the 'precautionary approach' that the AER has taken in the draft decision;

[1] The Tasmanian Government submission to the Issues Paper explained the reasons behind Basslink being progressed under the MNSP model, so this is not repeated in this submission.

- the undue weight being applied to the possibility of an enduring agreement between Hydro Tasmania and APA in relation to Basslink, particularly one that delivers the benefit of regulation (i.e. open flows) but without any direct costs to customers;

- the weight that should be given to the modelled customer benefits of conversion, relative to the modelled market benefits of conversion, given that these make the case for conversion;

- the lack of engagement in the draft decision on the very real possibility of Project Marinus eroding the commercial model for a MNSP; and

- the lack of weight in the draft decision given to known considerations, relative to modelled outcomes.

The draft decision frames a determination by the AER to approve regulation now as irreversible - hence the need for caution, because it can't be unwound.

The inference is that a decision to refuse conversion now is a reversible decision. This may not be the case, because only APA can submit a future application for regulation.

If APA is forced to establish a merchant trading position because its application for conversion is rejected by the AER, and that business model delivers outcomes that are value accretive for APA, but which other stakeholders do not like[2], there is no path for the jurisdictions or market participants to seek Basslink's conversion to ameliorate such impacts. There is no reason to doubt that APA will seek to maximise the commercial value of Basslink to its shareholders.

The fact is that Tasmania, Victoria and NEM market participants have no lived experience of how a merchant MNSP might maximise its value through strategic bidding. Rejecting Basslink's conversion will force this outcome. It is highly questionable whether the mid-2020s, with the national energy transition well underway, is the time to be taking such a step.

The ACIL Allen modelling shows the benefits to customers from regulation against the MNSP merchant counterfactual. A decision to refuse conversion at this time that forces the asset to

[2] Such as limitations on imports to Tasmania at periods of low demand in Victoria, leading to the curtailment of solar generation in Victoria, or Tasmania being unable to secure the level of imports desirable to offset low hydrological inflows, or access to Tasmanian generation in Victoria is curtailed by transport bidding by Basslink value at times of tight capacity in Victoria.

become a merchant trader may well prove to be an irreversible decision also. Accordingly, the Tasmanian Government calls on the AER to be equally cautious in its consideration of refusing conversion.

1. The Precautionary Approach

In reaching its 'finely balanced'[3] draft decision to not accept the conversion application, the AER has placed considerable focus on the uncertainties of benefits to customers arising from regulation relative to the certainty of costs to customers.

The draft decision highlights the irreversibility of a positive decision to convert Basslink, in the context of that uncertainty, and this appears to be the decisive factor that tips the finely-balanced decision to the negative.

This situation – uncertainty of future benefits and relative certainty of future costs - is no different to that the AER routinely faces in considering RIT-T decisions, both for very large proposed investments such as new interconnectors and more modest business-as-usual investments by TNSPs. There is nothing unique to Basslink's conversion in this regard.

In all of these situations, the AER is required to consider decades-long investments in a highly uncertain electricity market future (especially in the context of the national energy transition), delivering very uncertain market and customer benefits, when contrasted against a much more certain cost burden to customers. The approval of any interconnector (or other asset) under the RIT-T is also a once-off decision[4].

The Tasmanian Government argues that in the case of Basslink, the AER appears to be applying a more conservative approach and requiring a higher "burden of proof" for Basslink's conversion than that which it typically applies to RIT-T considerations. It is not reasonable for the AER to adopt a 'precautionary principle' to a higher level in the Basslink conversion matter than it does for equivalent matters, such as major RIT-T decisions.

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[3] Draft Decision, page 1.

[4] Noting that the feedback loop in the NER does not re-address the benefit/cost assessment of the RIT-T.

2. Weighting of a Hydro Tasmania – APA Basslink Agreement

A reoccurring theme through the draft decision is the potential for an enduring agreement between APA and Hydro Tasmania. On the basis of the ACIL Allen modelling, such a scenario would deliver lower benefits of conversion. Indeed, the draft decision (page 15) concludes that a counterfactual that involves the extension of the current agreement (which sees the link bid at a zero price difference), would deliver the same market outcomes as a regulated interconnector with no costs to customers, and give rise to zero benefits of conversion.

Because the contemplation of enduing agreements (of varying sorts) expands the number of potential counterfactuals, this increases the perceived uncertainty of benefits from conversion, and would appear to be a key reason for the 'precautionary principal' being applied to the conversion question.

The weight being given to the potential for a future long-term agreement is troubling. It appears to be based on the premise that there are incentives for an agreement to be entered into (because there is arbitrage value to be had) and that prior agreements (with particular features that deliver the equivalent of a regulated interconnector without direct costs to customers) have indeed been in place.

