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(via online submission)

Accommodating Financeablility in the Regulatory Framework - Consultation paper submission

The Clean Energy Finance Corporation (**CEFC**) welcomes the opportunity to make a submission to the Australian Energy Market Commissioner's (**AEMC's**) **Accommodating Financeablility in the Regulatory Framework.**

The CEFC is a specialist investor with a deep sense of purpose: to invest as Australia's 'green bank' to help achieve our national goal of net zero emissions by 2050. With a strong investment track record, we have been working across the economy to capture the benefits of the net zero transition – from renewable energy generation and transmission to energy efficiency, cleantech innovation and beyond. We invest alongside private investors, innovators and industry leaders, drawing on our deep sector experience, investment expertise and portfolio strength to fill market gaps and maximise our impact.

The CEFC supports the development of a secure, reliable and affordable electricity system whilst lowering emissions through its investment activities and has done so historically and will continue to, through its core $10 billion fund.

In accordance with the CEFC's recently announced new investment mandate, the CEFC will make available up to $19 billion for investment in projects that rebuild, modernise and strengthen Australia's electricity grids and energy systems, as the delivery partner for the Federal Government's Re-Wiring the Nation (RTN) policy. This is expected to be primarily achieved through investment in electricity transmission projects.

Given the CEFC's role as the key delivery partner of the RTN policy, we bring a perspective that reflects our practical experience in investing to facilitate the timely and efficient delivery of major energy infrastructure projects. Prior to the formation of the RTN policy, the CEFC has invested in large transmission projects – namely Project EnergyConnect in NSW (with Transgrid), the Southern Downs REZ in Queensland (with Powerlink) and Snowy 2.0 grid infrastructure (with Transgrid Services / Lumea).

We estimate that for the NEM, in the order of $120 billion of capital expenditure will be needed to fund new utility scale solar, wind, transmission, storage and ancillary services over the coming decade.[1]

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[1] Based on CEFC analysis of AEMO's 2022 Integrated System Plan, noting that since then the cost of capital (through interest rates) and the costs of completion have risen making this a conservative estimate

The CEFC agrees that there is a foreseeable risk that financeability challenges could arise for TNSPs in relation to large scale and/or concurrent actionable ISP projects. Financeability issues may arise from the way that cash flow is derived by large investments in ISP projects relative to their existing RABs, particularly during the construction phase of a project. The CEFC notes that the quantum and scale of actionable ISP projects presents a significant step change in business activities versus incremental network capex spend, and consequently can place pressure on a TNSP's credit metrics. The CEFC agrees that financeability risks need to be addressed over the short-medium term to help ensure the timely delivery of actionable ISP projects and evidenced by the CEFC's involvement in the financing of Project EnergyConnect.

The CEFC has considered four options to address financeability proposed through the Minister's rule change request as well as the Energy Network Association's (**ENA**) rule change request. These include:

- Original Minister's rule change request: AER discretion approach (i.e. a subjective test) to determine if and how financeability issues are to be addressed
- ENA Option 1: An objective test done on a project basis
- ENA Option 2: An objective test done on a corporate basis
- ENA Option 3: An objective test done on a 'no worse off' basis

The CEFC sees the AER discretion option and a variation to the 'no worse off' option as being the preferable solutions to address financeability issues. Irrespective of the preferred option, the financeability framework must be designed in a manner to meet the objective of providing investors with certainty to what the solution to financeability is in sufficient time ahead of a final investment decision. In return for this investment certainty, consumers should also expect that if the AER facilitates the financeability solution then there should be a mechanism to ensure timely delivery. This is critical to prevent delays to the delivery of actionable ISP projects.

The following sections outline the rationale for this position. The CEFC would welcome the opportunity to engage with the AEMC further on these options.

The Minister's rule change request

The CEFC agrees that the current regulatory framework in the NER is not sufficiently flexible to enable the AER to address potential financeability challenges when making revenue determinations. The CEFC agrees that further clarity is needed on how the AER should assess and, if necessary, adjust depreciation profiles for actionable ISP projects to address to address financeability.

Transparency with the AER

If (and when) the AER undertakes a financeability assessment (principles based or prescriptive) a TNSP must be transparent and provide sufficient data to the AER in order for a decision to be reached, in particular to prevent the impact of financeability being repeatedly addressed inadvertently. This information should include at a minimum:

- Credit metric impacts (pre/post incremental project) including direct engagement of the AER with the relevant credit rating agencies;
- Depreciation profile and total cash flow profile (pre/post incremental project); and

- Concessionality/grant funding received (if applicable).

The CEFC agrees that if concessionality/ grant funding has been provided to the TNSP for any reason, the TNSP should be required to disclose this to the AER.

