

Humelink Contingent Project Application Stage 2

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About the Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is leading social justice law and policy centre. Established in 1982, we are an independent, non-profit organisation that works with people and communities who are marginalised and facing disadvantage.

PIAC builds a fairer, stronger society by helping to change laws, policies and practices that cause injustice and inequality. Our work combines:

- legal advice and representation, specialising in test cases and strategic casework;
- research, analysis and policy development; and
- advocacy for systems change and public interest outcomes.

Energy and Water Consumers' Advocacy Program

The Energy and Water Consumers' Advocacy Program works for better regulatory and policy outcomes so people's needs are met by clean, resilient and efficient energy and water systems. We ensure consumer protections and assistance limit disadvantage, and people can make meaningful choices in effective markets without experiencing detriment if they cannot participate. PIAC receives input from a community-based reference group whose members include:

- Affiliated Residential Park Residents Association NSW;
- Anglicare;
- Combined Pensioners and Superannuants Association of NSW;
- Energy and Water Ombudsman NSW;
- Ethnic Communities Council NSW;
- Financial Counsellors Association of NSW;
- NSW Council of Social Service;
- Physical Disability Council of NSW;
- St Vincent de Paul Society of NSW;
- Salvation Army;
- Tenants Union NSW; and
- The Sydney Alliance.

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1. Introduction

PIAC welcomes the opportunity to respond to the Transgrid's Stage 2 (Delivery) Contingent Project Application (CPA2) for Humelink.

Humelink has been identified by the Australian Energy Market Operator (AEMO) as a strategically significant project in the latest Draft Integrated System Plan (ISP). Like other ISP projects it is relatively larger than historical transmission projects in the National Energy Market (NEM), which poses particular challenges for financing and the management of risk. However, Humelink is not so unique that it warrants undue amendment of the normal regulatory framework.

The Capital Expenditure Sharing Scheme (CESS) should not be waived for Humelink. The CESS, alongside the ex-post review, provides a vital check for consumers in their relationship with transmission network service providers (TNSP). There is no reason it should not play this role for what is such a substantial project.

Several of the requests in the CPA2 cannot be regarded as prudent and efficient. Specifically:

- We do not support the solutions proposed in the CPA2 for the problem of financeability.

No adequate evidence has been provided to satisfy the requirements of the financeability test per the recent rule change. We contend Transgrid has failed to provide the requisite evidence to pass or even assess the test.

We are also concerned with the duplication of measures Transgrid are proposing to resolve their perceived financeability concerns. A concessional finance package from the Clean Energy Finance Corporation (CEFC) has already been acquired. In addition to this Transgrid has requested 'incurred depreciation' of assets rather than the standard as 'commissioned depreciation', the depreciation of biodiversity offsets rather than incurring these costs up front or in two years' time, as well as waiving the CESS as noted above. This is excessive and the AER must consider the compounding impacts of these various solutions in its determination.

PIAC has seen no compelling evidence that Humelink poses a financeability concern so great risk must be passed to consumers.

- PIAC does not support the approval of the capex line item 'other construction costs' (also referred to as 'residual risk' in CPA2). Items of this nature are precluded by the AER's Guidance Note on the Regulation of actionable ISP projects.

Transgrid has insufficient incentive to minimise the cost they charge consumers for Transgrid to hold these risks. There is no certainty for consumers that further cost escalation will not fall on them, despite paying a premium of 14% of total capex for the privilege of not holding these risks.

It would be more appropriate for Transgrid to hold the risks detailed in this line item, and for them to be treated as a pass-through cost to consumer where appropriate via ex-post review.

- Transgrid has proposed that a new asset class is created for biodiversity offsets. If this is to occur, the new asset class should appear in opex rather than capex. This would avoid potential perverse incentives for TNSPs to select routes with greater biodiversity impacts as a means of increasing their regulated asset base.

PIAC has a number of serious concerns regarding Transgrid's process in developing the CPA2, including the unnecessary use of multiple consultants in the development of the application, and the depiction of consultants commissioned by Transgrid as 'independent'. We provide more detail regarding these concerns in the remainder of this submission.

2. The CESS should not be waived

PIAC strongly opposes Transgrid's proposal to waive the Capital Expenditure Sharing Scheme (CESS) for Humelink.

The CESS is crucial and key among the few protections for consumers in a principal-agent relationship with transmission service providers which is often defined by information asymmetry. It functions alongside the ex-poste review but is important as it does not suffer from the same limitations of the latter.

The ex-poste review has practical limitations in the protection it affords. It is difficult for the AER to establish with strong confidence how a different course of action taken by the transmission service provider would have been more efficient. In this assessment the AER is necessarily dealing with a counterfactual. Consequently, the AER has historically been loathe to impose any ex-post costs on transmission providers as a result of this review.

