Financeability of ISP Projects

Response to AEMC Draft Determination: Participant derogation – financeability of ISP projects

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Energy Networks Australia

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Key messages

- The issues highlighted by the TransGrid and ElectraNet derogation proposals are stark examples - given the size of the investments - of a broader trend of emerging issues of financeability for new investment across mature electricity and gas networks.
- To promote the long-term interests of consumers there should be a clear pathway for financeability assessments to play a role in informing future regulatory decision-making.
- The AEMC's draft determination has usefully identified inflexibilities in the current treatment of financeability in the Rate of Return Instrument and broader rules framework which need to be taken forward.
- To support predictability, the final determination needs to be based on a balanced and transparent assessment framework, counterfactual analysis, and assessment criteria which are more clearly linked to the National Electricity Objective and approaches in other rule determinations.

1 Overview

Energy Networks Australia (ENA) welcomes the opportunity to provide a response to the Australian Energy Market Commission's (AEMC) draft determination on ElectraNet and TransGrid's rule change proposals that aim to ensure the financeability of Integrated System Plan (ISP) projects.[1]

The Australian Energy Market Operator's (AEMO) ISP has determined a number of large-scale actionable ISP projects that are critical to address cost, security and reliability issues in the National Electricity Market (NEM). These projects have been independently assessed as providing a net benefit to consumers, and the task is now ensuring that the regulatory framework provides for *financeable* ISP projects.

The rule change proponents have proposed a targeted and proportionate approach that adjusts the revenue profile for only select projects, making them financeable and ensuring that consumers are able to therefore benefit from the implementation of the ISP.

ENA anticipates the rule change proponents will respond to key elements of the draft determination and its underlying analysis. Representing networks, ENA's focus is on the broader framework issues that arise through the draft determination and proposed next steps.

[1] Participant derogation – financeability of ISP projects (TransGrid) – Project Reference ERC0320.
Participant derogation – financeability of ISP projects (ElectraNet) – Project Reference ERC0322.

Need for development of a financeability framework through the Rate of Return Instrument review

The financeability issues of large actionable ISP projects represent a unique challenge – these projects face particularly acute financeability challenges, however mature energy distribution networks are also seeing financeability pressures arise which will worsen over time unless actively addressed.

ENA welcomes the Commission's examination of financeability assessment issues and methodologies, which will need to be considered and developed through 2021 as part of the Rate of Return Instrument (RORI) process. Regulatory determinations are now regularly resulting in negative net profit after tax (NPAT) outcomes for the benchmark entity throughout five-year regulatory periods. No business can be assumed to sustainably operate and make long-lived investments with continuous negative NPAT for between 5-10 years.

AEMC and CEPA have valuably identified and discussed several critical concepts which will need to be fully evaluated and settled through the RORI process. Examples of these include:

- expectations around gearing and equity funding through growth and investment cycles;
- financeability of the notional benchmark firm versus ensuring financeability for major 'one-off' projects; and
- relevant investor expectations around a reasonable opportunity to recover at least the efficient return on capital, and in particular, the timeframe and nature of this expectation.

These are important issues which have substantive linkages across issues of financeability and rate of return estimation.

Identifying inflexibilities in current treatment of financeability in RORI framework and broader rules

AEMC has also correctly observed some potential unintended impacts of the lack of flexibility in the existing RORI framework that should be examined and remedied if confirmed.

AEMC's foreshadowed future review should more fully consider any practical barriers to the Australian Energy Regulator (AER) addressing financeability concerns at both the RORI stage, and individual network determinations.

Need for clear, balanced and transparent assessment framework

The draft rule determination sets out a bespoke assessment framework and criteria which are used to assess the proposals.

This framework is not always clearly reconcilable to previous rule determination processes, or as clearly linked to the specific components of the National Electricity Objective (NEO) as other Commission decisions. This potentially creates a lack of clarity around how the Commission may assess future framework changes in this area. To ensure predictability and stakeholder confidence in AEMC rule assessment processes, it is important for the final determination to address the core issue of promotion of the NEO more clearly and for the assessment to more clearly demonstrate that the determination as made best promotes the NEO, in view of a clear set of potential counterfactuals.

