Transgrid

People. Power. Possibilities.

Suspension of CESS for Project EnergyConnect

2023-28 Revised Revenue Proposal

2 December 2022

Contents

Summary

Australia has recently entered a period of very high and unexpected inflation, with large increases in producer and consumer prices. As a result, Transgrid's input costs, including materials, labour and freight have increased. These cost increases have been driven by a range of factors beyond Transgrid's control, including:

- supply chain disruptions resulting in materials shortages;
- the war in Ukraine driving up fuel costs;
- labour shortages; and
- disruptions to international shipping and logistics.

The cost of construction projects across Australia have been affected by these supply-side factors, and construction firms have started to pass through these cost increases to customers as they have become too large to absorb. The facts that costs have increased across the whole construction sector, and that these costs are now being passed through to customers, has been documented extensively in official statistics produced by the Australian Bureau of Statistics (ABS), business surveys and recent commentary by the Reserve Bank of Australia (RBA).

There is significant uncertainty about the construction cost inflation outlook over the medium term. Transgrid proposes that the CESS be suspended temporarily (i.e., for the duration of the forthcoming regulatory period) for PEC, given:

- the significant uncertainty over when these inflationary pressures will abate;
- the fact that the current inflationary pressures were not (and could not have been) anticipated as recently as the start of 2022; and
- the cost increases related to Project EnergyConnect are largely beyond Transgrid's control.

Transgrid notes that all of these considerations apply to other major transmission projects that fall within the GreenConnect investment program, including HumeLink and VNI West. As such, there would seem to be a compelling case for temporary suspension of the CESS for all GreenConnect projects.

Australia has entered a period of high inflation and unexpected inflation

The headline Consumer Price Index (CPI) increased by 1.8 per cent (1.7 per cent seasonally adjusted) in the June quarter and by 6.1 per cent over the 12 months ending June 2022, the highest year-ended CPI inflation since the early 1990s.[1] The inputs Producer Price Index (PPI) for the construction and manufacturing sectors increased by 17.3% and 17.7%, respectively, over the 12 months to the end of June 2022.[2,3]

1 Reserve Bank of Australia, Statement on Monetary Policy, August 2022, p. 43.

2 ABS, 6427.0 Producer Price Indexes, Australia, Table 18. Input to the House construction industry, six state capital cities, weighted average and city, index numbers and percentage changes, June 2022.

3 ABS, 6427.0 Producer Price Indexes, Australia, Table 13. Input to the Manufacturing industries, division and selected industries, index numbers and percentage changes, June 2022.

ABS data also indicate that the increase in the cost of final goods and services over the 12 months to the end of June 2022 was driven by a 12.5 per cent rise in costs in the building and construction sector, and a 9.0 per cent rise in costs in the heavy and civil engineering sector.[4]

The RBA explained in its May 2022 Statement on Monetary Policy that these developments are not isolated to Australia; a sharp and unexpected increase in inflation has been felt globally:[5]

> *Inflation is high globally and has risen further in recent months. Strong demand, supported by monetary and fiscal stimulus, has come up against global supply capacity that continues to be impaired by the COVID-19 pandemic. In addition, some energy and food prices are higher as a result of Russia's invasion of Ukraine. Inflation has already reached 7–10 per cent in many economies and is expected to peak later and higher than previously thought. Unemployment rates remain around generational lows in most advanced economies.*

The RBA went on to explain that these recent cost increases were not anticipated even at the start of 2022:[6]

> *Inflation in Australia remains lower than in many other advanced economies, **but it has picked up faster and to a higher level than previously expected.** Headline inflation was 2 per cent (seasonally adjusted) in the March quarter and 5.1 per cent over the year. While petrol prices and other global factors contributed significantly to the quarterly outcome, the sources of inflation are broadening. Firms are increasingly passing on cost increases as supply chain pressures have persisted and demand has remained strong. Trimmed mean inflation was 1.4 per cent in the quarter and 3.7 per cent over the year.*
>
> ***The outlook for inflation is also materially higher than envisaged three months ago.*** *[Emphasis added.]*

This means that neither Transgrid nor the AER could have foreseen the current episode of high inflation when the AER made its final decision on Transgrid's contingent projects application decision for Project EnergyConnect in May 2021. Transgrid notes that in that decision, the AER approved:

- zero real input cost escalation for materials; and
- real labour input cost escalation rates in line with those escalation rates used in Transgrid's final revenue determination for the 2018-23 regulatory control period.

