Submission

Debt Omnibus

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Dear Mr Anderson

Ausgrid welcomes the opportunity to provide this submission to the AER's draft working paper on the return on debt. We welcome the opportunity to comment early on key matters, particularly where the AER is proposing changes to current methodologies.

The rate of return instrument is one of the most significant decisions made by the AER in terms of its effect on both outcomes for customers and the financial stability of network businesses.

As highlighted in other industry and investor submissions, returns have been severely constrained since the 2018 rate of return instrument. It is critical that the rate of return is set a level that is robust to all economic circumstances and allows networks to support the energy market's transformation, promote efficient investment and provide customers with desired outcomes.

Our submission outlines our concerns with the AER's proposed use of the Energy Infrastructure Credit Spread Index (EICSI) to determine the benchmark credit rating to be used in setting the return on debt. We also comment on some of the other matters raised in the working paper.

We look forward to continuing engagement with the AER and other stakeholders as we move towards the next phase of the rate of return review process in 2022. If you would like to discuss our submission in more detail, please contact Fiona McAnally on [redacted] or [redacted].

Yours sincerely

[redacted]

Rob Amphlett Lewis
Chief Customer Officer

Introduction

The rate of return instrument is one of the most significant decisions made by the AER in terms of its effect on both outcomes for customers and the financial stability of network businesses. The consequences of setting rate of return too high or too low can have significant effects on both.

The Rate of Return Instrument 2022 (RORI) is occurring when we are at a critical juncture in the transformation of the energy sector, with changes in the NEM over the next 5 to 10 years likely to have long term impacts for customers. For example, over the coming years there is an emerging need to invest in the capabilities required to efficiently integrate distributed energy resources (DER). Investing in reliability, resilience and the capability to flexibly respond to extreme weather risks is also an emerging need for networks, as global mean temperatures continue to rise.

We appreciate being able to work through AER proposals to change current methodologies well in advance of the draft instrument. Where reasonably significant changes are proposed, such as using debt data in a deterministic way, we expect that the assessment criteria are applied equally across all parameters. Ausgrid also supports the ENA submission which provides more detail on some of the matters raised.

Can EICSI be used deterministically?

Potential use of the Energy Infrastructure Credit Spread Index (EICSI) has been discussed in previous working papers with various ideas put forward about how best to use the index.

AER analysis of the current index indicates there may be debt cost outperformance compared to the 10 year, BBB+ benchmark. The ENA has raised the following issues with the AER analysis:

- based on the AER's interpretation of the data, the outperformance was almost all due to shorter tenor, rather than achieving genuine lower debt costs for an equivalent term and credit rating;[1] and
- the AER's selection of debt instruments influences its calculation of tenor - when all instruments are included appropriately tenor does not deviate significantly from the benchmark.[2]

The AER is still evaluating all the evidence but indicates in the Debt Omnibus draft working paper that if it is confirmed that the current approach overstates debt costs, an adjustment to debt allowance would be made through amending the credit rating blend[3]. We note that Lally advises that adjusting credit rating to account for the whole difference between actual and allowed debt costs is not the best approach to adjust for outperformance.[4]

Our main concerns with the AER's proposed approach are it:

- assumes any outperformance will continue;
- is not replicable;
- does not take account of demand-side factors; and
- lacks transparency.

Each of these are discussed below.

[1] ENA, Memo on AER final working paper – energy network debt data, 18 December 2020.
[2] ENA, The term of the rate of return – response to draft AER working paper, 2 July 2021, p 17.
[3] AER, Draft Debt Omnibus Paper, July 2021, p 17.
[4] Lally, The appropriate term for the allowed cost of capital, 9 April 2021, pp 47-48.

Assumes continued outperformance

We are concerned that using a backward-looking approach to set a forward-looking benchmark does not take into account unique factors that have affected past performance for specific businesses. There does not appear to be any analysis to understand the drivers of differences and whether they are expected to continue. We raised these issues in our submissions to the energy network debt data paper[5] and the term paper[6].

