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Thursday, 8 February 2024

Anna Collyer
Chair
Australian Energy Market Commission
Lodged online: www.aemc.gov.au

Dear Anna

AEMC draft rule determination on accommodating financeability in the regulatory framework

Transgrid welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) draft rule determination on accommodating financeability in the regulatory framework. The draft rule determination is in response to two rule change requests on this topic, submitted respectively by Energy Networks Australia (ENA) and the Commonwealth Minister for Climate Change and Energy, the Hon Chris Bowen MP. The AEMC's draft rule seeks to address the financeability risks that arise in relation to actionable Integrated System Plan (ISP) projects under the current regulatory framework in the National Electricity Rules.

As previously noted, Transgrid shares the Government's desire to accelerate the delivery of critical transmission infrastructure projects specified in the ISP, which will put downward pressure on the costs faced by electricity consumers. The Australian Energy Market Operator's (AEMO) draft 2024 ISP explains that $17 billion of net benefits are expected to be obtained from the actionable ISP projects that form AEMO's Optimal Development Path, i.e., the costs of serving electricity consumers will be $17 billion lower if these projects proceed as planned.

Transgrid welcomes and supports the following conclusions in AEMC's draft rule determination:

- Investor confidence is critical to the timely delivery of actionable ISP projects and the achievement of the associated benefits for consumers;
- Regulatory discretion associated with using a principles-based approach to assess and remedy financeability issues will not promote investor confidence. Instead, the financeability assessment and resolution must be replicable and predictable, so that certainty is provided to TNSPs and their investors;
- A financeability assessment method can be developed with reference to the financial metrics used by credit rating agencies for a BBB+ entity, using the regulated cashflows consistent with the Post Tax Revenue Model;
- The financeability assessment method should be mandated in financeability guidelines, which may be updated from time to time;
- Only the minimum cashflow required to address a financeability issue should be brought forward, so that the interests of consumers are promoted to the greatest extent possible; and

- The Rule should commence as soon as possible, even though the AER guideline may not be finalised until December 2024.

As a member of ENA, Transgrid notes that the AEMC has not accepted some aspects of ENA's Rule change request. In particular, the AEMC prefers the detail of the financeability test to be provided in AER Financeability Guidelines, rather than being mandated in the Rules. While the AEMC has not adopted Transgrid's preferred position, we accept that the AEMC's approach provides more flexibility without necessarily compromising the objective of providing investor certainty. Transgrid therefore accepts the AEMC's conclusion that Financeability Guidelines should be developed.

In the attachment, Transgrid has identified six issues with the AEMC's draft rule that could be improved:

1. Specifying an objective for the financeability test;
2. Requiring the application of the financeability rule to be prescriptive, replicable and predictable;
3. Addressing financeability risks associated with the 'no worse off' approach;
4. Applying the financeability test to early works;
5. Clarifying the linkages with concessional finance; and
6. Clarifying that biodiversity costs should be depreciated on an 'as incurred' basis.

Each of these issues is important in ensuring that the AEMC's objective of promoting investor confidence is achieved. As explained in the attached submission, Transgrid is particularly concerned that the 'no worse off' approach is likely to put doubt in the minds of investors that actionable ISP will be financeable. In the attachment to this submission, we provide modelling analysis which illustrates why this approach raises significant concerns. Transgrid supports the remedy proposed in ENA's submission to the AEMC's draft rule determination, which preserves the key elements of the AEMC's position while addressing the specific issues regarding the 'no worse off' approach.

Transgrid looks forward to working with the AEMC as it finalises its rule determination in the coming months. As noted above, Transgrid welcomes the significant progress the AEMC has made towards resolving the financeability issues associated with actionable ISP projects. Transgrid considers that the modifications proposed in this submission will ensure that the new rule promotes the long-term interests of consumers in accordance with the National Electricity Objective. If you have any queries regarding this submission, please contact Neil Howes in the first instance by email at neil.howes@transgrid.com.au.

