Attachment 9.5

Response to Draft Decision: Financeability

2016/17 to 2020/21 Access Arrangement Information Response to Draft Decision

Australian Gas Networks

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1 Response to Draft Decision on Financeability

1.1 Introduction

This attachment sets out Australian Gas Networks Limited's (AGN's) response to the Australian Energy Regulator's (AER's) Draft Decision in respect of financeability. AGN submitted that a consideration of financeability was required to ensure that the AER Draft Decision provided sufficient cash flow such that the benchmark entity could maintain the credit rating assumed by the AER in setting the cost of debt.

AGN demonstrated that the then most recent AER decision on rate of return would lead to credit metrics that would result in a lower credit rating than assumed by the AER in setting the rate of return. This would in-turn lead to an internally inconsistent decision in that AGN's South Australian business (AGN SA) (assessed on the basis it had a benchmark efficient expenditure profile and the cost of capital of the benchmark entity) is unlikely to be able to raise finance at the levels assumed by the AER in setting the benchmark cost of debt.

Such a result is inconsistent with the National Gas Law (NGL) because it:

- is inconsistent with the requirement in Section 24(2) that a service provider be provided with a reasonable opportunity to recover at least efficient costs;
- is inconsistent with the requirement in Section 24(3) that a service provider be provided with effective incentives to promote economic efficiency; a service provider may not be able to do so if it is handicapped in its ability to raise funds at a reasonable cost;
- is inconsistent with the requirement in Section 24(6) that regard should be had to the economic costs and risks of the potential for under and over investment in a pipeline; if a service provider cannot raise funds at a reasonable cost, this will adversely affect the potential for efficient investment in the pipeline; and
- is inconsistent with the National Gas Objective (NGO) because the above impacts will adversely affect the long-term interests of consumers.

To address these impacts and promote the long-term interests of consumers, AGN proposed an adjustment to the depreciation schedule in the terms contemplated by Rule 89(1)(e) of the National Gas Rules (NGR). That is, an adjustment to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs. This adjustment is to vary the level of indexation applied to the regulatory asset base (RAB) so as to increase cash flow. Such adjustment better achieves the NGO and therefore results in a materially preferable designated NGO decision.

The AER did not accept this approach for a number of reasons. These reasons included that the AER viewed the approach as an attempt to increase the rate of return. The AER also considered that as, in its opinion, its decision on rate of return complied with the rate of return requirements of the National Gas Rules (NGR) and its decision on depreciation complied with the depreciation requirements of the NGR, this was the end of the matter.

Such an approach is, in AGN's submission, an incorrect application of the NGL. Section 28 of the NGL requires the AER to take into account the manner in which constituent components of a decision relate to each other and outline the manner in which that interrelationship has been taken into account.

Clearly the rate of return materially impacts upon the cash flow available to the benchmark entity. But nowhere does the AER analyse this impact and consider whether, given the impact of the rate of return, its decision provides adequate cash flow to the benchmark entity to achieve the benchmark credit rating assumed by the AER in setting the cost of debt.

In contrast, AGN addresses these issues and seeks, consistent with the NGL, to ensure there are sufficient levels of cash flow to sustain credit metrics, which will enable debt to be raised at an efficient cost and facilitate efficient investment in the network.

1.2 AER Draft Decision

The AER outlined a number of criticisms of AGN's approach in its Draft Decision, including that:

- there is no requirement in the NGR to provide cash flows which will permit a specific credit rating to be achieved;
- the AER had correctly determined the rate of return and depreciation schedule and so there was no basis to adjust them; no further changes would reduce the long term costs of finance;
- AGN did not adequately specify the relevant credit metric thresholds that would trigger an adjustment to the credit rating;
- AGN did not specify a depreciation schedule reflecting the proposed financeability adjustment;
- AGN overstated the importance of credit metrics as an indicator of creditworthiness and over simplified the approach of credit rating agencies;
- AGN did not satisfactorily explain why an adjustment to regulatory depreciation addresses its concerns and why this is an appropriate response to what is a rate of return issue;
- an increase in cash flow in the short term may create long term financing problems, and as such, is contrary to the long-term interests of consumers;
- AGN had not considered the long-term implications of its proposed adjustment;
- in effect AGN's approach reflects an attempt to vary the return on equity;
- AGN's consultant Incenta Economic Consulting (Incenta) had incorrectly assumed that the current rate of return remains constant;
- no evidence had been presented demonstrating that AGN would be unable to raise capital; and
- the credit ratings of service provides vary, suggesting they are not sensitive to the approach used to set the rate of return.

