

# Financeability of ISP projects: Response to submissions

Australian Energy Markets Commission

7 April 2021



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## 1. RESPONSE TO SUBMISSIONS

CEPA has been engaged by the Australian Energy Market Commission (AEMC) to provide advice on the financeability of Integrated System Plan (ISP) projects. Our advice on this topic<sup>1</sup> was published alongside the AEMC's draft rule change determination<sup>2</sup>.

The AEMC has requested that CEPA provide a response to the following issues raised in submissions by TransGrid, ElectraNet and Ausgrid:<sup>3</sup>

- **Credit rating methodologies**, including the use and weighting of relevant financial metrics by credit rating agencies.
- Acceptability of a **BBB- credit rating** for a regulated utility such as TransGrid.
- **Materiality** of lower gearing ratios and changes in the funds from operation to net debt ratio (FFO/net debt).
- Practicality of **alternative financing options** (hybrid securities and inflation linked bonds) in the Australian context.

The AEMC has also requested that CEPA's response include a short discussion of the nominal return model applied by the Commerce Commission's regulation of Transpower in New Zealand, in the context of the rule change request.

In the following sections, we provide a brief response to each issue raised. We note that additional research and analysis may be helpful to explore certain points, which was not possible to prepare in the short time frame available for this response. We understand that the AEMC may however consider further analysis in its broader review of options to support the timely and efficient delivery of transmission projects.

### 1.1. OVERALL OBSERVATIONS

We make three overall observations in relation to the submissions.

Firstly, the overall return earned by Transmission Network Service Providers (TNSPs) is the weighted average of the return on debt, and the return on equity, with the weight on debt being the gearing. With lower gearing, and a higher proportion of equity, the risk to equity holders is lower, and the required return on equity is correspondingly lower. However, the overall return on capital is approximately the same. As noted on our January 2021 report, this outcome was reflected in the Australian Energy Regulator's (AER) 2018 Rate of Return Instrument (RORI), which found that the allowed cost of capital was relatively invariant to changes in gearing.<sup>4</sup>

The arguments set out in TransGrid's submission are inconsistent with this fundamental relationship of corporate finance between the cost of debt, cost of equity and cost of capital. For example, in its analysis of the impact of increasing equity in the business, TransGrid states "*the additional \$400 million of required equity earns only a debt rate of return*".<sup>5</sup> This is not the correct interpretation. Additional equity will earn a new, lower, cost of equity associated with lower gearing and the associated lower risk to equity holders, and all existing equity would also earn that same lower cost of equity. The overall returns to the enterprise will be approximately the same. It is not

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<sup>1</sup> CEPA (2021), *Financeability of ISP Projects*, 27 January 2021.

<sup>2</sup> AEMC (2021), *Participant Derogation – Financeability of ISP Projects (TransGrid)*, Draft Rule Determination, 4 February 2021.

<sup>3</sup> TransGrid (2021), *Submission to AEMC draft rule determination*, 18 March 2021; ElectraNet (2021), *Submission to AEMC draft rule determination*, 18 March 2021; and Ausgrid, *Submission to AEMC draft rule determination*, 18 March 2021.

<sup>4</sup> AER (2018), *Rate of Return Instrument – Explanatory Statement*, pages 66-67.

<sup>5</sup> TransGrid (2021), page 6.

the case, as claimed by TransGrid, that a TNSP would be expected to “*earn less if it is nominated to deliver an ISP project*”.<sup>6</sup>

Secondly, TransGrid suggest that the regulatory framework imposes a duty on the regulator to ensure that TNSPs can be financed at the gearing that the AER assumes is appropriate for the benchmark efficient entity. However, such a duty has not been established under the Australian regulatory framework. The benchmark efficient entity is a concept that is used to measure the cost of capital that is appropriate for network utilities. Actual companies, with their own capital investment and cash flow profiles, are not benchmark efficient entities even if financed at the gearing of the benchmark efficient entity. There is no requirement that the capital structure of actual companies must match that of the benchmark efficient entity. The regulatory framework gives companies a responsibility to set their own capital structure to best meet the needs of their investors. This is consistent with approaches in other jurisdictions.

Thirdly, TransGrid continue to assert in their latest submission that the likely credit rating outcome for a notional entity can be reliably assessed with reference to credit opinions for actual companies with much higher gearing and other characteristics that differ from a benchmark efficient entity. They produce no evidence for this assertion. In contrast, our assessment of potential outcomes for a notional entity has sought to avoid the influence of company-specific factors. While the TNSPs continue to focus on a single metric, our analysis has considered a range of quantitative metrics and qualitative factors. This is consistent with approaches used by both rating agencies and the regulators that undertake explicit financeability assessments.

These apparent misunderstandings underpin much of the commentary in TransGrid’s submission, to which we have responded in the remainder of this document.

## **1.2. CREDIT RATING METHODOLOGIES**

### **1.2.1. TNSP comments**

TransGrid’s submission suggests that CEPA’s analysis of potential credit rating outcomes has not accurately reflected the approach taken by credit rating agencies. In particular, CEPA have considered multiple financial metrics and qualitative factors to assess potential credit rating outcomes. TransGrid consider that this is inappropriate because:

- **FFO/net debt is the main factor driving rating outcomes.** TransGrid consider that “... *FFO/net debt is the primary financial indicator that is specified as likely to trigger an upgrade or downgrade in published credit rating agency reports on Australian energy network businesses.*”<sup>7</sup> Further, “...*the statements contained in these credit rating reports are the most reliable way to predict how the credit rating of a benchmark efficient entity would be determined. To suggest anything else is speculation and not supported by any evidence provided by CEPA or the AEMC.*”<sup>8</sup>
- **Gearing, as represented by the net debt/regulated asset base (net debt/RAB) ratio, does not drive ratings outcomes in practice.** TransGrid observe that “[t]here is no Australian regulated energy network for which the net debt/RAB financial indicator has been seen as having any material impact on the credit rating of a regulated business. We note CEPA have not provided any practical evidence to support its view

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<sup>6</sup> TransGrid (2021), page 2.

<sup>7</sup> TransGrid (2021), page 4.

<sup>8</sup> TransGrid (2021), pages 4-5.

that credit rating agencies would rely on this indicator.”<sup>9</sup> Further, they note that “[t]he net debt/RAB financial indicator is not applied by Standard and Poor’s, the other main credit rating agency.”<sup>10</sup>

- **Performance on other ratios does not determine ratings outcomes.** While TransGrid “...acknowledge the performance of a benchmark efficient entity for the FFO/interest cover indicator would be stronger than the FFO/net debt indicator”, they consider that “...a benchmark efficient entity would still be held back by an insufficient FFO/net debt measure.”<sup>11</sup>

As a result, TransGrid maintains its view that “credit rating agencies would rely on the FFO/Net Debt metric when determining the credit rating of a benchmark efficient entity”.<sup>12</sup>

### **1.2.2. Our response**

We disagree with TransGrid’s assertion that guidance on TransGrid’s own FFO/net debt ratio is the most reliable way to assess the credit rating of a notional TNSP. Rather, there is sufficient evidence to conclude that this factor should not be given determinative weight when assessing outcomes for a notional company.

