AEMC

INFORMATION

Fact sheet: Financeability

What is financeability?

Transmission network service providers (TNSPs) fund and build capital assets, and earn income from them over their lifetime, in a similar way to owners of other long-lived assets such as toll roads.

Financeability refers to the capacity of a business to finance its investment activities. This includes investments in new and replacement capital assets.

Financeability is not an explicit part of the National Electricity Law.[1] However, financeability issues could potentially impact achievement of the National Electricity Objective (NEO) if those issues result in higher costs or lower benefits for consumers.

How is a TNSP's income from capital investments determined?

The income a TNSP earns on an asset investment is made up of two components. The first component is a depreciation allowance, earned as the value of the asset is written down over time; the second is an allowed rate of return on the (depreciated) asset value. The depreciation rates and the allowed rate of return are determined by the Australian Energy Regulator (AER).

How does a TNSP raise funds to pay for assets?

Like any business, a TNSP raises funds from debt markets (e.g. banks) and equity providers (e.g. shareholders). TNSPs are free to raise any combination of debt and equity they wish, but for the purposes of setting the allowed rate of return the AER has chosen to adopt a gearing ratio of 60 per cent,[2], which means that the AER assumes 60 per cent of a TNSP's regulated asset base (RAB) is debt funded and 40 per cent is equity funded.

Based on this level of gearing and other factors the AER adopted a benchmark credit rating of BBB+ in determining their allowed rate of return.[3] The benchmark credit rating impacts the assumed cost of debt.

What is the financeability issue that TransGrid and ElectraNet are concerned about?

TransGrid and ElectraNet say that the revenue they receive early in an asset's life isn't enough to sustain a BBB+ or similar credit rating with a 60 per cent gearing ratio for that asset. In particular the ratio of Funds From Operations divided by Debt for an ISP project falls to a level that is not consistent with a BBB+ rating.

This is an issue now because there are a number of large Integrated System Plan projects, such as the new interconnector between New South Wales and South Australia (Project EnergyConnect), that are about to be built. This means that a significant proportion of TransGrid and ElectraNet's assets will be in an early phase of their life. According to the TNSPs, in order to finance these assets, they may have to either incur higher debt costs or reduce their level of gearing and hence returns to equity. They say this, in turn, may make these assets unattractive for the TNSPs, leading to a risk that they will not be delivered.

1 Financeability is recognised in some other jurisdictions. In England, Wales and Scotland the Gas and Electricity Markets Authority (GEMA) must have regard to the need to secure that licence holders are able to finance the activities which are subject of obligations imposed - United Kingdom, Electricity Act 1989, Part 1, section 3A(2).
2 AER, Rate of return instrument, Explanatory Statement, December 2018, section 4.
3 AER, Rate of return instrument, Explanatory Statement, December 2018, section 10.

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Why are revenues low early in an asset's life?

There are two reasons that revenues are low early in an asset's life.

The first reason is that **depreciation** revenue is not currently earned for works in progress. The asset has to be commissioned before this revenue is earned.

The second reason is to do with the way that **inflation** is incorporated in returns. The regulatory framework allows for investment returns that include inflation. However, there are two ways that inflation can be included.

The first method is to simply to grow the asset base by inflation each year. This is the current arrangement.[4] The second method is to add inflation to the allowed rate of return. Either option should ultimately provide the same value of compensation to the investor, but the cash flow profiles over time are quite different.

If inflation is added to the allowed rate of return (method two) then revenues are higher early on because a higher return is applied to the asset value. Revenues then fall over time as the asset depreciates.

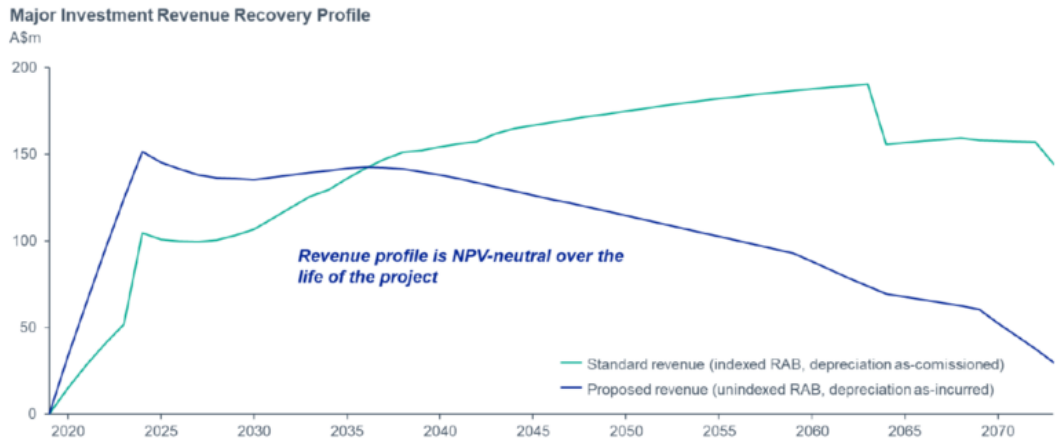
If inflation is added to the asset value each year (method one) then initial revenues are lower because of the lower rate of return, but revenues grow over time as the asset value grows by the inflation rate (less depreciation). Under this arrangement, consumers tend to pay most when the assets are delivering the most benefits.

What is being proposed?

TransGrid and ElectraNet are proposing rule changes by means of derogations to:

1. Allow depreciation on assets that are not yet commissioned; and
2. Incorporate inflation into the rate of return, instead of through growing the asset base.

TransGrid's illustration of the impact on the allowed revenue for a $2 billion project is shown below:



A joint consultation paper for both rule change requests was published on 5 November 2020. Stakeholders are invited to provide feedback on the key issues raised in that paper, or on any aspect of the proposed rule changes, by 3 December 2020.

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4 Strictly speaking the allowed rate of return also includes inflation, but this amount is netted off the allowed revenues, through an adjustment to the depreciation allowance.