Yours faithfully

Maryanne Graham
Executive General Manager
Corporate and Stakeholder Affairs

ATTACHMENT – ACCOMMODATING FINANCEABILITY IN THE REGULATORY FRAMEWORK

While Transgrid welcomes the significant progress the AEMC has made towards resolving the financeability issues associated with actionable ISP projects, we have identified the following five issues with the draft rule that would further improve its operation:

1. Specifying an objective for the financeability test;
2. Requiring the application of the financeability rule to be prescriptive, replicable and predictable;
3. Addressing financeability risks associated with the 'no worse off' approach;
4. Applying the financeability test to early works;
5. Clarifying the linkages with concessional finance; and
6. Clarifying that biodiversity costs should be depreciated on an 'as incurred' basis.

Of these six issues, the first two would improve the clarity of the rule so that it better reflects the AEMC's reasoning in its draft determination, which Transgrid strongly supports. While all stakeholders will benefit from these clarifications, the third, fourth and fifth issues are more significant in terms of importance as they address the ability of the AEMC's proposed solution to financeability to work in practice. The final issue – the depreciation of biodiversity costs – falls somewhere between the two groups, as it would help address the financeability issue while also providing improved clarity for stakeholders.

We address each of these six issues in turn.

1. Specifying an objective for the financeability rule

The AEMC explained that the objective of the draft rule is to improve the ability of TNSPs to access finance to deliver actionable ISP projects in a timely and efficient way. A key aspect of the draft rule is the requirement on the AER to develop Financeability Guidelines in accordance with the Transmission Consultation Procedures.

This aspect of the draft rule is particularly important because it determines how the financeability position for a TNSP is to be determined, which has consequences for the application of the financeability test. As presently drafted, the AER is required to explain its choice of financial metrics and weightings, and how the TNSP's current financeability position is to be established. However, the draft rule does not set any objectives to guide the AER's approach.

Given the importance of the Financeability Guidelines, Transgrid considers that the draft rule should include an overarching objective that the AER's approach should satisfy. For example, the objective could be expressed as follows:

> *The objective of the financeability rule is to enable a TNSP to finance each actionable ISP project by promoting investor confidence that sufficient cashflow will be brought forward, while maintaining the total regulated revenue in present value terms.*

Transgrid proposes that a further amendment to the draft Rule would be made to require the AER to establish its Financeability Guidelines in a manner that will promote the achievement of this objective. Transgrid considers that this relatively modest change would assist in ensuring that the Financeability Guidelines reflect the AEMC's intentions in its draft rule determination, which places an appropriate emphasis on promoting investor confidence. To the extent that the AER's Financeability Guidelines do not meet the objective of promoting investor confidence, then it is unlikely that the ISP projects would be able to proceed without government support.

2. Requiring the financeability test to be prescriptive, replicable and predictable

Transgrid welcomes the AEMC's statements in its draft rule determination which make it clear that the intention is for the financeability test to be prescriptive, replicable and predictable. Unless these conditions are met, it will not be possible to sustain investor confidence and project funding will remain problematic. In particular, Transgrid notes the following commentary in the draft rule determination, which we strongly support:[1]

> *The Commission's views on the appropriate balance between a principles-based approach and a prescriptive approach have evolved since this issue was considered in the TPIR review. We consider a more prescriptive approach to the financeability test is appropriate to provide TNSPs and their investors with certainty and predictability and therefore confidence to invest in actionable ISP projects. We consider this approach is more likely to achieve the purpose of this rule change, to support a TNSP's ability to obtain finance, than a principles-based approach. Given that we decided to apply a more prescriptive approach, our draft rule does not include any principles for how the AER is to assess requests from TNSPs to address financeability issues.*
>
> *[…]*
>
> *The AER's methodology for determining a TNSP's financeability position would also differ from credit rating agencies in that it would not be able to adjust the financeability position based on qualitative factors. Rather, the AER must only apply its chosen selection of financial metrics. This means that the financeability test would be replicable and predictable, providing certainty for TNSPs and their investors.*

While the draft rule determination clearly expresses the view that the financeability test should be prescriptive, replicable and predictable, these requirements are not mentioned explicitly in the draft Rule. In the interests of promoting investor certainty, as intended by the AEMC, and to provide transparency for all stakeholders, Transgrid would welcome the inclusion of these design objectives in the draft Rule. In Transgrid's view, this change would better align the rule with the AEMC's intentions as set out in the draft rule determination.

