

Our Ref: AER200206
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3 December 2020

Ms Merryn York
Chair (a/g)
Australian Energy Market Commission
Level 15, 60 Castlereagh St
Sydney NSW 2000

Dear Ms York

AER submission – Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC's) consultation paper on the two participant derogation rule change proposals from TransGrid and ElectraNet.

TransGrid and ElectraNet proposed changes to the National Electricity Rules as a solution to a perceived problem with efficiently financing large Integrated System Plan (ISP) projects.

The primary concern both proposals seek to address is the effect of large ISP projects on the cash flow metric: funds from operation to net debt (FFO/Net debt). FFO/Net debt is a financial metric considered by credit rating agencies in determining a firm's credit rating.

The proposals seek to address a decrease in the FFO/Net debt ratio, at a given debt to equity (or gearing) ratio, via two rule changes specific to their ISP investments:

- Moving to 'as incurred' depreciation. This means the firms start receiving a return of capital, or regulatory depreciation, during the time a new project is being built and before it is commissioned.
- Eliminating indexation of the regulatory asset base (RAB). This means the return that firms currently expect to receive from increases in the RAB via inflation is provided in the allowed revenue.

AER staff had a series of discussions with TransGrid staff prior to TransGrid lodging its rule change proposal. TransGrid staff have been helpful in providing and explaining their cash flow modelling and their financeability concerns. We appreciate this assistance.

We support the framework the AEMC has proposed for assessing the rule change and agree that it should be carefully considered. However, we suggest the explicit consideration of regulatory compliance and administration costs, which are likely to increase somewhat with the creation of a second RAB.

TransGrid's modelling shows expected large investments relative to the size of its RAB will decrease FFO/Net debt at a given debt to equity ratio. This is a consequence of the lower incremental depreciation relative to the size of the remaining RAB still to be recovered in the early years of the economic life of regulatory investments – we noted the effect of longer average residual asset lives on FFO/Net debt when we made the *Rate of return instrument* (RoRI) in 2018.

However, at this time it is not clear to us whether the decrease in FFO/Net debt at a given gearing ratio indicates there is a financeability issue that requires a regulatory response or rule change.

First, the FFO/Net debt metric is one component of a broader assessment made to assess financeability and credit ratings. Typically, credit rating agencies review a range of quantitative and qualitative factors when making their assessments. While FFO/Net debt is an important component of this assessment, a decrease in the metric does not of itself indicate an issue that requires the rule change.

Second, financeability is substantially impacted by the practices and choices made by the firm itself. Regulated firms can, and do, engage in a range of practices specific to managing their own operations. This includes adopting individual financing and capital structure decisions to accommodate circumstances and management choices. It is therefore important to assess whether any potential issues can be managed by TransGrid and ElectraNet before requiring a regulatory response funded by consumers. In particular, choices about the proportion of debt and equity are central as well as choices about the character of capital instruments. The AER does not have a formal obligation to consider financeability under the rules, however, where regulators have included financeability tests within the regulatory regime they have generally stressed that the primary responsibility for managing financeability rests with the regulated businesses.

Third, if it is the case that some adjustment to the rules is warranted, the proposed rule change does not appear to be proximate to the cause and other options should be considered. While the proposed rule change has the effect of increasing cash flows in the early years it introduces other consequences that may cause problems later. An alternative rule change would be to move to as incurred depreciation for all ISP investments but to not remove RAB indexation. We already use as incurred depreciation for distribution businesses. We note as incurred depreciation also brings forward some revenue recovery into the earlier years of project construction. It would remove the cash flow dip that is evident during the construction stage of ISP projects and avoids the broader consequences of removing indexation on the RAB as a result of the proposed rule change. It also retains the current 'real return' framework, meaning consumer prices continue to move with inflation. However, it encounters similar issues around a timing mismatch between payments and benefits received by consumers as the proposed rule change. Another alternative would be to consider whether the depreciation profile of ISP projects might be adjusted.

We think the rule change raises potential consequences that require careful consideration:

- The proposed changes are net present value neutral (NPV), but have the effect of moving regulatory depreciation forward in time. This materially increases FFO over roughly the first third of an investment's life. This changes the profile of revenue and ultimately the prices that consumers will pay.

- Current consumers pay for more of the regulatory asset than they consume in a value sense, while future consumers will pay less. This raises intergenerational equity considerations. There is also a question about whether this type of profile aligns with the expected net benefits of the project.
- There are changes to the allocation of inflation risk through no longer indexing the RAB and effectively moving to a 'nominal return' framework. As a result of this change prices will no longer move with actual inflation even though this is the case for most consumers' incomes.
- The regulatory cash flows will be materially lower in the second half of the assets' lives and this may cause cash flow problems in the future. We have seen this impact in overseas jurisdictions where accelerated depreciation has been employed.

Overall, we do not consider TransGrid and ElectraNet have made the case for the proposed rule change. The financing challenges service providers face on large investments are not unique and are faced by other firms with revenue streams increasing with inflation, for example through long term contracts or regulation. Nevertheless, we recognise this is a difficult assessment because it is necessary to anticipate the potential actions of TransGrid and ElectraNet and potential investors. There is some risk that TransGrid and ElectraNet might not go ahead with the project (even with the rule change). This would result in the net benefits from these projects not being realised. A broader framework issue is whether other parties should be permitted to invest in regulated infrastructure if the service providers do not do so.

In respect of ElectraNet's rule change proposal, we have not had contact from ElectraNet on financeability issues. We note that ElectraNet has not provided modelling to the AEMC, or the AER, in support of its proposal. We have undertaken some preliminary cash flow analysis which suggests that ElectraNet's financial metrics are consistent with its current credit rating at a 60% gearing ratio. This analysis suggests the issues raised in the rule change proposal are more likely to be specific to individual firms and their practices rather than the regulatory framework more generally and are therefore within the remit of each firm.

Finally, we note that as part of our process for preparing the next RoRI we will be considering a range of issues that intersect with your assessment including the appropriate benchmark gearing ratio going forward.

In the attachment to this letter, we set out our detailed considerations for the AEMC on specific aspects of the rule change proposals.

We look forward to continuing to work with the AEMC on these rule change proposals. To discuss any matters raised in this submission, please contact Warwick Anderson on [REDACTED].