It is also critical that the final rule determination provides consistent and clear signals to stakeholders about existing alternatives where these are identified. In particular, for the assessment framework to be effective in practice, any suggested alternative measures must be reasonably prospective routes for any proponent to pursue. Clearly this condition will not be satisfied where they may have already been pursued unsuccessfully or without resolution in discussions and review processes with either the AEMC or AER.

2 Background

2.1 Energy Networks Australia

Energy Networks Australia 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.

2.2 The energy transformation

Australia's energy system is undergoing a significant transition, moving away from large coal and gas centralised generation to smaller scale dispersed generation that is increasingly renewable generation.

AEMO's ISP is a whole-of-system plan that provides an optimal roadmap for the development of the NEM as electricity generation transforms to a low emissions future. As summarised by AEMO:

> *The ISP identifies investment choices and* ***recommends essential actions to optimise consumer benefits*** *as Australia experiences what is acknowledged to be the world's fastest energy transition.*[2]

Provided that the transmission investments are timely and kept at an efficient level, AEMO estimates that the proposed ISP investments will deliver $11 billion in **net** benefits to the NEM.[3] Under credible 'fast change' or 'step change' scenarios, these benefits may be higher.

The 2020 ISP sets out four major integrated transmission investments required across the period 2021-26 to support an efficient, stable and reliable national transmission architecture. A significant common feature of these projects is that they will:

» deliver sustainably lower electricity wholesale prices through enhancing competition and market access for new renewable generators, further supporting employment and economic growth;

» support private capital infrastructure expenditure during a period of extremely low expected capital expenditure across Australia; and

» support and generate significant employment outcomes through the design and construction phases.

These investments have been identified as high priority and energy agencies and Ministers have put in place a series of reforms to make the ISP 'actionable'.

Each proposed investment will be subject to streamlined regulatory arrangements aimed at promoting timely investment outcomes and ensuring positive net market benefit from their commissioning and operation. Clearly identified projects, and revised regulatory assessment processes, provide a required foundation for private investment decisions for individual projects, but do not automatically mean that the projects proceed.

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[2] Australian Energy Market Operator, 2020 Integrated System Plan, July 2020, emphasis added.

[3] Australian Energy Market Operator, 2020 Integrated System Plan, July 2020.

3 Role of financeability assessments

3.1 Financeability and regulatory decision-making

ENA welcomes the consideration given by the Commission to the important issue of financeability under the National Electricity and Gas Rules framework.

The draft determination observes that financeability assessment processes are a standard element of regulatory decision processes internationally. These typically involve the *ex ante* testing of proposed regulatory revenue determinations against common financeability methodologies, to ensure the financeability of the proposed decision. Critically, financeability assessments form part of regulatory practice in jurisdictions in which the regulatory framework includes explicit obligations to consider financeability issues, and in jurisdictions where no such obligations exist.

ENA recently commissioned a report from National Economic Research Associates (NERA) examining the current role and application of financeability in economic regulatory decision-making. A copy of the report is attached (**Attachment A**). The report highlights a number of significant benefits to the long-term interests of consumers of measures ensuring financeability of regulatory decisions. It also highlights that Australia's network regulatory regime shares common specific characteristics with those jurisdictions which these tests are in place (for example, RAB indexation and a benchmark cost of debt estimation approach).

In ENA's previous submission to the AEMC's Consultation Paper, the financeability challenges associated with current regulatory settings were identified. Regulatory determinations are now regularly featuring negative NPAT outcomes for the benchmark entity through the entire regulatory control period.

Should regulatory settings remain unchanged, an efficient benchmark network service provider meeting all service and performance targets will have been assumed to be capable of sustaining year on year losses for 10 years. No business can be assumed to sustainably operate and make the optimum mix of long-lived investments facing continuous negative profits for between 5 to 10 years.

The Commission and its expert advisor CEPA have valuably identified and discussed a range of relevant issues for future financeability assessments. Some of these will need to be considered and resolved in the Rate of Return Instrument review process, and others may require examination and resolution through other mechanisms.

