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3/12/2020

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

Lodged online: www.aemc.gov.au

Dear Ms York

Participant Derogation – Financeability of Integrated System Plan (ISP) Projects

We are pleased to provide our response to the Australian Energy Market Commission's (**AEMC**) Consultation Paper on our rule change request – Financeability of ISP Projects. The AEMC raises a number of issues in assessing the merits of our rule change request. Our response provides further clarification on a number of the issues raised.

In summary, we submit that our rule change will promote the National Electricity Objective by:

- Ensuring the timely delivery of our share of the ISP projects in order to unlock the significant consumer benefits that these projects will deliver, as identified through the ISP and regulatory investment test for transmission processes,
- Not changing the costs, benefits or risks of our share of the ISP projects for consumers,
- Allowing the financeability of our share of the ISP projects by better aligning the revenue we receive for these projects with the financing costs of these projects,
- Enabling us to achieve the benchmark efficient entity gearing level, and
- Enabling us to maintain our current credit rating as a minimum, noting that this is one level below the benchmark efficient entity assumption of BBB+ in the regulatory framework.

As previously set out, similar arrangements to those which we have proposed have been adopted by the Commerce Commission in New Zealand for Transpower. Our response provides further clarification on this regulatory precedent to assist the AEMC in its assessment.

Our submission also provides evidence of credit rating agencies' focus on cash flow metrics as a primary criteria in determining a credit rating upgrade or downgrade, in particular the metrics of Funds from Operations / Net Debt and Net Debt / Regulatory Asset Base. The extent to which a change in these metrics would impact a benchmark efficient entity's credit rating has been raised by stakeholders since the rule change request was lodged. To help address stakeholder feedback, this submission provides clarification on the importance of these metrics to the criteria applied by credit rating agencies.

We would like to thank the AEMC for treating this rule change request as a priority and for continuing to work to an accelerated timeframe. Providing a timely resolution to the issues identified in our rule change request will provide investment certainty for our share of the ISP projects, including Project EnergyConnect and HumeLink.

Please find attached a detailed response to the issues raised in your Consultation Paper. If you require further information or clarification, please feel free to contact me or Eva Hanly, Executive Manger – Strategy, Innovation and Technology.

Yours sincerely

Paul Italiano

Paul Italiano
Chief Executive Officer

Submission in response to the AEMC's Consultation Paper

We are pleased to provide our response to the AEMC's Consultation Paper on our rule change request – Financeability of ISP Projects.

The Consultation Paper raises a number of issues for consideration. Our submission focuses on those issues that are not addressed in our rule change request or where we consider there would be benefit in clarifying our position.

The remainder of this submission sets out our response.

QUESTION 1: RULE CHANGE REQUEST ASSESSMENT FRAMEWORK • Do stakeholders agree with the proposed assessment framework? • Are there any other considerations the Commission should take into account?

This section of our submission sets out:

- Overarching comments on the AEMC's proposed assessment framework.
- Key matters that the AEMC needs to consider as part of its assessment framework.

1. Overarching comments on the AEMC's proposed assessment framework

This section sets out our comments on the AEMC's proposed assessment framework with particular reference to the relevant objective in the National Electricity Law and the revenue and pricing principles also in the National Electricity Law.

The National Electricity Objective (NEO)

As noted in the Consultation Paper, the AEMC may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO.

The NEO has been interpreted by the Australian Competition Tribunal as follows:[1]

> *"The national electricity objective provides the overarching economic objective for regulation under the Law: the promotion of efficient investment in the long term interests of consumers. Consumers will benefit in the long run if resources are used efficiently, i.e. resources are allocated to the delivery of goods and services in accordance with consumer preferences at least cost. As reflected in the revenue and pricing principles, this in tum requires prices to reflect the long run cost of supply and to support efficient investment, providing investors with a return which covers the opportunity cost of capital required to deliver the services."*

In this context, we consider that the assessment framework for our rule change request should be constrained to whether or not a change in the revenue profile for our share of the ISP projects is more likely to contribute to the NEO than the profile provided by the current rules.