We expand upon the rationale presented in our report to the AEMC below, covering two key points:

- Ratings agencies and regulators consider factors other than FFO/net debt.
- Ratio guidance for actual companies should not be a binding constraint for a notional entity.

### **Ratings agencies and regulators consider factors other than FFO/net debt**

This point is evidenced by Moody’s provision of guidance on multiple metrics in credit opinions for Australian electricity networks. For example, in its most recent opinion for TransGrid, Moody’s provide guidance on appropriate thresholds for three financial ratios, net debt RAB, FFO/interest cover and FFO/net debt.<sup>13</sup> This suggests that performance against all three metrics will be considered. Similar guidance can be found in credit opinions for other regulated networks.

We appreciate that in practice the rating for an actual TNSP might well be constrained by their FFO/net debt ratio. For example, FFO/net debt may be the ratio for which actual and forecast performance is weakest, and accordingly the metric for which guidance thresholds would likely be breached first in the event of deteriorating financial performance. However, as discussed further below, we do not consider that it is appropriate to assume that guidance thresholds for actual companies create a hard constraint for a notional company.

In addition to consideration of multiple financial ratios, Moody’s also consider qualitative factors and apply judgement in determining the overall rating. For this reason, our report presented illustrative ratings outcomes for a notional company, based on Moody’s scorecard methodology, which reflects both qualitative factors and financial ratios. This analysis suggested scorecard indicated ratings of between Baa1 and A3.<sup>14</sup> As noted in our report, an actual company’s rating can differ from the scorecard-indicated outcome. However, we consider that this approach is a useful point of reference for a notional company assessment because it avoids the influence of company-specific factors (discussed further below). For example, TransGrid and ElectraNet are both currently rated one notch below their indicated scorecard rating. In both cases, this relates to exposure to unregulated revenues and

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<sup>9</sup> TransGrid (2021), page 5.

<sup>10</sup> TransGrid (2021), page 5.

<sup>11</sup> TransGrid (2021), page 5.

<sup>12</sup> TransGrid (2021), page 4.

<sup>13</sup> Moody’s (2020a), *NSW Electricity Networks Finance Pty Limited – Credit Opinion*, 7 September 2020, page 2.

<sup>14</sup> For TNSPs with projected capital expenditure equivalent to TransGrid and ElectraNet’s share of Project EnergyConnect (PEC), financed at the benchmark 60% gearing level. As noted in our report, the outcomes are subject to

the financial metrics targeted by each TNSP.<sup>15</sup> The credit opinions do not identify how much weight is placed on each of these factors. However, the reasons for this notching adjustment are not clearly relevant to a notional entity. This suggests that it is not unreasonable to have regard to unadjusted scorecard-indicated outcomes when considering potential outcomes for a notional TNSP.

Considering Moody's methodology more broadly, our understanding is that actual ratings often fall within a notch of the scorecard-indicated outcome.<sup>16</sup> While it is not based on the current ratings methodology, a 2009 analysis by Moody's indicated that over 80% of actual ratings for a sample of regulated gas and electricity networks were either consistent with, or within one notch of, the scorecard-indicated outcome.<sup>17</sup>

Finally, we note that regulators who conduct explicit financeability assessments will typically consider a range of factors, rather than drawing conclusions on the basis of a single metric. Qualified use of ratings guidance for actual companies alongside other evidence can also be seen in other regulatory contexts. For example, Ofgem's RIIO-2 framework involved an explicit financeability assessment of a notional network company. This "in-the-round" assessment considered:<sup>18</sup>

- *"financial projections from our financial model(s) as used to calculate revenues in line with these final determinations*
- *the implied Moody's methodology rating (as this is the most transparent and therefore replicable methodology of the three rating agencies)*
- *key ratios compared to stated rating agency guidance thresholds for ratings two notches above investment grade but without a hard requirement to always meet those guidance levels for every ratio, recognising the discretion that rating agencies have in applying those levels to their eventual ratings assessments*
- *the strength of other metrics and qualitative factors*
- *stress test results."*

It is important to highlight several differences between the circumstances around Ofgem's assessment and the Australian context. In particular, we note both Ofgem's duties with regard to the ability of efficient licensees to obtain finance for licensed activities<sup>19</sup>, and the licence condition for GB energy networks to maintain an investment grade rating<sup>20</sup>.

## **Ratio guidance for actual companies should not be a binding constraint for a notional entity**

As noted in our report<sup>21</sup>, caution should be applied when considering the implications of guidance on actual companies for the circumstances of a notional entity. This is because the notional and actual entities are not directly comparable, given the influence of company-specific factors on the latter. In particular:

- Actual companies may engage in unregulated activities that mean that their risk profile differs from that of a notional entity. For example, exposure to unregulated revenues was noted in Moody's most recent rating of

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<sup>15</sup> Moody's (2020b), *ElectraNet Pty Ltd – Credit Opinion*, 14 October 2020, page 9.

<sup>16</sup> Or where they do not, the reasons may not be relevant for a notional network business.

<sup>17</sup> Moody's (2009), *Regulated Electric and Gas Networks – Rating Methodology*, August 2009.

<sup>18</sup> Ofgem (2021), page 79.

<sup>19</sup> Electricity Act 1989.

<sup>20</sup> For example, see Transmission Licence Standard Conditions, Condition B10.

<sup>21</sup> CEPA (2021), page 7.

TransGrid and ElectraNet as a factor contributing to the final rating.<sup>22</sup> This factor is reflected in credit opinions for other regulated companies which engage in higher-risk unregulated activities.

- An actual company's historical track record and stated financial policies also contribute to the overall rating, as noted in the preceding section. Our reading of Moody's credit opinion for TransGrid also suggests an assumption that current net debt/RAB ratios will be maintained.<sup>23</sup> Accordingly, it is not clear that the same ratio guidance would apply to a notional company that had consistently achieved and continued to target gearing of 60%, rather than in the high end of the 80%-90% range.
- It is clear that rating agencies will also consider a range of other company-specific factors in determining the final rating, as evidenced by their comparisons to peers within the same sector. For example, Moody's has previously compared different features of TransGrid and ElectraNet's businesses, including size and customer base, to explain the relative rating of each entity.<sup>24</sup> Comparisons between Australian networks have also been made to consider the impact of ownership structures, among other factors.<sup>25</sup>
- Actual TNSPs are subject to other risks that a notional company would not face. For example, actual TNSPs may underperform their regulatory opex, capex and cost of debt allowances, whereas a notional efficient entity would by definition incur only efficient costs in providing regulated services. Expectations around over or under performance will also factor into rating agency analysis of historical and forward-looking financial outcomes.

