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James Hay
Deputy Secretary
NSW Department of Planning, Industry and Environment
Locked Bag 5022
PARRAMATTA NSW 2124

Dear Mr Hay

Network infrastructure projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy paper

The Australian Energy Regulator (AER) welcomes the opportunity to provide a submission on the Department of Planning, Industry and Environment's (DPIE) *Network infrastructure projects (Part 5 of the Electricity Infrastructure Investment Act 2020) policy paper*. We consider that the policy paper is an important step in increasing stakeholders' understanding of the proposed framework and seeking their feedback.

The policy paper notes that the NSW Minister for Energy intends to appoint the AER as the regulator for the functions under Part 5 of the EII Act. The primary roles are to develop and apply a Transmission Efficiency Test to the capital costs proposed by a REZ Network Operator, and then determine the annual revenues the Network Operator can receive for building and owning the REZ network project.¹ AER staff are working with DPIE on developing guidelines in relation to these roles.

We note that the policy paper contains a number of guiding principles against which DPIE will assess policy options. We particularly support the principle that the framework for network determinations should be as consistent as possible with the national regulatory framework. We suggest that the framework used for regulating Transmission Network Service Providers under Chapter 6A of the National Electricity Rules (NER) be applied to REZ Network Operators.

This approach would provide greater certainty for stakeholders. Consistency with the framework under Chapter 6A of the NER allows the AER to maintain the core elements of the regulatory framework that have been developed through extensive consultation and experience, and represents regulatory best practice. Further, the current regulatory regime

¹ Electricity Infrastructure Investment Act 2020, s.38.

that the AER applies is already well understood by consumer groups, network businesses and investors.

We recognise that there are areas where the EII regulatory framework will need to differ from the national framework. For example, under the EII framework the AER will not be required to assess the need, scope or timing of REZ network projects as those aspects will be authorised by the Consumer Trustee on the recommendation of the Infrastructure Planner. The scope of our assessment of a Network Operator's regulatory proposal is therefore more limited than under the NER.

Given the new roles and functions played by different parties under the EII framework, consultation and transparency will be important. This includes ensuring appropriate opportunities for stakeholder input into the process for assessing and recommending network options, the process for authorising the preferred network option and the methodology for setting the maximum capital amount for REZ network projects. Consultation and transparency around these key stages will ensure that stakeholder views are considered and that they understand how these important decisions have been made.

Appendix A responds to DPIE's consultation question on whether the AER should be required to take into account the financeability of REZ network projects as a principle in making our REZ network project determinations.

Appendix B contains our comments on select issues raised in the policy paper, including a number of the consultation questions.

We look forward to working with DPIE to develop and implement arrangements for the regulation of REZ network projects. To discuss any matters raised please contact Scott Haig on [REDACTED].

Yours sincerely



Justin Oliver
Board member, Australian Energy Regulator

Appendix A – Financeability of REZ network infrastructure projects

DPIE's policy paper states that some network businesses have raised concerns about the risk of large network infrastructure investments being unfinanceable under the current national regulatory framework. Specifically, DPIE indicates the following key concerns with the national process have been raised:

- It defers network revenue recovery into the future.
- The AER's determination process does not account for the increased risk and cost of the financial structuring required to deliver significant new projects.²

DPIE is of the view that the risk of Network Operators not being able to finance NSW REZ network projects, potentially delaying or preventing the delivery of these projects, is a factor requiring careful consideration in the policy design of the NSW framework. It considers options to address financeability could include prescribing a financeability principle in the regulations that must be taken into account by the AER in making each revenue determination, and empowering the AER to make adjustments to the building blocks to alleviate any financeability concerns identified by the Regulator.

We do not consider financeability should be elevated to being a principle that must be taken into account in the framework. This could inappropriately elevate the weight given to financeability relative to other relevant considerations that are not included as principles. Financeability is already a factor that the AER takes into account where relevant in determining if a regulatory decision will promote the National Electricity Objective.