In making a decision on our rule change, the AEMC is required to assess whether we are able to operate and invest within the National Electricity Rules (**NER**) framework. To achieve this, the regulatory framework needs to allow us to:

- Finance our functions in line with the benchmark efficient entity gearing level;

[1] See, for example, *Application by ElectraNet Pty Ltd* (No 3) [2008] ACompT [15].

- Maintain our current credit rating as a minimum, noting that this is one level below the benchmark firm assumption of BBB+; and
- Receive the associated benchmarked cash flows for us in order to fund projects of the size contemplated in the ISP.

If these requirements are not satisfied, Transmission Network Service Providers (**TNSPs**) will be discouraged, and perhaps prevented, from making investments in the ISP projects which will discourage this investment. This outcome is inconsistent with the NEO.

Consistent with this, the AEMC must also take into account the revenue and pricing principles in the National Electricity Law when considering a rule change request.

Revenue and Pricing Principles

The revenue and pricing principles require the AEMC when making a rule change to have regard to the provision of a return commensurate with the regulatory and commercial risks involved and consideration of the economic costs and risks of under and over investment by regulated network service providers. Our rule change request has the effect of ensuring all our investments, including ISP projects, can be financed efficiently under the NER by preventing a deterioration in our credit rating.

2. Other key considerations for the AEMC in assessing our rule change request

Alignment with the proposed assessment framework

The ISP projects have been determined to be of significant benefit to consumers by the Australian Energy Market Operator (**AEMO**) in the ISP. The ISP projects are also subject to rigorous testing and scrutiny through the Regulatory Investment Test for Transmission (**RIT-T**) and Contingent Project Application processes administered by the Australian Energy Regulator (**AER**).

We make the following additional comments on our rule change request in the context of the AEMC's proposed assessment framework:

- The RIT-T and ISP have clearly demonstrated the benefit to consumers of undertaking the investment in the ISP projects.
- The rule change is being sought to enable investment in our share of the ISP projects, not to change the costs, benefits, risks or returns of these projects.
- The rule change request seeks to ensure that the profile of revenue from investing in our share of the ISP projects would enable these projects to be financed, and at an efficient cost.
- The alternative is to maintain an approach that significantly increases the cost of finance (if available) with no offsetting benefit.

Financeability of transmission assets

The current NER, and the post-tax revenue model (**PTRM**) established under it, do not ensure that prudent and efficient TNSPs are able to invest in ISP projects.

The deferral of revenue recovery under the current NER results in a multi-decade period at the start of the asset's life where the revenue allowance for large projects like Project EnergyConnect (**PEC**), will fall substantially short of covering the efficient costs of financing the project during that period. A TNSP would be required to access debt and equity funding and should expect to be able to do so for the efficient cost set out by the regulator under the NER.

Businesses like ours are not able to make investments in ISP projects like PEC in accordance with the NER and the PTRM established under it. Our analysis confirms that cash flows from PEC (and other ISP projects) provided by the current rules are insufficient to support 60% debt funding at a BBB+ credit rating (or indeed an investment grade credit rating at all) for many decades. A TNSP should expect to be able to achieve the credit rating determined to be efficient for a regulated network service provider (in this case BBB+). The ability of a TNSP to do so should not rest on, or require, the profitability or leveraging of capital of its unregulated activities or reliance on concessional government financing initiatives.

If we proceed with PEC (and other ISP projects) under the current NER, we will cease to be capable of satisfying the requirements of the entity conceptualised by the AER when setting the rate of return. That is, we will cease to be able to earn the rate of return as determined for the benchmark efficient entity by the AER. This is not because of factors that are within our control, that is, this is not caused by a failure by us to be efficient. Rather, it is because of the delayed recovery of revenue under the current NER and PTRM.

Applications of credit ratings

We would like to clarify the importance of credit ratings and how key metrics are assessed by ratings agencies.

