

Australian Energy Market Commission  
PO Box A2449  
SYDNEY SOUTH NSW 1235

Lodged online: [www.aemc.gov.au](http://www.aemc.gov.au)

3 August 2023

### **Ensuring the Finance-ability of Actionable ISP Projects – ENA rule change proposal**

The Australian Energy Council welcomes the opportunity to make a submission to the Ensuring the Finance-ability of Actionable ISP Projects – ENA rule change proposal (**Proposal**).

The Australian Energy Council (**AEC**) is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

#### **Contestability the preferred alternative**

The AEC is strongly committed to the energy transition and the need for the timely delivery of ISP determined transmission investment. Energy Networks Australia’s (ENA) Proposal raises concerns regarding the construction of ISP projects in that incumbent Transmission Network Service Providers (TNSP) are claiming they cannot raise the necessary finance to fund construction on terms that allow them to maintain a BBB+ credit rating. The AEC has supported contestability for large ISP projects as it satisfies productive efficiency and has been successfully implemented across Victoria and in New South Wales Renewable Energy Zones. Productive efficiency as stated by the ACCC is:

*“Technical or productive efficiency, which is achieved where individual firms produce the goods and services that they offer to consumers at least cost. Competition can enhance technical efficiency by, for example, stimulating improvements in managerial performance, work practices, and the use of material inputs.”<sup>1</sup>*

Furthermore, contestability would make irrelevant repeated claims by TNSPs and the ENA of difficulties financing Integrated System Plan (ISP) projects. This rule change proposal was recently preceded by two substantively similar, but ultimately unsuccessful, proposals:

---

<sup>1</sup> <https://www.accc.gov.au/system/files/Network%20March%202017.pdf>

- 8 April 2021 - Participant derogation – financeability of ISP Projects (ElectraNet)<sup>2</sup>
- 8 April 2021 - Participant derogation – financeability of ISP Projects (TransGrid)<sup>3</sup>

Contestability would relieve incumbent TNSPs of these apparently challenging responsibilities to finance and build ISP projects by allowing others to do so. Another valuable economic outcome of contestability is that it would yield true price discovery. Nevertheless, in its Transmission Planning and Investment Review the AEMC chose not to pursue contestability and this submission will respond in that framework.

### **TNSP gearing, returns on equity and RAB multiples**

As noted in the ENA Proposal, in determining the rate of return the regulatory regime assumes a stand-alone 60 per cent geared entity that attracts a credit rating of BBB+. Prior to the 2006 review and subsequent changes to NER Chapter 6A,<sup>4</sup> the ACCC (as TNSP regulator) assumed a 60 per cent geared TNSP would attract a credit rating of A. Since then, BBB+ is the credit rating assumption. It is however still conceivable that a TSNP with 60 per cent gearing would achieve an A rating.

A profit maximizing TNSP will seek to increase its gearing well above the 60 per cent assumption and still maintain a BBB+ rating. This financing structure enables equity returns to be earned on a portion of financing costs that are only at debt rates and as such increases returns for the equity holders. A simplistic illustrative example involves ElectraNet’s recent determination, and the results are presented in Table 1.<sup>5</sup>

---

<sup>2</sup> <https://www.aemc.gov.au/rule-changes/participant-derogation-financeability-isp-projects-electranetaemc>

<sup>3</sup> <https://www.aemc.gov.au/sites/default/files/documents/erc0320 - final determination - transgrid - final.pdf>

<sup>4</sup> <https://www.aemc.gov.au/markets-reviews-advice/review-of-electricity-transmission-revenue-and-pri>

<sup>5</sup> <https://www.aer.gov.au/system/files/AER%20-%20ElectraNet%202023-28%20-%20Final%20decision%20-%20Attachment%203%20-%20Rate%20of%20return%20-%20April%202023.pdf>

Table 1: ElectraNet Final determination rate of return and 80 per cent geared scenario

	AER Final Decision		80% actual gearing scenario	
	\$M (60% gearing)	Rates (%)	\$M (80% gearing)	Rates (%)
RAB	3,854			
Equity	1,542	40%	771	20%
Debt	2,312	60%	3,083	80%
<b>Return on equity (ROE)</b>	<b>115</b>	<b>7.47%</b>	<b>82</b>	<b>10.7%</b>
Cost of debt	99	4.27%	132	4.27%
<b>Return on asset (ROA)</b>	<b>214</b>	<b>5.55%</b>	<b>214</b>	<b>5.55%</b>

The results in Table 1 can be easily replicated by changing the gearing assumption and solving for an equity return that results in same Return on Assets (ROA) as the AER's final decision. As can be seen the Return On Equity (ROE) increases by over three per cent to be 10.7 per cent and this will show in the Post Tax Revenue Model (PTRM) as the Internal Rate of Return (IRR) value. Gearing of 80 per cent has been selected because this is a plausible level to maintain a BBB+ rating which means the cost of debt rate does not need to be changed from the AER's final decision. Alternatively, at a more conservative 75 per cent gearing the resulting ROE would be 9.4 per cent. It is difficult to argue that a ROE between 9.4 and 10.7 per cent for a regulated, inflation protected, revenue capped, essential service is not attractive.

