PUBLIC FORUM ON FINANCEABILITY OF ISP PROJECTS RULE CHANGE REQUESTS

AEMC WEBINAR

26 NOVEMBER 2020

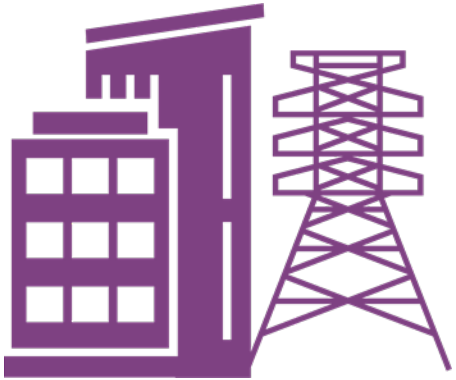
AEMC

Agenda

1.	Introduction – David Feeney, AEMC
2.	Opening remarks – Michelle Shepherd, AEMC Commissioner
3.	Overview of the regulatory framework – Alex Oeser, AEMC
4.	Overview of proposal – Jason Conroy, TransGrid
5.	Overview of proposal – Rainer Korte, ElectraNet
6.	Update on related AER work program – Warwick Anderson, AER
7.	Q&A – All
8.	Closing remarks – David Feeney, AEMC

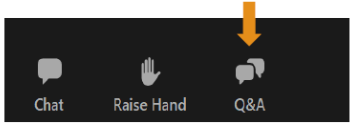
Housekeeping

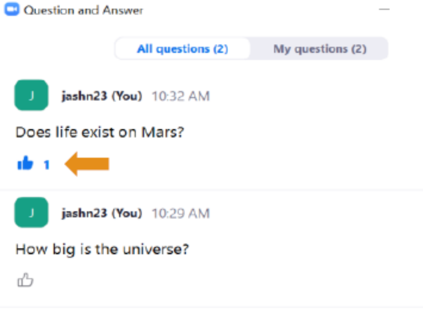
- All participants (except those providing presentations) are currently in 'listen only' mode
  - We'll switch you to speaking mode as needed during the Q&A
- Presentations from today will be posted on our website after the webinar
  - See the project pages for ERC0320 and ERC0322 at www.aemc.gov.au
- Today's session will be recorded and made available on request
- Please engage respectfully



Zoom Q&A function

- Q&A function is open throughout the webinar
  - Use the Q&A button on the bottom of your screen
- ‘Upvoting’ function
  - We will try to answer all questions, but will prioritise questions with most ‘upvotes’ first
- ‘Dismissed’ queue is a Zoom term
  - We will move questions here only if they are duplicates





Asking questions

- Questions will be answered at the dedicated Q&A session
- Please keep questions on topic and avoid making comments
  - we have a large audience and limited time
- When asking questions, please indicate which presenter you are directing your question to
- If requested by the moderator, please switch your mic or mic/video on to further explain your question
  - note your mic/video will not be switched on if you specifically request it not to be
- If we don't get to your question during the forum, the proponents and the AEMC will endeavour to get back to you

OPENING REMARKS

MICHELLE SHEPHERD, AEMC COMMISSIONER

OVERVIEW OF THE REGULATORY FRAMEWORK

ALEX OESER, AEMC SENIOR ADVISER

AEMC

What do we mean by financeability and why does it matter?

- Financeability refers to the capacity of a business to finance its investment activities
  - This includes investments in new and replacement capital assets
- **Financeability tests** used by some regulators as part of their regulatory determinations (Ofgem, IPART)
  - Notional gearing ratio and suite of financial metrics used to test whether allowed revenue is sufficient level for a *business* to remain financeable
- **Financeability** also used to refer to whether a business is able to raise debt finance for a *project* consistent with its regulated gearing level and target credit rating
- Financeability is not an explicit part of the National Electricity Law.
  - However, financeability issues could potentially impact achievement of the National Electricity Objective if those issues result in higher costs or lower benefits for consumers

How does the regulatory framework deal with investments in transmission assets?

The income a network business earns on an asset investment is made up of two components:

1. A **depreciation allowance** earned as the value of the asset is written down over time
   - Currently an asset must be commissioned before this revenue is earned
2. An allowed **rate of return** on the (depreciated) asset value
   - To ensure investors are compensated for inflation, the AER currently targets a real rate of return and applies this to an asset base indexed by inflation each year
   - An alternative would be for the AER to target a nominal rate of return and apply this to an unindexed asset base. Either option should ultimately provide the same value of compensation to the investor, but the cash flow profiles over time will be quite different.

