AER – Expert evidence sessions – 17 February 2022
Addendum on financeability

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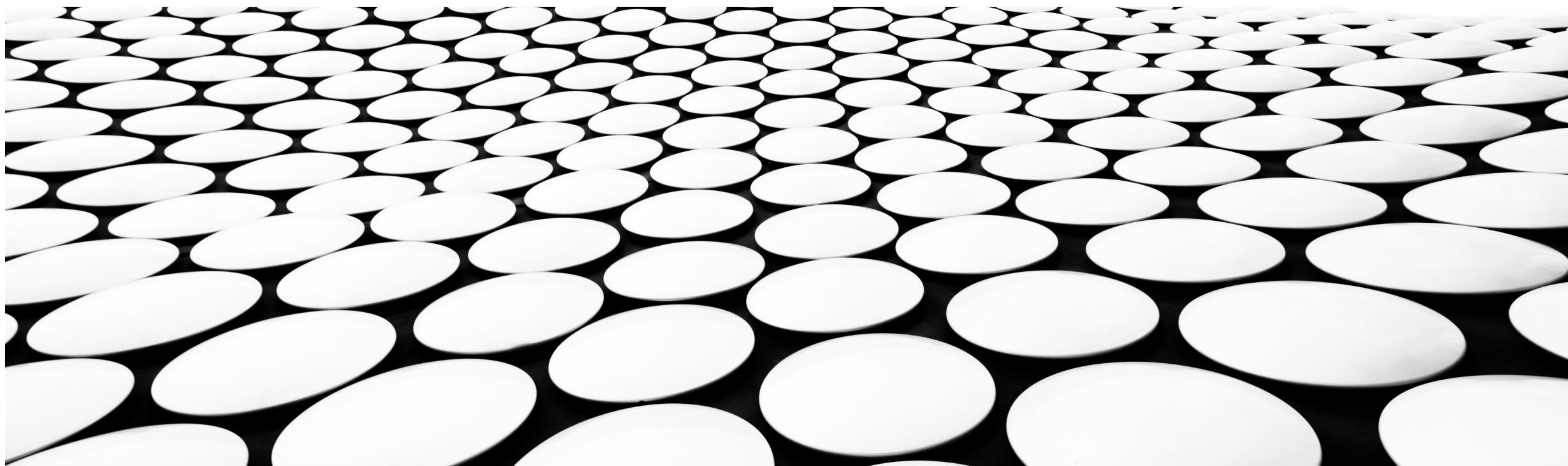

Financeability tests: implications of a company or the industry breaching financial ratio limits set by rating agencies (1) company

At the expert session on 17 February, it was suggested that if the financial ratios for the industry do not satisfy financeability ratios set by credit rating agencies there are only two reasons for this: ***either*** *the cost of capital is too low* ***or*** *depreciation is too low.*

The two slides in this addendum address this issue, elaborating on slides 23 and 24 of my expert evidence presentation pack.

- Financial ratios may become stretched for a **company** if capital expenditure increases
- The depreciation building block as a % of RAB will be lower for companies with younger assets. This will stretch financial ratios, e.g. FFO / net debt would typically be lower for a company with younger assets financed at the notional gearing than for a company with older assets
- A company faced with this situation has options to manage this, the most obvious (but by no means the only option) being that it can **raise equity**
  - The allowed return on capital remains roughly constant under the AER framework
  - The risk to equity falls with the lower gearing, so the appropriate return on that equity for that lower risk also falls
  - The reduction in gearing to accommodate higher capital expenditure reflects the actions of companies operating in competitive markets facing similar circumstances

Financeability tests: implications of a company or the industry breaching financial ratio limits set by rating agencies (2) industry

If the industry has a large capital expenditure plan, it may in aggregate breach financial ratio limits set by rating agencies if financed at the notional gearing. The industry has options to respond, including reducing gearing.

It is not the case that breaching financial ratio limits at the notional gearing implies that either depreciation is too low or the cost of capital is too low. The industry may need to adjust its capital structure, and/or the notional gearing may need to fall. Managements can also take other actions in response.

- The notional gearing, which is that of a "benchmark efficient entity" (BEE) is set using average gearing at the time of the RORI.
- If the whole industry is increasing capital expenditure, the average company may need to raise equity to satisfy limits on financial ratios.
- As a result, **aggregate industry gearing may become lower than the notional gearing** used to set the allowed return.
- There is no inconsistency here. The notional gearing (of the BEE) is only used to **measure** the cost of capital. Companies, and thus the industry in aggregate, may choose their gearing to suit their circumstances. Companies, and the industry in aggregate, may have cash flows that are different from the BEE used to measure the cost of capital, in particular when capital spending is increasing.
- The AER's duty is to set the allowed return commensurate with that of a BEE. That does not impose a duty to ensure that companies (or the industry) with different cash flows can be financed in a particular way with a specific gearing level, specific tenor of debt, nominal (rather than real) interest payments, and specific repayment terms.
- In later RORI decisions, the notional gearing may fall if industry gearing falls (i.e. the capital structure of the Benchmark Efficient Entity changes).