1.3 AGN Response to the Draft Decision

In response to the Draft Decision, AGN has commissioned a second report from Incenta that responds to the above matters raised by the AER in its Draft Decision. AGN has also commissioned a report from NAB Advisory Services which outlines the approach credit rating agencies take to setting credit ratings. These reports are attached to this response and their content is summarised in the remainder of this section.

1.3.1 NAB Report

Set out in Attachment 9.6 is the NAB Client Solutions & Advisory report "*Australian Gas Networks – Credit profile implications of alternative rates of return*" (referred to as the NAB Report).

The NAB Report considers a benchmark AGN SA, being an AGN SA with the rate of return set out in the Draft Decision and an expenditure profile reflecting levels of expenditure allowed under the NGL and NGR (that is benchmark levels of expenditure the AER assesses as being efficient). AGN submits this benchmark AGN SA is also reflective of the notional benchmark entity, there being no attributes of this AGN SA which distinguish it from a benchmark entity with benchmark rates of return and benchmark levels of expenditure.

The key observations and conclusions of the NAB Report are:

- The Funds from Operations (FFO) to debt ratio is a key input into credit rating agencies' assessment of AGN SA's financial profile. Different allowed rates of return will impact AGN SA's financial metrics as submitted to the AER. This would flow through into a credit rating assessment for AGN SA as a notional stand-alone entity (subject to assumptions outlined in Attachment 9.6).
- A rate of return of 6.02% results in FFO which would result in the following:

> *"S&P's BBB+ credit rating would initially be placed on Negative outlook, then progressively lowered to BBB-/Stable to reflect the absence of mitigating factors during the forecast period. The Moody's credit rating is also pressured, with the FFO-to-debt ratio significantly below the Baa1 downgrade threshold and more closely aligned with lower rated peers. Similar to S&P, Moody's would initially change the outlook to Negative prior to progressively moving the rating from Baa1 to Baa3/Stable."*[1]

- S&P has stated that maintaining a FFO-to-debt ratio below 7% could result in a rating downgrade by two notches to BBB- for AGN.
- Moody's has also commented that the FFO-to-debt ratio falling below 9% would place downward pressure on AGN's credit rating.

1.3.2 Incenta Report

To respond to the observations made by the AER in the Draft Decision, AGN commissioned a further report from Incenta, "*Assessing financeability for a benchmark regulated business: comment on the Draft Decision*" (referred to as the Second Incenta Report). This report is set out in Attachment 9.7. The key conclusions from the Second Incenta Report are:

- The credit metrics generated for a benchmark efficient entity resulting from the Draft Decision are substantially below the threshold required to maintain a BBB+/Baa1 credit rating. FFO to debt is below 7%, which is materially below the thresholds required by credit rating agencies.
- To address this, regulatory depreciation should be advanced by applying a fixed offset to the annual inflation indexation factor applied to the RAB (and not by changing the methodology for determining straight-line depreciation of the RAB, which is as approved by the AER).
- A minimum offset to the annual inflation factor applied to the RAB of 2% is required to maintain a BBB+/Baa1 credit rating for a benchmark entity under the AER Draft Decision rate of return of 6.02%. That is, the RAB would be indexed by CPI-2% (the report provides a numerical example demonstrating the application of this adjustment in determining benchmark revenue/prices).
- If credit metrics improve in subsequent periods, the 2% adjustment factor could be reduced/removed.
- These adjustments are necessary to ensure internal consistency within the AER's decision making and to enable AGN SA (assessed as a benchmark efficient entity) to recover its efficient costs of operations. If these adjustments are not made then the AER places service providers in a position where the rate of return is set on the assumption it will have a debt cost equivalent to that of a BBB+ entity but the service provider is hindered or prevented by the operation of the AER's decision from achieving such a rating and therefore accessing debt at such a price.

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[1] NAB Client Solutions & Advisory 2015, "*Australian Gas Networks Credit Profile Implications of Alternative Rates of Return*", December 2015, pg. 5. Provided as Attachment 9.6 to this Revised AA Proposal.

- In addition, and irrespective of the preceding point, adjusting cash flows at a time when the rate of return is low so as to preserve credit metrics increases the likelihood the benchmark entity can access debt at the benchmark efficient cost. This in turn promotes investment in the network consistent with the requirements of the NGL and the long term interests of consumers.

- In addition the approach of applying a fixed offset while the rate of return is low and then reducing that offset as the rate of return increases produces a flatter price projection than otherwise, thereby minimising price shock and distortions in decision making by end-users attributable to changes in reference tariffs.

In response to criticisms made by the AER of Incenta's first report, Incenta observed:

- It is not correct to characterise Incenta's analysis as a critique of whether the rate of return is set at the correct level. The analysis proceeds on the assumption the rate of return is set in stone and then considers the interrelationship between the rate of return and the remaining aspects of the AER's decision and how other aspects of the decision need to be addressed to ensure that the requirements of the NGL (including the NGO) are met.