Yours sincerely

Clare Savage
Chair
Australian Energy Regulator

Sent by email on 03.12.2020

Attachment: Detailed response to consultation paper

This attachment covers the following points:

- The framework for assessing the rule change proposals.
- The current regulatory framework, including the *Rate of return instrument* (RoRI) and whether regulated businesses should be able to achieve all parameters used in the RoRI.
- The TransGrid and ElectraNet proposals, their justification, and the expected impact of these on energy consumers.
- Financeability and the FFO/Net debt metric
- Can financeability be addressed under the current economic regulatory framework?
- Does it appear a rule change is required, and what are the risks if a rule change does not proceed?
- Are there preferable rule changes to provide flexibility to allow the AER to take financeability into account in its regulatory determinations?
- Transitional issues if a rule change went ahead.
- Other issues.

The framework for assessing the rule change proposals

The AER largely agrees with the AEMC's assessment framework, although we note that the criteria the AEMC set to help assess the proposals are interrelated. One addition we would suggest is the explicit consideration of regulatory compliance and administration costs, which are likely to increase somewhat with the creation of a second RAB.

Fundamentally, these rule changes raise the issue of whether the current regulatory framework and its settings remain appropriate for all investments (including large ISP investments), or if modifications are appropriate in certain circumstances.

We consider modifications may be appropriate where they would be expected to materially better promote the National Electricity Objective (NEO).

The current regulatory framework, including the RoRI and whether regulated businesses should be able to achieve all parameters used in the RoRI

The current regulatory framework provides investors with a stable and predictable regulatory investment framework that includes an ex-ante return on their investments. This allowed return should be commensurate with the efficient financing costs of these regulated investments. As we noted in our 2018 RoRI *Explanatory statement*, we consider this is reflected in the prevailing market cost of capital (or weighted average cost of capital) for an investment with a similar degree of risk as that which applies to a service provider in respect of the provision of regulated services.¹ The process for setting revenue and capital expenditure forecasts in regulatory determinations is clearly laid out in legislation.

The regulatory framework is effectively a 'real return' framework that provides an allowance for inflation via indexing the RAB.² Key features of the framework include:

¹ AER, *Rate of Return Instrument, Explanatory statement*, December 2018, p. 33.

² AER, *Draft position, Regulatory treatment of inflation*, October 2020, p. 10.

- A locked-in RAB that is maintained in real terms via increasing it in line with outturn consumer price index (CPI) inflation;
- A return of capital via regulatory depreciation over the economic lives of the assets;
- Ex-ante allowances for return on capital, operating expenditure, capital expenditure and tax;
- A range of incentive mechanisms to encourage and reward efficiencies in the provision of regulated services;
- Allowances for extra expenditure, beyond the revenue determination, under a number of NER mechanisms such as cost pass throughs and contingent projects;
- A revenue cap where any under (over) recovery is recovered (paid back) in the following year with interest at the regulated return on capital; and
- A well specified and clear propose-respond model for regulatory determinations.

These features of the regulatory framework make it relatively low risk and stable and have facilitated sufficient investment over multiple regulatory control periods. In our recent *Electricity network performance report* we stated:³

...we observe that consumers are getting a more reliable supply of electricity and paying less for this supply than they have previously. At the same time, NSPs continue to attract sufficient investment to fund efficient expenditure in their networks.

In this respect, the current real return framework with RAB indexation is well tried and tested in jurisdictions in Australia and overseas and has been shown over an extended period to support efficient investment.

The current regulatory framework should encourage efficient investment and use of infrastructure and promote the NEO by:

- Allowing an ex-ante return on capital in line with the efficient financing costs of the investment;
- Depreciating the value of the assets in the RAB using a profile that reflects the nature of the assets over their economic life; and
- Providing incentives to improve the efficiency of investment and provision of regulated services.

The Rate of return instrument

The allowed return on capital is set under the RoRI. This is arguably the central piece of the current regulatory framework. Other ex-ante allowances, for example for operating expenditure, provide for other expected costs and facilitate the ex-ante allowance under the RoRI being achieved.

We consider the regime should be set to achieve the NEO and provide service providers with a reasonable opportunity to recover at least their efficient costs. However, this does not require service providers to be able to achieve the benchmark assumptions used in making and applying the RoRI at all times. The benchmark assumptions used in making and applying the RoRI are for the purpose of estimating an allowed rate of return that is commensurate with the efficient financing costs of the regulatory investments, but go no further.

³ AER, *Electricity Network Performance Report 2020*, September 2020, p. 2.

We do not expect all regulated firms to operate consistently with any or all of these inputs, or the benchmarks they are based upon. For example, not all firms will:

- Have a capital structure of 60% debt to 40% equity. When we finalised the RoRI, the firms currently traded on the ASX we used as part of our benchmark set (APA, SKI and AST) all had less than 60% gearing in their capital structure.⁴ Firm gearing has also changed materially through time as shown in table 1.

Table 1 – Gearing estimates based on market values

	ENV	APA	DUE	AST	SKI	AVE
2006	66%	51%	79%	56%	60%	62%
2007	65%	59%	67%	55%	57%	61%
2008	77%	73%	76%	59%	70%	71%
2009	75%	68%	80%	70%	70%	73%
2010	74%	61%	80%	64%	65%	69%
2011	66%	53%	79%	64%	62%	65%
2012	63%	47%	72%	59%	59%	60%
2013	53%	46%	71%	57%	62%	58%
2014	47%	45%	64%	58%	55%	54%
2015	–	50%	62%	59%	56%	57%
2016	–	49%	51%	57%	51%	52%
2017	–	49%	–	52%	50%	50%
2018	–	45%	–	56%	54%	52%
2019	–	45%	–	55%	57%	52%
2020	–	45%	–	59%	–	52%
5 Year average	–	47%	51%	56%	53%	52%
10 year average	57%	47%	66%	58%	56%	55%

Source: Annual reports, AER analysis.

- Operate as a company and incur associated Australian corporate tax. We examined corporate structures in our 2018 tax review and found a number of firms were operating under a variety of corporate structures, including as partnerships or trusts. Different structures are set out in our final report on our *Review of regulatory tax approach*.⁵
- Issue 10 year maturity debt smoothly over 10 years. Consulting work by Chairmont for us in 2018 and 2019, and updated by us in 2020, show firms we regulate will materially vary the maturity of their debt at issuance.⁶

⁴ AER, *Rate of Return Instrument, Explanatory statement*, December 2018, p. 65.

