

AER Debt Issues Paper: Analysis

22 June 2018

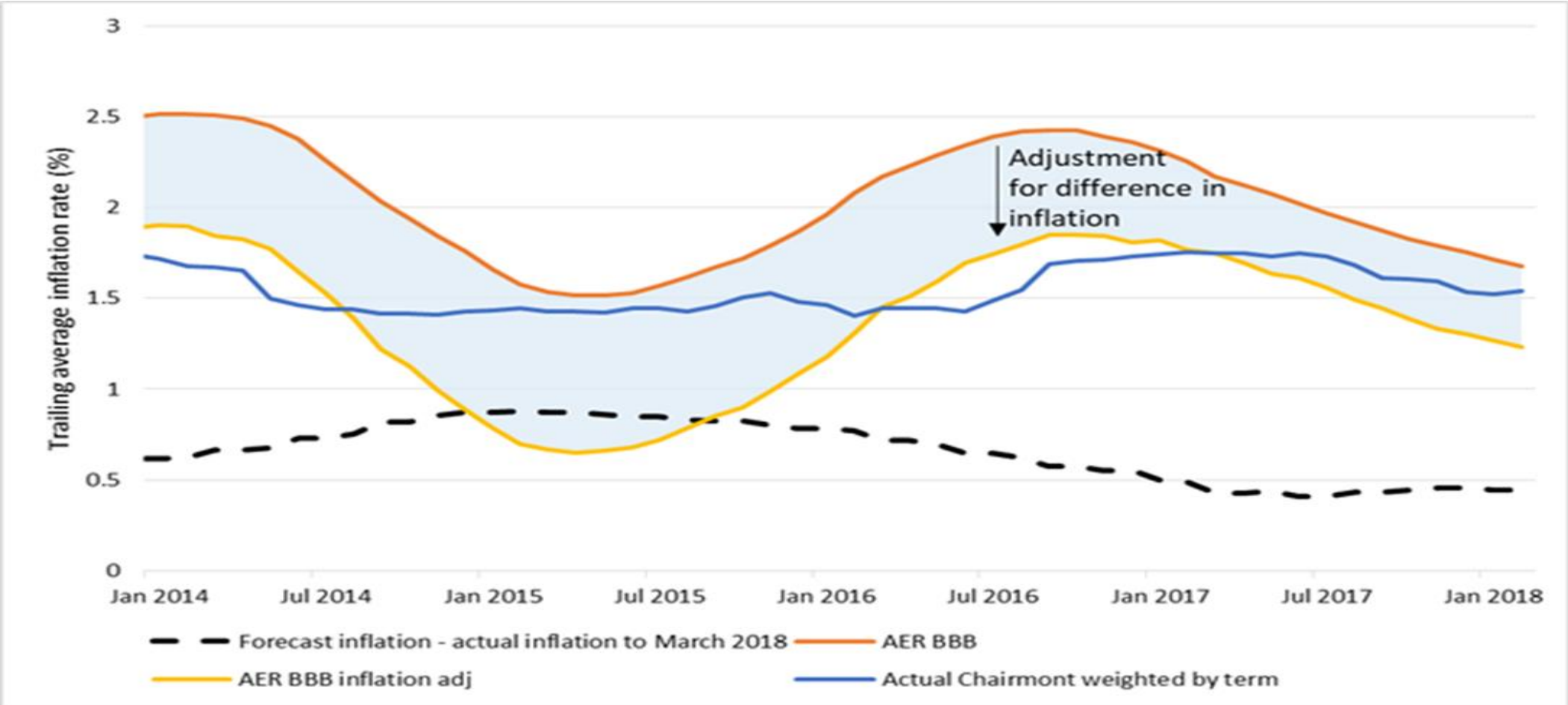
Purpose

- » To suggest changes to Chairmont's analysis to provide a robust comparison between debt costs and the AER's benchmark.
- » It is important that stakeholders can be confident in the conclusions before decisions are made.
- » The further information received about Chairmont's analysis since the debt submissions were lodged has been used in the analysis presented today.
- » Encourage publication of this presentation to promote transparency.

