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03 August 2023

Ms Anna Collyer  
Chair  
Australian Energy Market Commission  
GPO Box 2603  
SYDNEY NSW 2001

Dear Ms Collyer

**Re: Submission to the Accommodating Financeability in the Regulatory Framework consultation paper**

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) consultation paper on Accommodating Financeability in the Regulatory Framework.

The AER recognises that the scale of transmission investment required to transition Australia to net zero presents unique challenges for the existing regulatory framework. The current framework was developed over a period of incremental growth, rather than the current required pace of step change growth set out in the Australian Energy Market Operator's Integrated System Plan (ISP). The AER supports the review of the framework to consider whether it remains fit for purpose and will deliver the scale of transmission investment required.

As a matter of principle, financeability is substantially impacted by the practices and choices made by the firm itself. Consequently, financeability is an issue that is first and foremost to be managed by the firm and addressed by shareholders. Further, the optimal approach to capital and financeability is exposed through competitive processes where various parties can bid for the project. It would not be appropriate for the regulatory framework to address financeability concerns that are primarily driven by factors outside the framework such as business structure private financing decisions.

Nevertheless, we are supportive of changes to the Rules to provide greater flexibility in the revenue setting framework to the extent that the current framework does not allow Transmission Network Service Providers (TNSPs) to efficiently raise capital to finance their activities. We agree that an appropriate mechanism to do so under the regulatory framework is to allow flexibility in the depreciation profile of assets that form part of an actionable ISP project.

The AER stands ready to make adjustments to depreciation where we see they are in the long term interest of consumers and necessary to advance the National Electricity Objectives (NEO). The assessment of whether a financeability problem exists should be performed at the overall regulated network business level rather than at the ISP project level, which is consistent with the revenue and pricing principles. It is also important to consider that adjusting depreciation profiles delinks consumers' payments from the benefit they receive from the infrastructure being provided. While it is net present value neutral from a business perspective, it does not mean the same for consumers and society. We support a mechanism that is sufficiently flexible to address financeability on a case-by-case basis to the extent there is such a problem, but does not over-compensate at consumers expense.

However, we do not support the prescriptive formula-based approach proposed by Energy Networks Australia. This approach locks in a simple, formulaic approach that is unable to adapt to changing circumstances over time and the complex nature of financeability assessments. Moreover, the parameter values included in the formula appear to be excessive and may result in a material wealth transfer from consumers to shareholders as well as intergenerational equity issues.

If the Rules are amended to allow flexibility in the depreciation profile of assets that form part of an actionable ISP project, we consider it prudent for the AER to consult on and publish a guideline which sets out our approach to making a determination to vary depreciation profiles and any information required. The content of the guideline would be considered as part of the relevant consultation procedures, however, we have set out in our submission some initial thoughts on the content of a guideline.

The AER also suggests a minor change to drafting of the Rule to allow appropriate flexibility to vary depreciation profiles for ISP projects for financeability as intended by the Transmission Planning and Investment Review Stage 2 final report and Rule change proposal.

These and other matters are discussed in further detail along with our responses to the AEMC's consultation questions in the attachment.

The AER looks forward to continued engagement on this rule change. To discuss any matter raised in this submission please contact Esmond Smith (03) 9290 1956.

Yours sincerely



Dr Kris Funston  
Executive General Manager  
Network Regulation

Sent by email on: 03.08.2023

## Accommodating Financeability In The Regulatory Framework

### STAKEHOLDER FEEDBACK TEMPLATE

The template below has been developed to enable stakeholders to provide their feedback on the questions posed in the consultation paper and any other issues that they would like to provide feedback on. The AEMC encourages stakeholders to use this template to assist it to consider the views expressed by stakeholders on each issue. Stakeholders should not feel obliged to answer each question, but rather address those issues of particular interest or concern. Further context for the questions can be found in the consultation paper.

#### SUBMITTER DETAILS

**ORGANISATION:** Australian Energy Regulator

**CONTACT NAME:** Kris Funston

**EMAIL:** kris.funston@aer.gov.au

**PHONE:** (02) 9230 9142

**DATE:** 3 August 2023

#### PROJECT DETAILS

**NAME OF RULE CHANGE:** Accommodating financeability in the regulatory framework

**PROJECT CODE:** ERC0348

**PROPONENT:** The Honourable Chris Bowen MP, Commonwealth Minister for Climate Change and Energy

**SUBMISSION DUE DATE:** 3 August 2023

The Australian Energy Regulator (**AER**) welcomes the opportunity to comment on the proposed legislative changes to accommodate financeability in the regulatory.

#### 1. WHY ARE THE RULE CHANGES NECESSARY?

We recognise that a key feature of Australia's shift to net zero is the replacement of centralised thermal generation with geographically dispersed decentralised renewable generation, requiring additional investment in transmission infrastructure. As noted in the AEMC's consultation paper, the current framework was developed over a period of incremental growth, rather than the current required pace of step-change growth set out in the Australian Energy Market Operator's (**AEMO**) Integrated System Plan (**ISP**). We support the review of the framework and consideration of

whether it remains fit for purpose. This is key to ensuring a stable, transparent and predictable regulatory regime that provides efficient recovery of expenditures, including depreciation.

The AER is supportive of changes to the Rules to provide it with greater flexibility in the revenue setting framework to the extent that the current framework does not allow Transmission Network Service Providers (**TNSPs**) to efficiently raise capital to finance their activities. We agree that an appropriate mechanism to do so under the regulatory framework is to allow flexibility in the depreciation profile of assets that form part of an actionable ISP project. This reflects the recommendation in Stage 2 of the Transmission Planning and Investment Review (**TPIR**). While this creates some intergenerational equity concerns for consumers, we consider that if used only as required, it may be more in the long-term interest of consumers to adjust depreciation profiles than to require government funding bodies to step in with concessional finance. Further, when combined with concessional finance that is passed through to consumers, it can promote outcomes that are in the long-term interests of consumers. That is, a combination of lower prices and earlier delivery of infrastructure. We stand ready to make adjustments to depreciation where we see they are necessary to advance the National Electricity Objectives (**NEO**) and ensure an efficient business operating a TNSP's network is able to efficiently raise finance when undertaking large capex programs.

## 2. WHAT IS A FINANCEABILITY PROBLEM?

In general, the term 'financeability' refers to the ability and ease with which businesses access funds in the capital markets. 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. This is consistent with the definition of financeability set out in the Stage 2 of the TPIR.

There are currently no legislative requirements for the AER to conduct financeability assessments as part of our regulatory decisions. We provide an allowed rate of return that is set to cover the cost an efficient network would be expected to incur to raise its capital in the financial markets. Our Rate of Return Instrument sets out how we calculate this allowed rate of return. In developing the 2022 Rate of Return Instrument we considered the relevance of financeability assessments and used them as a cross-check on the reasonableness of the overall rate of return. This analysis showed that financeability has not emerged as a problem under our previous Instrument and is unlikely to be a problem under the largely unchanged 2022 Instrument.

As a matter of principle, financeability is substantially impacted by the practices and choices made by the firm itself. Consequently, financeability is an issue that is first and foremost to be managed by the firm and addressed by shareholders. Attempting to address financeability within the regulatory framework to be funded by consumers without first considering whether the issue is more appropriately addressed by the business owners or management, may undermine the fundamentals of the incentive-based framework we operate under and create moral hazard concerns. The decisions that management and shareholders make are central to the issue of financeability.