See **Fact Sheet: Financeability** at www.aemc.gov.au

What questions do we seek to answer?

- The key issues we are seeking to explore as part of this consultation process include:
    - Does the current regulatory framework allow for efficient cost recovery of a benchmark efficient firm?
    - What are the potential implications of creating a second RAB for ISP assets?
    - What are the likely consumer impacts of the rule change requests?
- We welcome your views on these issues and any other relevant matters in submissions due on **3 December 2020**

RULE CHANGE REQUESTS

PRESENTATIONS FROM THE PROPONENTS

TransGrid, Jason Conroy, Chief Financial Officer
ElectraNet, Rainer Korte, Group Executive Asset Management

Making ISP Projects Financeable

Jason Conroy – Chief Financial Officer

AEMC Public Forum

26 November 2020

Delivering the ISP for customers

> We support the Integrated System Plan (ISP) as the optimal path to providing customers with reliable, secure, affordable and clean electricity.

> We are committed to delivering the ISP projects with our stakeholders, subject to them being financeable.

> Financeability issues have been under examination by regulators and the sector over the last year.

> We have worked with the Australian Energy Regulator on these issues – leading to the submission of this rule change proposal.

TransGrid

Major Projects are not financeable under the NER

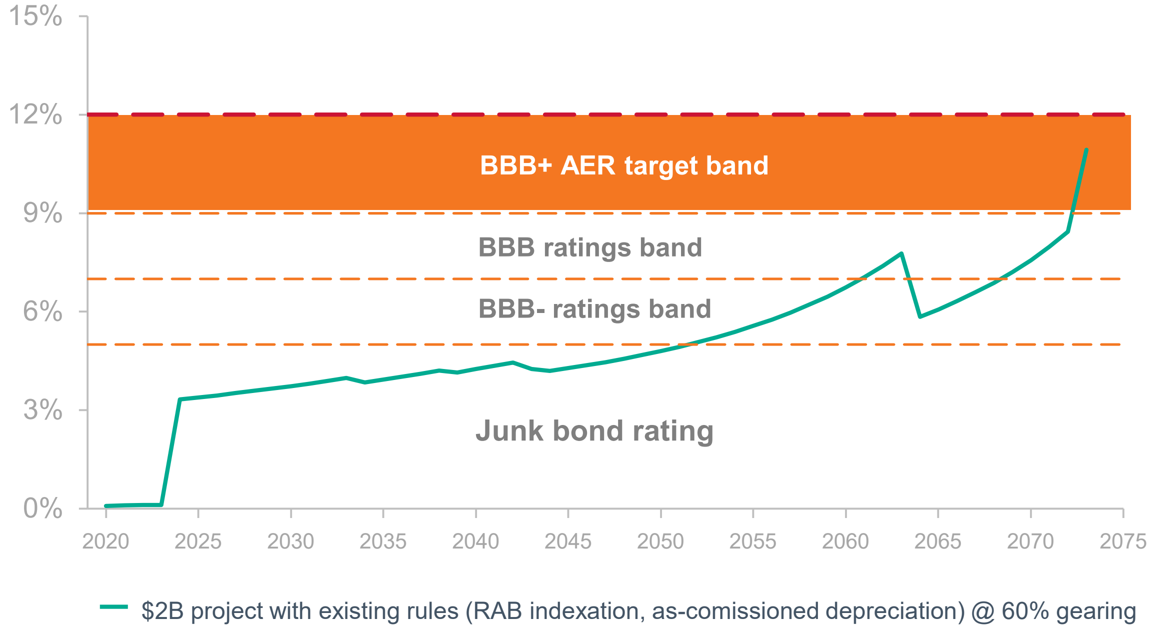
Under the National Electricity Rules, an efficient benchmark business is assessed as having 60% debt funding at a BBB+ credit rating.

> Cash flows from a typical ISP project will be insufficient to support 60% debt funding at a BBB+ credit rating.

> The current rules do not achieve: the regulatory policy for 55 years, or minimum investment grade for over 30 years.

> This creates a significant barrier to securing project funding and undermines the incentive to invest.

Funds from Operations / Net Debt, Illustrative $2 Billion Project



What will make ISP Projects financeable?