To summarise, businesses subject to a recent transaction, such as Ausgrid, effectively commence with 100% short-term bank debt because in this situation banks limit the tenor they will lend to typically less than 7 years with largest available volumes at 5 years and below. At the time of transaction, the debt and hedges have an immediate mismatch with the 10-year trailing average cost of debt. This debt is short term (due to real world market constraints) and because of that, cheaper than the benchmark 10-year trailing average cost of debt at the cost of greater refinancing risk. It was not possible for Ausgrid to issue longer-term debt to match the 10 year trailing average cost of debt immediately after the transaction to align with the regulatory benchmark because:

- the likelihood of achieving the full amount of debt in longer-tenor issuance would have been very low and/or prohibitively costly;
- the timing lag between the transaction and the 10 year trailing average period caused interest rate differentials.

Instead Ausgrid, follows the typical evolution of debt capital market financing for large amounts seen by other businesses in a similar situation. This is to follow a strategy of progressively refinancing debt over time in line with their long-term efficient debt strategy, which eventually achieves a debt portfolio that is more in line with the regulatory benchmark. This means any outperformance of the benchmark allowance will and has reduced over time, and debt costs will align more closely to the allowance. It should be noted while it has outperformed, as Ausgrid moves towards its long term debt strategy it faces increased refinancing risk which should not be underestimated. In addition, future outperformance will be further reduced given Ausgrid's credit rating is lower than the BBB+ benchmark making longer dated debt progressively more expensive.

For these reasons, it is our view that it is erroneous to adjust the benchmark credit rating to account for outperformance without taking account of the reasons for that outperformance and whether they will continue to be applicable during the term of the RORI. Ausgrid's current debt portfolio is not representative of its long-term optimal strategy and is not something that should contribute in a deterministic way to an efficient, benchmark debt cost.

Lacks replicability

Adjusting the credit rating to account for all differences between the benchmark allowance and actual cost means networks cannot implement a debt strategy that aligns with the benchmark allowance. It has been suggested that replicability is not necessary.[7] Ausgrid strongly disagrees with that notion and suggests that replicability is important in this context so that risks are appropriately mitigated.

Consider the following example: the benchmark debt term is set at 10 years but the benchmark credit rating is adjusted such that the debt cost allowance is reduced to be equivalent to an 8 year benchmark term. There are two options for a network business to rationally respond:

1. issue 8-year physical debt and swaps for 8 years, leaving both interest rate and credit margin risk for the final 2 years (in 8 years' time) of the 10-year trailing average. Prudent treasury policies do not generally allow this level of unhedged risk; or

[5] Ausgrid, Submission to Energy network debt data working paper, 14 August 2020.
[6] Ausgrid, Submission to Term of the rate of return working paper, 2 July 2021.
[7] CRG, Debt omnibus forum presentation, 9 August 2021, p 8.

2. hedge the interest rate for the full 10 years but as this is more expensive than allowance, the loss would need to be made up by issuing much shorter-term physical debt. This in turn increases refinancing risk.

This demonstrates that networks would need to take on imprudent and uncompensated risk or commit to underperformance of the debt allowance. In turn, this would increase debt costs at the following RORI. It is not clear how this would be in the long-term interests of consumers.

Further, this approach would assume there is a credit margin relationship between credit ratings and issuance term and that a credit rating adjustment can be used as a proxy for term. In reality, term and credit rating margins and margin relativities change according to prevailing market conditions and are not fixed. For example, the margin differential between 10 year single A and BBB changes over time and will not necessarily maintain a fixed relationship to the margin differential between 7 and 10 year issuance. Hence using credit rating adjustment as a proxy for other adjustments, including term, will introduce further risk for the networks.

Doesn't account for demand-side factors

There are important demand-side factors that impact issuance tenor and pricing that result in outcomes that differ from those that a network intends when it goes to market, and therefore the benchmark. Capital markets are not static and are affected by timing, sentiment, volume on issue and swap, precedent, basis market costs and the availability (and incremental cost) of bank credit lines.

For example, willingness of investors or banks to lend at a particular credit rating or tenor at a particular time is not guaranteed. At the time a business needs to refinance a portion of debt, there may be limited liquidity in the market to do so at for example at a 10 year tenor at a price aligned with the benchmark. It must refinance so it takes what the market provides, which could be seven years or 12 years. Or, it may choose a significantly shorter tenor and go to market again when liquidity returns for 10 year debt. Over the long term, the strategy is still to try and meet the benchmark but there will be cycles and this is not captured in the short series of data in the EICSI.

