Ref: ERC0320 & ERC0322

3 December 2020

Ms Merryn York
Acting Chair
Australian Energy Market Commission
Level 15, 60 Castlereagh Street
SYDNEY NSW 2000

Contact: merryn.york@aemc.gov.au

Dear Merryn

Participant Derogations: Financeability of ISP Projects – ElectraNet Submission

ElectraNet is pleased to respond to the Commission's Consultation Paper released on 5 November 2020 on the financeability Rule change proposals submitted by ElectraNet and TransGrid (refer *Participant Derogations ERC0320 & ERC0322).* This also follows the public forum held by the Commission on 26 November 2020 in which ElectraNet participated with TransGrid and the AER.

The Commission's Consultation Paper focuses appropriately on whether these proposals promote the National Electricity Objective (NEO). The key question to be addressed is whether the proposed changes will promote efficient investment, consistent with the long term interests of customers.

A number of important questions have been raised by the Commission and stakeholders alike in the consultation to date on the proposals. The enclosed submission provides our response to these issues. In summary, the Rule change will deliver a number of important outcomes that are in the long term interests of customers, including:

- Addressing an unintended consequence for large transmission investments under the current Rules – which establish a benchmark credit rating but provide a revenue stream unable to sustain it for these large projects – by rebalancing the timing of revenue recovery to support the financeability of Integrated System Plan (ISP) projects;
- Supporting the financeability and timely delivery of Project EnergyConnect, which has been demonstrated to deliver substantial market benefits and price reduction benefits for customers;
- Better aligning revenue recovery with the timing of the expected benefits of the project;
- Improving inter-generational equity by reducing the cost burden on future customers; and

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- Applying a targeted solution, aimed only at the timing of revenue recovery for future ISP projects undertaken by ElectraNet and TransGrid, through arrangements that are straightforward to implement and administer.

Our submission includes benchmark analysis which shows that the current regulatory framework would not support the financeaibility of Project EnergyConnect as intended under the regulatory framework. Historically, inadequate cashflows from new transmission projects have been compensated by cashflows from existing assets. However, this is no longer possible given the size of the ISP projects relative to the regulatory asset base.

This is further evidenced by ElectraNet's credit rating which has recently been downgraded to a level below the AER's benchmark following large transmission investments we are already delivering. This situation will be exacerbated by the addition of Project EnergyConnect in the absence of the Rule change.

As a central part of AEMO's optimal development path for the NEM, Project EnergyConnect will deliver significant benefits. Independent analysis shows an expected net price reduction in South Australia of approximately $100 per annum per customer, whilst the short-term impact of the Rule change proposal is approximately $5 per annum in the current period.

We have engaged with our Consumer Advisory Panel (CAP) to ensure that we understand our customers' concerns. During this engagement, we explained that the Rule change will not impact on the capital cost of the project and will result in unchanged total revenue in present value terms. Further, we explained that the Rule change will deliver substantially lower total revenue in absolute terms over the life of the project compared to the current regulatory framework.

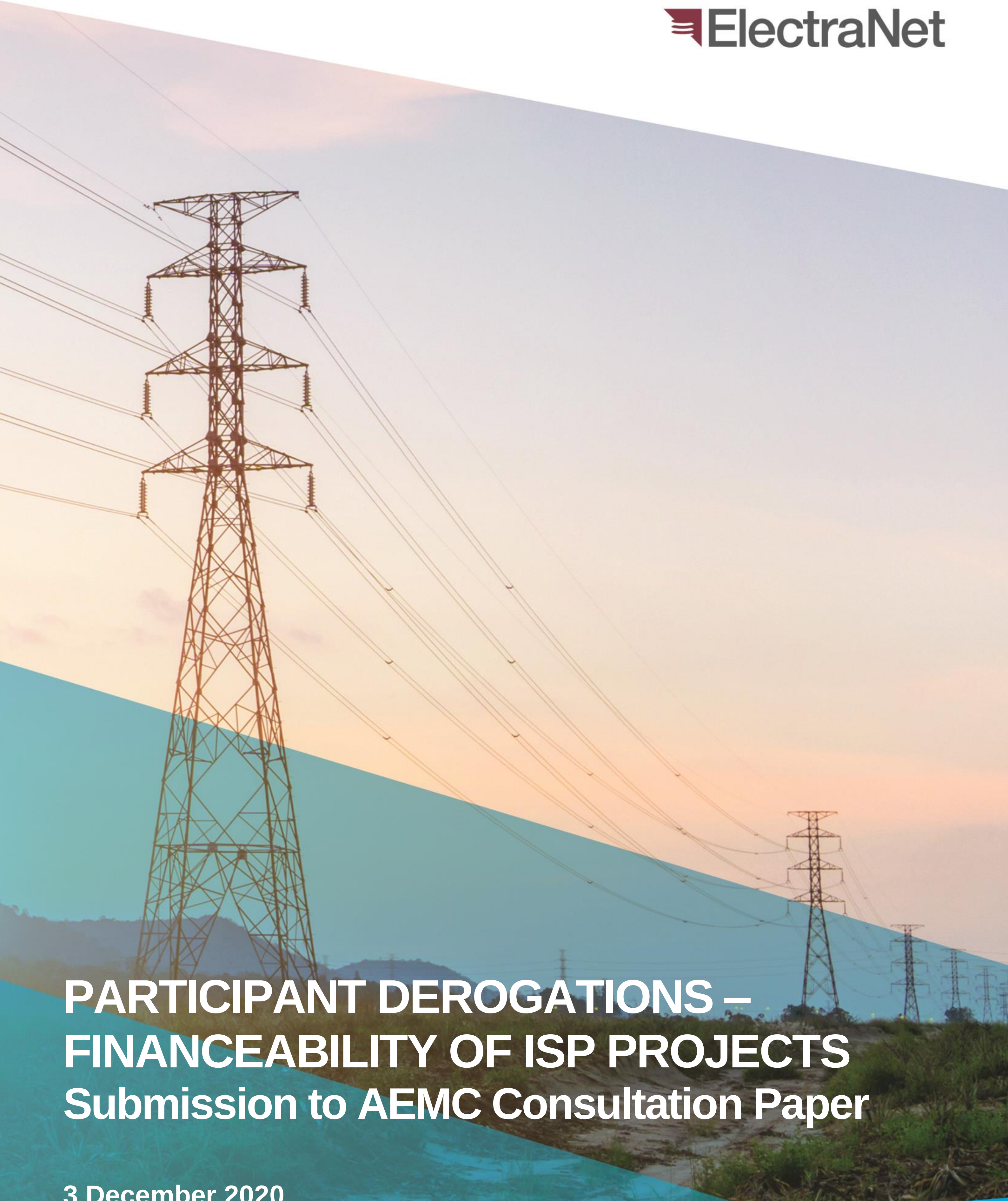
The analysis in our proposal shows it is not possible to address the identified issues under the current Rules. The Rule change proposal employs a revenue setting approach that has been adopted in other jurisdictions, and is consistent with good regulatory practice. The administrative costs of these changes are expected to be minimal.