Under the NER, the AER has determined that a benchmarked efficient entity should be rated BBB+. A benchmark efficient entity should be able to meet all the criteria for achieving a BBB+ credit rating and this is a fundamental principle that we have been aiming to comply with. Furthermore, any credit rating downgrade will affect the entirety of our business including our ability to finance the maintenance and refurbishment of our existing network, responding to emerging external challenges such as cyber security and climate related resilience, and meeting the changing needs of consumers.

Table 2.1 (page 10) of the AEMC's Consultation Paper references Moody's rating methodology 'Regulated Electric and Gas Networks Methodology' published in March 2017. This table sets out the methodology that Moody's applies in the assessment and assignment of a rating for a regulated utility. The Moody's regulated utility rating methodology applies defined weightings to a range of qualitative and quantitative assessment criteria. A number of the qualitative factors are exogenous to the business and are a function of the market it operates in, and regulatory framework it operates under.

Whilst the table shows a 12.5% weighting applied to Funds From Operations (**FFO**)/Net Debt, Moody's identifies FFO/Net Debt alongside Net Debt/Regulatory Asset Base (**RAB**) as the two key credit metrics in its rating assessment and determining factors in the decision to either upgrade or downgrade our credit rating. This is consistent across Moody's and S&P's ratings of comparable entities.

Moody's have specifically referred to FFO/Net Debt as one of the factors that in and of itself may trigger a credit rating downgrade of our business. (Please refer to our Moody's Credit Opinion dated 7 September 2020). Therefore, if either of these metrics were forecast to materially deteriorate on a sustained basis then Moody's would consider this as a possible trigger to downgrade our credit rating.

FFO/Net Debt for a benchmark efficient entity is entirely driven by the regulatory framework (a network service provider cannot independently change the regulated returns, revenue, profile of revenue, RAB or RAB debt). Therefore, this demonstrates the challenge we are facing within the regulatory framework when considering the investment decision for our share of the ISP projects.

An example to highlight our concern is the recent credit rating downgrade for ElectraNet which demonstrates:

1. The willingness of credit rating agencies to downgrade TNSPs, and
2. The credit rating agencies' focus on cash flow metrics as a key determinant of a credit rating upgrade or downgrade, in particular FFO/Net Debt and Net Debt/RAB.

Benefits to consumers are expected to be immediate

A final investment decision by us to commence projects, such as PEC, will result in immediate economic benefit to consumers. As described in the FTI Consulting report included with our rule change request, PEC is expected to result in a reduction of wholesale electricity prices for all National Electricity Market (**NEM**) regions, but particularly for New South Wales.

This forecast reduction in expected wholesale price is likely to be factored into decision-making by retailers as soon as PEC is announced because retailers make their pricing decisions based on forecast information. The benefits of de-risking of retailers' future wholesale electricity prices would be shared with consumers immediately through the competitive process. The decision to invest in PEC will also will provide greater certainty to generation investors dependent on the transmission services the project will provide

Thus, in considering whether the rule charge advances the NEO, it would be wrong for the AEMC to assume that consumers do not receive an immediate benefit from the announcement of the ISP projects that are forecast to reduce wholesale electricity prices.

Regulatory precedent

Regulatory precedent is also an important consideration for the AEMC in making its decision on the rule change request. As set out in our rule change request, the Commerce Commission in New Zealand (**NZ**) allowed for the value of assets for Transpower (NZ's government-owned transmission business) to be rolled forward without indexation when faced with a similar step change in required transmission investment. This effectively flattened the revenue profile for Transpower to facilitate financing of significant investment in its network, while doing so in a way that meant that consumers paid the same amount over the longer term (in net present value terms).

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?
• If you consider ISP projects to be materially different from other transmission network capex, how do you think the proposed changes would address this:
 - change to a nominal rate of return?
 - the change from allowing depreciation as commissioned to depreciation as incurred?
• Is the proponent's proposal in the long term interests of consumers with respect to the price of the supply of electricity?
• How could short-term cash flow variability be addressed under the current regulatory economic framework?
• How else could financeability issues be addressed in the regulatory framework?