For example, while we determined not to use financeability assessments to inform our rate of return in making the 2018 rate of return instrument, we considered submissions of stakeholders in reaching this decision. In reaching this view we noted a range of quantitative and qualitative measures rating agencies consider when assessing a firm's credit rating, including the Funds From Operations (FFO) to net debt financial metric. We calculated FFO to net debt metrics for a number of firms we regulate under several scenarios. We also considered if our regulated return on capital allowance was expected to be sufficient to allow firms to reduce their debt to equity ratio (to improve credit metrics) if they needed to do so.³ We also considered Australian Gas Network's submissions and experts' reports on financeability in making our final decision for Australian Gas Network's 2016 to 2021 Access Arrangement. In this case we did not accept AGN's proposed increase its regulatory depreciation by making a financeability adjustment when the FFO to net debt credit metric falls below nine percent.⁴ We consider a similar approach would be adopted under the EII framework.

To date we have not seen compelling evidence the current NER framework will not facilitate efficient investment and we are advocating elsewhere in this submission that the REZ regulatory framework be substantially based on that framework. It must be remembered that our approach is a benchmarking approach. We do not consider TNSPs need to be able to maintain the metrics used for setting the regulated rate of return at all times. We consider a TNSP can reduce its gearing ratio by raising more equity capital if they need to improve financial metrics.

We also note that the EII framework reduces the risk that would normally be borne by an NSP, by having the Infrastructure Planner assess network options, recommend a preferred

² Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p. 36.

³ AER, *Rate of return instrument Explanatory Statement*, December 2018, pp392 – 405.

⁴ AER, *Final Decision Australian Gas Networks Access Arrangement 2016 to 2021 – Attachment 5 – Regulatory depreciation*, May 2016, pp 18-23.

option and undertake preparatory activities and development works. Once a Network Operator is selected, the framework expects the construction of the network project to be completed relatively quickly to support the generation contracted for the REZ. These design elements aim to shorten the timeframe and uncertainty associated with large projects such as those identified in AEMO's ISP. We consider the reduction in risk under the EII framework is likely to lessen financeability concerns all else being equal, noting that risk and uncertainty are often cited as reasons for the regulator to consider the financeability of infrastructure projects.

In December 2020, the AEMC assessed a rule change from TransGrid and ElectraNet to bring forward cash flows for their share of current and future actionable Integrated System Plan (ISP) projects. The AEMC did not make the proposed rule changes and found the regulatory framework did not create a barrier to either ElectraNet or TransGrid financing their share of current ISP projects at that time.⁵ Our submissions to the AEMC did not support the rule changes proposed by TransGrid and ElectraNet because we did not consider the rule derogations were required on the specific facts.⁶ In our submission we noted:⁷

- A firm's credit rating is a signal to investors about the credit worthiness of a firm's debt. Therefore, the calculation of financial metrics by rating agencies is focused on this purpose. Whereas our calculation of gearing, and other inputs to the RoRI, have the purpose of determining an appropriate overall rate of return and are calculated accordingly.
- FFO/Net debt is only one of a suite of quantitative and qualitative measures considered by rating agencies. However, we acknowledge rating agencies do appear to expect rated firms to maintain this financial metric above a given threshold level over the longer term.
- Firms can alter the FFO/Net debt financial metric themselves through a range of measures. This may be via increasing equity capital, or via issuing hybrid debt partially treated as equity by rating agencies for example. Importantly, the AER does not determine (or mandate) a firm's actual approach to capital raising, or its capital structure.
- Rating agencies do not look at regulated benchmark 'hypothetical' cash flows. They look at a firm's actual cash flows and actual debt (at the gearing level they choose).

For TransGrid we found a relatively small decrease in its debt to equity ratio to 55% debt to 45% equity would maintain an FFO/Net debt financial metric consistent with its credit rating. This is within the range of debt to equity ratios firms we regulate have operated at over the last 5 years.⁸ For ElectraNet we found its investment in Project Energy Connect would not reduce its FFO/Net debt financial metric below the lower bound for its existing credit rating at 60% debt to 40% equity.⁹

⁵ AEMC, Rule Determination – Participant derogation financeability of ISP projects (TransGrid), 8 April 2021 pii; AEMC, Rule Determination – Participant derogation financeability of ISP projects (ElectraNet), 8 April 2021 pii.

