

17 March 2021

Mr Sebastian Roberts
General Manager
Transmission and Gas
Australian Energy Regulator

Via email: sebastian.roberts@aer.gov.au

Dear Sebastian

Re: Preliminary Position - Contingent Project Application - Project EnergyConnect

On 18 December 2020, the AER released its Preliminary Position on ElectraNet's contingent project application for Project EnergyConnect (the Project), setting out its views on the forecast capital expenditure and incremental revenues required to undertake the Project.

While accepting the majority of ElectraNet's capital expenditure forecast for the project, the AER proposed to make several adjustments to the project risk allowance.

We set out below our response to these adjustments, together with other relevant aspects of the AER's preliminary assessment.

In its Preliminary Position the AER also:

- Concluded that it is unable to make a formal determination on the contingent project application in the absence of a firmer commitment from the Board of ElectraNet to proceed with the Project, given concerns that have been raised over its financeability; and
- Highlighted ElectraNet's ongoing obligation to consider whether there has been a material change in circumstances which results in the Project no longer being the preferred option under the RIT-T, noting that a range of recent developments have occurred in the NEM that could impact on the net benefits of the Project.

ElectraNet will respond separately on these matters.

It should be noted that some of the information contained in this letter is provided on a confidential basis, as indicated, given its commercially sensitive nature.

Assessment of project risk allowance

In its preliminary assessment of ElectraNet's allowance for project risk, the AER concluded that:

- ElectraNet's methodology and process for calculating its risk allowance is transparent, logical and well documented;
- The risks proposed by ElectraNet (with the exception of exchange rate risk) are appropriate and reasonable to be included in a risk allowance for a project of this nature;
- The quantification of the potential cost consequences of each identified risk is acceptable; and
- ElectraNet's risk assessment overstates the likelihood of each risk occurring, and as a result overstates the calculation of overall risk costs.

Based on this assessment, the AER proposed to exclude exchange rate risk and to apply a reduction to the remaining risks based on reducing the likelihood assigned to each risk. The AER proposed to similarly adjust the allowances made for potential savings opportunities, as discussed further below.

Taken together, these proposed adjustments result in a reduction in the project risk allowance of approximately \$12m (2017-18). This represents a reduction in the project risk allowance from 3.5% of project value to less than 1% of project value.

While accepting the removal of exchange rate movements as a symmetrical risk, ElectraNet does not agree with other adjustments proposed to the risk allowance for the following reasons:

- A total risk allowance of less than 1% is not reasonable for a greenfield line project of this scale and complexity;
- ElectraNet continues to work through the Early Contractor Involvement (ECI) process and has yet to negotiate final pricing and award contracts for delivery of the South Australian portion of the Project;
- The proposed reductions would effectively lower the risk allowance from a P50 value, which has a 50% probability of exceedance and thereby represents a 'most likely' value of project contingency based on probabilistic assessment of risk outcomes, to a P25 value which would face a 75% probability of being exceeded; and
- This outcome would deny ElectraNet the reasonable ability to recover the efficient costs of delivering the Project.

ElectraNet's approach relies on a detailed evaluation and probabilistic assessment of known risks and opportunities that reflect the stage of the Project in the delivery cycle and complexity of the works involved in a project of this nature and magnitude. The risk assessments are conducted systematically, iteratively, and collaboratively relying on assessment by project team members in conjunction with subject matter experts to determine the consequence and likelihood of each risk.

ElectraNet submits that its proposed risk allowance for the Project continues to provide an accurate reflection of overall project risk at this point in time and produces an outcome that remains within a reasonable but conservatively low range based on accepted industry practice¹.

The reduction in risk likelihoods proposed by the AER in its preliminary assessment should therefore be reconsidered.

¹ Noting that the Risk Engineering Society recommends a 5-10% contingency level (on a P50 basis) for a project such as Project EnergyConnect that is at a pre-tender stage.

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Assessment of potential cost saving opportunities

ElectraNet’s project risk allowance identified several potential cost saving opportunities that may be realised in the final delivered costs of the project. In its preliminary assessment of these potential cost saving opportunities, the AER:

- Accepted ElectraNet's methodology and quantification of cost saving opportunities, including the specific types of technical efficiencies and unit costs; and
- Concluded that the likelihood that ElectraNet's contractors will be able to realise these potential opportunities is greater than ElectraNet has proposed.

Based on this assessment, the AER proposed to apply a higher likelihood that these savings will be achieved, which would increase the value of the expected savings opportunities from \$5.8m to \$10.4m (\$2019-20).

ElectraNet does not accept this proposed outcome as reasonably reflecting its efficient costs, for the reasons explained in relation to project risks above. The adjustments to the likelihood of potential saving opportunities proposed by the AER in its preliminary assessment should therefore be reconsidered.

We provide the following additional information in relation to several specific potential saving opportunities to support the reconsideration of these adjustments. This is provided on a confidential basis given the commercially sensitive nature of this information.

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Inflation Impacts

Movements in inflation directly impact on the nominal capital expenditure allowance available to deliver the Project. The revenue determinations of the AER, including contingent project decisions, include both an approved capital expenditure forecast expressed in real terms, and a determination of incremental revenue expressed in nominal terms based on an assumed rate of inflation.

However, the prevailing environment has seen a significant departure between the current inflation forecast applied by the AER and actual lower inflation outcomes. This has the effect of materially reducing the proposed capital expenditure allowance to deliver the Project, as shown in Table 1.

