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Warwick Anderson
General Manager, Network Pricing
Australian Energy Regulator
GPO Box 3131
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Dear Warwick

Rate of Return – Draft Omnibus Papers

AusNet welcomes the opportunity to provide feedback on the AER's Draft Omnibus Papers. We have focused this submission on a few key issues and strongly support the ENA's comprehensive submissions.

While we recognise the need for transparency where possible, due to the confidential nature of our debt practices it has been necessary to submit two confidential attachments with this submission. Where this has been the case, we have sought to provide an overview of our position in this public document.

Comments on the Process

The Omnibus Papers are the final round of the AER's Working Paper series which forms part of the 2022 Rate of Return Instrument review process. At this point in the process, it is worth reflecting on its effectiveness to date and desirable next steps.

The Working Paper process has been a beneficial addition to the Rate of Return Instrument review process, allowing many issues to be considered by stakeholders and the AER in a thorough way and at an early stage. In addition, the AER's interactive online Public Forums have been well-run and have been an effective channel in understanding stakeholder views.

To increase the effectiveness of the ongoing engagement process, the AER has a critical role to play in validating the 'fact base' that underpins this review. It is important for stakeholders to have a common understanding of the facts to enable constructive dialogue on the efficient approach to adopt in the 2022 RORI. Without this fact base being understood, the effectiveness of public forums, submissions and discussions will be limited.

We consider that these fundamental questions should be answered by the AER because currently they are the source of needless contention:

- **Is the 2018 RORI approach delivering returns on equity that are materially below those of internationally comparable regulators on – as far as is practicable – a like for like basis?**

  The Brattle report and the AER's analysis relevant to the 2018 RORI in the final 'International regulatory approaches to rate of return' Working Paper provide evidence that it is.

- **Does network debt data show a 'halo' effect driven by factors other than transitory factors, biases inherent in the index, or networks departing from the 1 year trailing average debt approach?**

  The findings of the AER's current analysis needs to be clearly presented to inform stakeholders of why there is a gap between the EISCI and the AER's benchmark debt allowance.

- **Is there evidence that the regulatory framework is geared towards making 'tweaks' to increase network returns?**

  This assertion has been made by the Consumer Reference Group and other customer advocates but is not supported by recent evidence. Most of the material changes to network regulation in recent years have ultimately been initiated by either Government, customer groups or the AER, including the move to the trailing average cost of debt, the Binding Rate of Return Instrument legislation, the AER's review of tax allowances, opex productivity and the upcoming incentives review. For avoidance of doubt, we consider it a fundamentally important part of the Australian regulatory framework that all stakeholders can make a case for change.

These are issues of importance to the review process, but in the absence of AER commentary or clarification, are not necessarily understood or accepted by other stakeholders.

In addition, we recommend the following steps would be valuable to the process:

- Constructive dialogue with the AER about the inclusion or exclusion of AusNet's debt information (particularly subordinated debt) in the EISCI, as we are very concerned that these instruments have been referred to as having 'equity-like features' when they do not.

- The December Information Paper should outline the AER's thinking on the approach to setting the Market Risk Premium. This will inform any subsequent discussions about whether and how updating the risk-free rate and the MRP during the RORI period is desirable. While we recognise an initial position could be shaped by the Expert Panel discussions, we consider an indication of the AER's thinking on this matter well in advance of the Draft Guideline in June 2022 will allow more time for these discussions to occur.

Debt Benchmark Approach

As outlined in previous submissions, AusNet strongly supports the retention of the current debt benchmark. We re-iterate our concern that the application of the AER's assessment approach is not being clearly applied in the case of the debt benchmark – with a radical new approach having been put forward by the AER before the case for change has been established.

Unlike equity, the performance of the current debt benchmark is not a theoretical exercise. The AER has access to industry debt data and is currently undertaking analysis to establish whether there has been sustained outperformance that would warrant an adjustment to the approach to be made. We would welcome engagement on the methodology the AER is applying in undertaking this analysis, so networks can have confidence that assumptions made are reasonable given their experience issuing debt, and the conclusion are accurate.