Humelink is a large project and this implies particular risks and challenges that set it apart from other projects. But this does not invalidate the role of the CESS. It is still the case that:

- Transgrid is better placed than consumers to manage the costs of the project; and
- Alignment of Transgrid's interests with those of consumers (to the greatest degree possible) is still required.

The size of the project makes the role and importance of the CESS greater for Humelink than for any other project, as the potential costs of overruns (borne by consumers) are much greater. This concern was raised with Transgrid directly via the Transgrid Advisory Council (TAC) but no alternative replacement for the CESS was offered, and no mention of this opposition has been noted or responded to anywhere in the application.

Alongside the Energy User's Association of Australia (EUAA), who also sit on the TAC, we also opposed Transgrid's proposal that the CESS be waived for the Waratah Super Battery. We

concur with the EUAA that “it is not in the interests of consumers to be continually required to take on risks that they have no way of managing.”¹

3. Financeability

PIAC does not agree that any major financeability problem has been sufficiently established and we oppose each of the proposals Transgrid has made in the CPA2 to manage financeability. Specifically, we oppose Transgrid seeking:

- confirmation from the AER that the CESS regime will not apply in relation to Humelink, given critical differences in the scale and complexity of Humelink relative to the context in which CESS usually applies;
- approval from the AER to establish a new asset class for biodiversity offsets to enable depreciation of these costs over the weighted average of the standard lives of all other depreciating assets;
- approval from the AER to adopt depreciable asset classes as incurred depreciation.²

3.1 No *financeability request* has been filed at this time

To our knowledge, Transgrid has not made a *financeability request*.

Additionally, any request for measures at this time is premature. No *financeability request* may be provided until a concessional finance agreement has been entered into by Transgrid with respect to Humelink.³ The AER must take into account the terms of the concessional finance arrangement and adjust the benchmark gearing ratio by increasing the equity component simply to determine the existence or not of a *financeability issue*.⁴ As the terms of the agreement between Transgrid and the CEFC have not, according to the CPA2, been finalised,⁵ it is not possible for the AER to conduct the *financeability test* and approve any consequent measures.

As no *financeability issue* has been established, the AER has no powers to take any action in accordance with National Energy Rule (NER) 6A.6.3A(n). Notwithstanding this, we make the following observations on financeability in general.

3.2 CPA2 does not establish a financeability issue

On 21 March 2024, the Australian Energy Market Commission (AEMC) handed down its final determination on the rule change proposed for managing financeability. While this requires bolstering with Financeability Guidelines from the AER, it provides a clear pathway for managing

¹ EUAA, 25 July 2023, ‘Submission: Transgrid – Revenue proposal: Waratah super battery project’, p.2.

² Transgrid, ‘HumeLink - Stage 2 (Delivery) - Contingent Project Application’, p.20.

³ NER 6A.8.2(e)(1E), 6A.6.3A(e).

⁴ NER 6A.6.3A(k).

⁵ Transgrid, ‘HumeLink - Stage 2 (Delivery) - Contingent Project Application’, p.20.

financeability concerns. This is relevant to the case of Humelink. The information required by the AER to make the assessment is outlined in NER 6A.6.3A(k) and also on page 19 of the CPA2.

However, the required information is not provided by Transgrid in a clear and unambiguous way, if at all. Some adjacent, general claims are made. For example, that the cost of financing large scale projects is substantially higher than allowed under the AER's 2022 Rate of Return Instrument (RORI) (p.19), and that the CEFC commitment "falls short of providing a complete solution". Without the necessary information it is not possible to assess the validity and materiality of these claims and approve the measures being asked for in the CPA2.

The comments made in CPA2 concerning the commercial viability of the Humelink also consider the project in isolation. This is not how the financeability test works. The financeability test considers the financeability position of the TNSP as a whole (or at least the regulated components of it). If a TNSP has enjoyed particularly good conditions in the years leading to the consideration of the project, or had other projects in its portfolio that enjoyed above average returns, it is quite possible that the project being assessed could fall below the average or threshold levels in terms of cashflow impacts without bringing the TNSP's credit rating below the financeability threshold.

Transgrid has returned profits above the level implied by the regulated rate of return, either due to the application of efficiency-enhancing incentives or another reason. It therefore appears possible that Humelink could have a return on capital that:

- Is below the average rate across Transgrid's portfolio of regulated projects;
- Does not move Transgrid below the financeability threshold; and
- Is at a level investors are willing to accept and provide capital in adequate volume to ensure Transgrid's gearing ratio remains below 60%.

3.3 Duplication of measures to resolve the financeability issue

The CPA2 requests three different measures for dealing with the financeability issues for Humelink (on top of simply approving the revenue allowance requested in the application):

- incurred depreciation of assets rather than the standard as commissioned depreciation,
- depreciation of biodiversity offsets rather than incurring these costs up front or in two years' time, and
- a waiving of the CESS as noted above.