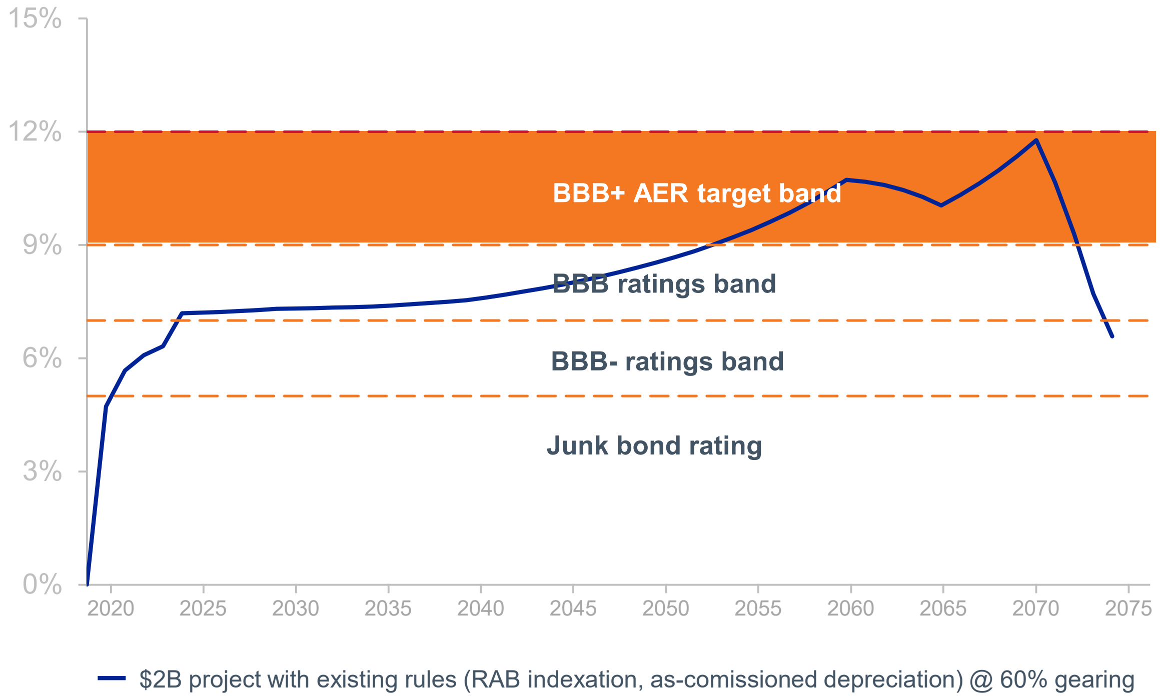
1. Remove indexation of the RAB for investment in major ISP projects.

2. Calculate depreciation on an 'as incurred' basis for the ISP projects.

Put simply, the rule change request seeks to bring forward revenue for a project which will provide benefits to customers for decades ahead.

The proposed rule change adjusts revenue profile on an NPV-neutral basis to improve project financeability.

Funds from Operations / Net Debt, Illustrative $2 Billion Project



TransGrid

How do customers benefit from the rule change?

If the rule change is approved there will be benefits for customers and the energy system.

ISP projects will be financeable and built, which will lead to lower electricity bills.

It is NPV-neutral for customers

No additional revenue to TransGrid

How will NSW customers benefit from EnergyConnect?

When applied to the ISP project EnergyConnect, the benefits include:

Lower electricity bills for customers
($180m in savings each year for NSW households)

More competition between generators – putting downward pressure on wholesale electricity prices

Increased system security and resilience

More renewable generation connected to the grid – lowering carbon emissions

1,500 construction jobs and around $4 billion in economic benefit

TransGrid

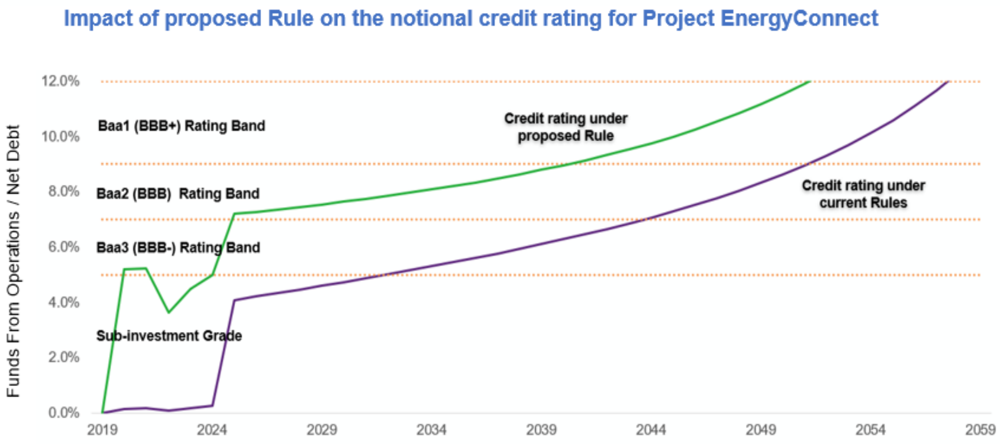
Making ISP Projects Financeable
ElectraNet Rule Change Request