We look forward to further engaging with the Commission as it assesses this important Rule change. 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

ElectraNet



PARTICIPANT DEROGATIONS – FINANCEABILITY OF ISP PROJECTS

Submission to AEMC Consultation Paper

3 December 2020

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1. Introduction

1.1 Background and context

ElectraNet welcomes the opportunity to make this submission in response to the Commission's Consultation Paper on the financeability Rule change proposals submitted by TransGrid and ElectraNet.

The Rule change proposals address concerns regarding the financeability of Integrated System Plan (ISP) projects such as Project EnergyConnect. Before turning to the issues raised in the Commission's consultation paper, it is important to recognise the economic case for Project EnergyConnect, which has now been settled under the Rules.

AEMO's 2020 ISP classified Project EnergyConnect as an 'actionable ISP project', which is required to deliver net market benefits and support energy market transition through:[1]

- lowering dispatch costs, initially in South Australia, through increasing access to supply options across regions;
- facilitating the transition to a lower carbon emissions future and the adoption of new technologies, through improving access to high quality renewable resources across regions; and
- enhancing security of electricity supply in South Australia.

In addition to AEMO's independent assessment of the need for Project EnergyConnect as part of its optimal development path for the National Electricity Market, which has been supported by a comprehensive stakeholder engagement process, the cost-benefit case has been thoroughly tested through the application of the RIT-T and associated extensive stakeholder consultation.

The process commenced with the release of our Project Specification Consultation Report (PSCR) in November 2016. Following the release of a Project Assessment Draft Report (PADR) in June 2018, the RIT-T assessment was concluded with the release of a Project Assessment Conclusions Report (PACR) in February 2019. This confirmed that a new interconnector between SA and NSW would deliver substantial economic benefits as soon as it can be built.

The AER carefully reviewed the economic case for Project EnergyConnect and reached a conclusion that the project satisfies the RIT-T in accordance with clause 5.16.6 of the Rules in January 2020.

[1] AEMO, 2020 Integrated System Plan, July 2020, p.86.

We subsequently conducted an updated cost benefit assessment that was published in September 2020 confirming that the project continues to deliver positive net market benefits and remains the preferred option under the RIT-T. This outcome was endorsed by the AER.

As the final regulatory approval step under the National Electricity Rules, the AER is currently reviewing the efficient costs of delivering Project EnergyConnect, following the submission of Contingent Project Applications by TransGrid and ElectraNet.

Noting that the economic case for Project EnergyConnect has been settled under the Rules, the present Rule change proposals are concerned with the specific question of the financeability of the project. While the question of the costs and benefits of the project are not within the scope of the Rule change, the customer benefits of the project remain relevant to the Rule change because they highlight the importance of delivering Project EnergyConnect without delay.

As explained in this submission, the evidence shows that:

- The current regulatory framework delays the recovery of revenue in a manner that raises risks for the financeability of Project EnergyConnect;
- These financeability issues can be addressed in a manner that will deliver a better outcome for customers, consistent with the National Electricity Objective; and
- The proposed changes to the regulatory framework are consistent with regulatory practice in other jurisdictions.

1.2 Structure of this submission

The remainder of this submission is structured to address the topics in the consultation paper:

- Section 2 discusses whether the regulatory framework creates a barrier to the financeability of the benchmark efficient firm;
- Section 3 considers the regulatory implications of creating a second RAB for ISP assets;
- Section 4 considers the consumer impacts arising from the proposed Rule change;
- Section 5 comments on how financeability issues could be addressed if the proposed Rule changes are not made; and
- Section 6 discusses whether there should be transitional provisions until the next revenue reset.

The information presented in the submission addresses the issues raised in the Consultation Paper. For convenience, we also provide answers to each of the specific questions raised in the Consultation Paper in the Appendix to this submission.

1.3 Contact details

To discuss any aspects of this submission, please contact:

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2. Does the regulatory framework create a barrier to the financeability of the benchmark efficient firm?

Key Points

- Under the current regulatory framework, the revenue profile for a large standalone ISP project commencing in 2020 does not achieve the benchmark credit rating for several decades. Our analysis provides compelling evidence that this unintended consequence raises financeability issues for Project EnergyConnect.
- Historically, cashflows generated by new transmission projects have been supported by revenue generated from existing assets. However, the magnitude of the ISP projects will undermine this portfolio effect, leading to financeability issues.
- The Commission's acceptance of the Rule change should not depend on evidence regarding the historical performance of the regulatory regime. Instead, it is appropriate to anticipate issues that may arise from ISP projects to ensure that these investments are not cancelled or delayed.
- We do not agree with the Commission's view that recovering costs prior to project commissioning is inconsistent with competitive market outcomes. Competitive markets exhibit a wide range of payment arrangements. It is not unusual, for example, for construction projects to involve scheduled payments at specified stages of completion.
- It is not possible to address the identified issues under the current Rules.

The Consultation Paper explains that the economic regulatory framework is designed to regulate the benchmark efficient entity as distinct from individual businesses and projects, consistent with the principles of incentive-based regulation. For this reason, the Commission is proposing to consider the financeability of ISP projects with reference to the AER's benchmark efficient entity.