Choices about capital structure, such as whether to fund new projects from retained earnings, debt or equity are fundamental. So are choices about the type of capital raised, whether debt, equity, hybrid or some other instrument. For example, in 2020 ElectraNet chose to finance its share of Project Energy Connect through debt. As a result, its gearing was expected to rise to around 85% in the next 2–3 years, there was a deterioration in other metrics, and its credit rating was lowered from BBB+ to BBB.<sup>1</sup> This was a conscious choice by shareholders in terms of their level of risk and expected returns. Presumably, the BBB+ credit rating could have been maintained if shareholders had chosen to fund some of the project through additional equity.

Nevertheless, we recognise that the purpose of the regulatory framework is to modify the cashflows of regulated businesses. In most cases, the regulatory framework operates to support financeability. This is recognised by ratings agencies in their qualitative assessments. The stable

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<sup>1</sup> Moody's Investors Service, *Ratings Action – Moody's downgrades ElectraNet to Baa2; outlook stable*, 9 October 2020.

cashflows generated under regulation where real returns are provided on an indexed regulatory asset base (RAB), are able to support high levels of gearing and low capital costs. However, in the current environment there may be circumstances where more flexibility is desirable to support large transmission investments. It is therefore important to be able review the full set of information to determine the source of any financeability issues and whether an adjustment to regulatory cashflows is in the long-term interests of consumers.

Ideally, the optimal approach to capital and financeability is best exposed through competitive processes whereby various parties can bid for the project. This is the approach being taken for some NSW renewable energy zone projects. If this option is not available there is a risk that the incumbent can engage in classical monopoly holdup behaviour.

In the following section we briefly outline the operation of the regulatory framework and how it may impact financeability.

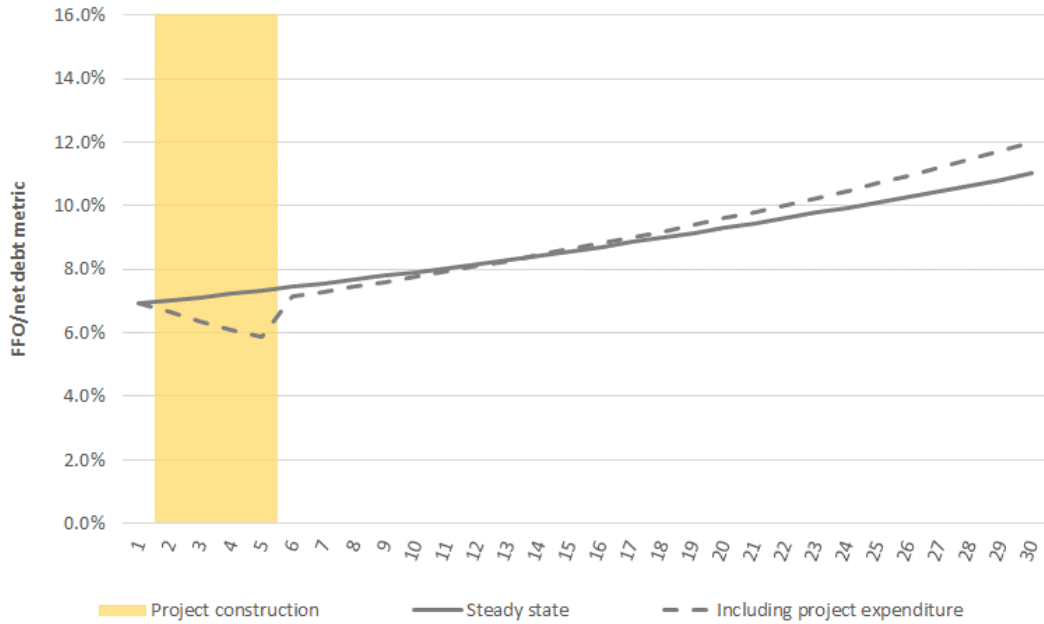
## 2.1. OPERATION OF THE REGULATORY FRAMEWORK

The current regulatory framework provides for the targeting of a real rate of return plus outturn inflation and is based on applying a nominal WACC to an indexed RAB, less the indexation amount from total revenues. This approach provides for outcomes that equate to applying a real rate of return to a RAB that is indexed for inflation. It was designed this way to provide relatively even cashflows reflecting the expectation that consumers pay the same price in real terms for the service provided by an asset over its lifetime.

For transmission, our current approach for providing returns on investments is a hybrid approach, known as the 'partially as-incurred' approach. This approach recognises capex as it is expected to be incurred by the TNSP for the purposes of providing the return on assets allowance. However, the depreciation allowance—return of capital—is only provided once the asset is commissioned. This reflects the large nature of electricity transmission projects, where there is often a number of years between when the capex for a project was incurred and when it is commissioned and providing prescribed services to consumers. We consider it generally not to be in the long-term interest of consumers to be required to pay the depreciation cost of assets that are not yet providing a service.

We recognise that this approach results in cashflow profiles that may not match expenditure profiles. It can result in a dip in cashflows during the construction phase where cash payments are required, but the majority of cash receipts are only received after commissioning. Figure 1 shows a stylised example of the impact of large project expenditures on an otherwise steady-state service provider's FFO/net debt financial metric. This tends to only be a temporary issue for businesses undertaking a single large capital project, and for most businesses with a constant stream of smaller replacement expenditure there is unlikely to be a noticeable dip. We also note that once the project is commissioned and providing depreciation cashflows there is an improvement in the metrics.

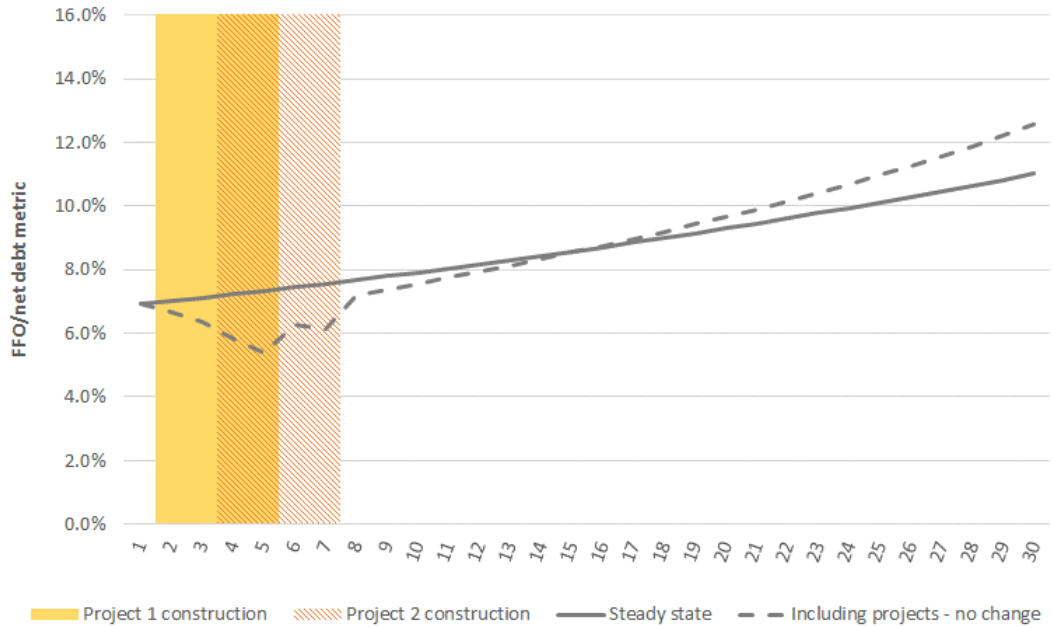
**Figure 1** *Impact of a single large project on FFO/net debt metric*



Notes: This steady-state example assumes an opening RAB of \$5 billion with capex offsetting depreciation (maintained in \$real terms). Return on debt = 5%, Return on equity = 9%, Inflation = 2.5% and 60% gearing. The large project expenditure is \$2 billion in total, being incurred equally over 4 years (years 2–5).