⁵ AER, *Final report, Review of regulatory tax approach*, December 2018, p. 35. Available here: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/regulatory-tax-approach-review-2018>

⁶ Chairmont, *Aggregation of return on debt* data, April 2018, p 10; Chairmont, *Aggregation of Debt Data for Portfolio Term to Maturity*, June 2019, p 4; AER, *Rate of return Energy network debt data Draft working paper*, June 2020, pp 11-14.

- Have a BBB+ credit rating (noting this is not directly used in the RoRI, but is the benchmark credit rating). When we finalised the RoRI in 2018, while the industry median credit rating was BBB+, firms we considered were rated BBB (or Baa2), BBB+ (or Baa1), and A- (or Aaa3).⁷

Of relevance to the rule change proposals, we noted the following in the RoRI explanatory statement:

- We decided not to reduce the benchmark firm gearing of 60% debt to 40% equity used in the 2013 *Rate of return guideline*, despite average firm gearing being under 55% debt over the prior 5 years. This was in part because the allowed return was relatively invariant to gearing.⁸
- We considered firms would have sufficient cash flow if they needed to reduce their debt levels (to achieve certain financial metrics).⁹

We also note we considered sector benchmarks rather than firm specific details in making the RoRI. The firms we regulate have flexibility in their capital structure decisions and employ this accordingly. For example, AusNet Services currently has around 1.4 billion AUD face value of subordinated callable floating rate notes, or close to 10% of the company's capital on issue; an Australian dollar (AUD) \$650 million callable floating coupon bond issued in Oct 2020 and maturing on 6 Oct 2080; a US dollar \$375 million callable floating coupon Eurobond issued in Mar 2016 and maturing on 17 Mar 2076; and a Singapore dollar \$200 million callable floating coupon Eurobond issued in Mar 2016 and maturing on 7 Sep 2016.¹⁰ In making the 2018 RoRI we treated this type of security as 100% debt, whereas a rating agency may not. In an ASX announcement, following AusNet Services' pricing of \$650 million of these securities in September 2020, AusNet Services indicated it expected these to be treated as 50% equity by rating agencies.¹¹

Finally, we note that the AEMC has effectively asked if it was appropriate for large new investments in the RAB to immediately receive the trailing average return on debt. We have discussed this further under "*Other issues*" at the end of this attachment.

TransGrid and ElectraNet's justification for the rule change, and the expected and potential impacts of these on energy consumers

TransGrid proposed the rule change will better achieve the NEO because:¹²

- The large ISP investments required will result in its free cash flow to net debt decreasing for an extended time below the lower bound threshold for BBB credit rating, absent further equity capital injections;
- Its shareholders are unlikely to be prepared to put in more equity capital; and
- Absent the rule change TransGrid and ElectraNet may choose to not proceed with the ISP projects, meaning, if others do not step forward, energy consumers lose the economic benefits these projects are expected to generate.

⁷ AER, *Rate of Return Instrument, Explanatory statement*, December 2018, pp. 284–285.

⁸ AER, *Rate of Return Instrument, Explanatory statement*, December 2018, pp. 66–67.

⁹ AER, *Rate of Return Instrument, Explanatory statement*, December 2018, p. 404.

¹⁰ In its 2020 Annual report, as at 31 March 2020, AusNet Services reported total assets of \$14.284.8 billion AUD: *AusNet Services Annual Report 2020*, p. 77; AusNet Services ASX Announcement, *AusNet Services successfully prices AUD 650M subordinated hybrid issue*, 25 September 2020; AusNet Services ASX Announcement, *AusNet Services successfully prices USD 375M hybrid offer*, 10 March 2016; AusNet Services, *AusNet Services successfully prices SGD 200M hybrid offer*, 1 March 2016; Thomson Reuters Eikon.

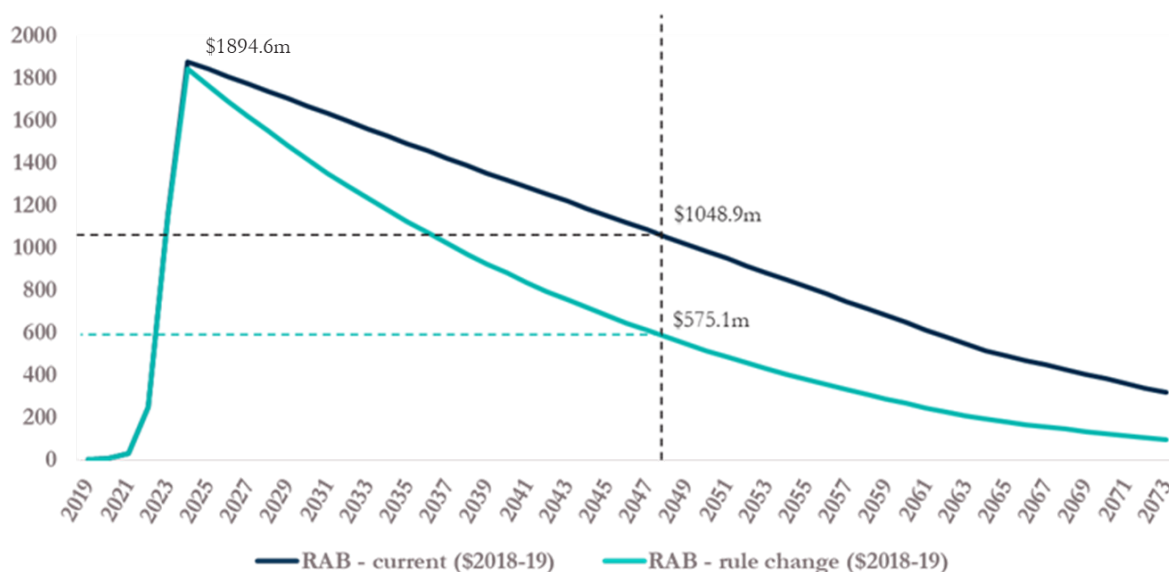
¹¹ AusNet ASX Announcement, *AusNet Services successfully prices AUD 650M subordinated hybrid issue*, 25 September 2020.

¹² Incenta, *TransGrid rule change proposal – Attracting capital for ISP projects*, September 2020, pp. 2–3, 14.