The draft decision states that the AER would "need to be satisfied that there would be no further contractual agreement between Basslink and Hydro Tasmania…" for the AER to conclude the benefits of conversion to be significant.

Firstly, there is no contract on foot that would apply from 1 July 2025.

Secondly, the context that underpinned the current agreement (securing a short-term revenue path for Basslink out of administration and through the regulation process) and that for the terminated Basslink Service Agreement (a financing agreement to have the link built) no longer apply. It seems misplaced that the burden of proof be applied to assurance that something that doesn't exist will not exist. It is difficult to see how such a test could practically be met.

It has been argued to the AER by some that a replacement enduring deal should be given material weight as a counterfactual. It is notable that such propositions have come from parties that have had no involvement in previous agreements. Of key importance, no evidence or cogent arguments have been made to support those propositions (other than the observations that prior agreements existed).

There has been no evidence provided to the AER ahead of the draft determination that there will be an enduring agreement between Hydro Tasmania and APA for Basslink, or any evidence of what such an agreement would entail.

Indeed, APA has advised the ASX that it intends to trade the link as merchant asset if the AER's final decision is to refuse conversion. APA is presently undertaking the preparations required to actively trade the link, and there is no reason to doubt the Company's incentive and ability to put the required resources to the task of maximising shareholder value. The benefits of regulation against a merchant counterfactual are well established in the ACIL Allen modelling.

The Tasmanian Government argues that a counterfactual that assumes an enduring agreement that see Basslink bid at zero over the asset life (delivering all the benefits of regulation at no cost to customers) should be set aside, as the evidence base for such a deal has not been established, especially following Marinus commissioning.

If the AER is to give weight to a counterfactual that involves an enduring contract between APA and Hydro Tasmania, then it needs to engage with APA and Hydro Tasmania on what the potential nature of that transaction might be – not given the incentives that existed for Hydro Tasmania to enter into the BSA (to get Basslink built), or the NSA (to provide a revenue bridge out of insolvency and through the regulatory process), but based on the current commercial incentives facing market participants. The AER should also consider the competition law implications of any conceptual contract that it is considering as a potential counterfactual, including discussions with the ACCC.

If the decision to refuse Basslink conversion is to be based on the premise of there being quite likely some commercial agreement between Hydro Tasmania and APA in the future, which would by its design obviate the benefits of conversion, then considerable rigor must be applied[5] by the AER having regard to contemporary circumstances.

The draft decision (page 15) makes observations about prior regulatory arrangements that applied to the BSA, and concludes:

[5] The ACIL Allen modelling analysed market outcomes under an agreement that provided Hydro Tasmania with full bidding rights for Basslink, and simply assumed competition law issues away. Such simplifying assumptions may be appropriate for the purposes of a modelling exercise, but are not sufficiently robust on which to make a conversion decision.

> Tasmanian Government would have an interest in preserving Tasmania's unrestricted access to the NEM and supporting Tasmania's electricity sector by maximising flows over Basslink, and could potentially intervene to ensure such terms remain in place (p 15)

As explained in the Tasmanian Government submission on the Issues Paper, the restrictions on Hydro Tasmania's contracted bidding rights in the BSA were enhancements to Tasmania's NEM entry framework, arising from the ACCC process of authorising the Tasmanian NEM entry package (being the vesting contract and the National Electricity Code derogations).

The AER should not assume that the Tasmanian Government will consider it necessary to restrain any Hydro Tasmania contracted bidding abilities in the same way that it did in the context of a long-term deal intended to facilitate construction of the interconnector and Tasmania's entry to the NEM – that context has long-expired.

Whilst historic comments are not necessarily indicative of what analysis today would show in relation to the effect on competition of Hydro Tasmania having bidding rights in any future contract, in the ACCC's NEM entry decision in 2001 the ACCC observed as follows: "The Commission believes that positive bidding of Basslink on northward flows of electricity raises less competition concerns than other forms of non-zero bidding. While a positive bid would allow Hydro Tasmania to export electricity at higher prices than at which it sells in Tasmania, Hydro Tasmania does not have a dominant position in the Victorian region. Consequently, Hydro Tasmania will bear the dispatch risk that a positive bid on Basslink will mean that it does not get the opportunity to export or, if it does, at a level below the maximum of 600MW".

The Tasmanian Government argues if the appropriate weighting is given to the Hydro Tasmania agreement counterfactual (i.e. very low), the apparent uncertainty over the benefits of conversion is reduced (because there are fewer plausible counterfactuals), and the AER's analysis, particularly the large customer benefits as modelled under the merchant link assumptions, suggests the 'finely balanced' decision should be in favour of conversion.