Figure 1 graphically displays the results from Table one and Figure 2 illustrates what the *required* ROE could be if the equity beta is adjusted to account for the additional leverage of 80 per cent gearing under as opposed to the assumed 60 per cent level. The *required* ROE is the ROE that is necessary to attract equity capital. As can be seen the equity beta would have to increase to greater than one to exceed a *required* ROE of 10 per cent. An equity beta of one for a defensive asset such as a TNSP is highly unlikely as one is the beta for the entire market.

Figure 1: AER 60% gearing and 80%

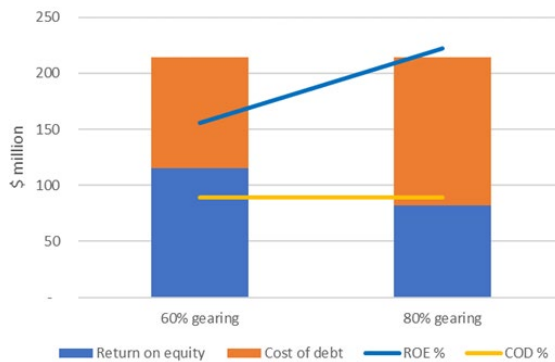
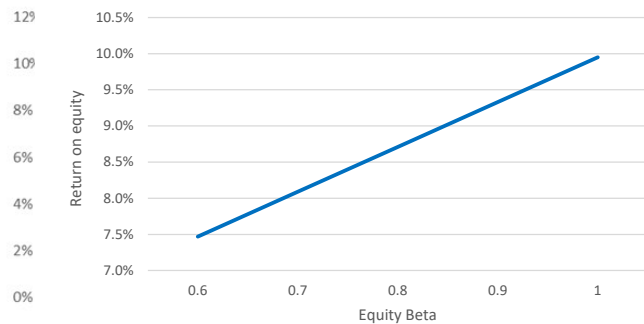


Figure 2: Required ROE increasing beta



The example above may contribute to the explanation of why TNSPs (eg, TransGrid and ElectraNet) typically transact on Regulated Asset Base (RAB) multiples of 1.5-1.65.<sup>6</sup> Furthermore, one of the equity holders in TransGrid appears to have been able to sell its 19.9 per cent stake for 1.6-1.8 times RAB.<sup>7</sup> Another recent transaction (in February 2022) was Australian Utilities Trust acquiring an additional 33.5 per cent of equity in ElectraNet for \$1.026 billion representing a RAB multiple of 1.5-1.6.<sup>8</sup>

ISP projects have been well telegraphed to TNSP investors and as such they would have factored any perceived issues regarding financing these projects into these multiples. It is not in the term interests of consumers to subsequently grant concessions to the sophisticated purchasers of these assets.

### Supportive risk reduction arrangements for TNSPs

The current arrangements for TNSPs include:

- A generous rate of return, in the AEC's view because the AER errs on the side of caution so as to render negligible the risk bankrupting an appropriately geared business.
- Returns negate inflation risk as the regulatory model is nominal and the RAB is inflated by forecast CPI in each year of the regulatory control period and then trued up for actual Consumer Price Index (CPI) at each five-yearly reset. Furthermore, The Maximum Allowed Revenue (MAR) is adjusted by CPI-X annually.
- A trailing average cost of debt is applied such that the cost of debt is updated annually to reflect prevailing interest rate market conditions and applied to 10 per cent of the RAB. A weighted average trailing cost of debt has been proposed which would further assist TNSPs but appear to have little interest in this change.
- They are on a revenue cap which means they face no volume risk. If a TNSP under recovers in year one, it is permitted to over recover in year three in neutral Net Present Value (NPV) terms based on its Weighted Average Cost of Capital (WACC).

