21 June 2019

Energy Security Board

By email: info@esb.org.au

Re: Converting the integrated system plan (ISP) into action – Consultation Paper 17 May 2019

We are providing this letter in response to the Consultation Paper on the governance of the Integrated System Plan (**ISP**) process and the structure of the regulatory framework reforms. Spark Infrastructure has a 15% interest in TransGrid which is expected to be a partner in delivering more than $3 billion in ISP projects by the mid-2020's.

We support the reforms being progressed by the ESB and AEMC to make the ISP actionable including:

- the recently implemented rules to streamline the AER's processes and further reforms to give the ISP standing in regulatory investment test for transmission (**RIT-T**) processes;
- to clarify that adopting ISP assumptions is reasonable; and
- to minimise the ability for essentially the same dispute to be brought in multiple processes.

We note that the ESB has prepared a paper on an underwriting fund that removes the risk of regulatory approval away from the Transmission Network Service Provider (**TNSP**) for time critical Group 1 ISP projects and for the financing of connecting transmission assets to priority renewable energy zones (**REZs**) to be presented to COAG Energy Council in July 2019. Although we disagree with the need to underwrite private investment in principle, we acknowledge that in the current environment of investor uncertainty due to heightened regulatory risk, low returns and reduced checks and balances on regulatory decisions with significant economic impact (such as expenditure forecasts and rate of return), that this has become necessary if these projects are to proceed. We would be happy to assist with developing an approach that minimises the cost to taxpayers and energy customers of these mechanisms.

We do however wish to ensure that the regulatory risk associated with delivering the projects identified in the ISP is not underestimated. For example, the investment required in the NSW/SA interconnector (project EnergyConnect) is greater than TransGrid's total five-year capital expenditure program as per its recent regulatory determination. In undertaking such a significant project at this time, a network service provider (**NSP**) is exposed to the following risks:

- Attracting capital – current regulated equity returns are significantly less than 6% as a result of the AER's recent Rate of Return Guideline (**RORG**) with further reductions in regulatory revenues from the increase in gamma and the change to the regulatory tax approach. In addition, as a result of a falling risk-free rate and inflation expectations considerably below the AER's forecast inflation, the realisable equity return is likely to be significantly lower again. This could impact on the ability of the TNSP to attract capital, or to attract capital at or below the regulated weighted average cost of capital.
- Ex-ante forecast risk – the contingent project application process consists of the AER reviewing the proposed forecast of the efficient cost of the project to allow the TNSP to recover revenue associated with the efficient cost of the project. If the AER forms a different view of the forecast of the efficient cost, the TNSP cannot recover the difference in cost for at least the remainder of the regulatory period.

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- Ex-post assessment risk – once the investment has been incurred, the AER may form a different view of the efficient cost of the project compared to the actual cost incurred. In this case, any reductions in capital expenditure will result in zero equity return being earned on the difference as well as continued financing cost on the difference for the life of the investment.

These are real and material risks especially where significant construction projects are involved. Construction companies who take on these risks on a regular basis demand returns at least 3-4 times the current regulated return.

These risks are also now greater than ever before as a result of the National Electricity Rules providing for an ex-post review where an NSP's capital investment during a regulatory period is greater than the forecast allowance, the reduced review rights available on AER capital expenditure decisions and the effective removal of judicial review rights on rate of return and gamma decisions.

We recommend that future ISP processes address this increased risk by incorporating an assessment of investability and long-term impacts on customers in relation to price, safety, reliability and security consistent with the National Electricity Objective utilising a transparent and objective assessment framework. This assessment is more likely to reveal challenges that may need to be addressed to ensure timely investment and provides a consistent framework for assessing outcomes when assumptions change with each subsequent ISP.

The ISP identifies a plan that maximises benefits to electricity customers. Difficulty raising capital to undertake the investment could lead to delays, and the requirement for government support or higher cost just-in-time investment. These factors will erode savings to customers. An assessment of investability and long-term outcomes will improve accountability, consistency over time and guide reforms to regulatory and policy settings.

I would be happy to discuss these matters further and can be contacted on 0421057821.

Yours sincerely,

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