

Financeability guideline

Final decision

November 2024

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1 Overview

The Australian Energy Regulator (AER) is the independent regulator for Australia’s national energy market. We are guided in our role by the national electricity, gas, and energy retail objectives set out in the National Electricity Rules (NER) and the National Gas Rules (NGR). These objectives focus on promoting efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers.

Australia’s electricity market is undergoing a fundamental transformation, transitioning from a reliance on coal to renewable sources of energy (mainly wind and solar) to meet State and Federal Government’s renewable energy targets. This transition will require an unprecedented level of investment in, and build of, transmission infrastructure to deliver power from renewable generation and energy storage to consumers efficiently.

On 21 March 2024 the Australian Energy Market Commission (AEMC) released its final determination on its *Accommodating financeability in the regulatory framework* rule change. This rule change is applicable to transmission network service providers (TNSPs) that are undertaking the large infrastructure projects set out in the Australian Energy Market Operator’s Integrated System Plan (ISP). These ISP projects are considered to be part of the optimal development path to transition to net zero greenhouse gas emissions by 2050. The nature of these projects mean that they generally take several years to complete, which under the current regulatory framework can give rise to cashflow issues for the TNSPs during the construction period.

The amended rules allow a TNSP to request an adjustment to bring forward cashflows related to the ISP project if it demonstrates that undertaking the project may result in issues with securing efficient financing for the investment. As a TNSP’s cashflows are determined through the AER’s process for setting total revenue requirements based on a building block approach, this is done by amending the recovery of depreciation for assets that form part of the ISP project. Providing an adjustment to cashflows through amending the timing of the recovery of depreciation allows for cashflows to be improved in the short term while not recovering more revenue from customers in the long-term. The final rule sets out a financeability test that a TNSP may apply to an ISP project and requires the AER to develop and publish a financeability guideline that provides further detail on how we would assess a TNSP’s financeability position using this test.¹

We released an explanatory statement of our proposed guideline in July 2024.² We received three submissions from stakeholders on the proposed guideline which broadly supported our proposed approach. However, some issues were raised in submissions regarding the approach for the financeability test and clarifications for the final guideline.³ We have considered these submissions in coming to the final decision and made some adjustments that we think improves the accuracy and operation of the guideline. This final decision sets

¹ AEMC, *National Electricity Amendment (Accommodating financeability in the regulatory framework) Rule 2024 No. 8*, March 2024.

² AER, *Explanatory Statement - Proposed financeability guideline*, July 2024

³ ENA, *Submission to AER Draft Financeability Guideline*, August 2024; Transgrid, *Submission to AER Proposed Financeability Guideline*, August 2024; CEFC, *Financeability guideline submission*, 4 September 2024.

out our position on the final guideline and our consideration of issues raised in submissions, in accordance with the NER.⁴ The financeability guideline accompanies this final decision, along with a financeability guideline model, which sets out our proposed approach to assessing financeability and adjustments to depreciation profiles. The rules require that a financeability guideline must always be in force. That is, we may amend the guideline, but a guideline must always be in operation.

1.1 Summary

Our final decision maintains most of the elements of our proposed guideline regarding how the financeability position of a TNSP is to be calculated and the impact that undertaking an actionable ISP has on this financeability position. The main elements that we are amending as part of the final decision are:

- scoring the financial metrics based on narrower credit notch bands in place of the broader credit bands
- using funds from operations (FFO) interest coverage ratio instead of the adjusted interest coverage ratio (AICR)
- amending the calculation of tax payable in the financeability model
- other minor amendments identified with the financeability model during consultation.

We have considered the suitability of each element of the financeability guideline on its own as well as its contribution and impact on the overall guideline's operation and purpose. We consider that the final guideline reflects the requirements of the NER, and our obligation under the National Energy Objective (NEO) to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers.

The final guideline also clarifies the relevant period over which a financeability assessment will be performed and how the guideline is expected to work in the circumstance of multiple financeability requests by the same TNSP for sequential or overlapping projects.

1.2 Next steps

This final decision is the final stage in the preparation of the financeability guideline as required by the NER. To ensure that the guideline remains fit for purpose we may amend or replace it from time to time when necessary.⁵ Section 2.2.3 and our proposed model amendment explanatory statement set out some changes to the current electricity transmission post-tax revenue model (PTRM) that we consider are required to fully implement the financeability guideline.

Consistent with the consultation processes under clauses 6A.20 of the NER we will commence formal consultation on the amendments to the PTRM to implement the required changes.⁶ Details of the changes and the invitation for written submission on the amended

⁴ NER, cl. 6A.20(e)–(f).

⁵ NER, cl. 6A.6.3A(q). This may include an update to the ratings methodology published by Moody's or any other material reason why the current guideline is no longer considered fit for purpose.

⁶ NER, cl. 6A.20(b)–(c).

model are set out in the explanatory statement.⁷ The proposed timeline for the model amendment is also set out in Table 1.

Table 1 Proposed project timeline and milestones

Date	Milestone
6 November 2024	Final financeability guideline published Proposed PTRM amendments and explanatory statement released
18 December 2024	Stakeholder submissions on proposed PTRM amendments due
3 March 2025	AER issues final decision on PTRM amendments

⁷ AER, Explanatory statement – Proposed amendments to electricity transmission post-tax revenue model (version 6), November 2024.

2 Final decision

Our final decision is informed by our consultation on the proposed guideline, the requirements of the NER, and our obligation under the NEO to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers. We consider that the changes in the final decision are in the long term interest of consumers as they better reflect the objective of the financeability test for assessing a financeability issue following such request associated with an actionable ISP project.