This section of our submission:

- Clarifies that consumers do not pay more for the ISP projects under our rule change request in light of the AEMC's question on whether the rule change request is in the long term interests of consumers.
- Clarifies our view on other options we have considered to address the financeability issues.

3. Consumers do not pay more for the ISP projects

We would like to clarify that the rule change request seeks to alter the revenue profile of the ISP projects to support the financeability of these projects, not change their profitability.

The intent of the rule change is not to seek additional revenue to that calculated under the current NER. The rule change is designed to be net present value (**NPV**) neutral for consumers over the life of the project. That is, the amount consumers would pay for the ISP projects under our rule change request is the same as what they would pay under the current arrangements in the NER. Our rule change request changes the timing of cash flows in order to make projects of this size financeable, not the amount consumers pay for the projects.

4. Other ways to address financeability

We have been working closely with the AER and other stakeholders through the course of this year to find an appropriate solution that facilitates the timely and efficient delivery of ISP projects and reduces the barrier to attracting capital in a manner that does not increase the costs to consumers. This dialogue has concluded that the financeability issue is unable to be resolved within the existing regulatory framework and a rule change is the most efficient solution.

In our rule change request, we outlined a number of other options that we have explored to address the issue.[2] These are:

- Financial assistance from governments including from the Clean Energy Finance Corporation;
- Accelerating regulatory depreciation;
- Shortening regulatory asset lives; and
- Changing capitalisation policy/ classification of expenditure.

An assessment of the other options that we have considered is set out in the Incenta Economic Consulting expert report that we submitted as part of our rule change request.[3] Information on the other options we considered can also be found in the modelling results report that we also provided as part of our rule change request.[4]

We concluded that the rule change proposed was the most preferable in terms of promoting the NEO because it ensures that our business remains financeable whilst not increasing consumer costs payable over the life of the assets. We consider that our proposed rule change is also relatively straight forward to implement compared to other options, which therefore enables the ISP projects to be constructed in line with the timeframes requested by AEMO as well as State and Federal governments.

For similar reasons, our rule change request is also consistent with the revenue and pricing principles. These principles require the AEMC to have regard to the provision of a return to network service providers that is commensurate with the regulatory and commercial risks involved. They also require the AEMC to have regard to the economic costs and risks of under and over investment by network service providers. In this context, it is important to ensure that our current credit rating is not adversely affected by undertaking the ISP projects.

[2] Refer to section 3.3 of the TransGrid rule change request, page 24.

[3] Incenta Economic Consulting, Attracting capital for ISP projects, TransGrid, September 2020, pp.16-24.

[4] TransGrid, Timing of revenue recovery for large projects, September 2020.

QUESTION 3: THE REGULATORY ASSET BASE
• Is the impact of ISP projects materially different enough from other transmission network capex projects to justify a separate treatment?
• 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?
• How does your view lead to a better outcome under the NEO or the revenue and pricing principles?
• How can the twin RAB model be implemented in practice and what are the effects on the other elements of the regulatory framework?
• Are there potential unintended consequences of the twin RAB model the Commission should be aware of?
• How could unintended consequences that only emerge in the future be addressed?
• If two RABs are allowed, which ISP investments should qualify for inclusion in the second RAB?

This section of our submission provides information on the materiality of the capital investment required for the ISP projects.

It also comments on the allocation of risk under our rule change request0. The AEMC provides some commentary on risk allocation in the lead up to this question (question 3) in its Consultation paper.

5. Materiality

The materiality of the capital investment required for the ISP projects has triggered the need for a rule change.