The AER should make clear the drivers of any outperformance it uncovers through this analysis. Potential drivers of sustained outperformance which indicate a change to the current debt approach is warranted include:

- An identified 'halo' effect whereby regulated energy networks are consistently able to issue cheaper debt than other firms with the same credit rating, as reflected in the 3rd party indices currently applied to set the debt allowance.

- A material and sustained change to observed debt financing practices towards issuing debt with shorter tenors, which would indicate a change to the benchmark efficient debt management strategy.

Potential drivers of outperformance for which no adjustment to the 2022 RORI approach should be made include:

- Impact of recent privatisations. The issuance of shorter tenor debt due to recently privatised networks building up debt books from scratch is not relevant to the AER's task in establishing efficient debt compensation to be set in the 2022 RORI. The impact will still be present even if the EISCI is tenor weighted.

- Any outperformance due to a transition to the trailing average approach. If this exists, this would be a transitory reason for outperformance which will largely disappear during the term of the 2022 RORI.

- An incomplete picture of industry debt being included in the EISCI (fees are omitted, for example, and the downwards bias resulting from the inclusion of AusNet's senior debt, but not its subordinated debt. The latter is discussed below).

- Some networks adopting riskier debt management strategies than the benchmark but by issuing shorter tenor debt (and bearing the corresponding risk). If there is a sustained and widespread reduction in debt issuance tenors, then the benchmark debt tenor should be reduced. However, if this is not the case then the industry-wide debt benchmark should not be impacted by network- specific practices.

As an example, AusNet currently has an A- credit rating. An adjustment to the credit rating applied by the AER to capture outperformance embedded in the EISCI would result in compensation for (close to) A rated debt[1] to be applied to AusNet. If this adjustment reflects a genuine halo effect – whereby networks can issue debt more cheaply than other firms captured in the 3rd party debt indices – this is appropriate; AusNet's costs would be reduced due to this halo effect and the AER's debt benchmark would continue to provide debt efficient compensation. However, if this adjustment were impacted by the privatisations of AusGrid, TransGrid and Endeavour – which are unrelated to the efficient benchmark cost of debt – then the adjusted benchmark would not provide efficient debt compensation to AusNet.

Our other material concerns regarding the AER's new approach – including the need for the benchmark to be replicable – are consistent with our previous submissions[2] and those made by the ENA[3], and are not repeated here.

CEG has advised the ENA that the current benchmark approach is performing well. That is, for networks that finance like the benchmark, the costs they bear are in line with the benchmark, which implies there is no case for change. We look forward to engaging with the AER on the methodology and conclusions of its analysis which we expect to align with CEG's results.

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[1] Alternatively, as driven by shorter tenors in the benchmark, could also be thought of as compensating for 8- or 9-year debt, but applied to a 10-year trailing average.

[2] AusNet Submission to AER Energy Network Debt Data Working Paper – 14 August 2020, AusNet Submission – Term of the rate of return and cashflows in a low interest rate environment – 2 July 2021

[3] Including ENA Memo on AER final working paper – Energy Network Debt Data 18 Dec 2020, ENA Submission to AER Energy Network Debt Data working paper 14 August 2020, ENA – Submission – Term of the Rate of Return – 2 July 2021.

Sub-ordinated Debt

AusNet's debt portfolio contains three material subordinated debt issuances, (USD $375m (AUD $500m) in March 2016, AUD $650m in September 2020 and EUR 700m in March 2021).

The AER has advised that it will exclude from the EICSI instruments that do not have simple debt characteristics and have listed 'non-convertible subordinated notes' as an example of such an instrument.

We are unclear why the AER considers AusNet's subordinated debt does not have 'simple debt characteristics'. These instruments do not have equity-like features. They are classified as debt for tax and accounting purposes – that is, both the Australian Tax Office and Australian accounting standards classify these instruments as debt. We are unsure why the AER's view on the nature of these instruments differs from that of those institutions. These instruments cannot be converted into equity and are not the equivalent of 'shareholder loans' that may be paid to return funds to equity investors.