While demand side factors affect all issuances, using the published indices from Bloomberg, Reserve Bank of Australia (RBA) and Thomson Reuters means the demand side effects are spread across all rated issuances. This is more representative of outcomes for the whole market, rather than the small number of businesses and issuances included in the EICSI. At this time, the data set behind the EICSI is not sufficiently large to mute these demand side effects to an extent that it can be used to deterministically set a component of the debt allowance.

Lacks transparency

Using the EICSI at this time to set the benchmark credit rating significantly reduces the transparency of the benchmark debt allowance. As noted by the ENA, the businesses do not fully understand the rules the AER applies to determine which debt instruments are included and excluded.

Of note is that the AER intends to exclude hybrids, or subordinated debt[8]. As noted in our submission to the overall rate of return draft working paper, we do not agree that these instruments should be excluded. Ausgrid's view is that this type of debt is, for all intents and purposes, a debt instrument and should not be excluded. While credit rating agencies may treat some proportion of this debt as equity for the purpose of calculating credit metrics, this is not the relevant test for whether an instrument is debt. The test should be the economic characteristics of the instrument, for example a mechanistically determined series of payments and ranking ahead of equity.

The main reason for raising such debt is to manage the credit rating. This means that the rating of the rest of the debt portfolio is reliant on the subordinated debt as part of the whole debt and credit rating management strategy. This debt is also generally independent of equity as it is raised with third parties

[8] AER, Draft Debt Omnibus Paper, July 2021, p 30.

rather than being a shareholder instrument. If the subordinated debt is excluded, all other debt of those businesses should be excluded.

Further, due to confidentiality of data, other stakeholders have no visibility of the underlying data or how it is being used to calculate the index. Until these issues are resolved, we recommend continuing to use the EICSI as an information and cross check tool rather than a deterministic tool.

Assessment criteria

In light of the concerns above, we have considered how the AER's proposed approach performs against the AER's assessment criteria to inform its regulatory judgment as explained in the Overall rate of return draft working paper.

Criteria 3: implemented in accordance with good practice

(a) supported by robust, transparent and replicable analysis that is derived from available credible datasets[9]

At this time, we consider the EICSI is not robust, transparent and replicable. As noted in previous sections:

- the relatively small number of datapoints means that the data is not robust to demand side factors that affects debt issuance;
- stakeholders do not have the data or methodologies used to calculate the index; and
- the index cannot be replicated, and based on the AER's proposed approach networks cannot follow a debt management strategy that replicates the benchmark without a significant increase in cost or risk.

Criteria 4: where models of the return on equity and debt are used these are

(a) based on quantitative modelling that is sufficiently robust as to not be unduly sensitive to errors in inputs estimation

(b) based on quantitative modelling which avoids arbitrary filtering or adjustment of data, which does not have a sound rationale[10]

As noted in previous sections, we do not agree with the AER's explanations regarding exclusion of some debt instruments from the EICSI, therefore we question whether criteria 4 is met by the AER's proposed change.

Criteria 6: sufficiently flexible as to allow changing market conditions and new information to be reflected in regulatory outcomes, as appropriate[11]*.*

The EICSI is based only on historic debt data with no consideration of factors affecting that data and whether those factors are likely to apply over the life of the RORI. Therefore, it is difficult to accept that a debt allowance adjusted based on this data would be flexible to changing market conditions.

Conclusion

The EICSI is a backward-looking tool to assess historic debt cost performance of the businesses against the allowed benchmark. If the index is to be used to set any of the forward-looking benchmark debt parameters we suggest the concerns outlined above should be adequately addressed. Currently, the index should be limited to a cross-check at most.

[9] AER, Overall rate of return draft working paper, July 2021, p22.
[10] AER, Overall rate of return draft working paper, July 2021, p22.
[11] AER, Overall rate of return draft working paper, July 2021, p22.

