Ensuring the Financeability of Actionable ISP Projects

Proposal to change the National Electricity Rules

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Energy Networks Australia

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1 Executive Summary

Energy Networks Australia (ENA) is pleased to submit a rule change proposal to ensure the financeability of Integrated System Plan projects to the Australian Energy Market Commission (AEMC).

ENA is the national industry body representing Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

The Australian energy sector is undergoing the most significant transformation in its history. In its Integrated System Plan (ISP), The Australian Energy Market Operator (AEMO) has identified the need for more than 10,000 km of new transmission lines in the NEM and it has already identified $12.8 billion of immediately actionable ISP projects.[1]

Importantly, customers are at the centre of this transformation. AEMO has estimated that every dollar spent on actionable ISP projects will deliver more than $2 of net financial benefit to consumers, excluding the wider benefits to Australia of actionable ISP projects facilitating emissions reductions and the achievement of Australia's net zero emission targets. By way of one example, Project EnergyConnect is forecast to reduce annual consumer bills by $127 in South Australia and deliver a total saving of more than $180 million each year to NSW consumers.

Consumers benefit from these projects proceeding and consumers lose if these projects are delayed or unable to go ahead.

Consequently, it is important that any roadblock to these actionable ISP projects is removed. One such roadblock is the current regulatory arrangements that make it impossible for an ISP project to support the financing parameters that are required to attract investment. The AER has determined that efficient financing for regulated energy networks involves 60% gearing and a BBB+ credit rating. However, the current regulatory arrangements make it impossible for an actionable ISP

project to support those financing parameters. This failure arises because the regulatory arrangements have been designed for a business-as-usual network with only steady, ongoing levels of capital expenditure – not for a major rebuilding of the transmission grid.

Because the current regulatory arrangements do not support efficient financing parameters, transmission networks are unable to raise finance for actionable ISP projects. This has resulted in lengthy delays as networks negotiate bespoke concessional financing arrangements with the CEFC.

This Rule Change request proposes a change to the regulatory arrangements that:

- Supports the AER-determined efficient financing parameters throughout the life of the ISP project;
- Removes the need for taxpayer-funded loans from government agencies to support the financeability of actionable ISP projects;
- Provides transmission investors with no more than the AER-determined benchmark return on capital; and
- Is NPV-neutral such that consumers pay no more over the life of the project than they would under the current regulatory arrangements.

[1] https://aemo.com.au/energy-systems/major-publications/integrated-system-plan-isp/2022-integrated-system-plan-isp.

The alternatives to this Rule Change are either that projects will be delayed or not proceed without Government support. In either case, consumers do not receive the full benefits that AEMO has identified.

Moreover, these actionable ISP projects also support Australia's efforts to meet its net zero commitments by bringing on new sources of renewable energy as quickly as possible. The ability to meet those commitments could also be jeopardised if actionable ISP projects are not financeable under the regulatory framework.

1.1 Overview of the Proposed Rule Change

For the purposes of this submission, 'financeability' refers to the ability of Transmission Network Service Providers (TNSPs) to raise capital for actionable ISP projects in line with the AER's assessment of efficient financing practice. If the regulatory arrangements are such that actionable ISP projects cannot be financed without bespoke funding from the CEFC, there is a financeability problem. That is the situation at present, wherein bespoke CEFC funding has been required for a number of actionable ISP project to date.

The Australian Energy Market Commission (AEMC) has recognised that it is particularly important that actionable ISP projects can be financed in an efficient manner and the AER has determined what it considers to be the efficient financing practice of a benchmark efficient network (in terms of gearing, credit rating, and required return).

The AEMC's Stage 2 report on the Transmission Investment and Planning Review recommended that changes to the National Electricity Rules (the Rules) should be made to address financeability risks that may arise for actionable ISP projects:

> *The Commission's final position is that the revenue setting framework would benefit from more flexibility to address the risk of financeability challenges that may arise for ISP projects. This flexibility should provide more confidence for investors while providing protections for consumers.* [2]

Our proposed Rule Change seeks to ensure that actionable ISP projects are allowed revenues that are sufficient to support the AER's benchmark credit rating at the AER's benchmark gearing, providing the AER's benchmark return on capital. This approach would provide investors with the confidence they require to finance actionable ISP projects efficiently in accordance with the benchmark financing parameters that the AER has adopted in its Rate of Return Instrument (RoRI).

Our proposed 'financeability' Rule Change does not seek any special treatment or accommodations, but simply provides a degree of certainty that actionable ISP projects can be financed in accordance with the benchmark efficient gearing, credit rating, and return on capital parameters that the AER has adopted. Our proposed Rule Change would also be NPV-neutral in that it would accelerate depreciation to the minimum extent required to support the AER's efficient benchmark financing parameters in each year.

Our proposal addresses two concerns we hold about the AEMC's draft Rules:

- » The draft Rules leave it open to the AER to adopt an approach, when making revenue determinations for actionable ISP projects, that is inconsistent with the benchmark efficient gearing, credit rating, and return on capital parameters that the AER applies to all other network assets; and
- » Under the draft Rules, the AER's decision about whether it has identified a financeability issue, and, if so, how that issue would be addressed would occur when the AER is making a revenue determination. This may be a number of years *after* investors have committed to an actionable ISP project (e.g., through stakeholder engagement that sets community expectations that the project will be delivered, and through expenditure on early works). By that point, it would be too late (reputationally and financially) for investors to withdraw from the project if the AER determines that no (or insufficient) regulatory action should be taken to address what, from investors' perspective, is a genuine financeability problem. If investors cannot be certain that the regulatory framework would properly identify and address financeability problems at the time the regulator makes revenue determinations for actionable ISP projects, then they

[2] AEMC, Transmission planning and investment – Stage 2, Final Report (AEMC Stage 2 Report), 27 October 2022, p. i.

may decline to commit to such projects or not proceed at all thereby denying consumers the associated benefits and impeding the energy transition.

We consider that this Rule Change request will promote the long-term interests of electricity consumers in accordance with the National Electricity Objective (NEO), whilst supporting the decarbonisation objectives of the Australian Government within the National Electricity Market (NEM). Our proposed Rule Change would do this by ensuring that actionable ISP projects are financeable, allowing investors to earn the efficient return on capital determined by the AER. This, in turn, would incentivise investments in actionable ISP projects that are required to deliver the large consumer net benefits that AEMO's ISP anticipates and to support Australia's energy transition and efforts to reduce emissions (which will soon be incorporated explicitly in the NEO).

1.2 Why is Financeability Important for Consumers?

AEMO's ISP explains that major new transmission projects are urgently required to support Australia's transition to renewable energy and the achievement of Australia's international net zero commitments. The 2022 ISP identifies a range of transmission projects throughout Queensland, New South Wales, Victoria, South Australia and Tasmania.

The Commonwealth Government has made clear that these projects are necessary to achieve three key strategic objectives: maintaining a reliable supply of electricity; bringing on new sources of renewable energy as quickly as possible; and pushing down the cost of electricity to consumers.

These actionable ISP projects are estimated by AEMO to cost $12.8 billion and deliver net benefits of $28 billion to the nation (excluding the wider benefits to Australia of actionable ISP projects facilitating emissions reductions and the achievement of Australia's net zero emission targets). In other words, AEMO has modelled more than $2 of net benefits for consumers for every dollar of ISP expenditure. For Project EnergyConnect, annual consumer bills are forecast to reduce by $127 in South Australia[3] and deliver a total saving of more than $180 million each year to NSW consumers.

Transgrid alone forecasts that it will need to invest approximately $8 billion over the next five years to support Australia's energy transition. This includes investment in Project EnergyConnect, HumeLink and VNI West. These projects must be delivered in a compressed timeframe and in addition to 'business as usual' (BAU) capital expenditure.

Actionable ISP projects compete in a fiercely competitive global market to attract international equity capital. Consequently, it is important to ensure that there are no regulatory impediments to attracting the required capital to Australian ISP projects—particularly any impediments that prevent investors from even being able to earn the AER's benchmark return or maintain the AER's benchmark credit rating at the AER's benchmark gearing.

Projects are not financeable if the regulatory framework fails to provide confidence that equity investors will be able to earn a reasonable return for the risk involved and that the allowed revenues will be sufficient to support the benchmark credit rating. In these circumstances, an actionable ISP project will either:

» be deferred until it becomes financeable or not proceed at all – in which case the net benefits of the project to consumers will be delayed or foregone; or

» require Government support to proceed.

In the first case, current and future consumers will suffer a cost by way of delayed or foregone benefits. AEMO has made it clear that project delays would be contrary to the interests of consumers resulting in higher energy costs and a less secure supply of electricity. Such delay will also imperil the achievement of Australia's emission reduction goals.

[3] ACIL Allen, Report to ElectraNet, Project EnergyConnect, Updated Analysis of Potential Impact on Electricity Prices in South Australia, 18 April 2023, p. iii.

In the second case, the Government will need to raise taxes, divert resources from other programs and/or increase government debt, all of which will affect consumers in their capacity as taxpayers and recipients of other government services.

For these reasons, it is important that the regulatory framework appropriately addresses financeability risks so that consumers and taxpayers avoid the adverse consequences that would arise under the AEMC's draft Rules.

Under the AEMC's draft Rules, we cannot see a path to ISP projects proceeding on schedule without Government support.

1.3 Shortcomings in the Current Regulatory Arrangements

The AEMC's draft Rule Changes are a significant move in the right direction in that they recognise that financeability concerns can affect the commercial viability of actionable ISP projects. However, the AEMC's draft changes are unlikely to deliver the desired outcomes for customers because they do not provide investors with sufficient confidence to support actionable ISP projects.

Globally, equity investors expect the regulatory framework to achieve the following high-level outcomes:

» Allow transmission networks to maintain a strong investment grade credit rating to ensure that the quantum of borrowing required to support the business and major projects can be accessed efficiently from the global debt markets; and

» Allow each form of capital (debt and equity) in the capital structure to earn its respective market return – which essentially means that equity (as the highest risk form of capital) is able to earn an "appropriate" return on the significant capital required to deliver actionable ISP projects.

Having regard to these high-level requirements, we are concerned that the current arrangements and the AEMC's draft Rules do not promote investor confidence to commit to actionable ISP projects and undertake the investments needed to deliver benefits to customers. Under the AEMC's draft Rule Changes, investors would not have sufficient confidence that financeability risks will be identified and resolved satisfactorily under the regulatory framework before investors would have to commit financially and reputationally to actionable ISP projects (e.g., at a CPA1 stage). To provide this confidence, a transparent and objectively replicable mechanism needs to be specified in the Rules so that investors can understand, in advance of committing to actionable ISP projects, how future financeability problems will be identified and addressed.

The AEMC has developed draft Rules that would provide the AER with considerable flexibility and discretion over how it would identify and resolve financeability problems in relation to an actionable ISP project. The draft Rules specify that the AER must have regard to the following matters when exercising its discretion:

» the relative consumer benefits from the provision of network services over time;

» the capacity of the network service provider to efficiently finance its overall regulatory asset base, including efficient capital expenditure; and

» any other factors the AER considers relevant.

From an investor perspective, the AEMC's approach would leave significant uncertainty about:

» the method that would be used to assess whether there is a financeability issue; and

» the method for adjusting the cashflow timing to resolve the financeability issue.

Moreover, under the draft Rules, the AER's assessment would occur only *after* a TNSP has effectively committed to a project through early works and stakeholder consultation that raises community expectations that these projects will be delivered by the project proponent – in which case investors are being asked to commit commercially and reputationally before knowing how financeability might be assessed and addressed by the regulatory framework.

In reality, investors need to have confidence *before* committing significant capital that the expected returns will be consistent with the AER's allowed return on capital and the AER's benchmark efficient assumptions of 60% gearing and a BBB+ credit rating. The Rule Change, therefore, should seek to achieve this outcome. We note that the recent Rule Change request by the Commonwealth Minister for Climate Change and Energy proposes that the AEMC should consider the use of a principles based approach, rather than a prescriptive test to assess whether the depreciation allowance should be varied to address financeability concerns. However, it also indicates the AEMC in its deliberations should also consider a prescriptive test for the assessment of whether to vary the depreciation profile of an actionable ISP project, as well as whether this assessment is conducted at the regulated business level or project level.

If the regulated cashflows are insufficient to support the AER's benchmark BBB+ rating over the regulatory period, the equity holders in a benchmark efficient firm will receive less than the AER's allowed return on equity because either:

- The credit rating will fall below BBB+ resulting in a cost of debt that is higher than the (BBB+) regulatory allowance, with the shortfall being borne by equity holders; or
- The TNSP increases the proportion of equity finance (i.e., beyond the benchmark level of 40%) sufficient to maintain the BBB+ rating, in which case the additional equity will receive only an allowed return in line with BBB+ debt — not the return on equity that the AER considers would be efficient for equity investors to earn on their investment.