Where a business is undertaking multiple large capital projects with overlapping timelines, this dip can be amplified and extended. Figure 2 illustrates this by beginning construction of a second project of the same size in the middle of the construction phase of the first. In this situation we consider that there is potential for financeability concerns to arise, where credit rating agencies and providers are not prepared to look through the dip. In such a case, an efficient business operating the TNSP’s network may have difficulty with efficiently raising new capital to fund its capex program. As such, the current regulatory framework may require flexibility in the approach to depreciation to address this concern.

**Figure 2** *Impact of multiple large projects on FFO/net debt metric*

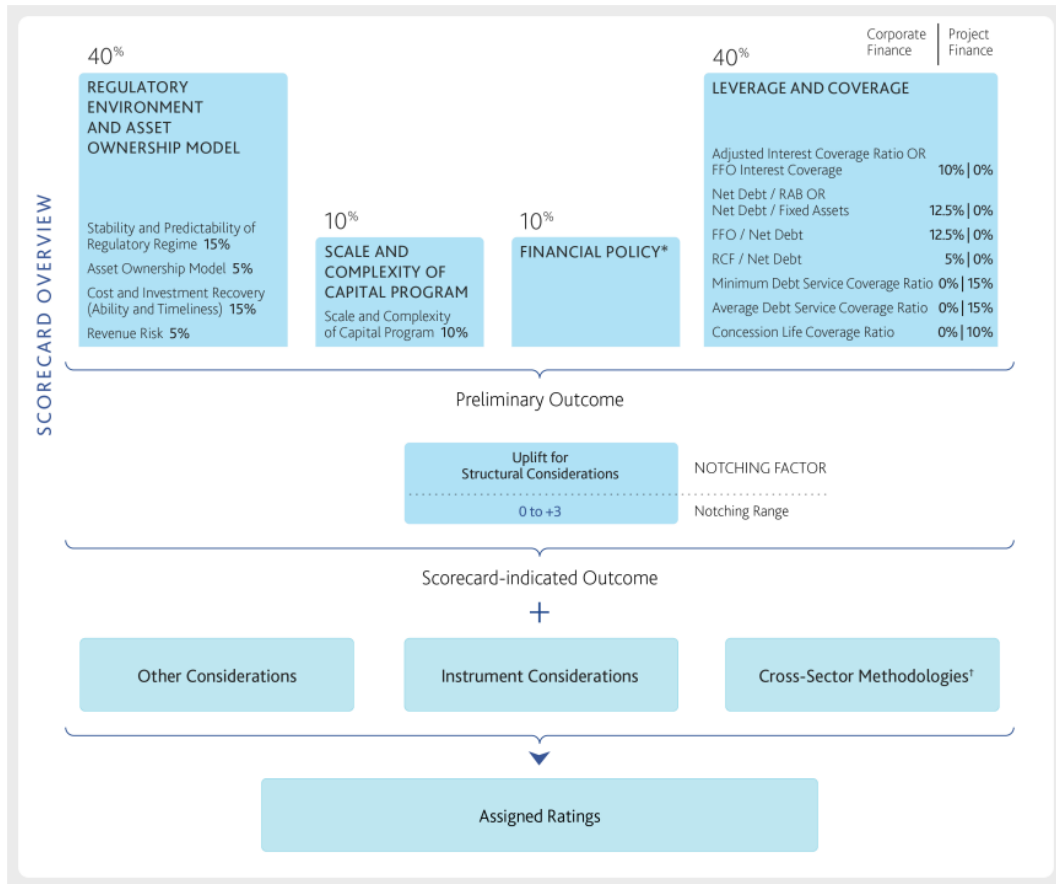


Notes: As above, with Project 2 added of \$2 billion in total incurred equally over 4 years (years 4–7).

## 2.2. HOW DO RATING AGENCIES ASSESS FINANCEABILITY?

When credit rating agencies perform their analysis, they consider the whole of business’ ability to finance its operations and pay back credit obligations. In doing so they place material weight on subjective factors in addition to financial metrics. In the case of Moody’s rating methodology it places only 40% of its initial assessment weight on financial metrics. The majority of its assessment is related to more qualitative factors such as the regulatory environment, ownership model and financial policies. The outcome of the qualitative assessment materially impacts the thresholds for the quantitative assessment that the rating agency applies in practice. For the TNSPs that we regulate, typically the strong qualitative assessment means that materially lower quantitative outcomes can be sustained at higher credit ratings than would otherwise be the case. Figure 3 illustrates Moody’s general framework for the analysis of regulated electric and gas networks, which illustrates the use of a scorecard where 40% of its ‘Preliminary outcome’ is based on its assessment of the business’ leverage and coverage (using financial metrics). However, it also notes that even the scorecard-indicated outcome is not expected to match the actual rating for each company due to other factors and limitations it may consider.

**Figure 3** *Moody's illustration of the regulated electric and gas networks methodology framework*



\* This factor has no sub-factors.  
† Some of the methodological considerations described in one or more cross-sector rating methodologies may be relevant to ratings in this sector. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

Source: Moody's Investors Service, *Rating Methodology – Regulated Electric and Gas Networks*, 13 April 2022, p. 3.

These assessments are considered taking the entity's consolidated business into account including actual cashflows and any unregulated activities that this might include. This approach means that if the qualitative factors in their assessments—such as the stability and predictability of the regulatory regime—are considered strong, ratings agencies are willing to accept weaker financial metrics than would otherwise be the case for a given credit rating. Due to this there is a wide variance in particular metric thresholds that could be considered financeable for a given credit rating depending on the qualitative factors of the business as a whole.

There are also interrelationships between the individual metrics that ratings agencies consider. If a business as a whole is highly geared, ratings agencies would be more likely to consider an expected weakening in another metric such as FFO/net debt as a sign of financeability concerns than if the business operated at a gearing ratio it considered less risky.

In the past, ratings agencies have also been comfortable to look through temporary dips in financial metrics if they are considered likely to improve on a sustained basis following the dip. Our understanding is that recently the period that they are comfortable to look through has reduced and recovery is generally expected within around 18 months.

Consequently, it is very important to recognise that assessments by credit rating agencies, and ultimately investment decisions, are undertaken on a different basis to assessments based purely on regulatory models.