To put this into context, our RAB at the start of the current regulatory control period was approximately $6.4 billion. We stand ready to invest in more than $10 billion on greenfield capital investments over the next ten years to deliver ISP projects. This is a significant additional investment profile. Our current RAB of $6.4 billion has a remaining life of approximately 24 years and will be depreciated over that life. Likewise, our ISP RAB would also be depreciated over its remaining life of 50 years. Both the size of investment and the deferral of the recovery of revenue to the latter years of a significantly greater remaining life have a material impact on our ability to finance the ISP projects within the benchmark requirements of the NER.

6. Allocation of Risk

We would like to offer some clarification in regards to the discussion on the allocation of risk in the Consultation Paper. In particular we would like to provide clarification on page 29 of the AEMC's Consultation Paper, where the AEMC states:

> *"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."*

This section provides our response to the AEMC's view that our rule change request would result in a change in construction and inflation risk. It responds to each of these risk types separately.

Construction risk

Construction risk remains the same in our rule change request as under the current arrangements in the NER.

The AER approves a forecast of capital expenditure and calculates depreciation for that expenditure. The AER then approves actual capital expenditure at each revenue reset when it determines the opening RAB for each period. Our rule change does not seek to amend this process. It seeks to amend when depreciation on forecast capital expenditure is recovered, in particular from an "as commissioned” basis to an “as incurred basis”. Actual capital expenditure will be approved by the AER at the time of each determination as per the current process.

Inflation risk

Our rule change request does not propose to amend the way inflation is applied by the AER. The AER calculates a nominal cost of capital and a forecast of inflation. It then subtracts the impact of the forecast inflation from the nominal asset base in the form of negative depreciation. Our rule change does not seek to change the way the AER determines the nominal cost of capital. The rule change seeks to apply the forecast nominal cost of capital to a real asset base.

Our proposal to remove indexation of the RAB (and annual revenues) has two effects:

- First, the timing of cash flows for our share of the ISP projects is advanced. This is because the compensation for inflation is provided in “cash” (i.e., as a component of the annual revenue requirement) rather than being capitalised into the RAB; and
- Secondly, when indexation is removed, the consequences of actual inflation being different to expectations change:
    - Under the current method for setting annual revenues, if inflation is higher than expectations then this higher rate of inflation flows through to both the revenue and the RAB, and so the asset owner is protected from unexpectedly high inflation. Similarly, if inflation is lower than expected, then revenue and the RAB are also lower than what was expected.
    - Under our proposal, in contrast, both annual revenues and the RAB associated with the ISP projects would be independent of the actual level of inflation. Thus, we will be worse off compared to the current model if inflation is higher than expected, and vice versa if inflation is lower than expected.

It is the first of these effects, namely, to advance the timing of cash flow and hence to improve the credit metrics that the ISP projects generate, that is the objective of our rule change request. The change in the allocation of inflation risk is something that we did not see as a material change, and this aspect of the proposal was retained in order to keep the proposal as simple as possible.

To the extent the AEMC considers that the change in allocation of inflation risk to be a more material issue then we note that it would be reasonably straightforward to separate the “cash flow timing” component of the proposal from the “inflation risk” component, and to modify our proposal to not alter the allocation of inflation risk.

The steps of the calculation required to leave the allocation of inflation risk unaltered would be to:

- First, calculate the annual revenues in the manner that is consistent with our proposal; and
- Secondly, to adjust annual revenues during the regulatory period and the RAB to account for the difference between the rate of inflation that was expected at the time of the price review and the actual rate of inflation.

Inflation risk - Regulatory precedent

As discussed in the rule change request and above, Transpower in New Zealand (**NZ**) has its regulated revenues calculated using a non-indexed model, similar to what TransGrid has proposed.