2.1 Financeability position calculation

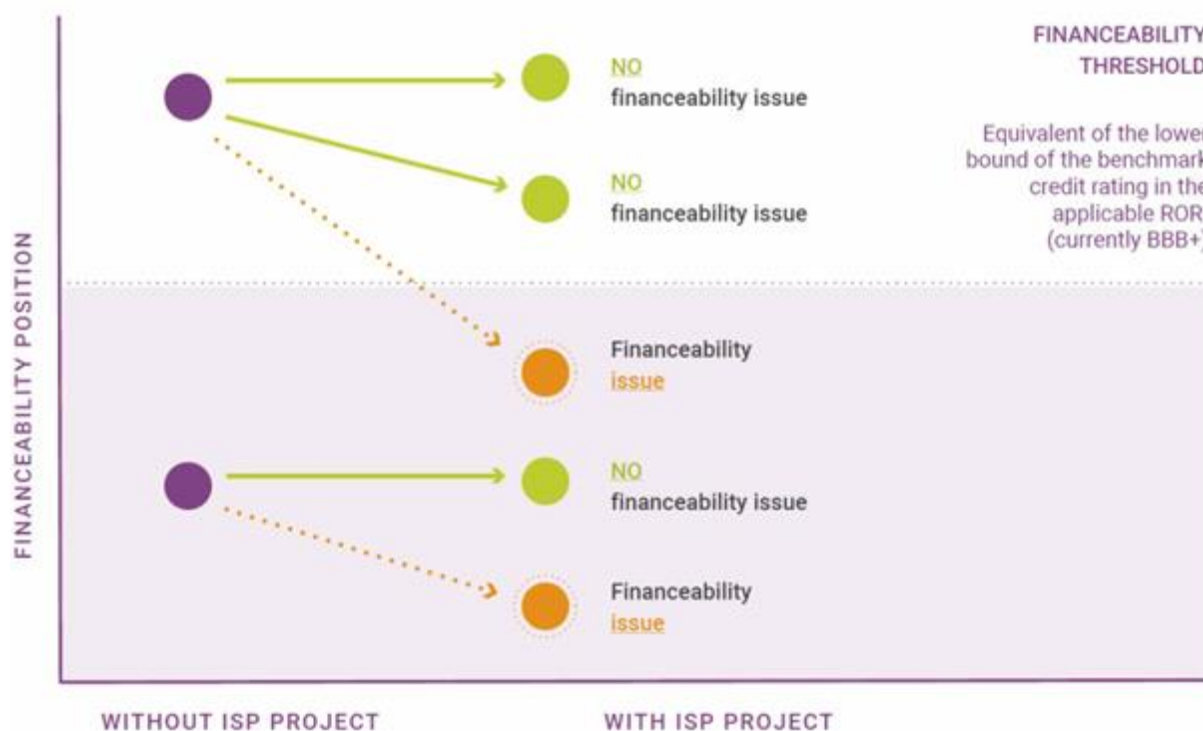
The amended rules set out a two-stage process for demonstrating whether a TNSP has a financeability issue from an actionable ISP project. First, we must determine a financeability position without the actionable ISP project using the revenues derived from the prevailing PTRM (step one).⁸ Following this we must determine the financeability position (using the same process) but including the relevant actionable ISP project cost and any adjustment to the gearing ratio agreed in a concessional finance agreement (step two). A financeability issue is determined to exist if the financeability position for the TNSP is either:

- equivalent to or higher than the financeability threshold at step one, and deteriorates below the financeability threshold following the application of step two; or
- lower than the financeability threshold at step one and deteriorates below that financeability position following the application of step two.

The financeability threshold for the purposes of this test means the benchmark credit rating used to estimate the return on debt component in the applicable *Rate of Return Instrument*. Figure 1 shows the process for demonstrating a financeability issue from the AEMC's final determination.

⁸ These revenues must reflect the benchmark gearing ratio, or the benchmark gearing ratio adjusted in accordance with any relevant concessional finance agreements.

Figure 1 Demonstration of a financeability issue – AEMC final determination



Source: AEMC, *Rule determination - Financeability of ISP projects*, March 2024, p. 21.

Following this test, we are required to adjust cashflows—primarily through an adjustment to depreciation—to ensure the TNSP’s financeability position either does not fall below the financeability threshold or does not worsen below the current level as a result of the ISP project—whichever requires the least adjustment to depreciation cashflows.

The amended rules require our guideline to set out how we will determine the financeability position of the TNSP for the purposes of the financeability test, including the basis and weighting for the selection of financial metrics used. It must also set out how the financeability position relates to the financeability threshold. Following consultation with stakeholders most elements of the calculation of the financeability position remain unchanged from the proposed guideline. The final decision also maintains the financeability threshold (a financeability position score of 8.5) in the proposed guideline. This reflects the threshold between Baa1 (equivalent to BBB+) and Baa2 (equivalent to BBB) from Moody’s ratings methodology.⁹ We discuss the elements of the final guideline that have been amended from the proposed guideline or where issues were raised in submissions in the sections below. The detailed calculations of each metric, weighting and overall financeability position is set out in the financeability guideline.

2.1.1 Narrower credit notches

The proposed guideline scored financial metrics based on broad credit bands. This is consistent with the scoring system set out in Moody’s published methodology. Submissions to the proposed guideline noted that this could result in a significant drop in metrics not being

⁹ Moody’s Investor Service, *Rating Methodology - Regulated Electric and Gas Networks*, 13 April 2022, p. 21.

identified as a financeability issue.¹⁰ For example, the FFO/net debt metric could drop from the top of the band (around 10%) to just above 5% and still be scored at the same financeability position. We have assessed various scenarios showing changes to this metric and agree that such a drop—particularly if sustained—is likely to be seen as a financeability issue to credit rating agencies and investors.

The Energy Networks Australia's (ENA) submission proposed instead to match the individual metric scores to the narrower credit notches rather than the broader credit bands.¹¹ In practice this means that the proposed bands would be split into three notches with different scores. For example, instead of any FFO/net debt value between 5–11% receiving a score of 12, this range would be split into three equal ranges. These ranges (5–7%, 7–9% and 9–11%) would score 13, 12 and 11 respectively. This means that a smaller drop in individual metrics will present as a financeability issue than under the proposed guideline. However, there is still some variation allowed in the metrics that would not be considered to demonstrate a financeability issue.