The growth in Transgrid's real input costs (particularly in the final year of the current regulatory control period) has far exceeded the real input cost escalation rates allowed by the AER.

4 https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/producer-price-indexes-australia/latest-release#data-download

5 Reserve Bank of Australia, Statement on Monetary Policy, May 2022, p. 1.

6 Reserve Bank of Australia, Statement on Monetary Policy, May 2022, p. 1.

The factors that have caused construction costs to increase unexpectedly are beyond Transgrid's control

In its August 2022 Statement on Monetary Policy, the RBA explained that construction firms had experience unusual growth in costs, and that these businesses were starting to pass through these cost increases to customers:[7]

> *Inflation is high and broadly based. The pass-through of non-labour cost pressures (such as higher materials and transport costs) to consumer prices, enabled by strong demand conditions, continued to drive strong goods price inflation in the June quarter of 2022 … Reports of larger-than-average wage increases to date have been most common among construction and business services firms.*

The RBA identifies supply-side factors as driving these cost increases (e.g., supply chain disruptions, labour and materials shortages, ongoing impact of Covid-19, etc.) including factors occurring abroad, for example:[8]

> *Global inflation is high and is likely to remain so for a while, given recent supply-side shocks. Energy and food prices have increased sharply following Russia's invasion of Ukraine. The spread of COVID-19 in China is disrupting production there, which will add to existing challenges in global supply chains. Core inflation is also high in a number of economies where strong demand has outpaced growth in supply capacity, although it is not quite as high as headline inflation*

All of these factors are beyond Transgrid's control and have resulted in significant cost increases across the construction sector. Project EnergyConnect has not been immune from these cost increases.

The construction sector is particularly exposed to the current supply-side factors driving high CPI-inflation. As a combination of these factors and strong demand became apparent, the RBA reported in its May 2022 Statement on Monetary Policy that construction companies' capacity constraints were being reached:[9]

> *Imports of capital goods also slowed alongside ongoing supply chain disruptions. The earlier rebound in non-residential construction paused as some large projects finished, and costs increased amid broader capacity pressures in the construction industry. Nevertheless, surveyed measures of investment intentions have continued to highlight a positive backdrop for business investment. The ABS Capital Expenditure survey, conducted in January and February this year, indicated that both mining and non-mining business investment are expected to increase in the 2021/22 financial year*

Construction cost pressures in NSW have been significant and above recent CPI-inflation. Figure 1 plots the PPI (Output) for the construction sector, which measures the price of products as they leave the construction sector. Since September 2020:

- NSW non-residential building construction PPI (output) increased 21% (versus 6% nationally); and

---

7 Reserve Bank of Australia, Statement on Monetary Policy, August 2022, p. 43.

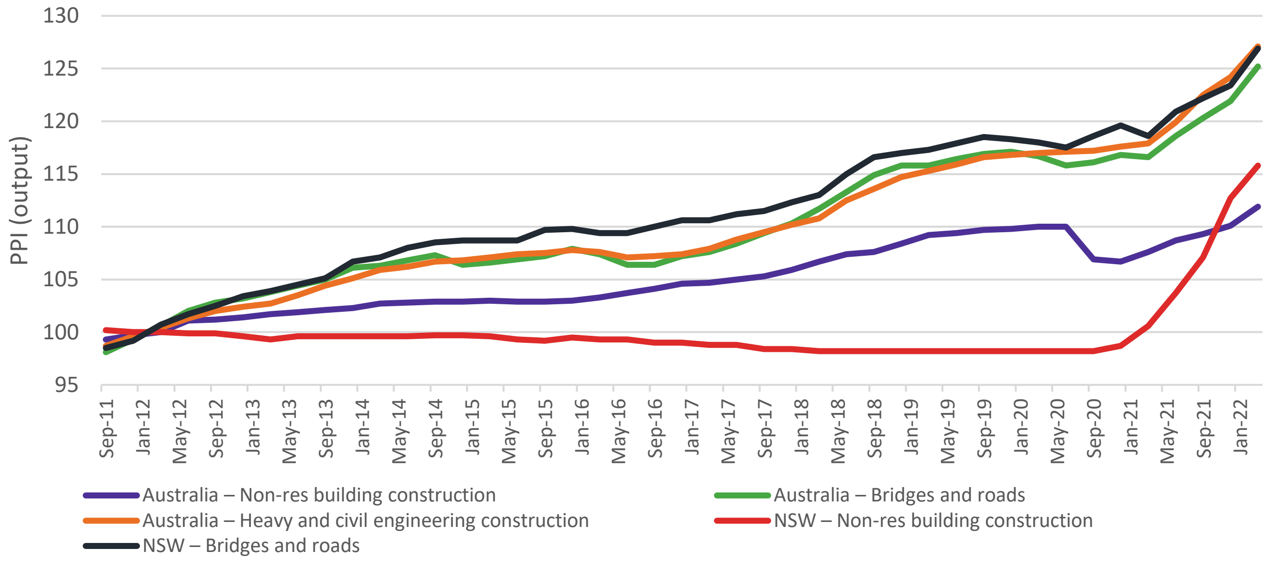
8 Reserve Bank of Australia, Statement on Monetary Policy, May 2022, p. 1.

