Ausgrid Submission

AEMC Consultation Paper: Financeability of ISP projects

3 December 2020

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Mr Alex Oeser
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Lodged online

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Dear Mr Oeser,

Ausgrid welcomes the opportunity to comment on the AEMC's consultation paper regarding the participant derogation rule change proposals put forward by TransGrid and ElectraNet for the financeability of integrated system plan (ISP) projects.

Ausgrid owns and operates a shared electricity network that powers the homes and businesses of more than 4 million Australians living and working in an area that stretches from the Sydney CBD to the Upper Hunter. Energy networks are going through the biggest transformation in almost a century. It is critical that the right policy settings are in place for networks to support this energy transformation.

The rule change proposals from TransGrid and ElectraNet provide further evidence that the current application of the regulatory framework is putting network businesses under threat of becoming unfinanceable at the benchmark credit rating assumed within the Australian Energy Regulator's (AER) estimate of the cost of capital. This situation is not unique to TransGrid and ElectraNet and is indicative of an emerging problem in the regulatory regime that needs to be addressed.

Please refer to our submission below for further details. If you have any queries in respect of this submission, please contact Fiona McAnally on 02 9160 3730 or fiona.mcanally@ausgrid.com.au.

Yours sincerely

Rob Amphlett Lewis
Chief Customer Officer

Submission

1. Overview

The financeability issues raised in the rule change proposals by TransGrid and ElectraNet highlight the financeability problems associated with the current rate of return settings and the macroeconomic environment under the National Electricity Rules.

As correctly pointed out in the rule change proposals, the current real inflation framework back-ends recovery of capital investment, which exposes networks with a low average asset life to greater financeability pressures than those with higher asset lives (further explored in section 3 below). Despite this underlying characteristic of the regulatory framework, networks have generally remained financeable because of how other elements of the framework have been implemented, including a reasonable forecast of inflation and benchmark rate of return.

However, in recent years, industry has been expressing concerns with the application of the regulatory regime, particularly in relation to inflation compensation and reductions to the benchmark rate of return. The application of this framework has embedded the lowest equity returns of comparable regulated businesses in the world (per Table 1).[1]

Table 1: Summary of international comparator equity and debt premium

		AER	ACM	FERC	STB	ARERA	NZCC	Ofgem	Ofwat
Decision year		2020	2016	2020	2018	2019	2019	2019	2019
Nominal									
Cost of debt, excluding issuance cost	[1]	*4.76%*	*2.04%*		*4.16%*		*2.72%*		
Cost of equity	[2]	4.69%	5.02%	10.05%	13.86%		*5.87%*		
Rf	[3]	1.03%	1.28%	2.70%	3.02%		1.12%		
Equity premium	[4]	*3.66%*	*3.74%*	*7.35%*	*10.84%*		*4.75%*		
Debt premium	[5]	*3.73%*	*0.76%*		*1.14%*				
Real									
Cost of debt, excluding issuance cost	[6]	*2.49%*				*2.39%*		*1.93%*	*2.04%*
Cost of equity	[7]	*2.42%*				5.77%		4.80%	4.19%
Rf	[8]	*-1.24%*				1.89%		-0.75%	-1.39%
Equity premium	[9]	*3.66%*				*3.88%*		*5.55%*	*5.58%*
Debt premium	[10]	*3.73%*				*0.50%*		*2.68%*	*3.43%*

Notes
Non-italized numbers come from the Appendix Tables corresponding to the individual regulators.
ACM: The latest method decision was issued in 2016 for for the regulatory period 2017 - 2021, in which the ACM determines a WACC for 2016 and 2021, then interpolates the WACC for each year of the regulatory period. The ACM also determines WACC for new and existing capital separately. This table shows the WACC determined for 2021 for new capital.
ARERA: Numbers shown are for gas distribution. Risk-free rate is the 0.5% risk-free rate plus the 1.39% country risk premium.
[1]-[3];[6]-[8]: see Table 4.
[4]: [2] - [3]
[5]: [1] - [3]
[9]: [7] - [8]
[10]: [6] - [8]

Source: Brattle Group

[1] Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p 50.

This confluence of factors is bringing to the surface material financeability problems for a number of network businesses, and, without corrective action, will challenge credit ratings and ultimately risk the low cost of debt finance network customers have enjoyed for some time.

2. The issue is not driven by actual gearing

We are aware of feedback from some stakeholders that emerging financeability issues are being caused by networks' actual gearing being greater than the benchmarking gearing. While some networks' actual gearing, including Ausgrid's, is above the benchmark gearing, this cannot explain the financeability concerns noted above. The concern stems directly from the application of the current regulatory framework.

