Return on debt

Initial network sector views

AER Stakeholder Forum, 9 August 2021

Draft Working Paper

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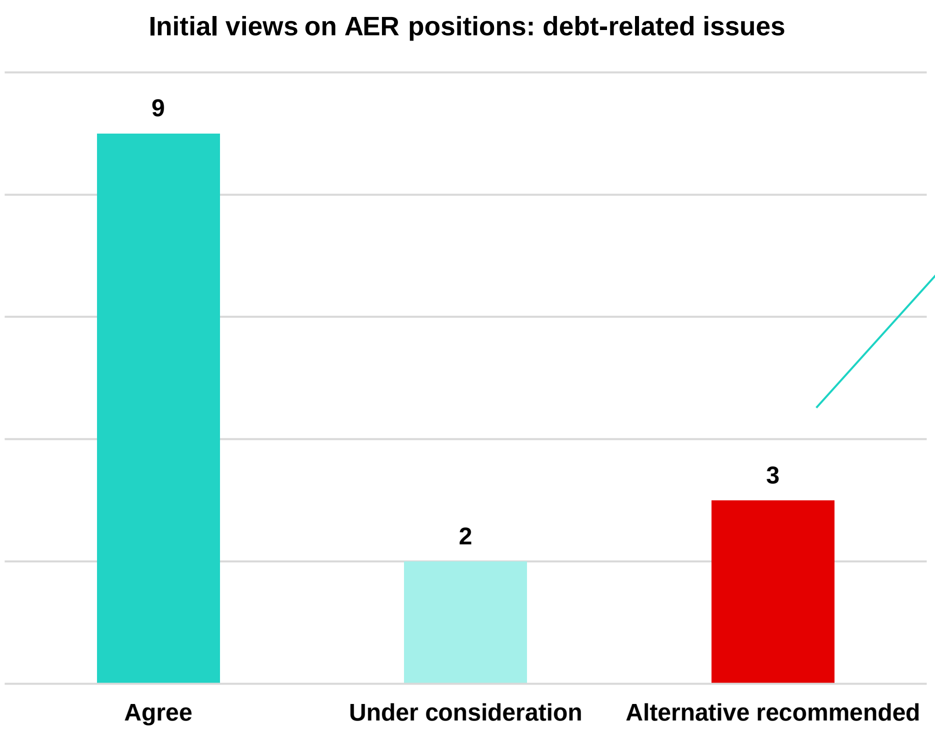
We share significant areas of common ground

Networks' initial positions on the debt related issues in the AER's overall rate of return paper (table 1) show much has been resolved

But measurement and use issues have a critical impact and remain unresolved



	Issue	AER position	Position status	Network position
1	EICSI – credit rating	Used to directly determine credit rating	Preferred	Use of EICSI to directly determine benchmark not consistent with a replicable benchmark. **Retain only as cross check**.
2	EICSI – credit rating	Implement the EICSI by adjusting the weights of A and BBB data to match network cost of debt over the past four years	Preliminary position	If EICSI is appropriately specified, including tenor-weighted, it could be used to estimate an outperformance **adjustment to benchmark debt margin**.
3	EICSI – exclusions	Included only pure debt instruments in the EICSI, excluding hybrids, working capital and bridging loans, any instrument with a term under 12 months, and any instrument not used to finance the RAB	Preferred	**Include all debt instruments that support the entity credit rating**. Need to apply consistent approach to inclusion/exclusion across cost of debt and gearing estimates to produce a replicable benchmark allowance.

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How is the 2018 RoRI performing?

Customers only pay in accordance with the efficient debt costs determined by the AER, and the current trailing average approach results in smoother prices

The 2018 benchmark is transparent, and networks can implement debt strategies to match the benchmark

Step 1: set a replicable benchmark debt management strategy (i.e. the 'benchmark strategy')

» AER sets a replicable benchmark strategy that is consistent with the observed efficient practice of networks

» Current benchmark strategy is a 10-year simple trailing average of fixed rate AUD debt and 60% gearing

Step 2: set benchmark compensation for the benchmark strategy

» Currently this is BBB+ costs based on average of RBA, Bloomberg and Reuters estimates for the benchmark strategy

Step 3: periodically test the benchmark compensation against network costs of following the benchmark strategy

» Consider raising or lowering compensation as appropriate based on this comparison