As credit rating agencies do not rate hypothetical notional entities, we cannot say what guidance would be provided for such an entity on FFO/net debt or other ratios. However, we consider that there is evidence to indicate that such guidance could be different from that applied to actual companies. For example, we can observe that in Moody's credit opinions of regulated water utilities in the UK, there are differences in financial ratio guidance for companies with the same credit rating, reflecting their particular circumstances. We can also observe that Moody's has, at times, revised its ratio guidance for companies as their specific circumstances have evolved.<sup>26</sup>

Our analysis has not attempted to construct ratio thresholds by correcting for company-specific factors, as this would clearly involve substantial judgement. Nonetheless, we consider that it is misleading to argue that such factors are not a driver of credit ratings or guidance thresholds. Further, given the factors highlighted above, we consider that it is reasonable to expect that a notional entity would have a lower risk profile than either TransGrid or ElectraNet.

We note that issues related to the use of actual company ratings guidance have been explored in depth by the Australian Energy Regulator (AER) in previous determinations for regulated energy networks. For example, in its Final Decision on 2016-2021 access arrangements for Australian Gas Networks (AGN), the AER considered financeability analysis presented by AGN and its consultants (Incenta and NAB). Similar to the evidence presented by TransGrid and ElectraNet, AGN's analysis consisted of a comparison between projected financial ratios (FFO/net debt and FFO interest cover) and threshold values sourced from credit opinions issued for AGN. In assessing this evidence, the AER noted that:

- *"As these thresholds come from credit opinions specific to AGN, it appears that they are likely to reflect the credit ratings agencies' judgements about factors specific to AGN in its actual circumstances. This might include factors such as AGN's willingness to adopt countermeasures to preserve its credit rating in a low*

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<sup>22</sup> Moody's (2020a), page 11.

<sup>23</sup> Moody's (2020a), page 7.

<sup>24</sup> Moody's (2020a), page 9.

<sup>25</sup> Moody's (2020a), page 9.

<sup>26</sup> For example, see Moody's (2019a), *Rating Action: Moody's changes outlook on National Express Group's Baa3 rating to positive*, 6 November 2017 and Moody's (2019b), *Rating Action: Moody's reviews Thames Water and Kemble Water's ratings for downgrade*, 20 December 2019.

interest rate environment. Therefore, it is not clear that these financial metric thresholds can be generalised to a benchmark efficient entity.

- We are not persuaded that the thresholds as discussed in the credit opinions are intended to be 'bright line' thresholds. Both S&P and Moody's emphasise the role of judgement in undertaking their credit ratings. Further, the nine per cent threshold that Incenta has adopted as its threshold [for FFO/net debt] is ambiguous.

*We are not satisfied that AGN and Incenta have taken account of relevant accompanying commentary in the credit opinions from which its thresholds are sourced. This commentary appears to be relevant to the weight that credit ratings agencies would give variations in financial metrics in a low interest rate environment.*<sup>27</sup>

We note that TransGrid's submission has not directly addressed our reasons for treating FFO / net debt guidance with caution. For example, evidence that would be informative for this purpose would include whether they have engaged with ratings agencies to understand whether their ratio guidance would be affected if they reduced gearing substantially or indeed adopted the notional gearing level.

Finally, we note that TransGrid has not presented evidence to support its view of how ratings agencies would evaluate the effect of the proposed rule change, noting that it would apply to Australian networks to varying extents. This issue may not be clear cut. For example, Moody's methodology notes that in circumstances where stronger FFO/net debt performance is driven by higher regulatory depreciation allowances, it may not indicate a more robust financial position.<sup>28</sup> Given that the proposed rule change is akin to accelerated regulatory depreciation, and will not apply equally to all network investments, it could complicate comparisons of credit strength across networks.

Basing regulatory allowances on an efficient notional entity is an established principle within the Australian regulatory framework. Placing substantial weight on constraints that exist for actual companies may be inconsistent with this principle, noting that consumers would bear the costs associated with actions to address any financeability concerns that are identified on the basis of this evidence. For these reasons, we consider that there is not adequate evidence to conclude that guidance on a single financial ratio for an actual company is a reliable indicator for a notional company, as TransGrid suggest.

### **1.3. BBB- CREDIT RATING**

#### **1.3.1. TNSP comments**

TransGrid asserts that BBB- is considered to be an appropriate credit rating for a benchmark efficient entity. In particular, TransGrid states:

*"The AEMC appears to assume that it is acceptable that a benchmark efficient entity can achieve a BBB- credit rating under the regulatory framework. We challenge this assumption and request that the AEMC provide examples in other jurisdictions globally where it is regarded as acceptable for a utility business to have a BBB- credit rating."*<sup>29</sup>

#### **1.3.2. Our response**

In its 2018 determination of the cost of capital, the AER stated that *"we remain of the view that a BBB+ benchmark credit rating remains appropriate for both gas and electricity providers"*.<sup>30</sup> The benchmark credit rating is used to estimate the cost of debt for a benchmark efficient entity at the notional gearing, and weighted with the cost of

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<sup>27</sup> AER (2016), *Final Decision – Australian Gas Networks Access Arrangement 2016 to 2021 – Attachment 5 – Regulatory depreciation*, May 2016, pages 73-74.

<sup>28</sup> Moody's (2017), *Regulated Electric and Gas Networks Rating Methodology*, 16 March 2017.

<sup>29</sup> TransGrid (2021), page 5.

<sup>30</sup> AER (2018), page 279.

equity to arrive at the cost of capital estimate. The analysis contained in our report is consistent with the AER's determination.

However, it is important to distinguish between the benchmark efficient entity which is used by the AER to estimate the cost of capital, and the actual companies, TransGrid and ElectraNet. The underlying operational cash flow profile of actual companies may differ from that of the benchmark efficient entity. That means that the capital structure that is appropriate for those companies may be different from that of the benchmark efficient entity. It is possible that the credit rating of those actual companies, were they to be financed at the gearing of the benchmark efficient entity, may be different from that of the benchmark efficient entity. These differences reflect the different underlying cash flow characteristics of the companies, and the financing choices made by management.

We do not consider that there is any inconsistency between the statements made in our report and the AER's position that the benchmark efficient entity financed at the benchmark gearing has a rating of BBB+. Accordingly, TransGrid's comment does not appear to apply to our report.

#### **1.4. MATERIALITY OF THE RULE CHANGE PROPOSAL**

CEPA's report for the AEMC made several observations in relation to the materiality of the financeability challenge highlighted by the rule change proponents. Our observations differed depending on the modelling scenario that was being discussed.