9 Reseve Bank of Australia, Statement on Monetary Policy, May 20, p. 27.

- Australian heavy and civil engineering construction PPI (output) increased 12%.

These cost pressures far exceed the 8.52% growth in the All Groups CPI over the same period.[10] There is a heightened risk of bankruptcy/insolvency if these costs cannot be passed through. Insolvency statistics from ASIC show that construction industry insolvencies jumped by 65 per cent in the three months to June 2022 – and were up 52 per cent compared to a year earlier.[11]

Figure 1: Construction Producer Price Indices (September 2011 – January 2022)



Source: 6427.0 Producer Price Indexes, Australia; Table 17. Output of the Construction industries, subdivision and class index numbers

In explaining recent movements in the PPI (Output) the ABS identifies external factors impacting the construction industry, including:[12]

> *Supply chain instability and high shipping costs, coupled with ongoing skilled labour shortages is continuing to drive up construction costs this quarter. Strong levels of activity across all construction sectors have enabled builders to pass through cost increases to buyers.*

These findings are supported by the results of the June 2022 ABS Business Conditions and Sentiment survey which found that 54 per cent of construction businesses are experiencing supply chain disruptions, of which 41 per cent reported the extent of the disruption to be 'great.'[13] The RBA has noted recently that these supply chain disruptions could continue for some time:[14]

> *On the supply side, further shocks to global energy supply could adversely affect both global growth and inflation. In addition, restrictions to control the spread of COVID-19 in*

[10] Reserve Bank of Australia, Consumer Price Inflation – G1, CPI index all groups, 28 July 2022.

[11] Australian Secutrities & Investments Commission, Insolvanvy statistics – Series 1A Companies entering external administration and controller appointments by industry, August 2022.

[12] ABS, Producer Price Indexes, Australia , June 2022.

[13] ABS, Business Conditions and Sentiments, June 2022.

[14] Reserve Bank of Australia, Statement on Monetary Policy, August 2022, p. 33.

> *China led to an unexpectedly large contraction there in the June quarter; further outbreaks could both weigh on growth in China and disrupt global supply chains.*

The inflationary outlook is characterised by considerable uncertainty

In its August 2022 Statement on Monetary Policy, the RBA noted that it expects inflation to peak in late 2022 and remain elevated through 2024:[15]

> *Headline inflation is expected to peak around 7¾ per cent in year-ended terms towards the end of 2022, before declining back to the top of the inflation target range by the end of 2024 … A significant share of firms in the Bank's liaison program have increased prices or expect to do so over coming months as a result of earlier increases in input costs.*

However, the RBA also acknowledges that there is considerable uncertainty over the outlook for inflation, noting that high inflation could persist longer than anticipated, or ease more quickly than expected, depending on how quickly supply and demand pressures ease: [16]

> *High inflation could prove to be even more persistent than expected, requiring a larger monetary policy tightening. Inflation could persist if supply remains more constrained than currently envisaged or if recent high inflation outcomes lead to changes in price and wage-setting norms that are inconsistent with inflation targets, particularly in economies with limited spare capacity. In this context, the risks to the inflation outlook from any further adverse supply shocks could be amplified, requiring a larger monetary policy response than currently expected. On the other hand, inflationary pressures could ease more quickly than assumed if global supply rises or demand eases faster than projected.*

Construction costs are likely to remain elevated above CPI-inflation across the medium term as increased levels of expenditure occur from an already high base. Figure 2 shows utility sector investment in buildings and structures grew 9.3% in the year to March 2022 from an historically elevated base. Figure 3 shows NSW private sector capital expenditure expectations are elevated in both the short and long-term, with short term capital expenditure expectations having increased almost 23% in the three quarters to December 2021. These trends are consistent with the RBA's observation that:[17]