Table 1: Capital expenditure allowance (\$nom)

Forecast	Prior	2020-21	2021-22	2022-23	Total
AER inflation forecast	-	2.45%	2.45%	2.45%	
AER allowance	12.6	31.8	186.3	274.8	505.4
Actual inflation / market forecast*	-	0.86%	1.55%*	1.76%*	
Updated allowance	12.6	31.3	181.8	266.3	492.0
Shortfall	-	-0.5	-4.5	-8.5	-13.4

*Source: Bloomberg (31 December 2020)

Table 1 shows that the lower market inflation forecast compared to the AER inflation forecast would reduce the proposed capital expenditure allowance by \$13.4m (\$ nominal).

To the extent that the efficient costs of the Project do not follow general inflation movements, this will increase the difficulty of recovering the actual costs of delivering the Project.

Reinforcing this, movements in the costs of general building and construction activity have consistently outpaced inflation in recent years. Table 2 below compares the rate of annual change for both the Adelaide Building Cost Index (BCI) as published by the Australian Institute of Quantity Surveyors (AIQS) and the CPI figures from the Australian Bureau of Statistics since 2018.

The BCI provides an indication of long-term fluctuations in general building costs in the various capital cities and incorporates input from a variety of sources such as the National Public Work Conference (NPWC), Institute of Building Research Index (BRIX) survey results, the relevant practising members of the AIQS and Rawlinsons Australian Construction Handbook.

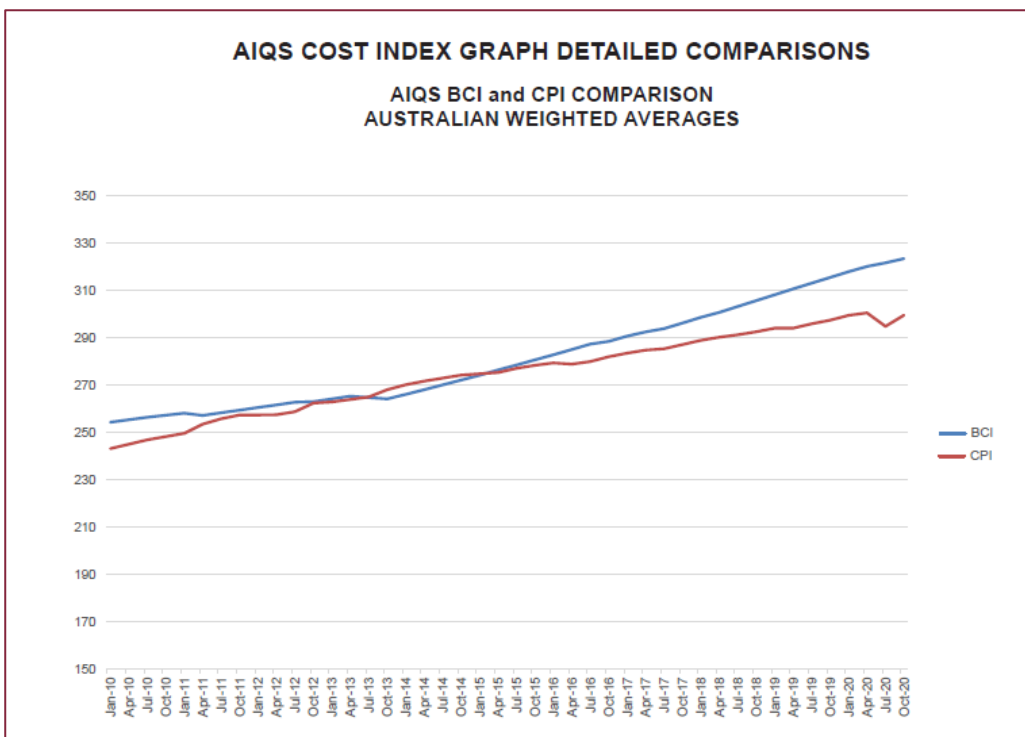
Table 2: Adelaide Building Cost Index

Year	Adelaide Building Cost Index	CPI	Average Variance
2018	2.42%	1.91%	0.51%
2019	2.70%	1.78%	0.92%
2020	2.96%	1.84%	1.12%
2021	3.83%	0.86%	2.97%

Source: AIQS Building Cost Index (December 2020)

National cost movements over a longer period have followed a consistent trend. Figure 2 below compares the rate of change in the BCI and CPI since January 2010, and reveals a steady rise in the rate of change for the BCI compared to CPI since July 2015.

Figure 2: CPI and BCI comparison (Australia Weighted Averages)



Source: AIQS Building Cost Index (December 2020)

This provides a strong indication that general building and construction cost movements will continue to exceed CPI, particularly in a low inflation environment.

The ongoing impacts of COVID-19 and the increased public spending on infrastructure are also expected to increase the demand for labour and materials, margins and therefore construction cost movements. Federal and State Governments have stepped up their infrastructure development plans, focusing on shovel-ready initiatives, and construction work is expected to surge by 15-20%.

These factors all add to construction cost pressures and the likelihood that transmission project cost movements will exceed currently depressed inflation levels. These impacts should be considered in the AER's final determination on the efficient costs of the Project.

Revenue Smoothing

At the time of submitting its contingent project application in September 2020, ElectraNet applied a smoothing adjustment to the incremental maximum allowable revenue required for the Project to correspond with the anticipated commencement of revenue recovery in 2021-22.

Given the passage of time, it is no longer possible to commence revenue recovery in 2021-22 as transmission prices for this year have already been published and cannot be adjusted. Given this, it is proposed that the revenue smoothing calculation be updated accordingly in the AER's final decision to align with the commencement of revenue recovery in 2022-23.

ElectraNet appreciates this opportunity to offer further information to inform the AER's final decision on ElectraNet's September 2020 contingent project application for Project EnergyConnect. We look forward to working with the AER to conclude its assessment to support the timely delivery of the Project in the interests of electricity customers across the National Electricity Market.

Please direct any queries to Simon Appleby in the first instance on 08 8404 7324.

Yours sincerely



Rainer Korte
Group Executive Asset Management