- **Gearing and financeability cycles** – there is a need for clarity around expectations of gearing and equity funding through potential growth and investment cycles and the relationship of this to the estimated rate of return. Definitionally, any financeability problem can be assumed away by assuming the presence of equity investors willing to provide equity for lower returns than assumed to be necessary by the AER. However, such an approach does not appear a promising long-term resolution of any underlying issues.
- **Network or project financeability** – As CEPA and the Commission recognise, financeability of stand-alone major transmission projects constitutes a distinct, if related, challenge to the underlying financeability challenges also arising under current regulatory settings for mature energy distribution and transmission networks. Our understanding is that the financeability of IPS projects will be a matter considered in the AEMC's foreshadowed review.

- **Clarity on assumed investor return expectations** – A key matter will be assumptions about investor expectations relating to a reasonable opportunity to recover at least the efficient return on capital. A specific issue in this regard is clarity around the assumed timeframe and nature of this expectation. For example, some key questions are whether AEMC and AER are making consistent and explicit assumptions around (i) whether this expectation applies on 'average' (ii) the term of this conceptual 'average' assumption, and (iii) the relationship of this to either investment cycles, or the economic lives of the assets.

ENA supports the final determination providing a clear reference to the above issues, and any others emerging from the Commissions' process, being taken forward in a coordinated manner by the 2022 RORI process which is currently in its initial stages.

3.2 Identified issues in current applying financeability measures

The Commission's review process has identified existing inflexibilities in the current treatment of financeability in the Energy Law and Rules framework.

These are significant issues which should be further considered by stakeholders, the Commission, and the AER as they have implications for decisions that promote the long-term interests of consumers in efficient investment in network services.

This is because while the specific financeability issues of large actionable ISP projects represent a unique challenge – mature energy networks are also seeing financeability pressures arise which will worsen over time unless actively addressed.

CEPA has highlighted that in relation to the legislative framework establishing the binding RORI, the AER face a number of constraints in recognising financeability issues, or in recognising efficient alternatives to benchmark financing practices to support a network undertaking a heavy investment programme.[4]

Some of these identified constraints are:

- A potential inability to recognise equity issuance costs, where a network is required to adopt gearing below the notional level in a period of rapid RAB growth.
- A potential inability for the AER to consider whether benchmark efficient debt costs should be different for a network business with a substantially different investment profile, for example, if it were established to be feasible and efficient for such a firm to fund a portion of its investment through index-linked debt (an alternative to the derogation proceeding examined by the Commission and CEPA).
- A potential lack of flexibility to consider whether adjustments to other cost of capital parameters could be appropriate to recognise financeability issues.

In response to these constraints CEPA advise:

> *Accordingly, it is possible that the current rate of return arrangements could prevent the AER from fully recognising instances where efficient financing costs might be different from the current view of a benchmark efficient entity.*

[4] CEPA *Financeability of ISP Projects – Report to AEMC*, January 2021, p.52

> *While we note that the rate of return framework sits outside the AEMC's scope for a rule change,* ***we suggest that further exploration of these issues may be appropriate.***[5] *(emphasis added)*

Future AEMC reviews should more fully consider any practical barriers to the AER to addressing financeability concerns at both the RORI stage, and at the level of individual network determinations. The attached NERA report also provides some initial commentary on potential approaches which could be taken in this regard.

4 AEMC assessment framework

4.1 Clarity in NEO assessment process

The Commission has identified that its primary reason for rejection of the proposed derogation is that it considers that the regulatory framework does not 'create a barrier' to TransGrid or ElectraNet financing their ISP project commitments.

4.1.1 Creation of a gateway 'barrier' test or promotion of NEO/NGO?

The draft determination suggests that 'nevertheless' it has assessed the proposal against the NEO to understand the potential impact of the proposed solution.[6]

This assessment framework and approach appears to differ from the standard process generally adopted by the Commission, in which the proposed change is considered with regard to whether the change will promote the NEO, having regard to the impacts on the long-term interests of consumers.