In relation to the Project EnergyConnect investment scenario (for a TNSP with TransGrid's starting RAB and share of the Project EnergyConnect investment), we noted that:

*"...the difference between the rule change and no rule change cases is relatively narrow. For example, ... the scores for the leverage and coverage ratios remain substantially the same as under the no rule change case, and the rule change would not markedly affect the overall scorecard indicated outcome. We also observe that while values for the FFO/Net Debt ratio improve if the rule change were introduced, relative to the base case, performance nonetheless remains below the 9% threshold that TransGrid considers necessary for Baa1. Finally, we note that the TNSP could achieve the same FFO/Net Debt ratio as under the rule change proposal, with a relatively small change away from the notional gearing level. ... under the current regulatory framework with average gearing of 56% over the first three regulatory periods, or 57% over the entire period modelled, the TNSP could maintain FFO/Net Debt ratios consistent with those achieved under the rule change scenario."*<sup>31</sup>

In relation to scenarios with more extensive ISP investment we noted that:

*"... the overall scorecard indicated outcomes remains within a Baa1 or A3 range over the period modelled, under both the rule change and no rule change scenarios. However, we can observe that credit metrics are weaker than those indicated above for PEC. Nonetheless, given the relative strength of the gearing metric in these scenarios (assumed to remain at 60%), and the counterbalancing positive qualitative aspects, we do not consider that the evidence supports a strong conclusion that the implied credit rating for a notional company (as opposed to TransGrid, the actual entity) would necessarily fall below an investment grade level."*<sup>32</sup>

And further:

*"...it appears significantly more challenging for a notional company, financed at the benchmark efficient gearing, to achieve an investment grade credit rating at the benchmark gearing level, if it were to undertake a level of investment commensurate with the full portfolio of TransGrid's potential ISP projects."*<sup>33</sup>

TransGrid makes two observations in relation to our comments on materiality, summarised below.

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<sup>31</sup> CEPA (2021), page 26

<sup>32</sup> CEPA (2021), page 30

<sup>33</sup> CEPA (2021), page 32

### 1.4.1. TNSP comments

#### Materiality – adjusted gearing

TransGrid consider that “(perhaps due to the manner in which CEPA has presented its analysis) the AEMC has significantly understated the impact on the quantity of equity finance required if the gearing of a benchmark efficient entity was reduced by 2-5 percentage points.”<sup>34</sup>

TransGrid go on to observe that if gearing were 55% rather than 60%, a notionally financed TNSP with its Project EnergyConnect investment profile would need to raise an additional \$400m in equity. They note that with an ISP investment profile of \$6b, equity requirements would be \$1.8b higher at 55% gearing, rather than the benchmark level. Further, TransGrid note that the additional equity would earn “only a debt rate of return”.<sup>35</sup>

#### Materiality – FFO/net debt

TransGrid “disagree with CEPA’s conclusion that a 2.5 percentage point increase in the FFO/net debt ratio under our rule change request is not material”.<sup>36</sup> For example, TransGrid note that - depending on the ‘no rule change’ starting point – a one percentage point improvement in the FFO/net debt ratio could mean the difference between meeting or not meeting the 7% threshold TransGrid consider to be necessary for a Baa2 rating.

Further, TransGrid observe that:

“...when looking at the portfolio of major ISP projects, CEPA’s results suggest that, without the rule change request in place, the FFO/net debt for the benchmark efficient entity may fall as low as 4.5 percent once the range of ISP projects are considered, whereas the rule change request would see this retained in excess of 7 percent. A reduction in FFO/net debt to 4.5 percent is material. A 4.5 percent FFO/net debt would not be sufficient to achieve even a baseline investment grade credit rating of BBB–, as set out in our rule change request.”<sup>37</sup>

### 1.4.2. Our response

#### Materiality – adjusted gearing

We agree with TransGrid’s observation that if notional gearing were 55% rather than 60%, more equity would need to be raised by the notional entity. As they state, in the context of a \$2 billion investment (similar to TransGrid’s share of PEC), gearing of 55% rather than 60% would imply approximately \$400 million more equity needs to be raised. This relates to both the financing of Project EnergyConnect and adjusting the gearing of the opening RAB.

However, in assessing whether this outcome is material, we suggest that it is relevant to consider not absolute equity values (which will naturally vary with the size of a given investment or RAB), but rather whether the gearing level itself is plausible, given the available evidence.

As highlighted in our report, a gearing level of 55% is consistent with (a) the market evidence considered by the AER in its 2018 RORI analysis; (b) notional gearing levels adopted in other jurisdictions; and (c) observed gearing levels for energy networks internationally. Combined, these factors suggest that it is plausible to expect that a notional network company could modify its capital structure to achieve 55% gearing in the context of a substantial investment program.

We also note that, based on our analysis of the Project EnergyConnect scenario, a notionally-financed TNSP would not need to maintain 55% gearing in perpetuity. As cited above, our analysis indicated an average gearing level of 57% over the entire period modelled. While below the current benchmark level of 60%, this is within a long-term range that is reasonable when considered against both market evidence and regulatory precedent. Further,

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<sup>34</sup> TransGrid (2021), page 6.

<sup>35</sup> TransGrid (2021), page 6.

<sup>36</sup> TransGrid (2021), page 8.

<sup>37</sup> TransGrid (2021), page 8.

requirements to maintain a particular gearing level over the long term will also depend substantially on the assumed rate of return (among other assumptions). As noted in our report, TransGrid's analysis was not based on an internally consistent rate of return scenario.

In this context, we consider it is reasonable to describe the modelled change in gearing levels for the Project EnergyConnect scenario (from 60% to 57% on average) as modest.

## **Materiality – FFO / net debt**

TransGrid suggest we have claimed that:

- A 2.5 percentage point reduction in the FFO/net debt ratio is not material.
- In a scenario where all actionable and future ISP projects are considered, the impact on the FFO/net debt ratio is not material.

However, this does not reflect the statements presented in our report.

It is not clear what scenario TransGrid's first observation is referencing. On page 17 of our report, we note that in TransGrid's own modelling, projected FFO/net debt is 6.95% in the no rule change case and 7.73% in the rule change case, a difference of 0.8 percentage points.<sup>38</sup> In our modelling of the Project EnergyConnect scenario (pages 24 and 25), the maximum difference in FFO/net debt between the no rule change and rule change scenarios is 1.0 percentage point.

In relation to TransGrid's second observation, in scenarios with more ISP investments, we have clearly stated that the impact on the FFO/net debt ratio is more material and that a notionally financed TNSP would face significantly greater challenges in maintaining an investment grade rating.<sup>39</sup> However, we continue to consider that these scenario results should be balanced against the following factors, as noted in our report:

- There is a high level of uncertainty around the outcomes of scenarios with more extensive ISP investments, given the widespread in the cost and timing projections associated with future ISP projects.
- The analysis is also highly dependent on other assumptions, such as the assumed level of business as usual capex, future allowed rates of return, and the assumed notional gearing.

We also note that there is more time to consider alternative options, such as contestability, to facilitate the timely delivery of ISP projects other than PEC. Accordingly, the fact that a higher level of ISP investment results in a more material impact on the notionally financed TNSP's credit metrics does not improve the case for the proposed rule change, as compared to possible alternatives.

## **1.5. ALTERNATIVE FINANCING OPTIONS**

### **1.5.1. TNSP comments**

Comments made on alternative financial structures by TransGrid can be summarised as:

- **Changing the capital structure.** TransGrid states that "*the ability of a TNSP to change its capital structure in response to financeability issues that is outside of the norms of regulated energy network practice, not supported by recent case studies, and not supported by other published reports.*"

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<sup>38</sup> Referring to a scenario which includes TransGrid's existing RAB plus a notional \$2b capital investment, representing its share of Project EnergyConnect.

