Due to the inflation framework and rate of return instrument, the AER's decision would deliver an inadequate FFO (funds from operations)/Debt to maintain Ausgrid's current credit rating.

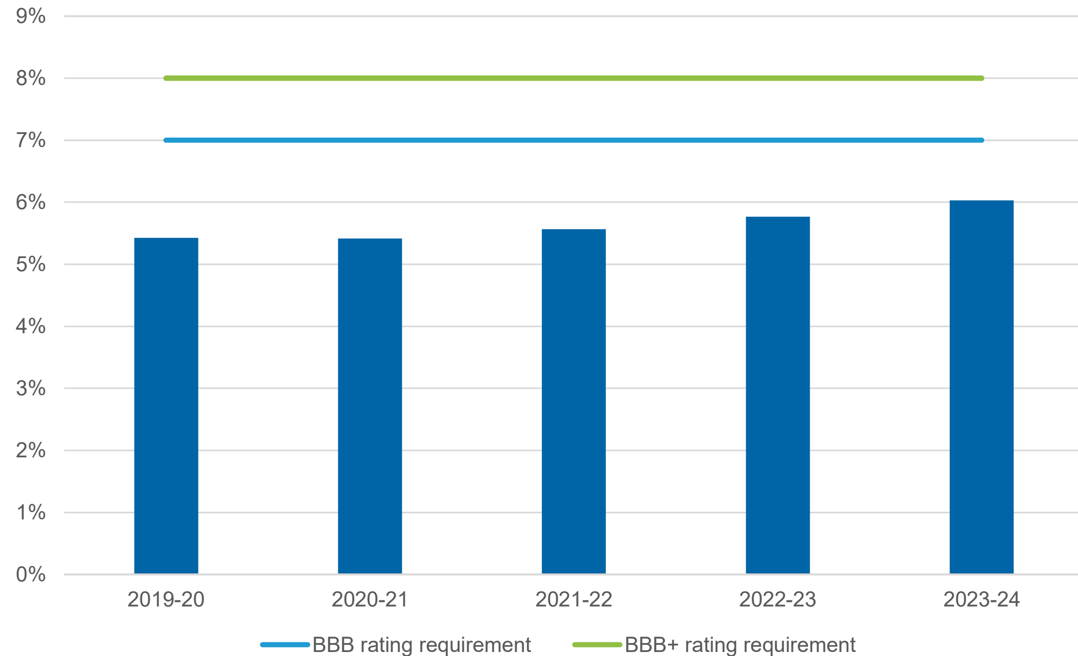
FFO/Debt is funds from operations as a proportion of debt and is a standard metric used by rating agencies to assess the cash flow position of companies.

This columns in the chart show the implied FFO/Debt of the AER's decision for the current regulatory period based on the benchmark allowances.

The blue line shows the required FFO/Debt for Ausgrid to maintain its BBB credit rating.

The green line shows the FFO/Debt that would be required to be upgraded to BBB+.

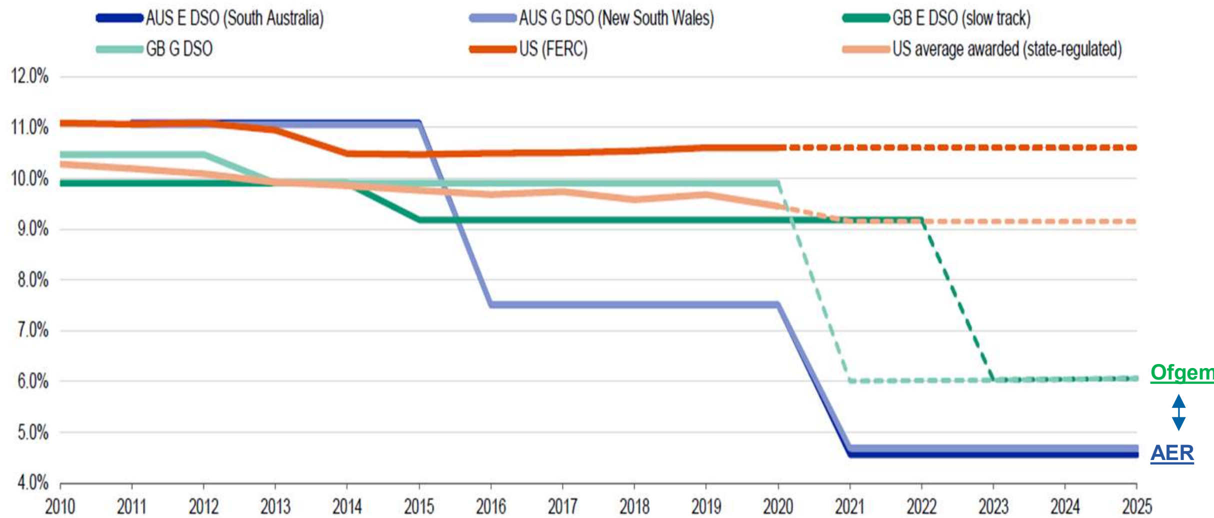
Standard & Poor's:
"Shareholder support will remain important for maintaining rating stability. The shareholders (represented through the board of directors) have approved the suspension of dividends through fiscal 2022. Nevertheless, we believe that Ausgrid's FFO-to-debt ratio will be significantly lower than 7% up to fiscal 2022, deviating from the company's stated intention and policy of maintaining the ratio above 7%. In addition, we believe that the metric would revert to just about 7% from fiscal 2022, which does not leave any headroom for underperformance. As such, we believe that Ausgrid's current leverage structure could present a risk that continued shareholder support might be required through the end of the current regulatory period in 2024 via a dividend holiday or in some other form."