### 2.3. HOW DO REGULATED BUSINESSES RAISE CAPITAL?

Our 2022 Rate of Return Instrument sets out how we calculate the allowed rate of return used to set the amount of revenue networks can earn. We set the rate of return to cover the cost an efficient network would incur to raise its capital in the financial markets. We do not set the rate of return with a specific network or project in mind. Instead, we set a benchmark across the sector. This provides incentives for networks to raise their capital at the lowest cost possible.

While the allowed rate of return is relatively invariant to changes in the benchmark debt to equity ratio (gearing), financeability assessments are especially sensitive to the choice of amount of debt compared with equity. Our revenue setting framework assumes a gearing ratio of 60% to derive the rate of return, however, there is no requirement for firms to operate at this level. Many choose to operate at a lower gearing ratio where they consider it efficient to do so, as noted in our 2022 Rate of Return Instrument analysis,<sup>2</sup> while in the past few years, we have seen regulated firms actively choose a higher level of debt, recognising this could lead to a credit rating downgrade.

Our analysis of RAB multiples—a measure of the value of the firm compared with the RAB—indicates that there is sustained interest from investors to acquire the assets we regulate at a good margin. While we accept that care is needed in the interpretation of RAB multiples, the number of firms that have moved into private structures highlights the appetite for these regulated assets that provide sufficient stable returns and that there is no lack of both debt and equity finance available to the firms we regulate.

### 3. WHAT ARE APPROPRIATE MECHANISMS?

As noted above, in the current environment there may be circumstances where more flexibility regarding regulated cashflows is desirable to support large transmission investments. We consider that an appropriate approach to identifying the financeability of the cashflows provided under the current framework is to mirror to the extent possible the assessment that ratings agencies undertake. In doing so it is important to be able to review the full set of information to determine the source of any financeability issues and whether an adjustment to regulatory cashflows is in the interests of consumers. This includes assessing how the project expenditures are likely to impact the ability of the business as a whole to raise new capital, and the impact of any concessional financing that has been received.

Following this assessment, if it is determined that the timing of regulatory cash flows is the principle source of financeability concerns, an adjustment to the regulated cash flows is in the long-term interests of consumers to avoid efficient capital programs not proceeding or being delayed. We consider an adjustment to the depreciation profiles of ISP assets is likely the most appropriate change to address any financeability problems that are the result of the operation of the regulatory framework. Such an adjustment is NPV neutral for the business, meaning cashflows received in the short-term are offset by foregoing cashflows in the future (after adjusting for the time value of money). Adjustments to regulated depreciation profiles though would not be an appropriate mechanism to address financeability concerns that are primarily driven by factors outside the regulatory framework—such as business's particular structure or financing decisions.

In making any adjustments it is important to consider that adjusting depreciation profiles (or beginning depreciation prior to an asset providing services) delinks consumers' payments from the benefit they receive from the infrastructure being provided. While depreciation adjustment is NPV neutral from a business perspective, it does not mean the same for consumers/society. This arises because of the limitations in the NPV analysis, such as assumptions of a single discount rate, consumers having different discount rates to the business and today's consumers not necessarily being the same consumers in the future. Any front loading of cashflows might be expected to make consumers in aggregate worse off and tend to suggest that it is NPV negative from a societal

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<sup>2</sup> AER, *Explanatory Statement - Rate of Return Instrument*, 24 February 2023, pp. 87.

viewpoint. Therefore, we consider that it should be applied cautiously, and only where not doing so would likely result in the project not going ahead or being significantly delayed. We are supportive of the principles reflected in the Rule change proposal and reflect a level of prescription appropriate to specify in the Rules. We consider that any further specifics are best suited to including in a guideline.

### 3.1. WHAT IS APPROPRIATE FOR A GUIDELINE?

If the Rules are amended to allow flexibility in the depreciation profile of assets that form part of an actionable ISP project, we consider it prudent to consult on and publish a guideline which sets out our approach to making a determination to vary depreciation profiles and any information required.

The content of the guideline would be considered as part of the relevant consultation procedures, however, we set out below our initial thoughts on what would be appropriate to include in a guideline.

The guideline should set out how we would assess whether any financeability problem was evident from the business' proposal, including any relevant information we would require from the business. The guideline would also include options available to adjust depreciation in a way that addressed the underlying problem while minimising the impact on consumers and promoting the long-term interests of consumers.

To identify if there is a financeability problem, we would aim to set out an approach that mirrored the assessment that ratings agencies undertake. This would consider the ability of the business as a whole to efficiently raise capital and how the forecast project expenditure and subsequent regulated cashflows impacted this ability. We would also consider how any concessional finance that has been made available might impact the business' ability to efficiently raise capital for its capital program.

As part of this assessment, the guideline would set out the requirements of the TNSP to provide annual expenditure forecasts—broken down by asset class for the relevant ISP project, and its impact on financeability metrics at the overall RAB level. We would expect a TNSP to include details of any relevant concessional finance arrangements and the amount to be shared with consumers, and how it is expected to be shared. This would be consistent with any requirements set out in the Rules following the final decision on the concessional finance rule change. We also expect the TNSP would undertake early engagement with consumers to explain why there might be a financeability problem from an ISP project and the appropriate mechanisms to address this.

In performing the quantitative element of the assessment, we would consider the impact of a project's expenditures for various financial cashflow metrics that ratings agencies consider. We understand that for large capex programs, there is a strong focus on the impact of the FFO/net debt metric and this would be reflected in the assessment set out in the guideline.

Given the wide range of metric thresholds that may be considered appropriate for a given credit rating band, we do not consider it would be appropriate to set specific thresholds that reflect a given financeability level in all cases. Instead, we are generally supportive of an approach to identifying a financeability problem that reflects the prevailing post-tax revenue model (**PTRM**) derived cashflows as the baseline to be compared against the impact of the ISP projects. Under this approach a financeability problem would be identified if the inclusion of the ISP related expenditure resulted in financial metrics that were materially worse than under the prevailing PTRM.

As such, any adjustment to cashflows to address this identified problem should be done in a way that sought to support the financial metrics in the TNSP's prevailing PTRM rather than meet any specific prescribed values. We consider that a level of materiality to the metrics' variation is also likely appropriate to consider before making an adjustment. Some amount of variance is to be expected with a changing expenditure profile. Adjusting depreciation profiles to match the baseline metrics exactly is likely to be complex and may result in making changes where they are not

required to promote the NEO. Any concessional financing arrangements that have been entered into should also be considered in any assessment of a financeability problem. For example, if concessional finance has been received the materiality of the variance from the baseline may be increased to account for the impact of concessional finance. This would avoid the TNSP receiving a double benefit to cashflows from depreciation adjustments and concessional finance which is not likely to be in the long-term interest of consumers.