<sup>39</sup> CEPA (2021), page 32

- In its report on the proposed rule change for TransGrid, **Incenta** made comments on groups of investors who prefer stable dividend yields. It also set out case studies of capital raisings by APA and Eastlink. CEPA did not comment on this material in its report.
- **Hybrid securities** (a) would have higher financing costs than the cost of debt allowance (b) there is limited issuance outside banks (c) this form of finance would not be prudent or efficient as otherwise the AER would include it in its cost of debt calculation, and if it were included in the capital structure of the benchmark efficient entity would lead to higher capital costs.
- **Inflation-linked securities** (a) the market in Australia is extremely limited (b) there are no instruments to allow similar securities issued overseas to be swapped back to an Australian CPI basis (c) credit rating agencies treat the inflation escalation component of the debt principal as interest cost, as a result it can play no role in enhancing financeability. With respect to point (c), TransGrid states “CEPA’s understanding of these instruments and their treatment by rating agencies is objectively incorrect”.
- **Ausgrid** has made further comments on the analysis of inflation linked issuance in our report.

## 1.5.2. Our response

### Changing capital structures to meet financeability concerns

In our report we highlight that the suggestion that companies manage their own capital structure in response to financeability concerns is explicitly stated by the AER and is part of the regulatory approach.<sup>40</sup>

It is worth considering further whether a change in capital structure is “outside the norms of regulated energy network practice” with reference to other jurisdictions.

Some regulators make “financeability” assessments, to evaluate whether actual companies are financeable at the notional gearing used for measurement of the cost of capital. The UK energy regulator, Ofgem, does this, most recently undertaken for the 2020 RIIO-2 determinations.<sup>41</sup> The rationale for Ofgem to make such financeability assessments relates to its interpretation of its statutory duties, which are different from those of the AER. However, the principle that companies are responsible for determining a financial structure that is appropriate to their cash flows, provided that the underlying allowed return is reasonable, is embedded in the regulatory framework and referred to by Ofgem in the determination. In particular, Ofgem makes reference to a determination by the Competition Commission (CC), the then appeal body:

*The CC has encountered weak financial ratios in projections starting with companies’ actual gearing, in previous CC inquiries. Financial structure, including gearing, is a matter for companies to determine and in those cases we found that weak financial ratios did not persist when financial modelling was carried out at lower, but still reasonable, levels of gearing. We recognized that modelling on the basis of lower gearing involved the assumption that shareholders supply the finance in some form (ie inject equity). However, we recognized too that shareholders could expect to obtain the real cost of equity included in the WACC on these funds. Moreover we noted that, if shareholders were able to withdraw large sums in periods with strong cash flow, it was reasonable they should also be willing to supply finance in periods of weaker cash flow. We considered that shareholders had an incentive to supply finance as long as the overall rate of return is in line with the WACC, and that the regulatory regime has appropriate provision for situations where shareholders are unable to, or refuse to, supply finance.<sup>42</sup>*

<sup>40</sup> AER 2018. *Rate of return guideline explanatory instrument. Section 12.3.4, pages 395 – 405.*

<sup>41</sup> Ofgem (2021). *RIIO-2 Final Determinations – Finance Annex (update).*

<sup>42</sup> Competition Commission (2014). *Northern Ireland Electricity Limited price determination. A reference under Article 15 of the Electricity (Northern Ireland Order 1992).*

When regulators provide companies with the opportunity to earn their allowed rate of return on overall capital (debt and equity), it is not unusual to give companies the responsibility for managing the provision of that capital from different types of provider. As noted in our January 2021 report, it is also not unusual for regulators to make changes to the notional capital structure if this is more appropriate to a regulated company's circumstances, provided that this remains plausible given market evidence.<sup>43</sup>

There is one further element that we mentioned in our report, which relates to “structural considerations and sources of rating uplift from creditor protection”.<sup>44</sup> This is a factor which Moody's uses to “notch up” ratings from the scorecard determined rating if there are measures in place that provide effective credit protection. This would include, for example, tight restrictive covenants which restrict financial flexibility. While not a change in the measured gearing, such measures are a change in the approach to corporate finance, and is another approach that could be considered by networks, but on which no evidence has been submitted.

### **Incenta's comments on investor clienteles**

In its submission, TransGrid refers to Incenta's report as follows:

*In coming to its view, CEPA did not comment in any substantive manner to Incenta Economic Consulting's (Incenta) analysis of the ability of a TNSP to adjust its gearing down and therefore its dividend yield. As demonstrated in Incenta's report, a consistent body of academic research has observed that certain groups of investors (including super funds, pension funds and older investors) prefer stable dividend yields rather than the prospect of faster growing income streams. [...] CEPA also did not comment on the Australian case studies of APA Group Limited (APA) and Eastlink that were presented in Incenta's report. These case studies demonstrate that Australian infrastructure firms go to some lengths to accommodate the dividend expectations of their investors.*

The theory of clienteles of investors goes back to Miller and Modigliani (1961).<sup>45</sup> They suggest that dividend policy for different companies would be set such that

*Each corporation would tend to attract to itself a “clientele” consisting of those preferring its particular payout ratio, but one clientele would be as good as another in terms of the valuation it would imply for firms.*<sup>46</sup>

The paper that Incenta quotes<sup>47</sup> analyses how companies adjust payout ratios to meet the requirements of the clientele of investors. Based on this and the previous literature on the topic, Incenta suggests that there is a particular clientele that favours a particular risk / return combination and payout profile.

Incenta's suggestion that there is such a clientele is reasonable. However, it does not follow that the needs of that particular clientele must be met through a change to the regulatory framework if the investment characteristics of the company changes. Other equity investors may have a preference for the growth associated with ISP investments. Market evidence on the interest of investors in core infrastructure assets suggests that there would be interest by other investors in funding such projects.

Incenta's reference to the Eastlink and APA examples highlighted by TransGrid support the argument that equity raising may be needed to fulfil investor expectations:

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<sup>43</sup> CEPA (2021), pages 41-43.

<sup>44</sup> CEPA (2021), page 21.

<sup>45</sup> Miller, Merton H & Modigliani, Franco (1961). Dividend policy, growth, and the valuation of shares. *Journal of business*, Volume 34 (4), 411-433.

<sup>46</sup> Miller & Modigliani (1961), page 431.

<sup>47</sup> Golubov, Andrey, Meziare Lasfer & Valeria Vitkova (2020). Active catering to dividend clienteles: evidence from takeovers. *Journal of Financial Economics*.

