AUSTRALIAN ENERGY REGULATOR

Our Ref: AER22005858
Your Ref: ERC0348/ERC0349
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Ms Danielle Beinart
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Australian Energy Market Commission
Level 15, 60 Castlereagh Street
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Dear Ms Beinart

Re: Draft rule changes submission – Accommodating financeability in the regulatory framework and sharing concessional finance benefits with consumers

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) draft determinations on *Accommodating financeability in the regulatory framework* and *sharing concessional finance benefits with consumers*.

The AER recognises that the scale of transmission investment required to transition Australia to net zero carbon emissions presents unique challenges for the existing regulatory framework. The current framework was developed over a period of incremental growth, rather than the current required pace of step change growth set out in the Australian Energy Market Operator's Integrated System Plan (ISP). The AER supports the review of the framework to consider whether it remains fit for purpose and will deliver the scale of transmission investment required.

As a matter of principle, financeability is substantially impacted by the practices and choices made by the business itself. Consequently, financeability is an issue that is first and foremost to be managed by the business and addressed by shareholders. Further, the optimal approach to capital and financeability is exposed through competitive processes where various parties can bid for the development of a project. It would not be appropriate for the regulatory framework to address financeability concerns that are primarily driven by factors outside the framework such as business structure and private financing decisions.

Nevertheless, we are supportive of changes to the National Electricity Rules (NER) to provide greater flexibility in the revenue setting framework to the extent that the current framework does not allow transmission network service providers (TNSPs) to efficiently raise capital to finance their activities. We agree that an appropriate mechanism to do so under the regulatory framework is to allow flexibility in the depreciation profile of assets that form part of an actionable ISP project. We are also supportive of the draft rule to facilitate the sharing of concessional finance benefits with consumers and its extended application to distribution network service providers.

The AER stands ready to make adjustments to depreciation where we see they are in the long term interest of consumers and necessary to advance the National Electricity Objective (NEO). We support the draft rule that requires the assessment of whether a financeability problem exists should be performed at the overall regulated network business level rather than at the individual ISP project level. This is consistent with the revenue and pricing principles.

However, we consider it is also important to understand that adjusting depreciation profiles delinks consumers' payments from the benefit they receive from the infrastructure being provided. Typically, costs are incurred up front, but consumers receive benefits later. Consumers usually face a higher discount rate than network businesses because they are unlikely to be able to borrow at a rate of interest similar to the businesses' cost of capital. Moreover, the consumers in future who receive the benefits may not be the same as today's consumers. An adjustment that is NPV neutral from a business's point of view may disadvantage consumers. We consider that these intergenerational effects require consideration in a balanced assessment. Therefore, we support a mechanism that is sufficiently flexible to address financeability on a case-by-case basis to the extent there is such a problem, but it should not over-compensate businesses at the expense of consumers.

We are broadly supportive of both the AEMC's draft determinations and draft rules, with some suggested areas for improvement. We are strongly supportive of the AEMC's decision to not embed a financeability formula into the rules, and the decision to extend the application of the concessional finance rule to include distribution network service providers. Our focus in this submission is a number of key areas in the draft determination on financeability that require further consideration by the AEMC to ensure the final rule change is able to be implemented in a manner that deliver outcomes that are in the long term interest of consumers and consistent with the NEO.

Our main comments on the draft rules address four main issues:

1. Retaining a principles-based approach
2. Removing the explicit link to a credit rating assessment in undertaking a financeability test in favour of a "material change" assessment
3. The ability to correctly account for the benefit from any concessional finance instruments provided to the TNSP when assessing financeability, and
4. Providing for transitional arrangements for current Contingent Project Application (CPA) Stage 2.

Retaining a principles-based approach

The Commonwealth Minister's rule change request considered that the AER should assess financeability applications from TNSPs to vary the depreciation profile for actionable ISP projects using a principles-based approach. These principles were set out in the proposed rule and included:

1. the consideration of intergenerational equity impacts of any change,
2. that the capacity to finance a project at the network business level—overall regulatory asset base (RAB), rather than at the project level, and
3. any other factors the AER considers relevant.

The AEMC's draft rule does not include any of these principles and applies a more prescriptive test rather than a principles-based approach to guide discretion.

