ERM Power Limited
Level 3, 90 Collins Street
Melbourne VIC 3000
ABN 28 122 259 223

+61 3 9214 9333
ermpower.com.au

Thursday, 3 December 2020

Alex Oeser
Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Dear Mr Oeser

RE: Financeability of ISP Projects

ERM Power Retail Pty Ltd (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) Financeability of Integrated System Plan (ISP) Projects consultation paper.

About ERM Power

ERM Power (ERM) is a subsidiary of Shell Energy Australia Pty Ltd (Shell Energy). ERM is one of Australia's leading commercial and industrial electricity retailers, providing large businesses with end to end energy management, from electricity retailing to integrated solutions that improve energy productivity. Market-leading customer satisfaction has fuelled ERM Power's growth, and today the Company is the second largest electricity provider to commercial businesses and industrials in Australia by load[1]. ERM also operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, supporting the industry's transition to renewables.

http://www.ermpower.com.au
https://www.shell.com.au/business-customers/shell-energy-australia.html

General comments

At the AEMC's public forum on 26 November, we heard that questions relating to the costs and benefits of the project itself are out of scope for the rule change. Instead, the rule change is focused solely on the financing mechanism itself. Given that, it is strange to see the rule change proponents argue that one of the reasons they believe the rule change should be made is to secure the benefits that Project Energy Connect would bring consumers.[2]

Assuming our interpretation of the discussion at the public forum is correct, then the forecast benefits of Project Energy Connect are largely irrelevant to the rule change. Instead the AEMC needs to focus on whether the rule change would meet the National Electricity Objective (NEO). This is the same test that applies to any rule change that the AEMC considers. ERM Power does not believe that the rule change will meet the NEO as it is not in the long-term interests of consumers.

ERM Power understands that Transmission Network Service Providers would already begin to recover the capital costs of constructing Project Energy Connect while it is still under construction, before any service is delivered to consumers. This is not a feature of capital investment recovery normally available to other infrastructure investors. We believe this is highly unusual and is in stark contrast to the usual arrangements for businesses where they

[1] Based on ERM Power analysis of latest published information.
[2] TransGrid, Making ISP projects financeable rule change request, pp 26-27.

generally only make a return once a project begins to deliver the product or service to the customer. For example, a firm constructing a toll road is unable to charge motorists tolls before the road is open. Further, the toll road operator faces stranded asset risk through declining traffic volumes, whereas a TNSP under revenue cap regulation does not. ERM Power therefore does not see how bringing forward cost-recovery associated with depreciation would be in keeping with a workably competitive market the regulation is meant to reflect. The rule change request is even more unusual considering the proponents will receive a guaranteed regulated return on their investment unlike firms operating in other markets which face uncertain returns.

There is a broader question at play in the rule change request. If TransGrid and ElectraNet are unwilling or truly unable to secure financing and maintain their current credit ratings under the AER's 60/40 benchmark capital structure, then we consider there is no reason why the projects should not be subject to an open tender to see if other companies are willing to deliver the project under the existing rules. Indeed, allowing more competition to deliver this project, along with future ISP projects, could deliver greater benefits to consumers over the longer term. We encourage the AEMC to consider how alternative approaches could still deliver Project Energy Connect and two other large projects – Eyre Peninsula and four synchronous condensers – if the rule change proponents are unwilling or genuinely unable to under the existing rules regulated network cost recovery framework.

The rule change proponents have argued that in order to fund the construction of Project Energy Connect they face the risk of a fall in their credit risk profile from an investment grade rating to that which the proponents term as "junk bond" status. We note that the ratings agency Moody's Investment Service on 9 October issued a review of the credit rating for ElectraNet senior secured debt. This review considered in detail ElectraNet's forecast of regulated and unregulated network projects including Project Energy Connect, in confirming continuation of an investment grade rating for Electranet, Moody's noted:

> *"ElectraNet's rating incorporates a high degree of predictability of its regulated revenue, which currently comprises about 80% of its total revenue. ElectraNet's highly predictable cash flow is underpinned by a revenue-cap regulatory regime, which insulates the company from volume risk, as well as the stable and transparent regulatory framework prevailing in Australia."* [3]

This review confirmed ElectraNet's ability to source debt based on an "investment" grade as opposed to "junk bond" rating as suggested by the proponents. The Moody's review confirmed the credit ratings benefits available from the current stable and predictable regulated network costs recovery framework.