The ENA and Transgrid's submissions also suggested another potential approach which was to score individual metrics by linearly interpolating against the Moody's score.¹² This would result in any minor deterioration in metrics as demonstration of a financeability issue. We do not consider that this approach is in the long term interest of consumers or reflects the intent of the NER. Such an approach would result in actionable ISP projects that are relatively small compared to a TNSP's regulatory asset base (RAB) or usual capex program requiring adjustments to depreciation to remain financeable, while in practice they would likely pose no significant strain on the TNSP's financeability position. This is not in line with investor expectations or how credit rating agencies would see such a project impacting a TNSP's financeability. We note the ENA submitted that Moody's apply this approach in assessing ratings in other industries (e.g. Communications infrastructure and Toll roads and Real estate investments). However, it is a significant deviation from the approach published by Moody's for regulated electric and gas networks.

Our final decision applies the narrower credit notches for scoring individual metrics as shown in Table 2. We consider that this addresses the underlying issue identified with the broader credit bands while maintaining an element of allowed variance in metrics that would be unlikely to signify a financeability issue to investors and credit rating agencies.

¹⁰ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 13–16; Transgrid, *Submission to AER Proposed Financeability Guideline*, August 2024, pp. 2–3.

¹¹ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 10–13.

¹² ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 11, 19 and 25; Transgrid, *Submission to AER Proposed Financeability Guideline*, August 2024, p. 2.

Table 2 Final decision ranges for financial metric results and rating category score mapping

Rating category	Final guideline score	Previous (proposed) score	FFO interest coverage	Net debt/RAB	FFO/net debt	RCF/net debt
Weighting			25.0%	31.25%	31.25%	12.5%
Aaa	1	1	>=7.5	<30%	>=35%	>=30%
Aa1	2	3	6.83-7.5	30%-35%	32%-35%	27%-30%
Aa2	3		6.17-6.83	35%-40%	29%-32%	24%-27%
Aa3	4		5.5-6.17	40%-45%	26%-29%	21%-24%
A1	5	6	5-5.5	45%-50%	23.33%-26%	18.67%-21%
A2	6		4.5-5	50%-55%	20.67%-23.33%	16.33%-18.67%
A3	7		4-4.5	55%-60%	18%-20.67%	14%-16.33%
Baa1	8	9	3.6-4	60%-65%	15.67%-18%	11.67%-14%
Baa2	9		3.2-3.6	65%-70%	13.33%-15.67%	9.33%-11.67%
Baa3	10		2.8-3.2	70%-75%	11%-13.33%	7%-9.33%
Ba1	11	12	2.47-2.8	75%-80%	9%-11%	5%-7%
Ba2	12		2.13-2.47	80%-85%	7%-9%	3%-5%
Ba3	13		1.8-2.13	85%-90%	5%-7%	1%-3%
B1	14	15	1.57-1.8	90%-93.3%	3.33%-5%	-0.67%-1%
B2	15		1.33-1.57	93.3%-96.7%	1.67%-3.33%	-2.33%-0.67%
B3	16		1.1-1.33	96.7%-100%	0%-1.67%	-4% - -2.33%
Caa1	17	18	0.73-1.1	100%-103.3%	-1.67%-0%	-5.67% - -4%
Caa2	18		0.37-0.73	103.3%-106.7%	-3.33% - -1.67%	-7.33% - -5.67%
Caa3	19		<0.37	>=106.7%	<-3.33%	<-7.33%

Source: Moody's Investor Service, *Rating Methodology - Regulated Electric and Gas Networks*, 13 April 2022, pp. 4–8, 20.

Note: FFO = funds from operations; RCF = retained cash flows.

2.1.2 Use of averaging

The proposed guideline used a 3-year forward average of individual metrics to calculate the financeability position score for a TNSP. The ENA's submission suggested that the use of 3-year forward averages may mask financeability problems in individual years.¹³ It submitted that each metric should be assessed on an annual basis, rather than using a 3-year forward averaging approach to ensure that any financeability issues in particular years are identified clearly.

The use of a 3-year forward average has two related advantages than assessing metrics on an annual basis. Firstly, it is an acknowledgement that credit ratings agencies are unlikely to downgrade a company's credit rating for a single year transient event impacting a metric that is expected to recover over the medium-term. The Clean Energy Finance Corporation

¹³ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 13–16.

(CEFC) also noted this in its submission to the proposed guideline. It submitted that that while it agreed that some rating agencies in the Australian market may undertake a year-on-year assessment of financeability metrics, rating agencies are often willing to look through a single year, once-off event when making decisions on changes to credit ratings.¹⁴

Secondly, using a 3-year forward average also enables a drop in metrics in a year where allowed revenues are already set—but where significant capex is expected to be incurred—to be addressed through an offsetting increase to revenue recovery in the following years, while an annual assessment would leave this unaddressed.

As an illustration of the second issue, take a contingent project application (CPA) that is lodged in the final three months of a regulatory year. In this case the allowed revenues and prices for the following regulatory year are already set.¹⁵ If the CPA includes significant forecast capex for the following regulatory year and this results in a dip in metrics for that year, there is no means to bring forward cashflows to solve that issue. The assumed cash inflows (revenues) are set for that year, while the cash outflows (namely capex) are increasing. Bringing forward depreciation—even in an extreme way such as depreciating all capex in one year—will not change the revenue inflow for that year, only future revenues. This means that under an annual assessment approach there will still be an identified financeability issue. Using a forward average allows the issue to be addressed by increasing metrics in the following years to offset the financeability issue identified in that year. However, this option is unavailable under an annual assessment approach which would lead to a demonstrated financeability issue being unaddressed in the year where revenue has already been set.