The Commission observes that it is not aware of any evidence that economic regulation in Australia has led to under-investment in transmission networks. In this context, the Commission is seeking evidence that the hypothetical efficient benchmark firm would be unable to access investment grade debt for New South Wales and South Australian ISP investments. In addition, the Commission questions the issues relating to finance during construction, noting that:

- This is not a new issue and regulated networks have been able to manage this in the past; and
- For projects in competitive sectors of the economy, revenue is normally generated only after benefits start being delivered.

The Commission has observed that there is no evidence that economic regulation in Australia has led to under-investment in transmission networks. In this respect, the regulatory framework, which has been subject to incremental improvements in light of experience, has worked effectively for transmission investment to date.

ElectraNet's issue regarding financeability has arisen in relation to actionable ISP projects, which are typically very large projects compared to the value of existing Regulated Asset Bases (RABs). Financeability issues are exacerbated by other large transmission projects in the case of ElectraNet[2], and future ISP projects in the case of TransGrid[3]. It is the magnitude of these ISP projects that is now exposing a shortcoming in the existing regulatory framework that has not been evident historically.[4]

TransGrid and ElectraNet are not alone in questioning the adequacy of the existing regulatory framework to address the specific issues arising from actionable ISP projects.

The AER has recently commenced a review to examine whether the regulatory framework is 'fit for purpose' in relation to actionable ISP projects. In commencing this review, the AER makes the following observations regarding the unprecedented nature of ISP projects:

> "The recent reforms to make the ISP actionable have changed the way transmission planning is undertaken. AEMO's 2020 ISP identifies a number of actionable projects which it forecasts to cost between $6.8 and $12.7 billion over the period 2022-32. The magnitude of this investment in large and complex transmission projects is unprecedented, particularly when compared to the current transmission regulatory asset bases ($21.4 billion), which have remained relatively stable over the past decade.
>
> […]
>
> We are seeking to provide more predictability about how we will assess actionable ISP projects under the economic regulatory framework, and improve our regulatory assessment tools/processes to ensure they remain fit-for-purpose for large actionable ISP projects."[5]

The AER's review of the regulatory framework in relation to ISP projects illustrates that:

1. The magnitude of actionable ISP projects is introducing new issues and challenges for the regulatory framework; and

2. It is appropriate to adopt a proactive approach by anticipating issues that are expected to arise from actionable ISP projects, given their size and complexity.

[2] Project EnergyConnect is $471 million ($2017-18); the Eyre Peninsula Reinforcement is $283 million ($2017-18); and the Main Grid System Strength project is $183 million ($2017-18).

[3] TransGrid's Rule change proposal (page 9) states that it expects to spend $9-10 billion on greenfield capital investments over the next ten years to deliver its share of the ISP projects.

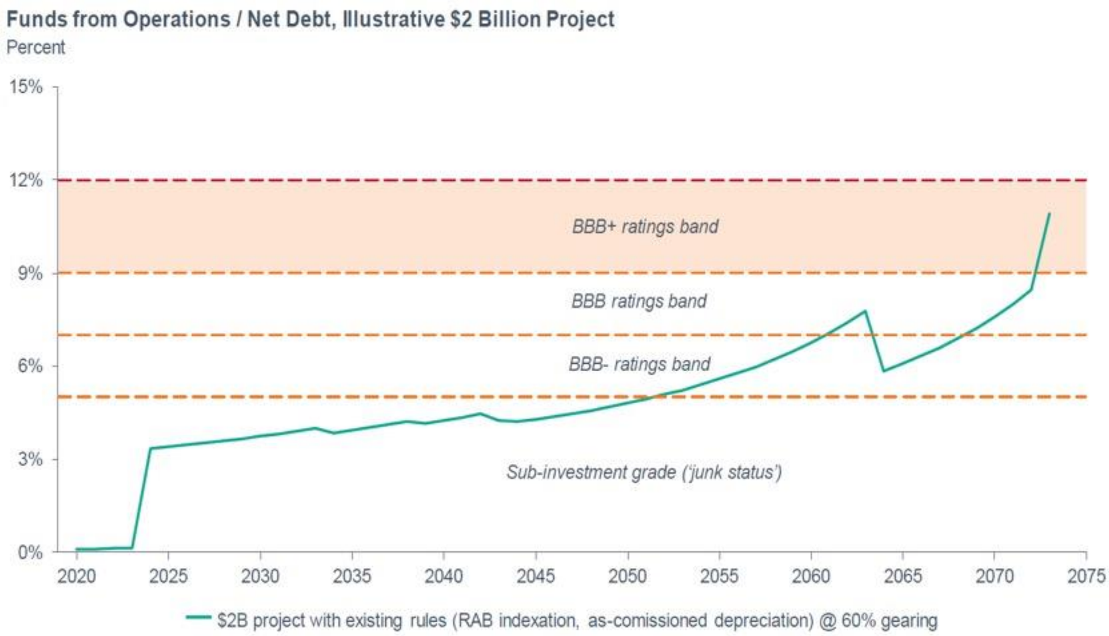
[4] By way of illustration, the latest annual regulatory reporting shows that the average size of ElectraNet's network projects is approximately $25 million (excluding Project EnergyConnect) with few projects over $50 million.

[5] AER, open letter, AER work program to support efficient delivery of actionable ISP projects —stakeholder views sought, 17 November 2020, page 2.

The AER is not waiting for evidence of a failure in the regulatory framework before considering the need for remedial action. Whilst the case for reform needs to be thoroughly tested, ElectraNet supports the AER's precautionary approach in examining the potential consequences of ISP projects for the effective operation of the regulatory framework.

The Rule change proposals submitted by ElectraNet and TransGrid are based on the same reasoning, focusing on the emerging issue of financeability. The Rule change proposals do not claim that financeability issues have caused projects to be cancelled – noting that no large ISP projects have yet been undertaken – instead the submissions identify a material risk that should be addressed, which is illustrated by Figure 1 below.

