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1 September 2022

Ms Anna Collyer
Chair
Australian Energy Market Commission
GPO Box 2603
SYDNEY, NSW, 2021

Dear Ms Collyer

Re: AER submission to the Material change in network infrastructure project costs draft rule

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) draft determination for the Material change in network infrastructure project costs rule change. Timely delivery of network infrastructure projects is crucial to a successful energy transition. Equally, it is important that consumers have confidence that transmission investments deliver benefits to them that exceed their cost, given that they ultimately fund them. To that end, the AER supports the intent of the AEMC's more preferable draft rule to clarify the existing provisions relating to a material change in circumstances (MCC). This includes providing additional transparency of the relevant regulatory processes to stakeholders, introducing a positive requirement for regulatory investment test (RIT) proponents to assess whether a material change in circumstances has occurred and clarifying the role of the AER to review the process the RIT proponent has undertaken.

The AER also supports consideration of how we can update guidance for RIT proponents around their development of cost estimates for use in RITs. We are of the view that the focus at the RIT stage should be to improve transparency around the costs while accepting that costs will not be fully accurate at this stage. As there are still significant project activities to occur after the RIT is completed, it is expected that the cost estimates will contain a level of inaccuracy at the RIT stage for the options assessment. We consider that stakeholders can engage more effectively with the options analysis if there is transparency around how the RIT proponent has developed its cost estimates and the nature of uncertainties involved. This should include transparency around the proponent's cost estimation methodology – the cost drivers and inputs and assumptions – as well as how the network service provider (NSP) has quantified allowance for risks. This may help build stakeholders' understanding of the degree of rigour of the options assessment, and the sensitivity of the options ranking.

Whilst the AER supports the aim of the draft recommendation to clarify the material change in circumstances provisions, we consider the proposed drafting should be further clarified to deliver this intent. We step through our recommended changes to better achieve the intent of the rule change below.

The AER supports the rule change as an interim solution but notes it should be subject to the AEMC's broader review of the economic assessment process under Stage 3 of its Transmission Planning and Investment Review. We are of the view that this broader review should aim to develop a more streamlined process that still promotes opportunities for stakeholders, particularly consumer and community groups, to meaningfully engage in and that retains a rigorous cost-benefit analysis. An economic assessment process that helps to produce more robust identification and assessment of options that stakeholders can have confidence in mitigates the risk of requiring the options to be re-assessed with consequential impacts to timeliness or cost.

Rule implementation

The AER notes that the regulatory process that different projects follow can vary. This depends on whether the project is an actionable ISP project or not, as well as whether the revenue allowance for the project is assessed via the revenue determination process at the outset of the TNSP's regulatory control period or part-way through the contingent project assessment. Further, the challenges surrounding major greenfield projects, such as those in the Integrated System Plan (ISP), are unique when compared to more incremental, 'business as usual' (BAU) projects. There is some evidence that these types of large-scale infrastructure projects have a higher likelihood of being delivered over-budget and later than originally expected.[1]

Therefore, the AER has concerns about the practicality of applying the same mechanism for assessing material changes in circumstances to all transmission and distribution projects. Subject to our more detailed feedback below, the AER recommends considering whether different approaches can be tailored depending on the process a project follows. This approach may help deliver more fit-for-purpose responses.

Feedback on proposed rule drafting

The AER agrees with the AEMC and stakeholder submissions that "the RIT proponent is best placed to determine whether a RIT should be reapplied."[2] The AEMC notes that as the RIT proponent undertakes the economic modelling under the RIT, it "will have the most up-to-date and accurate information on costs, benefits and customer expectations."[3] In its draft determination, the AEMC clarifies that the RIT proponent is therefore responsible for assessing whether a material change in circumstances has occurred and the appropriate course of action for determining the preferred option remains the most net beneficial.