This can be shown in the worked example released alongside the proposed guideline. In this worked example there were capex inputs for years 1–3 of the regulatory control period and that annual pricing had only been completed for year 1. As such, allowed revenues were able to be adjusted for years 2–5. If year 2 revenues have already been set at the time of the CPA then the financeability situation changes, because allowed revenue is a key input to FFO (allowed revenue, less opex, interest and tax payments). Figure 2 shows the FFO/net debt value that would be calculated using an annual assessment in the financeability test. It shows that on an annual basis FFO/net debt (black dash line) deteriorates well below the base case for year 2 (11.2% to 9.74%). This is because FFO is mostly unchanged (due to revenue being set), while net debt increases due to the capex expected to be incurred in years 1 and 2.¹⁶

Under the final decision’s narrower credit notches approach, this would show a deterioration of one notch and may indicate a financeability issue. Even applying a relatively extreme adjustment to solve this issue by depreciating all project capex incurred in the first year (\$250 million) in a single year and resmoothing revenues from year 3 (the earliest year possible to recover extra revenue), this adjustment would be insufficient to solve the issue identified under the annual assessment. This is illustrated in Figure 2 where the adjusted FFO/net debt (orange dash line) remains relatively unchanged in year 2 under the scenario described

¹⁴ CEFC, *Financeability guideline submission*, 4 September 2024, pp. 3–4.

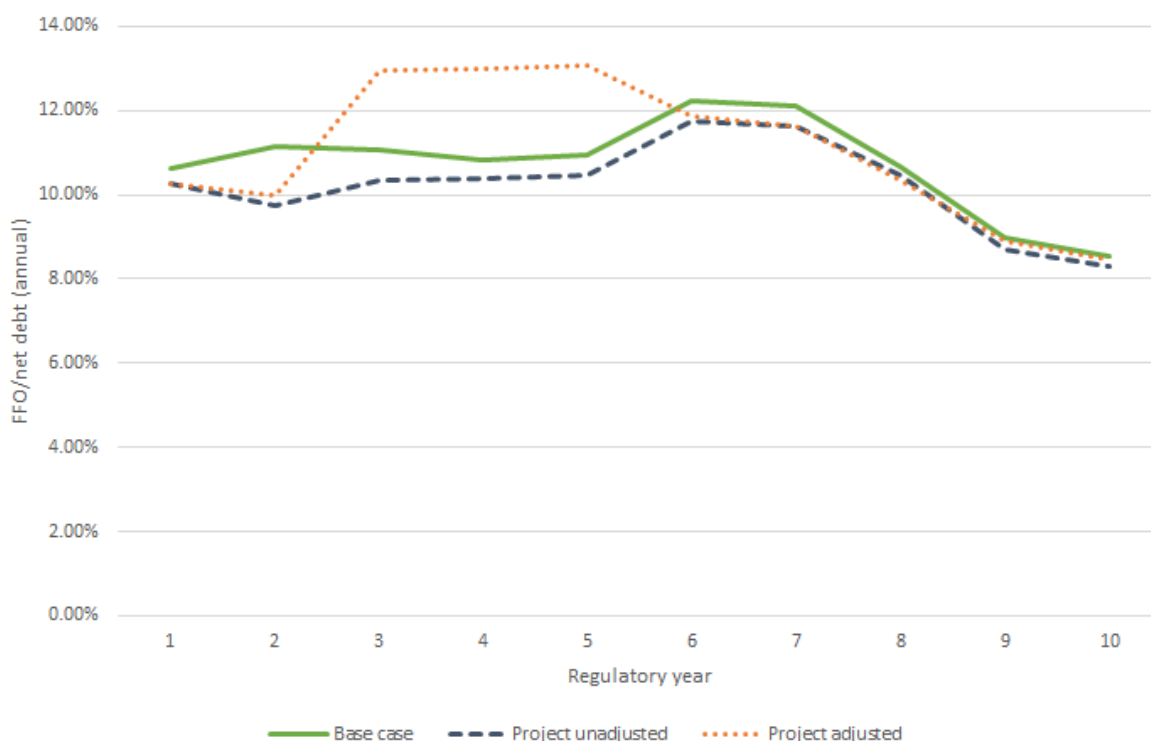
¹⁵ Annual network pricing is generally completed 3 months prior to the end of a regulatory year. This includes the setting of DPPC charges for the following year from which transmission revenue is recovered.

¹⁶ This is also assuming no concessional finance for simplicity.

above, and still well below the base case. A financeability test based on an annual assessment would consider this financeability issue as not mathematically possible to solve and would focus on simply solving issues that were identified in subsequent years. Likewise, the FFO/net debt for the following years (3–5) have improved beyond the base case and would likely be considered too large of an adjustment if considered on an annual basis.

Using the forward averaging approach means that the deterioration in year 2 is able to be offset by improvements in the metric in subsequent years, addressing the overall financeability issue demonstrated with the project.¹⁷ An expected rebound in metrics like this would be a consideration of ratings agencies when assessing the financeability of this project, and should similarly be considered in assessing the financeability position under the guideline.

Figure 2 Annual FFO/net debt metric of proposed guideline worked example assuming revenue for year 2 is already set at time of proposal



Source: AER analysis.

As noted in the ENA’s submission, the use of a forward average may highlight financeability issues in years where the TNSP does not incur any capex for the proposed ISP project. We agree that this is a possibility, but on balance we consider that having the flexibility to solve a financeability issue by improving cashflows in the years following a project’s capex phase is better than leaving this issue as unable to be addressed through the regulatory framework. We consider that ensuring that a demonstrable financeability issue is not left mathematically unsolvable is in the long term interest of consumers to promote efficient investment in the network and consistent with the final rule change. This is also consistent with our

¹⁷ In this extreme example the overall financeability position is still improved beyond the base case. As such less depreciation would be brought forward to address this particular issue, but more than under a purely annual assessment.

understanding of rating agencies actual practice for the sector. We are aware of cases where the key metric under pressure is expected to fall below the current rating tolerance level over the forward two years, while the overall outlook for the business still remains stable. This appears, in part due to the expected recovery in metrics after this period.