These are in addition to the concessional finance that Transgrid anticipates receiving from the CEFC.

The AER should take into account the compounding impacts of these measures intended to resolve the financeability issue (should one be found to exist). The AER should also consider the impacts any concessions (such as waiving the CESS) on the integrity and functioning of the regulatory framework itself. As a principle, the fewest measures required to resolve any issue is preferable. This creates fewer potential precedents based on *ad hoc* adjustment of the regulatory

framework, as well as minimizing scope for unintended consequences and impacts on consumers.

4. Prudence and efficiency

4.1 'Other construction costs' capex line item

The capex line item 'other construction costs' should not be included. This is also referred to as 'residual risk costs' in CPA2.⁷ This spending is not prudent or efficient.

Some of the elements are precluded by AER Guidance

The AER Guidance Note on Regulation of actionable ISP projects, published in March 2021, provides clear direction regarding the risk events TNSPs should seek to include in a risk cost allowance, and those they shouldn't. It states that:

It is only prudent to allow for residual risks that affect the cost of the project and cannot be efficiently transferred, avoided or mitigated (or included in cost passthrough events).

Examples of risks that are generally reasonable to allow for include...

- *Risks associated with the actions or requirements of a third party that are not able to be governed by contractual arrangements with the TNSP, which means that the risk is not able to be addressed through enforcing contract terms (for example, council approval or conditions imposed by environmental regulators).*
- *Risks associated with events that are outside the TNSP's control, such as extended wet weather or changes in market conditions.⁸*

The first example accords closely with sub-line items within 'other construction costs', such as 'ID2 – EIS Delay; Delay and cost claims from contractors due to delays in receiving planning approval.'⁹ Arguably it could also cover 'ID5 – Site Access; Delays to and claims by the contractor due to being unable to access the Site.

The second example covers sub-items such as 'ID27 – Exceptional Events: Exceptional Events such as lockdowns, war, terrorism or natural disaster' and 'ID42 – Increase in Plant: Reimbursable plant and equipment costs above estimate for Transmission Line Works.'

The Guidance Note continues:

Risk allowance would not be reasonably allowed for:

⁷ Transgrid, 'HumeLink - Stage 2 (Delivery) - Contingent Project Application', p.13.

⁸ AER, March 2021, 'Guidance Note on Regulation of actionable ISP projects', p.17.

⁹ All sub-line items from Transgrid, 'HumeLink - Stage 2 (Delivery) - Contingent Project Application', p.56-58.

- *Risks that are reasonably under, or should reasonably be under, the TNSP's control (for example, deficiencies in the TNSP's policies and procedures)*
- *Risks that would normally managed by the TNSP as part of its business as usual practices within its overall portfolio of projects (for example delays in appointing contractors)*
- *Risks that are, or should be, reasonably covered by contract terms (for example contractor delay)*
- *Risks that are, or should be, covered by insurance (for example, fire or theft) or costs that are reasonably recoverable from third parties.¹⁰*

These appear to clearly preclude the following.

- ID57 – Tower Design Growth: Design refinement and growth of towers occurs during detailed design [*reasonably under Transgrid's control*]
- ID71 – Uncertainty in the estimate of Owner's non-labour costs for support, travel, legal, etc.: Owner's non-labour costs that vary substantially depending on events or time of year. [*business as usual*]
- ID33 – Interface Contractor: Lack of coordination with interface contractors (OEM, East/West) resulting in design delays, construction delays, scope gaps, responsibility gaps and additional costs. [*reasonably covered in contract terms*]
- ID56 – Conductor Delay: Delays to Transgrid-supplied conductor and OPGW from delayed overseas manufacturing and shipping timeframes. [*reasonably covered in contract terms*]
- ID6 – Reliance Info: Variation claims by contractors due to changes in substation reliance information included in the contract (e.g., general arrangements, single line diagrams, existing assets, geotech substation sites UGL). [*reasonably covered in contract terms*]
- ID80 – Insolvency of a JV member: Insolvency of one of the JV members of the delivery partner. [*insurable*]

Other sub-line items are relatively borderline in terms of the advice in the Guidance note.

There is a misalignment between Transgrid's and consumers' interests

The propositions of the 'Other construction costs' line item are that:

¹⁰ AER, March 2021, 'Guidance Note on Regulation of actionable ISP projects', p.18.

(a) consumers are best served by Transgrid holding risk rather than them, or in the case of some elements of the line item, rather than the service providers contracted by Transgrid; and

(b) the price Transgrid offers to hold these risks is less than the expected (negative) value of the risks.

Both of these propositions are at this stage too opaque for consumers or the AER to meaningfully assess, and so cannot be deemed prudent and efficient.

