3 December 2020

The Commissioners
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Sent to: AEMC by online lodgement

Dear Commissioners

Financeability of ISP Projects
Consultation Paper on Rule Change Proposals
ERC 0320 and ERC 0322

Major Energy Users Inc (MEU) is pleased to provide its thoughts on the issues raised in the Consultation Paper for rule change proposals to change the approach to revenue recovery from ISP projects carried out by TransGrid and ElectraNet.

The MEU was established by very large energy using firms to represent their interests in the energy markets. With regard to all of the energy supplies they need to continue their operations and so supply to their customers, MEU members are vitally interested in four key aspects – the cost of the energy supplies, the reliability of delivery for those supplies, the quality of the delivered supplies and the long term security for the continuation of those supplies.

Many of the MEU members, being regionally based, are heavily dependent on local staff, suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those interests of smaller power and gas users, and even at the residences used by their workforces that live in the regions where the members operate.

It is on this basis the MEU and its regional affiliates have been advocating in the interests of energy consumers for over 20 years and it has a high recognition as providing informed comment on energy issues from a consumer viewpoint with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

The MEU stresses that the views expressed by it in this response are based on looking at the issues from the perspective of consumers of electricity and it has not attempted to provide any significant analysis on how the proposed changes might impact other stakeholders.

Expediting the rule change proposals

The MEU notes that both rule change proponents sought for the rule change to be expedited as delays in approval of the rule changes proposed would result in further delays to the delivery of Project EnergyConnect (PEC) and potentially other ISP projects. The MEU agrees with the AEMC that these two rule changes have such wide-reaching effects they should be assessed on their merits in a full consultation process.

The MEU is of the view that the full evaluation process must apply to what are quite fundamental changes to the NEM processes that have been developed over many years and to make a change of such magnitude without proper consultation would not reflect the degree of attention that was applied in the past when establishing these rules.

The MEU is quite concerned that, despite the significance of the implications of these rule changes across the NEM, the AEMC has agreed with the proponents that it will speed up the review process. The MEU considers that the AEMC has erred in this regard and should allow for the changes to follow the usual process and not hurry to a solution.

Recovery of capital

The first part of the rule change proposals is for the TNSPs to be allowed to not only to receive a return on the expenditure incurred during the design and construction phase of ISP projects, but to also receive the benefits of depreciation on these projects during the design and construction phases, prior to them coming into operation. Effectively, the TNSPs want consumers to pay for a service before it can even provide a service and before the TNSPs deliver any benefit to those that will have to pay for these assets for the next 50-60 years.

The MEU points out that regulation is supposed to replicate the effects of competition. Firms in competition receive no benefit at all from their investments during the design and construction phase and it is only when the investments commence generating revenues do the firms get any return on their investment.

The MEU also points out that firms in competition rarely get anywhere near the long-term target revenue from their investment as soon as the investment is operational. Usually, such firms have to devote considerable efforts in selling the products from their investment so it can be many years before the revenue from the investment exceeds the ongoing costs and so deliver a return on the investment. In contrast, TNSPs get full recovery from their investment from the time they complete construction and the asset is available for use.

The TNSPs propose that they should overturn what is an entirely appropriate control if the role of the regulator is to replicate competition. While the MEU recognises that its members would be pleased to receive a return of and a return on their investments prior to them generating revenue, this doesn't happen in the competitive world.

On this basis the MEU considers that it would be entirely wrong for the AEMC to make a rule change to allow the TNSPs to get any benefit from the investment prior to consumers getting a benefit in terms of the rewards the TNSPs advise will come from the investment. Specifically, the AEMC should reject the proposal for recovery of depreciation before the assets go into full service.

Changing the approach for revenue generation

The proponents seek for the long-standing rule that the return on an investment is to follow the approach of Depreciated Replacement Cost (DRC) x real weighted average cost of capital (WACC) which underpins the current rules. Instead the proponents want revenue on ISP projects to be based on Depreciated Actual Cost (DAC) x nominal WACC.