Projects in which equity investors must commit equity capital but only receive a return on debt allowance in relation to that capital are not financeable and cannot be reasonably expected to attract the equity capital required to proceed without Government support.

In the 2021 *Financeability of ISP Projects Rule Change* process, the AER proposed that financeability problems faced by a TNSP when investing in actionable ISP projects could be addressed by shareholders in the TNSP investing more equity capital than the 40% benchmark level assumed by the AER when setting rate of return allowances.[4] If the AER maintains this view, or if the Rules provide the AER with full discretion to be exercised *after* investors have effectively committed to the project, then investors are unlikely to agree to finance these actionable ISP projects, especially in the absence of any merits review process. In these circumstances, it seems unlikely that any actionable ISP project could proceed without Government support—as is the case with Transgrid's actionable ISP projects to date.

We are seeking a Rule Change that would require that the depreciation allowances for actionable ISP projects be set to support the AER's benchmark credit rating at the AER's benchmark gearing, providing investors with the AER's benchmark return on capital. We are not seeking any additional return for risk on greenfield actionable ISP projects or any other special accommodation – just the ability to finance the project in accordance with the benchmark efficient parameters adopted in the AER's Rate of Return Instrument (RoRI).

1.4 Our Proposed Rule Change

We propose a Rule Change that would require that the allowed revenues for an actionable ISP project must be set (by adjusting the depreciation allowance in an NPV-neutral way) such that the resulting cashflows are sufficient to support the AER's benchmark credit rating at the AER's benchmark gearing level.

In order for investors to commit to financing actionable ISP projects, they need to be able to understand, prior to the FID:

- how a regulatory assessment of financeability of actionable ISP projects will be undertaken; and
- how any financeability problem identified by such a process would be remedied through regulatory action.

To achieve these objectives, it is essential to specify a transparent mechanism that can be applied objectively in a repeatable and predictable manner. In this regard, regulatory discretion – to be applied *after* investors have effectively committed to the project – falls short of the certainty that investors require.

We are proposing a Rule Change that each time the AER makes a revenue determination for an actionable ISP project (e.g., at the CPA2 stage and when making subsequent revenue reset determinations), it would be required to apply a *financeability formula* that would ensure that the depreciation allowance for the project enables it to be financeable in each year of the relevant regulatory period. The financeability formula would be specified in the Rules and it would be such that allowed revenues are just sufficient to support the AER's benchmark financing parameters set out in the RoRI.

[4] AER submission, Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects, 3 December 2020.

An objective requirement such as this that would produce predictable financeability assessments and regulatory action to address financeability problems would provide investors with the confidence they need to commit to actionable ISP projects.

Our proposed financeability Rule Change does not seek any additional return or any other accommodation not applied to other network assets. Under our proposed financeability Rule Change, investors in regulated assets would simply recover their investment in actionable ISP projects and receive the allowed rate of return set by the AER. The RoRI would apply to actionable ISP projects and any reprofiling of cashflows would be performed in an NPV-neutral way.

Furthermore, our proposed Rule Change would not require any change in the way allowed revenues are set for regulated transmission assets that are *not* actionable ISP projects or for regulated distribution assets. The proposed Rule Change is targeted narrowly at effectively solving financeability problems that may otherwise prevent investment in *actionable ISP projects*.

Consistency with AER Benchmark Financing Parameters

Our proposed Rule Change sits squarely within the AER's benchmark regulatory framework as it provides investors with the allowed return set out in the AER's RoRI and it adopts the benchmark efficient financing parameters set out in the RoRI. We note that, by construction, when modelling a benchmark efficient TNSP the AER's Post-tax Revenue Model (PTRM) ensures that the TNSP maintains the AER's benchmark gearing level in every year of the regulatory period. Our proposed Rule Change would ensure that the benchmark credit rating is also maintained within the PTRM in every year—thus ensuring internal consistency in the AER's revenue determination for actionable ISP projects.

In principle, there are two ways in which our proposed financeability Rule Change could implement the AER's benchmark financing parameters:

- ***Option 1 – financeability assessment applied to each discrete actionable ISP project***.

  Under the first option, the AER would be required to set the depreciation allowance for an actionable ISP project using a 'financeability formula' specified in the Rules that ensures that *the actionable ISP project, on a discrete basis*, is able to achieve at least the benchmark credit rating (BBB+) at the benchmark level of gearing (60%) in each year of the regulatory period; or

- ***Option 2 - financeability assessment applied to the whole benchmark regulated business (using the AER's PTRM) inclusive of the actionable ISP project.***

  Under the second option, the AER would be required to set the depreciation allowance for an actionable ISP project using a financeability formula specified in the Rules that ensures that *a benchmark efficient regulated business that undertakes the actionable ISP project* (as modelled by the AER's PTRM) is able to achieve at least a benchmark credit rating (BBB+) at the benchmark level of gearing (60%) in each year of the regulatory period.

In both cases, the AER's benchmark financing parameters would be supported. In Option 1 those parameters would be applied to the actionable ISP project (i.e., the ISP PTRM) and in Option 2 the same parameters would be applied to the whole business (i.e., the combined PTRM).

We have modelled the regulatory outcomes under both of these options using the AER's PTRM (to represent the existing benchmark TNSP without the ISP project) and an illustrative $3 billion actionable ISP project that is assumed to be built and commissioned over a five-year (i.e., 2023-28) regulatory control period.[5] The regulated cashflows (under the AER's standard approach) would be insufficient for the project to be financeable. Therefore, the project would not proceed without regulatory action to address the financeability problem or Government support.

Our modelling indicates that Option 2 would likely result in more incremental cashflows being brought forward than would in fact be required to make the benchmark actionable ISP project financeable. This is because the forecasted regulated cashflows for the existing regulated business in the example used (as modelled using the AER's PTRM) are *lower*

[5] For the purposes of modelling a realistic scenario, the existing TNSP (i.e., without the actionable ISP project) is modelled using the PTRM that Transgrid submitted to the AER along with its revised revenue proposal for the 2023-28 regulatory period. However, the example provided in this Rule Change proposal is purely for illustrative purposes.

than the cashflows that would be required over that period to support a benchmark BBB+ credit rating at the benchmark gearing level of 60%. Consequently, sufficient regulated cashflows belonging to the actionable ISP project would need to be brought forward to (a) make the project more financeable, *and* (b) restore the original credit rating of the rest of the benchmark regulated business.

As a consequence, consumers would pay more over the 2023-28 regulatory control period than would be needed to ensure that the actionable ISP project proceeds. In our view, this would not promote the interests of consumers. By contrast, Option 1 would deliver just sufficient incremental cashflows to ensure that the ISP project could go ahead.

For this reason, we propose that Option 1 (i.e., an assessment of financeability at the level of the discrete ISP project) be adopted by the AEMC.

There are two possible circumstances that could arise in relation to existing RAB assets:

» The regulated cashflows are insufficient to support the AER's benchmark credit rating at the AER's benchmark gearing level. We consider that the regulated cashflows that relate to the whole benchmark regulated business should be sufficient to support the AER's benchmark credit rating at the AER's benchmark gearing level. However, we do not seek to address that issue with this Rule Change. Rather, by applying the financeability assessment on a discrete basis, we limit the scope to financeability issues pertaining to each specific actionable ISP project. The objective of this Rule Change proposal is to ensure the financeability of an efficient and actionable ISP project – not to address broad financeability issues faced by the existing TNSP; or

» The regulated cashflows are more than sufficient to support the AER's benchmark credit rating at the AER's benchmark gearing level. In this case, there may be a suggestion that the existing RAB assets could be used to address financeability problems faced by actionable ISP projects. However, such an approach would be unacceptable to investors. A project that cannot be supported by its own stream of regulated cashflows would not be considered to be commercially viable and, therefore would not proceed by diverting cashflows from other assets.

The AEMC has expressed a preference for a "network business level" assessment of financeability on the grounds that it:

» Provides service providers with a reasonable opportunity to recover at least their efficient costs; and

» Is consistent with the current approach to setting revenues.[6]

Our view is that this Rule Change should be limited to ensuring that efficient costs (including return on capital) can be recovered for the particular ISP project, not for the entire network business. Option 1 does this by ensuring that the regulated cashflows associated with each discrete actionable ISP project is able to support the AER's benchmark credit rating at the AER's benchmark gearing, thus allowing investors to earn the AER's benchmark return on capital. In the illustrative modelling presented in this Rule Change request, the more limited scope, with a focus on the particular ISP project, results in a materially lower price impact for consumers.

Moreover, our proposed Option 1 is also consistent with the current approach to producing a separate determination for each actionable ISP project.

A 'no worse off' approach

We also considered a version of the financeability test in which the formula is used to ensure that the ISP project makes the proponent firm 'no worse off.' This approach differs from the options set out above in that it would seek to support the credit metrics in the proponent's prevailing PTRM rather than the AER's benchmark BBB+ rating in every case. This test would ensure that a credit rating downgrade cannot occur as a consequence of an ISP project.

Under this approach, there is no distinction between applying the test to the PTRM of the discrete ISP project or to the PTRM of the combined firm – because the financial metrics of the existing firm would be maintained at their current level. Consequently, this 'no worse off' approach is equivalent to applying either Option 1 or Option 2 from above, but with the financial metrics from the existing firm rather than the financial metrics that would be required to support the AER's benchmark BBB+ rating.

[6] AEMC, October 2022, *Transmission planning and investment – Stage 2, Final Report*, p. 13.

The key advantage of this approach is that it is consistent with how TNSPs evaluate investment and financing decisions – i.e., by considering the incremental impact of a particular project on the existing portfolio of assets, to ensure that proceeding with the individual project would not result in a credit downgrade for the whole business, and the funding of debt as a portfolio.

However, our detailed analysis of this 'no worse off' approach has identified the following issues:

- The assessment of ISP projects under this approach would be dependent on the circumstances of the proponent at the time the AER makes a revenue determination. Identical ISP projects would receive different cashflow uplifts depending on the starting circumstances of the proponent's existing business.
  - At the time investors commit to the project there may be some uncertainty as to likely credit rating position of the regulated business in the future, which would in turn create some uncertainty regarding the expected regulated cashflows.
- The adjustments to regulated cashflows may in some circumstances be insufficient to ensure that a prospective actionable ISP project is in fact financeable. Consider, for example, a situation where the benchmark regulated business has a sub-investment grade (e.g., BB) rating before it undertakes a proposed actionable ISP project. In this situation, if the financeability formula is designed to ensure that the business is 'no worse-off' with the project than without it, then the regulated cashflows brought forward would only be sufficient to ensure maintenance of this sub-investment grade rating. In these circumstances, the proposed formula would not succeed in securing the financeability of the project.
- This approach would target financeability outcomes that may be materially different from the benchmark credit rating adopted by the AER when setting regulatory allowances.

While we do not propose a 'no worse off' approach, we consider there could be value in the AEMC further considering this option to determine if it may better promote the long-term interests of consumers.

1.5 Benefits for Consumers

Our proposed Rule Change would not result in consumers paying more than the efficient cost of delivering an actionable ISP project over the life of that asset.

Under our proposed Rule Change, which would introduce a requirement for the AER to set the depreciation allowance in line with a financeability formula, the proposed regulatory response to any financeability problem identified by the financeability formula would be an NPV-neutral re-profiling of allowed revenues via the depreciation allowance.

Our proposed Rule Change would result in equity investors being provided an opportunity to receive the return on equity allowance set by the AER on the benchmark quantum of equity finance also set by the AER by introducing a financeability formula which would bring forward revenues to the extent necessary to make an ISP project financeable.

In exchange, consumers can expect to receive the significant net benefits that these projects would unlock. These net benefits may be delayed significantly or foregone altogether if our proposed Rule Change is not adopted. This is because without our proposed Rule Change, investors would not have sufficient confidence (at the time they are deciding whether to commit to a particular project) that the regulatory framework will properly identify and address any financeability problems that become apparent at the time the AER makes a revenue determination in relation to those projects.

The AER's costs of administering the new Rules would be immaterial compared to the potential benefit of the changes.

1.6 Environmental and Other Benefits

By facilitating investment in actionable ISP projects, our proposed Rule Change would also deliver wider societal benefits (i.e., beyond those that would flow directly to consumers of electricity), for example by:

- Supporting Australia's efforts to meet its net zero commitments by bringing on new sources of renewable energy as quickly as possible. As the Commonwealth Government has recognised, transmission investment is critical to the transition net zero emissions.
- Providing new employment opportunities across the NEM, particularly in regional areas.