Rainer Korte, Group Executive Asset Management

26 November 2020

Proposed Rule rebalances cash flow timing to support the financeability of ISP projects, without increasing total revenue

- Under the current rules, the revenue recovered from PEC would be insufficient to support even a baseline investment grade rating for several years
- Rule change proposal adopts a targeted approach delivering cashflows more consistent with an investment grade rating
- This would increase average customer charges in SA by about $5 pa in the current period
- This is more than offset by the net price reductions of $100 pa estimated by ACIL Allen

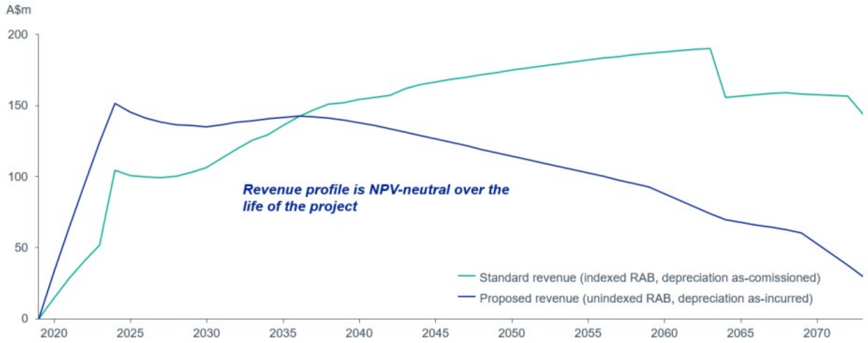


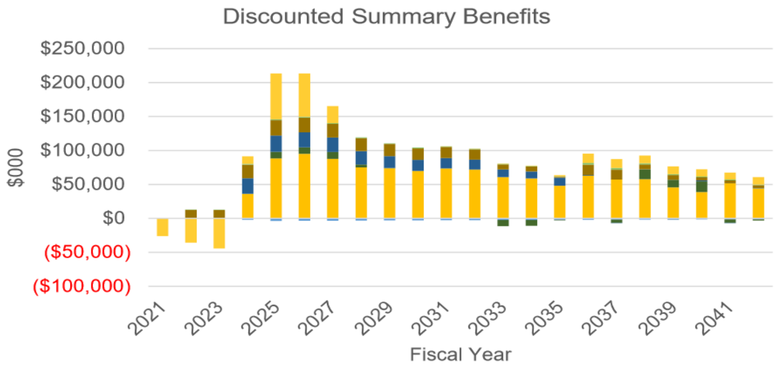
ElectraNet

The rule presents a targeted solution to address the identified shortcomings of the current framework

- The rule supports a timely investment decision on PEC, which is required for the security and reliability of the electricity supply system, as identified by AEMO

- The revenue recovery profile under the rule would align much more closely with the profile of expected benefits, improving inter-generational equity