By contrast, the draft determination appears to apply a preceding 'gateway' assessment of whether the existing regulatory framework creates a 'barrier' to project financing on the part of TransGrid or ElectraNet.

If such a 'gateway' assessment has been applied, it is not readily reconcilable with a set of recent rule changes which were specifically designed and approved in order to positively enable and progress implementation of 'actionable ISP' projects. The approval of these actionable ISP rules was clearly on the basis that the new rules *better* enabled the delivery of ISP projects, and therefore promoted the NEO.

ENA may have misunderstood the description of the assessment process in this regard but considers it critical that a consistent and predictable analytical framework is adopted across rule change proposals.

4.1.2 Net present value: one discount rate or multiple?

A further area requiring clarification is the Commission's approach to NPV neutrality and discount rates. In the draft determination the Commission notes some stakeholder positions that different discount rates may be appropriate to use in discounting costs and benefits of the project. In discussing the proposal, the Commission states:

[5] CEPA (January 2021), p.52

[6] AEMC *Draft Determination: Participant derogation – financeability of ISP projects*, January 2021, p.10

The Commission considered the proponent's argument about the NPV-neutrality of their proposal but noted that stakeholders pointed out that consumers may have different discount rates yielding different NPV impacts than those experienced by the proponent.[7]

It is unclear what this observation is intended to convey, or the role it plays in the Commissions draft decision.

The surrounding discussion highlights the clear point that not all NPV paths (100% upfront payment versus deferred payment) will have equal preferability. The concept of undertaking an NPV analysis using different discount rates in this context, however, would not seem to align with the purpose and function of an NPV analysis for regulatory purposes.

This is because the only relevant discount rate for NPV analysis in this regulatory context is the AER determined regulatory rate of return, established under the RORI. This is the discount rate set by the AER as required to attract efficient investment and support the efficient operation and use of network infrastructure for the long-term interest of consumers.

It is unclear what is the basis for the use of, or weight being applied to, any alternative discount rate, as this would explicitly undermine the role of the AER's rate of return assessment process.

4.1.3 Application of assessment criteria

ENA continues to have some concerns with the criteria the AEMC has applied to help assess whether the rule is likely to promote the NEO.

In ENA's view it would be appropriate to assess all aspects of the rule change proposal with direct reference in any assessment criteria to each aspect of the NEO and the long-term interests of consumers. In some cases, the linkage between the overarching NEO and elements of the AEMC criteria are not clear.

As an example, the criteria '*Impacts on economic regulatory framework'* and '*Impact on regulatory compliance and administration costs*' are not as clearly relevant to achieving the NEO as other criteria and should not be given significant weight in the AEMC's decision making process alongside such primary considerations such as the impact on the efficient operation of and investment in the national electricity system.

To further illustrate, the modest administrative impact of the AER maintaining a separate Post Tax Revenue Model (PTRM) assessment in relation to several ISP projects, which is a natural extension of its funded role as a national economic regulator, is clearly not a material factor compared to whether the rule change would be more likely to deliver efficient investment outcomes under the actionable ISP.

Similarly, the current PTRM is, properly considered, simply a regulatory tool designed to meet the objectives of and support the application of the existing Rules. Its current outcomes do not provide clear evidence that alternative rules would not *better* promote the NEO. The PTRM was designed as an instrument to practically implement the requirements and intent of the current rules in a transparent manner to stakeholders. Axiomatically, its outcomes cannot be said to have any particular 'normative' weight on what the applicable Rules, which sit above and govern the PTRM, should be.

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[7] AEMC (January 2021) p.55

The specific economic regulatory framework to be applied for achieving the NEO is a matter for consideration and potential adjustment. Consideration of administrative follow-on impacts of any determined adjustments are a matter for consideration but should not ultimately have the effect of outweighing other NEO factors. Similarly, all other aspects of the rule change that the AEMC considers should be assessed with direct reference to the NEO.

4.2 Need for clear counterfactual assessment

4.2.1 Analytical framework for promotion of NEO decisions

To clearly assess the merits of any proposed rule change, the AEMC requires a clear counterfactual scenario or a set of clear counterfactual scenarios to assess the rule change against.