The CEFC's submission also raised the potential issue of volatility in prices and revenues if metrics are assessed and addressed on an annual basis.¹⁸ It noted that because under a year-by-year financeability assessment any single year deterioration must be addressed in that year, which may drive volatile outcomes. Based on our assessment of the material before us, we agree that the move to an annual assessment of financeability metrics would lead to a more volatile revenue recovery, and in some cases lead to years where a demonstrable financeability issue is unable to be addressed.

Our analysis of current TNSP revenue determinations also suggests that—when combined with the use of narrower credit notches to score metrics—applying a 3-year forward average does not have significant impact on whether a project of a given size demonstrates a financeability issue or not. In other words, if a project shows a financeability issue in at least one year under the annual assessment approach, in almost all cases it will also show a financeability issue for at least one year using the 3-year forward average approach. However, the use of a 3-year forward average does impact the specific years in which a financeability issue is identified as well as the ability to address the issue identified. For example, under an annual assessment a financeability issue may be demonstrated in years 1 and 2, and cashflows must be brought forward to those years to address the issue. Meanwhile, under the 3-year forward average the same project will still generally demonstrate a financeability issue, but in years 2 and 3 instead. The forward averaging approach also then allows the financeability issue to be addressed by improving cashflows in these years, or in subsequent years (years 4–5).

We also performed similar analysis using a shorter 2-year forward average. Similarly, this approach did not materially impact whether a project would demonstrate a financeability issue or not. However, it limits the flexibility of making a depreciation adjustment because of the reduced available years where cashflows can be adjusted to appropriately be address the issue. It also increases the likelihood of potential volatility of revenue and prices from the adjustment required to address the issue.

We consider that when assessing this issue along with the other aspects of the final financeability guideline package that the 3-year forward average approach should be maintained. This approach ensures that a project with a demonstrated financeability issue is able to be provided an adjustment to depreciation, while having regard to the volatility to revenue and prices that consumers face. We are satisfied that this will promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers in accordance with the NEO.

2.1.3 FFO interest coverage

The proposed guideline used the Adjusted Interest Coverage Ratio (AICR) as a measure of the ability of a network to service the interest costs on its existing obligations to creditors. AICR is a variation on the FFO interest coverage ratio but eliminates the effect of regulatory

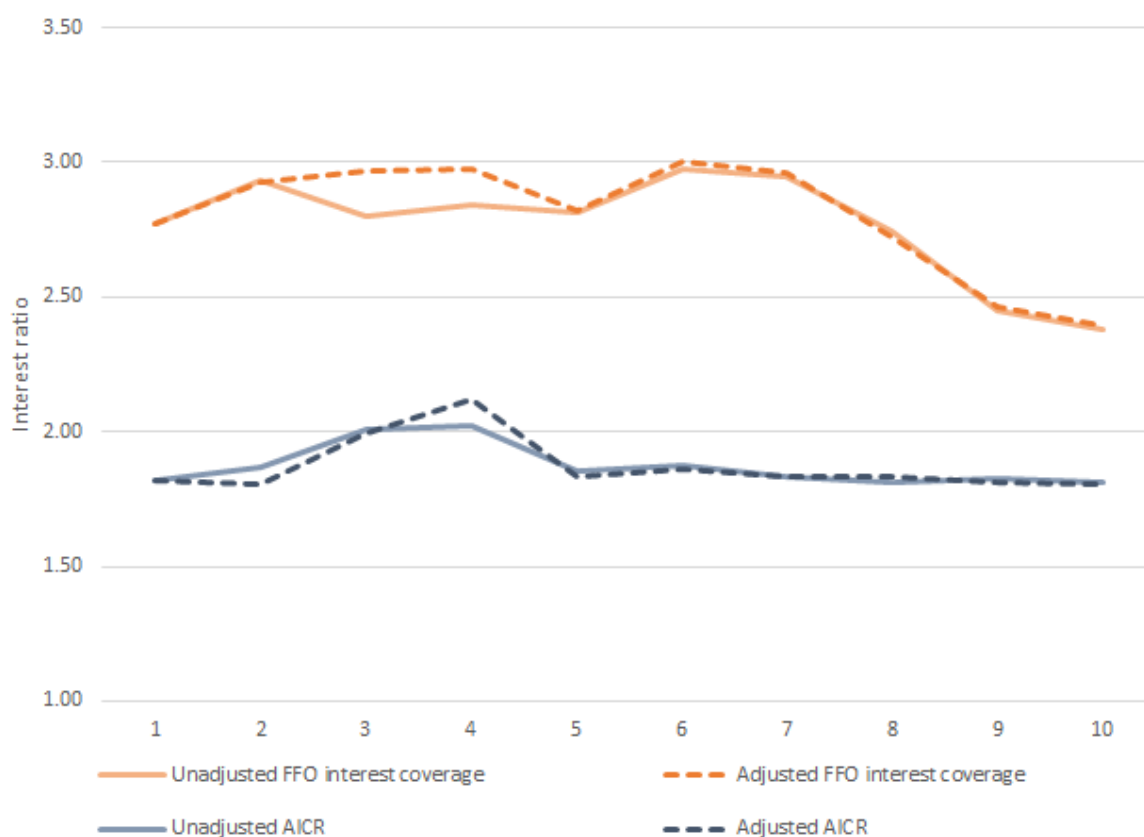
¹⁸ CEFC, *Financeability guideline submission*, 4 September 2024, pp. 3–4.

depreciation's contribution to the calculation of FFO. Moody's global methodology notes that in assessing networks regulated under a building block framework like the NER which applies to TNSPs it generally uses the AICR rather than straight FFO interest coverage. However, our understanding of Moody's actual application in the Australian context is that it tends to put more weight on straight FFO interest coverage.