⁶ AER, AER submission – Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects, 3 December 2020; AER, AER submission – Draft Rule Determination (Participant derogation – Financeability of ISP Projects (TransGrid and ElectraNet) Rule 2021, 5 March 2021.

⁷ AER, AER submission – Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects, 3 December 2020, p 10.

⁸ AER, AER submission – Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects, 3 December 2020, p 12.

⁹ AER, AER submission – Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects, 3 December 2020, p 13.

However, this does not mean there will never be financeability challenges. For this reason, the DPIE might consider clarifying that the AER can adjust depreciation profiles in specific circumstances where warranted. Adjustments to depreciation profiles are Net Present Value neutral for customers. Front-loading of depreciation can alleviate financeability concerns in the early stages of a project but care is needed because early depreciation can lead to challenges later in an asset's life.

We agree with the policy paper position that where capital costs and the rate of return (including payment schedule) are determined through a contestable process, there should not be financeability concerns.¹⁰ Under a contestable process, with appropriate bidding conditions in place, potential network operators would be expected to bid costs for which they are willing and able to deliver the project if selected.

¹⁰ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p. 36.

Appendix B – Detailed comments on policy paper

Consultation question/ issue	AER comments
<i>Guiding principles</i>	
<i>Question 1: Do you agree with the proposed guiding principles? Are there additional principles that should be considered?</i>	<p>We consider the proposed guiding principles listed on page 10 of the policy paper are reasonable, particularly those around protecting the long-term financial interests of NSW electricity consumers, facilitating appropriate cost and risk sharing arrangements and aligning the REZ regulatory arrangements with the national framework where feasible. As noted in our cover letter, we recommend maintaining consistency with the national framework for economic regulation of networks to the extent possible. This is because most stakeholders are familiar with the framework and how it is applied by the AER. We separately address the point around ensuring that projects are financeable in Appendix A of this submission.</p> <p>We recommend DPIE add a principle around transparency and consultation. We consider that transparency and consultation is important to build stakeholder confidence in the process for identifying and authorising REZ network projects, as well as in the process of making revenue determinations for such projects. Opportunities for stakeholder scrutiny and input at key decision-making points throughout this process will assist in delivering efficient network solutions that will ultimately be paid for by NSW electricity consumers.</p>
<i>Network infrastructure projects authorisation</i>	
<i>Question 6: What eligibility criteria should apply for Network Operators that may be authorised or directed to carry out a REZ network infrastructure project?</i>	<p>We recommend that the criteria should be the same as the AEMO criteria for registration of a Network Service Provider (NSP). The Network Operator will interface directly between generators and the National Electricity Market and will need to operate their network in conformance with all standard market procedures. We suggest that the Network Operator should be required to register with AEMO as an NSP.</p>