Corporate level credit assessment

Specific feedback has been sought by the AEMC as to whether a financeability assessment should be considered at the corporate (TNSP Regulated Asset Base) level or at a project level. The CEFC has deep experience in undertaking credit rating analysis, undertaking this internally for our own debt investments. The CEFC's strong view is that financeability should be considered at the corporate level. This is on the basis that:

1. TNSPs derive benefits from their (monopoly) position in the market including the benefits of operating a network as a portfolio. Separating a project, discounts this advantageous position and would likely overstate the financing cost and underutilise the corporate advantages, likely at the cost to consumers.

2. Regulated businesses predominantly fund their debt activities at a corporate level, typically through a combination of senior bank debt and bond markets or State Treasury for State Government-owned TNSPs.

3. A significant part of determining a credit rating for a counterparty is to incorporate qualitative factors which are advantageous for regulated utilities at the corporate level and dependent on the situation at the time of the credit rating. Not taking these qualitative factors into account is expected to understate the benefits enjoyed by regulated monopolies.

4. There are different credit rating methodologies applied to projects financed on a project level only basis compared to those financed at a corporate level.

Principles-based approach

The principles underpinning this approach should include those outlined in the AEMC's Transmission Planning and Investment Review Stage 2 recommendations, whereby the AER have regard to:

1. Principle 1: the relative consumer benefits from the provision of network services over time

2. Principle 2: the capacity of the network operator to efficiently finance its overall regulatory asset base, including efficient capital expenditure, and;

3. Principle 3: any other factors the AER considers relevant, having regard to Principles 1 and 2.

The CEFC proposes an additional principle:

> *In determining the level of accelerated depreciation/cash flow support necessary to support a TNSP's credit rating, it should be the minimum level of support required to reasonably expect that the current credit rating can be maintained. In other words, a credit rating downgrade should be avoided, equally no credit upgrades should ensue.*

From the CEFC's investor lens, if a principles-based approach is adopted, TNSPs will require a degree of certainty in a timely manner regarding how financeability issues will (or will not) be addressed to support their investment decision making processes. The CEFC considers that increased certainty may be achieved where the AER provides the TNSP, 6-9 months ahead of the contingent project application determination / financial investment decision, certainty on:

- whether there is a financeability issue; and
- the basis on which financeability is to be addressed (i.e. revised depreciation profile).

The CEFC acknowledges that bringing forward a decision on the cash flow profile 6-9 months ahead of the contingent project application would mean the full and final project information may not be available to enable the AER to make its final determination. To address this risk, conditionality regarding the financeability solution will be needed to ensure the amount of financeability support to be determined balances the requirements of investor certainty. For example, CEFC expects that if capex estimates or capex profiles change, the financeability solution needs to recalibrate accordingly.

Prescriptive approach

If the preferred path is a prescriptive approach, the CEFC agrees that the AER should be required to publish guidance on how it may vary the depreciation profile for assets that form part of the actionable ISP projects. The CEFC recommends that the elements detailed in the Option 3 – 'no worse off' below should be considered.

The Energy Network Association's (ENA) rule change request

The ENA (on behalf of TNSPs, excluding Ausnet) has sought to propose an objective test to provide TNSPs with greater certainty around how financeability issues will be addressed.

An objective test, which utilises a fixed financeability formula, aims to reduce subjectivity in the assessment process. However, there are several conceptual and practical issues the CEFC, as an experienced financier, sees that make its implementation challenging, including:

- Credit rating agencies typically evaluate a range of quantitative and qualitative factors, assigning different weights to each, when conducting their assessments. In the case of TNSPs, financial ratios (quantitative factors) are usually rated at a sub-investment level, lower than BBB, and are offset by favourable qualitative factors (including that the TNSPs are regulated businesses) to determine the final rating. These factors and weightings can vary across different credit rating agencies and are subject to periodic updates as market conditions change. While rating thresholds may change over time, the rules set through the regulatory framework should be long lasting and, if possible, through economic cycles.
- There is dynamism in the weighting of sub-factors in the credit rating process where credit rating agencies would typically assign greater weightings to lower scores than higher scores in the scorecard. This approach recognises that a significant weakness in one area cannot be fully compensated by strengths in other areas. This means that an approach that applies fixed weightings on individual quantitative metrics is not appropriate.
- While credit rating agencies refer to rating methodologies/ scorecards when assigning ratings, the actual credit rating may be adjusted upward or downward (notched) to arrive at the final rating depending on qualitative macroeconomic or firm-specific

matters which are applicable at the time of rating. This discretion means the credit rating agency may see through particular metrics in determining their overall rating outcomes, thus this may or may not solve the credit rating issue at that time.

- Different rating agencies use different rating methodologies and metrics. A change in credit rating provider may vary the approach to financeability materially and would mean the prescriptive metrics are not applicable.