UK energy networks may be a canary in the coalmine – credit rating impacts are resulting from Ofgem financing decisions, and the AER is going even further.

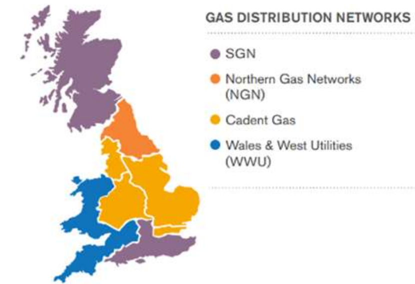
Evolution of allowed equity returns over time

All returns shown in nominal post-tax terms



DSO = distribution system operator, E = electricity, G = gas. To reflect nominal returns for GB networks, we applied 3% long-term inflation assumptions for the retail prices index (RPI), which applies until 2021 and 2023 for gas and electricity networks respectively. Thereafter, the regulator will use the consumer prices index, adjusted for housing costs (CPI-H), which we assume to be 2% over the long term, in line with the Bank of England's inflation target. FERC returns can vary by region; the chart largely reflects rates applied in New England. US returns for state-regulated networks show the average of the regulatory equity returns awarded in a given year. Beyond 2020, the chart reflects final determinations by AER for Australian networks and draft determinations for GB gas networks (as quoted by Ofgem), assumed to result in a similar movement for GB electricity networks in 2023. For US networks we expect returns to remain largely stable, but with potentially more pressure from state regulators.

Sources: AER, FERC, Ofgem and Moody's Investors Service



Wales and West (February 2019)

*Moody's has today **downgraded to Baa2 from Baa1** the backed senior secured notes maturing in 2021 issued by Wales & West Utilities Finance plc (the notes)….The **outlook remains negative**….The rating action **follows the publication, in December 2018, of a regulatory consultation** that sets out detailed proposals for the RIIO-GD2 period that begins in April 2021. **The consultation by Ofgem, the industry's regulator, signals a sharp cut in allowed return…***

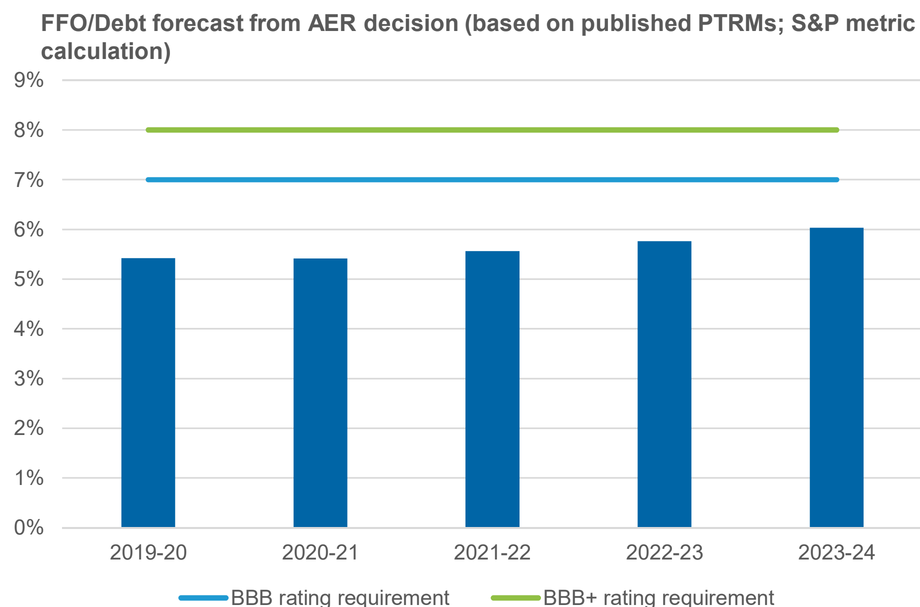
SGN (January 2019)

*Moody's has today **changed to negative** from stable its outlook on the Baa1 senior unsecured and backed senior unsecured ratings and (P)Baa1 senior unsecured programme ratings of Scotland GN and Southern GN, two Gas Distribution Networks (GDNs)….**the driver for today's rating action is a methodology consultation published by Ofgem**, the industry regulator, in December 2018, which **signals a sharp cut in allowed returns and reduced scope for financial outperformance** in the RIIO-GD2 period that begins in April 2021.*

Ausgrid
Connecting communities, empowering lives

Inflation review

- Ausgrid is positioned to deliver efficient investment to modernise the grid to become a platform for DER, ultimately create jobs and support economic recovery post COVID-19.
- The current low return environment (10yr CGS yield <1%) combined with the AER's approach to estimating inflation has the following impacts:
    - Regulatory decisions reflecting 5 years of losses
    - Cashflows that don't support the assumed credit rating which the AER applies in setting the WACC.
- If credit ratings can't be supported, there will be upward pressure on prices, despite investors wanting to keep prices low for the community we serve.
- Investment is needed to facilitate the energy market change.
- The inflation review highlights a significant problem for customer prices and investment signals – prices are unnecessarily high when actual inflation is higher than forecast, and unsustainably low (currently delivering 2% expected (RoE) when inflation is lower than expectations.
- We are calling for the AER to support a change to the "hybrid approach" for inflation that eliminates these unnecessary windfall gains and losses for customers and networks.



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