3. Addressing financeability risks associated with the 'no worse off' approach

The AEMC's draft rule proposes an asymmetric 'no worse off' approach whereby the AER would be required to adjust the TNSP's cash flows such that:

- If the TNSP's current financeability position is at or above the benchmark credit rating, which is currently BBB+, the TNSP's financeability position, including the ISP project, is not allowed to fall below the financeability threshold; or
- If the TNSP's current financeability position is below the benchmark credit rating, the TNSP's financeability position with the ISP project is not allowed to worsen. We refer to this aspect of the draft Rule as the 'no worse off' approach.

[1] AEMC, Draft determination, National Electricity Amendment (Accommodating Financeability in the Regulatory Framework) Rule, 14 December 2023, p.19 and 20.

Conceptually, the ‘no worse off’ approach raises a concern because it supposes that a new actionable ISP project could be financed no matter the TNSP’s implied credit rating in the post-tax revenue model. For example, if a TNSP’s implied credit rating were below investment grade, the draft Rule would incorrectly assume that a new actionable ISP project could be financed at below investment grade. For that reason, Transgrid has concerns that the ‘no worse off’ component of the draft Rule cannot ensure that actionable ISP projects could be financed.

A further concern arises in relation to the implementation of the no-worse off approach. TNSPs must typically commit (financially and reputationally) to an ISP project years before the AER makes a revenue determination in relation to that project, particularly if the financeability test only applies to the construction stage of a staged actionable ISP project (CPA-2). The long interval between the TNSP proposing (and effectively committing to) an ISP project and the AER making a financeability assessment means that it is impossible to forecast with any reasonable degree of certainty the financeability position of the TNSP when the AER makes its revenue determination. This means that investors cannot predict whether any action taken by the AER to accelerate cashflows for a particular ISP project would be adequate to make that project financeable. This uncertainty is exacerbated:

- if the TNSP may be required to commit to large, non-ISP projects; and/or
- if large asset classes that typically make material contributions towards the TNSP’s return of capital allowance are depreciated out of the RAB fully.

Both of these situations would cause the TNSP’s financeability position to worsen over time.

Contrary to the AEMC’s intentions, therefore, the draft Rule will not provide certainty to investors that any actionable ISP projects will be financeable. In effect, the draft Rule defines the TNSP’s financeability position in a way that makes it a moving target, noting that it may deteriorate over time.

Transgrid recognises the importance of illustrating these concerns with specific examples. We have therefore set out in the figure below, analysis that shows how the AEMC’s draft rule may apply in Transgrid’s specific circumstances. The figure presents the following information:

- The current benchmark credit rating, being BBB+, depicted by the light blue horizonal line;
- The lower bound of investment grade rating, depicted by the orange horizonal line; and
- A forecast of how Transgrid’s financeability position may change over the period from 2023-24 to 2032-33, reflecting a range of plausible modelling scenarios (the high and low scenarios reflect paths for the risk free rate used to set the allowed rate of return where those paths are simulated using historical data on 10 year government bond yields).