- While Incenta had conducted its analysis on the basis there would be no change in the Weighted Average Cost of Capital (WACC) over time, addressing this criticism does not change the analysis. The implication of a higher WACC in later periods is simply that the revaluation offset should be lowered or removed.

- The criticism Incenta had not demonstrated AGN could not raise capital was not valid as Incenta's analysis is based on the position of a benchmark entity. Regardless, the relevant point is whether AGN SA (assuming it has the rate of return and expenditure profile of a benchmark efficient entity) has a reasonable opportunity to raise debt at the rates assumed by the AER in its Draft Decision.

1.3.3 Specific AER Comments

This section considers AGN's responses to the specific issues raised by the AER in the Draft Decision.

1.3.3.1 No Requirement in the Rules to Achieve a Specific Credit Rating

The AER comments:

> *"Further, we do not accept the key premise of AGN's proposal on maintaining credit metrics. AGN submits that the AER's decision should target cash-flows to achieve credit metric benchmarks that Incenta assumes to be necessary in order to achieve a BBB+/Baa1 credit rating. In contrast, the benchmark credit rating is a broad indicator to reflect the level of risk (principally, default risk) that we consider the benchmark service provider faces. Our approach to implementing the return on debt is designed to reflect the costs associated with raising debt at that credit rating. We do not agree that the provision for 'reasonable cash flow needs' in the NGR depreciation criteria implies that overall revenue must result in cash flows that will permit a specific credit rating for each individual service provider. Further, we are not persuaded that the achievement of any particular credit rating is required explicitly or implicitly under the rules."*[2]

AGN does not argue that the AER's decision must allow a specific credit rating for an individual service provider, but instead argues that the NGL requires an internally consistent decision. It is an uncontroversial proposition that the NGL requires a regulatory decision to be internally consistent, particularly given the emphasis in Section 28(1)(b) on the relationship between constituent components of a decision.

[2] AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-221.

AGN's point is that it is internally inconsistent to set the cost of debt for a service provider on the assumption the service provider has a particular credit rating and then otherwise set parameters in the regulatory decision that in effect make it unlikely the service provider will achieve that credit rating. The service provider is given an allowance to cover its cost of debt based on an efficient benchmark entity's cost of debt but is given credit metrics making it unlikely the service provider can raise debt at a cost that is covered by the allowance. This is not in the long interests of consumers as the service provider is hindered in its ability to efficiently raise debt and thereby undertake efficient investment.

1.3.3.2 Rate of Return and Depreciation Allowances have been Correctly Determined

The AER comments:

> *"In addition, we have assessed both our rate of return and depreciation allowances for consistency with their respective rules and objectives. Overall, for the reasons set out in attachment 3 and attachment 5, we are satisfied that our allowances for the return on capital and for regulatory depreciation will contribute to a revenue allowance that encourages efficient investment in and use of pipeline services. We do not agree with Incenta's assertion that increasing the cost of capital or depreciation allowance will reduce the long-term costs of finance. Rather, we consider that transparency and predictability in setting revenue allowance will achieve this goal."*[3]

In the first line of this statement the AER appears to be saying it has assessed the rate of return and depreciation allowances in accordance with their separate tests and that this is all the AER is required to do. This is not consistent with the NGL. The NGL requires the AER to consider the interrelationship between components of a regulatory decision and not to assess them only as separate components. Indeed only when the decision is considered as a whole can a determination be made whether the NGO and the requirements in Section 24 of the NGL have been met and whether the determination is a materially preferable one.

The statement that the long term cost of finance is better managed through "*transparency and predictability*" than by setting parameters at a level such that a service provider has a reasonable opportunity to recover efficient costs does not reflect a proper application of the NGL. Transparency and predictability is of no benefit in itself if parameters are transparently and predictability set at the wrong level.

1.3.3.3 Determination of Credit Rating

The AER comments:

> *"Incenta's mechanistic application of two credit metrics to test whether AGN would maintain BBB+ rating misrepresents and oversimplifies the approach of credit rating agencies. These agencies take into account a much wider set of quantitative and qualitative factors to determine credit ratings. Further, we do not agree that the way Incenta has proposed to use these metrics on notional cash flows for a regulated service provider is comparable with the way that credit agencies use these metrics as a test on unregulated companies."*[4]

The NAB Report demonstrates that the FFO to Debt ratio is a key metric applied by credit rating agencies. The Report comments:

> *"S&P and Moody's assess an issuer's financial profile and business profile as part of the credit rating process. A key aspect of the financial profile assessment is the evaluation of an issuer's financial ratios against rating agencies' tolerance levels (or 'thresholds') for the current rating.*

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3 AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-221.