3. Weighting of modelled customer benefits

The third principal issue the Tasmanian Government highlights is the weighting the draft decision gives to modelled customer benefits. The AER is placing greater weight on the modelled market benefits, on the basis of the NEO's reference to prompting efficient investment in, and efficient use of electricity. The draft decision states:

> The price changes of conversion and an important consideration, although they are less informative in determining whether the conversion of Basslink will result in efficiency benefits in accordance with the NEO. This is because these prices changes largely represent changes in payments between produces, transporters and consumers of electricity. (p.6)

The NEO references efficiency (in operations and investment) on the basis that these factors are considered to drive the ultimate objective of promoting the long erm interest of consumers. Efficiency is the means to an end, and the end is the interest of customers. This is made plain in the Australian Energy Market Agreement in Section 2 that sets the objective of the Agreement as "the promotion of the long term interests of consumers with regard to the price, quality and reliability of electricity and gas services"[6].

Given that objective, changes in payments between producers and transporters of electricity to the benefit of customers (whether or not they give rise to efficiency gains) support the objective (i.e. even purely transfers of producer surplus to consumer surplus). In this context, there is no basis for the AER to prefer modelled measures of efficiency gains over modelled price impacts on customers, and full weight should be given to the modelled customer benefits of conversion in the conversion consideration.

6 The second reading speech for the National Electricity Law in 2005 stated "An important objective of the Australian Energy Market Agreement was the promotion of the long term interests of energy consumers. This new objective is refected in the National Electricity Law *as the key objective for the national electricity market*". (emphasis added)

4. Basslink ceasing operations

The Tasmanian Government is concerned about the absence of any analysis in the draft decision on the consequences of Basslink ceasing operation with the commencement of Project Marinus. The draft decision states:

> We consider it unlikely that Basslink would cease to operate in advance of the commissioning of Marinus Link.… Beyond this time, the likelihood that Basslink will cease operations is low but cannot be ruled out" (p.17).

The Tasmanian Government agrees that this possibility cannot be ruled out, and argues that it is a counterfactual that should be properly analysed to establish the benefits of conversion.

By rejecting the conversion application, the AER is forcing Basslink to remain a MNSP, with its only commercial model being monetising the value of IRRs between Tasmanian and Victoria. To the extent that Marinus, operating as a TNSP, materially erodes the value of IRRs to the point that it is no longer profitable for the Basslink owner to operate the link (from the perspective of stay-in-business capital expenditure and operational expenditure), the clash of commercial models between the two interconnectors will lead to the cessation of Basslink[7]. Figures 1 and 2 of the August 2024 Consultation Paper provide little reassurance that this is not a genuine possibility. Indeed, it is a principal concern for the Tasmanian Government.

That is not to say that the AER should blindly accept Basslink's conversion. Rather, it requires the AER to genuinely engage with the possibility, and analytically explore the benefits of conversion against that counterfactual, rather than pass it over as a 'low likelihood' outcome.

There is no question that Marinus (even with just the single 750MW cable) will materially challenge the MNSP commercial model for Basslink. There is a very real risk that if Basslink is forced to remain a MNSP, Tasmanian and Victorian customers could end up paying for the costs of 750 MW of new interconnection and the consequential network upgrades required to support it, and ultimately only see a net increase of 250MW of interconnection. Such an outcome is plainly not in customers interests.

[7] Alternatively, it may materially change in the incentives Basslink's owners have in recruiting generator and load tripping services in Tasmania and could mean that Basslink operates at a materially lower level of continuous rating. The draft decision fails to include any consideration of the implication for SPS load tripping and Basslink's continuous ratings in refusing conversion.

The draft decision suggests that conversion of Basslink may transfer risk from its owners to customers -

> If an outcome of conversion is that consumers pay transmission charges for an asset that is underutilised or that without conversion may plausibly cease to operate (in other words, it may fail to earn sufficient revenues to meet its stay-in-business costs), that may suggest that both the economic efficiency and wholesale price benefits of conversion are unlikely to be great, or even positive. If so, this could represent an undesirable transfer of risk from the owners of Basslink to consumers (p.20)

This mis-frames the potential position. It is the clash of the commercial models of a large regulated interconnector – funded by customers and open flowing, against a MNSP that is at the heart of the issue.

The Tasmanian Government is unaware of any modelling that suggests the combination of the physical capacity of Project Marinus (either one or two links) together with an open-flowing Basslink leads to an 'oversupply' of transmission capacity and an underutilisation of it[8]. The risk of stranding is not one of whether the physical transfer capacities are no longer required, rather it is a commercial stranding arising from the mismatch of commercial models between regulated interconnectors and a MNSP.