<sup>6</sup> <https://www.afr.com/street-talk/transgrid-investors-pass-up-rights-ready-to-welcome-omers-20200401-p54fv7>

<sup>7</sup> Op.cit

<sup>8</sup> <https://hrlmorrison.com/news/australian-utilities-trust-to-acquire-an-additional-335-interest-in-electranet/>

- The product they are paid to deliver is an essential service that is completely price demand inelastic in the short run and exhibits minor elasticity in the long run.
- The Commonwealth through its Rewiring the Nation fund) is providing concessional finance at what is likely to be the Commonwealth's cost of borrowing. Although this may be unattractive to TNSPs as it is likely to limit the scope for regulated cost of debt outperformance.
- The AER is expected to be granted scope to adjust depreciation profiles if a TNSP can demonstrate this is necessary.
- Contingent project arrangements.
- The possibility of revenue cap reopeners.

The above points illustrate the favourable conditions that TNSPs face, especially when compared to competitive industries, and why they are attractive to investors.

### **The AER Post Tax Revenue Model (PTRM)**

TransGrid's 2023-2028 regulatory determination contains allowances for Humelink and Project Energy Connect (PEC) capital expenditure (capex). In the case of PEC, it is \$989 million.<sup>9</sup> and the Humelink contingent project application resulted in the MAR increasing by two per cent.<sup>10</sup>

In the PTRM, in the year when forecast net capex as incurred its real value is inflated by the square root of one plus the real WACC and is then inflated to create a nominal value. This value is then added to the RAB and in the next year it earns:

- a WACC return on asset; and
- Forecast CPI indexation<sup>11</sup>

The WACC return on asset is recovered through the MAR but indexation through the RAB value. The PTRM is fundamentally a nominal model and the RAB is indexed by forecast CPI each year. In TransGrid's case, indexation is a non-trivial amount as it totals \$1.5 billion over five years. Ignoring other factors, a TNSP that is maintaining an active gearing ratio of 80 per cent debt to RAB can increase its debt by \$1,2 billion against the increase in the RAB from indexation. Furthermore, based on a RAB multiple of 1.6, the market value of the TNSP will have increased by \$2.4 billion.

However, there are annual deductions from the RAB for nominal straight-line depreciation which in TransGrid's case totals \$2.1 billion (19 per cent of TransGrid's closing RAB). When this is factored in the adjustment to the RAB is negative \$0.9 billion or nine per cent of TransGrid's closing RAB. Active 80 per

---

<sup>9</sup> <https://www.aer.gov.au/system/files/AER%20-%20Transgrid%202023-28%20-%20Final%20Decision%20-%20Attachment%205%20Capital%20expenditure%20-%20April%202023.pdf> p12.

<sup>10</sup> <https://www.aer.gov.au/system/files/AER%20-%20Amendment%20of%20Transgrid%E2%80%99s%202023%E2%80%9328%20Revenue%20Determination%20for%20Hemelink%20Early%20Works%20Contingent%20Project%20%28Stage%201%20Part%201%29%20-%20July%202023.pdf> p6.

<sup>11</sup> Forecast capex as commissioned would also earn a return of asset through regulatory depreciation in the MAR.

cent gearing would require a reduction in debt of \$0.7 billion and the market value of the TNSP would have decreased by \$1.4 billion (at 1.6 RAB multiple). Therefore, CPI indexation reduces the impact of nominal depreciation on the RAB by 70 per cent. However, this is reflected in the MAR where regulatory depreciation (straight line depreciation less RAB indexation) is recovered.

The point being illustrated here is that the PTRM is a nominal model that maintains value in the RAB and as it grows, active gearing ensures funds through borrowing are available for distribution to equity holders which allows them to monetise the increase in value. Whereas only regulatory depreciation is recovered in the MAR. Hence, when considering actual returns to equity holders both cash flow streams need to be considered.

### **Moodys assessment of TransGrid and Powerlink's metrics<sup>12</sup>**

Moodys reported on these TNSPs in late 2020. It was for a senior secured \$3 billion medium term note program and the rating was Baa2 stable which is investment grade and corresponds with a S&P BBB rating. Moodys notes that it expects FFO/met debt to remain around seven per cent and net debt/RAB to remain in the high eighties compared to rating tolerances of 7 per cent and 90 per cent for this rating. The report goes on to state that “a rating upgrade is unlikely in the absence of deleveraging.” However, as part of the 2021 TransGrid rule change proposal, TransGrid expressed its views on changing its capital structure,

*“a TNSP to change its capital structure in response to financeability issues would represent a change that is outside of the norms of regulated energy network practice, not supported by recent case studies and not supported by other published reports.”<sup>13</sup>*

This is an unexpected statement in that it is normal for businesses to alter their leverage in response to market conditions or increased capex requirements. Indeed, Moodys suggests it as a way for TransGrid to improve its credit metrics. While TNSP capital structures may be more consistent, a recent example of substantially increasing gearing occurred in Queensland (2015) where Powerlink and the DNSPs increased their gearing levels substantially (for example over \$1 billion of debt increase for Powerlink in 2015/16).<sup>14</sup>