2 Issues with the Current Regulatory Framework

2.1 Background

The Australian Energy Market Operator's (AEMO's) Integrated System Plan (ISP) explains that major new transmission projects are urgently required to support Australia's transition to renewable energy and the achievement of Australia's international net zero commitments. The ISP already identifies a range of transmission projects throughout Queensland, New South Wales, Victoria, South Australia and Tasmania[7] that are required to help meet those commitments.

The Commonwealth Government has made clear that these projects are necessary in order to achieve three key strategic objectives:

- maintaining a reliable supply of electricity;
- bringing on new sources of renewable energy as quickly as possible; and
- pushing down the cost of electricity to consumers.

AEMO estimates that the actionable ISP projects it has identified to date are estimated to cost $12.7 billion and deliver net benefits of $28 billion to the nation (excluding the wider benefits to Australia of actionable ISP projects facilitating emission reductions and the achievement of Australia's net zero emission targets).[8] That is, according to AEMO's modelling, every dollar of investment in actionable ISP projects is expected to deliver more than $2 of consumer benefits, in addition to meeting the costs of the investment. Hence, consumers will be the key beneficiaries of these actionable ISP projects.

As the AEMC has recognised, the amount of investment required by TNSPs to deliver these projects is "unprecedented."[9] To put the scale of the task into context, the cost of these actionable ISP projects is similar in magnitude to the total capital expenditure incurred by all transmission networks over the 10-year period from 2009-18.[10] Transgrid alone forecasts that it will need to invest approximately $8 billion over the next five years in order to support Australia's energy transition. This includes investment in Project EnergyConnect (PEC),[11] HumeLink,[12] and VNI West.[13] These projects must be delivered in a compressed timeframe and in addition to the 'business as usual' (BAU) capital expenditure to continue the operate the existing network at current levels of reliability and to improve resilience of that network to climate change related events and cyber attack.

In order to provide the capital required for these investments, investors must have confidence that the regulatory framework will provide a reasonable return to compensate them for the significant risks they bear. The risks associated with delivering very large, new 'greenfield' transmission projects are materially higher than the risks associated with developing smaller add-on or 'brownfield' projects or BAU operations of the existing transmission networks.

In this context, equity investors will apply particularly close scrutiny to proposed actionable ISP projects before deciding to invest funds.

In order to deliver large new transmission projects of the scale required by the ISP, a TNSP must take on a significant quantity of new debt financing. If the regulated cashflows do not increase sufficiently to service the step increase in new

[7] AEMO, 2022 Integrated System Plan, June 2022, p. 15.

[8] AEMO, 2022 Integrated System Plan, June 2022, p. 15.

[9] AEMC, Transmission planning and investment – Stage 2, Final Report (AEMC Stage 2 Report), 27 October 2022, p. i.

[10] AER spreadsheet, Electricity transmission network service provider data report - 24 July 2019.

[11] https://www.transgrid.com.au/projects-innovation/energyconnect.

[12] https://www.transgrid.com.au/projects-innovation/humelink.

[13] https://www.transgrid.com.au/projects-innovation/vni-west.

debt obligations, the TNSP may suffer a deterioration in credit quality, which may threaten its ability to deliver other required projects or even carry on its day-to-day operations.

These projects also require a significant amount of new equity capital in addition to new debt finance. If the regulatory framework fails to provide confidence that (a) equity investors will earn the required benchmark return for bearing the risk of delivering these large and complex projects, and that (b) the regulated cashflows will be sufficient to service the associated increase in debt obligations, the projects will not be able to attract the equity investment necessary to proceed without Government support. In these circumstances, actionable ISP projects cannot proceed without public funding, in which case the consumer benefits that will flow from these projects will depend on the availability of that public funding.

In a fiercely competitive global market for infrastructure equity, investors are more likely to redirect funds to those projects that are most attractive from a risk-reward perspective. Actionable ISP projects are competing in this global market to attract international equity capital.

It is important to note that the core of the issue is the extent to which investors can reasonably be expected to approve the actionable ISP projects, unlocking the benefits for consumers, the environment and the broader economy. This is not a contest between investors and consumers, and there is no gold plating or excessive returns – under AEMO's own modelling, consumers benefit more than 2-to-1 from these projects. The issue is whether the current regulatory framework acts as an impediment to the investment in these projects, against the long-term interests of consumers.
Investors' concerns about the current regulatory arrangements

Investors are concerned that, under the existing arrangements (and under the AEMC's recent proposed Rule Changes), there is insufficient certainty to investors about whether and how genuine financeability problems associated with actionable ISP projects will be addressed before investors commit financially and reputationally to a new actionable ISP project. If genuine financeability problems arising from insufficient regulated cashflows are not addressed properly in the AER's revenue determination for these projects, then equity investors would need to contribute additional equity capital to the project and earn a return on that additional capital that is lower than what the AER considers to be the efficient return on equity. This would make the project financially unviable from the perspective of equity investors.

In order to avoid this situation, investors must have certainty and confidence at the time they commit to an actionable ISP project that the regulatory framework will properly address any financeability problems that become known at the time the AER sets the revenue allowances for such projects, which may be many years after investors have committed to the project. Lack of investor confidence that the regulatory framework would properly identify and address a financeability problem *in every instance* will act as a significant barrier to investment in, and delivery of, actionable ISP projects.

In its Final Report on Stage 2 of the Transmission Planning and Investment Review, the AEMC recognises that "financeability concerns for a TNSP may arise from the way that cashflow is impacted by major investments."[14] We welcome this acknowledgment by the AEMC.

The key question is the extent to which the current regulatory framework acts as an impediment to the investment in ISP projects. As we have noted, AEMO and the Commonwealth Government have identified how these actionable projects are in the long-term interests of consumers and necessary for the decarbonisation of the national electricity system. Thus, the focus of this review should be on aspects of the regulatory framework that are likely to impact on such projects achieving investment approval. The key considerations in this regard are the confidence that investors have in (a) being able to achieve a reasonable return for the risks involved, and (b) having sufficient cashflow to service the debt obligations associated with the ISP projects.

However, the AEMC has, to date, focused on a particular definition of 'financeability':

> *Financeability refers to the ability of TNSPs to efficiently raise capital to finance their activities*.[15]

Whilst we agree with this very general statement it seems that the AEMC has erroneously gone down the path of considering the extent to which the TNSP might be able to raise *some* debt finance (even if that is less than the regulatory

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[14] AEMC Stage 2 Report, p. 8.

[15] AEMC Stage 2 Report, p. 8.

benchmark), rather than the extent to which the actionable ISP projects might reasonably be expected to achieve investment approval. That is, a project is only 'financeable' in any relevant sense if it is capable of achieving investment approval.

Moreover, the AEMC suggests that the effect of these financeability challenges may be temporary, resulting in "short-term negative impacts to some of the financial metrics that are used to assess the creditworthiness of a business." [16]

The AEMC also suggests that a TNSP may be able to manage these temporary financeability challenges through appropriate changes to its capital structure, for instance by:

> *…shareholders (equity) supporting cashflow in earlier years, and receiving higher cashflow in later years*.[17]

The AEMC reiterates this point by stating that:

> *It is possible for network businesses to adapt their capital structures in order to be able to efficiently finance investment requirements. In periods of expansion it is likely that networks will need to rely more heavily on finance from equity investors, relative to less capital intensive periods*. [18]

Our view is that, in a regulatory context, financeability means that the regulated cashflows available to a regulated business that has adopted the benchmark efficient level of gearing determined by the regulator (60% under the AER's 2022 Rate of Return Instrument) should be at least sufficient to support and maintain the benchmark credit rating assumed by the regulator when setting the allowed revenues (BBB+ in the AER's case). If the regulated cashflows are insufficient to support the benchmark credit rating at the benchmark level of gearing—that the AER considers to be the efficient financing practice—then there is a fundamental internal inconsistency in the regulatory determination that should be corrected.

Under the existing regulatory arrangements, revenue allowances are set for transmission networks, on the basis that an efficient network business would finance all of its investments using 60% debt and 40% equity. The allowed return on capital is set to enable the firm to pay interest (to the 60% debtholders) in line with a BBB+ credit rating with the remainder available as a return to the (40%) equity holders. This is set out in the AER's 2022 Rate of Return Instrument (RoRI).

However, if the regulated cashflows are insufficient to support the benchmark BBB+ rating over the regulatory period, the equity holders in a benchmark efficient firm will fall short of the AER's allowed return on equity because either:

- The credit rating will fall below BBB+ resulting in a cost of debt that is higher than the (BBB+) regulatory allowance, with the shortfall being borne by equity holders; or
- The TNSP increases the proportion of equity finance (i.e., beyond the benchmark level of 40%) sufficient to maintain the BBB+ rating (as suggested by the AEMC), in which case the additional equity will receive only an allowed return in line with BBB+ debt— not the return on equity that the AER considers would be efficient for equity investors to earn on their investment.

In either case, equity holders would receive a lower allowed return than the AER has determined would be appropriate for equity investors in a benchmark efficient firm. Projects in which equity investors must commit substantial equity capital but only receive a return on debt allowance in relation to that capital are not commercially viable and cannot be reasonably expected to receive investment approval. In those circumstances, either actionable projects will not go ahead, or they will be delayed significantly until solutions to this 'financeability' problem can be found on a case-by-case basis (e.g., the negotiation of Government support to enable the projects to be financeable). This means that actionable ISP projects (and the associated benefits to consumers and the environment, including lower prices over the long-term) would be delayed significantly, or may not proceed at all.

[16] AEMC Stage 2 Report, p. 9.

[17] AEMC Stage 2 Report, p. 9.

[18] AEMC Stage 2 Report, p. 9.

To date, ISP projects have required Government support to address financeability concerns. Assertions that investors 'would' or 'should' be willing to commit to actionable ISP projects under the current or AEMC draft rules are belied by this observed experience.

It is important to emphasise that we are *not* suggesting that TNSPs should be allowed a return on equity that is higher than the return on equity allowed under the AER's RoRI. Rather, our key point is that if equity investors in an actionable ISP project must invest more than the 40% benchmark level of equity in order to support the benchmark credit rating, then those equity investors can expect to earn a return that is *below the allowed return on equity under the RoRI*. This would undermine the financeability of that project.

In order for investors to commit equity to actionable ISP projects, they must have confidence that the regulatory framework will deliver allowed cashflows that would be sufficient to support the benchmark efficient (BBB+) credit rating at the benchmark level of gearing (60%), such that equity investors:

- would not need to subsidise interest payments to debt holders; or
- step in to provide additional equity capital that would only be compensated at a BBB+ debt rate of return.

In other words, investors cannot be expected to provide equity capital unless they can reasonably expect to receive the AER's allowed return on equity on that capital, rather than something less than this. We consider that the AEMC's draft Rule Change does not yet provide investors with this confidence. Therefore, we have proposed an alternative Rule Change that we consider would facilitate the financeability of actionable ISP projects and attract the private equity capital that is needed for those projects to be delivered.

2.2 The AEMC's draft Rule Changes

The AEMC's draft Rule Changes provide the AER with greater flexibility to accelerate regulated cashflows (by adjusting the depreciation allowance) in an NPV-neutral way to the extent that the AER considers such action would be necessary.

The draft Rule Changes require the AER to have regard to the following matters when exercising its discretion:[19]

- the relative consumer benefits from the provision of network services over time;
- the capacity of the network service provider to efficiently finance its overall regulatory asset base, including efficient capital expenditure; and
- any other factors the AER considers relevant.

The AEMC considers that its draft changes to the Rules "should provide more confidence for investors while providing protections for consumers."[20]

However, the AEMC's draft Rule Changes do not provide investors with **sufficient** certainty over:

- the method that would be used to assess the financeability of future actionable ISP projects;
- the matters the AER might consider when making such a determination;
- the circumstances in which a financeability problem would be deemed to exist; or
- in the case where a financeability problem is identified, whether, and to what extent, the depreciation allowance would be adjusted to address the problem.

The AER has suggested that it could develop a guideline that explains how it would approach any future assessment of financeability. However, investors do not consider that this would provide them with sufficient certainty that genuine financeability problems would (at the time of an AER revenue determination) be identified in every instance and addressed through adequate regulatory action.

[19] AEMC, Proposed Rule Change: TPIR Stage 2, October 2022, paragraph 6A.6.3(f).

[20] AEMC Stage 2 Report, p. i.

Any guideline that the AER develops is likely to be non-binding, in the sense that the AER would not be *required* to make a finding of a financeability problem if an objective threshold or set of criteria were met, and the AER would not be *required* to take any particular action to remedy a financeability problem that might exist under its regulatory determination. The broad discretion that a non-binding guideline would confer on the AER would mean that investors could not anticipate (at the time they are deciding whether to commit to the project) the outcome of any financeability assessment the AER would make as part of its revenue determination.