In the context of the financeability guideline, the use of the AICR metric leads to outcomes that can make the financeability adjustment unworkable in some circumstances. This is particularly the case where depreciation of a long-lived asset has been reallocated to a single year or short-lived asset class. Due to the interaction between revenue smoothing and underlying depreciation building block not perfectly matching there may be cases where the more depreciation that is brought forward, the worse the AICR metric becomes. This may lead to a situation where one metric (e.g. FFO/net debt) is forecast to deteriorate as a result of an actionable ISP project, but in solving this problem by bringing forward depreciation the AICR metric deteriorates—even though straight FFO interest coverage improves. As such, we may end up in a circular problem that is unable to be addressed by accelerating depreciation.

This issue can be illustrated in the worked example from the proposed guideline. As shown in Figure 3, the AICR deteriorates below the unadjusted case in years 2 and 3 after an adjustment to bring forward depreciation before improving in year 4 and then dropping again in year 5. FFO interest coverage on the other hand, experiences an overall improvement from the accelerated depreciation during the construction stage of the project and is relatively unchanged after.

Figure 3 Impact of accelerated depreciation on FFO interest coverage and adjusted interest coverage ratio (AICR)



Source: AER analysis.

We note that while Moody’s methodology refers to its use of AICR for this portion of the scorecard for networks regulated under framework like the NER, in practice we understand that FFO interest coverage is the metric Moody’s applies in the Australian context when assessing financeability. This also mirrors the rule change request from the ENA which proposed to include a financeability formula into the NER—also based on Moody’s methodology—that used FFO interest coverage ratio for this element of the formula rather than AICR.¹⁹ Further consultation with stakeholders following release of the proposed guideline did not raise any issues with this change for the final decision.

In reality while there are many tools available to businesses to improve metrics and financeability, for the financeability guideline we are limited to addressing any financeability issues mainly through an adjustment to depreciation profiles. Having regard to material put forward in submissions as well as the context and purpose of the financeability guideline, on balance we consider that FFO interest coverage should be used in the calculation of a TNSP’s financeability position instead of AICR.

2.1.4 RCF/net debt

The CEFC’s submission noted that a deterioration in the RCF/net debt metric can in some circumstances require a significant amount of revenue to be brought forward to remedy the financeability issue.²⁰ It submitted that one of the main causes was the higher imputation credit payout ratio assumed under the benchmark framework. In circumstances where the RCF/net debt metric’s score deteriorates a notch, an offsetting improvement in another credit metric is needed to compensate for this deterioration. In some cases, this requires significant revenue to be brought forward and results in subsequent volatility in annual revenue.

The CEFC’s analysis was based on the ENA’s proposal to assess financial metrics on an annual, rather than 3-year average approach under the proposed guideline. As discussed in section 2.1.2 the annual approach of assessing financial metrics exacerbates the volatility in revenues and limits the ability to address financeability issues in a given year. Using the annual assessment basis, a deterioration in RCF/net debt must be offset by an improvement to another metric in that year. Under an averaging approach there is flexibility to offset this by improving the average of another metric over the relevant 3 years. We consider that this is appropriate to avoid sharp changes in revenues and allow a financeability issue to be addressed. Further, the use of AICR in the proposed guideline—and in ENA/CEFC’s modelling—rather than FFO interest coverage means that in practice the only metric that can be improved to offset a deterioration in RCF/net debt is FFO/net debt. This further exacerbates the observed volatility in revenues and ability to address financeability issues. When considered in combination with the positions arrived in the final financeability guideline, our view is that the volatility that may arise from the RCF/net debt metric does not pose as a material issue to the financeability test.²¹

Following the release of the proposed guideline, we also identified a secondary issue with the RCF/net debt calculation related to the treatment of revenue adjustments in the building

¹⁹ ENA, *Ensuring the financeability of actionable ISP Projects – Proposal to change the National Electricity Rules*, June 2023, p. 17.

²⁰ CEFC, *Financeability guideline submission*, 4 September 2024, p. 3.

²¹ Using FFO interest coverage, 3-year forward averages, narrower credit notches and adjustments to tax payable all minimise the volatility of adjustments to solve an RCF/net debt deterioration.

block approach. In the proposed guideline the revenue adjustments were removed from smoothed revenues when calculating retained cashflows.²² This means that if a positive revenue adjustment (generally related to incentive mechanism benefits) was included in revenues, it was removed from revenues when determining the retained cashflows. Likewise, if a negative revenue adjustment was impacting smoothed revenues it was added back when calculating retained cashflows, which essentially ignored its impact on cashflows. This was inconsistent with the treatment of revenue adjustments when calculating FFO used for the FFO/net debt and FFO interest coverage metrics. We consider that the approach used to calculate FFO is correct as a positive revenue adjustment—all else being equal—should improve retained cashflows and vice versa. Therefore, our final decision is that the financeability guideline provides for RCF to be calculated in a consistent manner as FFO in respect of the treatment of revenue adjustments. We also raised this issue with the ENA in subsequent discussions who agreed that this was the appropriate treatment of revenue adjustments.

2.1.5 Tax calculation

In the proposed guideline, the tax payable element used for the calculation of financial metrics was based on the PTRM output for each case (unadjusted and adjusted). The ENA's submission raised two issues with this approach. First, on the revenue used for the tax calculation, and second on the tax depreciation expenses calculation. On the first issue the PTRM's estimate of tax payable requires the use of unsmoothed revenues as the basis for calculating the expected annual tax cost.²³ In practice, the taxable revenue for a TNSP will be dependent on the allowed (smoothed) revenue for each year, not the unsmoothed building block costs. We do not consider this to be a material issue with the resulting revenues calculated within the PTRM as it is simply a model simplification made to avoid the circular relationship between the tax building block and overall allowed revenues. However, it can have a material impact on the annual financial metrics calculated in the financeability model for use in the financeability test. The ENA's submission proposed to include a separate calculation of tax payable in the financeability model based on smoothed (rather than unsmoothed) revenue for the purposes of implementing the financeability test.²⁴ We agree with this proposed change as it better matches the expected annual tax payable of a benchmark TNSP and have implemented it in the final guideline model.

