18 March 2021

Ms Anna Collyer
Chair
Australian Energy Market Commission
Level 15, 60 Castlereagh Street
SYDNEY NSW 2000

Via email: anna.collyer@aemc.gov.au

Dear Anna

Draft Determination – Financeability of ISP Projects (ERC0322)

ElectraNet appreciates the opportunity to lodge this submission in response to the Commission's draft determination on the proposed participant derogation relating to the financeability of ISP projects. In preparing this response, ElectraNet has carefully considered the Commission's reasons for its draft determination and the accompanying report from Cambridge Economic Policy Associates (CEPA).

While ElectraNet is disappointed in the outcome of the draft determination, we share the Commission's focus on the interests of customers and the need to promote the achievement of the National Electricity Objective. Importantly, the Rule change proposal was aimed at bringing forward the timing of revenue recovery to support the financeability of major projects and electricity customers were not being asked to pay any more over the life of a project. This is intended to deliver improved customer outcomes, including inter-generational revenue profiling that better reflects the timing of project benefits.

This submission seeks to clarify aspects of our proposal that may have been misinterpreted by the Commission or CEPA. ElectraNet requests the Commission's consideration of these issues in its final determination, to ensure a fully informed outcome is reached.

The remainder of this submission is structured as follows:

- Clarification of ElectraNet's proposal;
- Comments on the Commission's reasons in its draft determination; and
- Next steps.

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1. Clarification of ElectraNet's proposal

Our Rule change proposal was intended to address the risk that actionable ISP projects may not proceed because finance is either unavailable or too expensive. In support of the proposed Rule change, we referred to subsection 7A(6) of the National Electricity Law, which requires that regard should be had to the economic costs and risks of the potential for under-investment in transmission networks. Our Rule change proposal adopted the precautionary principle in relation to the financeability of ISP projects, i.e. that it is sometimes better to address potential risks, even if they may not eventuate.

We raised concerns that financeability challenges were emerging in relation to ISP projects, driven by their relatively large size and long asset lives. The Commission's consultants, CEPA, reached a similar conclusion under some investment scenarios, although they suggested that other actions are available to manage this risk:[1]

> "…the ISP investment plans are likely to be financeable under the current regulatory approach. However, in more investment intensive scenarios, the TNSPs may be required to adopt capital structures that differ from the notional assumption. We consider this, and other actions that a TNSP, or the AER, could potentially take to improve credit profiles during an investment-intensive phase, in the following section."

In response to the emerging financeability challenges, ElectraNet proposed changes to the revenue profile, while leaving total revenue unchanged in present value terms. In particular, our Rule change proposal explained that the short-term increase in annual revenue would be approximately $4 for an average residential customer in South Australia, with offsetting revenue reductions in later regulatory periods. In the context of Project EnergyConnect, we considered this reprofiling of revenue to be reasonable when compared with the expected net project benefits of $100 per annum per customer.

We note that the Commission's draft determination described the proposed short-term increase in annual revenue as "substantial".[2] While ElectraNet understands the concern with any increase, even if it is neutral in present value terms, we regard the $4 impact to be modest in the context of the expected customer benefits of Project EnergyConnect.

The Commission also raised concerns that the inter-generational wealth transfer caused by the proposed Rule change is unlikely to be in the long-term interests of customers, as today's customers would be paying for benefits enjoyed by future customers.[3] ElectraNet discussed the issue of inter-generational equity in our submission to the Commission's consultation paper on the proposed Rule change. For completeness, we include the relevant excerpt from our submission below:[4]

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[1] CEPA, Financeability of ISP Projects, Final Report, 27 January 2021, page 36.