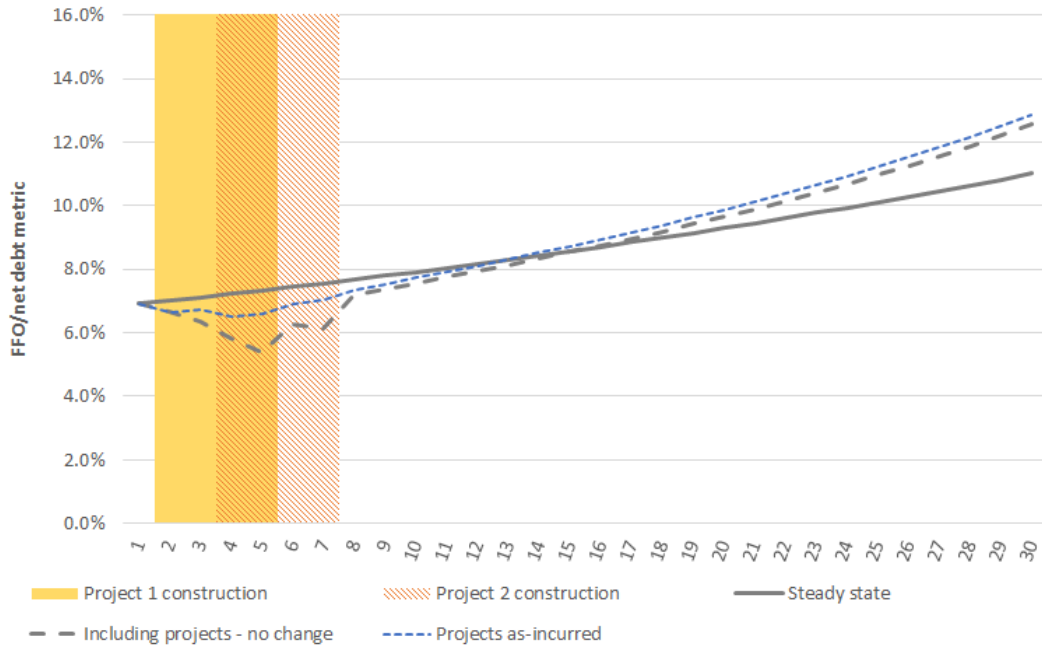
This approach of using the prevailing PTRM as the baseline to compare the impact on metrics against reflects that some of the financeability issues raised may be due to business specific financing decisions. We do not consider it would be appropriate to make changes to the incentive regulatory framework to address individual financial decisions outside of the framework. It also reflects that financial metrics only provide an element of financeability assessments and the other parts of the assessment are relatively unchanged as a result of the ISP projects.

In terms of approaches to address any financeability problem, we consider that a hierarchy of methods to apply could be the starting point for adjustments specified in the guideline. However, the appropriate method (or mix of methods) and level of adjustment would ultimately be guided by our assessment of the long-term interests of consumers. For example, applying as-incurred depreciation to a subset of assets—such as biodiversity offset costs—may be the first option that could be applied to alleviate a financeability problem. Applying depreciation on an as-incurred basis reduces the dip identified in section 2.1 by allowing depreciation of the asset to be recovered through revenues prior to the asset providing prescribed services. The Rules are silent on whether the recovery of depreciation on an as-incurred basis is already available to the AER for transmission assets if we consider it appropriate. However, clarification in the Rules regarding the ability to apply as-incurred depreciation to ISP related assets would ensure this option is available as necessary.

Applying as-incurred depreciation to a larger subsection of the capex may also be considered as an option to remove the dip in financial metrics. Our initial assessment is that this approach is likely to alleviate much of the short-term impacts of a large ISP capex, while having minimal impact on the longer-term cashflows. We also consider that this approach may be applied without requiring a change to the template regulatory models.

Figure 4 illustrates the of the impact on the FFO/net debt metric of applying as-incurred depreciation to the large projects in the example used in section 2.1.

**Figure 4** *Impact of as-incurred depreciation on FFO/net debt metric*



Notes: Assumptions as above, depreciation on project capex provided on an as-incurred basis.

If applying as-incurred depreciation to the ISP capex is not sufficient to alleviate the financeability problem identified, we consider that further options to adjust the depreciation recovery should be considered—either in place of or in addition to as-incurred depreciation. This may take the form of applying shorter asset lives to capex or applying a form of shaped depreciation to bring forward cashflows. Simply assigning a shorter asset life to certain capex is a convenient option as it does not require any changes to the template regulatory models, however, particular consideration of the long-term impacts should be considered in its application.

Shortening asset lives is a blunt instrument that should be applied cautiously and minimally. For example, the short-term depreciation cashflows from an asset can be doubled by halving the economic life for financeability purposes. This may alleviate a short-term problem, but it also means that the asset is expected to continue delivering services for the second half of its effective life while providing no return on capital or depreciation return. As such, it may simply postpone a financeability problem until later. This is consistent with previous experience in the UK, where the regulator’s previous decisions adjusted depreciation profiles as a result of financeability. The UK regulator’s consultant (CEPA) found that this resulted in ‘an increase in the proportion of assets that were subject to accelerated depreciation in part because the previous acceleration exacerbated the perceived cashflow constraints as the capex programme grows.’<sup>3</sup> There must therefore be careful consideration of whether such an adjustment—and the level of adjustment—is in the long-term interest of consumers.

An alternative to simply applying shorter asset lives is to apply a form of shaped depreciation. Shaped depreciation does not change the length of time over which depreciation of the asset is provided, but instead changes the timing of the depreciation cashflows. An alternative to the current straight-line depreciation method is the sum-of-the-years’ digits method to calculating depreciation, which provides greater depreciation cashflows in the early years of an assets life, while still providing some (reduced) cashflows later in the asset’s life. This approach results in less longer-term cashflow impacts than depreciating an asset over a shorter period while providing

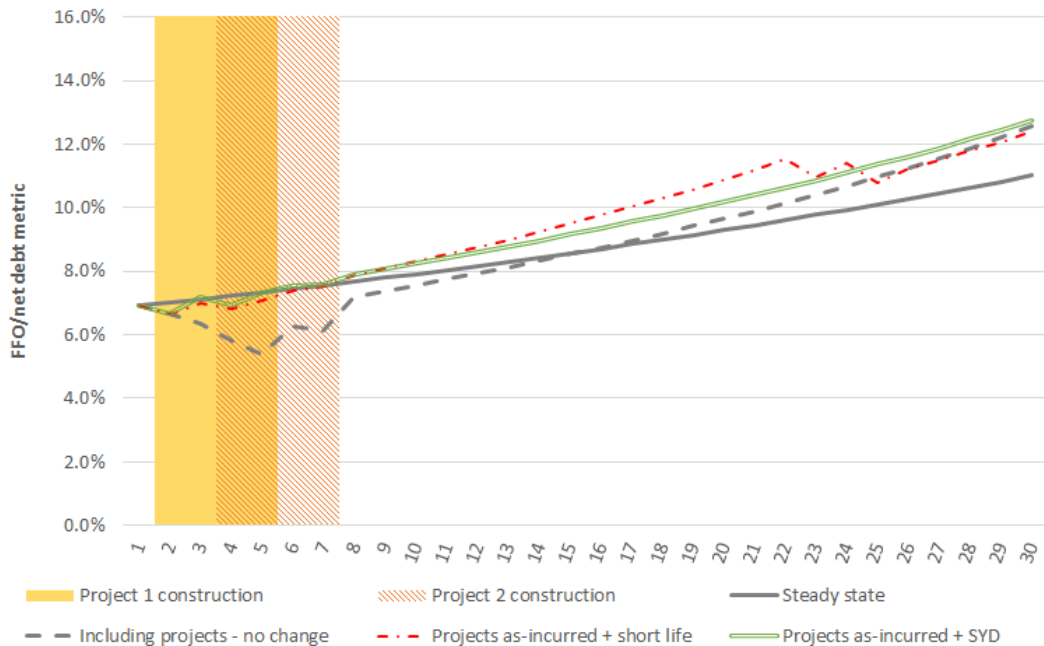
<sup>3</sup> CEPA, *RPI-X@20: providing financeability in a future regulatory framework*, May 2010, p. 2.

similar short-term benefit. However, there must similarly be careful consideration of the appropriate proportion of the capex to depreciate in this manner that would alleviate the financeability problem and promote the long-term interest of consumers. This approach would require an amendment to the template regulatory models to apply, requiring a further consultation process to implement.