Actionable ISP projects involve very substantial investment in early works (CPA1) before the precise nature of any financeability issues are known.[21] Only after this expenditure is incurred can the financeability issues associated with the project be assessed properly.

Under the AEMC's draft Rule Change, the AER would determine whether an adjustment to the depreciation allowance is required at the time it makes a revenue determination at the end of the CPA2 stage. The point at which the AER makes such an assessment may be years after the commencement of the project. Hence, the proponent of an actionable ISP project would need to incur the costs of these early works, and an effective social obligation to complete the project, without knowing how the regulatory framework might deal with any identified financeability issue — or even whether the regulatory process would successfully identify a financeability problem.

The key problem to address is that there are some aspects of the current regulatory framework that may prevent an actionable ISP project (that would produce significant benefits to consumers) from obtaining investment approval. In particular, under the present regulatory arrangements there is no objectively verifiable process that is replicable by any stakeholder to determine:

- Whether a financeability problem exists. Indeed, there appears to be no agreement on exactly what would constitute a financeability problem; and
- How any such financeability problem should be fixed.

The AEMC's proposed solution is to give the AER more flexibility and discretion to determine whether a financeability problem exists and, if so, what to do about it. But the AEMC's proposed solution would occur well after that investment approval is required. Investors would not know how the regulatory framework would assess or address a possible financeability issue until after the investment decision had been made.

Due to the significant flexibility and broad regulatory discretion afforded the AER by the AEMC's draft Rule Changes, equity investors would face significant uncertainty about whether the regulatory framework would properly diagnose and remedy genuine financeability problems that only become apparent much later (e.g., at the CPA2 stage). This means that equity investors will not have clarity at the time an actionable ISP project is proposed (e.g., at the start of the CPA1 stage) whether the regulatory regime will deliver the allowed returns that the AER determines is fair compensation for the risks that equity investors face when committing capital to such projects.

Furthermore, the lack of certainty created by the AEMC's draft Rule Changes also exposes TNSPs to the risk of significant reputational harm and loss of social licence if an actionable ISP project were to be halted or delayed at the end of the CPA2 stage (which may be several years after the project was first consulted on with the community), if financeability problems identified late in the revenue approval process are not addressed adequately. Such knowledge can be reasonably expected to spread to other markets, and in particular those related to renewable generation investment, with the knock-on effect of delays in those investment projects.

The scope for such outcomes may deter investors from committing capital to actionable ISP projects that would otherwise be forthcoming if investors could have confidence at the start of the process that the regulatory framework will properly identify and address any financeability problems that might arise.

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[21] In its Stage 3 Transmission Planning and Investment Review Final Report the AEMC recommends that TNSPs be able to seek a regulatory allowance for early works before a RIT-T is concluded and AEMO feedback loop is passed. Whilst we would support such an approach, we note that this in itself would not address the problem of regulatory uncertainty that investors are concerned about, and which this Rule Change request seeks to address.

In order to commit the large amount of capital needed to deliver actionable ISP projects without Government support, investors require an objective and prescriptive process to be included in the Rules that specifies in advance precisely:

- how a regulatory assessment of financeability of actionable ISP projects will be undertaken; and
- how any financeability problem identified by such a process would be remedied through regulatory action.

We consider that any regulatory process for testing the financeability of actionable ISP projects should satisfy the following principles in order to provide investors with sufficient confidence to commit to the delivery of such projects:

- **Objectivity:** The test should be objective, such as in the form of a prescribed formula, rather than subjective, being based on the judgment or discretion of the regulator.
- **Predictability:** The test should be one that produces the same outcome regardless of who implements it. A financeability test that is characterised by vagueness and discretion might produce different conclusions and outcomes depending on who might be implementing that test. Thus, a given set of data inputs should always produce the same outcome/conclusion.
- **Replicability:** Related to the previous principle, it should be possible for any stakeholder to implement the test from a given set of data inputs and predictably produce the same outcome.
- **Transparency:** The rationale/basis for the test should be clearly explained in advance, any inputs should be clearly and objectively defined, and no private information or judgment should be required to implement the test.
- **Timeliness:** The nature of the test should be known to investors at the time of effective commitment to the project.

Only a prescriptive process for conducting financeability assessments at the time of a regulatory determination would satisfy all of these principles. In the absence of such a prescriptive process, equity investors will not have sufficient confidence to invest in actionable ISP projects.

We note that the recent Rule Change request by the Commonwealth Minister for Climate Change and Energy proposes that the AEMC should consider the use of a principles based approach, rather than a prescriptive test, to assess whether the depreciation allowance should be varied to address financeability concerns. However, the request indicates the AEMC in its deliberations should also consider a prescriptive test for the assessment of whether to vary the depreciation profile of an actionable ISP project, as well as whether this assessment is conducted at the regulated business level or project level.[22]

Under the AEMC's draft Rules, we cannot see a path to actionable ISP projects proceeding on schedule without Government support, as has been the observed experience for many ISP projects to date.

2.3 Issue Outside of the Scope of this Rule Change Request

We note that one of our members, Transgrid, has identified a further issue under the current arrangements in the NER.

The issue is that, while the current approach of setting the return on debt allowance based on an historical trailing average of market rates is suitable for BAU capital expenditure, it cannot be achieved in practice for the ISP projects which will need to be debt financed at prevailing market rates.

We do not propose to address this issue in this Rule Change request. However, we note that Transgrid will continue to seek a solution to this issue with stakeholders separately.

[22] Honourable Chris Bowen, Commonwealth Minister for Climate Change and Energy, Rule Change Proposal Treatment of financeability for Transmission Network Service Providers, March 2023, p. 6.

3 Proposed Rule Change and Rationale

3.1 Overview of our Proposed Rule Change

For the reasons explained in section 2, we consider that a more formulaic set of arrangements that maximises the predictability of any financeability assessment applied to actionable ISP projects is necessary to promote investor certainty and confidence. Without this certainty, investment in actionable ISP projects—and the associated consumer benefits—will either be delayed or not realised at all.

Hence, changes to the existing Rules that prescribe a clear, formulaic process for diagnosing and remedying financeability problems will ultimately promote the long-term interests of consumers by removing a potentially significant barrier to the timely delivery of actionable ISP projects.

We propose a Rule Change that would require the AER to allow regulated cashflows that are consistent with its regulatory benchmark assumptions. Under our proposed Rule Change, *the AER would be required to allow cashflows that are sufficient to support its benchmark credit rating of BBB+ at its benchmark gearing level of 60% debt*. We are not seeking any additional or extra return. Under our proposed Rule Change, investors in regulated assets would simply recover their investment in actionable ISP projects and receive the allowed rate of return set by the AER.

The role of the financeability formula in either case would be to conduct an assessment of financeability in each year of the regulatory period over which allowed revenues for an actionable ISP project are to be set and to determine what revenue adjustment (if any) is required to ensure that financeability is achieved.

Specifically, each time the AER makes a revenue determination in relation to an actionable ISP project (e.g., during a CPA2 decision or during the course of a normal regulatory reset) the financeability formula would first assess whether the regulated cashflows for the project are sufficient, given the costs that the AER has determined are efficient (assuming the benchmark level of gearing).

If the financeability formula identifies that the regulated cashflows would not be sufficient to support the benchmark credit rating in any year withing the regulatory period, then the financeability formula would automatically specify the minimum NPV-neutral adjustment to the depreciation allowance required to ensure that the benchmark credit rating is achieved.

3.2 Implementation of the Proposed Financeability Formula

The purpose of the proposed Rule Change is to ensure that the regulated cashflows available for an actionable ISP project are sufficient to support the benchmark credit rating at the benchmark level of gearing in each regulatory year.

Since the revenue allowances set by the AER are determined based on the efficient costs (rather than actual costs) of a benchmark project, any *regulatory* assessment of the financeability of an actionable ISP project should also be conducted on a benchmark basis. This would ensure that any financeability problem identified by the test cannot be attributed to the actual financing decisions of the TNSP undertaking the actionable ISP project.

It is for this very reason that most regulators that undertake financeability tests as part of their regulatory determinations do so on a benchmark basis—i.e., using only benchmark revenues, costs, allowed returns, gearing and credit rating to perform the necessary calculation of the financial metrics used in the test. For example, ESCV, ESCOSA, and UK regulators Ofgem and Ofwat all apply financeability tests to the benchmark efficient entity. IPART applies a financeability test to the benchmark entity as well as to the actual business (taking into account all aspects of the financial position of the owner of the regulated asset). However, IPART has explained that the explicit role of the test performed on a benchmark basis is to assess the adequacy of the regulatory allowance.

The AER has also explained that the role of a financeability assessment is to ensure that regulated revenues are sufficient for a hypothetical efficient entity (rather than the actual business) to support a benchmark credit rating at the benchmark level of gearing:

We acknowledge that financeability tests can help assess whether a hypothetical entity with a capex program, gearing and level of risk, reflected in our rate of return allowance, can raise debt at the credit rating consistent with the benchmark credit rating.[23]

All of the information required to implement the financeability formula that we propose is available readily from the AER's Post-Tax Revenue Model (PTRM).

We propose that whenever the AER makes a revenue determination in relation to an actionable ISP project (e.g., as part of a CPA2 decision or during a normal regulatory reset), it would be required under the Rules to set allowed revenues (by adjusting the depreciation allowance, to the extent required) such that the following financeability formula is satisfied in each regulatory year:

$$35.71\%\frac{FF0/ND_t}{9.0\%} + 28.57\%\frac{FF0\ ICR_t}{2.4} + 35.71\%\frac{Gearing_t}{Gearing_t} \geq 1,$$

where:

- t is the regulatory year;
- $FF0/ND$ is the Funds From Operations (FFO) to net debt ratio calculated using the AER's PTRM;
- 9.0% is the benchmark BBB+ threshold for the FFO to net debt ratio;
- $FF0\ ICR$ is the FFO interest coverage ratio calculated using the AER's PTRM;
- 2.4x is the benchmark BBB+ threshold for the FFO interest coverage ratio; and
- $Gearing$ is the benchmark level of gearing specified in the applicable rate of return instrument.

The three financial metrics specified in our proposed financeability formula—the FFO to net debt ratio, the FFO interest coverage ratio and the gearing ratio—have been selected because these are the three key financial metrics that Moody's has regard to when conducting rating assessments of regulated energy networks in Australia. The information (e.g., allowed revenues, estimated efficient costs, benchmark gearing and quantity of debt) required to calculate these three metrics would be obtained from the relevant PTRM used to set the allowed revenues.

The proposed benchmark thresholds for the FFO to net debt ratio (9.0%) and the FFO interest coverage ratio (2.4x) are consistent with the minimum ratios that Moody's has indicated would need to be achieved in order to be upgraded from a rating of BBB (i.e., Moody's Baa2) to a rating of BBB+ (i.e., Moody's Baa1) in recent rating decisions for regulated energy networks in Australia. The proposed threshold for the gearing ratio (the numerator in the third term of the formula) is defined to be equal to the benchmark level of gearing specified in the 2022 RoRI, since the benchmark regulated business is modelled in the AER's PTRM as always maintaining the benchmark level of gearing (currently 60%). Since the numerator and denominator of the third term are defined to be the same, the third term will always equal 1.

The proposed financeability formula computes the ratio of each financial metric and its respective benchmark BBB+ threshold. A ratio of at least 1 would indicate that, on that particular metric, there are sufficient expected cashflows available in the regulatory year to support the benchmark BBB+ credit rating. A ratio lower than 1 would indicate that, on that metric, there are insufficient expected cashflows available in the regulatory year to support the benchmark BBB+ credit rating.

The financeability formula then calculates the weighted average of each of these three ratios to derive an overall weighted financeability score in each regulatory year. If the weighted financeability score in a given year is at least 1, the expected regulated cashflows in that year would be deemed sufficient to support the BBB+ benchmark credit rating, and no additional depreciation allowance would be brought forward in that year. However, if the weighted financeability score in a given year is less than 1, then the expected regulated cashflows in that year would be deemed insufficient to support the BBB+ benchmark credit rating. In these circumstances, the AER would be required, under our proposed Rule Change, to

[23] AER, Overall rate of return, equity and debt omnibus, Final working paper, December 2021, p. 124.

increase the depreciation allowance in that year until the weighted financeability score is at least 1. At that point the regulated cashflows in that year would be deemed just sufficient to support the BBB+ benchmark credit rating.