The AEMC notes that "under the mechanism set out in the draft rule, the AER would not have a role in testing the merits of a RIT proponent's view as to whether a [material change in circumstances] has occurred."[4] Rather, the AER would test the RIT proponent's proposed course of action. We consider this parameter is important – as the AEMC notes, the AER does not have complete visibility of the relevant project's costs and benefits. The AER would

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1 PwC, Managing capital projects through controls, processes, and procedures, 2014, p. 4; KPMG, Managing risk in the Australian construction industry, May 2020; Grattan Institute, Cost overruns in transport infrastructure, October 2016; McKinsey & Company, A risk-management approach to a successful infrastructure project.

2 AEMC, Material change in network infrastructure project costs – draft determination, 2022, p. 22.

3 AEMC, Material change in network infrastructure project costs – draft determination, 2022, p. 22.

4 AEMC, Material change in network infrastructure project costs – draft determination, 2022, p. 22.

find it relatively difficult to undertake this assessment, due to information asymmetry, and proponents would face additional risks and uncertainty. We add that, if the AER did undertake such an assessment, we would adopt our own modelling. This may result in inconsistencies with the NSP's RIT assessment, including with the modelling methodology, such that the outcomes of the AER's assessment may not satisfactorily measure whether a material change in circumstances has occurred and the nature of the change.

As flagged above, we consider the rule drafting needs refining to better deliver the AEMC's intent to clarify the process for assessing whether a material change in circumstances has occurred. We consider the current drafting could be misinterpreted as the AER being required to assess the costs and benefits of the project (similar to a merits review), rather than a strict check of the process followed by the NSP to determine whether a material change in circumstances has occurred and any proposed course of action. Without clarification, there is a risk stakeholders will raise issues at the wrong stage of the process and/or with the wrong party, resulting in those stakeholders missing the opportunity to have meaningful input to the assessment and/or overall delays to the process.

Explicitly defining the process and roles of the different parties

We consider the rule drafting should explicitly state the parameters around both the RIT proponent and AER's respective roles in the process. Specifically, we recommend the rules state:

(a) the NSP is required to consult on its assessment of whether a material change in circumstances has occurred, any required proposed course of action and supporting analysis, and

(b) the AER will review the process the NSP followed in undertaking its assessment, including that the NSP has demonstrated that it has had regard to the relevant factors in reaching its determination (discussed below), and that it sufficiently engaged with stakeholders and considered stakeholder feedback.

Place the factors to inform the material change assessment on the decision-maker

For RIT-Ts, paragraph 19 of the draft rule amends clause 5.16.4(z5) of the NER to insert additional factors the AER must have regard to when determining whether to approve or reject the proponent's proposed course of action. These include whether reapplication of the RIT-T is justified and the costs and delay that may result from the proposed course of action. As the draft rule aims to clarify that the RIT proponent will be the party assessing whether a material change in circumstances has occurred and the appropriate course of action, we recommend the requirement to consider all of the factors in amended sub-clause (z5) be placed on the RIT proponent in making that determination. This includes whether failure to promptly undertake the RIT-T is likely to materially affect the reliability and secure operating state of the network.[5] The AER, in line with the draft rule's intent, would then review the information provided by the RIT proponent to confirm it had regard to these factors in reaching its decision. These comments equally apply to the proposed amendments to clauses 5.16A.4(p) (for RIT-Ts for actionable ISP projects) and 5.17.4(v) (for RIT-Ds). The AER considers that failing to make this change to the rule amendment may result in misinterpretation of the rules and, in turn, stakeholder confusion around the process.

[5] National Electricity Rules, clause 5.16.4(z5)(3).

Separate the material change assessment from the contingent project assessment

The draft rule requires an NSP to submit analysis in its contingent project application demonstrating whether a material change in circumstances occurred and, if so, that the NSP completed the required course of action. The AER is of the view that linking the material change in circumstances process to the contingent project process risks duplication in assessment and unnecessary uncertainty for the NSP. For example, under the draft rule, the NSP will have a positive requirement to assess whether a material change in circumstances has occurred and, if there has been, to notify the AER. The AER would then review the NSP's process for reaching that determination, including evidence that the NSP sufficiently consulted with stakeholders. If that analysis and supporting evidence is resubmitted with the NSP's contingent project application, it must be consulted on again as part of the AER's assessment of that application. This risks the issues underpinning the NSP's material change in circumstances assessment being re-litigated a second time. As a result, the AER may be required to seek further information, in response to stakeholders, from the NSP to support its contingent project application with matters already consulted upon, resulting in delays to the process.