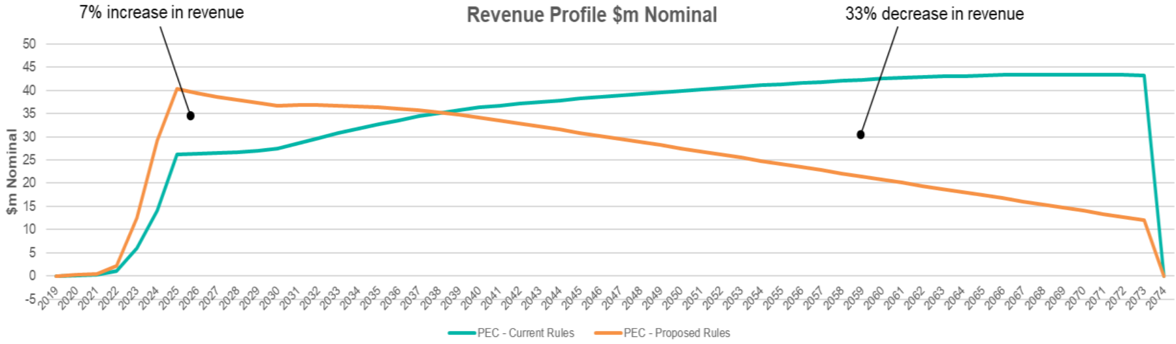
[2] AEMC, Draft rule determination Participant derogation – financeability of ISP projects, February 2021, page ii.

[3] AEMC, Draft rule determination Participant derogation – financeability of ISP projects, February 2021, page ii.

[4] ElectraNet, Submission to AEMC Consultation Paper, 3 December 2020, pages 15 and 16.

"…Figure 3 shows the nominal revenue profile under the proposed Rule compared to the current regulatory framework.

Figure 3: The impact of the proposed Rule on project revenues

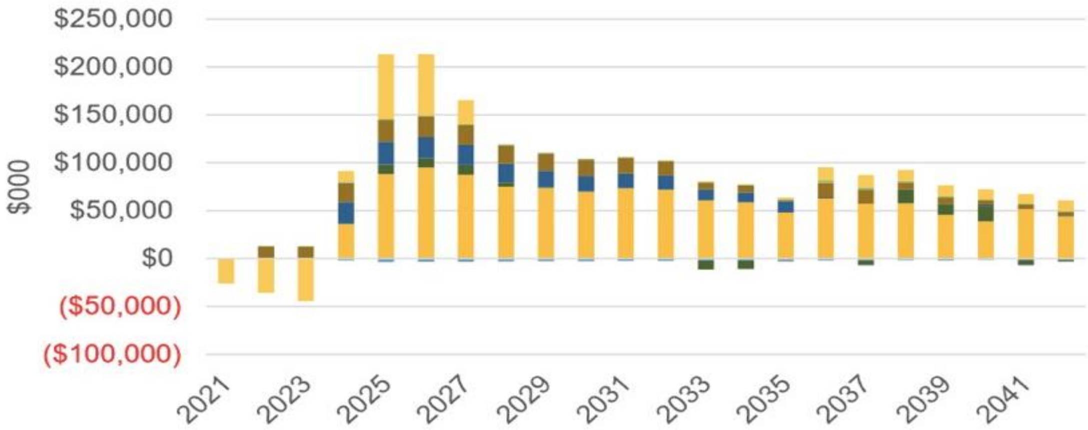


In present value terms, the revenue streams are unchanged as a result of the rebalanced revenue profile under the proposed Rule. However, it is also worth highlighting that the total undiscounted revenue is significantly lower under the proposed Rule compared to the current framework[5]. In relation to inter-generational payments, therefore, future customers will be paying less than existing customers.

[…]

Our updated Cost Benefit Analysis, built on the original RIT-T assessment and endorsed by the AER, shows that Project EnergyConnect delivers significant net benefits early in the project's life, as shown in Figure 4 below[6].

