Ms Merryn York
Chair, Australian Energy Market Commission
Level 15, 60 Castlereagh St
Sydney NSW 2000

Submitted via online portal

03 December 2020

Dear Ms York,

Participant derogation – Financeability of ISP projects ERC0320, ERC0322

ENGIE Australia & New Zealand (ENGIE) appreciates the opportunity to respond to the Australian Energy Market Commission ("the Commission") in response to the consultation paper on rule change proposals ERC0320 and ERC0322 relating to the financeability of ISP projects ("the Consultation").

The ENGIE Group is a global energy operator in the businesses of electricity, natural gas and energy services. In Australia, ENGIE has interests in generation, renewable energy development, and energy services. ENGIE also owns Simply Energy which provides electricity and gas to more than 720,000 retail customer accounts across Victoria, South Australia, New South Wales, Queensland, and Western Australia.

ENGIE's views on the issues raised in the Consultation is summarised below.

- The proponents have failed so far to make the case that there is a problem of sufficient materiality to require a derogation from the rules.
- The proposed solution appears unnecessarily complex and based on a contradictory approach to the matching of costs and benefits.
- The cost benefit trade-off presented by the proponents is based on the questionable premise that the proponents' ISP projects will not go ahead if they don't obtain the derogation.
- In the unlikely case that the premise is true, it points to a much bigger issue with the regulatory framework for major transmission projects that should be addressed through consideration of more fundamental changes, specifically including removal of the monopoly rights of transmission network service providers (TNSPs) to build major projects in their own service area.

These points are expanded on further below.

Lack of evidence of a problem requiring a derogation

Based on the information provided by the parties seeking the derogations (TransGrid and ElectraNet, hereafter “the proponents”), it is not clear that there is a financeability issue sufficient to warrant the material changes to the standard regulatory framework sought.

Much of the case rests on presentation of the indicative financeability of a standalone “notional project”. But this is meaningless in the context of the financeability of a regulated network, which is the matter under consideration.

Most pertinently, networks receive revenue that includes a return on capital and a return of capital that are both calculated with reference to an indexed regulatory asset base (RAB). In other words, these revenue flows are inflated compared to the historical costs of the original capital expenditure that was added to the RAB. This feature, which is a *quid pro quo* for receiving a real return on capital rather than a nominal return provides a buffer to assist in the financing of new capital expenditure.

ENGIE acknowledges that the size of this buffer relative to the new investments proposed under the ISP may be smaller for the proponents than for a network in a “steady state” of regular capital expenditure. Nonetheless, it is incumbent on the proponents to demonstrate that using their RABs and planned investment that financeability is an issue. That they have chosen not to, preferring the “notional project”, undermines the argument.

In any case, as the Consultation recognises, assessing financeability is a nuanced process that entails qualitative and quantitative assessment. The ratings agencies, whose ratings processes form an important input into any assessment of financeability do not solely rely on quantitative metrics. This is another reason that the notional project presentation is flawed.

Another factor that should be taken into account in assessing financeability is whether it is reasonable to expect equity investors to contribute to the financing of major investments. In this respect, ENGIE notes a number of key points in respect of TransGrid.

- The Consultation states that TransGrid’s latest publicly available gearing is 79.8 per cent[1]. This is well above the benchmark gearing of 60 per cent used by the AER.
- Equity investors continue to show a good deal of appetite for an investment such as TransGrid. Canadian pension investor OMERS acquired a 19.9 per cent stake in the business in July at a reported value of 1.6x RAB[2]. OMERS would have been aware of the proposed capital expenditure requirements given that these had largely been signalled at least since the release of the initial ISP in 2018. They would not have predicated their investment on changes in the regulatory framework.

[1] Consultation, p9, based on Spark Infrastructure, investor presentation, half-year 2020, August 2020 p15.

[2] Australian Financial Review 14 July 2020, accessed at https://www.afr.com/street-talk/firb-paves-way-for-omers-transgrid-deal-20200714-p55brw

- Existing investor Spark Infrastructure referenced this deal as a positive sign for the value of its own stake, commenting that the apparent uplift "can be attributed to the large growth opportunity coming from the proposed integrated system plan build-out and further transmission connection opportunities."[3]

In other words, this large investment pipeline appears to be a positive factor for equity investors. The current aggressive gearing ratio means an equity injection would move the gearing closer to the AER's benchmark.