Figure 5 illustrates the impact on the FFO/net debt metric of applying shorter lives, or shaped depreciation to part of the project expenditure in the example used in section 2.1—in addition to as-incurred depreciation. This illustrates the volatility in metrics that occurs when applying shorter asset lives to project capex. After initial strengthening in the short-medium term, there is a drop once no further depreciation cashflows are being provided. This effect is amplified if shorter lives are used or it is applied to a greater proportion of capex. This can also lead to a business facing financeability problems in the longer term as a result of low regulated cash flows.

We consider that a key principle to considering the level of adjustments to depreciation would be to ensure that any adjustment is no more than necessary to ensure that an efficient business operating a TNSP’s network is able to efficiently raise finance when undertaking the forecast capex program. This principle is consistent with promoting the NEO and maintaining the fundamentals of the incentive based regulatory regime.

**Figure 5** *Impact of possible depreciation adjustments on FFO/net debt metric*



Notes: Assumptions as above. The 'short life' scenario reduces the assumed life of each project's first year of capex (25%) from 35 years to 20 years. The SYD scenario applies the sum-of-the-years' digits approach to depreciate the first year (25%) of each project's capex.

Another key consideration when assessing adjustments to depreciation profiles would be its impact on consumer bills. Including large capex projects into a TNSP’s asset base will increase bills for consumers no matter what the approach to depreciation is taken. In the steady-state example used in this submission—assuming a \$2000 starting bill and transmission costs representing 5% of the bill—customer bills would be expected to be around \$30 (1.7%) higher annually over the life of the project, mainly rising following the construction period. If as-incurred depreciation was applied to all project capex the increases would begin earlier, resulting in annual bills being an additional \$2.50 higher over the first 10 years. Applying shaped depreciation to part of the project capex

would have a similar additional impact on top of this—an extra \$2.50 per annum over the first 10 years.

This moderate impact on bills is due to the small proportion that transmission charges contribute to residential customers' overall bills, however customers' willingness, and ability to pay is a key issue we would consider when assessing adjustments to depreciation profiles.

#### 4. THE ENA'S PROPOSED RULE CHANGE

The ENA has proposed an alternative Rule change for actionable ISP projects. This proposal would require the AER to apply the financeability formula that the ENA submitted to modify depreciation allowances in each regulatory year. The ENA proposed to specify this formula in the Rules and used a 9% FFO/net debt threshold and 2.4 times interest coverage ratio as its target metrics. It also included gearing, but as the ENA assumes the benchmark ratio of 60% it does not impact the formula at all. The proposal noted that the formula is informed by Moody's published rating methodology for regulated energy networks—as well as some judgement and inference.

The ENA's rule change locks in a simple, formulaic approach that is unable to adapt to changing circumstances over time and does not account for the complex nature of financeability assessments. By their nature such assessments do not lend themselves to a 'set and forget' formula as proposed, and using such a formula can have harmful and unintended consequences. Moreover, the parameter values included in the formula appear to be excessive and may result in a material wealth transfer from consumers to shareholders and intergenerational equity issues. Prices paid by consumers would be raised far beyond any potential adjustment required solely to address financeability.

As highlighted earlier when credit agencies use financial metrics, it is only a part of their overall review of the whole business' financing ability. In Moody's published methodology shown in Figure 3 for assessing regulated electric and gas networks—which is the primary source for the proposed formula—financial metrics only accounts for 40% of their initial assessment. We consider that employing a formula with specific thresholds that must be met promotes the metrics to a level not consistent with actual financeability assessments.

Prescribing such a formula within the Rules removes the flexibility to adapt to changing circumstances that may result in under/over-compensation at a particular point in time, or a given project. While this may be NPV neutral from the business' perspective, it may require current customers paying significantly more than necessary to benefit future customers. This is particularly the case for the short-term focus of the ENA's proposed formula. It only considers the cashflows within a single regulatory control period.

As discussed in section 3.1, bringing depreciation recovery forward to meet short-term financial metrics means future financial metrics will necessarily be relatively worse compared to the alternative.<sup>4</sup> We consider that a longer-term view must be considered in making any adjustment to avoid a 'ratcheting' effect where higher depreciation is required in the future due to the previous higher depreciation that resulted from the application of the proposed formula.

Careful consideration of the thresholds specified in such a formula and their interlinkage between the metrics is also required. ENA stated that 9% FFO/net debt and 2.4x FFO interest coverage ratio 9.0% are the benchmark BBB+ thresholds for these metrics. It stated that it has adopted lower thresholds than those set out in Moody's published methodology to account for the strong qualitative assessment for the average Australian network. ENA suggested that these are the minimum ratios that Moody's has indicated would need to be achieved in order to be upgraded from a rating of BBB (Moody's Baa2) to a rating of BBB+ (Moody's Baa3). We are not aware of any such specification by Moody's that applies to all businesses. An FFO/net debt ratio of 9% and 2.4x FFO interest coverage ratio appears to reflect the agency's opinion of thresholds for a particular business operating at a relatively high gearing ratio. We do not think these thresholds would apply

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

to a business operating at the benchmark gearing assumption of 60% net debt to RAB assumed in the formula.

Moody's published methodology only includes broad ranges of metrics for credit rating bands, i.e. it specifies a range of metrics it considers would score in the Baa band, but does not specify thresholds within that band for Baa1 (broadly equivalent to BBB+). Specific credit rating categorisation is only applied after bringing together all elements of its scorecard-indicated outcome. Furthermore, the scorecard-indicated outcome itself is not expected to match the actual rating for each company due to various other considerations and limitations.<sup>5</sup>

This issue with specifying specific thresholds is highlighted by the fact that the ENA's proposal is to only apply the formula to each discrete project. It recommended this approach as applying the proposed financeability formula at the network business level shows that the forecast revenues of the regulated business in the example used are already lower than the formula implies are financeable. Our analysis suggests that a number of our recent revenue proposals and determinations would also not meet the ENA's definition of 'financeable', however, there is no evidence that this has led to broad financeability issues for these networks. Table 1 shows the range of FFO/net debt and FFO interest coverage ratios from our most recent revenue determinations of networks that are operated by rated regulated businesses. This range in outcomes from the PTRM metrics illustrates the issues with applying a 'set and forget' financeability formula that would apply across all determinations based on PTRM modelling.