4 Ibid, pg. 3-222.

> *A breach of a threshold could pressure the current rating and, if sufficiently material and sustained, precede a rating movement."*[5]

In considering these financial ratios, the NAB comments:

> *"S&P and Moody's emphasise the FFO-to-debt ratio when evaluating AGN's credit profile."*[6]

Rather than mispresenting and oversimplifying the approach of credit rating agencies, the Incenta reports identify a key concern those agencies hold. While qualitative factors (for example country and industry risk) are taken into account in setting credit ratings, these qualitative factors are essentially static in the case of an Australian regulated business. Moreover, both the NAB and Incenta have assumed the highest business risk profile of "excellent" in their analysis for the S&P rating, which if anything, AGN believes to be a conservative assumption. Therefore, in terms of factors likely to drive a reduction in credit rating, the financial impact of a regulatory decision is key.

In respect of the last sentence in the above extract the relevance of the reference to unregulated companies is not clear to AGN as the issue in question is how credit rating agencies assess regulated entities. Further it is AGN's submission that the NAB Report confirms that the Incenta metrics are reflective of analysis undertaken by credit rating agencies.

1.3.3.4 Indirect Test of Rate of Return

The AER asserts:

> *"In practice, Incenta's approach to estimating credit metrics is an indirect test of the return on equity. This is because, under Incenta's approach, opex and tax cancel out as offsetting revenues and costs, and the depreciation and rate of return allowances increase in proportion to the size of the capital base. When the estimated return on equity is low, this approach necessarily results in worse credit metrics (and vice versa). We are satisfied that a low return on equity appropriately reflects the required return on equity in the low interest rate environment. We therefore are not persuaded that commensurately low credit metrics indicate a financeability problem."*[7]

AGN does not agree with the above statement. The Incenta Report proceeds on the assumption that the rate of return is a given and assesses the impact of this on the credit metrics of the benchmark entity. It is not a critique of the rate of return but a consideration of the impact of that rate of return on other inter-related parts of the AER's decision. AGN does however agree with the AER premise that lower returns "*necessarily results in worse credit metrics (and vice versa)*".

The fact the return on equity is commensurate with a low interest rate environment does not mean the service provider may not have a financeability problem. Notional return on equity is not the same thing as cash flow.

If the rate of return is set at a low level (consistent with a low interest rate environment) this can give rise to lower credit metrics for the service provider. These credit metrics are made worse still if the service provider is assessed on a benchmark efficient cost of debt but cannot, taking into account the other components of the building blocks, borrow at that cost of debt.

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5 NAB Client Solutions & Advisory 2015, "*Australian Gas Networks Credit Profile Implications of Alternative Rates of Return*", December 2015, pg. 5. Provided as Attachment 9.6 to this Revised AA Proposal.

6 Ibid.

7 AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-222.

1.3.3.5 Analysis of Consequences of AGN Adjustments

The AER comments:

> *"AGN has proposed that, if the AER does not accept its proposed rate of return, it should alter the approach to indexation of the RAB, which has the effect of accelerating regulatory depreciation and improving credit metrics. However, neither AGN nor Incenta has not [sic] engaged with the potential consequences of this approach, or demonstrated why accelerated depreciation would achieve the depreciation criteria in the rules, or be in the long term interests of consumers."*[8]

And:

> *"AGN focuses on rule 89(1)(e) of the NGR, which states that the depreciation schedule should be designed 'so as to so as to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs'. However, AGN appears to interpret 'reasonable needs for cash flow' only with regard to the 2016–21 access arrangement period. Using depreciation to accelerate cash flows in the short-term will necessarily result in relatively lower cash flows available for regulatory depreciation in the future. The long term interests of consumers will not be served by adopting accelerated depreciation if this bolsters short-term financing cash flows, but exacerbates financing problems in the medium or longer term. Nor does it address the remaining criteria in rule 89."*[9]

These matters are addressed in the Second Incenta Report. That report sets out the long run price trajectory of the benchmark efficient entity and demonstrates:

- there is no adverse long term impact on consumers from the application of AGN's proposed financeability adjustment;
- the implementation of the adjustment mitigates price shocks and thereby promotes allocative efficiency; and
- adjusting cash flows when the rate of return is low so as to preserve credit metrics increases the likelihood funds are accessible at an efficient cost and pipeline investment continues at an efficient rate.

AGN notes that the focus is on the cash flow of the business. The second of the AER's paragraphs quoted above fails to take into account that the effect of the adjustment is to increase cash flows at the period in a service provider's life when those increased cash flows are required; that is during a period of low returns. As returns trend back towards a long run mean then an adjustment to cash flow of the kind AGN proposes is less likely to be required. The adjustment does not exacerbate medium to longer term financing problems but instead addresses them by ensuring cash flow is available at the time it is needed most.

