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18/03/2021

Ms Anna Collyer
Chair
Australian Energy Market Commission
Level 15
60 Castlereagh Street
SYDNEY NSW 2000

Lodged online: www.aemc.gov.au

Dear Anna

Submission to AEMC draft rule determination on financeability of ISP projects derogation

We welcome the opportunity to respond to the Australian Energy Market Commission's (AEMC) draft rule determination on our Financeability of Integrated System Plan (ISP) projects rule change request participant derogation (rule change request).

We understand the AEMC's draft rule determination is to not make our rule change request.

We appreciate the AEMC working to an accelerated timeframe on the rule change request, however we are disappointed with the outcome of the draft rule determination.

We disagree with a number of the conclusions contained in the AEMC's draft rule determination, in part because of the assessment approach adopted by the AEMC, but also because of its reliance on an inaccurate understanding of capital markets by its consultant. In addition, we do not fully understand some aspects of the AEMC's draft rule determination and request that the AEMC provide further information and/or the analysis it has relied upon in coming to its draft rule determination.

Please find our detailed response to the draft rule determination attached to this letter. If you require any further information or clarification, please feel free to contact me or Neil Howes, Manager, Policy Reform Office at neil.howes@transgrid.com.au.

Yours sincerely

Eva Hanly
Executive Manager, Strategy Innovation and Technology

Financeability of ISP projects participant derogation

TransGrid submission to AEMC's draft rule determination

1. Summary

We welcome the opportunity to respond to the Australian Energy Market Commission's (**AEMC**) draft rule determination on our Financeability of Integrated System Plan (**ISP**) projects rule change request participant derogation (**rule change request**).

We understand the AEMC's draft rule determination is to not make our rule change request.

We appreciate the AEMC working to an accelerated timeframe on the rule change request, however we are disappointed with the outcome of the draft rule determination.

We disagree with a number of the conclusions contained in the AEMC's draft rule determination, in part because of the assessment approach adopted by the AEMC, but also because of its reliance on an inaccurate understanding of capital markets by its consultant. In addition, we do not fully understand some aspects of the AEMC's draft rule determination and request that the AEMC provide further information and/or the analysis it has relied upon in coming to its draft rule determination.

Concerns with the assessment approach taken by the AEMC

We have four principal concerns with the AEMC's assessment approach in making its draft rule determination:

1. The AEMC determined that the bar for making the rule change was **certainty** that the ISP projects are not financeable. We consider that this criteria of certainty has no basis under the National Electricity Objective (**NEO**) and revenue and pricing principles in the National Electricity Law (**NEL**).[1] Our view is that we have met the criteria for **credible risk**.
2. The AEMC states that there are options outside of the regulatory regime that TransGrid could use to address financeability. It is more appropriate that the AEMC assess whether the regulatory framework supports the financeability of a benchmark efficient entity.
3. The AEMC has applied its assessment by comparing the short term price impact of the ISP projects with and without the rule change. This comparison is not appropriate due to the credible risk that without the rule change the ISP projects will not proceed. The appropriate comparison is the long term impacts on price, reliability and security with and without the ISP projects – or even with or without less or delayed investment compared to the ISP projects.
4. The AEMC has placed little and insufficient weight on regulatory precedents that have occurred in other jurisdictions in making its draft rule determination. In particular, the arrangements that were established by the New Zealand Commerce Commission for Transpower, when it was faced with the same issue.

Concerns with the AEMC's draft rule determination findings:

We disagree with a number of the findings outlined in the AEMC's draft rule determination as outlined below.