Figure: Plausible range of financeability outcomes under the AEMC's draft rule

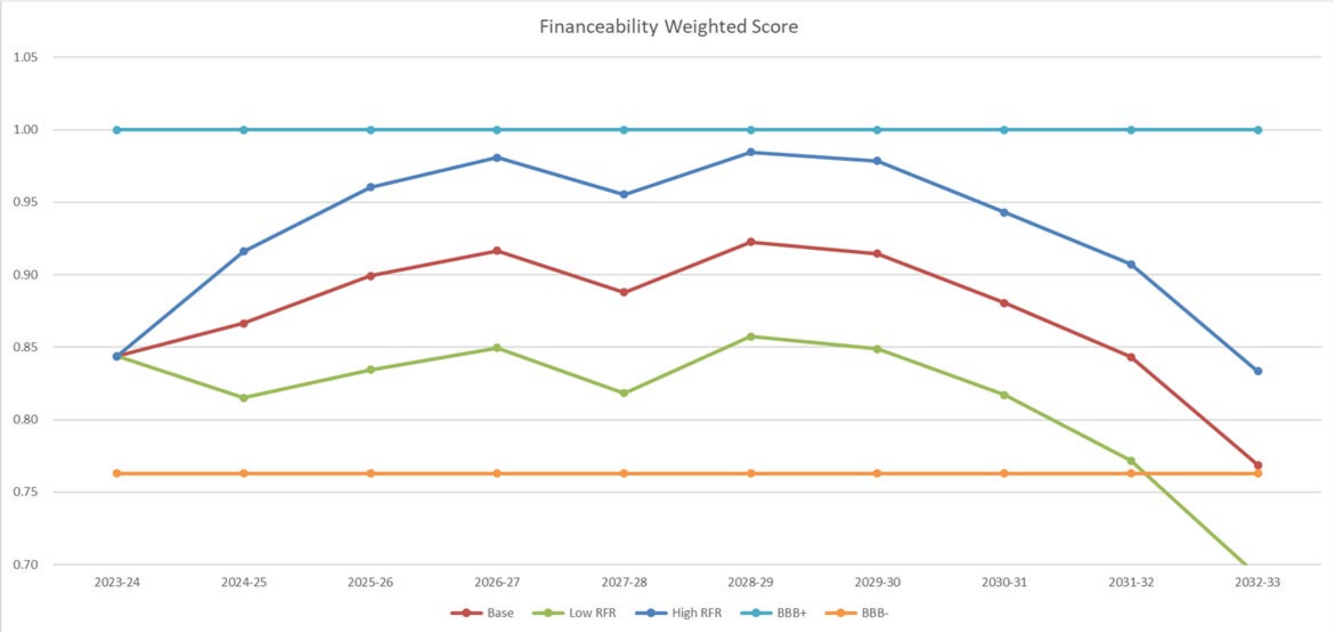

Figure note: We have assigned a numerical score of 1 to the current credit rating of BBB+ adopted by the AER in its 2022 Rate of Return Instrument.

From an investor perspective, the range of outcomes that are plausible under the AEMC's draft rule include an outcome that is below the orange line, i.e., below investment grade. The decline in financeability outcomes towards the end of the period reflect the impact of existing assets becoming fully depreciated and the associated reduction in the return on capital allowance. The potential range is even broader than illustrated in the above figure because there is a risk that unexpected, large non-ISP capital expenditure projects will be required in the future. The effect of large non-ISP projects would be to weaken the financeability of the TNSP relative to what is presented in the figure above. Thus, the 'low' financeability scenario would be shifted downwards, thus widening the spread of possible financeability outcomes.

In order to apply the AEMC's framework, investors will need to consider how a TNSP's financeability position may change by the time the AER conducts its financeability assessment. The risk that Transgrid's future financeability position may decline below investment grade, even if that fall is temporary, would be sufficient to undermine investor confidence that a future ISP project will not be made properly financeable under the draft Rule as it is currently formulated. The lengthy time period between investors effectively committing to an ISP project and the point at which the AER applies the financeability test exacerbates this risk because the financeability position of the TNSP could change materially during that time.

Transgrid's proposed remedy

Transgrid supports ENA's submission, which proposes that the 'no worse off' element of the draft Rule should be replaced with a financeability test that is applied to each discrete project. The discrete project approach ensures that each project obtains a cashflow profile that is consistent with achieving the benchmark credit rating for that project. As noted in ENA's submission, for the avoidance of doubt, Transgrid accepts the following aspects of the AEMC's financeability test:

- If a TNSP's financeability position is above the benchmark credit rating, a whole of regulated business approach to assessing financeability should be adopted.
- The minimum cashflow required to ensure the financeability of an actionable ISP project should be brought forward.
- If a TNSP's financeability position is below the benchmark credit rating, cashflow should only be brought forward with the objective of enabling the new project to be financed (and not to improve the financeability position of the TNSP).

In terms of applying the financeability test, Transgrid's strong preference is to allow the test to apply at the early works and CPA-2 stages (we discuss 'early works' in further detail next). The financeability test would be repeated in the revenue determination immediately following the completion of project construction, once the actual costs are known. This final application of the financeability test would ensure that the minimum required cashflow adjustment to achieve financeability over the life of the asset takes account of the actual capital expenditure, recognising that this may be higher or lower than forecast. At present, the draft rule does not address this issue.