**Table 1 Range of financial metrics calculated from recent AER decisions for networks under rated regulated businesses (5 year averages)**

	Incl. revenue adjustments		Excl. revenue adjustments	
	FFO/net debt	FFO ICR	FFO/net debt	FFO ICR
<b>Maximum</b>	12.22%	4.14	11.62%	3.73
<b>Minimum</b>	5.22%	2.21	5.55%	2.15
<b>Median</b>	7.88%	2.87	7.80%	2.89
<b>Average</b>	8.40%	2.99	8.19%	2.93

Notes: Revenue adjustments generally include incentive scheme payments/decrements, but may also include other adjustments such as from under/over-recovery of revenue for the six-month extension period for Victorian gas distribution networks. These are the result of prior under/out-performance, therefore it is not clear that they should be considered as part of the metrics, as they should not be expected to continue. For reference we have presented both cases.

Source: AER analysis.

Applying the ENA's proposed formula to an individual project as suggested is also inconsistent with rating agencies assessment of individual project financing. For project-financed issuers, Moody's uses a separate set of metrics related to average and minimum debt service coverage which reflects the cashflow timing issues expected when financing individual greenfield projects.

Prescribing a formula within the Rules would also appear at odds with the recommendation in the final report of Stage 2 of the TPIR. The recommendation was to provide the AER with flexibility in the revenue setting framework to address cashflow issues without increasing the cost to consumers. As such, we recommend against prescribing any specific formula within the Rules that must be met to consider a project, or capex programme financeable.

It is also worth noting that the proposal does not accommodate consideration of funding provided or obtained from government funding bodies that improve financeability metrics. For example, we understand the Clean Energy Finance Corporation (CEFC) provided some hybrid financial funding to Transgrid to finance PEC that will have improved its financeability metrics. The CEFC may also provide more hybrid or concessional financing that will improve financial metrics that we consider needs to be taken into account in any regulatory decision. Applying the formula as proposed by the

<sup>5</sup> Moody's, *Rating methodology – Regulated electric and gas networks*, 13 April 2022, p. 3.

ENA without regard to concessional finance may well lead to 'double dipping', whereby concessional finance has been provided to address financeability concerns, but the formula—based on PTRM cashflows—still indicates a required adjustment to depreciation profiles. While it may be the case that some further adjustment would be required to ensure the project's delivery, it is unlikely to be at the level specified in the formula, and would not be in the long-term interest of consumers.

We also note that changes to the Rate of Return Instrument may change FFO, net debt, or interest paid within the PTRM. Absent a change in the depreciation profile, these changes could alter the FFO/Net Debt ratio and the interest coverage calculated using the PTRM cashflows for AER determinations. This means the Rate of Return Instrument under the ENA's prescriptive approach would also (effectively) drive the depreciation profiles for AER determinations. This would therefore mean the AER will need to consider this in determining the Rate of Return Instrument that will best achieve the NEO.

For example, part of our reasoning for not reducing the benchmark gearing ratio below 60% in making our 2022 Rate of Return Instrument was that the overall WACC does not vary materially with small changes in gearing.<sup>6</sup> However, even a relatively small 5% reduction in gearing would have a material impact on the financial metrics calculated in the PTRM, and under the ENA's prescriptive approach would also result in less required depreciation adjustments.<sup>7</sup> For this reason, we consider if any prescriptive approach was adopted it should not come into force until after the next Instrument is made (i.e. only apply to AER regulatory determinations made after the commencement date of the next Rate of Return Instrument). This would allow the AER to consider the likely impact on depreciation allowances of the gearing chosen in making the next Rate of Return Instrument and ensure the Instrument (and gearing chosen) best achieved the NEO.

## 5. DRAFTING OF THE FINANCEABILITY RULE

The intent of the proposed Rule change is to provide the AER with flexibility in approving depreciation profiles for ISP related assets to ensure the networks' financeability. We consider that this requires the AER to not be bound by approving depreciation profiles that reflect "...the nature of the assets or category of assets over the economic life of that asset or category of assets" as currently required under clause 6A.6.3(b)(1). Approving only depreciation profiles that reflect the nature of the assets limits our ability to adjust profiles as a result of financeability concerns. Adjustments made for financeability reasons would generally result in depreciation profiles no longer reflecting the nature of the underlying assets.

The current drafting of the Rule change does not amend the requirements of this clause. The proposed Rule proposes new subclauses under clause 6A.6.3 regarding depreciation. This includes a proposed clause (6A.6.3(d)) that states:

*Where an asset (or group of assets) forms part of an actionable ISP project, a Transmission Network Service Provider may submit a request to the AER to approve that the asset (or group of assets) is depreciated on a basis other than on a straight line basis.*

We consider that while this clause allows us the flexibility to consider deviating from applying the straight-line method of depreciation for ISP related assets, it does not remove the requirements under clause 6A.6.3(b)(1). In our view, an exception to this clause is required to allow sufficient flexibility to adjust depreciation profiles for financeability.

We suggest including a minor change to the proposed clause 6A.6.3(b) outlined below:

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<sup>6</sup> AER, *Explanatory Statement - Rate of Return Instrument*, 24 February 2023, pp. 84–95.

<sup>7</sup> This is because, while the FFO value is largely unchanged both the net debt value (for FFO/net debt), and interest payments (for FFO ICR) are reduced substantially leading to a strengthening of both metrics based on the PTRM modelling.



## PROPOSED CLAUSES

6A.6.3(b) (unchanged)	The depreciation schedules referred to in paragraph (a) must conform to the following requirements: (1) except as provided in paragraph (c), the schedules must depreciate using a profile that reflects the nature of the assets or category of assets over the economic life of that asset or category of assets;
6A.6.3(d) (new)	Where an asset (or group of assets) forms part of an <i>actionable ISP project</i> , a <i>Transmission Network Service Provider</i> may submit a request to the <i>AER</i> to approve that the asset (or group of assets) is depreciated on a basis other than on a straight line basis.

## AER SUGGESTED CLAUSES (AMENDMENT)

6A.6.3(b) (amended)	The depreciation schedules referred to in paragraph (a) must conform to the following requirements: (1) except as provided in paragraph (c) and (d), the schedules must depreciate using a profile that reflects the nature of the assets or category of assets over the economic life of that asset or category of assets;
6A.6.3(d) (as proposed)	Where an asset (or group of assets) forms part of an <i>actionable ISP project</i> , a <i>Transmission Network Service Provider</i> may submit a request to the <i>AER</i> to approve that the asset (or group of assets) is depreciated on a basis other than on a straight line basis.

We consider that this additional exception added to clause 6A.6.3(b)(1) would provide the appropriate flexibility to vary depreciation profiles for assets that form part of an actionable ISP project to assist in financeability as intended by the Stage 2 final report and Rule change proposal.

## 6. RESPONSES TO SPECIFIC QUESTIONS - FINANCEABILITY

### QUESTION 1 – IDENTIFYING THE PROBLEM

Do stakeholders have any new information or views on the problem raised in this rule change request, having regard to what has already been consulted on and established in TPIR?	Our views are set out in this submission.
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### QUESTION 2 – HOW TO ASSESS FINANCEABILITY APPLICATIONS

(a) Should TNSPs have to submit an application to the AER to vary the depreciation profile of actionable ISP projects? If so, what information should this include?	We agree with the proposed timeline for a TNSP submitting an application to vary depreciation. In the absence of a guideline outlining the information required to be provided, we consider an application should include detailed annual expenditure forecasts—broken down by asset class for the relevant ISP project, and its impact on financeability metrics at the overall RAB level. This should include detail on any
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	concessional financing arrangements entered into related to the project.
(b) Should the AER vary the depreciation profile of actionable ISP projects using principles or a prescriptive approach?	The Rules should be sufficiently flexible to address financeability on a case-by-case basis. Note concerns with including specific financial metrics that must be met.
(c) What level of AER discretion is appropriate?	
(d) Do you consider that the proposed principles are appropriate? Should any other assessment factors be taken into account?	We agree with the proposed principles and the inclusion of “any other factors the AER considers relevant”.