ElectraNet proposed it shares the same challenges as TransGrid and has therefore lodged an equivalent rule change request.¹³

The rule change effectively proposed bringing forward regulatory depreciation via two methods: the removal of the indexation of the RAB; and using ‘as incurred’ depreciation. Economically, this results in approximately 70 per cent of the asset value being paid off in real terms by consumers (via regulatory depreciation) over the first half of the project’s life. The current approach, that indexes the RAB and uses ‘as commissioned’ depreciation, results in real straight line depreciation with around 45% of the asset value being paid off in real terms over the first half of the project’s life. This is shown in Figure 1.

Figure 1 TransGrid portion of Project EnergyConnect – real RAB over time



Source: AER analysis, TransGrid, A.3A – PEC – Post-tax revenue model – BAFO outcome, September 2020.

Note: TransGrid’s cost estimates for Project EnergyConnect contains \$295 million (\$2018–19) of land and easements which are not subject to depreciation. Therefore there is some residual value in the RAB at the end of Project EnergyConnect’s estimated economic life.

We note that the UK energy regulator Ofgem had accelerated revenue recovery at various points in the past, in part driven by financeability concerns.¹⁴ These adjustments appear to have been made in an NPV neutral manner, and therefore have the effect of accelerated depreciation, in the same manner that TransGrid and ElectraNet’s rule change proposes.

We have examined the future consequences of adjusting depreciation allowances to meet certain financial metrics in the short term in past determinations. In particular, our final decision for AGN (SA)’s 2016–21 access arrangement found that accelerating depreciation in one or more regulatory periods means future financial metrics will necessarily be relatively worse compared to a long term indexed RAB depreciation approach, all else being equal.¹⁵ Similarly, Ofgem engaged CEPA to consider ‘issues relating to financeability’, and found that Ofgem’s approach of factoring in financeability in past decisions has resulted in ‘an increase

¹³ ElectraNet, *Rule change proposal Making ISP Projects Financeable – Participant Derogation*, p. 3.

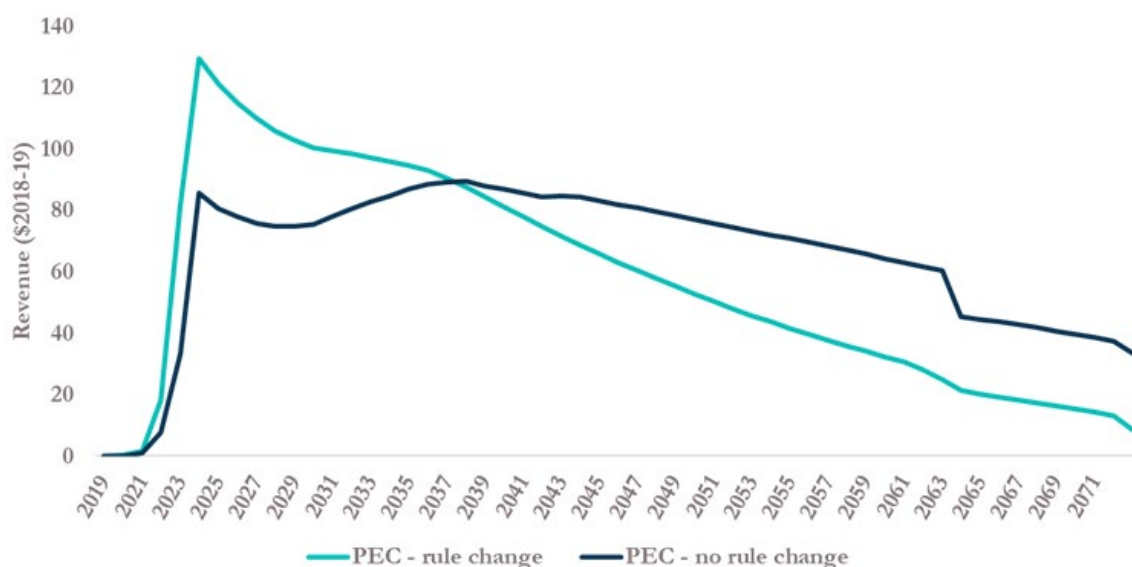
¹⁴ Ofgem, *RPI-X@20 Finance Working Group Paper*, October 2009, pp. 5–6.

¹⁵ AER, *Final decision Australian Gas Networks access arrangement – Attachment 5 – Regulatory depreciation*, May 2016, pp. 42–46.

in the proportion of assets that are subject to accelerated depreciation in part because the previous acceleration exacerbated the perceived cash flow constraints as the capex programme grows.¹⁶ This highlights a long term risk of using regulatory depreciation to increase cash flows in the short to medium term.

We have also modelled the profile of TransGrid’s revenue (comprising return on capital and regulatory depreciation) under our current regulatory framework as well as its profile if a rule change was to apply to the Project EnergyConnect ISP investment. Figure 2 demonstrates the front-loading of cash flows in the earlier years and then lower cash flows in future years, relative to the current framework.

Figure 2 TransGrid – real return on capital and regulatory depreciation for Project EnergyConnect



Source: AER analysis, TransGrid, A.3A – PEC – Post-tax revenue model – BAFO outcome, September 2020.

TransGrid, in its rule change proposal, stated that consumers will be paying, on average, an additional \$3 per year for the remaining years of the current 2018–23 regulatory control period as a result of the rule change for Project EnergyConnect.¹⁷ We agree with TransGrid’s calculations, however we note that the capex profile for Project EnergyConnect is skewed towards the final years of the construction period. As a result, the additional \$3 per year does not accurately reflect the true extent of the impact on consumers due to the rule change. When considering the impact over the next two regulatory control periods (10 years) from 2023–24, we expect the average household would pay an additional \$6.5 per year. Given the NPV neutral nature of the rule change over the life of the ISP project, consumers will be paying less in the future. Based on our modelling, we would expect the average household to be paying \$5 less per year over 2040–50.

Financeability and the FFO/Net debt metric

‘Financeability’ in a regulatory sense is a term that has been used to refer to a service provider’s ability to meet its financing requirements and to efficiently raise new capital.¹⁸

¹⁶ CEPA, *RPI-X@20: providing financeability in a future regulatory framework*, May 2010, p. 2.

¹⁷ TransGrid, *Rule change proposal – Making ISP projects financeable*, September 2020, p. 8.