> **Impact on consumer prices in the short term:** the draft rule determination asserts that "the proposed rule would result in payments for TransGrid's share of ISP projects being weighted towards the early period of an asset's life, substantially increasing costs for consumers in the near to medium term, with

[1] The revenue and pricing principles are in Section 7A of the NEL. In particular, clause 7A(2) of the NEL states that "A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in-- (a) providing direct control network services; and (b) complying with a regulatory obligation or requirement or making a regulatory payment."

lower prices later in the life of the asset". We agree that the rule change request would result in a relatively minor impact on short term transmission prices of $3 per annum in our current regulatory control period. However, the ISP projects will lower overall system costs and therefore lower the total price for electricity paid by consumers. In addition, given the expected fall in annual residential bills anticipated by the AEMC in its Residential Electricity Price Trends 2020 report, any change in the timing of transmission costs as a result of our rule change is not going to lead to 'substantial costs for consumers in the short term'. The AEMC's Residential Electricity Price Trends 2020 report sets out that annual residential bills in New South Wales are expected to decrease by 2.2 percent (or $29) from 2019-20 to 2022-23.[2] We address this in section 2.

- **Whether the credit rating agencies rely on funds from operations (FFO)/ net debt ratio:** Based on the views of Cambridge Economics Policy Associates (**CEPA**), the AEMC has stated that credit rating agencies would not predominantly rely on the FFO/net debt metric when determining the credit rating of a benchmark efficient entity. Based on our own direct, regular and ongoing discussions with the credit agencies as well as published precedent from the ratings agencies, the market advice provided by CEPA and relied on by the AEMC is inaccurate. We address this in section 3.
- **Whether a lowering of the gearing ratio of 2-5 percentage points is material:** Based on the views of CEPA, the AEMC appears to consider that a lowering of the gearing ratio by between 2-5 percentage points is not material and is a legitimate solution to the financeability issue. Unfortunately, CEPA has failed to consider what a 2-5 percentage point change in gearing ultimately means for the capital required for the incremental project - which is material. To illustrate, the 2-5 percentage points reduction in whole of entity gearing quoted by CEPA amounts to a 30-50 percent increase in the equity required to fund a $2 billion ISP project. This means that the required equity funding for such a project increases from $800m to $1.0-1.2 billion, where the additional $200-400 million of required equity earns only a debt rate of return. We address this in section 4.
- **Whether a reduction in the FFO/ net debt is material:** CEPA suggests that without the rule change request in place, the FFO/net debt ratio for the benchmark efficient entity may fall as low as 4.5 percent, once the range of ISP projects are considered, whereas with the rule change request it would remain above 7 percent. The draft rule determination asserts that the reduction of FFO/net debt of 2.5 percentage points is not material. This is incorrect. A 2.5 percentage point reduction is a 35 percent reduction in this metric which is a very material reduction in the key metric applied by ratings agencies in their credit assessment of regulated utilities such as TransGrid. 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. We address this in section 5.
- **Whether there are viable alternatives to the rule change:** The AEMC states that it is satisfied there are options available to TransGrid outside the regulatory framework to manage financeability. In coming to this view, the AEMC notes that "CEPA identifies alternative financial instruments that could lower cash interest costs such as inflation linked bonds or hybrid securities". We submit that we have already investigated these options and found that neither improve financeability. **Hybrid securities** would result in higher financing costs for the project (we note the AER does not include hybrid securities in its benchmark efficient entity because it would lead to higher prices for consumers). Further, these instruments are not generally available outside the banking sector. In regards to **inflation linked bonds**, CEPA's understanding of these instruments and their treatment by ratings agencies is objectively incorrect. Published precedent from the credit ratings agencies shows that adjustments are made in their ratio calculations to net out precisely the benefit that CEPA suggests these instruments would provide (inflation indexation of the principal amount is added into the calculation of interest for ratings purposes, so they have no positive affect on credit metrics). We address this in section 6.
- **Whether changing the capital structure is a viable option to address financeability:** CEPA suggests that the financeability issues can be addressed by a TNSP changing its capital structure. This

[2] AEMC, *Residential Electricity Price Trends 2020*, Final report, 21 December 2020, p. 9.

suggestion is inconsistent with the NEL and regulatory framework. If the efficient capital structure required to deliver ISP projects is different to that on which the efficient cost of capital is estimated, the TNSP should maintain an opportunity to recover those efficient costs. The alternative is to build in an assumption that a TNSP should expect to earn less if it is nominated to deliver an ISP project. This suggestion is outside of the norms of regulated energy network practice, not supported by recent case studies and not supported by other published reports. We address this in section 7.