On the second issue when a change to depreciation profiles is applied to address a financeability issue there are two sub-issues. One is when as-incurred depreciation is applied to a stream of capex, and a second more material issue is if a vastly shorter life is applied to accelerate depreciation of a stream of capex than its assumed useful life. The first sub-issue occurs because the approach used to apply as-incurred RAB depreciation in the PTRM is to set the as-commissioned capex for that stream of capex equal to the 'as-incurred' value. Consequently, the tax depreciation calculation becomes based on the same as-incurred capex. In practice, consistent with tax rulings, a TNSP is only able to claim tax depreciation on an asset once it is commissioned and in use. The impact of this assumption is relatively minor as it is only bringing forward a year or two of otherwise unchanged tax depreciation

²² AER, *Proposed financeability guideline*, July 2024, p. 8 and attachment B.

²³ This is predominantly done as a model simplification to avoid the circular relationship between the tax building block and overall revenues.

²⁴ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, p. 21.

which has minimal impact on the overall tax payable. The ENA’s submission proposed that the tax depreciation used for the separate calculation of tax payable in the financeability model should be unchanged between the ‘unadjusted’ case and the ‘adjusted’ case.²⁵ This ensures that the tax payable in the financeability test is not impacted by the application of as-incurred depreciation. We agree with this proposed change and have implemented it in the final guideline model.²⁶

The second tax depreciation sub-issue is evident when a shorter life is applied to a stream of capex to bring forward cashflows to solve a financeability issue. In the PTRM, the standard asset life for RAB depreciation is the asset’s useful/economic life. Once this asset is assumed to be at the end of its useful life the PTRM writes-off the remaining value of that asset for tax depreciation purposes. In the event of an asset’s RAB depreciation life being shortened to address a financeability issue this assumption no longer holds because the asset still has a useful life for many years after the accelerated depreciation period. This can lead to the PTRM calculating a significant tax depreciation early in an asset’s life that the TNSP would not be able to claim as a tax deduction in practice.

As a result, the calculated taxable income (and in turn the tax building block) can be significantly reduced for a TNSP based on the capex subject to a financeability adjustment. Due to the nature of the tax building block this can result in a material net present value (NPV) difference between the calculated tax payable and the expected tax payable of a benchmark firm operating the TNSP’s network. The ENA’s submission proposed to leave the tax depreciation unchanged between the ‘unadjusted’ case and the ‘adjusted’ case in the financeability model goes some way to solving this in the financeability test.²⁷ However, we consider that this still leaves a lasting issue in the underlying PTRM that will impact future determination revenues and result in a material NPV impact to the TNSP over the life of the asset.

We consider that to fully address this issue the electricity transmission PTRM template requires an amendment to correctly apply this adjustment. This proposed amendment would allow a separate ‘financeability life’ to be recorded and applied to a stream of capex—separate from its assumed useful life—to bring forward depreciation cashflows to address a demonstrated financeability issue. This amendment would ensure that the tax depreciation of this stream of capex is still spread across the assumed useful life, while the life used to calculate regulatory depreciation can be shortened for strictly financeability reasons. The explanatory statement for the proposed amendment sets out more detail about the amendment and initiates the NER consultation process for the amended template PTRM.

2.1.6 Other model changes

In its submission to the proposed guideline, the ENA identified a number of issues and suggested improvements to the financeability model for us to consider. These suggestions were focussed on:²⁸

- Better aligning the model with the approach specified in the guideline.

²⁵ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, p. 21.

²⁶ AER, *Financeability guideline*, November 2024.

²⁷ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, p. 21.

²⁸ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 19–23.

- Correcting calculation and formulaic discrepancies.
- Enhancing the flexibility and transparency of the model to accommodate different concessional finance arrangements.

We have reviewed the suggested amendments to the financeability guideline model proposed by the ENA and agree with the suggested changes outlined in Table 6 of its submission.²⁹ We consider that these changes correct some unintended errors in the model and improve the accuracy of the financeability guideline model. As part of this final decision, we have implemented the changes in our financeability guideline model (Attachment B). While we have amended the calculations for the treatment of concessional finance adjustments in the model, as noted in the CEFC’s submission,³⁰ these calculations are illustrative only. The NER requires that we adjust the benchmark financeability outcomes in a manner specified in a Concessional Finance Agreement made between a TNSP and a Government Funding Body.³¹ The illustrative calculations in the model are predominantly to assist stakeholders in the possible impact of various concessional finance arrangements on the outcome of a financeability test.

2.2 Other issues

The proposed guideline did not specify in detail the period over which a financeability test would be performed, or how the guideline was expected to operate in circumstances of multiple financeability requests by the same TNSP. The final guideline includes some further detail on these issues. We also propose some changes required to the current electricity transmission PTRM to implement changes to depreciation for a financeability adjustment.

2.2.1 Period of assessment

The ENA’s submission requested clarification in the final guideline on the horizon over which the financeability test would be implemented. The financeability model provided by the AER allows for the test to be performed over a 10-year period, but the NER does not specify the timeframe over which the test should be applied. The ENA submitted that it should be left to the applying TNSP to propose the timeframe for the test and be responsible for justifying the need for the test over the proposed horizon.