In its recent Input Methodologies review, the NZ Commerce Commission offered Transpower the option of modifying its regulatory model to alter the allocation of inflation risk, and described a method along the lines that has been set out above:[5]

> *"Our lack of indexation of Transpower's RAB means that capital recovery is frontloaded relative to an indexed approach (as applied to the EDBs). We considered this was appropriate in 2010 given their relatively large investment programme, since an un-indexed approach would likely lead to higher revenues in the near term that better matched their investment needs. We signalled that we would re-consider the arrangement in the future once their major investment tranche came to an end. This has now happened.*
>
> *On balance, we propose to maintain the current approach, whereby we do not index Transpower RAB to inflation. We have not identified any problems in relation to our approach and we are not aware of a compelling enough reason that warrants a change to the status quo.*
>
> *…*
>
> *Although we propose to maintain our current approach for Transpower—which is not indexing its RAB to inflation—we consider that there is a potential improvement we could make to this approach. All other things being equal, the current approach delivers ex-post nominal returns, which exposes both consumers and Transpower to the risk that outturn inflation differs from the inflation expectation inherent in the nominal WACC used."*

However, the modification to alter the allocation of inflation risk to match an indexation regime was not applied, being neither something that Transpower sought to take up, or something the NZ Commerce Commission considered to be sufficiently important to impose. This demonstrates it is important to consider whether a modification to address inflation risk would generate sufficient benefit that would offset the additional complexity required.

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? • Does TransGrid's proposed changes result in intergenerational wealth transfers? • Are consumers willing to pay more now for future benefits that are likely to occur in the future? • Are consumers willing to pay for assets before being able to obtain any benefits?

This section of our submission:

- Clarifies our views on the consumer impacts of our rule change request.
- Sets out our views on intergenerational issues.

7. Consumer impacts

As noted above our proposed rule change does not change the net present value of regulated revenue over time. It would only change the timing of revenue recovery. In relation to the intergeneration impacts of this change, it should be noted that:

- A proper assessment of the intergeneration allocation of cost involves considering all elements of the electricity supply chain. The potential exists that recovering a greater share of the ISP projects over the next decade may advance intergenerational equity given the

5 Commerce Commission (NZ), 2016, Input methodologies review draft decisions - Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower, paras.227-228, 233.

substantial costs that will need to be incurred across all parts of the electricity industry supply chain to meet net carbon zero targets;

- By focusing on consumer impacts in the early years rather than over the life of the investment, rather than focusing on the long-term interests of consumers, the AEMC is introducing an alternative test to the NEO that prices should be maintained or reduced at all times – an approach that the introduction of the NEO was intended to avoid. This would also differ to the tests adopted in the RIT-T and ISP and be dependent on the behaviour of retailers (i.e. will they change their tariffs for movements in transmission tariffs which represent less than 5 per cent of a typical consumer's bill); and

- A lower overall price for consumers that additional transmission network investment can deliver should be the primary consideration of the AEMC. The alternative is to disallow any network investment that increases network tariffs at any time even if it results in lower bundled prices to consumers. Again, this is inconsistent with the NEO.

We noted in our rule change request that any assessment of intergenerational equity assumes that required investments will take place in a timely manner, and so it is possible to have a debate about how those net benefits should be distributed to consumers over time. However, the impetus for our rule change request is that, under the current regulatory methods, the ISP projects will not be financeable, and so not able to be undertaken or undertaken in a timely manner. Thus, placing a substantial weight on perceptions of intergenerational equity focussed solely on transmission revenues creates a risk that consumers ultimately may be made worse off.

The rule change request seeks to apply the same method as that deemed appropriate in competitive markets – the same competitive markets that regulation is designed to mimic.

8. Issues of intergenerational equity

Intergenerational issues are rooted in the current system whereby future consumers pay the price for benefits achieved by current consumers. AEMO's 2020 ISP concludes that delivering the optimal development path, including PEC, will strengthen the NEM and deliver gross market benefits of $11 billion in present value terms in its central scenario, with potentially higher benefits if the NEM moves quickly towards a renewable future.

In addition, the de-risking of retailers' wholesale prices through the announcement of PEC (and other ISP projects) is likely to be immediately passed into retail prices through the competitive process as discussed above. This represents a significant benefit being received by current consumers, which is not accounted for in the regulatory framework.