- With Eastlink, Incenta states “out of a total raising of \$3.795 billion, including \$2.008 billion in bank debt, \$315 million was to be set aside to pay equity “coupons”, which were distributions providing a high dividend yield ahead of revenue being earned through operations.”<sup>48</sup>
- With APA, the company “facing large capex requirements APA has consistently sought large injections of capital rather than compromising the payment of dividends”.<sup>49</sup> It “undertook three separate equity capital raisings in 2011 and 2012 that raised \$965 million”, followed by a \$1.8 billion raise associated with the acquisition of the Wallumbilla Gladstone Pipeline in 2015, and an additional equity raise in 2018 (based on the chart on page 32 of Incenta’s report).

It is open to the management of both ElectraNet and TransGrid to raise additional equity to return cash back to their investors (to replicate the case of Eastlink). They can also raise equity to finance capital investment which would allow continued payment of dividends at the same time as investing, like APA. The regulatory framework does not need to change to accommodate this, it is rather the capital structure of the TNSPs that would need to change to replicate those case studies.

## Hybrid securities

The TNSPs make three main points about hybrid securities:

- That they are more costly than debt.
- That there is limited issuance outside banks.
- That the AER does not include hybrids in its determination of the capital structure for a Benchmark Efficient Entity.

We respond to each of these points below after making a general observation on approaches to financing.

### *Innovative financial structures*

TransGrid is itself an unusual financial structure. Rather than the company fully owning the transmission network and associated easements, it has a 99- year lease from 2015 with ownership retained by the state of NSW. This structure was designed to allow privatisation while meeting political commitments made by the NSW government. Consortium owners hold shares or have rights in NSW Electricity Networks Operations Holdings Trust together with NSW Electricity Network Assets Holdings Trust.<sup>50</sup>

There are other examples of special financing techniques in Australian networks. Investors in Spark Infrastructure, which has a stake in TransGrid, hold units in a trust, the Spark Infrastructure Trust, and a Loan Note issued by the Trust. These two securities are “stapled” together and can only be traded as a single “stapled security”, although for tax purposes they are treated separately. There are a few stapled securities traded on the ASX, but they are rare outside Australia. Such structures have tax advantages to particular classes of investor.

These two examples demonstrate that financial structures can be designed to meet the needs of investors or other stakeholders. Australian financial markets can innovate to enable the capital structure to meet the needs of investors and the financing of the economy.

It is in the light of the creativity of financial markets that we suggested that TNSPs might consider alternative financial structures if they are unable to determine a combination of ordinary debt and equity securities to finance

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<sup>48</sup> Incenta (2020), *Attracting capital for ISP projects*, September 2020, page 30.

<sup>49</sup> Incenta (2020), page 30.

<sup>50</sup> See [sparkinfrastructure.com/investor-centre/faqs](http://sparkinfrastructure.com/investor-centre/faqs). The diagrams of the consortium structure included in transmission licence applications (e.g. those posted on the website of the Essential Service Commission in Victoria) are more complex than this.

themselves. The above two structures have costs associated with them, which investors apparently find acceptable. This is relevant in the light of the rejection by TNSPs of other types of finance on the grounds of cost.

### ***Hybrids – more costly than debt, but lower cost than equity.***

There are a range of different types of securities that are termed “hybrids”. There can be perpetual notes with no guarantee of repayment, some give options to defer payment of dividends; there can be trigger events at which there is conversion into equity; other conversion options can be built in at the option of the investor or company. In terms of security, they are riskier than debt, have equity like characteristics, but do not benefit from the upside potential that equity investors have. Hybrids can be listed on an exchange, or unlisted.

With characteristics that sit between debt and equity, it is unsurprising that the cost of this particular type of capital is higher than debt, but lower than equity. However, issuing a hybrid does not change the cost of capital for the enterprise as a whole; rather it changes how risk and returns are allocated between investors with an interest in different parts of the capital structure. Accordingly, it follows that while issuance of a hybrid is likely to have a higher cost than debt, as it has a lower cost than standard equity, its issuance may allow returns from equity to be maintained in the context that the weighted cost of capital to the overall enterprise doesn't change.

TransGrid has represented that they are reluctant to issue equity; in this context issuance of a hybrid security should be seen as a lower cost alternative than equity, rather than a higher cost form of debt.

Hybrids are seen by credit rating agencies as a mixture between debt and equity, and for calculation of credit metrics allocated to both, with the proportions depending on the terms of the hybrid and the extent to which it is closer to debt or equity.

### ***Hybrids – sector focus?***

TransGrid states correctly that in Australia, listed hybrid issuance is dominated by banks, for which there are regulatory reasons why such intermediate securities have become attractive for issuers.

However, this does not provide evidence that issuance of a hybrid security by a corporate in a different sector would not be possible, or would be difficult. The Australian electricity network Ausnet services issued a \$650m subordinated hybrid in September 2020, following the issue of two offshore hybrids in 2016. These securities are considered as a mix of debt and equity for credit rating purposes.

Convertible bonds, one form of “hybrid” security, are actively traded in global markets. A wide range of sectors of issuing companies are represented in this market.<sup>51</sup>

### ***Hybrids – a choice for management, not the benchmark efficient entity***

The AER makes a choice about the securities that it includes in the capital structure of the benchmark efficient entity. This does not restrict companies from making choices that are different to the AER. For example, TNSPs are able to choose a gearing level that is different from that of the benchmark efficient entity. The AER's approach to calculating the cost of debt using a trailing average does not restrict actual companies from choosing to issue in bonds that have a different tenor or currency.

Thus issuance of hybrids as a part of a company's capital structure is a choice for management. The ability for actual companies to issue hybrids does not require the AER to include hybrids in the capital structure of the benchmark efficient entity, nor is issuance of hybrids by companies contingent on such a decision by the AER.

## **Inflation linked finance**

TransGrid makes the following main points about inflation-linked finance:

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<sup>51</sup> For example, see State Street Global Advisors (2020), *Convertible bond indices, an overview*. Fixed income insights, Q1 2020.

- the market in Australia is extremely limited;
- there are no instruments to allow similar securities issued overseas to be swapped back to an Australian CPI basis; and
- credit rating agencies treat the inflation escalation component of the debt principal as interest cost, and as a result it can play no role in enhancing financeability.

We respond to each of these points below.

### ***The potential for the inflation linked market in Australia***

In our report, we noted that there is limited issuance of inflation linked bonds in Australia, in common with the response by TransGrid. However, without further information, we cannot judge whether this represents a reasonable forward-looking position.

- Australian utilities, with regulatory asset values that increase with inflation, are natural issuers of this financing.
- There are investors with inflation-linked liabilities for which inflation linked bonds are a natural component of their portfolio
- Issues of inflation linked corporate bonds are dominated by UK utilities, where underlying regulatory asset values are index linked, as they are in Australia.

This does not prove that active issuance of inflation linked bonds is the best option for companies, and nor did we say that in our report. But it does indicate that there is potential for such issuance by Australian networks, and it could be actively considered. The large volume of investment in the ISP over the coming years, combined with expansion of the distribution network (e.g. in response to increased investment to accommodate distributed energy resources) could potentially support issuance and the development of an active market in such debt.