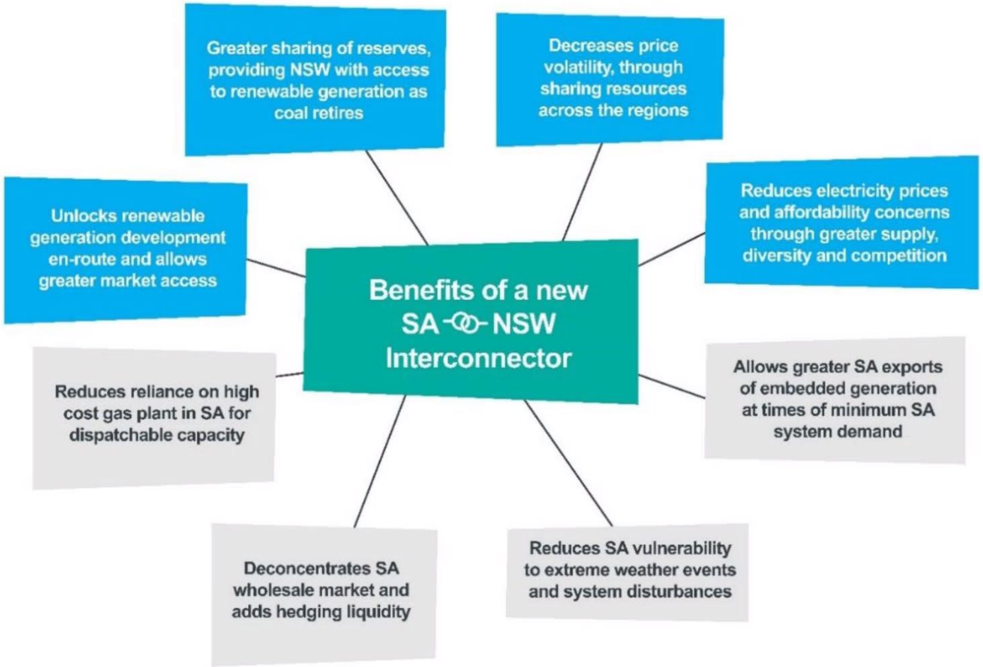




ElectraNet

A timely investment decision is required to deliver the benefits of stronger interconnection

- PEC is a central part of AEMO's roadmap for the transition of the NEM and delivers a range of benefits
- For NSW customers, benefits include improved diversity of supply and access to cheaper renewable energy sources as the coal fleet progressively retires – it also unlocks significant renewable energy development en route
- For SA customers, benefits include access to additional capacity when needed to replace expensive gas generation and improved resilience and security of the power system
- Modelling shows expected customer price reductions in both regions which outweigh the additional transmission costs by a factor of 6 - 7 times or more



ElectraNet

PRESENTATION FROM THE AUSTRALIAN ENERGY REGULATOR

WARWICK ANDERSON, GENERAL MANAGER, NETWORKS FINANCE AND REPORTING

AEMC public forum – ISP financeability rule change

26 November 2020

AUSTRALIAN ENERGY REGULATOR

AER engagement with TransGrid

- We had a series of discussions with TransGrid focusing on modelling assumptions and results
  - Included reviewing TransGrid's cash flow modelling
- We generally agree with TransGrid's modelling
  - Its FFO/Net debt ratio is likely to decrease, at an assumed gearing ratio, as a result of large investments relative to existing RAB
  - Impact is driven by low depreciation relative to the size of the remaining RAB still to be recovered in the early years of investments
  - Until the project is commissioned, the return of capital doesn't commence until commissioning

Modelling assumptions

- TransGrid's modelling assumes:
  - $2 billion investment with costs spread evenly over 5 years by asset classes
  - The model tracks the investment over a period of 50 years
  - The model also adopts the AER's 2018 RoRI, including a 60% gearing ratio and a trailing average return on debt
  - The modelling does not include opex or revenue adjustments, as it assumes for calculating the FFO these allowances are equal to expenses
  - To examine the combined impact of investment and existing RAB, the model assumes TransGrid's opening RAB as at 2018 and approved capex program for the 2018-23 period (this capex is repeated every 5 years)
- ElectraNet has not approached the AER prior to lodging its rule change application
- We have not seen any cash flow modelling from ElectraNet

Implications of the rule change

- The proposed rule change removes indexation from the RAB, which brings regulatory depreciation forward
  - This is a form of accelerated depreciation (and NPV neutral)
- No longer indexing the RAB effectively means a move to a 'nominal return' framework
  - This changes the balance of inflation risk. The implications of a nominal return framework are discussed further in our current inflation review draft position paper
- Depreciation under an as incurred (as opposed to an as commissioned) approach means customers start paying for the asset cost before it delivers a service

AER submission

- The AER is intending to put in a submission to the rule change
- Likely discussion points in our submission include:
  - What is the FFO/Net debt metric?
  - How does the current regulatory framework work?
  - A number of the AEMC's questions raised in its consultation paper

FFO/Net debt

- Our submission is likely to explore a range of questions, such as:
- Is the reduction in the FFO/Net debt a problem?
  – Based on our discussion with the ratings agencies, we understand they look at a range of factors (qualitative and quantitative)
  – One of theses factors is the FFO/Net debt – while we acknowledge it is an important factor, it is only one part of a suite of other metrics that should be taken as a whole
  – We note that ratings agencies do not look at 'hypothetical' benchmark cash flows, but the firm's actual cash flows

Managing FFO/Net debt metric

- If a lower FFO/Net debt metric is a problem, does this lead to financeability concerns?
  - Should concerns around financeability metrics be managed by the businesses themselves?
- And if there are financeability concerns requiring a rule change or regulatory response, what would this response look like?
  - Are there other alternatives to a rule change that can address these concerns?

AUSTRALIAN ENERGY REGULATOR

Q&A

HOST: DAVID FEENEY, EGM TRANSMISSION AND DISTRIBUTION NETWORKS

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CLOSING REMARKS

DAVID FEENEY, EGM TRANSMISSION AND DISTRIBUTION NETWORKS

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