> *Some of the recent increase in investment spending intentions also reflects cost pressures, as a growing number of firms have noted that rising material and construction costs are increasing the nominal value of capital investments.*

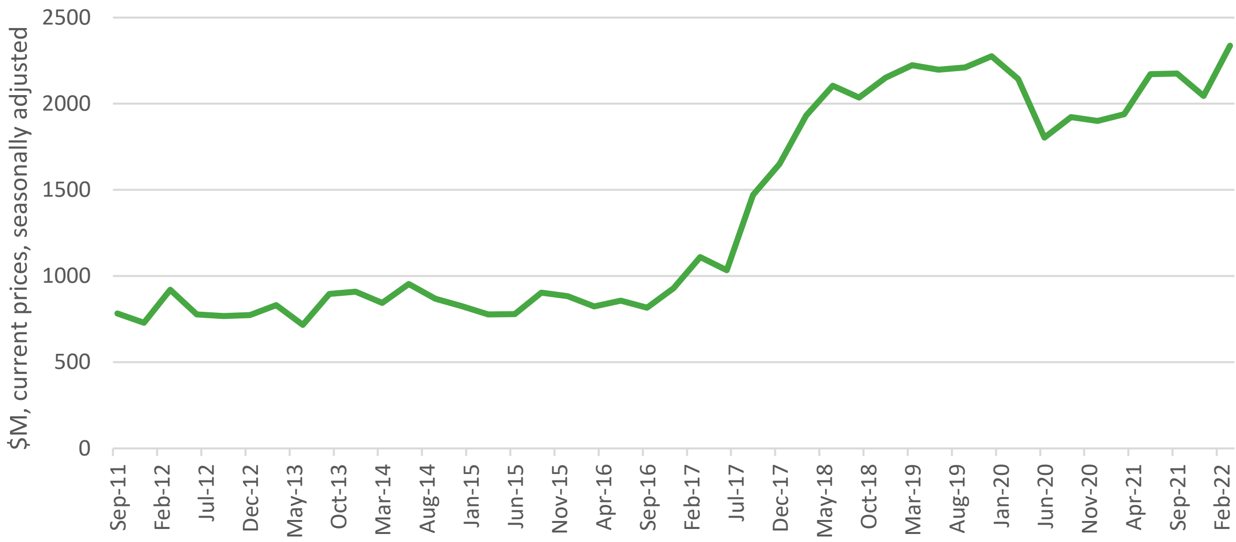
The weight of available evidence suggests a plausible scenario that construction cost inflation will remain very high for some time. While Covid-19 was the initial source of disruption domestically and abroad in early 2022, the war in Ukraine, lockdowns in China and the east coast flood recovery effort are expected to exacerbate these issues in the near term. These constraints could intensify or persist longer than current expectations, and firms may become more willing to pass on input cost pressures to their customers.

[15] Reserve Bank of Australia, Statement on Monetary Policy, August 2022, p. 58.

[16] Reserve Bank of Australia, Statement on Monetary Policy, August 2022, p. 9.

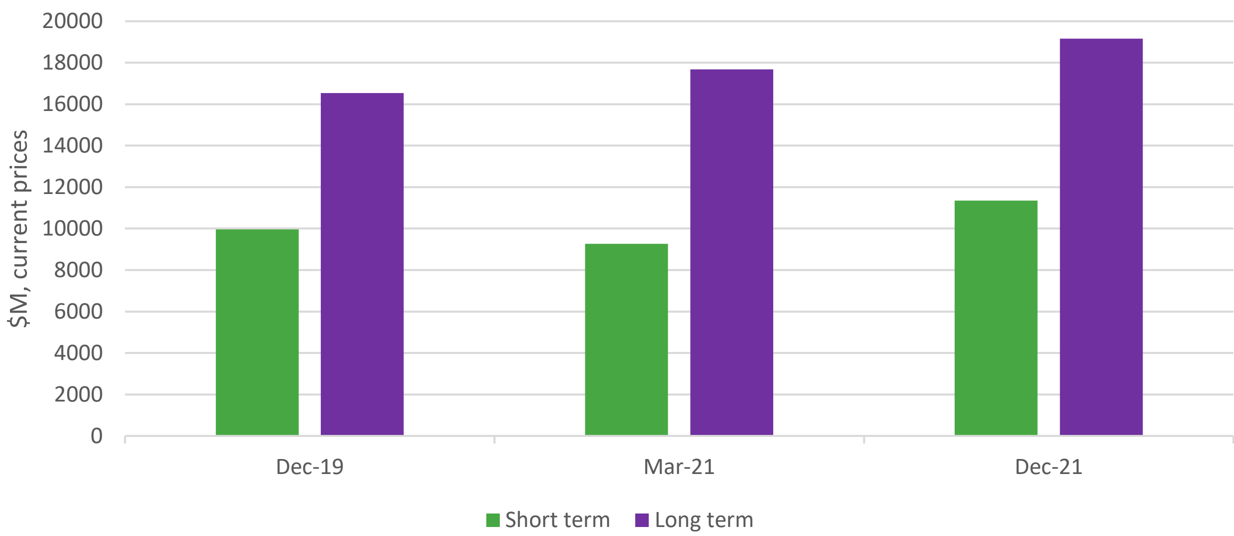
[17] Reserve Bank of Australia, Statement on Monetary Policy, August 2022, p. 58.