Request for further analysis by the AEMC

There are two aspects of the AEMC's draft determination that we do not understand fully and given the importance of this rule change, we request that the AEMC provide examples or details of the analysis it has relied on in relation to these matters.

Specifically:

- 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 only a BBB– credit rating.
- We request that the AEMC provide the analysis that led to the statement that the rule change would "substantially increasing costs for consumers in the near to medium term, with lower prices later in the life of the asset", when considered as part of the evolving energy system, the reduction in prices from the ISP projects and the fall in overall prices the AEMC anticipates will be paid by consumers for electricity.

The remainder of this submission sets out our concerns with the draft rule determination findings in more detail.

2. Consumer price impacts of our rule change request

2.1. AEMC's view

The AEMC states that:

> *While being NPV neutral from TransGrid's perspective, the proposed rule would result in payments for TransGrid's share of ISP projects being weighted towards the early period of an asset's life, substantially increasing costs for consumers in the near to medium term, with lower prices later in the life of the asset. The proposed rule would also create an intergenerational wealth transfer between current and future customers, remove the link between the inflation component of network charges and the inflation component of the income of users of electricity and move away from the current alignment between the profile of revenues to TransGrid for its share of ISP projects with the timing of benefits to consumers in respect of these projects."*[3]

The AEMC also states that:

> *The Commission considers that the price volatility subsequently experienced by current customers attributable to these sharper increases would not be in their long term interests, particularly as it is stable prices that allow consumers to make informed decisions as to their energy spending and usage."*[4]

[3] AEMC draft rule determination, p. v.

[4] Ibid. p. 66.

2.2. Our response

It is a requirement under the NEL that the focus of the AEMC's assessment is on the long-term interests of consumers, and so the AEMC should avoid focusing on short-term price impacts.

The NEO requires the AEMC to take into account the likely investment effects of the rule change as well as its allocative impacts. That is, the economic well-being of a TNSP should be considered and promoted so that it is able to invest appropriately in the development and maintenance of the electricity network over the long term.

Against this standard, we consider that:

> The rule change request would result in a relatively minor impact on short term transmission prices.
> However, the ISP projects will lower overall system costs and therefore lower the total price for electricity paid by consumers.

In addition, given the expected fall in annual residential bills anticipated by the AEMC in its Residential Electricity Price Trends 2020 report, we consider any change in the timing of transmission costs as a result of our rule change is not going to lead to 'substantial costs for consumers in the short term'.

The AEMC's Residential Electricity Price Trends 2020 report sets out that annual residential bills in New South Wales are expected to decrease by 2.2 percent (or $29) from 2019-20 to 2022-23.[5] Any impact on transmission prices as a result of our rule change request would therefore be absorbed by expected decreases in consumer bills.

3. The impact on a benchmark efficient entity's credit rating

3.1. AEMC's view

The AEMC considers that the regulatory framework does not create a barrier for ISP investments. In coming to this decision, the AEMC does not agree with our view that credit rating agencies would predominantly rely on the FFO/net debt metric when determining the credit rating of a benchmark efficient entity.[6]

It states:

> *"In practice, rating agency assessments are more sophisticated, reflecting other financial credit metrics and a range of qualitative factors including the quality of the entirety of the regulatory framework….*
>
> *By modelling the credit scoring framework used by rating agencies using the full range of different quantitative metrics and qualitative factors, CEPA's analysis shows that a notional TNSP would be able to maintain an investment grade rating with this assumed investment profile."*[7]

3.2. Our response

We maintain our view that credit rating agencies would rely on the FFO/net debt metric when determining the credit rating of a benchmark efficient entity.

Our reason for this view is 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, as provided by us to the AEMC. We maintain that 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

[5] AEMC, Residential Electricity Price Trends 2020, Final report, 21 December 2020, p. 9.

[6] AEMC draft rule determination, pp. ii-iii; 28-29.

[7] Ibid. p. 3.

determined. To suggest anything else is speculation and not supported by any evidence provided by CEPA or the AEMC.