The benchmark firm remaining financeable is critical to network businesses also remaining financeable. The analysis presented by TransGrid and ElectraNet appropriately shows financeability at the benchmark gearing, not the actual gearing of each firm.

If the equity required for the hypothetical efficient firm to meet required credit metrics is substantially higher than provided for in the revenue allowance, the efficient return on equity would not be available to the additional proportion of equity. This does not satisfy the following revenue and pricing principle:

> *A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates*.[2]

As noted by the AEMC, the framework is designed to regulate the benchmark efficient entity.[3] It follows that an assessment of financeability and whether the framework is best meeting the National Electricity Objective (NEO) and the revenue and pricing principles (RPP) would be based on the outcomes delivered in the post-tax revenue models (PTRMs) for each business. The actual gearing of a particular business is irrelevant. While rating agencies base their ratings on actual cash flows of a business, it is important that the regulatory framework delivers a financeable outcome for the benchmark firm. The benchmark firm should not be dependent on outperformance or unregulated revenue streams to maintain its credit rating.

Figure 1 shows the implied FFO/Debt from Ausgrid's final determination. This is calculated from the decision PTRMs i.e. at the benchmark 60% gearing.

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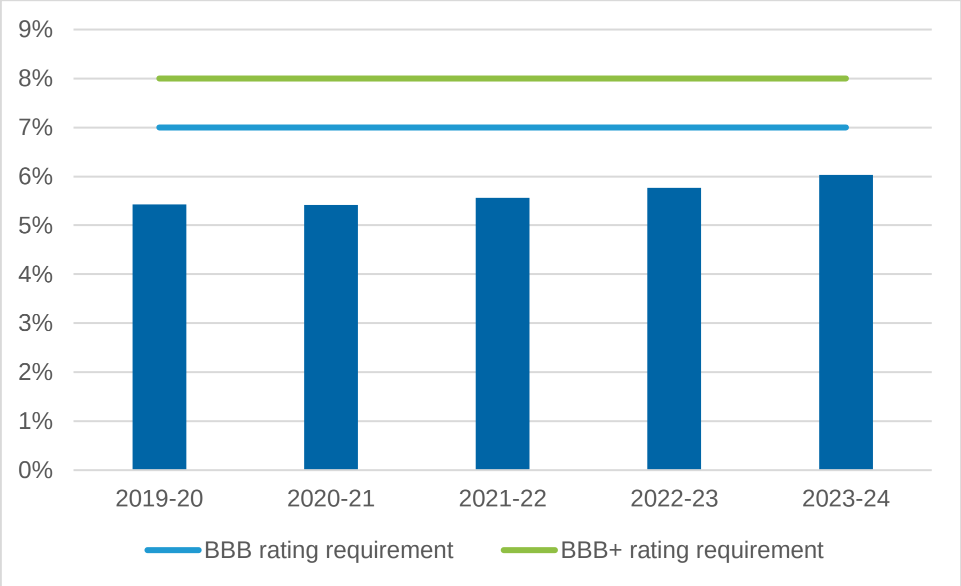
[2] National Electricity Law, section 7A(5).
[3] AEMC, Participant derogation – financeability of ISP projects, Consultation paper, 5 November 2020, p.25.

Figure 1: Implied Ausgrid FFO/Debt from FY20-24 regulatory decision*



*FFO/Debt threshold for upgrade/downgrade may vary between businesses.

It is difficult for a network business to maintain its credit rating when the regulatory allowances for the benchmark firm do not provide sufficient revenues to do so.

3. The investment recovery profile

The real rate of return framework and its application by the AER is not financeable for new investment on its own. It assumes that:

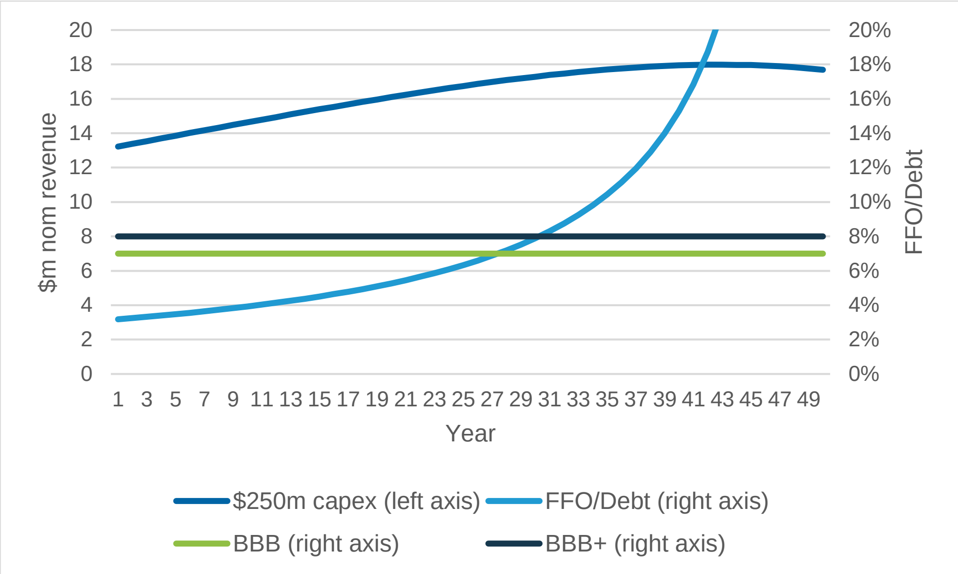
- there is an existing asset base through which return on equity can be compensated in the future through indexation, and
- a proportion of the assets are near the end of their useful lives to provide cash flow through return of asset to build new assets.

Under the existing framework, the bulk of cash revenue for new assets occurs towards the end of the asset's life, which means a younger asset base will be less able to support required credit metrics.

This can be demonstrated in the post-tax revenue model (PTRM) by starting with a zero regulated asset base (RAB) and inputting capex additions for assets with long lives. At any value of additions, the resulting implied net profit after tax (NPAT) is negative and the FFO/Debt ratio does not meet the threshold to support a BBB rating for around 30 years or a BBB+ rating for around 32 years. This is caused by the delay in return on equity which is compensated in future regulatory periods through

RAB indexation (proposed to be removed for particular projects in this rule change).[4] Businesses effectively pay customers' return of asset in the early years of a long-lived asset's life. Figure 2 shows the back-ended revenue and FFO/Debt profile for a 50-year, $250 million asset using inflation and rate of return parameters from Ausgrid's final decision.

Figure 2: Revenue and FFO/Debt for $250m capex with 50 year life*



*FFO/Debt threshold for upgrade/downgrade may vary between businesses.

TransGrid and ElectraNet are adding substantial amounts of capex to their RAB's in a relatively short timeframe, which will dramatically decrease the weighted average age of their respective RABs. This overwhelms the return of asset "cross-subsidy" from older assets to younger assets which normally maintains reasonable profitability and credit metrics for the whole asset base.

It is however important to note that financeability constraints caused by this framework are also evident in other businesses that have a relatively young asset base, and whose investments are depreciated on an as-incurred basis.

[4] This method requires indexation to be removed from revenues to avoid double counting, so depreciation is reduced by the value of RAB indexation. If the annual straight-line depreciation is less than the AER's estimated inflation rate (for example, a 50 year asset is depreciated at 2% per year and AER estimated inflation is historically around 2.5%) the return of asset is negative because the inflation deduction is more than the compensation for depreciation.

4. Options to alleviate financeability stress

Hybrid inflation framework

An extended period of low inflation has not been reflected in the inflation estimate used to remove revenue from return of asset.[5] The consequential impacts on financeability have been highlighted in submissions to the AER's inflation review, and an alternative remedy, known as a hybrid framework, was put forward.[6]

This alternative was not supported by the AER in its draft position.[7] It is possible that the hybrid could put TransGrid's and ElectraNet's ISP projects in a more financeable position and we remain of the view that this could be a reasonable change to the framework, for all businesses, to alleviate the financeability problem. We encourage the AEMC to investigate whether this alternative approach as a solution not only for Transgrid and Electranet but the wider industry. It has the advantage of maintaining real return on equity, but compensates businesses with the efficient nominal cost of debt determined by the AER. This also reduces the impact of the difference between the inflation estimate and actual inflation to both customers and equity holders.