We have derived the weights used in the financeability formula based on the following considerations:

- Moody's specifies in its global rating methodology for regulated energy networks that 40% of its overall rating assessment relates to quantitative rating factors in the form of four financial metrics, each with the following weight:[24]
  - FFO to net debt ratio (12.5%);
  - FFO interest coverage ratio (10%);
  - Gearing ratio (12.5%); and
  - Retained Cashflow (RCF) to net debt ratio (5%).
- It is not apparent from recent Moody's rating decisions that Moody's attaches any material weight to the RCF to net debt ratio when conducting rating assessments of regulated energy networks in Australia.
- Hence, if the 5% weight attributed in the global rating methodology to the RCF to net debt ratio were redistributed proportionally to the remaining three ratios, and the resulting weights were rescaled to sum to 100%, then the following weights specified in our proposed financeability formula would obtain:
  - FFO to net debt ratio (35.71%);
  - FFO interest coverage ratio (28.57%); and
  - Gearing ratio (35.71%).

Our proposed drafting of the Rule Change text in relation to the proposed financeability formula is provided in Appendix A.

3.3 Assessment of Financeability at the "Network Business Level" or "Project Level"?

The AEMC has expressed a preference that any assessment of financeability should be performed at the level of the whole network business rather than at the level of individual actionable ISP projects. Specifically, the AEMC has stated that:

> *The Commission considers it appropriate that the AER will consider the capacity to finance the ISP investment at the network business level and not at the project level. As part of this assessment, consideration should also be given to how an investment in a particular project may impact the overall position of the business (including in relation to financial metrics) and where the TNSP will sit after the inclusion of the project*.[25]

Given the AEMC's current views on this issue, we have considered the implications of using the proposed financeability formula to assess financeability at two different levels:

- ***Option 1 – financeability assessment applied to each discrete actionable ISP project.***

  Under the first option, the AER would be required to set the depreciation allowance for an actionable ISP project using a 'financeability formula' specified in the Rules that ensures that *the actionable ISP project, on a discrete basis*, is able to achieve at least a benchmark credit rating (BBB+) at the benchmark level of gearing (60%) in each year of the regulatory period; or

- ***Option 2 - financeability assessment applied to the whole benchmark regulated business (using the AER's PTRM) inclusive of the actionable ISP project.***

  Under the second option, the AER would be required to set the depreciation allowance for an actionable ISP project using a financeability formula specified in the Rules that ensures that *a benchmark efficient regulated business that*

[24] Moody's, Rating methodology – Regulated electric and gas networks, 13 April 2022, p. 3.

[25] AEMC Stage 2 Report, p. 13.

undertakes the actionable ISP project (as modelled by the AER's PTRM) is able to achieve at least a benchmark credit rating (BBB+) at the benchmark level of gearing (60%) in each year of the regulatory period.

We have modelled the incremental regulated cashflow outcomes under these two options in the case of an illustrative actionable ISP project that is assumed to be constructed and commissioned by Transgrid over the forthcoming (i.e., 2023-28) regulatory control period. For this illustrative example, our analysis assumes that:[26]

- For purely illustrative purposes, the existing benchmark TNSP (i.e., without the actionable ISP project) is modelled using the PTRM submitted by Transgrid in its revised revenue proposal to the AER for the 2023-28 regulatory control period. Whilst the precise outcomes of a financeability assessment would vary from one TNSP to another, and the prevailing circumstances at the time the AER makes each regulatory determination, the modelling results presented below are sufficiently representative to illustrate the broad outcomes that could be expected under the two proposed options.
- The actionable ISP project has a total capital cost of $3 billion and an asset life of 45 years.[27] The project takes three years to plan, construct and commission. Work on the project is assumed to commence in the first year of the 2023-28 regulatory control period.
- The financeability formula is applied throughout the project life, including the construction period, to ensure that any financeability issues are addressed by accelerating depreciation by the minimum required amount.

Table 1 below presents the weighted financeability scores produced by the proposed financeability formula under Options 1 and 2 *before* the depreciation allowance is adjusted to address any financeability problem identified by the formula.

Table 1: Weighted financeability scores under Options 1 and 2 before adjustment to depreciation Allowance

	Target threshold	2023-24	2024-25	2025-26	2026-27	2027-28
Option 1	≥ 1	0.27	0.32	0.40	0.65	0.65
Option 2	≥ 1	0.91	0.85	0.81	0.90	0.88

Note: The financeability scores in the first and second rows of this table are not directly comparable. The scores in the first row relate solely to the individual ISP project. The scores in the second row relate to the whole of the benchmark regulated business, including the ISP project. The difference between the scores in each of the rows and the target threshold of ≥ 1 are not necessarily indicative of the size of the cashflow adjustment required to meet the financeability requirement under each option. The second row suggests that the there is a fairly small gap between the financeability score for the whole of the regulated business in each year and the target threshold, whereas the first row indicates a fairly large gap between the financeability score of the individual project and the target threshold. However, as Figure 1 shows, a significantly larger cashflow adjustment would be needed under Option 2 than under Option 1, because under Option 1 sufficient cashflows would need to be accelerated to bring a single ISP project up to the BBB+ benchmark credit rating, whereas under Option 2 sufficient cashflows would need to be accelerated to bring the whole benchmark regulated business up to the BBB+ benchmark credit rating.

Under both options, the weighted financeability score in each year is lower than the target threshold value of at least 1 in every year.

- The first row of the table shows that the regulated cashflows associated with just the ISP project would be insufficient to support the BBB+ benchmark credit rating at the 60% benchmark gearing level.

[26] The model and its input assumptions will be provided to the AEMC to support this Rule Change request.

[27] For context, the current expected cost of HumeLink is approximately $3.3 billion.

- The second row of the table indicates that the regulated cashflows associated with the whole of the benchmark regulated business (as modelled in the AER's PTRM), inclusive of the ISP project, would be insufficient to support the BBB+ benchmark credit rating at the 60% benchmark gearing level.[28]

In either case, the regulated cashflows would not be sufficient to ensure financeability, so the illustrative actionable ISP project would not proceed without action to increase the regulated cashflows (by adjusting the depreciation allowance in an NPV-neutral way) or without Government support.

Figure 1 below presents the incremental cashflows that would be required over the 2023-28 regulatory control period under the two options.

Figure 1: Additional regulated cashflows required to address financeability – illustrative case.

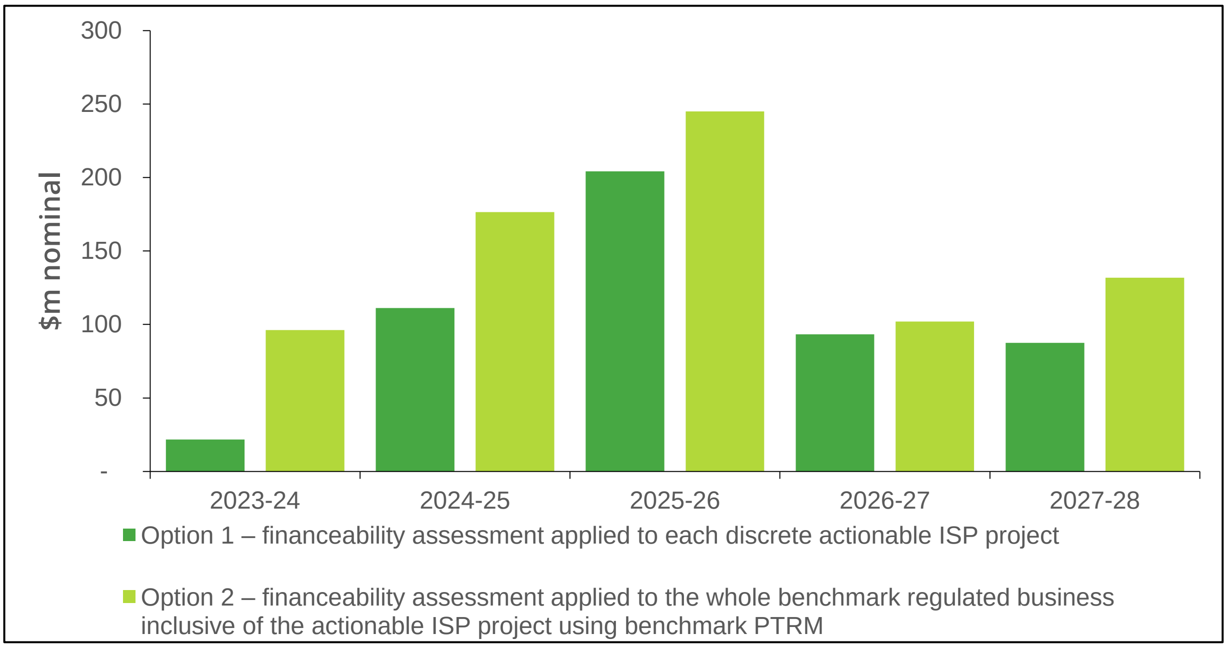

Figure 1 shows that in this example if the financeability assessment were applied to the whole benchmark regulated business (i.e., Option 2), then significantly more regulated cashflows would need to be brought forward to ensure that the entire regulated entity can achieve a BBB+ benchmark credit rating at 60% benchmark gearing in each year than would actually be needed to make the project financeable.

This is because the existing benchmark business (i.e., without the actionable ISP project) is (under existing regulatory settings) not expected to generate sufficient cashflows to support the efficient benchmark BBB+ credit rating in any of the years of the 2023-28 regulatory control period.

This can be seen in Table 2 below, which presents three key financial metrics considered by Moody's when rating regulated energy networks in Australia, and the target thresholds for each metric.

[28] Note that when modelling the financeability outcomes for the whole regulated business (under Option 2), we have excluded any cashflows associated with Project EnergyConnect from the PTRM. This is because the financeability issues that related to that actionable ISP project were addressed via a financing agreement with the Clean Energy Finance Corporation, and therefore do not need to be addressed again via the proposed financeability formula. The inclusion of cashflows related to Project EnergyConnect would result in weaker financeability for the existing regulated business, and therefore more cashflows being accelerated in order for the benchmark regulated business to support a BBB+ credit rating at 60% gearing. Hence, the exclusion of the effect of Project EnergyConnect in this illustrative example is a conservative approach.

Table 2: Financeability metrics for existing regulated business (no ISP project) over the 2023-28 regulatory control period.

	Target threshold	2023-24	2024-25	2025-26	2026-27	2027-28
FFO/ND	9.0%	6.8%	7.0%	7.3%	7.8%	7.3%
FFO ICR	2.4x	2.5x	2.5x	2.6x	2.6x	2.5x
Gearing	60%	60%	60%	60%	60%	60%

As Table 2 shows, the FFO/ND for Transgrid's existing regulated business (as modelled by the AER's PTRM) falls materially short of the benchmark BBB+ threshold in every year of the forthcoming regulatory period. In our experience, Moody's attaches by far the most weight to the FFO/ND ratio when conducting rating assessments for Australian regulated energy networks. The FFO ICR surpasses the target BBB+ threshold in all years. However, as noted above, Moody's attaches less weight to this metric than to the FFO/ND ratio when conducting rating assessments for Australian regulated electricity networks. By construction, the gearing ratio for the benchmark regulated business reflected in the PTRM is always 60%, so is consistent with the target threshold in every year.

Under Option 2, sufficient ISP project cashflows would need to be brought forward not just to achieve the benchmark credit rating for the actionable ISP project, but also the benchmark credit rating for the existing benchmark regulated business. This results in more regulated cashflows being accelerated for the ISP project than would in fact be needed for that project to become financeable and proceed. That is, consumers would pay more in regulated charges over the forthcoming period than would be needed for the project to go ahead. Such an outcome, which is a direct result of assessing financeability at the level of the "network business level" will not promote the long-term interest of consumers as required by the National Electricity Objective.

By contrast, Option 1 would accelerate just enough regulated cashflows to ensure that the actionable ISP project is financeable and able to go ahead. As Figure 1 shows, these cashflows are materially lower in each year than the incremental cashflows required under Option 2. For this reason, we recommend that the AEMC adopt Option 1 for this financeability Rule Change. Such an approach would not seek to solve any financeability problems that might exist for the rest of the regulated business. Rather, Option 1 is targeted at solving only financeability problems that arise in relation to actionable ISP projects.

We also note the following considerations in support of Option 1:

» This is the basis on which revenue determinations for actionable ISP projects are made. The AER seeks (correctly) to set revenue allowances by estimating the efficient, benchmark costs of such projects as if they were discrete investments. The AER does not seek to set revenue allowances for such projects below the efficient cost on the basis that any shortfall could be met by surpluses generated by another part of the business. In our view, the regulatory financeability assessment should be guided by the same principle. A benchmark efficient business that had no access to sources of revenue beyond those set by the regulator in a revenue determination for an actionable ISP project could not rely on such cashflows to address a financeability problem in relation to that project. Hence, the financeability test should be consistent and not have regard to any extraneous considerations outside the revenue determination for each discrete actionable ISP project.