One potential solution could be to require the process surrounding the material change in circumstances provisions be completed before the NSP finalises and submits its contingent project application. Under this option, once the NSP has exercised its positive requirement to consider whether a material change in circumstances has occurred, it notifies the AER of the outcome, including where it has determined no change has occurred and no action is needed. The NSP will be required to provide evidence to support its decision, even where no action is recommended. The AER would then, at this stage, approve or reject the outcome by reviewing the process the NSP followed in reaching its decision, including that it had regard to the relevant factors and sufficiently engaged with stakeholders.

Alternatively, if these steps cannot be completed sequentially by the NSP (for instance if it would introduce an unacceptable risk of project delay and failing to deliver consumer benefits) the Rules and associated framework should make clear that the AER's review of the NSP's process relating to a material change in circumstances is separate from its assessment of a contingent project application.

Six month "exemption window"

The AER supports a mechanism to appropriately mitigate the risk of the NSP being required to re-do analysis multiple times ('analysis paralysis'). Measures must balance the risk of locking-in a solution that is no longer preferred due to a change in circumstances with the potentially negative impacts on investment certainty and timeliness caused by repeatedly needing to re-assess the merits of the selected option. Neither extreme outcome would be in consumers' interests and highlights the importance that the RIT process (or indeed any equivalent planning tool) reach a robust conclusion. The AEMC has proposed to address this by introducing an exemption window where a RIT proponent would not need to consider whether a material change in circumstance has occurred until six months after completion of the RIT.

The AER offers some reflections on the effectiveness of this feature of the draft rule. The benefit of the feature is that it creates an incentive on the RIT proponent to arrive at a preferred option in the Project Assessment Conclusions Report (PACR) that is robust both in terms of cost estimates and benefits of the preferred option versus other credible options considered. This is because the proponent has a six-month window following the PACR where it has certainty that the preferred option is "locked in". This theoretically incentivises them to progress the project to the CPA stage within that window, at which point the preferred option is more formally locked in – both in terms of the preferred option to pursue

but also the cost that consumers will bear. This would be in consumers' interests as it promotes more robust selection of the option that maximises net benefits to them and minimises the risk of project delay from subsequent re-assessment.

However, the potential need to re-assess the suitability of the selected option returns following this period, which is where the risk of analysis paralysis will arise. This could be addressed by alternatively "flipping" the exemption timeframe such that RIT proponents would need to consider whether a material change in circumstances has occurred within the set period following the completion of the RIT but would no longer be required to do so once that period has lapsed. This would create a clear milestone following which the preferred option is confirmed and RIT proponents can progress project development with greater certainty. However, doing this would lose the incentives on the TNSP to ensure the PACR is robust. In fact, it may incentivise proponents to defer further development work until the initial six-month window is over. Then they can progress work knowing they don't need to revisit the preferred option. This risks the project being delivered late.

Under either option above, circumstances external to the project may change such that the benefits of the project are significantly changed. It raises the question of whether such a change is significant enough to warrant re-assessment despite being in the exemption window. We recommend also considering whether the six-month timeframe is appropriate. The timeframes underpinning an exemption window should reflect the time reasonably required by an NSP to prepare its contingent project application after the RIT is completed. We are keen to work with the AEMC through the various competing considerations, to reach a pragmatic solution that best addresses the risk of 'analysis paralysis'.

We look forward to continuing working with the AEMC on this rule change process as a short-term solution in the interim to broader holistic reforms to the regulatory framework for the efficient and timely delivery of major transmission projects. To discuss any matter raised in this submission, please contact Arista Kontos on [redacted].

Yours sincerely

[redacted]

Jim Cox
Deputy Chair
Australian Energy Regulator

Sent by email on: 01.09.2022