At a different rate of return to that proposed in the Draft Decision, the service provider is likely to have sufficient cash flow.

For example, at an 8.49% rate of return, the NAB find:

> *"A rate of return of 8.49%, as per AGN SA's Revised AA submission, produces forecast financial ratios that are below current levels. S&P is expected to place the current BBB+ credit rating on Negative outlook given the proximity of forecast ratios to the indicative FFO-to-debt threshold of 8%. Moody's is expected to move the credit rating from Baa1 to Baa2, reflecting*

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8 AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-222.

9 AER 2015, "*Attachment 5 – Regulatory Depreciation | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 5-15 and-5-16.

> *ratios sustainably below the 9% FFO-to-debt threshold and 2.4 times FFO-to-interest threshold."*[10]

The requirement of the National Gas Law is to ensure there are sufficient cash flows available to an efficient service provider to operate at the credit rating assumed by the AER in setting the rate of return. This makes the adjustment proposed by AGN necessary.

1.3.3.6 Incenta Approach not Sufficiently Robust

The AER then expresses the following concern as to Incenta's analysis:

> *"Even if we were to adopt a policy of targeting credit metrics through revenue allowances, we are not persuaded by AGN or Incenta's analysis. Incenta has drawn on two brief excerpts from two confidential credit opinions to establish its threshold level for the primary credit metric it has focused on. We are not satisfied that this is a robust approach, or that Incenta has appropriately represented the way in which credit ratings agencies would view this credit metric in context. In particular, we are not persuaded that the approximate Moody's benchmark for Baa2 (BBB) or the approximate Standard & Poor's benchmark for BBB- (Baa3) as cited by Incenta are intended to be bright-line thresholds that would necessarily or automatically trigger a rating downgrade. Further, these metrics are specified in the context of credit assessments for AGN, as opposed to the benchmark efficient entity. It does not follow that these thresholds can be generalised to the benchmark efficient entity, as they may reflect characteristics or circumstances specific to AGN."*[11]

These matters are addressed both in the Second Incenta Report and the NAB Report. The NAB Report demonstrates that the FFO-to-debt ratio is a metric which is key to a credit rating agency's rating. The Second Incenta Report undertakes its analysis against the benchmark rate of return and benchmark expenditure levels set for AGN SA (that is the approved levels of expenditure set at rates the AER regards as efficient from an industry wide assessment) and assesses the credit metrics in this benchmark scenario. As the Second Incenta Report outlines, its analysis is that of a benchmark entity:

> *"I did not argue that AGN would have difficulties in reality with raising capital in the future. The focus of my analysis was on the situation of the benchmark firm. Similarly, it is irrelevant that firms in practice make decisions that result in credit ratings that differ to the benchmark. This is the intention of applying benchmarks when setting regulated prices – firms can decide to do different things (for example, to take on more gearing) and possibly be rewarded, but equally consumers are not exposed if decisions are made that turn out adverse. However, none of this provides any basis for not deriving reference tariffs such that a firm that made decisions consistent with those of a benchmark efficient firm was able to recover its (efficient) costs."*[12]

AGN again notes that both experts have assumed that the business risk profile is rated as "excellent" by S&P. This is the highest rating available to an entity, although entities may be assessed as being at the 'weaker' or 'stronger' end of an "excellent" assessment. In AGN's view, holding the business risk profile as "excellent" is, if anything, a conservative assumption if the AER decision were to stand.

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[10] NAB Client Solutions & Advisory 2015, "*Australian Gas Networks Credit Profile Implications of Alternative Rates of Return*", December 2015, pg. 17. Provided as Attachment 9.6 to this Revised AA Proposal.

[11] AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-222- 3-223.

[12] Incenta Economic Consulting 2015, "*Assessing Financeability for a Benchmark Regulated Business: Comment on the Draft*", December 2015, pg. 14. Provided as Attachment 9.7 to this Revised AA Proposal.

1.3.3.7 Incenta did not Consider the Fact the Rate of Return May Change Over Time

The AER correctly identified that Incenta's original analysis assumed a constant rate of return:

> *"Incenta has assumed for the purposes of its longer term analysis that the current rate of return remains constant into the long-term future. This is a strong assumption that Incenta has not justified or tested. While Incenta has undertaken sensitivity tests on the level of assumed capital expenditure, it has not tested the sensitivity of its analysis to different assumed paths of the rate of return. This is a significant weakness in its analysis, because:*
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> - *rates of return are variable over time*
> - *the rate of return multiplied by the capital base accounts for at least 50 per cent of revenue for most service providers. Therefore, assumptions about the rate of return have a significant impact on the revenue allowance and credit metrics."*[13]