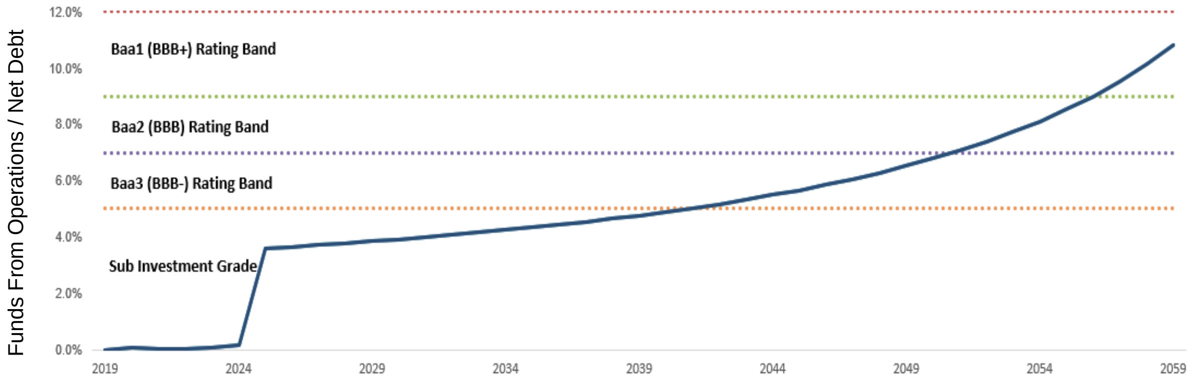
Figure 1: Implied credit rating for a standalone $2 billion project



TransGrid's analysis in Figure 1 above shows that a $2 billion standalone project commencing in 2020 does not achieve an investment grade rating under the current regulatory framework until 2050. Historically, this deficiency in the regulatory framework has not caused any financeability issues, as the portfolio of assets with different vintages have provided sufficient total revenue to support an investment grade rating. However, this portfolio effect will diminish as much higher value ISP projects are added to the RAB and financeability risks increase progressively.

Similarly, ElectraNet's analysis shown in Figure 2 below shows that a $500 million standalone project faces the same set of challenges, failing to achieve the current benchmark credit rating for over 35 years.

Figure 2: Notional credit rating for a $500 million standalone project



In relation to ElectraNet's circumstances, in October 2020 Moody's downgraded our credit rating one notch to Baa2 (stable) based on our current outlook, which is equivalent to Standard & Poor's BBB rating. The credit downgrade indicates ElectraNet's finances are already stretched based on the current capital program and the large investments we are already undertaking (including Eyre Peninsula and the Main Grid System Strength Project, as noted in our Rule change proposal).

The impact of Project EnergyConnect is not reflected in our current credit rating, which already sits below the AER's benchmark, and confirms the challenge of absorbing the impact of this project on a portfolio basis.

Rating agencies consider a range of factors in their credit rating assessments, since their methodologies are intended to be applicable to all corporates. However, regulated energy networks, and transmission businesses in particular, are quite homogeneous, and so the majority of these factors are common – the key difference is amongst the financial ratios.

While the rating agencies look at financial ratios, as documented in their published credit reports, Funds From Operations (FFO) over Net Debt is the factor that represents the principal constraint, and is considered a 'primary ratings action trigger'. Adequate cashflows are therefore central to these credit assessments, and FFO/Net Debt metrics not consistent with Moody's thresholds can result in credit rating downgrades and/ or negative 'outlooks'.

In relation to the issue of financing projects during the construction phase, we agree with the Commission that this has not been an issue in the past. However, the size of ISP projects means that project lead times are longer and the total costs during the construction phase will be greater. It is an area where a relatively minor change to the regulatory framework would help to ease the emerging financeability issues.

ElectraNet does not agree with the Commission's observation that a competitive market would ordinarily allow for payment only when the asset provides services, such as property leases or toll roads. We note, for example, that it is not uncommon for Governments to contribute to the costs of new toll roads, including prior to the commissioning date. A wide range of different payment arrangements can be observed in competitive markets. Large construction projects, for example, may typically require payment at various stages of completion. Cashflow is one reason why scheduled payments are observed in relation to construction projects.

Consideration of competitive market arrangements does not undermine the case for the proposed Rule change. On the contrary, competitive markets are characterised by a range of payment arrangements which are designed to facilitate transactions between suppliers and customers. In the case of Project EnergyConnect, the reprofiling of revenue is an appropriate response to the cashflow issues that have been identified.

The Commission has noted that the requirement for depreciation to be deferred arises through the Roll Forward Model and Post Tax Revenue Model made by the AER under Chapter 6A of the Rules. The Commission also notes that these models can be amended by the AER.

However, it is important to recognise that it is not possible to give effect to the Rule change proposal through modifications to these models under the current Rules, as indexation of the RAB and depreciation on commissioning of assets are each prescribed in the Rules (unlike the National Gas Rules).

Consistent with this, the AER has confirmed that the identified cash flow issues impacting on financeabilty cannot be addressed under the current Rules, and this has led to the Rule change proposals put forward by TransGrid and ElectraNet.

3. What are the implications of creating a second RAB for ISP assets?

Key Points

- The purpose of the Rule change proposal is to rebalance the revenue profile for ISP projects to support financeability. The proposal will not affect the allocation of construction risk, which depends on other aspects of the regulatory framework.
- The AER's rate of return instrument is not expected to be affected by the Rule change, as the AER will continue to estimate the nominal rate of return.
- The practicalities of a second RAB will need to be considered. However, this is not expected to be administratively costly or complex. The establishment of a second RAB also provides a level of transparency and rigour that is appropriate from a regulatory perspective.

The Commission comments that changing the economic regulatory framework by allowing two differently administered RABs for the same transmission business would represent a significant change from current regulatory arrangements. The Commission raises the following concerns:

- Whether the nominal rate of return RAB model (proposed ISP RAB) would be more attractive for providers of debt financing than the real rate of return RAB model (existing RAB) and what are the trade-offs for consumers and equity investors.
- Whether a second RAB using a nominal rate of return model may require consideration of the relative riskiness of each RAB investment. This would involve considering if the rate of return should be different for the nominal rate of return model since some construction risk would be eliminated and inflation risk would be transferred to consumers.
- Whether there may be related implications for the AER's rate of return instrument, including debt profiling arrangements, that may feedback into the proposed rule change.