Figure 4: Profile of expected benefits from Project EnergyConnect



In broad terms, if the revenue and benefit profiles are more closely aligned, current and future customers make contributions to the project that are proportional to the benefits they receive. It is evident from Figure 3 and Figure 4 that the proposed Rule performs better in this regard than the current regulatory framework. In terms of inter-generational equity between customers, therefore, the proposed Rule delivers an improved outcome and reduces the burden on future customers. "

5 In the illustrative example above, the revenue to be recovered from customers on a notional $500m project would fall over 25% from approximately $1,870m over the life of the asset to approximately $1,386m under the proposed Rule.

6 ElectraNet, Project EnergyConnect: Updated Cost Benefit Analysis, 30 September 2020.

In summary, the analysis presented in our earlier submission shows that the impact of the Rule change in terms of inter-generational revenue outcomes is reasonable and closely matches the profile of the benefits expected from Project EnergyConnect.

We provide the above clarification to ensure stakeholders understand that our proposed Rule change is intended to provide a proportionate response to the emerging financeability risks. We also consider it important to clarify the materiality of the revenue impacts of the proposed Rule change in the context of Project EnergyConnect.

2. Comments on the Commission's reasons

In this section, we respond briefly to each of the Commission's principal reasons for its draft determination. In providing this response, our intention is to clarify our proposal and highlight areas where we disagree with the Commission's reasoning.

- **Risk allocation:** *By applying depreciation as incurred and an unindexed RAB to ElectraNet's share of current and future ISP projects, the proposed rule would transfer some risks — in particular, inflation risk and completion risk — from ElectraNet to consumers who are not best placed to manage these risks. By requiring consumers to pay regulatory depreciation on investments for several years before a project is commissioned, at least some construction risk (for example, the return of capital aspect of construction risk) can be transferred from businesses to consumers. More importantly, however, is the risk that moving to as incurred depreciation may weaken incentives for businesses to complete capital projects in a timely and efficient fashion (for example, through careful contracting and effective monitoring throughout the construction process). This is because the more income a business receives prior to completion of a project, the less incentive there is to complete the project.*

  <u>ElectraNet's Response</u>

  ElectraNet's proposed Rule change is intended to address cashflow issues, rather than reallocate risk to customers. Under the regulatory framework, ElectraNet would continue to be subject to incentives to minimise the total cost of the project and achieve (or exceed) our service performance targets. These incentives support the timely delivery of projects, notwithstanding the cashflow benefits from the proposed Rule change. The failure to complete an ISP project would also have significant reputational consequences for the business. In relation to the optimal allocation of inflation risk, it is worth noting that neither ElectraNet nor customers can manage this risk, so there is no strong rationale for this risk to rest with investors in transmission.

- ***Regulatory framework:*** *The proposed rule would represent a significant departure from established principles of regulation in Australia. It has the potential to undermine the AER's role in administrating the regulatory framework, introduce substantial regulatory uncertainty to TNSPs not covered by this rule change and distort the achievement of efficient outcomes in both the NEM and financial markets by tilting the playing field towards ElectraNet and its ISP projects relative to other TNSPs and non- network providers.*

  <u>ElectraNet's Response</u>

  ElectraNet does not agree with the Commission that the proposed Rule would represent a significant departure from established principles of regulation in Australia. The proposed change would lead to a reprofiling of regulated revenues for specific projects, but would not change any of the incentive properties of the regulatory framework or planning arrangements that apply to transmission investments. Our submission to the Commission's consultation paper also noted that the proposed approach is consistent with regulatory practice in other jurisdictions, most notably the Commerce Commission's regulation of Transpower in New Zealand which applies a nominal return model.

In addition, the investment decision-making framework in relation to actionable ISP projects, which includes the application of the RIT-T, would remain unchanged. It is therefore doubtful that the proposed Rule change could tilt investment towards particular projects, as suggested by the Commission.