The CEPA report identifies net debt/RAB and FFO/interest cover as two other financial indicators that would be considered by a credit rating agency to determine the credit rating of a benchmark efficient entity. It considers a benchmark efficient entity would perform better on these indicators than under the FFO/net debt indicator.[8]

In response to CEPA's comments on specific other indicators, we note:

- There 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 that credit rating agencies would rely on this indicator.
- The net debt/RAB financial indicator is not applied by Standard and Poor's, the other main credit rating agency.
- We acknowledge the performance of a benchmark efficient entity for the FFO/interest cover indicator would be stronger than the FFO/net debt indicator. However, clear statements contained in published credit rating reports provided by us to the AEMC demonstrate that a benchmark efficient entity would still be held back by an insufficient FFO/net debt measure. Again, we note CEPA provides no evidence in support of its views in this regard.

More generally, we note that in making its draft rule determination, 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. Our research indicates that, globally, utilities generally have a BBB credit rating or above and there would be cause for concern should they fall below this. This is also supported by the median credit rating for network service providers in Australia over time as determined by the AER in its rate of return assessment which is set out in Table 1.

Table 1: Median credit rating of network service providers over time

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Industry Median	BBB+	BBB	BBB	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+

Source: AER, Rate of return annual update, December 2020, p. 19.

4. The materiality of reducing the gearing ratio by 2-5 percentage points on financeability

4.1. The AEMC's view

The AEMC agrees with our analysis that there is a negative impact on our FFO/Net debt ratio and that this negative impact would be reduced if the rule change were to be made. However, it states that:

> *"…while CEPA's analysis supports TransGrid's claim that performance against the FFO/Net Debt ratio would likely improve if the proposed rule was made, CEPA also shows that the notional*

[8] CEPA, Financeability of ISP projects, 27 January 2021, pp. 26.

entity with an investment profile consistent with TransGrid's share of ISP projects would be able to achieve a similar improvement in this ratio by using a gearing level of 55-58 per cent."[9]

It also states:

"This [the CEPA analysis] raises questions of the materiality of the rule change's effect, and consequently the significance of the financeability challenge that has been highlighted by the rule change proponents."[10]

4.2. Our view

The AEMC appears to be asserting that a lowering of the gearing ratio by between 2-5 percentage points is not material and is a solution to the financeability issue. We 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.

The significance of the change is masked by the fact that CEPA focuses on the change in gearing required for the TSNP business overall, and fails to consider what this means for the new equity required to be provided for the incremental project to proceed. This is demonstrated in the simple example in Table 2.

The example demonstrates:

> A TNSP that is geared to the benchmark 60%, and is able to continue to gear to 60 percent, then it will require another $800 million in equity to fund the notional $2 billion ISP project.

> However, if the TNSP needs to reduce its gearing by 5 percentage points after undertaking the ISP project, then in order to undertake the national $2 billion ISP project, the equity requirement will increase from $800 million to $1.2 billion, an increase of 50 percent, where the the additional $400 million of required equity earns only a debt rate of return. Such a change to the quantum of equity required is material.

The same analysis can be applied to a program of ISP projects.

Based on an existing RAB of $6 billion and an ISP program of $6 billion:

> A TNSP that is geared consistent with the AER's benchmark efficient entity will be able to borrow 60% of the funds necessary, meaning it can support $3.6 billion in new debt, leaving $2.4 billion in new equity to be required.

> However, if the TNSP needs to reduce its gearing by 5 percentage points after undertaking the ISP program, then the new equity requirement jumps from $2.4 billion to $4.2 billion, an increase of 75 percent.

Such a change to the quantum of equity required is material.

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9 AEMC draft rule determination, p. 3.