### ***Lack of availability of swaps***

In our report, we identified the use of swaps as an approach that market participants had conveyed to us as an economic way for the replication of inflation linked bonds. TransGrid argues that swap instruments are not available to allow issuance of a debt instrument overseas which would then provide the economic equivalent of inflation linked finance. Ausgrid (see below) has also indicated that swaps are not available in sufficient volumes.

In making their case for the rule change, the TNSPs did not set out any detailed evidence in support of these claims, such as the steps that they had taken to assess the market for inflation linked debt and associated instruments, or what evidence they had identified on the costs of such instruments.

In other regulated markets where RABs are indexed to inflation, such as the UK energy and water sectors, utilities actively seek inflation linked finance. As in Australia, obtaining appropriate swaps has on occasion been a challenge. However, in order to achieve the desired financing outcome, banks have actively designed, and implemented custom solutions that provide the appropriate swap instrument. For example, water companies in the UK have achieved this with the use of special purpose vehicles (SPV) as intermediaries between the utility and underlying investors. In recent transactions, the SPV has been replaced by a bank itself acting as the intermediary, reducing complexity.<sup>52</sup> The size of the transactions are comparable to the financings undertaken by Australian networks.

Detailed evidence of consideration of innovative approaches to obtaining inflation linked finance has not been provided by the TNSPs.

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<sup>52</sup> For example, see Risk publications (2019). *Risk awards 2019*.

### ***Inflation-linked finance and financeability***

TransGrid makes the observation that credit rating agencies, in calculating credit metrics, adjust the interest cost to include the accretion to the principal amount from inflation. They therefore suggest that inflation-linked finance could make no contribution to supporting financeability of electricity networks.

It is our understanding that the Moody's interest cost in its standard definition of FFO does include non-cash accrued interest, and so in this case use of inflation-linked finance does not directly affect the FFO/ Net Debt ratio. However, the impact is not clear cut, and Moody's approach is more nuanced than the definitive statements made by TransGrid suggest. The statements made in our report are not "*objectively incorrect*" as claimed by TransGrid.

For example, in the UK water and energy sectors, inflation accretion may be added back to FFO in circumstances where Moody's identifies a beneficial effect from the long-term deferral of the inflation element. We understand that such adjustments:

- May be applied in the context of long-dated debt that aligns the debt service profile with the regulatory return assumptions, and where the asset base grows by the same measure of inflation as the debt.
- Would therefore not be applied in relation to inflation accretion of short-dated swaps or where there are frequent pay-downs of accretion.

Therefore, the extent to which inflation-linked finance could improve the FFO/net debt ratio would likely depend on both the nature of the instrument and the rating agency's judgment on its effect. Short term securities are considered not to enhance credit ratings because there will still be a cash flow effect when the instrument matures. Long term securities may, however, provide credit enhancement, in particular when assets backing the debt increase in value at the same rate as the debt principal increases. For example, Moody's states that its ratios with respect to inflation-linked financing instruments will be "*calculated excluding the benefit of instruments that are not viewed as providing long-term cash flow benefit*".<sup>53</sup> It follows that instruments that do provide long-term cash flow benefit will enhance credit metrics. More recent credit opinions confirm that this treatment is still applied in practice.<sup>54</sup> At present, there is only limited inflation linked debt issued by Australian utilities. Accordingly, rating agencies have not been required to develop an appropriate approach to assessing its effects. Given that indexation of the underlying regulated assets increases the capacity of companies to generate cash flows to meet increasing debt liabilities, it is possible that similar consideration to those outlined above would arise in Australia. Evidence has not been provided by the TNSPs on discussions they may have had with rating agencies about the conditions under which long-term inflation-linked financing would receive the same treatment in Australia as it receives in the UK.

Whatever the decision of rating agencies, inflation linked finance can still contribute to financeability. As it reduces cash outflows, it increases the cash available within the business, reducing the need for equity finance. If a TNSP were to issue a hybrid security with higher interest costs, it would increase the cash available for distributions for such securities.

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<sup>53</sup> Moody's (2012) *Index-linked swaps may create risks for UK regulated utilities*.

<sup>54</sup> In Moody's (2020) *Moody's downgrades Thames Water and confirms ratings of Kemble*, Moody's note the beneficial impacts of RPI-linked swaps issued by Thames Water. The positive impact of the cash flows associated with this are seen to be credit positive relative to nominal finance. Other features of the transaction, including the linkage to RPI while assets increase in line with a different index, a mixture of RPI and CPI are seen to be credit negative.

## Ausgrid's comments on inflation linked and hybrid finance

In its submission to the AEMC, Ausgrid has commented on our analysis of inflation linked and hybrid securities. In its submission, Ausgrid states that “[a]fter making the above assertions, it is concluded by CEPA that index-linked and hybrid securities are reasonable options for network businesses”.<sup>55</sup>

Our conclusions were more nuanced than have been represented by Ausgrid in its submission. On index-linked debt we said:

*“Index-linked finance is a possible option for a company that wishes to retain higher gearing while reducing cash interest costs. The companies proposing the rule changes appear not to have explored this option before making the submission for a rule change. There may be additional costs and risks to companies from this, and we suggest that it would make sense to compare these to alternative actions, and whether this is a better option for customers than the proposed rule change. If further investigation indicates that it may be worthwhile, we suggest that consideration is given to the AER including inflation linked finance in its approach to estimating the cost of debt”.*<sup>56</sup>

On hybrid securities we said:

*“Financial market participants are creative, and securities that meet the needs of companies and investors are regularly being created. TNSPs could potentially achieve benchmark gearing in effect (i.e. in a way that ratings agencies would recognise, even if the AER in its benchmark gearing would not). While proposing a detailed design for such alternatives structures sits outside the scope of our role for this advice to the AEMC, it is relevant to note that the TNSPs do not appear to have considered them.”*<sup>57</sup>

We consider both statements to be appropriate conclusions from the analysis and consideration of available evidence on these alternative instruments.

In our report, we made statements to indicate that appropriate investors would have interest in inflation-linked securities, that swap markets could also be used to access the market, and that the lack of available issuance was one reason for lack of familiarity with the product. These statements were based on interviews that we held with a range of market participants, who made these comments on the basis that we would not quote them directly in our report. In the short time frame available for preparation of our report to the AEMC, the number of discussions that we were able to engage in was limited. However, our statements accurately reflect our conclusions from those interviews, and support the nuanced statements that we made above.

Ausgrid states that its discussions with brokers and banks lead to a different conclusion, i.e. that inflation-linked finance is not a viable option. To allow for an assessment of this evidence, and its implications for the rule change proposal, it would be helpful for Ausgrid to provide more information. For example, Ausgrid state that “we are generally unable to obtain comparable pricing for derivative instruments in any significant volume or tenor”.<sup>58</sup> It would be helpful to understand:

- The nature of the additional costs that it highlights, what volumes it could obtain and the magnitude of credit margins relative to nominal debt.
- Whether in addition to its discussions with “brokers and banks”, Ausgrid has had discussions directly with investors, and in particular investors who might have a particular interest in this type of finance.