- Typically, credit rating agencies review a TNSP's financial metrics based over a time period (e.g. a three-year average rather than on an annual basis), downgrading the rating if sustained deterioration is observed.

- Certain qualitative factors may also face downward pressure, depending on the scale of actionable ISP projects. For instance, under the Moody's methodology, sub-factors such as "scale and complexity of capital program" and "financial policy" may experience downgrade pressure.

- One of the key challenges is determining the forecast set of assumptions within an objective test – i.e. is it based on the benchmark efficient entity or reflective of an organisation's actual capital structure. There is limited scope to validate the forecast cash flow and capital management assumptions that underpin an TNSP's forecast.

- Lastly, it is important to highlight that a fundamental discrepancy between the AER's PTRM benchmark financing parameters and the credit rating agencies' methodology already exists in the current framework. For example, a BBB+ rating would typically require a net debt/RAB standalone metric of below 75%, while the AER's PTRM benchmark assumes 60% gearing. The proposed financeability formula proposed by the ENA under this option assumes a target of 60% gearing, whereas the minimum requirement for BBB+ is 75%. If consistency of the PTRM with credit rating methodology is being sought, then this approach should apply more broadly to the whole regulatory framework including the benchmark efficient entity capital structure. That is, the assumed gearing under the PTRM to increase from 60% to just below 75%.

Overall, these factors highlight some of the issues in implementing this objective test and the complexities involved in aligning the financeability formula with credit rating agencies' methodologies and benchmarks set by the AER.

The ENA has proposed 3 different objective assessment processes, including a:

1. Project level assessment

2. Corporate Assessment

3. No 'worse off' approach

Option 1 – Project Level Assessment:

Re-iterating comments in the section above, the CEFC believes that a project level assessment is not appropriate, and that any financeability assessment should be adopted on a corporate basis. Therefore, the CEFC does not see option 1 as being viable. If a financeability assessment (conducted separately for each discrete actionable ISP project) is the AEMC's preferred approach, there is a valid argument this approach should only be applicable where the project is being funded on a project finance basis without a corporate monopoly incumbent, and project finance metrics are applied to evaluate the credit rating

of that particular project. For issuers employing project financing, leverage and coverage scorecard comprises three sub-factors: the Minimum Debt Service Coverage Ratio (**DSCR**), Average DSCR and Concession/Loan Life Coverage Ratio (**CLCR/LLCR**). These sub-factors are quite different to those applicable to rating that of a corporate entity.

The CEFC does not support the flexibility to apply both corporate level and/or project financing approaches which increases complexity and invites the possibility of higher consumer impost in the short term.

Option 2 – Corporate Level Assessment:

ENA's submission puts forward the case that as the benchmark entity structure is based off BBB+ credit rating therefore the financeability rule change should apply an objective test based off selected BBB+ equivalent credit metrics. There are a number of issues with this approach.

A feature of the existing regulatory framework is the ability of TNSPs to manage their own capital structure (and associated credit rating), which could include deviating from the Benchmark Efficient Entity (**BEE**) credit rating of BBB+. If Option 2 were to be adopted, in a scenario where the TNSP has a credit rating that is lower than BBB+, the obligation for the AER to adjust the cashflow to increase cashflow in the front end to a level that supports BBB+ credit rating metrics may result in perverse outcomes such as materially improved credit metrics and possibly a credit rating upgrade due to this improved cashflow profile.

The CEFC strongly rejects the prospect that financeability should facilitate an improvement in credit rating that is supported by consumers despite the capital structure chosen by the TNSP.

Option 2 may also incentivise TNSPs to lower their credit ratings (likely in the form of increased gearing) if there is an expectation that financeability will restore the BEE credit metrics. This process may then be repeated and result in cumulative cash flows being accelerated over multiple projects and exacerbating intergenerational concerns.

This incentivises capital management approaches that could increase risks to the energy market while being inefficient from a consumer perspective.

Option 2 is also problematic in that it allows TNSP to deviate from a BBB+ credit rating (as per the current regulatory framework allows) and obligates the AER to vary cashflows to address financeability of the entire business at a BBB+ credit rating level but places no obligation on the TNSP to maintain this rating. Again, if consistency of the PTRM/ BEE with credit rating methodology is being sought, then this approach should apply more broadly to the whole regulatory framework including consideration of the benchmark efficient entity capital structure to be required to be maintained at a credit rating of at least BBB+.