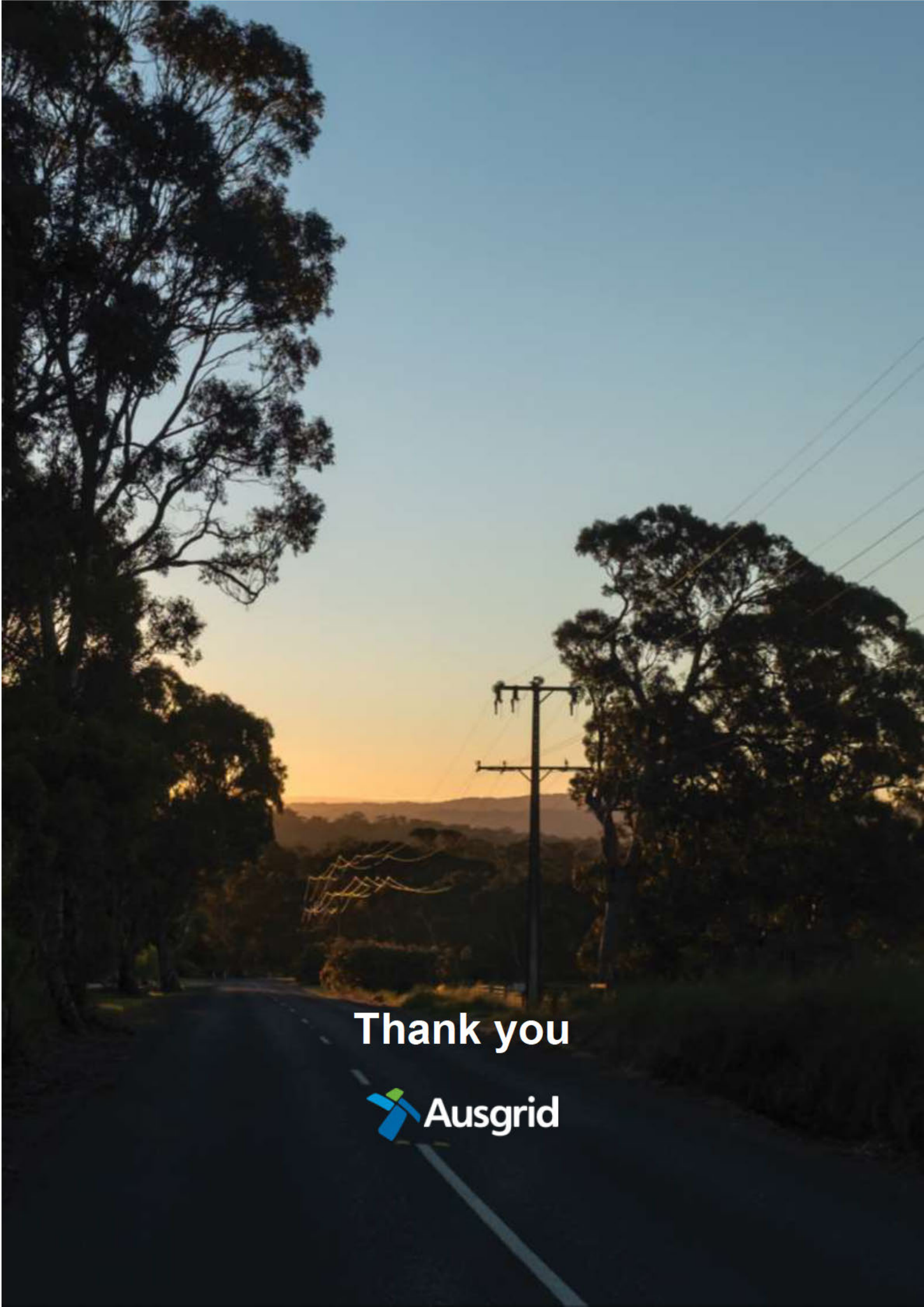
Capex weighting of the trailing average

Ausgrid would like to see more evidence regarding changing the trailing average to be weighted by capex, along with more information about how it would be implemented, before evaluating whether it meets the assessment criteria for change. If the AER does decide to make this change, we suggest that it uses forecasts capex from final decisions rather than actuals. Using capex actuals moves away from the ex-ante regulatory framework and will cause additional administrative burden for both network businesses and the AER.

Averaging periods

The AER has suggested that the windows available for nominating averaging periods should be changed due to administrative issues with the timing of data releases and finalising WACC for use in annual pricing proposals. Moving the averaging period window back one month does not raise a significant issue, however we note that this could add an incremental cost to swaps due to the window being further from the start of the period being hedged by the swaps.

It appears that the changes may reduce the averaging period window for the first year of a regulatory to 11 months. This may be an issue for some networks, and we encourage the AER to be sure it is completely necessary before deciding to make the change.


Thank you
Ausgrid