10 AEMC draft rule determination, p. 29.

Table 2: Example of the amount of additional equity required to invest in a typical ISP project if gearing is reduced to 55 percent

		Gearing consistent With BEE	58% gearing of whole business to support ISP	55% gearing of whole business to support ISP
Existing RAB	A	6,000	6,000	6,000
Debt at 60% BEE Leverage	B = A x 60%	3,600	3,600	3,600
Equity at 40% BEE Leverage	B[1] = A x 40%	2,400	2,400	2,400
ISP Project	C	2,000	2,000	2,000
New RAB	D = A+C	8,000	8,000	8,000
Assumed Leverage	E	60%	58%	55%
Total Debt	F = D x E	4,800	4,640	4,400
New debt available to fund ISP	G = F – B	1,200	1,040	800
Effective gearing of ISP Project	G/C	60%	52%	40%
Equity required to fund ISP project at BEE Leverage	H = C x 40%	800	800	800
Equity required to fund ISP project at assumed Leverage	J = C – G	800	960	1,200
Delta to BEE Equity Funding Requirement ($)	K = J – H	0	160	400
Delta to BEE Equity Funding Requirement (%)	K/H	n/a	20%	50%

Note: This example assumes that the existing RAB is $6 billion and that the ISP project is $2 billion.

5. Materiality on the financeability of ISP projects from a change in the FFO/net debt ratio

5.1. AEMC view

In coming to its view that the regulatory framework does not create a barrier for ISP investments, the AEMC notes:

> *"…CEPA's finding that the effect of the proposed rule on the ability of the notional entity to finance these projects is not likely to be material."*[11]

CEPA's results suggest that, without the rule change request in place, the FFO/net debt ratio for the benchmark efficient entity may fall as low as 4.5 percent, once the range of ISP projects are considered, whereas, with the rule change request it would remain above 7 percent.[12]

5.2. Our response

We 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.

We note that even a one percentage point change in the FFO/net debt ratio would mean a FFO/net debt ratio of around 6.5 percent for a benchmark efficient entity without our rule change request, compared to 7.5 percent with our rule change request, which would represent a 15 percent improvement in this key metric. This would directly impact a benchmark efficient entity's credit rating by enabling it to cross the 7 percent threshold between BBB- / Baa3 and BBB / Baa2.

As noted above, 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.

6. Alternative financial instruments available to manage financeability

6.1. AEMC's view

The AEMC states that "it is satisfied there are options available to TransGrid outside the regulatory framework to manage financeability".[13] In coming to this view, the AEMC notes that "CEPA identifies alternative financial instruments that could lower cash interest costs such as inflation linked bonds or hybrid securities".[14]

6.2. Our response

The AEMC should not be assessing whether there are options outside of the regulatory framework for TransGrid to manage financeability. The AEMC should be assessing whether the regulatory framework supports the financeability of a benchmark efficient entity.

Notwithstanding that important point, the alternative financing instruments proposed by CEPA that could lower cash interest costs are not feasible. Nor do they address the issue.

There is limited issuance of **hybrid securities** outside of banks and even without considering the marketability of such an instrument, the cost of this form of finance would be higher than the cost of debt allowance made for the benchmark efficient entity due to their quasi-equity nature. As such, use of this form of finance would not be prudent and efficient, otherwise the AER would already apply this in calculating the cost of debt. If this kind of finance were included in the capital structure of the benchmark efficient entity, this would lead to a higher total cost for the ISP projects relative to that resulting from our proposed rule change, which is not in the best interests of consumers.

In relation to **inflation linked bonds,** the market in Australia is also extremely limited. Furthermore, there are no instruments to allow similar securities issued overseas to be swapped back to an Australian CPI basis. The viability of large scale issuance of such securities is therefore unclear. CEPA's view is that the issuance

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11 Ibid. P. iii.

12 CEPA, Financeability of ISP projects, 27 January 2021

13 AEMC draft rule determination, Financeability of ISP Projects participant derogation, p. iv.

14 Ibid. p. iii.

of inflation linked bonds are the solution for a firm that "wishes to retain higher gearing while reducing cash interest costs" and that TNSPs should investigate this as a way of overcoming the likelihood of a credit rating downgrade under the current National Electricity Rules."[15]

However, this shows an incomplete understanding of how these instruments are treated by ratings agencies. In the UK for example, Moody's has issued guidance with respect to electricity networks whereby the interest costs attributed to these instruments in the credit rating process is adjusted upwards to add in the inflation escalation of the debt principal. In short, neither funds from operations nor interest is improved from this form of debt.[16]

Credit rating agencies are cognisant of the efforts of companies seeking to apply nonstandard financing techniques in order to circumvent credit rating metrics. As a result, credit rating agencies will either adjust their credit metric definition or adjust the target against which a standard credit metric will be applied.