5. Basslink and the national energy transition - a practical perspective

The draft decision places material weight on modelling outcomes in framing the conversion question, but fails to engage with practical considerations that are highly relevant.

The modelling undertaken to inform the AER's consideration of conversion, shows a smooth transition through the national energy transition through the various scenarios modelled. Like all modelling of this type, it assumes that market signals will deliver generation in those places where it is most efficient, and at the right time, given assumed costs profiles and capacity factors.

[8] For example, the 2024 ISP assessed that the combination of Project Marinus and an open flowing Basslink avoids the need for 500 MW of additional deep utility storage capacity required in Victoria by 2037-38, increasing to 760MW by 2044-45. All of the analysis of Marinus has been undertaken using the assumption of Basslink openly flowing (as it would under regulation), and no analysis suggest that Basslink's continuous capacity is unrequired or 'stranded' with Marinus' commissioning.

We know that reality is very different, and that a range of interventions have been required by governments to drive the transition (hence the Australian Government's Capacity Investment Scheme, State-based pull forward mechanisms and the need for the current NEM review that has been commissioned by the Australian Government).

The energy transition has not been, and is unlikely to be orderly. The actual development of the NEM will not follow the 'optimal development path' as set out in the routine two-yearly AEMO ISPs.

Currently, Victoria structurally relies on Tasmanian generation (transported by Basslink) to meet capacity at certain times of the year, and regularly at other times on a less predictable basis as unplanned outages occur. Victoria relies on Tasmania to import energy at other times to deal with minimum demand levels (avoiding the need for solar curtailment).

While there is ongoing debate about the precise timing of the withdrawal of thermal generation, there is no doubt that it will be withdrawing over the coming years, being replaced by non-firm variable renewable generation. The role of interconnection to optimise the national energy transition is well understood.

Access to Tasmania's firming resources, through our existing hydro generation sources, will become increasingly critical to the smooth functioning of the NEM, and most importantly for the Victorian region.

Countless modelling exercises of the potential new VRE and battery capacity investment required to meet this loss of generation can be undertaken, but none of those exercises provide any genuine confidence that this investment will actually be forthcoming and at the time required.

And yet Basslink is in operation now, and has a design life until 2046, and the Tasmanian hydro system sits ready to play its role.

Basslink regulation provides confidence to the NEM that its available capacity at all points in time will be fully available to transmit excess renewable generation from Victoria (and elsewhere) when it is available to displace dispatchable hydro electricity in Tasmania, and that same capacity (actually higher with dynamic rating) will be available to transmit from Tasmania the increasingly-needed firm electricity Victorian and other NEM customers need when that new renewable generation is not available.

Given Tasmania's supply and demand balance, that firming capability will not be available unless the corresponding imports also flow – the Tasmanian 'battery' needs to be recharged.

The NEM needs confidence about open flows across Basslink to have confidence that the very real existing firming capability of Tasmania's hydro system can be access when required. Only regulation delivers this outcome. And while no increases in electricity bills for customers is ever welcome, the annual change in bills for Tasmanian and Victorian customers arising from delivering that confidence is not large (and the costs of bringing on new alternative firming capacity has to be funded).

Moreover, regulation provides a transparent framework for developing capital investment proposals for Basslink that could well see the asset extend its practical life past 2046. The MNSP model delivers no such confidence[9].

The AER fully acknowledges the incentives for Basslink as a MNSP to constrain flows over the interconnector in order to drive price differences between Tasmanian and Victoria. It is difficult to see how it is in the interests of customers in either jurisdiction to have a situation where those flows can be curtailed to drive up price differences between the jurisdictions. Moreover, capital investment to maintain the link, or extend its life, will be driven by uncertain shareholder considerations from time-to-time.

As Australia moves through the energy transition, particularly the shift from firm thermal energy on the mainland to variable renewable production, the importance of interregional trading between Tasmania and Victoria, with our existing reliable deep storage and world-class untapped renewable reserves (both energy and capacity) becomes increasingly important. While Basslink will always be important to Tasmania, it is becoming increasingly important to the NEM, and particularly the Victorian region. This reality reinforces the case for regulation over and above the ACIL Allen modelling, which in the broad, supports the same proposition.

[9] The proposed replacement of the Basslink control system is a practical case in point, as explained in the ReCFIT submission to the Consultation Paper. It is not sufficient to merely assume that private sector operators have similar incentives for capital investment as those that can be delivered through a regulatory framework. Tasmania has lived experience in dealing the consequences where private sector infrastructure owners have not taken a long-term perspective on their assets, and rather have been driven by shorter-term shareholder interests, leading to the transfer of risk to the Tasmanian tax payer (e.g. the sale of Pacific National's Tasmanian rail operations and the creation of TasRail Pty Ltd in 2009).