We understand the desire to remove specific considerations to provide greater clarity to stakeholders on the likelihood and quantum of any adjustment. However, we consider that the final rule and determination should ensure that the overall objective/purpose of providing a financeability adjustment is made clear. We suggest that the objective of approving a financeability adjustment is to ensure that the TNSP remains able to efficiently raise capital in order to deliver the ISP projects. Setting out this objective clearly in the determination will guide the AER's assessment and development of the financeability guidelines. If we are required to implement a more prescriptive approach without a clear objective it may lead us to make adjustments that are not required, to the detriment of consumers and may introduce inconsistencies with the requirements of the NER and the objectives of the National Electricity Law (NEL).

Adopting a material change assessment approach

As we previously raised in our earlier submission, in our view the linking of financial metrics to a credit rating is problematic in a number of ways and is unnecessary.

In our previous submission to the consultation paper, we pointed out that the benchmark credit rating assessed in the preparation of the Rate of Return Instrument (RoRI) was not set anticipating its application and use in financeability assessments. It is not clear that the same 'benchmark credit rating' would have been determined if it was also to be used for the purposes of assessing the financeability of cash flow metrics. We maintain that it is not appropriate for the financeability test to be explicitly linked to a credit rating in the RoRI that was not determined with this purpose in mind.

The draft rules require us to set out the thresholds for a financeability position that is equivalent to this benchmark credit rating in the financeability guideline. We do not consider that it is appropriate to set out thresholds for financial metrics in a guideline that would be expected to apply in all circumstances. Of the major three credit rating agencies (Moody's, Standard and Poor's and Fitch Ratings), only Moody's publishes any methodology regarding how it assesses credit ratings. While Moody's provides some illustration of how it develops its scorecard-indicated outcome—of which only 40% reflects quantitative metrics—it also notes that this outcome is not expected to match the actual rating for each company. It further notes that there are various reasons why scorecard-indicated outcomes may not map closely to actual ratings assigned, highlighting how complex the task is in developing and assessing an appropriate credit rating. The assessment and setting of credit ratings is a role for rating agencies that are experienced in this complex process that reflects more than simply financial metrics related to the business's actual circumstance and capital structure choices.

In order to perform an appropriate financeability test that is linked to a given benchmark credit rating we consider that an assessment of a benchmark service provider's qualitative factors would also be required. This is likely to be a significant undertaking that we do not consider is required, and may not have the relevant information available to properly assess.

We consider that a more appropriate approach is one that assesses the adequacy of cash flows, not linked to a specific credit rating. In our view, more appropriate wording for draft clause 6A.6.3A(1)(m) in identifying a financeability issue would be to reflect a situation where there is a 'material change' in the financial position for the TNSP to the extent that it is unable to efficiently raise capital. The definition of what constitutes a material change in financial position can then be developed and set out clearly in the financeability guideline in place of draft clause 6A.6.3A(1)(s)(3).

For example, the calculation of the financial position could reflect the metrics scoring and weighting methodology for Moody's 'leverage and coverage' score.[1] However, instead of linking this score to a particular credit rating, the financeability test could simply reflect a 'material change' in the score of more than 1 point (equivalent to a credit rating change for this element). We consider that applying a 'material change' assessment is more reasonable as it avoids the unnecessary complexity of linking benchmark financial metrics to particular credit ratings. Our view is that applying this extra link to credit ratings would require either an assessment of the qualitative factors of a benchmark business, or application of alternative threshold metrics from those published by Moody's. Both of these processes would require a substantial consultation process that we consider is unnecessary. We do not consider that this amendment would materially impact the overall adjustment or objective of the rule change. However, it is simpler and avoids the AER taking the role of a credit rating agency in assessing qualitative factors or alternative thresholds. As noted above, we also consider that the inclusion of an overall objective or principle would also assist in satisfying this definition and assessment of financeability issues.

Treatment of concessional finance in financeability assessment

Gearing and treatment of hybrid instruments

The draft rules also specify that the financeability assessment must reflect the benchmark gearing ratio set out in the applicable RoRI. We are supportive of an approach that employs benchmark assumptions in the PTRM as the basis for a financeability assessment rather than a business's actual circumstance. However, we consider some flexibility is required to ensure the correct adjustment is applied in certain circumstances. This is particularly the case when considering the impact of any concessional finance on the TNSP's financial position. Our understanding is that concessional finance, as currently defined in the draft rules, may encompass a whole package of financial arrangements provided by a government funding body. One of the key instruments that can be used in these arrangements is the provision of hybrid debt instruments. We note the Clean Energy Finance Corporation (CEFC) provided some hybrid financial funding to Transgrid for Project Energy Connect that would have improved its financial position.[2]