Competitive tendering of REZ network projects	<p>The policy paper states:</p> <p><i>As noted previously, the NSW Roadmap introduces the opportunity for competition for the selection of a Network Operator in certain circumstances. Unless determined to be inefficient or inappropriate, the Infrastructure Planner is expected to undertake a competitive market tender process to select the preferred Network Operator or Network Operators to deliver or all or some of the project. It is currently intended that the Network Operator appointed as a result of a contestable market tender process would be granted a right to own, construct and finance the new REZ network infrastructure assets. Transmission system operation will remain the responsibility of TransGrid as the primary transmission network service provider.¹¹</i></p> <p>The AER supports the use of contestability in the provision of transmission services. In our recent submission to the AEMC on its Transmission Planning and Investment Review, we outlined the benefits flowing from competitive tendering arrangements and noted our preference for a sponsor-based competitive tendering approach.¹² In our submission to the AEMC we noted that in considering the introduction of competitive tendering in the NEM it was important to assess the potential competitive outcomes (including assessing whether there is sufficient depth of competition in the market for transmission services in Australia and understanding how to design any competitive tendering framework in a way that maximises engagement by bidders). This includes removing any actual or perceived advantages by the incumbent TNSP to ensure a level-playing field for non-incumbent bidders.</p> <p>We recommend that any regulations developed by DPIE allow for flexibility as to what aspects can be competitively tendered. We also recommend that DPIE consider measures to ensure that competitive tender processes deliver efficient outcomes for NSW consumers. This could include setting out the circumstances when a REZ network project should be tendered, and the need to be satisfied that a tender is likely to provide a competitive outcome. It could also include the criteria by which the Infrastructure Planner is to assess tender proposals.</p>
Assessment by the Infrastructure Planner of network options	<p>The policy paper broadly discusses the Infrastructure Planner assessing different network options and recommending the optimal REZ network project for a REZ to the Consumer Trustee. However, we consider there would be benefit for stakeholders in the Infrastructure Planner setting out in more detail the approach to be used to assess network options and to determine the optimal network project.</p>

¹¹ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p.24.

¹² AER submission to the AEMC's Transmission Planning and Investment Review consultation paper, pp 13-16.

	<p>The EII Act requires that in assessing and making its recommendations about REZ network infrastructure projects the Infrastructure Planner must consult with some specific parties (e.g. AEMO, relevant operators and local councils). The policy paper also mentions that a degree of public consultation is likely to occur with relevant stakeholders (local and Aboriginal communities) and potential solution providers. We consider broader consultation on the options considered and the optimal project to be recommended would be prudent given that this is the key stage in the process where stakeholders can influence the REZ network project, which will ultimately be paid for by NSW electricity consumers. In this regard we note that s30(5) of the EII Act allows for regulations to make further provision for public consultation.</p>
Authorisation by the Consumer Trustee	<p>The policy paper states that the Consumer Trustee's has a power to determine which network infrastructure project should be authorised, having regard to the relative merits of recommended network infrastructure projects and the upgrades required to achieve the infrastructure investments objectives.</p> <p>It is not clear how the Consumer Trustee decides whether or not to authorise a network infrastructure project. Further it is unclear whether the Consumer Trustee will publish its reasons for authorising a network project. We consider that this would be good for transparency, subject to any confidentiality requirements. It may be the case that the Consumer Trustee's assessment processes will be set out in the Authorisation Guidelines to be developed by the Consumer Trustee.</p> <p>The paper also does not address in any detail the methodology by which the Consumer Trustee will determine the maximum capital expenditure amount. We consider it would be good for stakeholders to know this given the important role the cap plays in the revenue determination process.</p>
Augmentations to the existing network (inside and outside a REZ)	<p>The policy paper states that:</p> <p><i>"Many REZ network projects will include augmentation of existing assets both inside and outside the geographic area of a REZ. It is expected that those works will be developed, built and maintained by the owners of those networks."</i>¹³</p>

¹³ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p. vi.

	<p>We consider that further clarity would be useful on how augmentations to existing network assets will be dealt with, in particular:</p> <ul style="list-style-type: none"> • what framework will apply to the augmentation (if it is the EII framework, will the regulator be required to undertake a separate determination in relation to the incumbent NSP?). • how will costs associated with the augmentation be allocated? • how will costs be recovered for the augmentation, through the scheme fund or via the relevant NER pricing rules? <p>We suggest that the costs associated with augmentations to existing assets both inside and outside the REZ be regulated under the EII framework and that costs associated with the augmentations should be recovered from the REZ scheme. This will maintain transparency around the costs related to the REZ developments. At a later stage such assets could be added to the Regulated Asset Bases of the incumbent NSPs under the national framework. See our response to question 17 (below).</p>
Building greater capacity than is originally required	<p>The policy paper states that:</p> <p><i>It is important that these parties [the Infrastructure Planner and Consumer Trustee] have regard, in their respective roles, to the infrastructure investment objectives and the need to earn and maintain local community support for network projects. This may, for example, mean building more capacity than what is the minimum immediately needed. This could reduce corridor duplication to minimise adverse impacts on communities and other land uses. This in turn could help future-proof the network to create greater optionality and price competition for LTES Agreements over time.</i></p> <p><i>The Roadmap policy and the recent Dinawan upgrade on Project Energy Connect identified clear concerns about the ability of the existing transmission investment regime to take account of the need for wider coordination of generation and transmission investment over more than just the short term. To that end the Roadmap policy has expressly provided options for low cost finance options so network project scopes can be optimised to align with the long-term interests of consumers and host communities.”¹⁴</i></p>