We also consider that it is helpful to look at the sale of TransGrid, one of the rule change proponents, in 2015 to a consortium of investors. TransGrid was bought for 1.6 times the value of its Regulatory Asset Base (RAB)[4] suggesting that investors valued the potential for growth in the business, including its RAB. Spark Infrastructure, one of TransGrid's minority owners, flagged that it saw "Long term growth in the Regulatory Asset Base… supported by macro economic driven demand growth expectations, and change in generation mix to renewables"[5]. Given that one of the owners expected the RAB to grow in part to service increased volumes of renewables – one of the key reasons for building Project Energy Connect – it is hard to fathom how TransGrid could not have foreseen that it would need to access debt for future capital expenditure.

We are also concerned that making this rule change would set a precedent for future ISP projects. In isolation changing the rules for a single project may be acceptable – noting that we do not consider this to be the case for this rule change – but a blanket change to regulated network cost recovery rules would lead to more significant cost increases for consumers which would be unacceptable. ERM Power has little confidence that if this rule change is made it would apply solely to Project Energy Connect. Instead, we believe that this rule change could be

[3] Moody's, *Moody's downgrades ElectraNet to Baa2; outlook stable*, 9 October 2020.
[4] Frontier Economics*, Response to submissions on the relevance of the TransGrid sale*, February 2016, p 6.
[5] Spark Infrastructure, *Equity Investment in TransGrid and Equity Raising*, 25 November 2015, p 9

used as a precedent to fundamentally change the regulatory framework that is not in the long-term interests of consumers.

On the AEMC's question of whether the rule change proposal would create an intergenerational transfer of wealth, we agree this would clearly be the case. If the rule change were made, increased costs would be recovered in the early years, from today's consumers while, as indicated in the various reports associated with Project Energy Connect, the majority of benefits would be delivered in the later years of the project from future consumers who would also benefit from lower regulated costs. Although some of those consumers may be the same, we consider it sub-optimal to require existing consumers to pay significant, known costs, while delivering non-certain benefits to future consumers.

The proponent's proposal involves a move from a real return to a nominal return framework which would shift inflation risk to consumers though there is no explicit mention of this in their proposals. Such a fundamental change should be part of the current AER rate of return review, not prosecuted through the narrow derogation. This is no different from the AER's rejection of the networks' proposal for a hybrid approach (involving a nominal return on debt) in the current review of expected inflation.

Further, the rule change proponents' claim that their proposal in net present value (NPV) neutral is only based on the costs that would be imposed on customers, rather than the overall costs to consumers. With costs incurred upfront and benefits delivered over the long term, it is more likely that consumers will find that the net present value benefits are in fact negative, that is, the approach proposed in the rule change will cost consumers more. It is likely these costs would be more pronounced given the differing discount rates that consumers would use compared to the rule change proponents.

In addition, energy network businesses are currently transitioning to a 10-year trailing average return on debt. This process began in 2015 and replaced the previous on-the-day rate. Given the large fall in the cost of debt due to the COVID-19 pandemic, the average return on debt allowable by the AER will be significantly higher than the current rate available to networks to fund projects now. This is due to the higher cost of debt in previous years. So, even if the network businesses do face a downgrade in their credit rating, the cost of debt may well be below what the AER currently allows. While current low interest rates will have an impact in the future if on-the-day interest rates increase, that is a known aspect of the trailing average approach.

Finally, the proponents argue that the impact on households is just a few dollars per year. This may be true, but it ignores the impacts on commercial and industrial users who consume far more energy and as such will be burdened with far higher costs. This is an issue largely ignored in both the consultation paper and the rule change request – no attention has been given to how this rule change would impact large users. We encourage the AEMC to specifically consider the impacts of making the rule change on business users – commercial and industrial users and the impact this may have on the economy as we emerge from the COVID-19 recession as well as small and medium businesses – and households.

Conclusion

ERM Power considers the case for making the rule change is weak at best and that there is no reason for the AEMC to make the rule change. We do not believe that the rule change would meet the NEO as it is not in the long-term interests of consumers. The rule change will add costs to consumers beyond what is allowed under the existing regulatory process for network costs, in exchange for highly uncertain benefits. It would also lead to consumers paying for depreciation on the infrastructure before it is in service, a highly unusual scenario for any business.

If the rule change proponents are genuinely unable to access debt in order to build Project Energy Connect, then we consider that other parties may be able to step in to build the project under the current regulatory arrangements. This may actually be of greater benefit to consumers by introducing more competitive tension in the construction of monopoly assets.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

Ben Pryor
Regulatory Affairs Policy Adviser
03 9214 9316 - bpryor@ermpower.com.au