Furthermore, as part of its response to TransGrid's statement above, the AEMC's consultants CEPA referred to a determination by the UK Competition Commission:<sup>15</sup>

<sup>12</sup> [https://finance.yahoo.com/news/nsw-electricity-networks-finance-pty-085306727.html?guccounter=1&guce\\_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlMmNvbS8&guce\\_referrer\\_sig=AQAAAExAe4KTe5-3oCRNSfJewnJsCJ1wHO-8Mp8zxWRRXs\\_pekwnSU4uKGLp2s6y5b5456qHNX7\\_Br1O5HY\\_L2VI\\_C0z\\_TraR1U8CyAY-CJFZLoiUC9B9XS\\_kPpCMqURqETpQ90\\_VzVrF9nwyIKy\\_oHlqGuSQunZqYs04dK-aRXCLT](https://finance.yahoo.com/news/nsw-electricity-networks-finance-pty-085306727.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlMmNvbS8&guce_referrer_sig=AQAAAExAe4KTe5-3oCRNSfJewnJsCJ1wHO-8Mp8zxWRRXs_pekwnSU4uKGLp2s6y5b5456qHNX7_Br1O5HY_L2VI_C0z_TraR1U8CyAY-CJFZLoiUC9B9XS_kPpCMqURqETpQ90_VzVrF9nwyIKy_oHlqGuSQunZqYs04dK-aRXCLT)

<sup>13</sup> [https://www.aemc.gov.au/sites/default/files/documents/rule\\_change\\_submission\\_-\\_erc0320\\_erc0322\\_-\\_transgrid\\_-\\_20210318.pdf](https://www.aemc.gov.au/sites/default/files/documents/rule_change_submission_-_erc0320_erc0322_-_transgrid_-_20210318.pdf)

<sup>14</sup> <https://www.powerlink.com.au/sites/default/files/2017-12/Annual%20Report%20-%202015-16.pdf>

<sup>15</sup> [https://www.aemc.gov.au/sites/default/files/documents/cepa\\_response\\_to\\_submissions\\_-\\_final\\_report\\_7\\_april\\_2021.pdf](https://www.aemc.gov.au/sites/default/files/documents/cepa_response_to_submissions_-_final_report_7_april_2021.pdf) p13.

*“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>16</sup>*

Moodys notes some of the characteristics of TransGrid’s business:

- shortfalls in regulated revenue can be recovered under future periods within the regulated framework.
- the essential nature of the provided services,
- the low price elasticity of electricity demand,
- the diverse customer base of the group, with much of the demand underpinned by households.

Moodys acknowledges that in future, TransGrid will be undertaking large partially debt funded capex projects and raises returns over the possibility of a lower WACC at its 2023 reset because of low prevailing interest rates. However, this didn’t materialise, because in October 2020 the yield on 10-year Australian Government Bonds averaged 0.82 per cent whereas it was 3.76 per cent for TransGrid’s 2023 reset.

From this report, if TransGrid wants to achieve a BBB+ credit rating it will need to reduce its gearing from the high eighties noting again that the assumed rating is based on sixty per cent gearing. For a comparison, Powerlink which publishes financial statements has net debt/RAB of 76.5 per cent and 9.1 per cent FFO/debt.<sup>17</sup>

## Conclusion

If a TNSP chooses to gear its business beyond 80 per cent debt to RAB and possibly approach 90 per cent and then claim it needs rules to force the AER to ensure the TNSP maintains a credit rating of BBB+ through its cash flows as it undertakes ISP projects: Should consumers be required to pay for TNSP’s capital structure and purchase price decisions? The AEC believes the answer is no. However, the ENA’s Proposal is substantively arguing for this, stating that it is in the long-term interest of consumers. If the ENA’s claims

---

<sup>16</sup> Competition Commission (2014). Northern Ireland Electricity Limited price determination. A reference under Article 15 of the Electricity (Northern Ireland Order 1992)

<sup>17</sup> <https://www.powerlink.com.au/sites/default/files/2022-09/Powerlink%20Queensland%20Statement%20of%20Corporate%20Intent%202021-22.pdf>

are true then it raises the question as to whether an extremely highly geared TNSP is an appropriate business model for the transition to be achieved.

Any questions about this submission should be addressed to me directly, by email to [peter.brook@energycouncil.com.au](mailto:peter.brook@energycouncil.com.au) or by telephone on 03 9206 3103.

Yours sincerely,



Peter Brook  
**Wholesale Policy Manager**