The AEMC’s final rule determination noted that a decision to bring forward cashflows through adjusting depreciation may apply to the current and the subsequent regulatory control periods. As such, the NER requires that if an adjustment applies to the subsequent regulatory control period, the AER’s determination is binding.³² This suggests that the financeability assessment should not span more than the current and subsequent regulatory control periods (typically totalling 10 years). Any adjustment provided beyond that period would not be binding on the AER under the NER.

The CEFC’s submission also did not support any lengthening of the test beyond 10 years.³³ It noted that in practice it has not observed a financeability issue persisting longer than this, and its analysis of benchmark scenarios have not indicated a true financeability concern

²⁹ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 21–23.

³⁰ CEFC, *Financeability guideline submission*, 4 September 2024, p. 5.

³¹ NER, cl. 6A.6.3A(k).

³² NER, cl. 6A.6.3A(o).

³³ CEFC, *Financeability guideline submission*, 4 September 2024, pp. 4–5.

persisting after 10 years. The CEFC highlighted that the longer the assessment period, the more likely the model will show financeability issues that are a model construct rather than a true financeability issue.

Our analysis shows that the key period for financeability issues that may occur is during the construction period of the actionable ISP project. In most cases this will be in the current regulatory control period when the CPA is to be lodged. Depending on the timing of the CPA and the length of the project construction period there may be cases where the construction spans the current and subsequent regulatory control periods. Having regard to this, we consider that the key period for a financeability assessment is the current regulatory control period. This period may be extended to no longer than 10-years if proposed with sufficient justification by the TNSP as part of its actionable ISP related CPA.

If the TNSP proposes to extend the financeability assessment beyond the current regulatory control period we consider that some amendments to the scenario PTRMs underpinning the financeability assessment are required to perform the assessment. This includes providing values of 'business as usual' capex and opex forecasts for the subsequent regulatory control period to ensure financial metrics for the eligible project are calculated on a reasonable basis. These inputs are not expected to be detailed forecasts, but should be based on a reasonably informed expectation of non-ISP project expenditures that will be incurred over the subsequent regulatory control period. The PTRM will also require placeholders for rate of return inputs and some other amendments to expected inflation and revenue smoothing to operate correctly.³⁴ We have included a worked example as an attachment to the final guideline (Attachment A) that illustrates the application of a financeability assessment with forecast capex spanning the current and subsequent regulatory control periods.

2.2.2 Treatment of multiple financeability requests

The ENA's submission noted that if a TNSP pursues multiple ISP projects sequentially then the financeability test should be applied sequentially to each ISP project.³⁵ This is the case whether we have reached a decision on the first CPA prior to the subsequent CPA being submitted. We agree with the ENA's submission and consider that this approach is consistent with our intent when developing the proposed guideline.

If we made a determination in relation to the first eligible project prior to a second eligible project being proposed, then this determination PTRM is used as the 'base case' for the financeability test for the second project. If the TNSP proposes a new project before the AER has made a determination in relation to the first project, then the 'base case' for the new project in the financeability request should be based on its proposed first project PTRM. This 'base case' PTRM will be updated by the AER as required when a determination on the first project is made. If the determination on the first project is delayed due to its complexity and the determination for the new project is made before that first project, then the base cases for each financeability test will be swapped. In this circumstance, we will ensure there is clear communication between the AER and the TNSP regarding how the financeability test is to be updated and applied. We consider that this is consistent with how the AER would update the

³⁴ Placeholder return on equity and portfolio return on debt values should be included for years 6–10, expected inflation rate should be hardcoded at the current regulatory period rate and smoothed revenues for years 6–10 should be set equal to unsmoothed revenues.

³⁵ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, pp. 18–19.

revenue allowance for other overlapping determination amendments, such as cost pass-through application and annual debt updates.

2.2.3 Amendments to the transmission PTRM

In the explanatory statement for our proposed guideline, we discussed the potential of shaped depreciation as a method to bring forward depreciation cashflows to address a demonstrated financeability issue. We noted that this would require an amendment to the regulatory models to implement. The ENA supported the regulatory models being amended to enable a TNSP to propose any NPV-neutral adjustment to regulated cash flows to address an identified financeability issue, including applying shaped depreciation.³⁶ The CEFC's submission suggested that a more targeted approach could be adopted by simply taking a portion of the capex of the new project and depreciating it over a single year.³⁷ This effectively converts the capital expenditure into revenues and allows the adjustment to revenues to be more targeted and only bring forward the minimum cashflows required to address a financeability issue with minimal impact on medium-longer term cashflows.

We agree that this more targeted approach is appropriate for applying the financeability guideline given the prescriptive nature of the financeability test. Therefore, we are not proposing to amend the regulatory models to include an option to apply shaped depreciation. However, as discussed in section 2.1.5, the calculation of tax depreciation in the current PTRM template can result in a material NPV difference between the calculated tax payable and the expected tax payable of a benchmark firm operating the TNSP's network where depreciation is accelerated to address a financeability issue. We consider that the current electricity transmission PTRM (version 5.1) requires an amendment to correct this issue. The explanatory statement released alongside this final decision sets out our proposed amendments to the PTRM and invites submissions from stakeholders.³⁸

³⁶ ENA, *Submission to AER Draft Financeability Guideline*, August 2024, p. 26.

³⁷ CEFC, *Financeability guideline submission*, 4 September 2024, p. 3.

³⁸ AER, *Explanatory statement – Proposed amendments to electricity transmission post-tax revenue model (version 6)*, November 2024.

Shortened forms

Term	Definition
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
AICR	adjusted interest coverage ratio
capex	capital expenditure
CEFC	Clean Energy Finance Corporation
CPA	contingent project application
ENA	Energy Networks Australia
FFO	funds from operation
ISP	Integrated System Plan
NEL	National Electricity Law
NER	National Electricity Rules
NEO	National Electricity Objective
NGR	National Gas Rules
NPV	net present value
PTRM	post-tax revenue model
RAB	regulatory asset base
RCF	retained cash flows
RFM	roll forward model
TNSP	transmission network service provider