¹⁸ AER, *Rate of Return Instrument, Explanatory Statement*, December 2018, p. 392.

However, it is not unique to regulated firms. Both regulated and non-regulated firms would be expected to seek to efficiently finance their new and existing capital investments.

In considering financeability, both regulated and unregulated firms will consider how they will fund potential investments. In looking at this we expect they may consider the financial metrics associated with the investment options, any implications for their capital structure, and ultimately if investments are financeable.

Firms consider the financial metrics employed by rating agencies when managing their finance strategy. In this context, rating agencies have lower bounds for financial metrics including the FFO/Net debt metric. While there can be exceptions without ratings downgrade, rating agencies may expect firms to stay above lower bounds in the medium to long term.

We note that different remaining asset lives are likely to result in different forecast cash flow profiles for a given RAB size. This is because it alters the depreciation allowance as a percentage of the value of the RAB. This may in turn result in materially different forward looking financial metrics across regulated firms for a given gearing level. We observed this fact when we made the 2018 RoRI.¹⁹ Therefore, all else being equal, firms with large investments relative to the RAB in a relatively short period would be expected to have lower free cash flows as a percentage of their RAB value. This is consistent with TransGrid's modelling.

What is FFO/Net debt and how is this metric used by rating agencies?

The FFO/Net debt financial metric is a measure of free cash flow to the debt a firm has. Rating agencies use this as one of a suite of measures, both qualitative and quantitative, to determine a firm's credit rating. There are several things to note here:

- 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).

How is FFO/Net debt calculated using regulatory numbers and what do changes imply?

In a hypothetical sense, based on regulatory benchmarks, FFO/Net debt can be calculated as follows:

$$\text{FFO/Net debt} = [\text{RoE} \times (1 - \text{gearing ratio}) \times \text{RAB} + \text{depreciation (net of RAB indexation)}] / \text{Debt proportion of RAB}$$

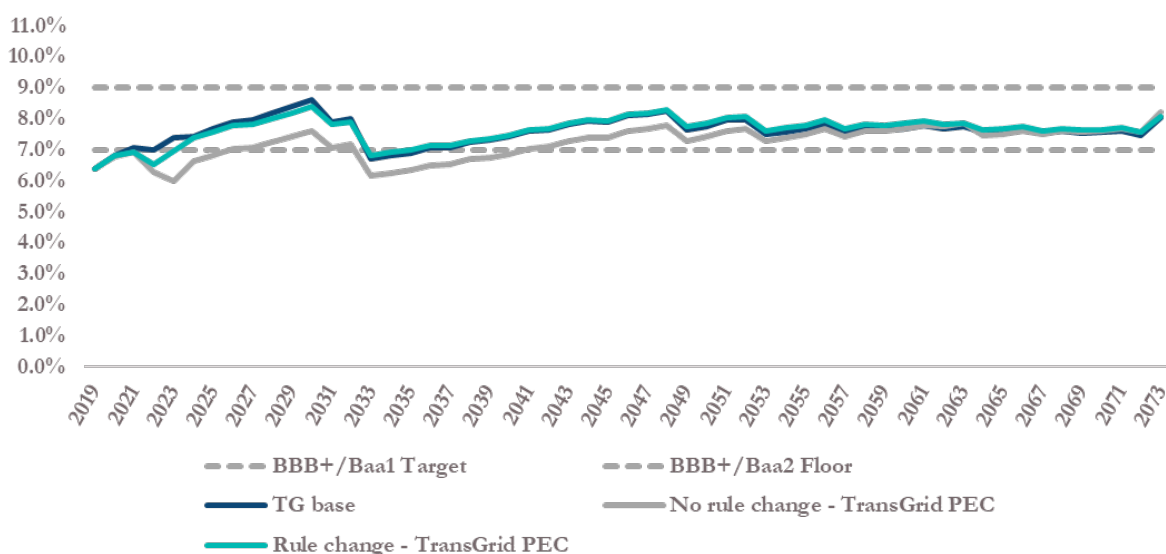
¹⁹ AER, *Rate of Return Instrument, Explanatory Statement*, December 2018, p. 402.

This is a simplified calculation that assumes other costs equal regulatory allowances (e.g. operating expenditure). However, it shows that the metric will be sensitive to the debt proportion of the RAB used in the calculation. As we noted in our 2018 RoRI explanatory statement, if the debt proportion decreases, both the cash flows to equity increase and the debt proportion of the RAB decreases.²⁰

The FFO modelling also incorporates the regulated tax allowance less the tax the service provider is expected to pay. This reduces the calculated FFO because the regulated tax allowance is net of the value of imputation credits. Both our and TransGrid's modelling incorporates this impact on FFO.

In TransGrid's case, the investment in Project EnergyConnect is expected to decrease its FFO/Net debt metric, at 60% gearing as shown in Figure 3.

Figure 3 TransGrid FFO/Net debt – Project EnergyConnect and rule change



Source: AER analysis, TransGrid, A.3A – PEC – Post-tax revenue model – BAFO outcome, September 2020.

Note: TG base indicates TransGrid's FFO/Net debt metric if it does not undertake any ISP investments. The modelling assumes an ongoing 'business as usual' (BAU) capex profile based on our final decision for TransGrid's 2018–23 regulatory determination, repeating every 5 years. TG base for the initial 5 years also includes the approved capex amount for QNI minor.

However, an expected change in forecast financial metrics at a given debt to equity ratio does not of itself indicate a financeability issue, or that there is a regulatory framework problem. We considered hypothetical FFO/Net debt extensively when we made the 2018 RoRI.²¹ In determining to not use a financeability assessment to inform our rate of return we considered:²²

- The rate of return was relatively invariant to gearing; and
- Therefore, our regulated return should be sufficient for all regulated firms to finance their operations.

²⁰ AER, *Rate of Return Instrument, Explanatory Statement*, December 2018, p. 403.

²¹ AER, *Rate of Return Instrument, Explanatory Statement*, December 2018, pp. 392-405.

²² AER, *Rate of Return Instrument, Explanatory Statement*, December 2018, pp. 67, 404.

Can financeability issues be addressed under the current economic regulatory framework?

How might financeability concerns be addressed by service providers?

We consider regulated firms can and will vary their capital structures and choose to target a credit rating based on their specific financial position and objectives.