The purpose of the proposed Rule change is to provide a revenue profile that supports the financeability of actionable ISP projects. The proposed approach is to provide for a nominal return on ISP projects and to allow for depreciation on an 'as incurred' basis. A nominal return model has been adopted in other jurisdictions, including by New Zealand's Commerce Commission.

The intention of the Rule change is to rebalance the revenue profile for ISP projects, consistent with the AER's benchmark assumptions. The proposal does not affect how the AER sets the capital expenditure allowance for ISP projects and, therefore, it has no impact on the allocation of construction risk.

The application of the nominal return model to ISP projects is not expected to have any impact on the AER's rate of return instrument, since its purpose is to align the revenue profile and cash flows with the benchmark assumptions adopted by the AER in establishing the regulated rate of return. In this way the Rule change does not reduce the risk profile to the TNSP relative to the assumptions applied in setting the rate of return, and consequently there are no implications for the AER's rate of return instrument. Under this model, the AER will continue to establish a nominal rate of return, as is currently the case.

Equally, the current framework assumes that customers pay for network assets regardless of their use over time, and so bear this form of stranded asset risk. Accordingly, adjusting the revenue profile can only result in an intertemporal transfer between customers, not a reduction in risk to TNSPs. As TNSPs are not directly exposed to or compensated for stranded asset risk, changes to the timing of revenue recovery have no implications for the regulated rate of return.

The practicalities of a second RAB will need to be considered. However, this is not expected to be administratively costly and should impose no significant burden on the AER or the businesses. The establishment of a second RAB also provides a level of transparency and rigour that is appropriate from a regulatory perspective.

ElectraNet believes the proposed solution represents the best available approach that balances the interests of customers and investors and ensures the viability of ISP projects, built on established methods applied in other jurisdictions as good regulatory practice. Nevertheless, we remain open to engaging further with the AEMC on any refinements or improvements to these proposals, in the interests of ensuring an optimum solution that best meets the interests of customers.

4. What are the consumer impacts of the proposed rules?

Key Points

- The proposal is important to support the financeability and timely delivery of Project EnergyConnect which will deliver substantial benefits to customers.
- The proposed Rule delivers a revenue profile that is more closely aligned with the profile of customer benefits and improves inter-generational equity by reducing the cost burden on future customers.
- The key issues of concern raised by our Consumer Advisory Panel regarding the impact on customers are addressed in the proposal. Specifically, the proposed Rule change will:
    - have no impact on the total capital cost of the project;
    - lead to no increase in revenue in present value terms, but result in substantially lower total revenues on an undiscounted basis; and
    - increase costs to South Australian customers by $5 pa which will be substantially outweighed by expected net price reductions of $100 pa.

The Commission notes that the proposals are said to allow consumers to obtain significant benefits in the long term while still ensuring the neutrality of revenue in present value terms. In response, the Commission is seeking feedback from stakeholders on the impact of the proposed changes on consumers, including the inter-generational wealth transfers the changes may create.

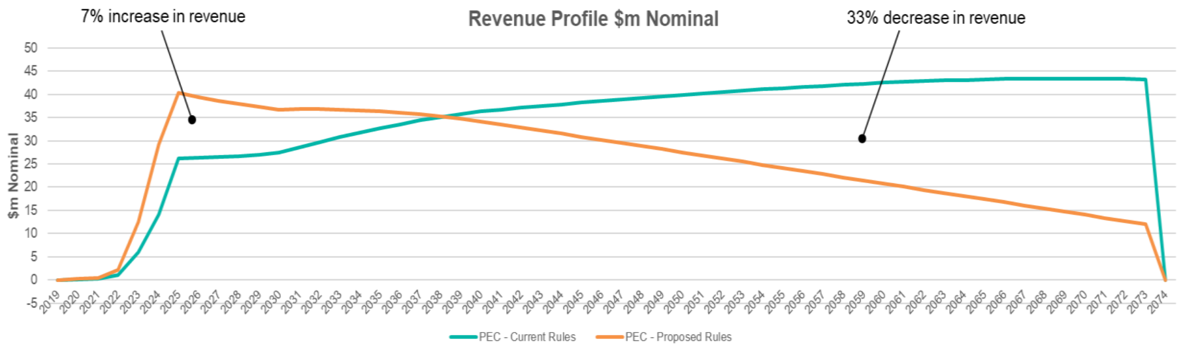
ElectraNet agrees with the Commission that the impact on customers should be the primary focus of its assessment of the Rule change proposal, consistent with the National Electricity Objective. The key question to be addressed is whether the proposed changes will promote efficient investment, consistent with the long term interests of customers. A secondary consideration is the impact on inter-generational equity, which is a question of allocative efficiency, considering the profile of costs and benefits.

We have obtained input from our Consumer Advisory Panel to understand member's views and potential concerns in relation to the Rule change proposal. The following points emerged from this engagement:

- Members were keen to understand that there would be no increase in the capital cost of the project from this Rule change;
- Members wanted to confirm there would be no change in the amount of revenue to be recovered over the life of the project; and
- Members also wanted to understand the net impacts on customer prices.

ElectraNet has provided information to the Consumer Advisory Panel which addresses each of these concerns. In particular, 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[6]. In relation to inter-generational payments, therefore, future customers will be paying less than existing customers.