The MEU points out that the National Electricity Code (NEC) was developed on the basis of the Optimised Deprival Value (ODV) for valuing assets for the Regulated Asset Base (RAB) but this was changed (probably for convenience due to the difficulty in assessing the ODV) over the years to the current regulatory inflation adjusted basis form of DRC.

The MEU notes with interest that during the development of the third party gas access code in the late 1990s, networks were fierce opponents of using the DAC approach that consumer representatives tended to support at that time and networks insisted that the Depreciated Optimised Replacement Cost (DORC) was the most appropriate method for calculating the RAB of gas pipeline assets for regulatory purposes. Subsequently, the NEC converted to the DORC approach to asset valuation as well. Over time, the networks were able to convince the AEMC that there should be no optimising of the asset base so the DORC has since degenerated into the DRC.

So, it is intriguing that the networks, seeing that the RAB calculation on a DRC basis doesn't work for them at the moment, consider a change to the DAC approach is suddenly needed. This has all the hallmarks of a "policy approach" to regulation by networks to consider that "heads I win, tails you lose" is the way regulation should operate. Presumably, when conditions change in the future, they will seek a reversion to DRC asset valuation process[1].

[1] The MEU has recently seen this "policy approach" (where networks seeking the best outcome for them at any point in time) in operation by them requesting the AER to use a different approach to calculation of inflation in the AER post tax revenue model (PTRM) and to change the very model that they insisted upon back in 2007!

The MEU notes that if the rule change was made for ISP projects, then there would be a need for two “RAB” accounts, increasing regulatory complexity. But even more so, while the proponents state that they are only seeking a rule change to apply their own ISP projects, other TNSPs will seek to get the benefit of the same derogation. Once the precedent has been created, the MEU can see all TNSPs and even DNSPs seeking the same derogation for their “ordinary” investments where they see this would be to their advantage.

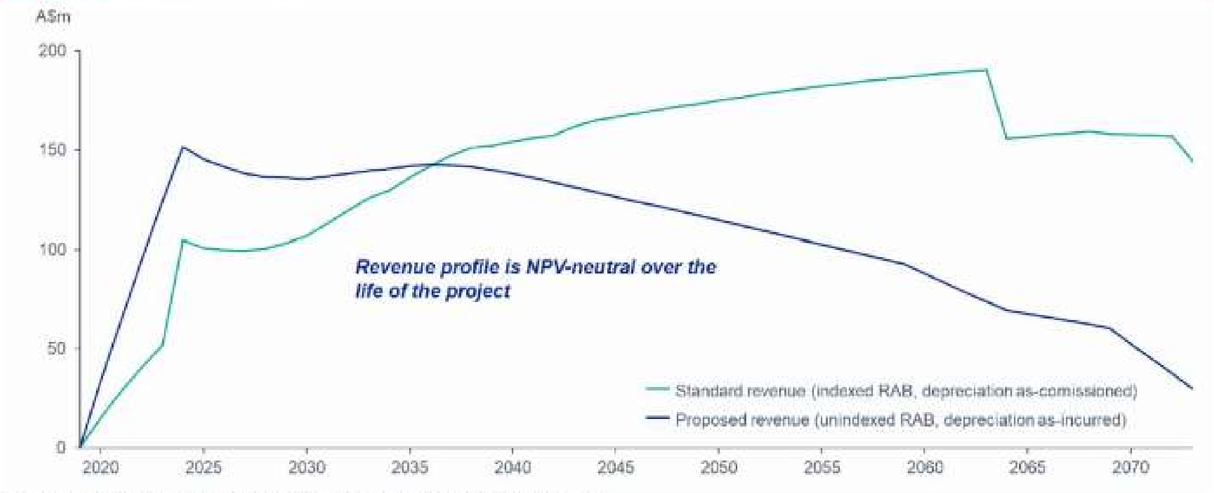
With this in mind, the MEU sees that granting this rule change derogation has the potential to flow through to all NSP investments. While this option has been countenanced in the recent AER discussion on the assessment of the approach to forecast inflation for the PTRM, it was also recognised that such a change would be a major change to the rules. The MEU considers that such a major change cannot properly be assessed within the short time frame the AEMC has allowed for this rule change proposal.