### QUESTION 3 – LEVEL OF FINANCEABILITY ASSESSMENT

(a) Should the financeability assessment be at the TNSP RAB level or the ISP project level?	We agree with the AEMC final report recommendation that any financeability assessment should be at the regulated network business level. This is consistent with the revenue and pricing principles.
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### QUESTION 4 – FINANCEABILITY ASSESSMENT PROCESS AND TIMING

Is the proposed process and timing to assess requests to vary depreciation for actionable ISP projects practical and efficient? If not, what alternative processes and timings do you suggest be specified in the NER?	We have no issues with the proposed timeline for a TNSP submitting an application to vary depreciation.
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### QUESTION 5 – WILL THE PROPOSAL RESOLVE THE PROBLEM?

(a) Will the proposed solution to vary depreciation profiles resolve the problem raised in the rule change request? Would it reduce or eliminate the need for concessional finance from governments for ISP projects?	We cannot form a view on whether the proposed solution would resolve the problem raised in all cases. Financeability concerns should be considering on a case-by-case basis with regard to specific expenditure forecasts and impact on the financeability at the overall RAB level for each TNSP.
(b) Are there any alternative solutions that would resolve the problem and be more preferable and aligned with the long-term interests of consumers?	In many situations a preferable solution would be additional equity injections from existing shareholders or a new capital raising that will improve cashflow metrics without consumers being made worse off, either overall or from a timing perspective. This supports a flexible (non-prescriptive) approach being used in the Rules.

### QUESTION 6 – AER GUIDANCE

<p>Should the AER be required to publish guidance on how it may vary the depreciation profile for assets that form part of an actionable ISP projects?</p>	<p>We agree with the proposed Rule that the AER may develop guidelines on its the approach to making a determination to vary depreciation profiles and any information required.</p> <p>We recommend that the Rules not prescribe the specific requirements of the guideline, such as specifying how the AER intends to treat specific asset categories ex-ante.</p>
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## QUESTION 7 – TRANSITIONAL ARRANGEMENTS

<p>(a) If the proposed rule is made, should the AER be required to develop any guidance, or amend any AER models, before or after the commencement of the rule? If so, what level of prescription should be included in the NER?</p>	<p>It is unclear how we would practically develop guidance material or amend models before the commencement of the rule.</p>
<p>(b) If the proposed rule is made, should it provide a transitional period to enable market participants to prepare? If so, how long should such a transitional period be?</p>	<p>If any prescriptive formula-based approach was adopted, we consider it should not come into force until after the next Rate of Return Instrument is made. This would allow the AER to consider the likely impact on depreciation allowances of the gearing chosen in making the next the Rate of Return Instrument and that it best achieved the NEO.</p>
<p>(c) Is there a need for any transitional arrangements to assist with managing interactions other NER amendments or other market reforms? If so, what?</p>	

## QUESTION 8 – BIODIVERSITY OFFSET ARRANGEMENTS ACROSS NEM JURISDICTIONS

<p>Are the costs of meeting biodiversity obligations material? Are they likely to impact financeability of actionable ISP projects?</p>	<p>We cannot form a view on the materiality of biodiversity obligations without assessing specific proposals. We understand that biodiversity offset costs will differ significantly depending on the project and the likely paths and corridors that are chosen and impacted.</p>
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## QUESTION 9 – RECOGNISING AND MANAGING BIODIVERSITY OFFSET COSTS

<p>(a) Does the AER already have discretion to do what the rule change request is proposing (i.e. applying depreciation as incurred for transmission assets)?</p>	<p>Under the current Rules, depreciation profiles must reflect the nature of the assets.</p> <p>If the assets were considered to begin losing value from the time the expenditure is incurred (prior to the broader project being commissioned and providing prescribed services) then we consider the Rules would allow depreciation of these assets to begin on an as-incurred basis.</p>
<p>(b) Should land purchased specifically for the purpose of meeting biodiversity offset obligations be depreciable? Should other costs of meeting</p>	<p>Our understanding of biodiversity offset costs is that they generally reflect a one-off payment with minimal, or zero value at the end of a project's life. As such, we consider that from an economic perspective these costs can be considered depreciable assets. They also exhibit the attributes of an</p>

biodiversity offset obligations be depreciable?	intangible asset and therefore the costs should be amortised (depreciated).
(c) Do you agree or disagree that recovering depreciation of biodiversity offset costs as incurred (as opposed to as commissioned), would be an appropriate solution to the financeability problem? Does this re-allocate completion risk from TNSP's to consumers?	We cannot form a view prior to assessing specific proposals, but it would likely form part of a solution if a problem was identified.
(d) Are the nature of biodiversity offsets different from other assets that comprise a specific actionable ISP project, such that biodiversity offsets should be depreciated on a different basis to other assets?	The nature of biodiversity offset costs is that they relate to intangible assets, unlike physical transmission assets. We maintain our preference for depreciating on as-commissioned basis in the absence of any financeability concerns.

#### QUESTION 10 – APPLICATION OF PROPOSED SOLUTION TO INTENDING TNSPS

If TNSPs are able to recover depreciation of biodiversity offsets on an as incurred basis, should this be extended to intending TNSPs?	It is not clear how this would impact intending TNSP cashflows as it is unclear how revenues could be recovered from consumers before the intending TNSP is providing prescribed transmission services.
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#### QUESTION 11 – CLARIFYING DEPRECIATION TREATMENT OF ASSET CLASSES

(a) Do you agree with the proposal to require the AER to explicitly outline how depreciation would apply to all asset classes in actionable ISP projects? Should this include biodiversity assets?	We do not agree with the proposal for the AER to outline how depreciation would apply to all asset classes in actionable ISP projects on an ex-ante basis. Depending on the project, only certain asset classes for a TNSP's revenue determination would be affected by the inclusion of an ISP project.
(b) If you agree that the deprecation treatment of asset classes should be documented, how should it be implemented — through the NER, AER guidelines and/or other methods?	We consider that the intent of the Rule change was to provide the AER flexibility in amending depreciation profiles. Providing ex-ante advice on how depreciation would apply to all asset classes in all cases would appear counter to the intent of the Rule change.

#### CHAPTER 12 – ASSESSMENT FRAMEWORK

Do you agree with the proposed assessment framework? Are there additional principles that the Commission should take into account or are there principles that are not relevant?	We agree broadly with the recommendation and the analysis that there may be issues with financeability in a regulated context where there are large investments undertaken in a short period of time. We consider that the analysis of financeability should be performed at the overall RAB level rather than at the project level. We note that financeability issues can be addressed in various ways—at the firm, regulatory or lender level—which may or may not be NPV neutral.
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