Deferring the recovery of revenue (as is currently in place) means that future consumers will be required to pay more than they would under our rule change request. This intergenerational impact will become more challenging in the future as a result of the changing operating environment. Limiting the proposal to the ISP projects addresses the issue while limiting the short term impact on consumer bills.

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?
• If construction risk is one of the factors low credit ratings for ISP projects, could equity provide sufficient support to bring those projects through the construction phase?
• What options, other than changes to the economic regulatory framework, could be considered to ensure timely investment and delivery of ISP projects?

This section sets out our view on the consideration of enterprise value as a factor in assessing the rule change request.

It also sets out our view on the availability of investment funds for electricity transmission network infrastructure in light of questions that have been raised in our discussions with stakeholders.

9. Consideration of enterprise value

The AEMC has asked why a transmission businesses may change hands for an implied enterprise value to RAB ratio of greater than one, and yet face difficulties attracting the investment funds required for ISP projects. Stakeholders have also made similar comments. We would like to offer the following observations to help clarify these two issues.

RAB multiples implied by transactions outcomes reflect a wide range of factors. The existence of RAB multiples above one is not an indicator of the financeability required for the actionable ISP projects. There are two key reasons for this which are outlined below.

First, the price paid includes the value of both the 'regulated' business and the 'contestable' business, as well as expected benefits that are factored in by the purchaser such as efficiency gains and future investment opportunities.

Secondly, a RAB multiple above one paid in a transaction does not mean that investment funds can be attracted in future activities, particularly where the financial characteristics of those activities are materially different to the RAB activities. Corporate finance tells us investment decisions are efficiently made by an assessment of the future cash flows and risks of the project, not past decisions.

This is relevant to our rule change request as the cash flows for the ISP projects are substantially more distant than existing RAB-related activities (i.e., having approximately double the remaining life). This point is supported by Dr Darryl Biggar who cautions against drawing any inference from the existence of RAB multiples above one to the financeability of projects. In an Australian Competition and Consumer Commission presentation by Dr Biggar entitled 'What do RAB multiples tell us about the cost of capital', the following explanation is provided in recognition that RAB multiples may vary for a wide range of reasons:[6]

- *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?*
- *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?*

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

- *Perhaps the regulator overestimates the firm's cost of capital?*
- *Perhaps the trailing average approach favours the firm?*

10. Availability of Investment Funds

Whilst there are large pools of low-cost debt finance currently available for firms that have a strong investment grade credit rating, the quantum of this finance that can be sourced is limited by the strength of the relevant project's cash flow. The more distant cash flows for the ISP projects materially weaken these projects' credit metrics, and so limits the quantum of debt finance that can be sought.

In addition, whilst there are substantial pools of equity funds available for quality energy network infrastructure investments, attracting those funds requires projects to meet the expectations of investors.[7] As outlined in our rule change request, and the accompanying report by Incenta Economic Consulting, the clienteles of investors that are attracted to regulated energy networks have strong expectations that regulated returns will be available and consistent with the regulators estimate of efficient costs including gearing levels and credit ratings that are assumed as regulatory benchmark. The substantially more back ended cash flow for the ISP projects means that such a gearing level cannot be maintained whilst also maintaining a prudent, strong investment grade credit rating, and so the character of the cash flows places a constraint to meeting the expectations of these investors.

QUESTION 6: TRANSITIONAL ISSUES
• If the proponents' rules are made, should there be transitional provisions to apply them to VNI minor and PEC?

This section sets out our views on transitional arrangements in line with the question posed by the AEMC.

11. Arrangements for PEC and VNI minor

The issues we are seeking to address in our rule change request were identified in the course of our assessment of PEC and are relevant for the ISP projects. Our rule change request provides reasons on why transitional arrangements should apply to these projects, in particular in Chapters 3 and 6 of the rule change request.

7 The notion that there is an excess supply of funds necessarily requires there to be a shortage of projects that are attractive to these investors.