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<sup>55</sup> Ausgrid (2021), page 3.

<sup>56</sup> CEPA (2021), page 47.

<sup>57</sup> CEPA (2021), page 48.

<sup>58</sup> Ausgrid (2021), page 3.

It is possible that Ausgrid's observations are correct. Regardless, while the market may not exist now, it could emerge over time with sufficient demand, spurred on for example by large investments such as the financing required by the ISP projects. As we noted in our report, there may be regulatory barriers to energy networks issuing inflation-linked bonds, and overcoming these could allow this form of finance to develop in the interests of networks seeking finance and investors seeking inflation protected returns. In our view, further evidence is needed before ruling this form of finance out as an option.

Ausgrid notes broader questions on financeability which it says it will raise in the context of the AER's consultation on financeability in its rate of return process. Further consideration of these points, as suggested, is sensible.

## **1.6. TRANSPOWER CASE STUDY**

As noted in our report to the AEMC, the New Zealand Commerce Commission (the Commission) currently applies an unindexed RAB approach in its price determinations for Transpower. This approach has a long history in New Zealand.

For example, prior to the establishment of the current input methodology (IM) framework, under Part 4A of the Commerce Act 1986 the Commission administered a 'targeted control regime'. Following breaches of the price path threshold set for Transpower under this framework, in 2007 the Commission reached agreement with Transpower on an administrative settlement proposal. As part of this process, the Commission reviewed Transpower's pricing proposal, including in relation to RAB indexation. In making its decision, the Commission noted that *"all other things being equal—an indexed valuation approach is generally to be preferred over an un-indexed approach, because it provides a time profile of (average) prices that is more consistent with allocatively efficiency"*.<sup>59</sup> However, the Commission also considered that *"there may be some limited circumstances where an un-indexed approach is preferable for reasons related to investment, such as when capital expenditure requirements face a significant step change in the short term"*, although given that *"cashflows are not the only source of funds that businesses have available to cover their efficient capital expenditure requirements [...] providing for increased cashflows may not be necessary even where future investment needs appear to be substantial."*<sup>60</sup> On balance, the Commission was satisfied that an unindexed RAB approach was *"an appropriate solution to help reduce Transpower's cash flow burden"*, in particular considering that *"the relative scale of Transpower's proposed investments in upgrading and renewing its services are well beyond those of any other large electricity line business"* and that *"a significant portion of Transpower's planned investment programme involves expenditures being incurred a number of years in advance of commissioning"*.<sup>61</sup> The Commission's decision does not describe the detailed evidence that it relied upon in reaching this conclusion.

In its 2010 IM determination for Transpower, the Commission considered whether the factors identified in its 2007 decision were still relevant. The Commission concluded that the reasons for adopting an unindexed approach continued to apply. In particular, they noted that Transpower was proposing to invest over NZ \$3 billion over the next five years (which would more than double the value of its RAB) and that a large proportion of this expenditure would be incurred some years in advance of commissioning.<sup>62</sup> These circumstances were considered to outweigh the protection against inflation risk provided by RAB indexation, at least in the short to medium term.<sup>63</sup> The Commission also noted that as an unindexed approach had already been implemented under the terms of the

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<sup>59</sup> Commerce Commission (2007), *Regulation of Electricity Lines Businesses - Targeted Control Regime: Draft Decisions and Reasons for Not Declaring Control & Draft Decision on Resetting Transpower's Thresholds*, 5 October 2007, paragraph 268.

<sup>60</sup> Commerce Commission (2007), paragraph 269.

<sup>61</sup> Commerce Commission (2007), paragraph 272.

<sup>62</sup> Commerce Commission (2010), *Input Methodologies (Transpower) – Reasons Paper*, December 2010, paragraph 4.3.12.

<sup>63</sup> Commerce Commission (2010), paragraph 4.3.13.

settlement agreement, changing the RAB valuation approach could incur additional compliance costs.<sup>64</sup> In its 2010 cost of capital decision, the Commission set a notional gearing assumption of 44% for Transpower.<sup>65</sup>

The unindexed RAB approach was re-assessed in the Commission's 2016 IM review, noting the 2010 decision to *"re-consider the arrangement in the future once [Transpower's] major investment tranche came to an end."*<sup>66</sup> As part of the 2016 review, the Commission considered whether it would be appropriate to either apply indexation to the RAB, or potentially make another adjustment to the revenue determination, due to the inflation risk associated with an unindexed RAB approach:

*"Our existing (un-indexed) approach for Transpower delivers ex-post nominal returns, which exposes both consumers and Transpower to the risk that out-turn inflation differs from the inflation expectation inherent in the nominal WACC used."*<sup>67</sup>

Ultimately, the Commission *"consider[ed] that the increased compliance and complexity that would be required to change the approach for Transpower do not justify the benefits in terms of protection from inflation risk."*<sup>68</sup> Further, an alternative approach to addressing inflation risk was not pursued on the basis that it *"would be an additional complication that is unlikely to result in significant benefits to suppliers or consumers in the current low inflation environment."*<sup>69</sup> Similar to the 2010 IM WACC decision, Transpower's notional gearing was set to 41%.<sup>70</sup>

Our overall observations on the Commission's approach are that:

- The Commission's decisions have clearly linked adoption of an unindexed RAB to Transpower's cash flow requirements in the context of a large capital expansion program. The Commission has also considered this factor to outweigh the benefits of an indexed approach in relation to inflation risk exposure.
- The Commission's publications do not suggest that they relied on a financeability assessment as proposed by TransGrid and ElectraNet. However, the Commission did have regard to projected capital expenditure that would have more than doubled Transpower's RAB within five years. This is a larger increase than Project EnergyConnect represents for TransGrid and ElectraNet. However, we note that it is similar in magnitude to a scenario in which all TransGrid's actionable ISP projects proceed (although we note that the timing and magnitude of these is uncertain).
- The Commission's decisions were made in the context of notional gearing assumptions that are substantially lower than that applied in the AER's 2018 Rate of Return Instrument (RORI), being 44% in 2010 and 41% in 2016. This is also relevant in assessing the implications of New Zealand regulatory precedent for the Australian context.

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<sup>64</sup> Commerce Commission (2010), paragraph 4.3.14.

<sup>65</sup> Commerce Commission (2010), paragraph X28.

<sup>66</sup> Commerce Commission (2016), *2016 Input Methodologies Review Decisions – Topic Paper 1 – Form of Control and RAB Indexation for EDBs, GPBs and Transpower*, December 2016, paragraph 307.

<sup>67</sup> Commerce Commission (2016), paragraph 308.

<sup>68</sup> Commerce Commission (2016), paragraph 316.

<sup>69</sup> Commerce Commission (2016), paragraph 319.

<sup>70</sup> Commerce Commission (2016), *2016 Input Methodologies Review Decisions – Topic Paper 4 – Cost of capital issues*, December 2016, paragraph 443.



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