While Transgrid recognises that the AEMC rejected the discrete project approach in its draft rule determination, we would urge the AEMC to reconsider this position at least for those cases where the TNSP's financeability position is below BBB+. In those cases, Transgrid considers that a discrete project approach is the only method that can ensure that sufficient cashflow is brought forward to enable the project to be financed.

4. Application of the financeability test to early works

As already noted, the draft Rule currently precludes the financeability test from applying to the early works stage of an actionable ISP project. The AEMC considered that financeability issues would not arise for early works because the expenditure involved is likely to be modest. In contrast to the AEMC's position, however, for VNI West, AEMO identified the following as early works activities:[2]

- Project initiation – scope, team mobilisation, service procurement
- Stakeholder engagement – with local communities, landholders and other stakeholders
- Land-use planning – identifying and obtaining all primary planning and environmental approvals, route identification, field surveys, geotechnical investigations, substation site selection and easement acquisition
- Detailed engineering design – transmission line, structure and substation design, detailed engineering design and planning
- Cost estimation – finalisation, including quotes for primary and secondary plant, and
- Strategic network investment – an uplift to the delivered capacity of PEC between Dinawan and Wagga Wagga.

In addition to pre-construction activities, therefore, strategic network investments have been identified as a component of early works expenditure for VNI West. As explained in Transgrid's CPA for VNI West, this expenditure includes works associated with Project EnergyConnect that need to be brought forward in order to minimise the total costs to consumers.

[2] AEMO, 2022 ISP, p.75

As a consequence of this broader-than-usual scope of work, Transgrid's total forecast costs for early works for VNI West exceeds $1 billion. While this level of expenditure is not typical for an early works CPA, it illustrates that the Rules should be sufficiently flexible to allow the financeability test to apply to early works expenditure.

5. Clarifying the linkages with concessional finance

The AEMC has separately prepared a draft Rule in relation to concessional finance. As recognised by the AEMC, there are important interactions between the financeability test and concessional finance. In particular:

- A TNSP's current financeability position could be distorted if concessional financing benefits relating to existing projects are not properly considered. It will be important to ensure that the operation of the financeability test accounts for the impact of concessional finance, including any concessional finance obtained prior to 14 December 2023.[3]
- The financeability draft rule assumes that the concessional finance agreement will be in place prior to the AER conducting its financeability assessment. In practice, however, the concessional finance agreement is likely to occur after the revenue determination and the financeability has been concluded.

In relation to the latter point, Transgrid notes that draft rule for concessional finance requires the agreement to specify how the benefit should be treated by the AER in conducting the financeability test. While this requirement is helpful, both rules should recognise the likelihood that the concessional finance agreement will be determined after the financeability test is conducted. ENA's submission has suggested some drafting changes to address this issue.

6. Clarifying that biodiversity costs should be depreciated on an 'as incurred' basis

Transgrid supports the Commonwealth Energy Minister's proposal that biodiversity offset costs should be depreciated on an 'as incurred' basis. As explained in that rule change request, the benefits of biodiversity offsets will be obtained before project commissioning[4], which supports an 'as incurred' depreciation approach.

In its draft rule determination, the AEMC concluded that it is not necessary to make a Rule change to address the Commonwealth's position because the existing Rules already allow for 'as incurred' depreciation to apply. While Transgrid agrees with the AEMC's view that the Rules already allow for 'as incurred' depreciation, we also consider that there is a strong case for clarifying that biodiversity costs should be depreciated on an 'as incurred' basis. Transgrid notes that providing clarity on this issue in the Rules will provide additional certainty to investors and assist in reducing the number for financeability requests that the AER will be required to assess.

Transgrid would therefore welcome the AEMC's reconsideration of this issue in its final rule determination. In particular, Transgrid considers that a decision to require 'as incurred' depreciation to apply to biodiversity offset costs would promote the interests of consumers in accordance with the National Electricity Objective.

[3] The AEMC's draft rule defines concessional funding agreements as commencing after 14 December 2023.

[4] Australian Government, Department of Climate Change, Energy, the Environment and Water - Treatment of financeability for Transmission Network Service Providers, Rule change proposal, March 2023, p. 4 and 5.