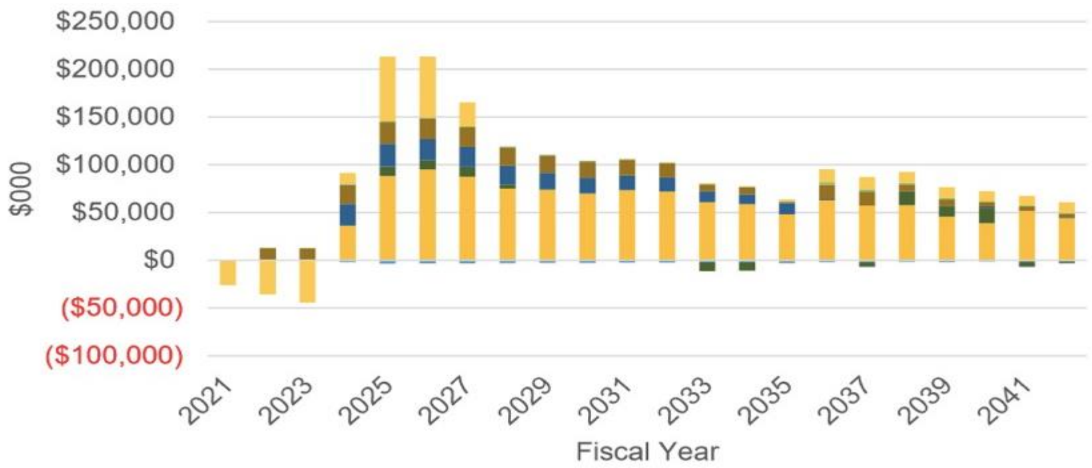
The Commission has rightly asked whether the reprofiling of revenues that would arise from the proposed Rule is appropriate when the benefits of Project EnergyConnect are considered. In this regard, the Commission notes that FTI's modelling indicates that the bulk of the wholesale electricity price reduction benefits of Project EnergyConnect occur after 2030, whereas the proposed Rule change would bring forward the recovery of revenue.

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[7]. As required under the RIT-T framework, this analysis considers the full range of market benefits delivered by Project EnergyConnect (which do not include wholesale electricity price movements, which are regarded as a wealth transfer).

6 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.

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

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.

In this regard it is also noted that the historic deferral of revenue recovery for large transmission projects under the current framework was more suited to a rising demand environment where the greatest benefits of these investments lay further in the future. In contrast, ISP projects such as Project EnergyConnect are expected to deliver significant benefits in the short term.

It is also important to have regard to the relative magnitude of the costs and benefits in considering the impact on customers of the proposed Rule change. ElectraNet estimates that the proposed Rule will result in additional short-term costs to South Australian customers on average of approximately $5 per annum per customer in the current regulatory period, compared to net price reduction benefits that have been independently estimated at approximately $100 per annum per average residential customer.

Given the information presented above, the proposed Rule change performs well in terms of inter-generational equity. However, inter-generational equity is a secondary consideration in comparison to the financeability issue, which may prevent Project EnergyConnect from proceeding. The potential loss from this event, or any delay to the project, would average $100 per annum for a typical South Australian residential customer.

The financeability issue is therefore significantly more material from a customer perspective than inter-generational considerations, which are essentially transfer payments between customers (which sum to zero).

5. How can financeability issues be addressed if the proposed changes are not made?

Key Points

- The Commission observes that utilities have typically traded at RAB multiples that exceed 1.
- There are a wide range of reasons why transactions occur at RAB multiples above 1. Consequently, it is not possible to draw inferences regarding the effectiveness of the regulatory regime from these transactions.
- The historical evidence of RAB multiples provides no guarantee that ISP projects are financeable or will proceed on a timely basis, which will depend on the prospective credit ratings for TransGrid and ElectraNet.

The Commission has sought feedback on how the financeability issues may be addressed under the current regulatory framework if the proposed Rule change were not made.

In particular, the Commission is interested in stakeholder views on why TNSPs may be unwilling to invest in ISP assets, considering that:

- the current regulatory framework allows for efficient cost recovery; and
- historic transactions indicate that investors value network businesses significantly higher than their regulatory asset value.

In relation to these two points, the Commission is particularly interested in understanding why a transmission business would potentially be unwilling to invest in an asset that, on its face, could be sold for more than it costs to build.

In addressing the Commission's question, it is important to recognise that RAB multiples may occur for a wide range of reasons, as explained in an ACCC presentation titled 'What do RAB multiples tell us about the cost of capital', by Dr Darryl Biggar who lists the following possibilities:[8]

- Perhaps the firm has access to additional revenue which is outside the building block model?
- Perhaps the firm expects to systematically benefit from the incentive schemes (persistently out-performing)?
- Perhaps the firm expects to pay less tax than is forecast under the building block model?

8 What can RAB multiples tell us about the cost of capital? Darryl Biggar, CRG Meeting, 11 December 2017, slide 8.

- Perhaps the buyers overpaid for strategic reasons, irrational exuberance, or winners curse?
- Perhaps the firm expects to expand output or adjust its prices within a price cap to earn more revenue?
- Perhaps the firm expects the regulation to be removed in the future?
- Perhaps the regulator overestimates the firm's cost of capital?
- Perhaps the trailing average approach favours the firm?

Given the range of possible explanations for RAB multiples above 1, Dr Darryl Biggar concludes in a subsequent paper that inferences regarding the effectiveness of the regulatory process cannot be drawn from RAB multiples:[9]

> "In my view, due to each firm's ability to earn rewards for taking desirable actions, an EV/RAB ratio of slightly above one should be considered normal.
>
> […]
>
> How then, might we use information on RAB multiples in regulatory processes? If the RAB multiple is close to 1, is this evidence that the regulatory framework is operating effectively? If the RAB multiple is different from 1, is this evidence that the regulatory framework is failing in some way?
>
> Not necessarily. As I emphasised above, there are several factors which affect the RAB multiple. The RAB multiple could be different from one for legitimate reasons."

The analysis presented by Dr Darryl Biggar would also caution against drawing inferences from the existence of RAB multiples above 1 to the financeability of actionable ISP projects. As explained in section 2 of this submission, there is overwhelming evidence that the cashflows produced by the regulatory framework do not support an investment grade rating for a standalone \$2 billion or \$500 million project. The fact that historical transactions have traded at RAB multiples above 1 across the broader network sector does not undermine the cashflow analysis for new ISP projects and the consequential financeability issues.

ElectraNet also notes that evidence of historical RAB multiples above 1 does not imply that Project EnergyConnect can be built and then sold at a multiple of its construction cost. Firstly, historical transactions relate to the value of the entity compared to its historical RAB, and it therefore provides limited information regarding the market value of a new project. Secondly, projects can only proceed if they can be financed, which depends on the company's prospective credit rating. The observation that utilities have traded at a RAB multiples above 1 does not imply that all new capital expenditure projects can be financed, particularly large ISP projects, none of which have yet been delivered.