The MEU sees that the proposed rule change will change the PTRM where some of the inflation risk carried by the NSPs will transfer fully to consumers. The MEU sees that as the AER is currently in the process of assessing the allocation of inflation risk through the current rate of Return Instrument (RRI) assessment, to use this narrowly focused rule change to impact the wider aspect of inflation management is inappropriate.

The MEU accepts that the DAC x nominal WACC is the approach used by firms operating in the competitive world, and this approach tends to work reasonably when the outlook term is much shorter than the lives of the assets contemplated by these ISP projects. Typically, firms in the competitive sector recognise that future revenues from an investment have a reasonably firm forecast ability of up to ~15 years – forecasts and expectations even within this timeframe (but more so beyond) are beset by the likelihoods of technological changes, new smarter competitors leading to lower costs for the products being produced from the investment, so forecast economic asset lives are seldom considered beyond this timeframe even though the technical life might well exceed this term.

In contrast, the ISP projects have an expected economic lifespan of 50-60 years over which consumers are required to guarantee a return of and on the investment. Equally, the forecast benefits of these projects have been assessed over a similar asset lifespan (ie 50-60 years), raising concerns as to whether the forecast benefits will in fact be achieved. The concept of the DRC x real WACC is more appropriate for such long lived assets both in terms of long-term revenue streams and for intergenerational allocation of costs. This is shown in figure 3.4 of the consultation paper where the revenue profile reflects a more equitable intergenerational sharing of the costs of the asset

Figure 3.4: Revenue profiles



Source: TransGrid, rule change request, 30 September 2020, p. 14.

The proposed rule change will not only lead to an effective acceleration of depreciation (ie compared to the DRC x real WACC approach) but it will increase costs to current consumers to the benefit of future consumers. There needs to be a balance so that the costs are fairly allocated between generations and the current approach does this reasonably well.

The MEU notes that the bulk of the benefits identified for the PEC are quite heavily back ended which will further distort the intergenerational aspect such that current consumers will pay more for fewer benefits and future consumers pay less for greater benefits – this is not an equitable allocation between the generations.

NPV is maintained by the change, or is it?

TransGrid opines that the long-term interests of consumers are maintained by the change, so the National Electricity Objective (NEO) is maintained. The MEU questions this.

The NPV calculation by TransGrid is based on the WACC developed by the AER in its RRI assessment. While the MEU accepts that the RRI provides an appropriate return for the investment made by NSPs, this is based on the risk profile faced by networks and the risk mitigation provided by the rules.

However, the RRI is not the appropriate discount rate for use where the risks faced by consumers into the future are totally different and are much greater. In particular, the benefits of the project are thought to deliver involve considerably higher risk in their achievement than the certainty that NSPs get in achieving their future cashflows. With this in mind, the MEU has sought advice from its members who are not only capital-intensive businesses, but who operate in an environment where they do not enjoy the certainty of cashflows that NSPs do. They advise that they use discount rates of 12-

15% nominal as a method to assess the risks they face in their forecasts of future cashflows.

With this in mind, the MEU considers that to ensure NPV neutrality, the NPV of the two options (ie current and proposed) should be based on a much higher discount rate, one which reflects the risk profiles of consumers rather than the risk profile faced by NSPs. If a higher discount rate is used, then the MEU considers that the two different approaches to setting cashflow will not be neutral.

Without the change, the project might not proceed

On page 8 of the AEMC Consultation Paper, the AEMC observes that TransGrid asserts

> "…without the rule change, there is a "serious risk that the ISP projects may not be delivered, or are not delivered in a timely manner."

The underlying assumption in this statement is that as the projects will deliver net benefits to consumers, the projects must proceed. The MEU has quite severe concerns about this. The only ISP project so far that has so far "passed" a RIT-T is Project EnergyConnect (PEC). At a capital price of $1.5 Bn, the AER assessed that this project would deliver a net benefit of some $290 m. Since then, the project cost has risen to $1.99 Bn in the 2020 ISP and then to $2.4 Bn in the Contingent Project Application at which point the project is forecast to deliver net benefits of about $150 m (central case)[2]. The MEU has serious concerns that the revised net benefits have even been assessed appropriately but notes that the AER has reviewed the new capital costs and revised (increased) benefits. Unfortunately this review has not been exposed to stakeholder assessment on the basis that the increase in cost and revised (increase) in benefits are, in the view of the proponents, "not material"[3] – this assertion has been apparently accepted.