Step 4: periodically test the benchmark strategy against the observed efficient practice of networks

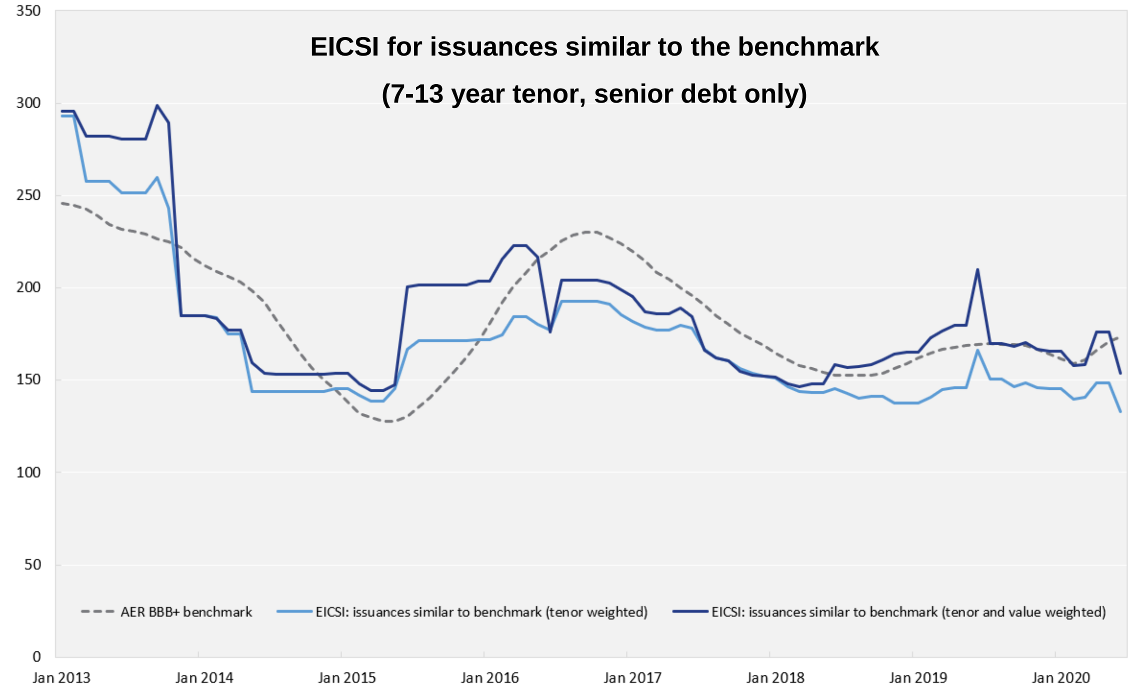
» If material divergence exists, consider transitioning to a new replicable benchmark strategy consistent with the observed efficient practice of networks

Existing benchmarks are performing well

Does a 10-year term benchmark strategy and BBB+ credit rating benchmark compensation remain appropriate?

The 2022 benchmark term of debt should only be changed if evidence shows the currently adopted term no longer represents the efficient steady-state financing practice

» No clear evidence that the AER's debt benchmark could now be considered inefficient



» WATMI indicates that networks, on average, issue debt close to a 10-year term

	30 June 2018	30 June 2019	30 June 2020
Excluding subordinated debt			
All firms	8.5	8.9	8.8
NSW firms excluded	8.9	9.1	8.9
Including subordinated debt			
All firms	9.3	9.7	9.5
NSW firms excluded	10.1	10.2	10.0

..in moving to a trailing average approach we consider that we are ***committing to a debt term for the period nominated****. To change the benchmark debt term in response to updated debt portfolio information would* ***not be conducive to regulatory stability****. '*

AER – 2013 Rate of Return Guideline

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Any benchmark must be replicable

The regulatory benchmark strategy should be within the broad range of debt management strategies observed from networks

Networks can implement debt strategies to match the existing benchmark

- The AER's preliminary position of adjusting the credit rating to account for a perceived difference in the term of debt results in a benchmark debt management approach that is not viable to implement
- Lally (2021) advised that the assumed efficient debt financing strategy that forms the basis of the allowed return on debt will only satisfy the NPV=0 principle if that assumed strategy is 'viable' (defined as 'feasible and not so inefficient that firms would avoid it')
- If departures from the benchmark term are driving outperformance, the better option would be for the AER to adjust the benchmark term (including corresponding transitional arrangements):
  - the evidence does not support reductions to the term
  - reducing the term would transfer risk of shorter tenors to customers, it is not obvious that customers are best placed to manage this risk
  - the AER's consultant (Lally) agrees that adjusting the term would be the appropriate course of action in these circumstances