Rate of return

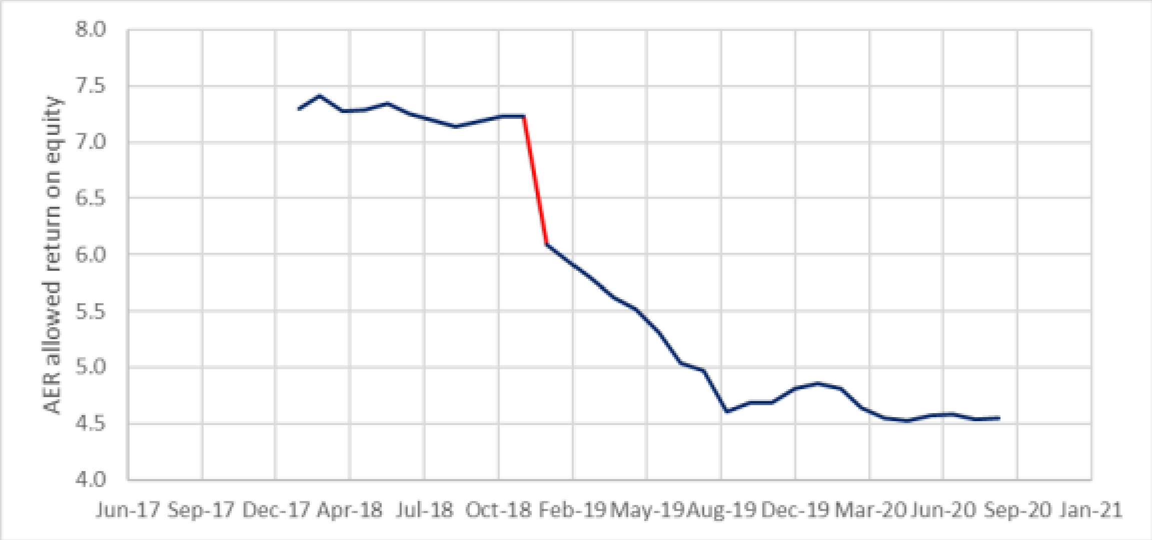
We note that rates of return are at historically low levels which is also contributing to financeability issues. In 2018 equity risk premium was reduced significantly and in combination with extraordinarily low risk-free rates we are seeing returns on equity at unsustainably low levels. Figure 3, prepared by the ENA, demonstrates this.

[5] The AER draft position in its inflation review proposes to amend the method to calculate estimated inflation, which would improve the estimate.

[6] For example: Ausgrid, Submission to discussion paper, inflation review 2020, July 2020 and ENA, A hybrid approach that has regard to market data, Response to AER review of regulatory treatment of inflation, 29 July 2020.

[7] AER, Draft position | Regulatory treatment of inflation, October 2020.

Figure 3: AER allowed nominal return on equity since 2018[8]



Source: AER decisions, RBA 10-year government bond yield data.

While this is not a matter under the AEMC's jurisdiction, it demonstrates the need for a holistic view of how the framework operates in all economic circumstances, particularly in the context of the energy transformation. In its World Energy Outlook 2020 the International Energy Agency stated:

> *There is a disparity in many countries between the spending required for smart, digital and flexible electricity networks and the revenues available to grid operators, creating a risk to the adequacy of investment under today's regulatory structures*.[9]

It is important that regulators and rule makers consider the implications and interactions of their decisions as part of a whole framework for current and future services to customers.

5. Credit ratings

The AEMC outlines the credit rating framework used by Moody's and notes that the metric focused on by TransGrid and ElectraNet, FFO/Debt, is worth 12.5% of the overall assessment. The implication appears to be that FFO/Debt on its own would not carry enough weight to result in a downgrade.

We note that significant weight is placed on the stable regulatory environment and ownership model which drives up the credit rating. However, this is generally offset by lower metrics in the leverage and coverage category which averages the overall rating somewhere in the middle. A drop in the

[8] From: ENA, Best-practice framework for setting the allowed return on equity: Response to AER's Pathway to 2022 Rate of Return Instrument: Return on Equity Working Papers, 9 October 2020, p11.

[9] International Energy Agency, World Energy Outlook 2020, p 19.

FFO/Debt value for a sustained period can result in a downgrade. FFO/Debt is regularly cited in credit reports as the key metric that influences decisions for upgrades and downgrades.[10] This is because of the perceived stability in the regulatory environment and ownership of networks, which means FFO/Debt becomes a key differentiator for credit ratings.

Conclusion

Financeability is a genuine issue in the regulated network industry. The AEMC may find that the participant derogations are sufficient to manage the financeability risks, however it is our view that there is a wider financeability problem that may have an alternative solution, and suggest the AEMC considers the hybrid framework put forward in the AER's inflation review.

[10] For example, S&P Global Ratings, Ratings on Australian Regulated Electricity Distributor Ausgrid Affirmed at BBB, Outlook Stable, 29 June 2020. While not a specific credit report, this document indicates the focus on the FFO/Debt metric by Moody's: Moody's Investor Services, Sector in-depth: Regulated electric and gas networks – cross region, 8 September 2020.


Ausgrid