¹⁴ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p. 27.

	<p>The AER considers that electricity consumers should only be required to pay for efficiently sized and timed network investments and not costs associated with additional capacity that may never be required.</p>
<p><i>Transmission Efficiency Test and Regulator's determination</i></p>	
<p><i>Question 8: How can consumer and stakeholder input be considered in the TET and revenue determination processes?</i></p>	<p>The AER considers stakeholder input to be a critical part of the revenue determination process. We propose that stakeholder input would be obtained through the same approach as under the national framework, that is, through consultation on the regulatory proposal and on our draft decision. We would also propose to utilise our Consumer Challenge Panel as we do for other revenue determination processes.</p> <p>We also note that an expedited revenue determination process for a REZ infrastructure project determination may be required in some limited circumstances. Nevertheless, the AER would still seek to undertake some form of consultation so that stakeholder's views are understood and taken into consideration in making the final revenue determination.</p>
<p><i>Question 9: Is clarification required with regard to the principles to be taken into account by the Regulator and the objects of the Act, and are there any additional principles that should be considered by the Regulator?</i></p>	<p>The paper states that:</p> <p><i>In terms of considering all of the objects of the EII Act, the Department is considering regulatory solutions that minimise the extent to which the Regulator may be required to choose between different objects, such as affordability and prioritising local and indigenous employment, if and where these are in conflict. The Department considers that this is a values-based trade-off that an economic regulator may not be well equipped to make, and this would also be a departure from equivalent processes in the national framework.</i></p> <p><i>The TET and revenue determination process could be designed to focus on the principles under section 37 of the EII Act as the primary consideration of the Regulator for Part 5 of the EII Act. The other objects will be achieved across the breadth of other functions under the Act and do not need to be specifically addressed in the regulatory process.</i>¹⁵</p> <p>We agree with the position proposed in the policy paper that the scope of the AER's revenue determination should be limited to the principles under s.37 of the Act rather than the broader objects under the EII Act. We also note that the principles in s.37 broadly align with the revenue and pricing principles under the national framework.</p>

¹⁵ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, pp. 33-34

	<p>In terms of additional principles, we consider that DPIE should include a principle in the regulations that the Regulator should be required to have regard to the long-term interests of NSW consumers. We note that this is similar to one of the guiding principles listed in the policy paper that the Department will use to consider its policy positions.</p>
<p><i>Question 10: What views do you have on these elements and is there any other guidance that should be included in the TET guidelines to be developed by the Regulator?</i></p>	<p>The policy paper states that some elements that the TET guideline could cover include the following:</p> <ul style="list-style-type: none"> • Timeframes for undertaking the TET, including public consultation; • Requirements on the Network Operator to provide information to the Regulator; • How the Regulator will consider information provided by a Network Operator; • The process and approach by which the Regulator will undertake the capital cost assessment; • How the Regulator will apply the TET if the Network Operator is selected through a contestable process; and • How the Regulator will treat confidential or sensitive information (including information provided during any contestable process if applicable). <p>We support including the above elements in the policy paper in the TET Guideline. However, we note that we propose to develop a combined TET/Determination Guideline as the assessment of capital costs is generally undertaken as part of the broader determination process.</p>
<p><i>Question 11: Should financeability concerns be addressed in the NSW framework?</i></p>	<p>See Appendix A.</p>
<p><i>Question 12: What views do you have on these elements and is there any other guidance that should be included in guidelines regarding the revenue determination to be developed by the Regulator?</i></p>	<p>The policy paper includes the same elements as set out for Question 10 (above) but in this case for the determination process rather than the Transmission Efficiency Test. We support including the identified elements set out in the policy paper in a combined TET/Determination Guideline.</p>