» Commercial investment decisions for individual projects of this size are made assuming that those projects are standalone. Rational firms do not make commercial investment decisions on the basis that projects that are not financeable in their own right can proceed on the basis that they can be subsidised by cashflows generated by other assets.

» Under Option 2, the adjustment to the regulated cashflows necessary to make an actionable ISP project financeable will depend not only on the cashflows associated with that project, but also who the proponent of the project is and their financial strength. This would mean that two groups of consumers served by identical actionable ISP project assets may pay different amounts in individual years for regulated services depending on the particular financial circumstances of the TNSP delivering each project.

- In this illustrative example (which reflects a plausible scenario that could be faced by TNSPs regulated by the AER), the incremental cashflows under Option 2 that would need to be brought forward to satisfy the financeability formula are so high that the project costs would be recovered much more quickly than would occur if the financeability assessment were performed on a discrete basis (i.e., Option 1). Since the bring-forward of cashflows is NPV-neutral, this would mean that much reduced cashflows would be available in future years. The more rapid depreciation of the project under Option 2 could therefore create financeability problems in future years that cannot be resolved because once the actionable ISP project assets have been depreciated fully, there would be no future cashflows available to accelerate.

3.4 Application of Financeability test to AER Benchmark Parameters or Proponent's Prevailing PTRM? The 'No Worse Off' Test.

We also considered a version of the financeability test in which the formula is used to ensure that the ISP project makes the proponent firm 'no worse off.' This approach would apply the same test as above except that the threshold metrics would reflect the proponent's prevailing PTRM rather than the AER benchmark BBB+ rating. For example, if the proponent's current PTRM has financial metrics that support a BBB rating, the financeability test would target that same BBB rating rather than the AER's benchmark BBB+ rating.

Under this approach, there is no distinction between applying the test to the PTRM of the discrete ISP project or to the PTRM of the combined firm – because the financial metrics of the existing firm would be maintained at their current level. Consequently, this 'no worse off' approach is equivalent to applying either Option 1 or Option 2 from above, but with the financial metrics from the existing firm rather than the financial metrics that would be required to support the AER's benchmark BBB+ rating.

The key advantage of this approach is that it is consistent with how some TNSPs evaluate investment and financing decisions – i.e., by considering the incremental impact of a particular project on the existing portfolio of regulated assets, to ensure that proceeding with the individual project would not result in a credit downgrade for the whole regulated business.

Our detailed analysis of this 'no worse off' approach has identified the following issues:

- The assessment of ISP projects under this approach would be dependent on the circumstances of the proponent at the time the AER makes a revenue determination. Identical ISP projects would receive different cashflow uplifts depending on the starting circumstances of the proponent's existing business. If the PTRM of the proponent firm currently supports a BB rating, that would be applied to the ISP project. And if the PTRM of the proponent firm currently supports an A+ rating, that would be applied to the ISP project.
- At the time investors commit to the project there may be some uncertainty as to likely credit rating position of the regulated business in the future, which would in turn create some uncertainty regarding the expected regulated cashflows. Consequently, under this approach, there may be some uncertainty for investors regarding the cashflow adjustment (if any) that would be made in the AER's revenue determination for the actionable ISP project to solve a financeability problem. Hence, the approach would not provide investors with the certainty and predictability of outcomes they require to commit to actionable ISP projects.
- The adjustments to regulated cashflows may be insufficient to ensure that a prospective actionable ISP project is in fact financeable. Consider, for example, a situation where the benchmark regulated business has a sub-investment grade (e.g., BB) rating before it undertakes a proposed actionable ISP project. In this situation, if the financeability formula is designed to ensure that the business is 'no worse-off' with the project than without it, then the regulated cashflows brought forward would only be sufficient to ensure maintenance of this sub-investment grade rating. In these circumstances, the proposed formula would not succeed in securing the financeability of the project.
- This approach would target financeability outcomes that may be materially different from the benchmark credit rating adopted by the AER when setting regulatory allowances. The AER's current RoRI assumes, when setting the allowed rate of return, that the benchmark regulated business maintains a BBB+ credit rating (at 60% gearing) in

each regulatory year. It would therefore be internally inconsistent (and incompatible with the benchmark principle) for the financeability formula to adjust the depreciation allowances of an actionable ISP project to support a higher or lower credit rating for the benchmark regulated business.

For the reasons explained above, we consider that the financeability formula should:

- Target financeability outcomes that are consistent with the benchmark credit rating (currently BBB+) at the benchmark level of gearing (currently 60%); and
- Focus on the financeability outcomes of each individual actionable ISP project rather than the financeability outcomes of the whole business undertaking each project.

While in our view these considerations suggest that Option 1 above should be pursued, on balance we also consider there could be value in the AEMC considering this option more closely to determine if it could better promote the long-term interests of consumers.

3.5 Implementation Issues Previously Raised by the AEMC

The AEMC has previously expressed a number of views about implementing changes to the Rules that would require a formulaic assessment of financeability:

- Any financeability problem identified should be addressed through an NPV-neutral adjustment to depreciation allowances;
- Any financeability adjustments should be targeted only to those specific projects that have a financeability problem;
- Rating agencies take account of qualitative factors that cannot be codified formulaically; and
- It is inappropriate to rely on a single financial metric (such as the FFO/net debt ratio) when conducting financeability assessments.

We address each of these issues below.

3.5.1 Financeability Problems Should be Addressed in an NPV-Neutral Way

The AEMC has indicated that the appropriate way to address financeability problems associated with actionable ISP projects is through an NPV-neutral adjustment to depreciation allowances:

> *The Commission considers that changing the TNSP's cashflow profile through a net present value (NPV) neutral adjustment to depreciation is an appropriate solution to address financeability issues, should they arise in the future. This aligns with the Commission's position in the draft report that adjusting the rate of depreciation is more appropriate and proportionate for addressing short-term impacts from specific projects than changes to the rate of return.*[29]

We have taken the AEMC's view onboard in the development of this proposed Rule Change. In particular, any financeability problems identified by our proposed formula would be addressed only through an NPV-neutral adjustment to the regulated cashflows via the depreciation allowance. The financeability formula would not require any adjustment to the allowed rate of return. Any required adjustment to the depreciation allowance to address a financeability problem could be implemented in a completely formulaic way. The quantum of any such adjustment would be the minimum required to address the financeability problem.

[29] AEMC Stage 2 Report, p. 10.

3.5.2 Adjustments to the Depreciation Allowance should be Targeted Towards those Specific Projects that have Financeability Problems.

The AEMC has indicated that regulatory action to address financeability concerns should be targeted only towards those specific actionable ISP projects where genuine financeability problems have been identified:

> *A more targeted approach to considering financeability, only where this is raised by a business with respect to a specific actionable ISP project, would be more appropriate given the issue is likely only to arise in limited circumstances.*[30]

We agree with this position. Our proposed financeability formula is designed such that adjustments to regulated cashflows (via the depreciation allowance) would only be made if a financeability problem is objectively identified. No adjustment to regulated cashflows would occur:

- If there is no objectively identified financeability problem in relation to an actionable ISP project; or
- In relation to non-ISP investments.

In particular, under our proposed approach there would be no adjustment in relation to any financeability issue that might exist in relation to existing RAB assets. Our view is that any such issue should not be addressed via a Rule Change relating specifically to ISP projects.

3.5.3 The Role of Qualitative Factors in a Regulatory Assessment of Financeability.

In response to the AEMC's Draft Report on Stage 2 of the Transmission Planning and Investment Review, we proposed that the Rules be amended to incorporate a mandatory and formulaic regulatory financeability test that would apply to actionable ISP projects.[31] A key feature of that test (like the financeability formula that we propose now) was that it involves an objective formula based on key credit metrics.

In response to that submission, the AEMC stated that:

> *Moody's and other credit rating agencies combine an assessment of both qualitative and quantitative metrics to arrive at an overall rating...there are a range of company-specific factors that contribute to credit ratings and credit metric thresholds, such as how a company has structured their balance sheet and the risks associated with non-regulated revenues. These factors may lead to a narrowly defined approach to assessing financeability producing unintended consequences*.[32]

The AEMC has indicated that a formulaic assessment of financeability based on quantitative considerations only "would be unlikely to promote the long-term interests of consumers in all cases" because such an assessment would not be able to incorporate the qualitative factors that rating agencies such Moody's take into account when undertaking rating assessments.[33]

In its published *Ratings Methodology*, Moody's identifies the quantitative metrics discussed above and it also identifies a number of qualitative factors such as:[34]

- The stability and predictability of the regulatory regime;
- The extent to which regulatory allowances cover the cash costs incurred by the network;
- The scale and complexity of the network's capital program;
- The firm's financial policy; and
- The quality of the firm's management.

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30 AEMC Stage 2 Report, p. 13.

31 The details of that financeability test are set out in: Frontier Economics, *Addressing financeability challenges associated with major transmission investments*, 13 July 2022.

32 AEMC Stage 2 Report, p. 13.

33 AEMC Stage 2 Report, p. 13.

34 Moody's, Rating methodology – Regulated electric and gas networks, 13 April 2022.

For a given set of financial metrics, a network that scores more highly on the qualitative factors would be expected to receive a higher rating. That is, a firm with financial metrics that are consistent with a particular rating may receive a rating some notches higher on the strength of its qualitative characteristics.

Actual ratings reports indicate that Moody's considers Australian electricity networks to score highly on the set of qualitative factors. Specifically, in reports for Australian networks, Moody's has indicated that quantitative metrics that would otherwise support a lower rating, would be sufficient to support an investment grade rating in Australia.

That is, the quantitative metrics required for an average Australian network to achieve a BBB+ rating are lower than they would otherwise be, due to relatively strong scores on the qualitative factors.

We have taken this qualitative consideration into account in our proposed test by adopting thresholds that are lower than those set out in Moody's published methodology. Specifically:

» We have adopted an FFO/Net debt threshold of 9% rather than the minimum of 11% that is required for an investment grade rating in the published Moody's ratings methodology; and
» We have adopted a FFO interest coverage ratio of 2.4 rather than the minimum of 2.8 that is required for an investment grade rating in the published Moody's ratings methodology.

The adoption of these lower thresholds (which appear in the Ba sub-investment grade range in the Moody's ratings methodology) reflect the fact that a strong qualitative assessment for the average Australian network can result in the rating rising several notches. Consequently, our proposed test would be easier to pass as a consequence of adopting these lower thresholds than it would be if the thresholds specified in Moody's standard global rating methodology were adopted.

We think that those qualitative factors that are defined for the benchmark firm by the AER are not relevant to the regulatory financeability test—because every benchmark efficient firm would (by virtue of the regulatory assumptions made by the AER) perform equally well in relation to those factors.

This only leaves those qualitative factors that vary between Australian regulated firms. It is not clear to us how these factors could be taken into account in a financeability analysis while still providing the sort of timely objective test that would be required to support the required investment (in the absence of Government support). In our view, these factors could only be taken into account by exercising some degree of regulatory judgement. However, this would mean that the outcomes of the test would no longer be objective, predictable, replicable, transparent or knowable to investors at the time a commitment was made to the project.

3.5.4 Use of Multiple Financial Metrics

The AEMC also expressed the following concern about the formulaic financeability assessment previously proposed by Transgrid:

> *…adopting specific metrics as the sole measure of businesses' financeability may not be appropriate… For example, while FFO/Net Debt is a key factor considered by Moody's, it is not appropriate for an assessment of financeability to rely so strongly on a single metric.*[35]

We agree with the AEMC that it would be inappropriate to rely on a single financial metric. As such, we propose that the financeability formula specified in the Rules should reflect the same range of financial metrics considered by rating agencies such as Moody's.

3.6 The Appropriate Level of Regulatory Discretion

The AEMC distinguishes between prescriptive and principle-based rules.[36] Under a prescriptive Rule, the manner or means of obtaining the objectives are specified in the Rule. Under a principle-based Rule, the objectives are specified in the Rule but the relevant entity is able to choose how they meet the objective.

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[35] AEMC Stage 2 Report, p. 13.

[36] AEMC, Rule drafting philosophy, 8 October 2020, pp. 5-9.

The objective of our proposed Rule Change is to ensure that regulated cashflows are sufficient for TNSPs to be able to finance actionable ISP projects and expect to receive a rate of return that is consistent with the RoRI. This is a necessary condition for investors to commit the capital required to deliver these projects for consumers.