9 Understanding the role of RAB multiples in regulatory processes, Darryl Biggar 20 February 2018, pp 11 and 12.

6. Should there be transitional provisions until the next regulatory reset?

Key Points

- The proposed transitional provisions enable the AER to take account of the Rule change in its decision on our Contingent Project Application, which the AER is currently reviewing.
- In order to address the financeability issues identified by ElectraNet it is necessary for the Rule change to apply to Project EnergyConnect in the current regulatory period.

The Commission notes that the Rule change proponents have requested that their proposed changes to the Rules be applied to their current regulatory control periods as the investment in actionable ISP assets will commence before the next revenue reset. The Commission is seeking feedback on whether stakeholders believe that this is necessary and whether there are potential alternative options.

ElectraNet notes that Contingent Project Applications have been lodged with the AER in relation to the South Australian and New South Wales components of Project EnergyConnect. This process will culminate in the AER setting a revenue allowance in relation to Project EnergyConnect that will apply for the balance of the current 5 year regulatory period.

The purpose of the transitional provisions in the proposed Rule change is to ensure that the AER is able to apply the revised approach to revenue setting in relation to its decision on our current Contingent Project Application to address the financeability concerns in relation to Project EnergyConnect. Deferring the applicability of the Rule change proposals to the next regulatory period will not help timely decision making and delivery of customer benefits from Project EnergyConnect.

In order to address the financeability issues identified by ElectraNet it is necessary for the Rule change to apply to Project EnergyConnect in the current regulatory period. The proposed Rule drafting addresses this by enabling the AER to make a *variation amount determination* approving the additional amount of revenue to be recovered during the construction period to support the financeability of the project.

APPENDICES

Appendix: Response to the Commission's questions

Commission's question	Response
QUESTION 1: RULE CHANGE REQUEST ASSESSMENT FRAMEWORK	
Do stakeholders agree with the proposed assessment framework?	Yes, ElectraNet supports the Commission's assessment framework, which is firmly focused on the National Electricity Objective (NEO). In relation to financeability, it is appropriate for the Commission to consider the matters set out in the consultation paper. In terms of weight, the Commission should give primacy to the impact on customers; efficient investment; and efficient operation of electricity services, as these are matters directly mentioned in the NEO. The impact on the regulatory framework should be a secondary consideration, guided by these matters. The regulatory framework should serve the long term interests of customers with respect to efficient investment in and operation of electricity services. As such, the impact of the proposed Rule change on the regulatory framework should only be relevant in terms of understanding the practicality and cost of the proposed change, guided by these objectives.
Are there any other considerations the Commission should take into account?	No.
QUESTION 2: CHANGING THE ECONOMIC REGULATORY FRAMEWORK	
Does the current economic regulatory framework allow transmission networks to recover their efficient costs when ISP capex is included?	The Rule change proposal will not change the ability of transmission networks to recover the efficient costs of delivering ISP projects, as determined by the AER, nor will it change the total revenue (in present value terms) to be recovered from customers, . Instead, the Rule change proposal is concerned with changing the timing of revenue recovery to support financeability. As already noted, the total revenue in undiscounted terms will be significantly lower under the proposed Rule.

Commission's question	Response
If you consider ISP projects to be materially different from other transmission network capex, how do you think the proposed changes would address this: - the change to a nominal rate of return - the change from allowing depreciation as commissioned to depreciation as incurred?	The scale of ISP projects raises unique challenges, as recently noted by the AER in announcing its review of the regulatory framework relating to these projects. In addition, actionable ISP projects have a particular role in the ISP and AEMO's optimal development path for the NEM. The proposed Rule change applies targeted and proportionate changes to these elements of the revenue setting arrangements for ISP projects to rebalance the revenue profile in order to mitigate the financeability issues that have been demonstrated under the current regulatory framework for these projects.
Is the proponent's proposal in the long term interests of consumers with respect to the price of the supply of electricity ?	Yes. The case for delivering Project EnergyConnect has been settled under the Rules following extensive analysis and review since November 2016. The Rule change proposal will assist in securing the financeability of the project, which will deliver substantial benefits to customers. The price impact of bringing forward the revenue recovery also delivers improved inter-generational outcomes for customers, as the project benefits are also front-end loaded, thereby better aligning revenue recovery with the project benefits.
How could short-term cash flow variability be addressed under the current regulatory economic framework?	The AER has confirmed that the cash flow issues cannot be addressed under the current Rules. While incremental changes could potentially be made to depreciation, for example, to bring forward revenue recovery to some extent under the current Rules, this would likely require much shorter asset lives, which would be inconsistent with their economic service life and unlikely to fully address the financeability issues.
How else could financeability issues be addressed in the regulatory framework?	ElectraNet remains open to alternative remedies, but we are not aware of a better approach that balances the interests of customers and investors and ensures the viability of ISP projects.

<table>
<tr><th>Commission's question</th><th>Response</th></tr>
<tr><td colspan="2">QUESTION 3: THE REGULATORY ASSET BASE</td></tr>
<tr><td>Is the impact of ISP projects materially different enough from other transmission network capex projects to justify a separate treatment?</td><td>Yes. As noted above, actionable ISP projects have a number of unique characteristics both in relation to their size and the value they provide to the NEM. Rule changes have already been introduced that apply a different regulatory approach to the planning and approval of actionable ISP projects. Other than these projects, all other past and future transmission investments would remain subject to the current treatment.</td></tr>
<tr><td>If you consider ISP projects to be materially different from other transmission network capex, how do you think the proposed changes would address this:
the change to a nominal rate of return
the change from allowing depreciation as commissioned to depreciation as incurred?</td><td>As noted above, the proposed Rule change will address the financeability issues arising from actionable ISP projects as these changes relate to the Regulatory Asset Base. The proposed approach is consistent with regulatory practice in other jurisdictions in this regard, most notably the Commerce Commission's regulation of Transpower in New Zealand.</td></tr>
<tr><td>How does your view lead to a better outcome under the NEO or the revenue and pricing principles?</td><td>The Rule change facilitates the delivery of priority ISP projects such as Project EnergyConnect in a timely manner, which has been demonstrated to maximise net market benefits in accordance with the RIT-T. As such, it promotes efficient investment in accordance with the NEO.