Table 1 above updates Table 4 from page 65 of the RoRI explanatory statement with 2019 and 2020 gearing data added. It shows there appears to be no single efficient gearing ratio and firms we examined in making the 2018 RoRI have carried debt levels of between 45% and 80% between 2009 and 2020.²³ The firms with predominantly regulated assets, AusNet Services (AST) and Spark Infrastructure (SKI), have carried debt levels between 51% and 52% and 70% respectively over this period.²⁴

We also examined the credit ratings of a number of regulated firms in making the 2018 RoRI. While we set a BBB+ benchmark, the data implies there is no single efficient credit rating and not all firms will operate at a BBB+ rating. Table 25 from the 2018 RoRI explanatory statement shows firms we regulate have carried BBB-, BBB, BBB+, and A- credit ratings between 2009 and 2018.²⁵ Currently, firms we regulate have credit ratings ranging from BBB to A- with a median of BBB+.²⁶

This data indicates there appears to be a range of options regulated firms take to optimise their overall capital structure and to make regulatory investments financeable. It also appears the firms we regulate have been able to manage their capital structure and cash flows to maintain investment grade credit ratings.

We note on 9 October 2020 ElectraNet was downgraded by Moody's Investor Services from Baa1 (roughly equivalent to S&P BBB+) to Baa2 (roughly equivalent to S&P BBB).²⁷ We recommend that the AEMC should obtain a copy of the Moody's notice and review the reasons for the downgrade including the impact of choices made by ElectraNet.

To examine what TransGrid might do to improve its financial metrics, we have forecast TransGrid's regulatory cash flows including all actionable ISP projects, with a combined investment value of approximately \$5.9 billion (\$nominal). Based on this analysis it appears TransGrid will broadly maintain an FFO/Net debt financial metric consistent with its current credit rating if it adopts a gearing of around 55% debt to 45% equity. This is within the gearing range regulated firms have operated at over the past 5 years as shown in Table 1. TransGrid's FFO/Net debt at 55% gearing is shown below in Figure 4.

²³ Calculations are based on the market value of equity and book value of debt, treat hybrid securities as 100% debt, and treat shareholder loan notes as 100% equity.

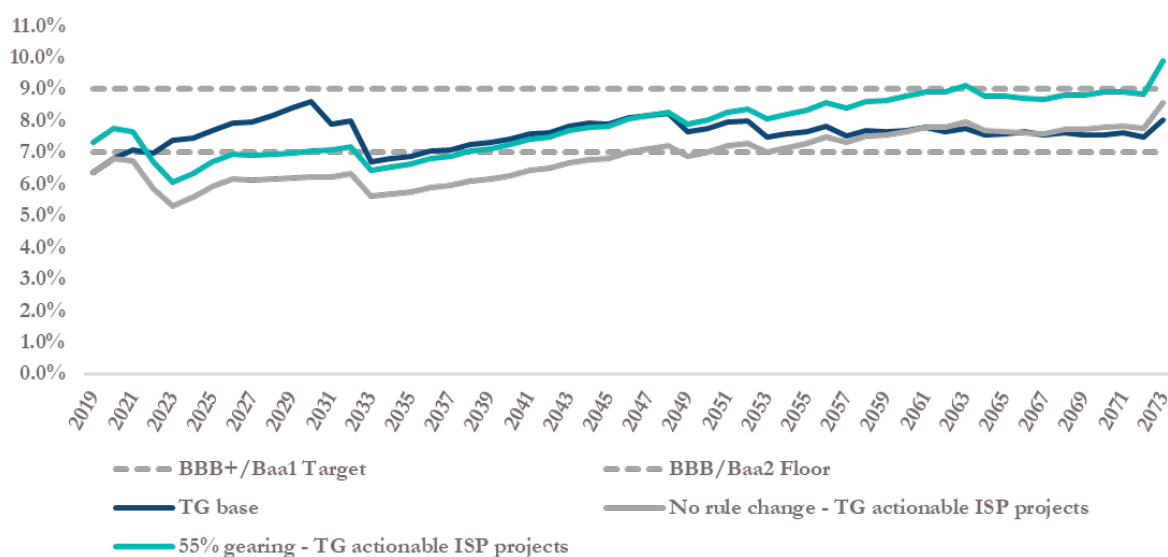
²⁴ Calculations are based on the market value of equity and book value of debt, treating hybrid securities as 100% debt, and treating shareholder loan notes as 100% equity.

²⁵ AER, *Rate of Return Instrument Explanatory Statement*, December 2018, pp. 284-285.

²⁶ AER analysis based on data sourced from Bloomberg on 10 November 2020.

²⁷ Moody's Investors Service, *Rating Action: Moody's downgrades ElectraNet to Baa2; outlook stable*, 9 October 2020.

Figure 4 TransGrid FFO/Net debt – all actionable ISP projects at 55% gearing



Source: AER analysis; AER, *TransGrid – Post-tax revenue model – 2020–21 RoD update – QNI contingent project*, April 2020; TransGrid, *A.3A – PEC – Post-tax revenue model – BAFO outcome*, September 2020; AEMO & TransGrid, *Attachment A – PACR Market Benefit Calculations*, February 2020; TransGrid, *PADR – Net Present Value Model*, January 2020; AEMO, *2020 ISP Transmission Outlook – Central-West Orana REZ*, July 2020; AEMO & TransGrid, *Victoria to New South Wales Interconnector West (VNI West) Regulatory Investment Test for Transmission Project Specification Consultation Report (PSCR)*, December 2019.