The MEU advises that its members would not seek to invest $2.4 Bn for a net benefit of merely $150 m. This raises the important issue as to whether the project should proceed on such a high capital investment for such a modest reward.

The MEU also questions the impact on the project of the trailing average approach to debt as the trailing average approach will change the future cost of debt assumed in the forecast revenue stream. Currently, at the behest of the networks (amongst others), the debt component of the revenue stream currently provides the networks with a benefit as the average trailing average includes a considerable contribution from the higher cost debt that occurred in past years. It is recognised that the cost of debt is currently very low but that at some time in the life of these projects, the cost of debt will

[2] ElectraNet report – Project EnergyConnect Updated Cost Benefit Analysis dated 30 September 2020 page 23
[3] Under any reasonable test, the MEU considers the changes are "material

rise, potentially returning to levels seen between the 1990s and up to the middle of the current decade. The trailing average debt of the future will include the current very low interest rates and contrary to now when the trailing average is higher than the current costs of debt, the trailing average will be lower than the then current cost of debt.

If these ISP projects are so finely balanced that they cannot proceed without a rule change to increase early cash flow, then the impact of the trailing average approach to calculating debt will, at a point in the future, reduce revenues compared to the then cost of debt and impact FFO/net debt assessments as future debt costs rise. As the proponents have not included this reality into their assessments, the MEU questions the assertion that this rule change must proceed if the ISP projects are to be implemented.

Is the TransGrid/ElectraNet proposal the most cost efficient?

Implicit in the TransGrid and ElectraNet approach to changing the rules is that they might be unable to finance the projects without the rule change, but is this need unique to them and is the rule change really necessary? Obviously TransGrid and ElectraNet consider the rule change advantageous to them but that does not imply that the rule change would be an essential element to other proponents.

The MEU notes that in Victoria, AEMO awards augmentation projects after there is a competitive tender process and the recently announced NSW Energy Infrastructure Roadmap includes the ability of the Minister to

> "…direct a network operator to carry out … a priority transmission infrastructure project".

Implicit in such a direction, would be that if one TNSP did not carry out the work for "a priority transmission infrastructure project" (for whatever reason) then the Minister may direct another party to provide the work.

So far only ElectraNet and TransGrid have been involved in PEC and TransGrid and AEMO (as the Victorian TNSP) for other ISP projects scheduled in the near future. The market has not been tested as to whether another provider could deliver the project under the current rules and without the need for a rule change.

The MEU considers that, while the assumption is that a rule change is needed to deliver the projects by the current proponents, this does not mean that all potential providers have the same need that TransGrid and ElectraNet assert is essential.

Credit rating impact on the project

TransGrid has commented that its assessment of the metric "funds from operations (FFO) to net debt" under the current rules would render an ISP project (using PEC as an example) to be exposed to a sub-investment grade credit rating and therefore to finance the project would require more than the Benchmark Efficient Entity (BEE) equity share of 40%.

The AEMC Consultation Paper provides information that the metric FFO/net debt is but one metric used by rating agencies and that, while important, is not the only metric which drives the outturn credit rating and there are a number of equally important other metrics (both qualitative and quantitative) that have just as much influence as FFO/net debt.

With this in mind, the MEU considers that perhaps TransGrid is a little disingenuous in its portrayal that FFO/net debt is the prime metric that results in the ISP projects being non-viable under the current rules.

The MEU also points out that ElectraNet has had a recent credit review by Moody's[4] and despite the introduction of PEC and two other large projects, Moody's reduced ElectraNet credit rating from Baa1 to Baa2. Moody's observed that ElectraNet could return to the higher credit rating if it reduced its gearing to less than 80% even with these other projects added to the RAB. As the RRI assumes that gearing is 60% debt, it would appear that ElectraNet decision to have such a high level of gearing does not lead to it being at risk by the inclusion of the PEC under the current rules.