In addition, the Rule change proposal is also consistent with subsection (6) of the Revenue and pricing principles in the NEL, which requires that "regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider." In accordance with this provision, ElectraNet's view is that the economic cost of Project EnergyConnect not proceeding in a timely manner justifies the Rule change.</td></tr>
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Commission's question	Response
How can the twin RAB model be implemented in practice and what are the effects on the other elements of the regulatory framework?	This change is administratively straightforward, and can be introduced without substantial costs to either the AER or ElectraNet.
Are there potential unintended consequences of the twin RAB model the Commission should be aware of?	The twin RAB model is relatively straightforward and not without precedent, as outlined above. One detailed aspect of its implementation is the allocation of inflation risk. ElectraNet would be happy to engage further with the AEMC on the detailed design elements of the proposal as required.
How could unintended consequences that only emerge in the future be addressed?	Please refer to the above answer.
If two RABs are allowed, which ISP investments should qualify for inclusion in the second RAB?	ElectraNet has provided a definition in its Rule change proposal, which limits the inclusion in the second RAB to future ISP projects, the only one of which currently applies in South Australia is Project EnergyConnect.
QUESTION 4: CONSIDERING CONSUMER IMPACTS	
Considering the expected consumer benefits from commissioning the ISP assets, do you agree that not making a change will result in a loss of those benefits?	Yes. In the absence of the Rule change there is an increased risk that Project EnergyConnect will not proceed in a timely manner due to the difficulty in financing the project. However, it is not necessary to prove that the project will not proceed in order for the proposal to meet the Rule making criteria. Instead, it would be appropriate for the Commission to adopt the precautionary principle by making the Rule change based on the evidence that the regulatory framework creates substantial financeability risks in relation to actionable ISP projects under the current revenue setting arrangements, based on inadequate revenues to meet benchmark criteria. It would be contrary to the interests of customers to wait until an ISP project is actually cancelled or delayed before taking action.

Commission's question	Response
Does TransGrid's proposed changes result in intergenerational wealth transfers?	In relation to ElectraNet's customers, we have demonstrated that the inter-generational impacts will tend to improve equity compared to the status quo, as the revenue profile will better match the benefit profile and significantly reduce the burden on future customers.
Are consumers willing to pay more now for future benefits that are likely to occur in the future?	ElectraNet has discussed customers concerns with our Consumer Advisory Panel. Section 4 explains that each of their concerns have been addressed. As our illustrative example above shows, a rebalanced revenue profile would result in a revenue increase in the order of 7% initially, in return for a 33% decrease in the revenue recovered over the remaining life of the asset.
Are consumers willing to pay for assets before being able to obtain any benefits?	The current framework already provides a return on capital expenditure as it is incurred on network investment. Depreciation currently commences on commissioning of an asset, and would commence during construction under the proposed Rule in line with the existing return on capital timing. In ElectraNet's case, revenue recovery would commence in 2021-22 with completion of the project due to follow in 2022-23. This timing remains the same under the current and proposed Rules, while the profile of revenue recovered will change. This is not inconsistent with outcomes in other markets, as it is necessary to fund the construction of a project in order to realise its benefits. As the improved cashflow supports the financeability of Project EnergyConnect, this delivers significant benefits to customers, with the expected net price reduction from the project far exceeding the price impact of the Rule.

Commission's question	Response
QUESTION 5: CAN FINANCEABILTY BE ADDRESSED UNDER THE CURRENT ECONOMIC REGULATORY FRAMEWORK?	
Given the RAB multiple paid by investors in Australian energy networks, what are the impediments to investors when the investment involves an ISP project?	The historic RAB multiples observed do not prove the financeability of Project EnergyConnect, nor do they undermine the analysis that ElectraNet has provided to show that the cashflows produced by the current regulatory framework do not support an investment grade rating for a standalone actionable ISP project.
If construction risk is one of the factors [for] low credit ratings for ISP projects, could equity provide sufficient support to bring those projects through the construction phase?	As detailed in Incenta's report that accompanies TransGrid's Rule change proposal, investors that are attracted to regulated energy networks have strong expectations about the stable nature of the returns that are generated, which requires gearing that is similar to the regulatory benchmark. This limits the amount of equity financing that can reasonably be expected before negatively impacting on equity returns, which would be contrary to the benchmark assumptions. Inadequate returns would undermine investor confidence and create challenges in attracting equity finance from providers of equity funds to support ongoing investment in the sector. In addition to these constraints, the regulatory framework should be internally consistent, so that the AER's benchmark gearing and credit rating are consistent with the revenue profile derived from the PTRM. The evidence presented shows that the framework is internally inconsistent in relation to actionable ISP projects, as it adopts a BBB+ benchmark credit rating but generates a revenue stream inadequate to sustain it. The Rule change provides an appropriate resolution to the issue of financeability by restoring the internal consistency that has been achieved historically when it was possible for new transmission projects to be supported by revenue from existing assets.

Commission's question	Response
What options, other than changes to the economic regulatory framework, could be considered to ensure timely investment and delivery of ISP projects?	ElectraNet considers that the best approach is to most directly address the deficiencies in the regulatory framework through a targeted and balanced change, as this is driving the financeability issues. As already noted, the AER is also considering changes to other aspects of the regulatory framework to address the unique characteristics of actionable ISP projects. In this regard, the Rule change proposal is aligned with the AER's recognition that changes to regulation may be necessary to promote the achievement of the NEO for these projects.
QUESTION 6: TRANSITIONAL ISSUES	
If the proponents' rules are made, should there be transitional provisions to apply them to VNI minor and PEC?	In order to address the financeability issues identified by ElectraNet it is necessary for the Rule change to apply to Project EnergyConnect in the current regulatory period. The proposed Rule addresses this by enabling the AER to make a *variation amount determination* approving the additional amount of revenue to be recovered during the construction of the project to support the financeability of the project.

ElectraNet