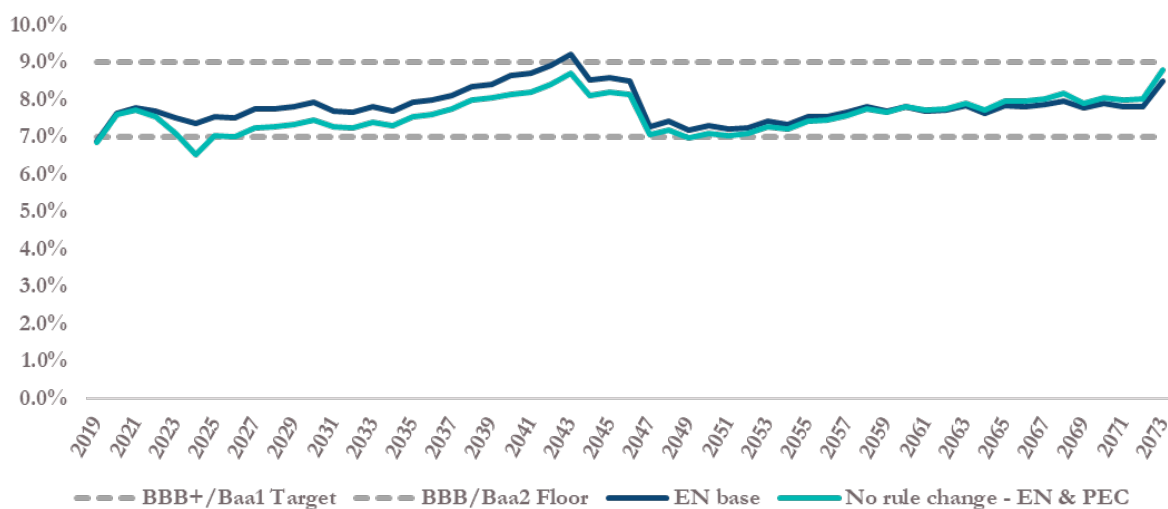
Note: TG base indicates TransGrid's FFO/Net debt metric if it does not undertake any ISP investments. The modelling assumes an ongoing 'business as usual' (BAU) capex profile based on our final decision for TransGrid's 2018–23 regulatory determination, repeating every 5 years. TG base for the initial 5 years also includes the approved capex amount for QNI minor.

The above figure shows that beyond the late-2030s TransGrid could sustain higher gearing than 55%, although we note any change to its return on equity will impact this as may any further ISP investments

We have also forecast ElectraNet's cash flows including its current contingent projects and Project EnergyConnect. Based on this analysis it appears ElectraNet will maintain a FFO/Net debt metric consistent with its current credit rating at 60% debt to 40% equity. This is shown below in Figure 5.

The results imply if there is an issue with financeability it appears to be specific to firm circumstances and choices rather than a broader issue requiring a regulatory response or rule change.

Figure 5 ElectraNet FFO/Net debt – approved contingent projects and Project EnergyConnect



Source: AER analysis; AER, *ElectraNet – Final decision – Post tax revenue model – 2020–21 RoD Update – Eyre Peninsula contingent project*, September 2020; ElectraNet, *Project EnergyConnect PTRM*, September 2020.

Note: EN base indicates ElectraNet's FFO/Net debt metric if it does not undertake its ISP investment. The modelling assumes an ongoing 'business as usual' (BAU) capex profile based on our final decision for ElectraNet's 2018–23 regulatory determination, repeating every 5 years. EN base for the initial 5 years of modelling includes ElectraNet's approved 'Main Grid System Strength' and 'Eyre Peninsula' contingent projects capex.

How might financeability concerns be addressed by the AER?

While we consider service providers should manage financeability issues where possible, the AEMC's consultation paper asked what the AER might do to address any financeability issues under the current rules. Things the AER might do to impact financeability financial metrics include:

- Changing benchmark gearing at the next RoRI review to be completed in 2022
- Changing the regulatory depreciation allowance.

While reducing gearing will make hypothetical financial metrics better, we note our prior analysis indicates it slightly reduces overall cash flows.²⁸

While we have some flexibility in relation to regulatory depreciation, it is important that it is linked to economic principles to prevent distortions. The rules require depreciation schedules to reflect the nature of the assets over their economic lives.²⁹ Accordingly, we consider depreciation profiles should largely reflect the decrease in the real value of regulatory assets through time.

We also determine other regulatory parameters that have a material impact on financial metrics, particularly our estimate of expected inflation and the return on equity. We are presently finalising our review of inflation and we have indicated a proposed position that would result in higher cash flows for the businesses we regulate. The inflation method must

²⁸ AER, *Rate of Return Instrument, Explanatory Statement*, December 2018, pp. 403-404.

²⁹ NER, cl. 6A.6.3(b)(1).

provide the best estimate of inflation and the return on capital should reflect the efficient financing costs of the regulatory investment.³⁰

Does it appear a rule change is required, and what are the risks if a rule change does not proceed?

For the reasons set out above, we do not consider the case has been made for the rule change. We do not consider either service provider has made the case they cannot efficiently finance the ISP investments, or recover their efficient costs when ISP investments are included in the RAB, under the current rules.

The financing challenges service providers face on large investments is not unique and is faced by other firms with revenue streams that increase with inflation. For example, toll roads in Australia typically have charges increased by CPI, although they may also have a minimum level of increase where inflation falls below a certain point.³¹ These challenges are also not unique to Australian firms.

However, we acknowledge there is some risk the ISP projects will not go ahead absent the rule change as the investment decision is for the TNSP and their investors. This would result in the net benefits from these projects not being realised.

A broader framework issue is whether other parties should be permitted to invest in regulated infrastructure if the service providers do not do so.

Are there preferable rule changes to provide flexibility to allow the AER to take financeability into account in its regulatory determinations?

If the AEMC does consider a change is warranted, an alternative is to move to as incurred depreciation but continue RAB indexation. This would be consistent with the depreciation approach we use for distribution assets. This change would remove the cash flow dip that is evident during the construction stage of ISP projects and avoids the broader consequences of the proposed rule change. This is demonstrated in Figure 6. It also retains the current 'real return' framework meaning consumer prices continue to move with inflation.