Reviewing a determination

Question 15: Do you agree there should be limited circumstances under which the Consumer Trustee directs the Regulator to review and remake a revenue determination outside of the five-yearly cycle?

The EII Act permits the regulator to remake a determination every five years or at any time a Consumer Trustee directs. The paper includes two circumstances when it may be appropriate for the Consumer Trustee to direct the regulator to remake its decision (outside of the five-year cycle):

1. To align a Network Operator's five-year determination cycle under the EII Act with its existing five-year cycle under the national regulatory framework
2. To align the determinations of multiple REZ projects under the EII Act where these projects are carried out by the same Network Operator.¹⁶

As a general principle, we consider that the circumstances under which a revenue determination can be remade should be limited so as to provide certainty for all stakeholders and incentives for asset operators to operate regulated assets efficiently. As such, we support the regulations limiting the circumstances under which the Consumer Trustee can direct the AER to remake its determination to the two circumstances contained in the policy paper. We consider that those circumstances are likely to result in administrative efficiencies for both the regulator, the Network Operator and stakeholders more generally.

Question 16: Do you agree with the proposed circumstances under which the Regulator may adjust a revenue determination during the five-yearly cycle?

In addition to the above circumstances for remaking a determination, the EII Act states that the Regulator may also review and remake a determination at any time, subject to the regulations. The paper indicates support for regulations clarifying that the reasons for adjusting an existing revenue determination should be consistent with those in the national framework. It notes that under the national framework there are three reasons where the AER can reopen elements of the revenue determination:

1. A material error was made in the original determination;
2. A cost pass through event occurs; or
3. A contingent project is triggered.¹⁷

We agree with the proposed approach in the paper that circumstances under which the AER may adjust a revenue determination are limited to those under the national regulatory framework to the extent they are applicable in the REZ context.

¹⁶ Electricity Infrastructure Investment Act, s.40(2).

¹⁷ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p. 42.

<p><i>Question 17: Is there a need to clarify the process for transitioning of assets between the NSW and national frameworks?</i></p>	<p>The EII Act provides for the possibility that a Network Operator’s asset base under the REZ framework could be transitioned to a NSP’s Regulated Asset Base under the NER.</p> <p>The policy paper states that “Any decision on whether to roll NSW-specific assets into the national framework is likely to be dependent on: (a) who the Network Operator is, and (b) how similar the two frameworks and methodologies for regulating are”. The paper also states that “A decision to transition assets into the national framework could be made at the Regulator’s discretion, providing certain criteria are met (which could be prescribed in the regulations), including the Network Operator approving the transition and the Regulator assessing that the transition is in the interests of NSW electricity consumers.”¹⁸</p> <p>The AER considers that in the short to medium term it would be practical and sensible to maintain REZ assets separate from NER assets so the costs of the REZ scheme are separately identifiable. This means the complex issues associated with moving assets between frameworks do not need to be addressed right now, however should DPIE wish to pursue this possibility we recommend a future process be foreshadowed.</p>
<p><i>Question 18: Is there a need to clarify the circumstances by which a transfer of network infrastructure from a Network Operator to another person may occur under the EII Act?</i></p>	<p>We consider that it would be prudent to clarify the circumstances under which a transfer of network infrastructure asset from a Network Operator to another person may occur under the EII Act. For example, what approval process must be undertaken and what requirements the transferee must meet (such as licence or other registration requirements before a transfer can occur).</p>

¹⁸ Network Infrastructure Projects (Part 5 of the Electricity Infrastructure Investment Act 2020) – Policy Paper, p. 43.