In order to achieve this objective, we propose a requirement that allowed cashflows must be set at a level that is sufficient to support the AER's benchmark credit rating of BBB+ at the AER's benchmark gearing level of 60% debt (these parameters having been determined in the AER's 2022 RoRI).

This could be achieved in a prescriptive manner whereby a formula (as published by credit rating agencies) would determine the minimum level of regulated cashflows that would be required to support the benchmark credit rating and gearing levels.

The alternative is for the AER to be given the flexibility to assess whether a financeability problem exists and to determine what adjustment to the depreciation allowance may be required to address any financeability concerns identified.

Our view is that a prescriptive Rule is necessary in the current circumstances because:

- A formulaic approach to assessing and addressing financeability concerns that is specified in the Rules would maximise the investor certainty required to deliver the actionable ISP projects that would unlock material benefits to consumers, the environment and the broader economy. It would be available to investors at the time of making the investment decision, not afterwards.
- The AEMC notes that under a principle-based Rule, "the regulatory task is then to monitor outcomes and work with industry to ensure that the desired outcomes are achieved."[37] In the case at hand, there is unlikely to be time to try a less structured principle-based approach, observe the outcomes, and make changes to the approach if required. For example, a delay of two years for the AER to run a consultation process, develop a guideline, and then make adjustments if required, would amount to a quarter of the total time available to meet Australia's 2030 commitments.
- Credit rating agencies have already published the relevant financial metrics and thresholds that are used when determining credit ratings. It is not clear what is to be gained from substituting the metrics and/or thresholds that are actually being used by credit rating agencies when conducting rating assessments of regulated energy networks in Australia with either:
  - The AER's judgement about what credit rating would be supported in a particular case; or
  - The AER's judgment about what credit rating should be supported in a particular case.

  The determination of credit ratings is not within the core expertise of the AER.

3.7 Rationale for the Proposed Rule Change

Our proposed Rule Change would require an internally consistent regulatory framework where the cashflows based on a BBB+ credit rating are sufficient to achieve that credit rating for the benchmark firm. Importantly, our proposed Rule Change preserves the AER's regulatory benchmark credit rating and ensures that investors (equity and debt) can each have a reasonable expectation of receiving the AER's allowed return for that form of capital.

To the extent that the financeability issue can be addressed properly via a Rule Change such as that one that we have proposed, there will be less need for concessional finance from the Rewiring the Nation Fund because the allowed cashflows provided by the regulatory regime would be sufficient for actionable ISP projects to be commercially viable. Electricity consumers' interests are best served by ensuring that the regulatory framework provides cashflows that underpin the commercial viability of actionable ISP projects. It would also be expected to reduce the transactions costs associated with securing bespoke concessional finance and reduce the risk of unintended consequences by increasing transparency of funding and financing decisions. It would also eliminate the long delays that arise in relation to the negotiation of bespoke financing arrangements, such as has occurred with actionable ISP projects to date.

[37] AEMC, Rule drafting philosophy, 8 October 2020, p. 6.

The AEMC has developed an assessment framework for its Transmission Planning and Investment review, which addresses (amongst other things) the issue of financeability.[38] The table below assesses our proposed Rule Change using the AEMC's framework.

Table 3: Assessment of our proposed Rule Change against the AEMC's criteria

Criterion	Explanation	Assessment of our proposal
Outcomes for consumers	Assesses whether the regulatory arrangements promote and appropriately balance the timely and efficient delivery of major transmission projects.	Our proposed Rule Change would remove a major barrier to investment in actionable ISP projects by providing up-front certainty to investors that financeability problems associated with those projects would be identified and addressed by the regulatory framework.
Economic efficiency	Assesses whether the solution promotes efficient investment in, and use of, electricity services in the long-term interests of consumers with regard to: 1. **Efficient risk allocation**: allocating risk (and costs) to parties best placed to manage them and who have the incentives to do so will support efficient decision-making. 2. **Effective price signals/incentives**: effective incentives are needed to support service providers in making efficient and timely investment decisions. 3. **Information provision/transparency**: service providers require clear adequate information to inform decision-making in an evolving market. 4. **Clear, consistent, predictable rules**: a stable regulatory environment creates confidence in the market and will encourage investment and innovation through the transition and beyond. Evaluates whether the solution provides service providers with a reasonable opportunity to recover at least their efficient costs.	1. **Efficient risk allocation**: Our proposed Rule Change would not result in any transfer of risk from TNSPs to consumers. Consumers would only pay the efficient cost of actionable ISP projects over the lifetime of those investments. However, failure to provide certainty to investors about how the regulatory framework will address financeability problems may result in actionable ISP projects (and the associated consumer and environmental benefits) being delayed or foregone altogether. The proposed Rule Change involves less reliance on bespoke concessional finance, which reduces delays associated with the negotiation of bespoke financing arrangements with the CEFC and reduces the risk of unintended consequences by increasing transparency of funding and financing decisions. The proposed Rule Change is also NPV-neutral and provides investors with nothing more than the benchmark financing and rate of return parameters set out in the AER's RoRI. 2. **Effective price signals/incentives**: Our proposed Rule Change would provide equity investors with confidence that they can expect to receive the allowed return on equity determined by the AER, rather than a lower return that would provide insufficient compensation for the risks that investors bear. This would provide efficient investment signals and incentives.

38 AEMC Stage 2 Report, p. 5.

Criterion	Explanation	Assessment of our proposal
		3. **Information provision/transparency**: Our proposed Rule Change, would provide equity investors with clarity and certainty over how financeability problems would be addressed before they commit capital to the project. Our proposed Rule Change also provides consumers with greater certainty that the actionable ISP projects that would deliver significant consumer benefits will not be delayed or foregone due to financeability problems. 4. **Clear, consistent, predictable rules**: Our proposed Rule Change would increase the predictability of outcomes under the regulatory framework, thus supporting efficient investment incentives.
Implementation	• Considers the complexity of implementing a solution, i.e., whether it will require law and rule changes or other jurisdictional legislative changes. • Assesses the costs of implementing a solution (practical implementation and compliance costs). • Evaluates the timing of costs and benefits.	Our proposed Rule Change: • would not require any consequential legislative changes; • would be relatively low cost to implement, requiring simple changes to the AER's PTRM to reflect the proposed financeability formula; and • unlock immediate benefits for consumers by removing a material impediment to investment in actionable ISP projects (i.e., investor uncertainty over how future financeability problems will be addressed).
Flexibility	• Assesses whether the solution is consistent with the long-term direction of energy market reform. • Evaluates whether the solution is flexible enough to accommodate uncertainty regarding unknown technological, policy and other changes that may eventuate.	• Our proposed Rule Change is an appropriate and proportionate measure that would facilitate Australia's energy transition. Such a transition would not be feasible without investment in actionable ISP projects. • Our proposed Rule Change is restricted to actionable ISP projects only. Hence, the arrangements that we have proposed would not apply to BAU TNSP assets or other non-ISP investments (e.g., investments made by DNSPs or regulated gas networks). • The proposed Rule Change supports the efficient delivery of projects identified through the existing planning framework, including the RIT-T and ISP. This planning framework addresses uncertainty through scenario analysis and sensitivity testing.

Criterion	Explanation	Assessment of our proposal
Decarbonisation	• Considers whether market arrangements will enable the decarbonisation of the energy market.	• Our proposed Rule Change is aimed at removing impediments and delays to investment in actionable ISP projects, which are critical to decarbonisation of the energy market.

4 Costs and Benefits of the Proposed Rule Change

The purpose of this section is to explain the costs and benefits of the proposed Rule Change. We present an illustrative actionable ISP project to examine the impact on consumers of our proposed financeability formula. We also discuss the inter-generational equity issues raised by the AEMC and the administrative costs of implementing our proposed Rule Change.

The remainder of this section presents the following information and analysis:

Section 4.1 addresses the impact of our proposed financeability formula by examining the annual costs and benefits of the proposed change for electricity

- Section 4.1 addresses the impact of our proposed financeability formula by examining the annual costs and benefits of the proposed change for electricity consumers. The key findings from this analysis are:
  - For an actionable ISP project with a capital cost of $3 billion, electricity consumers are estimated to receive total benefits of $9.6 billion over the life of the asset.
  - Addressing the financeability problems associated with the project would allow it to proceed on time and consumers would obtain the expected benefits. In addition, our analysis shows that:
    - For the first 14-years of the project, which includes three years of construction, network charges for this project would be above the level determined by the standard regulatory approach (i.e., without any financeability adjustment to regulated cashflows). These higher network charges would be offset by lower charges thereafter, leaving consumers NPV-neutral over the life of the project.
    - The final year of construction is the most significant in terms of financeability challenges. With the exception of this year, network revenues for this project would be approximately 60% above the standard regulatory model at commissioning, declining to around 25% six years after commissioning.
    - While the financeability issue is significant in magnitude and duration, consumers would still remain net beneficiaries in each year following project commissioning if the financeability problem were addressed by increasing the depreciation allowance. In the first year of operation, the total benefits to consumers would be approximately twice the price consumers would be asked to pay. These benefits would increase to approximately seven times the price charged by year 25.
- Section 4.2 discusses the intergenerational issues arising from the application of the financeability formula. The key point here is that current consumers are better off (over 5 years) and future consumers are also better off if the ISP project proceeds. Failure to solve a financeability problem would mean that the project may not proceed—in which case the net benefits that would otherwise accrue to all consumers would be foregone.
- Section 4.3 discusses the administrative costs associated with implementing the proposed Rule Change. It explains that these costs are very modest compared to the net benefit to consumers of ensuring that the regulatory framework supports the timely delivery of actionable ISP projects.

In summary, our proposed Rule Change ensures that consumers would only be asked to pay the minimum cost required in order to make actionable ISP projects financeable and thus be capable of proceeding in a timely manner. In exchange, consumers can expect to receive the significant benefits that these projects would unlock.

4.1 Impact of the Financeability Formula

The purpose of the analysis presented below is to show the consumer impact of our proposed financeability formula. For this illustrative example (which builds on the illustrative example introduced in section 0), our analysis assumes that: [39]

- The existing TNSP is modelled using the PTRM submitted by Transgrid in its revised revenue proposal to the AER for the 2023-28 regulatory control period.

[39] The model and its input assumptions will be provided to the AEMC to support this Rule Change request.

» The actionable ISP project has a total capital cost $3 billion and an asset life of 45 years.[40] The project takes three years to plan, construct and commission. Work on the project is assumed to commence in the first year of the 2023-28 regulatory control period.

» The total benefit obtained from the project is $9.6 billion in present value terms,[41] which is consistent with the average net benefit for actionable ISP projects estimated by AEMO in its 2022 ISP.

» The total annual benefit from the actionable ISP project is constant throughout the asset's life. This is a reasonable working assumption, although the urgent nature of actionable ISP projects suggests that greater benefits may be obtained in the early years.

» The financeability formula is applied throughout the project life, including the construction period, to ensure that any financeability issues are addressed by accelerating depreciation by the minimum required amount.

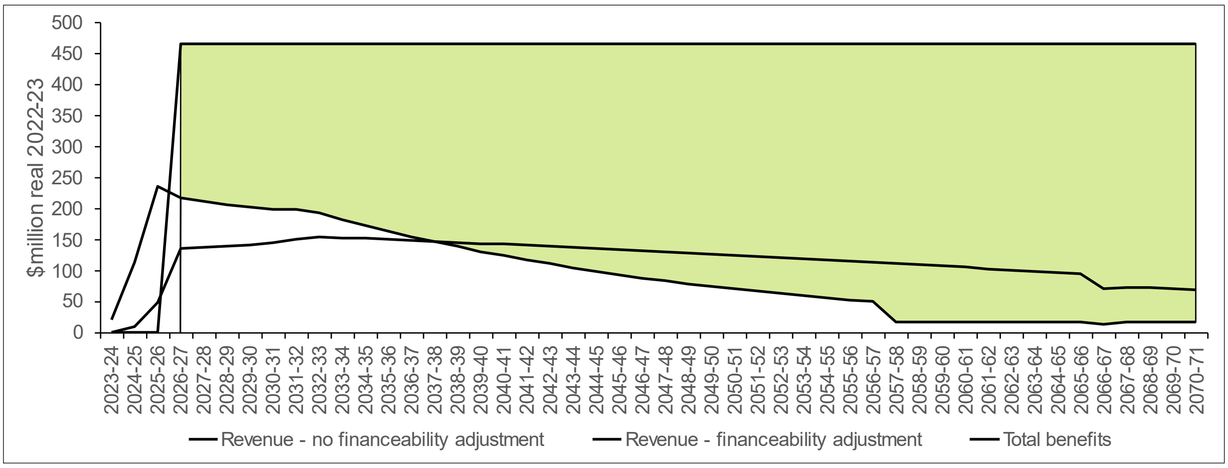
» The assessment of financeability is performed at the level of the discrete ISP project.