Option 3 - 'No Worse Off'

Of the options proposed by the ENA, the CEFC consider that this option balances the need for investor certainty with the interests of consumers. If a TNSP decides that a particular credit rating delivers their investors a better risk / return profile, financeability should be assessed by reference to that rating (consistent with our comments in the prior section). This reduces the moral hazard of incentivising TNSPs to downgrade their ratings through a more highly geared capital structure and seek financeability support to obtain BEE benefits. In order for this option to be considered, the CEFC believes there are certain key principles to adhere to in the AEMC's design of the solution:

1. The relevant 'no worse off' credit rating should be the lower of the TNSP's then current rating, the TNSP's historic credit rating over the last three years or the TNSP's target credit rating (Financeability Credit Rating). This objective test to determine the Financeability Credit Rating is needed to provide certainty to the AER on what profile it needs to solve to. It also avoids the situation where the TNSP proposes a theoretical future credit rating scenario, or a situation where the TNSP rearranges its capital structure (likely to obtain an upgrade in credit rating) in preparation for submitting a change to its depreciation profile to address financeability issues (which would result in consumers paying for higher cashflow in the earlier years);

2. We would not recommend a fixed set of metrics, including specific thresholds, to be stated in the regulatory framework for the reasons outlined above. In determining what level of financeability support is needed to maintain the Financeability Credit Rating, the AER should adopt the relevant rating metric threshold at that time. There also needs to be consideration of different credit rating agencies' credit metrics and thresholds, as well as a scenario where there is multiple (typically up to two) rating agencies separately rating the same entity. In addition, when testing against particular metrics it may be relevant to apply a small buffer to accommodate market volatility and risks facing the business;

3. The test would need to be applied on a periodic look-forward basis that is greater than short-term annual measurement. The CEFC understands that rating agencies may look through short-term departures in particular credit metrics where it is demonstrated that the profile of such metrics improve over time. Therefore, the CEFC considers it fundamental that financeability should not be solved on a year-by-year basis, as it unduly impacts consumers and creates volatility in TUOS charges. The CEFC suggests the AEMC consider a trailing average approach for example, over a three-year period;

4. We agree with the ENA that this approach should be considered on a full corporate basis, that the mechanism to be considered is accelerated depreciation, and that the impact of bringing forward depreciation is to be NPV neutral to consumers;

5. Given our points outlined above regarding the ultimately discretionary nature of the final credit rating attributed, direct engagement between the AER and the relevant credit rating agency may be required to understand the impact a financeability decision may have on a TNSP and supported by a sufficient level of disclosure by the TNSP to the AER.

<u>Other issues raised by the AEMC in the consultation paper</u>

<u>Transitional arrangements</u>

The CEFC, with RTN funding, is engaging with the market to address financeability issues in advance of any regulatory changes. The effect of allowing for an accelerated depreciation profile enables the CEFC to reduce both the volumes of the CEFC's capital commitments and level of concessionality applied. The concessional finance rule change enables the CEFC to pass on concessional finance through to consumers.

Financeability support should be restricted in circumstances where other forms of support (for example RTN funding, grant funding or otherwise) have been applied to a particular project. In circumstances where only a portion of a project's capex has been supported, for example early works capex, financeability should be considered in respect of the incremental capex only.

Biodiversity offsets

The CEFC agrees that biodiversity offset costs should be depreciated on an as-incurred basis, where a financeability concern exists, and doing so is in the long-term interests of consumers. Biodiversity offsets are required to be in place (and thus utilised) prior to construction and can be seen as separate to other construction costs.

The materiality of the biodiversity offset costs vary depending on the project and can impact on financeability of actionable ISP projects (amongst other factors). By allowing these costs to be depreciated, it would provide the opportunity for concessional financing to be applied elsewhere that has a more direct flow through benefit to consumers. From our analysis, the 'as-incurred' treatment of these costs has a more significant impact in addressing financeability than on an 'as-commissioned' basis due to credit metrics being under greater strain during construction, this is also relevant across all capex costs.

The CEFC considers that applying a weighted average useful life approach to the biodiversity offset asset class as reasonable, so that their remaining life reflects the remaining life of the asset for which they were procured.

Timely Delivery of Projects

The issue of financeability raises a broader question of the timely delivery of these critical projects to support Australia's transition to net zero. Where the AER determines a level of financeability support for a project, the TNSP still has the right not to proceed with the project. In the case where a TNSP deems the AER financeability support insufficient, the AEMC may need to consider the implications and alternative solutions to enable the timely delivery of these projects. For example, if consumers are paying for the early works of a project and the AER has determined what it considers as appropriate to address financeability and the TNSP still chooses not to progress with the project, consumers should have the right of assured delivery of the project through the transfer of such rights to another party who is willing to deliver the project. This may necessitate new rules to ensure TNSPs' procurement practices support the transferability of information and contracts for works.

We very much value the opportunity that the AEMC has provided to enable the CEFC to provide input into this process. We look forward to the opportunity to engage further with the AEMC. Should you wish to discuss this submission further, please contact Bobby Vidakovic, Head of Grid, bobby.vidakovic@cefc.com.au.

Yours sincerely

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