Example of practical impacts of a non-replicable benchmark

- AER decides to set rate based on 10-year term, but adjusts the cost down to reflect an equivalent 8-year cost

Network decision

- Hedge using swaps (and issue physical debt) for 8-years and open up both interest rate and credit margin risk for the remaining 2-years (that is in 8-years' time)
- Hedge the interest rate for 10-years using 10-year swaps but try and make up underperformance by going much shorter on physical debt (as credit margin for shorter term debt are less)

Potential impact

- Companies hedging for 10-years using swaps but issuing 3-year physical debt, for example, would dramatically increase the whole refinancing risk for the industry
- This violates the AER's new criterion – that it will have regard to the longevity or sustainability of new arrangements

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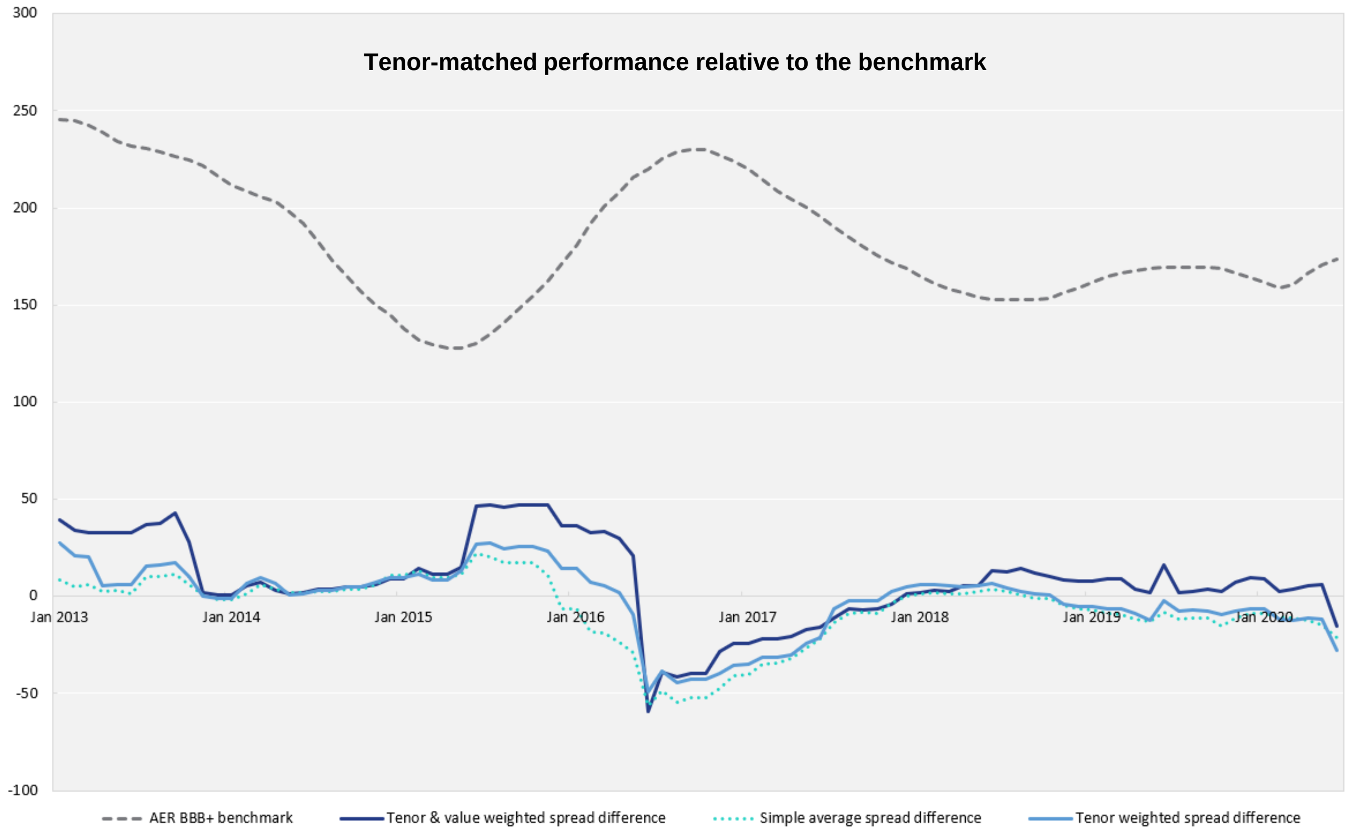
Tenor-matched comparisons show any outperformance is small