- **Efficient operation of electricity services:** *The proposed rule is unlikely to promote efficient operation of the power system relative to the current arrangements. Specifically, the depreciation component of the proposed rule could weaken incentives for ElectraNet to deliver projects to time by providing it with income from a project prior to its completion. This is unlikely to be in the long-term interests of consumers.*

  ElectraNet's Response

  ElectraNet agrees with the Commission that timely project delivery is an important issue. As a commercial business, ElectraNet is naturally motivated to deliver projects in a timely and efficient manner, in accordance with good project management practices and governance arrangements.

  In relation to incentives, delays in completing a project would typically result in increased total project costs. The regulatory framework provides strong incentives to achieve efficiency savings, including the Capital Expenditure Sharing Scheme (CESS), and therefore it is unlikely that allowing depreciation prior to project commissioning would encourage ElectraNet (or any other TNSP) to delay the delivery of a project. Therefore, the proposed Rule would not affect the efficient operation of the power system.

- **Efficient investment in electricity services:** *The economic regulatory framework currently already provides ElectraNet with a reasonable opportunity to recover its efficient financing costs, and therefore currently supports efficient investment in electricity services. The application of the proposed changes to ElectraNet's share of ISP projects only is likely to be detrimental to efficient investment in electricity services by tilting the playing field towards ElectraNet and away from other proponents and similar ISP projects, and weaken investment incentives on onshore and offshore equity investors seeking capital growth by removing the linkage to, and hence protection from, inflation. Removing the RAB indexation could also cause a financeability issue in the future as the value of the RAB stops being indexed by inflation every year.*

  ElectraNet's Response

  As already noted, ElectraNet does not agree with the Commission's view that the playing field would be tilted towards ElectraNet's projects. Our view is that the Rule change would ease the financeability issues that arise from large ISP projects and, therefore, should promote efficient investment, and enhance the attractiveness of investment to equity providers.

  The Rule change only applies to ISP projects, which means that the RAB would continue to be indexed by inflation in relation to non-ISP assets. This should go some way to ameliorating the Commission's concern in relation to future impacts.

- **Impact on consumers:** *While being NPV neutral from ElectraNet's perspective, the proposed rule would result in payments for ElectraNet's share of ISP projects being weighted towards the early period of an asset's life, substantially increasing costs for consumers in the near to medium term, with lower prices later in the life of the asset. The proposed rule would also create an intergenerational wealth transfer between current and future customers, remove the link between the inflation component of network charges and the inflation component of the income of users of electricity and move away from the current alignment between the profile of revenues to ElectraNet for its share of ISP projects with the timing of benefits to consumers in respect of these projects.*

ElectraNet's Response

As explained in section 1 of this submission, the analysis ElectraNet has presented indicates that the proposed Rule change would achieve a more equitable outcome between today's customers and future customers.

Although today's customers would pay more compared to the status quo, this closely aligns with the expected benefits that they will obtain from the project compared to future customers. As noted in the Commission's reasoning, the proposed Rule change is revenue neutral in present value terms, ensuring no more revenue is recovered overall.

3. Way forward

ElectraNet requests the Commission's consideration of the issues raised in this submission in its final determination, to ensure a fully informed outcome is reached. It remains open for the Commission to consider whether a more modest change to the regulatory framework may be warranted, noting that CEPA discussed some potential measures in its report.[7]

More broadly, ElectraNet notes that the Commission intends to commence a broader review, in cooperation with the other market bodies, to consider options to support the timely and efficient delivery of large transmission projects that are in the long-term interests of consumers. ElectraNet looks forward to working with the Commission through the course of this review.

We look forward to engaging with the Commission as it finalises its determination and appreciate the constructive engagement with staff throughout this process. Please feel free to direct any queries in relation to this submission to Simon Appleby in the first instance on 08 8404 7324.

Yours sincerely

Rainer Korte
Group Executive Asset Management

[7] CEPA, Financeability of ISP Projects, Final Report, 27 January 2021, Table 3.1, page 50. ElectraNet notes that the UK water regulator, Ofwat, now has a duty to secure the long-term resilience of the water and sewerage system, which it interprets as including financial resilience.