In the case of the second proposition, if consumers accept that Transgrid is best-placed to value the risks, it is not clear why, having produced the lowest possible price for holding the risks themselves, Transgrid would accept their side of the deal – to hold the less valuable risks. There is a misalignment of interests between Transgrid as agent and consumers as principle here, and consumers are required to accept that Transgrid is acting in consumers' interests rather than its own without any other assessment to ensure this is the case.

This premium does not insulate consumers from further cost increases

There is nothing to guarantee that the burden of a further cost blowout would not ultimately fall on consumers despite paying this premium to move risks from themselves on to Transgrid.

Consumers have already paid a substantially larger sum than usual for CPA1 stage 2, part of which was explicitly to de-risk the project, before seeing cost escalation of around 30%. Despite this they are now asked to pay a premium equal to 14% of capex for the benefit of Transgrid holding residual risks, rather than carrying it themselves.

If Transgrid is to offer an up-front price for holding these risks, there should be a clear and enforceable mechanism to ensure that further cost escalation will not fall on consumers. No such undertaking appears in the CPA2, and we are not aware of any mechanism in the regulatory framework that would protect consumers who have paid \$599 million to de-risk the project from once again incurring cost increases for the project. It is not prudent or efficient for consumers to pay a substantial sum to insure themselves from risk when (a) it is not clear why the starting assumption is that the risk should fall on them alone rather than being shared between all stakeholders and (b) there is no reasonable prospect of the insurance policy being paid out if the risks eventuate.

A more appropriate way of dealing with the line item would be for Transgrid to hold the risks detailed in it. As risks eventuate, Transgrid should absorb them when they are deemed to be part of business-as-usual costs, or, where appropriate, treated as pass-through costs and transferred to consumers via the ex post review.

4.2 Classification of biodiversity offsets

Transgrid has proposed that a new asset class is created to capture biodiversity offsets. They propose that the life of the asset class is calculated as the average of all other asset classes. They assert this would improve the financeability of the project by smearing the costs of

biodiversity offsets over the life of the asset, rather than requiring them to be paid up front (or, as the rules allow, up to two years after revenue approval via the use of a banking guarantee).

PIAC recommends that instead of creating this as a capex item, which would enter Transgrid's Regulated Asset Base (RAB) and earn interest, the AER considers treating it as opex. This would reflect that spending on biodiversity offsets is not productive per se and should not receive a return on 'investment'.

It would also avoid the issues that arise from allowing expenditure on biodiversity offsets to receive returns. This includes the risk of 'gold-plating' offsets in a way that is not prudent or efficient from the perspective of consumers, or producing perverse incentives such as encouraging TNSPs to select routes with greater biodiversity impacts (and offset requirements). The incentive, from both an environmental and consumer impact perspective, should be to minimise the requirement to offset the biodiversity impacts of transmission investments.

5. The process of developing the CPA

5.1 Use of consultants

The employment of consultants in producing the CPA2 is unnecessary and excessive, with potential implications beyond the costs involved. Any one of these consultants could reasonably have been employed to offer advice on more than one item.

This use of consultants makes the AER's task of evaluating the claims harder, given the reduced pool of experienced consultants that it can now draw on for expert advice, without encountering a conflict of interest.

Referring to consultants they have commissioned as 'independent' is inappropriate and incorrect. We support the potential use of genuinely independent consultants to sense-check or confirm the claims of a TNSP in contingent project applications. However, these should be commissioned and paid for by the Australian Energy Regulator (AER), not the proponent. To do otherwise undermines the premise of an independent review. Any claims made or supported by consultants commissioned by Transgrid cannot reasonably be regarded as genuinely independent and should not be given any more weight than is given to Transgrid's own claims and assessments.

5.2 Consultation

The CPA2 fails on several occasions to accurately depict the consultations undertaken with the Transgrid Advisory Council.

While substantial time and staff resources were devoted to engaging with the TAC on the CPA2, the process was not deliberative. In PIAC's view much of the engagement could be reasonably characterised as a 'Decide, Announce, Defend' model of engagement.

The only substantive feedback the Transgrid received from the TAC was opposition to the line item referred to in the CPA2 as both 'residual risk' and 'Other construction costs', and opposition to the proposal to waive the CESS. Transgrid's response to the former concern was not substantive – it was to change the name of the line item. The response to the second concern was to ignore it, continuing with the proposal without any recognition of the opposition. PIAC does

not consider this meaningful consultation with stakeholders, particularly in relation to such substantive issues of cost and risk to consumers.

6. Continued engagement

We welcome the opportunity to meet with the AER and other stakeholders to discuss these issues in more depth. Please contact Michael Lynch at mlynch@piac.asn.au regarding any further follow up.