The Second Incenta Report acknowledges this assumption is not reflective of likely outcomes and considers the scenarios of rates of return varying over time. As the Second Incenta Report demonstrates the consequence of rates of return rising over time is simply that the adjustment factor would be reduced/removed to reflect the improved credit metrics:

> *"Importantly, however, the fact that the WACC may return to a more normal value in the future does not affect the principal conclusion of my analysis. That is, my analysis showed (and still shows) that a benchmark efficient entity could not maintain a BBB+/Baa1 credit rating over the next regulatory period unless there is a change to how reference tariffs are determined (such as by advancing the return of capital).*
>
> *Rather, if the WACC does increase in the future, it may not be necessary to advance the return of capital to the same extent (or at all) for a benchmark efficient entity to be able to maintain a BBB+/Baa1 credit rating. This means that it would be appropriate for the AER to review the method of regulatory depreciation at future access arrangement reviews in light of the WACC that is prevailing at the time. Indeed, my proposed method of advancing the return of capital – which is by applying an "offset" to the annual indexation of the RAB – is particularly suited to being fine-tuned at future regulatory periods if the extent of financeability issues abate (i.e., if a 2 per cent offset is applied in the next period, this could simply be reduced to a 1 per cent offset in a future period or indeed no offset at all). However, to underscore the previous point, the possibility that the WACC may increase in a future regulatory period does not resolve the financeability issue in the next period."*[14]

The adjustments proposed by AGN are not an indirect adjustment to the rate of return. They do not alter the rate of return. Each adjustment, specifically to the level of indexation applied to the RAB, is made to ensure that a decision is made which reflects the NGO, the revenue and pricing principles and the remaining requirements of the NGR and NGL. These adjustments result in a decision which is materially preferable to one which does not make such adjustments, because a decision which does not make such adjustments will frustrate achievement of the NGO.

1.3.3.8 AGN Can Still Raise Capital

The AER criticised the Incenta analysis on the basis Incenta had not demonstrated that AGN would be unable to raise capital.

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13 AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-223.

14 Incenta Economic Consulting 2015, "*Assessing Financeability for a Benchmark Regulated Business: Comment on the Draft*", December 2015, pg. 15-16. Provided as Attachment 9.7 to this Revised AA Proposal.

> *"Neither AGN nor Incenta has presented evidence to support the claim that AGN would be unable to raise capital, even if the regulatory determination resulted in a credit rating downgrade within the investment grade band. While BBB+ is the benchmark credit rating for the purposes of estimating the return on debt, service providers maintain a variety of different credit ratings. For example, in the Kanangara report submitted by the ENA in June 2013, prevailing credit ratings across the sector ranged from BBB- to A- (S&P) or Baa3 to A3 (Moody's)"*[15]

This is not however the submission AGN is making. Our submission is that AGN is not likely to be able to raise finance at a rate consistent with the benchmark cost of debt. This is because the cost of debt is set assuming AGN can raise finance at a different cost to the cost reflective of the credit metrics the AER in effect sets for AGN.

Clearly AGN will still be able to raise debt but it is not likely to be raised at the rates assumed by the AER in setting the rate of return on debt, which is contrary to promoting efficient investment in the network and promoting the long term interests of consumers.

The AER goes on to observe:

> *"According to Kanangara's analysis, Envestra (AGN's parent company) maintained a stable BBB- credit rating from 2008 to 2012. However, over that same period Envestra (SA)'s capital base increased by 33 per cent, or approximately 6.5 per cent per year. This rate of growth in the capital base suggests that Envestra SA/AGN was able to raise significant capital while maintaining its credit rating, even with a credit rating at the bottom band of investment grade."*[16]

Again AGN's argument is not that AGN cannot raise debt but that it is unlikely to be able to do so at a rate which is covered by the cost of debt set by the AER. As a result, the AER's decision will distort investment decisions away from what is in the long run interests of consumers.

1.3.3.9 Service Providers Actual Credit Ratings Vary

The AER correctly observes that the actual credit ratings of service providers vary:

> *"Further, under the previous rate of return regime, all service providers had their rates of return set under a common approach. Nonetheless, in practice, these service providers maintained different credit ratings (BBB- to A-) despite this common approach. This suggests that the actual credit rating that a firm achieves is not highly sensitive to the approach used to set the rate of return, despite this being a critical driver of revenue and hence credit metrics."*[17]

This analysis is speculative and the NAB Report notes that credit metrics are a key factor assessed by credit rating agencies in considering whether a credit rating may be downgraded. AGN notes that the AER's focus is on the benchmark efficient entity and not the circumstances of individual service providers.

1.3.3.10 Greater Precision Required in Setting Adjustment

The AER was concerned that AGN did not identify the credit metric thresholds that would trigger an adjustment. It commented:

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[15] AER 2015, "*Attachment 3 –Rate of Return | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 3-223.