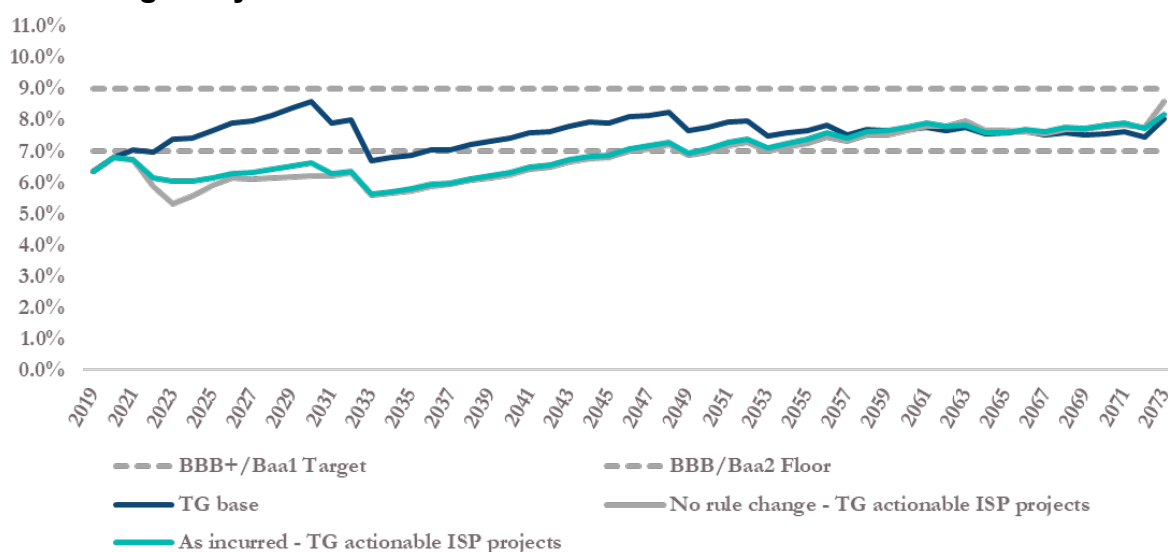
However, in our view this would still require a separate RAB for the ISP investments of each service provider. We consider a rule change to facilitate as incurred depreciation for ISP investments is desirable for clarity.

We note the as incurred depreciation rule change results in consumers paying regulatory depreciation on investments for several years before projects are commissioned. We think it is undesirable for consumers to pay for the cost of an asset before it is placed in service and note this is more of a problem for transmission than for distribution given the greater time taken to commission transmission projects. For this reason we consider this change should only be made if the AEMC is satisfied of the need.

³⁰ NER, cl. 6A.5.3(b)(1) and NEL, s. 7A(5).

³¹ Zheng, Li and Hensher, D. A., *Toll Roads in Australia: An Overview of Characteristics and Accuracy of Demand Forecasts*, Transport Reviews, 30-5, 541-569, pp 546-547, 565.

Figure 6 TransGrid FFO/Net debt – all actionable ISP projects and as incurred rule change only



Source: AER analysis, AER, *TransGrid – Post-tax revenue model – 2020–21 RoD update – QNI contingent project*, April 2020; TransGrid, *A.3A – PEC – Post-tax revenue model – BAFO outcome*, September 2020; AEMO & TransGrid, *Attachment A – PACR Market Benefit Calculations*, February 2020; TransGrid, *PADR – Net Present Value Model*, January 2020; AEMO, *2020 ISP Transmission Outlook – Central-West Orana REZ*, July 2020; AEMO & TransGrid, *Victoria to New South Wales Interconnector West (VNI West) Regulatory Investment Test for Transmission Project Specification Consultation Report (PSCR)*, December 2019.

Note: TG base indicates TransGrid’s FFO/Net debt metric if it does not undertake any ISP investments. The modelling assumes an ongoing ‘business as usual’ (BAU) capex profile based on our final decision for TransGrid’s 2018–23 regulatory determination, repeating every 5 years. TG base for the initial 5 years also includes the approved capex amount for QNI minor.

Transitional issues if a rule change went ahead

As part of their proposed rule change, TransGrid and ElectraNet have requested transitional provisions apply to Project EnergyConnect and VNI minor that are currently undergoing (or expected to undergo) the AER’s contingent project application process.³² The purpose of such a transitional provision would be to allow for any rule change to apply to ISP investments that have been approved as part of the AER’s contingent project process prior to the rule change coming into effect. We consider that, in the event the AEMC decides a rule change is necessary, transitional provisions should be in place to apply the rule change to Project EnergyConnect given the size of the investment.³³ However, the AEMC may wish to examine whether transitional provisions are required for smaller ISP projects, such as VNI minor, where it would not be expected to have a material impact on TransGrid’s FFO/Net debt metric. Transitional provisions would be similarly required in the event of an alternative rule change, different to the one proposed by TransGrid and ElectraNet.

³² TransGrid, *Rule change proposal – Making ISP projects financeable*, September 2020, pp. 19–20; ElectraNet, *Rule change proposal – Making ISP projects financeable*, October 2020, p. 28. Project EnergyConnect has commenced the contingent project process, while VNI minor has not yet commenced this process.

³³ For comparison, our analysis indicates that based on TransGrid’s contingent project proposal, under the proposed rule change, there would be additional revenue of \$67.2 million (\$nominal) that TransGrid would be entitled to recover over the remaining three years of the current 2018–23 regulatory period.

Other issues

An issue identified by the AEMC's consultation paper is with the application of the trailing average cost of debt to large new investments.

The trailing average implicitly assumes firms raise 10% of their debt capital each year on a rolling basis. However, where firms make large new investments this assumption does not hold. In this situation, and where interest rates have changed significantly over the period of the current trailing average, firms may be materially incorrectly compensated on these new investments.

A resolution to this issue is to provide all new investments the spot rate on debt and then transition these new investments to a trailing average. This would be consistent with our approach when we introduced the trailing average in our regulatory determinations post 2013. For all decisions made since 2013 we have started (or continued) the transition of the return on debt from the 'on the day', or spot rate, to a 10 year trailing average over 10 years.

We consider this issue might also be addressed by using a trailing average weighted according to the amount of debt relative to the RAB each year. This approach was originally proposed by Queensland Treasury Corporation.³⁴ We will consider if this is desirable and can be done under the RoRI when we remake the RoRI in 2022.

We also note that if a rule change occurs (proposed or alternative) the establishment of a separate RAB for ISP projects would add complexity and require modifications to the AER's regulatory models (post-tax revenue model and roll forward model). As such, we would need to amend and publish updated regulatory models following the required consultation process. TransGrid and ElectraNet's rule change proposals include a timing of no later than 5 February 2021 for the AER to publish an updated model.³⁵ If the rule change was to proceed, we consider that the timing for publishing updated models should be postponed beyond the proposed date given the timing of the AEMC's final determination of March 2021.

³⁴ Queensland Treasury Corporation, *Energex – Appendix 7.7 QTC Return on debt analysis*, July 2015.

³⁵ TransGrid, *Rule change proposal attachment – Proposed draft Rule*, p. 3; ElectraNet, *Rule change proposal – Making ISP projects financeable*, October 2020, p. 27.