We support the AER's commitment to further investigate the drivers of any perceived outperformance relative to the benchmark

To the extent that any outperformance adjustment is evidenced, any assessment must be tenor matched

- The AER should first precisely define the efficient benchmark strategy, and then distinguish:[1]
  - the extent to which its regulatory allowance for 10-year fixed rate debt exceeds the true cost of 10-year fixed-rate debt
  - any difference from networks adopting approaches that differ from the benchmark strategy
- When individual instruments are compared to the benchmark at their tenor the average outperformance is only around 2bp
- Any outperformance should also be measured over a longer timeframe than the 4-years relied upon by the AER



(1) This is the approach adopted by the Queensland Competition Authority in its recent review

Stakeholders must be able to critically review the EICSI

ENA is deeply concerned about the transparency and process problems created by relying on the EICSI to set debt compensation

Compiling the EICSI is complex, non-transparent, and requires a number of contentious methodological choices to be made which impact on the outcome

- Due to the confidential nature of the debt data, it is impossible for the construction of the EICSI to be transparent to stakeholders
- Consumers and networks can never know which debt instruments are included in the index nor the weight each instrument might receive
- The lack of transparency of the EICSI is critical threshold point of failure in relation to its proposed use to directly estimate costs
- The EICSI, however, has some evidentiary value and we will continue to work with the AER on improvements—caution should be applied in using the EICSI deterministically

2022 RoRI must adopt a robust approach to observed data

Problems with the construction of the EICSI

We have previously raised concerns with the construction of the EICSI that have not yet been addressed

ENA encourages the AER to engage with these concerns, and clearly specify all data inclusions/exclusions

	Issue	Network position
1	The AER's debt omnibus paper presents two versions of the EICSI: one a simple average and the other a tenor weighted average. The AER does not discuss which of these it considers most relevant. The AER also does not present or discuss a value weighted version of the EICSI.	The EICSI should be both tenor and value weighted. Tenor weighting ensures that shorter term debts, which are refinanced more regularly, are not given more weight than they represent in networks' debt portfolio. Value weighting ensures that small debt issues are not given more weight than they represent in networks' debt portfolio.
2	At a minimum, debt classified as debt for both statutory accounting (consistent with accounting standards, as verified via audit), and tax purposes (by the ATO), should be treated as debt by the AER. Credit rating agency treatment of subordinated debt supports the issuance of senior (lower cost) debt; cannot look at one but not the other.	A consistent approach to subordinated debt is required across the cost of debt and gearing estimates. If the EICSI is meant to reflect networks' actual RAB debt issuance costs, need to include all actual RAB debt issuances. Excluding subordinated debt – which is an integral part of some firms' debt portfolios – while continuing to include those firms' senior debt – is not internally consistent. If AER excludes subordinated debt, it should also exclude senior debt supported by the subordinated debt.
3	Bank debt has high fees that are not included in the EICSI spreads.	It is reasonable for the AER to include bank debt used to fund the RAB. But the AER needs to look at total cost: • cannot look at spreads (relatively low compared to bonds) alone • must also look at fees (relatively high compared to bonds).

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Other issues

The AER's debt omnibus paper raised two other issues: capex weighting the trailing average and amending the averaging period

Networks are reviewing the impact of these changes

Trailing average weighting

- >> A forecast capex-weighted trailing average will increase complexity, but may better align with actual debt issuance profiles for some networks
- >> Changing the trailing average weights is unlikely to resolve financing challenges with ISP projects

Averaging period window

- >> Bringing forward the averaging window will result in an increase in debt management costs (i.e. due to longer forward start swaps)

Summary of initial views

- » The case for change has not been made (existing benchmarks are performing well)
- » Any benchmark must be replicable
- » Tenor-matched comparisons show any outperformance is small
- » Stakeholders must be able to critically review the EICSI
- » Problems with the construction of the EICSI need to be resolved to ensure confidence in the regulatory framework

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