[16] Ibid.

[17] Ibid, pg. 3-224.

> "On the first point, AGN's proposal did not adequately specify the relevant credit metric thresholds that should trigger an adjustment to the indexation component of the depreciation allowance. AGN stated that the key credit metric is a FFO to debt ratio of 9 per cent or more. It also stated that its proposal (with a higher rate of return) passes the credit metric assessment and so no indexation adjustment is required. However, in AGN's proposal, the FFO to debt ratio was below 9 per cent in every year of the access arrangement period. Accordingly, it is unclear precisely what the threshold is that AGN suggested should trigger an adjustment to indexation."[18]

This issue is addressed in the Second Incenta Report, which sets out the minimum adjustment required to avoid falling below this metric. At the rate of return parameters set out in the Draft Decision, this is 2% and is the level of adjustment AGN proposes. The NAB Report identifies 9% as a key metric threshold, which is the FFO-to-debt downgrade threshold for AGN's Baa1 Moody's rating. At the Draft Decision rate of return parameters 2% enables the service provider to raise finance and operate efficiently by avoiding both a Moody's and a S&P downgrade/revision

The AER goes on to state:

> "Further, AGN did not specify any explicit alternative depreciation schedule, other than suggesting that the AER should vary the indexation component of the depreciation allowance to offset the possible reduction to cash flows due to a lower rate of return. Hence, it is unclear precisely how AGN proposed the indexation method should be adjusted in the event that its (unclear) threshold is met. AGN has not set out the relevant details for any alternative depreciation schedule that might apply if there were to be some adjustment to indexation."[19]

AGN acknowledges the correctness of the AER's observation but it reflects the fact that the credit metric adjustment was an alternative scenario, activated only if the AER selected a rate of return such as to adversely affect credit metrics. The Second Incenta Report explains precisely how this adjustment should be made in the event it is required.

1.4 Rule 89

For the reasons set out above AGN submits that the adjustment it proposes is consistent with the requirements of Rule 89.

In *Re Application by DBNGP (WA) Transmission Pty Ltd (No 3)*[20] the Australian Competition Tribunal stated:

> *"The Tribunal observes that rule 89 is prescriptive in a broad manner that reflects conventional thinking about the purpose of depreciation, as well as allowing for a practical determination of depreciation amounts that allow for the service provider's reasonable needs for cash flow."* [21]

The purpose of Rule 89(1)(e) was further discussed by the Tribunal in *Re Application by APA GasNet Australia (Operations) Pty Ltd (No 2)*[22]*:*

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18 AER 2015, "*Attachment 5 – Regulatory Depreciation | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 5-14-5-15.

19 Ibid, pg. 5-15.

20 [2012] ACompT 14.

21 At 453.

22 [2013] ACompT 8.

> *"Nor has it been shown that the AER erred by failing properly to take into account the material adduced by APA GasNet to support its claim that the AER depreciation methodology would not satisfy criterion (e) of rule 89. APA GasNet relied upon a report by Australian Ratings that expressed opinions on the likely credit rating that would be attributed to APA GasNet based on Standard & Poor's criteria and methodology. In its Final Decision, the AER gave consideration to the Australian Ratings' report. The AER said that its analysis is sensitive to contentious assumptions which in several instances the AER did not accept. The sensitivity of the conclusions to these assumptions was untested, so the AER gave little weight to it to assess revenue decisions. Otherwise, there was little or no material to suggest that criterion (e) would not be met by the AER's depreciation methodology. It is clear that a service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing reference services and complying with regulatory obligations. APA GasNet produced no cogent evidence in support of its contention that the tariff profile that would result from the AER's depreciation methodology would fail to satisfy its reasonable cash flow needs."*[23]

The above passage from the Tribunal recognises that the depreciation methodology can be adjusted using rule 89(1)(e) to ensure reasonable cash flow needs. In *GasNet* the applicant for review had failed to produce cogent evidence to support such an adjustment. In contrast through the Incenta and NAB Reports AGN has provided such evidence.

1.5 Summary

AGN submits that its approach is one that achieves the NGO, reflects the revenue and pricing principles and properly takes into account the relationship between the interrelated component parts of the AER's decision. At every level the NGL supports the approach and no aspect of it operates inconsistently with the requirements of the law.

The NGO (as set out in section 23 of the NGL) is:

> *"to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."*

The AGN approach achieves this objective as it ensures efficient investment is not frustrated by a service provider being unable to access debt at the cost the AER has set for it. This is in the long term interests of consumers with respect to price, safety, reliability and security. The AER's objection seems in part to be based on a concern about the short term interests of consumers – that is in the near term prices will be higher. AGN believes this does not reflect a proper application of the NGO, which requires a consideration of the long term interests of consumers.