Figure 2: Electricity, gas, water and waste services investment in buildings and structures



Source: 5625.0 Private New Capital Expenditure and Expected Expenditure, Australia; Table 4. Actual Expenditure, by Type of Asset and Industry, Seasonally Adjusted - Current Prices $m

Figure 3: Expected private NSW capital expenditure (buildings and structures)



Source: 5625.0 Private New Capital Expenditure and Expected Expenditure, Australia; Table 11. New South Wales, Actual and Expected Capital Expenditure, by Asset, by Industry, Original - Current Prices $m

Transgrid proposes a temporary suspension of the CESS for Project EnergyConnect

The expenditure allowances set by the AER in its final decision on Transgrid's contingent project application for Project EnergyConnect represent the *incremental* operating and capital expenditures related to the project. As the AER explained in its final decision:

> *The forecast capex approved in this determination will be added to the target capex for the capital expenditure sharing scheme (CESS) and the target opex for the efficiency benefit sharing scheme (EBSS).*

Under the schemes that apply to TransGrid over the 2018–23 regulatory control period, target capex and opex allowances are based on our approved allowance (as determined prior to the start of the regulatory control period), plus any adjustments we allow for contingent projects. Any incentive rewards and penalties TransGrid receives as a result of under or overspending on the project would be applied as additional revenue adjustments in the next regulatory control period.

The incremental nature of the capital expenditure related to Project EnergyConnect means that it is easily separable from target capital expenditure used to implement the CESS.

In its contingent project application for Project EnergyConnect, Transgrid proposed that certain capital expenditures (i.e., environmental offsets) should be excluded from the CESS because of the significant uncertainty over those costs. The AER concluded that it was unable to make a determination about whether and how the CESS would apply as part of a contingent project decision, and that:[18]

The decision on the rewards or penalties applied under the CESS as a result of expenditure in the 2018–23 regulatory control period will be made at the time of the next revenue determination.

With this in mind, Transgrid proposes that the incremental capital expenditures related to Project EnergyConnect be excluded from the CESS over the 2023-28 regulatory control period because:

- The unprecedented uncertainty over how long the existing inflationary pressures faced by major construction projects, including by Project EnergyConnect, will last. As the AER has acknowledged recently, capital expenditure related to transmission projects is generally difficult to forecast because it is less recurrent and involves “more project ‘lumpiness’ with significant major projects including new interconnectors”. The uncertainty over the current inflationary pressures compounds the difficulties associated with forecasting the capital expenditures related to Project EnergyConnect;[19]
- The fact that these inflationary pressures could not have been anticipated, and are largely driven by supply-side factors that are beyond Transgrid’s control; and
- The scale of Project EnergyConnect means that any resulting CESS penalties could have a material adverse impact on cash flows and financeability in future regulatory control periods.

Transgrid notes that all of these considerations apply to other major transmission projects that fall within the GreenConnect investment program, including HumeLink and VNI West. As such, there would seem to be a compelling case for temporary suspension of the CESS for all GreenConnect projects.

[18] AER, Transgrid Contingent Project – Project EnergyConnetc, Final Decision, May 2021, p. 30.
[19] AER, Review of incentives schemes: Options for the Capital Expenditure Sharing Scheme, Position Paper, August 2022, p. 9.