What is also not clear is, when making the assessment that the firms would degenerate into "junk bond" status if the rule change was not made, whether this assessment is made uniquely with regard to the project expenditure and revenues or whether it was across all of the TNSPs' activities. Based on Moody's assessment of ElectraNet credit rating, it would appear that the TransGrid assessment has been made on an individual project basis[5] and the MEU points out that TransGrid already has a RAB of >$7 Bn and annual revenue exceeding $800m pa from its existing regulated operations which would ameliorate the impact of the new project. In addition, TransGrid has unregulated activities that add to its regulated revenue stream.

On this basis, the MEU considers that the impact of new projects (ISP and those in the transmission annual planning reports - TAPRs) would ameliorate considerably the implied descent into "junk bond" status. Without a more detailed analysis demonstrating to the contrary, the MEU considers that TransGrid, like ElectraNet, might suffer a small reduction in credit rating as a result of the ISP projects being implemented based on the current rules but they would not "descend" into junk bond status across the whole of the TNSP activities.

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[4] Moody's Investor Services rating Action: "Moody's downgrades ElectraNet to Baa2; outlook stable" 9 October 2020

[5] As the TransGrid assessment is based on the assumption of a $2 Bn project in isolation, this view of the TransGrid assessment being a project basis is reinforced by the chart provided in the Consultation Paper figure 3.1 on page 13.

Consultation with stakeholders

The MEU points out that not only has ElectraNet and TransGrid had limited consultation with stakeholders about the decision to increase the cost of PEC (along with the increase in supposed benefits), they have taken the same limited consultation process (basically at the “inform” level under the IAP2 spectrum) in the discussions with stakeholders on the financeability of the PEC and other ISP projects.

In its observations during discussions with its Consumer Advisory Panel meetings (where the MEU has representation), when questioned as to what ElectraNet might do if the rule change was not made, ElectraNet only highlighted that both firms were needed to commit to the project in order for it to proceed. Based on the Moody’s report on ElectraNet credit rating it would seem that ElectraNet could reasonably be expected to continue with the PEC in the absence of the rule change requested.

Conclusions

The MEU does not support the proposed rule change for a number of reasons as, in addition to the obvious concerns, it also brings with it a number of potentially unintentional outcomes that have not been canvassed because the issues have been too tightly focused on the immediate needs identified by the proponents. To address these unintended consequences will require a much longer timeframe than the AEMC has allowed for the rule change proposal.

In summary, the MEU does not support the rule change because:

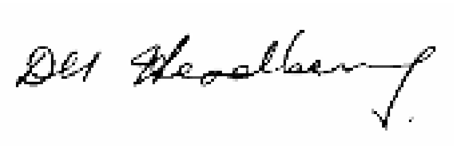
- The approach to permitting receipt of revenue before the investment is complete and operational does not reflect the reality that in the competitive world, a facility has to be fully operational before any revenue can be generated; this concept should be applied to all TNSP projects including ISP projects
- The current process is one that networks fought for inclusion in the rules in the past (and actively opposed what they now seek) when the concepts now embedded in the rules were being fully developed
- Introducing the change would create a precedent for all network investment
- The rule change would increase costs on current consumers due to the effective acceleration of depreciation and imposition of higher costs, changing the current balance between the interests of current consumers and future consumers
- The assertion that the NPV of the two approaches is the same does not hold when a discount rate appropriate to the risks faced by consumer is used to generate the net present value of the options
- The assertion that the project might not proceed without the change does not hold when assessing the addition of the project to a fleet of assets has only a minor impact on the overall credit rating of the NSP
- If the projects are so tightly balanced then the impact of the trailing average approach to debt will impact the project in the future as debt costs rise and as

this aspect has not been raised as an issue by the proponents this implies that the projects are not as tightly balanced as asserted

- If ElectraNet/TransGrid cannot carry out the project under the existing rules, then the project should be tendered for a third party to provide, following the approach used by AEMO for Victorian transmission augmentations
- While TransGrid and ElectraNet have advised stakeholders about their proposals, there has not been deeper consultation beyond the "inform" level under IAP2

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at davidheadberry@bigpond.com or 0417 397 056

Yours faithfully



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