Without these counterfactuals, it is not clear on what basis the AEMC can form a full assessment of whether a rule change requested is in the long-term interests of consumers and meets the NEO compared, for example, to the circumstances in which a rule is not made.

The draft determination does not state explicitly what counterfactual underlies it decisions. From the discussion in the draft determination, however, the apparent counterfactuals viewed as most likely appears to be that the identified ISP project:

1. proceeds without delay funded by the derogation proponent, potentially with new equity partners or through alternative debt funding arrangements; or
2. does not proceed, resulting in the identified wholesale market benefits not being available to customers, or alternatively that these will be captured by alternative unspecified means.

Meaningful assessment of the strength and quality of the AEMC's final determination will not possible unless further clarity is provided in that document around the primary counterfactuals that informed the decision that the derogation would not promote the NEO, relative to no rule change being made.

An analytical decision-making framework which assumes that *both* a private investment proceeding, and the same investment *not* proceeding, as outcomes that equally contain no implications for regulatory decisions on appropriate investment incentives is incapable of being assessed.

Such a circumstance arising would represent an asymmetric framework, which would over time weaken the capacity of the rule assessment process to benefit and improve from the observed 'real world' results of Commission decisions. Over time, an approach which consistently fails to specify a clear point of comparison, against which promotion of the NEO is assessed, will also risk degrading the credibility, quality and strength of the regulatory framework

4.2.2 Consideration of existing alternative options to address issues

The AEMC's draft determination to reject the proposed derogation appears to be based on findings that a range of existing alternative options exist to address the financeability issues identified by the rule change proponents.

For clarity around the basis of the final determination, ENA considers that this decision should clearly separate:

- existing mechanisms and options that can be carried out under the existing rules within the actionable ISP timelines;

- options that may be adopted in the future, but which would require law or rule changes taking them beyond the scope and timelines of the actionable ISP; and
- options that may be considered in a future Commission review, but which are not currently available to any party.

This will provide critical clarity regarding the Commission's views on which alternate option were considered as workable alternatives to the derogation application.

As an example, the Commission's draft determination highlights that movement to total expenditure (or 'TOTEX') style allowances could in future play a role in addressing financeability issues.

Network businesses have previously supported a long-term Commission-led examination of the potential benefits and implementation options of TOTEX style approach. The Commission has not progressed work in this area, following earlier exploratory work in a previous review of network regulation issues. In this context, where no active consideration of movement to TOTEX is in place or planned, and the Commission has elected not to further progress the issue at this time, it is difficult to view TOTEX as a relevant existing or alternative option for addressing the issues raised by proponents.

Similarly, as highlighted previously, the Commission's expert adviser CEPA has identified limitations and inflexibilities in the existing Law and Rules frameworks relating to rate of return and depreciation issues which may present a barrier to a number of the alternative 'options' highlighted in the draft determination.

A further matter not discussed in detail in relation to these existing options is the extent to which prior discussions between the primary rule proponent and AER had already ruled out these options as viable alternatives to the proposed changes.

From statements from a number of parties at the public forum, ENA understands that TransGrid engaged in detailed discussions over months on potential existing alternatives under the current Rules to address the underlying financeability issues identified. The progression to the rule change process beyond these discussions suggests that these discussions did not provide any clear alternatives within the scope of the existing rules.

It would be beneficial for stakeholders to more fully understand whether the alternatives discussed in the draft determination go beyond, or are a subset of, any alternatives suggested by AER in discussions prior to the application. Clearly, it would be invalid to regard an alternative as a strongly credible existing option if the AER had previously indicated to parties it would not be likely to be able to implement that option.

This clarity would help provide transparency around any alignment, or misalignment in views between the AEMC and AER as to what constitutes a credible alternative option to the rule change.

Regulatory confidence and predictability would not be supported in circumstances in which rule change proponents are informed by one market body that no existing alternatives can be applied under the Rules, but such options are erroneously considered as reasonable and open alternatives to be given weight in determinations on rule changes.

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