In the case of UK electricity networks, guidance published by Moody's states that:

> *"For regulated networks that utilize unconventional debt funding, such as zero-coupon, capital accretion, index-linked bonds or swap arrangements, we seek to make the appropriate adjustments to the ratio calculations to improve consistency and comparability to the peer portfolio."*[17]

Similarly, Standard & Poor's has stated that:[18]

> *"Going forward, under our new methodology, our analysis will consider applying a charge for the indexation of principal for inflation-linked debt in our calculation of FFO. We believe this approach better captures the after-interest cash flow generated by the company's operations, including the full cost of the debt used to finance those operations."*

Therefore, even if an inflation linked bond was used, it would be treated by credit ratings agencies on a basis that would mean there would be no positive impact on financeability.

7. Ability of a TNSP to change capital structure to address the financeability issue

7.1. AEMC's view

In coming to its view that there are options a benchmark efficient entity could take outside of the regulatory framework to manage financeability, the AEMC also notes CEPA's view that a TNSP could reduce its actual gearing below the notional level in order to improve financial ratios.[19]

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15 CEPA, Financeability of ISP Projects, 27 January 2021.

16 Moody's Investor Service (16 March, 2017), *Rating Methodology – Regulated electric and gas networks*.

17 Moody's Investor Service (16 March, 2017), p.19, Fn 4.

18 Standard & Poor's (10 February, 2009), *Methodology And Assumptions: Recognizing The Sustainable Cash Cost Of Inflation-Linked Debt For Corporates*, p.3.

19 AEMC draft rule determination, p. iii.

7.2. Our response

CEPA's conclusions about the ability of 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.

The evidence shows that:

> The gearing levels of the Australian regulated energy network businesses have been very stable over time, when gearing is measured in a manner that focuses on the equity funds provided to the businesses, and so ignores the transitory effect on the market value of equity associated with changes in share prices.

> In Australia, the regulatory benchmark gearing of 60 percent debt to assets has been a very longstanding assumption that businesses have based decisions upon.

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.[20] Of particular relevance to the benchmark efficient entity, a recent comprehensive study by Golubov, Lasfer and Vitkova (2020) showed this observation is even more evident in Australia than in most northern hemisphere countries due to the presence of dividend imputation credits.[21]

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 APA case demonstrates that dividend policy has not been a residual that is dependent on the size of capital expenditure relative to current cash flow. Instead, APA clearly has sought to maintain the rate of dividends paid on its equity capital. For example, when undertaking the large Wallumbilla Gladstone Pipeline in 2015 APA raised new debt and equity and broadly maintained its gearing level (in fact, gearing increased slightly). The outcome was that APA maintained the rate of dividends paid on equity capital. Relevantly, the cash flow characteristics of this project permitted APA to apply its existing level of gearing to this incremental project.

> Similarly, Eastlink addressed a lack of revenue during construction of a tollway by funding the early dividends from the initial capital that was raised from investors, which enabled the dividend yield sought by its investors to commence ahead of revenue being earned through operations.

If the efficient capital structure required to deliver ISP projects is different to that on which the efficient cost of capital is estimated, the TNSP should maintain an opportunity to recover those efficient costs. The alternative is to build in an assumption that a TNSP should expect to earn less if it is nominated to deliver an ISP project. The expectation that returns for an ISP project are to be less than the return set out in the Rate of Return Instrument provides an inefficient disincentive to invest in ISP projects.

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[20] Incenta, *Attracting Capital for ISP Investments*, September 2020.

[21] Andrey Golubov, Meziane Lasfer and Valeriya Vitkova (2020), "Active catering to dividend clienteles: Evidence from takeovers," *Journal of Financial Economics*, 137, pp. 815-836.