It's likely that similar considerations hold for ElectraNet.

The proposed solution does not appear appropriate

If there is a financeability issue, then there are in principle a range of tools that can be used, albeit some may require a derogation or a rule change. The simplest, which would not disturb the basic framework that includes RAB indexation, would be to make an NPV neutral adjustment to the profile of cash flows, either within a price control period or between multiple periods. Alternatively, some of the investment could be recovered as it spent rather than being added to the RAB (i.e. treated as if it is operating expenditure). This would also be NPV neutral. Both of these options would avoid the complexity associated with maintaining two RABs, each with their own indexation rules and each requiring a different calculation of the rate of return on capital.

These suggestions would of course increase customer bills in the short term and are only NPV neutral for customers that happen to have the same discount rate as the regulated networks. With customer debts reportedly on the rise[4], it is likely that customers would rather defer costs where possible rather than advance them.

ENGIE is not convinced by ElectraNet's logic that the proposed solution is preferable because it better matches benefits to costs. The benefits, specifically the market benefits, of a project such as EnergyConnect, are highly dependent on modelling assumptions, especially with regard to fuel costs. Whilst they currently form part of the RIT-T evaluation process they are not appropriate for use as a profile for cash revenues.

In any case, it is contradictory to simultaneously advance the matching of costs and benefits over time as an important principle while also to seek a return of capital on assets that are still under construction. Clearly, they cannot be providing benefits before they are commissioned, and yet the proponents would have their customers begin paying for them.

The cost benefit analysis presented is flawed

In assessing the merits of the proponents' requests and whether the derogations would further the long-term interests of customers, as required by the National Electricity Objective (NEO), the Commission will naturally consider the costs and benefits of the derogations. In this respect, the implicit cost-benefit analysis presented by the proponents is flawed. On the one hand there is an implied cost to consumers of zero, since the proposed cashflow adjustments are NPV-neutral (noting the point made above that NPV-neutrality is in the eye of the

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[3] See https://realassets.ipe.com/news/omers-buys-stake-in-australias-energy-transmission-company-transgrid/10046938.article

[4] AER, Annual retail markets report 2019–20, November 2020

beholder). On the other hand, the implied benefits are those of the ISP projects, since there is a clear threat by the proponents that these will not proceed unless the proponents get their way. As noted above, there is a lack of evidence that the projects are genuinely at risk. To the extent that they are then, as discussed below, there is a bigger issue at stake.

Major projects may need a broader review

To the extent there is a problem, it warrants a broader consideration of arrangements for major projects. The current, partly implicit, regulatory bargain is that TNSPs get the monopoly right to build transmission assets in their local service area because there are existing stable regulatory arrangements that make them well placed to finance them[5]. The proponents' claim is that this no longer holds. If this is so, and if the rules must be changed in any case, then there is no longer any merit in relying on existing TNSPs.

This would mean a broader range of solutions should be considered including competitive procurement for the right to build major projects such as interconnectors. This would in turn allow financing arrangements to be designed around the needs of particular assets and current financing costs. One element of financeability not highlighted by the proponents is that interest rates are at historical lows, meaning that new projects should be able to attract debt finance well below the AER's current cost of debt benchmark, which is based on a ten-year trailing average. Of course, these conditions will not persist indefinitely, but since they coincide with a major round of transmission investment through the ISP, consumers should be able to benefit from them.

Concerns that such a broader enquiry will take longer to resolve and for alternative arrangements to be put in place are not relevant; at best this may mean that an interim approach is required for EnergyConnect.

Concerns that TNSPs and state governments may have entered into contracts that inhibit some of these alternative approaches are of limited relevance: the regulatory framework should not be driven by such contract terms. Rather the onus is then on state governments to solve such issues; recent evidence is that they will contribute towards transmission investments they deem necessary.

Should you have any queries in relation to this submission please do not hesitate to contact me on, telephone, (03) 9617 8415.

Yours sincerely,

Jamie Lowe
Head of Regulation,
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[5] This bargain is not quite the same in Victoria where AEMO is the transmission planner and AusNet, the local TNSP has to tender for new projects but typically wins the right to build them.