AGN also notes, as set out in the Second Incenta Report, that the adjustment AGN proposes is net present value neutral for both consumers and AGN (that is no additional revenue is recovered by AGN over the life of the assets than would otherwise be the case). Given this, there is no detriment to consumers where their interests are assessed over the long term.

Sections 24(2), (3), (5), (6) and (7) of the NGL provide:

> *(2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—*
>
> *(a) providing reference services; and*
>
> *(b) complying with a regulatory obligation or requirement or making a regulatory payment.*

[23] At 223.

(3) A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes—

(a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and

(b) the efficient provision of pipeline services; and

(c) the efficient use of the pipeline.

(5) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.

(6) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides pipeline services.

(7) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services."

The AGN proposal is consistent with Section 24(2) as it facilitates the service provider been provided with a reasonable opportunity to raise debt at a rate consistent with that set by the AER. In contrast, the AER's approach is not consistent with Section 24(2) as it hinders or prevents a service provider's ability to finance operations at the benchmark rates set by the AER.

The AGN proposal is consistent with Section 24(3) as it increases the likelihood of efficient investment, again by facilitating the ability to raise funds at a cost consistent with benchmark rates. The AER's approach threatens efficient investment because it would be likely to increase the cost of debt above the levels allowed by the AER.

The AGN approach will facilitate the setting of a reference tariff which covers the cost of debt set by the AER. The AER approach would not be sufficient to allow a return commensurate with the cost of debt. The AER approach therefore does not allow for the realisation of returns which are commensurate with the regulatory and commercial risks involved in providing reference services.

The AGN approach is consistent with Section 24(6) as it increases the likelihood there will be neither over nor under investment by placing the service provider in a situation where its cost of debt is more likely to be consistent with that properly determined by reference to a benchmark efficient entity. The AER approach increases the risk of under investment by increasing the cost of debt above the regulatory cost set by the AER.

The AGN approach minimises price shock and therefore minimises the potential distortion of pipeline usage. The AER approach results in greater price shock (or variability) and so maximises the potential for distortion of pipeline usage.

Section 28(1)(b) of the NGL provides that the AER must specify:

"(A) the manner in which the constituent components of the decision relate to each other; and

(B) the manner in which that interrelationship has been taken into account in the making of the decision;"

The AGN approach takes into account the interaction between the rate of return and depreciation and the need to ensure that overall a decision contributes to the National Gas Objective and meets the revenue and pricing principles. The AER approach focuses on component parts of a decision and does not analyse the links between them.

The AGN approach is consistent with the requirement in rule 89(1)(e) that the depreciation schedule should:

> *"allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs."*

It does not contradict any of the other requirements of Rule 89. The Second Incenta Report demonstrates 89(1)(a) is better met by the AGN approach.

The AGN approach is transparent. The required credit metric is clearly defined (FFO-to-debt of 9% in the case of Moody's) and both the adjustment mechanism (CPI-Z%) and the adjustment required to achieve the benchmark credit rating assumption (2%) are readily ascertainable, as set out in the Second Incenta Report.

As demonstrated above the AER's criticisms of the approach are not consistent with the NGL and the assertion the approach is not clear and transparent is not consistent with our submission.

Given these factors, if the AER persists with a rate of return consistent with that set out in its Draft Decision (i.e. in the range of 6.02%), then the AGN approach to adjustment of regulatory depreciation, as set out in the Second Incenta Report, should be adopted. As compared to an approach which does not make this adjustment, the AGN approach is the materially preferable designated NGO decision as it is the approach which best gives effect to the NGO.

Finally, and importantly, under Rule 89(3) the AER has a "*limited*" discretion[24] in relation to a depreciation schedule AGN proposes under NGR 89. The AER may not withhold its approval of the proposal if it is satisfied that the proposed schedule:

- complies with applicable requirements of the NGL (including the NGRs); and
- is consistent with applicable criteria (if any) prescribed by the NGL (including the NGRs).25

The AER is therefore constrained to accept the depreciation schedule as proposed by AGN if the AER is satisfied that it meets Rule 89. In other words, provided the schedule falls within what is permitted by Rule 89 and does not infringe Rule 89, the AER cannot reject it. The AER is not at large simply to choose a depreciation methodology that in its view is preferable (because it ignores the proposed adjustment under Rule 89(1)(e)).

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24 Per NGR 40(2) (which applies to depreciation, see NGR 89(3)).

25 The converse therefore applies - unless the AER concludes that such an element of an access arrangement proposal does not comply with the NGL/NGR or is inconsistent with criteria prescribed by the NGL/NGR, the AER is to approve that element of the AA proposal.