The interest rates of hybrid debt instruments are generally not concessional in nature and may actually have a higher interest cost than standard secured debt of the business. However, these instruments can improve the financial position of the business as they are not treated as entirely debt funding by credit rating agencies and instead generally treated as 50% equity. The package of financial arrangements provided by a government funding body to assist in financeability of a project may include an element of debt issued at a concessional rate combined with some hybrid debt issuances. The former has a clear positive impact on cash flows, while the latter may have a negative impact on cash flows, but improves the financial position due to the impact on the gearing assessment. It is possible that the net effect of the entire package on cash flows may be zero due to the opposing impacts of the interest rates, however the financial position of the business is improved—and may eliminate any financeability issue completely—as a result of the gearing assessment.

To properly account for the impact of hybrid forms of concessional finance on the business's financial position we consider that we would need to reflect its impact on both cash flows and improving the gearing position of the business.

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1 Moody's Investors Service, *Rating Methodology – Regulated Electric and Gas Networks*, 13 April 2022.

2 Spark Infrastructure, *ASX release – Transgrid to build new electricity interconnector to facilitate Australia's renewables transition*, 31 May 2021, p. 2.

However, draft clause 6A.6.3A(l)(2) requires us to use the benchmark gearing ratio. This appears to be the case even if the concessional finance agreement sets out a different gearing ratio should be used when the AER takes the financing package into account in carrying out the financeability test as provided in draft clause 6A.6.3A(f)(5). In the case noted above, we could be required to reflect the net impact of the interest costs (zero), but not be able to reflect the benefit to the gearing ratio. This situation would likely lead to a further depreciation adjustment being applied when the financeability issue has already been addressed through the package of funding arrangements. This situation is at odds with the intent of the originally proposed rule change.

If the intent of the draft rule is to either reflect only the interest costs of hybrid debt instruments that form part of a concessional finance agreement, or to exclude hybrid instruments completely, the AEMC should set out how it considers this reflects the NEO and is in the long term interest of consumers. Where there are inconsistencies with the rule requirements and the detail set out in the concessional finance agreement we consider that details on how we are to deal with these inconsistencies should be made clear. As it stands the assessment may result in an incorrect adjustment being applied that is not in the long term interest of consumers. We consider that, if the concessional finance agreement specifies an approach to account for the benefits when carrying out the financeability test that is incompatible with the other requirements of the NER, the AER should have discretion to adjust the approach as required.

We suggest that clause 6A.6.3A(l)(2) be amended to ensure that any adjustment specified in the agreement can be accommodated in the financeability test. We consider that including the underlined drafting would allow us to make the relevant adjustments required:

> (2) second, determine a financeability position using the same process used under sub-paragraph (1), but including the relevant *actionable ISP project* <u>and any adjustments specified in paragraph (f)(5).</u>

<u>Treatment of previous concessional finance</u>

Draft clause 6A.6.3A(d) specifies that only concessional finance agreements entered into after 14 December 2023 may be taken into account by the AER in carrying out its financeability test. This requirement for such a cut-off date creates an anomaly in our financeability assessments. If concessional finance has been provided to a TNSP relating to the delivery of the ISP project before the cut-off date, we consider that it should be able to be taken into account when assessing the financeability of the TNSP. Not doing so may result in a larger financeability adjustment being provided—through early recovery of depreciation from customers—than is actually required to ensure the TNSP is able to efficiently raise finance.

For example, if significant concessional finance had been provided to a TNSP prior to 14 December 2023 the current benchmark financeability position used in future financeability assessments may be artificially low if this finance cannot be accounted for in the test. As a result, the financeability test may show the TNSP's financial position dropping below the threshold once the future ISP project expenditure is included and requiring a financeability adjustment. However, if the current financeability position included the prior concessional finance the TNSP's financial position may still be above the threshold after including the future ISP project and not require a financeability adjustment. Therefore, not being able to reflect any concessional finance entered into prior to 14 December 2023 may result in more depreciation being brought forward than necessary to ensure the TNSP is able to efficiently raise finance. We do not consider that this is consistent with the NEO.