In terms of their simplicity, they are callable – as is bank debt, which is included in the EISCI. They also have relatively few terms and conditions and are certainly not be more complex than other debt issuances included in the EISCI. For example, senior debt issued in the US can have numerous complex special terms and conditions – such as covenants etc. There is no distinguishing feature of this subordinated debt that means it should be excluded from the EISCI.

We note that credit rating agencies treat these instruments more favourably in their credit rating calculations. This relieves pressure on credit metrics compared to issuing senior debt. The issuance of this subordinated debt therefore supports the issuance of AusNet's senior debt with an A- credit rating (one can't happen without the other, therefore, they must be linked in any analysis). Credit rating agency treatment – rather than being a reason to exclude subordinated debt from the EISCI – is the very reason to include it. Omitting higher cost subordinated debt, while including lower cost senior debt (supported by the subordinated debt) introduces a clear bias into the index. To remove this bias the AER must include AusNet's subordinated debt in the EISCI and for its gearing analysis. Alternatively, it should remove all of AusNet's debt from the EISCI and remove AusNet from the sample of firms included in its gearing analysis to ensure consistency.

We urge the AER to discuss with us on its reasons for excluding these instruments from the EISCI. Further detail on AusNet's subordinated debt is provided in confidential Attachment 1.

This issue also raises a concern about the transparency of the index and the confidence stakeholders can have in the results it is producing. While the highly confidential nature of the debt data underpinning this index will always (and appropriately) limit the transparency the AER is able to provide, the AER is applying a large amount of judgement in its construction (inclusions, exclusions and methodology). For the EISCI to be applied in the way the AER is intending it needs to be able to be tested and debated by stakeholders to promote confidence it is robust. The EISCI is still a work-in-progress in this regard supporting its role as a cross check.

Changes in the Timing of Averaging Periods

We do not support the changes to the timing of the averaging period windows. This change will impose costs on networks attempting to replicate the benchmark using forward start hedges, which become more costly the longer in advance of a decision they are put in place. In the context where the AER is considering adjusting for perceived outperformance based on an incomplete picture of industry debt costs (and a biased view of AusNet's costs), we are

concerned that this additional cost to our business will not be considered by the AER in setting efficient debt compensation.

We consider that 4 months prior to the start of the regulatory year should be adequate time for networks, the AER and retailers to calculate a cost of debt outcome and incorporate it into annual pricing, in the interests of avoiding additional, uncompensated costs for networks.

We also note that if the proposed change is made, it is essential that the entire 12-month window is shifted backwards by a month. Shifting back the end date without shifting back the start date would compress the window for averaging period nominations to 11 months. This would remove a month from the allowed window. Networks with long-term debt and/ or swap instruments expiring in this month would be required to take on additional risk, as they would be unexpectedly precluded from nominating an averaging period during this month. Further details on our position are contained in confidential Attachment 2.

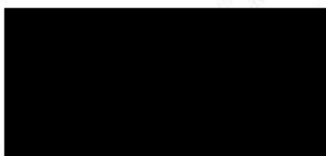
Weighted Trailing Average of Expenditure

We are open to the debt trailing average being weighted to reflect forecast capex over a regulatory period and consider that it will better reflect the profile of debt raising a network undertakes to fund capex, and therefore, will enable networks to better match debt costs with debt revenues.

The AER's position on this issue is based on the need to meet NPV=0 (which can only be achieved where a replicable benchmark is adopted according to Lally[4]) and the potential for mismatch between a network's actual cost of debt and the regulatory return on debt allowance being undesirable. Essentially, the AER is proposing fine-tuning to the trailing average approach to enhance its replicability. This is inconsistent with the AER's very significant high-level change to the debt approach (changing the credit rating to adjust for outperformance) which would leave the debt benchmark non-replicable.

Please contact Charlotte Eddy, Manager Economic Regulation on [redacted] with any questions about the issues raised in this submission. We look forward to engaging with the AER over the remainder of this review.

Sincerely,



Tom Hallam
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[4] Dr Martin Lally, The Appropriate Term for the Allowed Cost of Capital, 9 April 2021, p.3, 53