The results of this analysis are presented in Figure 2 below.

Figure 2 shows the annual network charges for this illustrative project under the standard regulatory model (the dark green 'Revenue – no financeability adjustment' curve). Where the application of our proposed formula identifies a financeability issue, this is addressed by accelerating the depreciation allowance for the actionable ISP project by the minimum amount required to support a BBB+ benchmark credit rating at 60% benchmark gearing. The resulting annual network charges are also presented in Figure 2 (the light green 'Revenue – financeability adjustment' curve).

The total real annual expected benefits to consumers from the actionable ISP project (the black 'Total benefits' curve), which arise principally from lower wholesale prices, sit substantially above the annual network charges that would accrue if the financeability issue were addressed. The net benefits to consumers (the shaded region representing the difference between the black and light green curves) are positive and very substantial in every year of the project following commissioning.

Figure 2: Consumer impact of the proposed financeability formula (real $2022).



It is critical to recognise that *none* of these net benefits would be realised in the circumstances where a financeability problem that remained unaddressed prevented the project from proceeding. That is, the net benefits from the project if the financeability problem were not addressed by the regulatory framework (i.e., the difference between the black and dark green curves) would be unattainable because in those circumstances the project would not go ahead in the absence

[40] For context, the current expected cost of HumeLink is approximately $3.3 billion.

[41] AEMO's Integrated System Plan 2022, June 2022, page 15. In accordance with the ISP, this estimate reflects a net benefit of 2.2 times the capital cost – i.e., $3 billion + 2.2 x $3.3 billion = $9.6 billion of estimated total consumer benefit.

of Government support (which would also involve an additional delay while the details of that additional support are negotiated).

The key points to draw out from this illustrative example are:

- In 2025-26, the regulated revenues for this illustrative ISP project under the scenario where the financeability problem is addressed is approximately 60% higher than the revenues for the project if the financeability problem were not addressed. This 'gap' then declines steadily over time to 2037-38. For the remainder of the project's life, the relationship reverses and the revenues under the scenario where the financeability problem is addressed are *lower* than the revenues under the scenario where the financeability problem is not addressed. Over the life of the project, consumers pay the same total network charges in NPV terms under both scenarios.
- The financeability problem is significant in duration and magnitude, as it requires a material increase in network charges for a 14-year period. Therefore, it is not that case that investors could 'look through' a relatively short period where regulated cashflows are below the required level. In the absence of Government funding, and if no regulatory action is taken to address the financeability problem, the regulated revenues would not provide sufficient cashflows over this period for the project to be financeable and it would not proceed.
- The net benefits to consumers from the actionable ISP project remain material and positive in every year of the project after commissioning, including in those years when regulated cashflows need to be increased to address a financeability problem. This means that although consumers are being asked to pay more for this project compared to the standard regulatory model, the benefits they obtain from the project are always at least twice the annual network charge attributable to the actionable ISP project.

While this example is illustrative only, it demonstrates that the consequences of not addressing the financeability problem are significant for customers. Our modelling suggests that all consumer groups (including residential customers) would be net beneficiaries if our Rule Change request were adopted so that financeability problems could be addressed effectively and predictably, thus allowing actionable ISP projects to proceed in a timely manner.

4.2 Considerations About Intergenerational Equity

The AEMC's Final Report on Stage 2 of the Transmission Planning and Investment Review and recommended rules provisions included the following principle to guide the AER's approach to amending the depreciation profile to address a financeability issue:

> *The AER will have regard to any impact on inter-generational equity as a result of a decision to amend a depreciation profile.* [42]

Our proposed Rule Change focuses on ensuring that the regulatory framework will support the timely delivery of actionable ISP projects by ensuring that the allowed revenues are consistent with the benchmark parameters adopted in the RoRI. Importantly, these projects will reduce the total costs of electricity to consumers, meaning that *all* consumers would be better off if these projects proceed. This observation is illustrated by the analysis presented in section 4.1, which shows that a $3 billion project may be expected to provide total benefits to consumers of $9.6 billion.

We recognise the concern that accelerating the depreciation allowance to address financeability problems may result in higher transmission charges for near-term consumers compared to the standard regulatory model. However, the above modelling demonstrates that current consumers are better off (over 5 years) and future consumers are also better off if the ISP project proceeds. Failure to solve a financeability problem would mean that the project may not proceed—in which case the net benefits that would otherwise accrue to all consumers would be foregone.

Hence, the primary objective must be to address the financeability issue to ensure that these projects proceed as planned, thus unlocking benefits to all consumers—including over the short-term and the long-term.

We note that the AEMC's reasoning on intergenerational equity appears to be closely aligned with our views on this issue:

> *A shift in depreciation will be net present value neutral from the perspective of the TNSP. This means that consumers overall will pay the same over the life of the asset. Near-term consumers will pay a*

[42] AEMC Stage 2 Report, p. 12.

larger share than later consumers, but this in turn allows the project to proceed. If shifting of the depreciation profile allows the project to proceed in a timely manner then these consumer benefits from the delivery of the project can be unlocked. We expect the AER will have regard to this perspective when assessing requests to amend depreciation profiles. [43]

It is only possible for near-term consumers to be 'worse off' in the short-term if the price they are required to pay for the project exceeds the benefits they expect to receive. Our analysis in section 4.1 shows that this is unlikely to be the case. As this illustrative actionable ISP project demonstrates, both sets of consumers will be worse off if the project is delayed or does not proceed. Both groups of consumers would be strictly better off if the project proceeded on time, even if that required consumers in the short-term to pay more via accelerated depreciation charges. This observation is consistent with AEMO's view that the actionable ISP projects are urgently needed – i.e., they will deliver substantial benefits to near-term consumers.

Furthermore, many consumers will be both near term *and* future consumers. Intergenerational equity concerns do not arise for such consumers.

In summary, our view is that consumers' interests are best served by ensuring a clear and predictable process is prescribed in the Rules to ensure that any financeability problems that arise in relation to actionable ISP projects are addressed effectively. Our illustrative example in section 4.1 shows that near-term consumers are likely to be significantly better off as a result of our proposed Rule Change.

4.3 Administrative Costs Associated with Implementing the proposed Rule Change

There are no significant administrative costs for proponents of actionable ISP projects arising from our proposed Rule Change.

The Rule Change would require the AER to amend its PTRM to incorporate the financeability formula in the Rules. However, this would be a straightforward task that could be implemented readily. We have already developed an amended PTRM to reflect our proposed Rule Change. This amendment would be a useful starting point for the AER's process to amend the PTRM. The input data required to implement a financeability formula is already available in the AER's existing PTRM. Therefore, no new information would be needed in order to implement the proposed financeability formula.

Because the proposed Rule Change would allow actionable ISP projects to be financeable, there would be no need to rely on concessional Government finance to deliver these projects, and the transactions costs associated with securing such finance could be saved.

5 Assessment against the National Electricity Objective

5.1 How the Proposed Rule Change Contributes to the National Electricity Objective

The National Electricity Objective (**NEO**) is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to—

(a) price, quality, safety, reliability and security of supply of electricity; and

(b) the reliability, safety and security of the national electricity system.

AEMO's ISP explains that major new transmission projects are urgently required to support Australia's transition to renewable energy and the achievement of Australia's international net zero commitments. The ISP already identifies a range of transmission projects throughout Queensland, New South Wales, Victoria, South Australia and Tasmania. The Federal Government has also made it clear that these projects are necessary to achieve three key strategic objectives:

[43] AEMC Stage 2 Report, p. 12.

» maintaining a reliable supply of electricity;
» bringing on new sources of renewable energy as quickly as possible; and
» pushing down the cost of electricity to consumers.

Each of these strategic objectives is closely aligned with the NEO. In particular, each objective is focused on promoting efficient investment for the long-term interests of consumers of electricity in relation to price, quality, reliability and security of supply.

Actionable ISP projects are expected to deliver net benefits of $28 billion over the life of these projects. Consequently, a failure to deliver these projects in a timely manner will substantially increase the costs of providing reliable and secure electricity services to consumers. It follows that improvements to the regulatory framework that support the timely delivery of actionable ISP projects are in the long-term interests of consumers, in accordance with the NEO.

For the reasons already explained in section **Error! Reference source not found.**, financeability risks arise under the current regulatory framework that jeopardise the timely delivery of actionable ISP projects, and therefore a Rule Change is required to promote the long-term interests of consumers in accordance with the NEO. We note that the AEMC's Final Report on Stage 2 of the Transmission Planning and Investment Review reached the same conclusion:

> *The Commission's final recommendation is that the revenue-setting framework will benefit from explicit flexibility to address the risk that financeability challenges may prevent future actionable ISP projects from progressing in a timely manner*.[44]

In relation to the Rule Change proposal, we note that it will enable actionable ISP projects to attract equity and debt finance in internationally competitive markets for project funding by:

» providing investors with the confidence that equity and debt will achieve appropriate rates of return in accordance with a well-functioning regulatory framework;
» establishing a transparent and objective mechanism for identifying and resolving financeability problems;
» ensuring that the regulated cashflows produced by the revenue setting process are consistent with the AER's building block approach and input assumptions, including its BBB+ benchmark credit rating; and
» providing revenue allowances for actionable ISP projects that recognise the fact that the debt used to finance actionable ISP projects must be raised at the prevailing market cost of debt.

By promoting these outcomes, the proposed Rule Change will remove the risk to customers that actionable ISP projects that are urgently needed to provide reliable electricity supply at the lowest total cost to consumers cannot be financed through the regulatory framework. As such, the proposed Rule Change would promote the achievement of the NEO.

5.2 Consideration of the Revenue and Pricing Principles

As the proposed Rule Change relates to regulated revenue that may be earned by TNSPs, section 88B of the National Electricity Law requires the AEMC to take into account the revenue and pricing principles in making a Rule. To assist the AEMC in this regard, the revenue and pricing principles that are most relevant to this Rule Change are discussed below.

» Section 7A(2)(a) of the NEL states that:

> *A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services.*

As explained in section 3, the current regulatory framework does not satisfy this principle in relation to actionable ISP projects. The Rule Change request would address this issue by ensuring that each form of capital (debt and equity) in the capital structure is able to earn its respective market return. This revenue and pricing principle therefore supports the proposed Rule Change.

» Section 7A(6) of the NEL states that:

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44 AEMC Stage 2 Report, p. 7.

regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in, as the case requires, a distribution system or transmission system with which the operator provides direct control network services.

We note that this principle captures the central rationale for the proposed Rule Change which is to avoid the economic costs of under-investment that would follow if one or more actionable ISP projects is delayed or cannot be financed. Accordingly, we regard this revenue and pricing principle as supporting the proposed Rule Change.

6 Contact Details

This Rule Change proposal is submitted by Energy Networks Australia (ENA).

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Appendix A – Proposed Rule Change text

The AEMC has published a set of draft Rule Changes alongside its Final Report on Stage 2 of the Transmission Planning and Investment Review.[45] This Appendix presents our proposed amendments to the text of the AEMC's draft Rule Change to reflect our Rule Change request.

We propose an amendment of the proposed new paragraph (f) of rule 6A.6.3 as follows:

(f) In making a determination under paragraph (d), the AER must adopt a method of depreciation that is sufficient to maintain the benchmark credit rating at the benchmark level of gearing adopted in the prevailing Rate of Return Instrument for each proposed actionable ISP project for each year of the regulatory determination.

For the purposes of determining whether a method of depreciation is sufficient to maintain the benchmark credit rating, the AER must apply the following formula:

$$35.71\%\frac{FF0/ND_t}{9.0\%} + 28.57\%\frac{FF0\ ICR_t}{2.4} + 35.71\%\frac{Gearing_t}{Gearing_t} \geq 1,$$

where:

- *t is the regulatory year;*
- $FF0/ND$ *is the Funds From Operations (FFO) to net debt ratio calculated using the AER's PTRM;*
- *9.0% is a benchmark BBB+ threshold for the FFO to net debt ratio;*
- $FF0\ ICR$ *is the FFO interest coverage ratio calculated using the AER's PTRM;*
- *2.4x is a benchmark BBB+ threshold for the FFO interest coverage ratio; and*
- $Gearing$ *is the benchmark level of gearing specified in the applicable Rate of Return Instrument.*

We also propose an amendment to the proposed new paragraph (d) of rule 6A.6.3 to include the following words at the end of the sentence, before the full stop:

(d) *…., for the life of the asset*.

[45] AEMC, Proposed Rule change: TPIR Stage 2, October 2022.