Further, we consider it would assist us if the rules should specify what process step of an agreement is to be considered 'entered into'. Our understanding of the process of developing and providing a concessional finance agreement may have several stages where the agreement may be considered 'entered into'. Part of an agreement may be signed before 14 December, while the final agreement and actual transactions may occur after 14 December. In this case it is not clear what details are required to be provided and whether we are able to reflect any of the detail of this agreement in our assessments.

We are supportive of reflecting the impact of any concessional finance benefits that are retained by the TNSP in our financeability assessment to ensure only the required adjustment to depreciation is applied so that the TNSP continues to efficiently raise capital. However, the current prescriptive detail in the draft rules regarding how concessional finance is to be treated when assessing financeability may result in outcomes that are not in the long term interest of consumers.

Transitional arrangements for current contingent project applications

We understand that under the draft rule a financeability adjustment can only be requested as part of a CPA (Stage 2), and only following the rule change being finalised. This means that any ISP projects with CPAs already lodged under consideration by the AER at the time of the final rule change would be ineligible for any financeability adjustment not already permitted by the NER.

In December 2023, the AER received an application from Transgrid for its HumeLink Stage 2 contingent project. This contingent project is the largest actionable network investment in the optimal development path of the 2022 ISP.[3] It would appear inconsistent with the rationale for the rule change to have this project ineligible for any financeability adjustment if there was sufficient evidence that one was required. As noted above, in the absence of a financeability request allowed for under amended rules, the depreciation schedules we approve must reflect a profile that reflects the nature of the assets over the economic life of the assets, consistent with clause 6A.6.3(b)(1).

We consider that the AEMC should consider whether a transitional arrangement is required to allow for the HumeLink project to be eligible for a financeability adjustment if one is deemed to be required. Importantly, however, we consider that any such transitional arrangement must also include the ability for the AER to be provided and appropriately account for any concessional finance provided for this project, even if entered into prior to 14 December 2023. This would ensure that the financeability benefits associated with this finance are reflected in the financeability test and subsequent adjustment.

Additional comments

As-incurred depreciation

The AEMC's draft determination also notes that allowing "as incurred" recovery of depreciation for assets is an existing mechanism available under the current arrangements. It states that because there is no substantive difference between the existing depreciation provisions for distribution networks in Chapter 6 (where we allow depreciation as-incurred) and for transmission networks in Chapter 6A the AER could choose to take the same approach of allowing for "as incurred" depreciation of transmission assets.[4]

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3 AEMO, *2022 Integrated System Plan*, June 2022, p. 67.

4 AEMC, *Draft determination*, 14 December 2023, p. 36.

While we agree that this is an approach that is available to us under the current arrangements, in the absence of a financeability adjustment required under draft clause 6A.6.3A, the depreciation schedules we approve must still reflect a profile that reflects the nature of the assets over the economic life of the assets, consistent with clause 6A.6.3(b)(1). As the AEMC's draft determination also notes, there is a shorter time between the distribution network service providers spending the money and commissioning the asset, as such applying an as-incurred approach in distribution reflects the nature of these assets.[5] For transmission projects there is generally significant lead time between when the costs are incurred and the assets are commissioned. The nature of transmission assets means there is a long lag for when it begins providing prescribed services and generally be considered depreciable.

As such, we maintain that our standard approach to begin depreciating transmission assets only when they are commissioned and providing services is consistent with the requirements of chapter 6A. However, if there is a particular reason that depreciating an asset or category of assets on an "as incurred" basis better reflects this requirement—as may be the case for biodiversity offset costs—then we will consider such a proposal as required.

Accommodating changes to concessional finance sharing

Under the draft rule the trigger requiring an NSP to provide the AER with the detail of concessional finance to be shared with consumers is when the agreement is entered into. It is not clear under the current drafting whether there is a responsibility to provide the AER with details of changes to the sharing arrangement or cancelation of the agreement. We would expect that if there was a material change in the amount expected to be shared with consumers the AER should be informed in order to make the required adjustment. However, we consider that any change to the sharing should only be made on a prospective basis. For simplicity and certainty to consumers, we consider there should be no adjustment to sharing already provided.

The AER looks forward to continuing its engagement with the AEMC on this rule change. To discuss any matter raised in this submission please contact Jonathan Seymour on [redacted].

Yours sincerely

[redacted]

Dr Kris Funston
Executive General Manager
Network Regulation

Sent by email on: 08.02.2024

5 AEMC, *Draft determination*, 14 December 2023, p. 36.