Customers are paying less than actual debt costs due to inflation mismatch

- » Discrepancy in AER forecast and actual inflation means businesses have been undercompensated for debt costs.
- » While the approach to the inflation forecast has recently been considered by the AER (and we are not seeking to re-open this), it is important to clarify that **customers have not paid more than the networks' debt issuance costs over this period.**
- » In the current framework need to estimate the nominal cost of debt, the remainder of the presentation focuses on this.

Customers are paying less than actual debt costs due to inflation mismatch

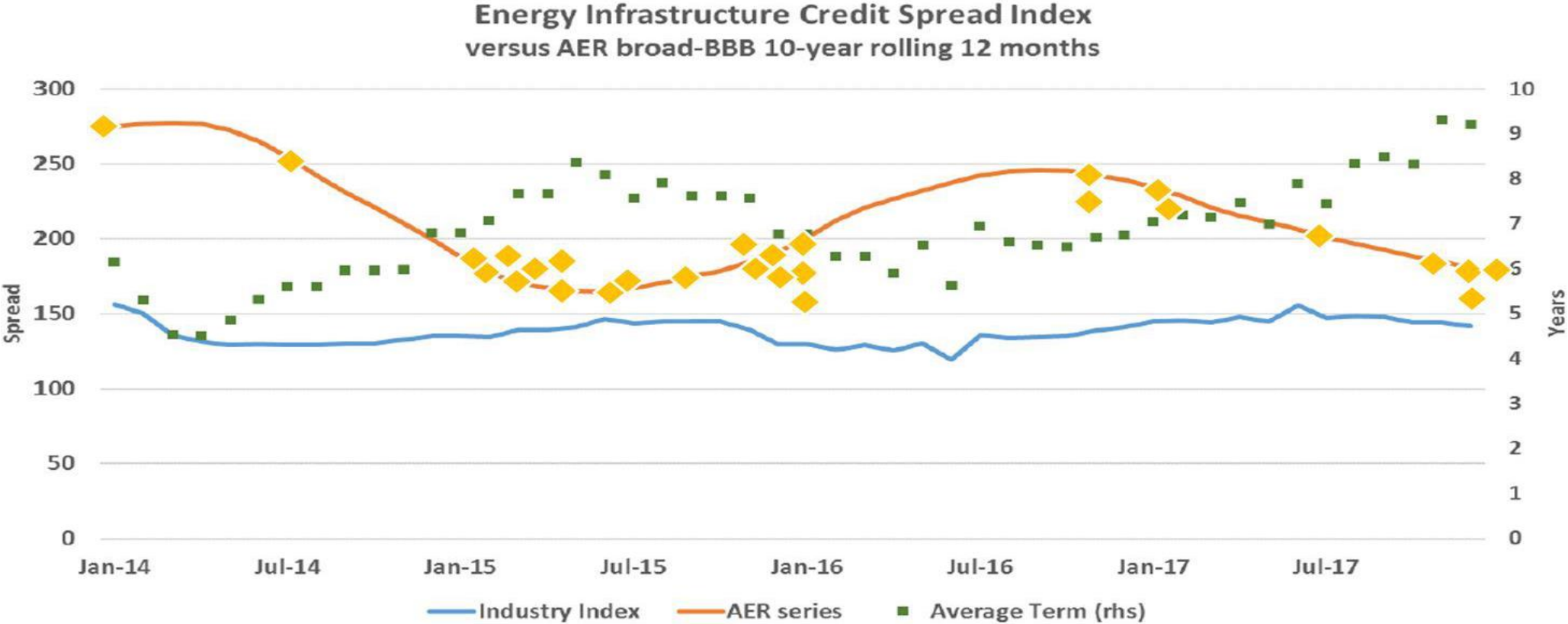


Suggested changes to Chairmont analysis

The following changes to the Chairmont/ AER analysis are suggested:

- Only compare benchmark on days when debt issued
- Weight by term
- Include callable and subordinated debt
- Include full impact of fees, less those funded via opex benchmark

Only compare benchmark with cost on days when debt was issued



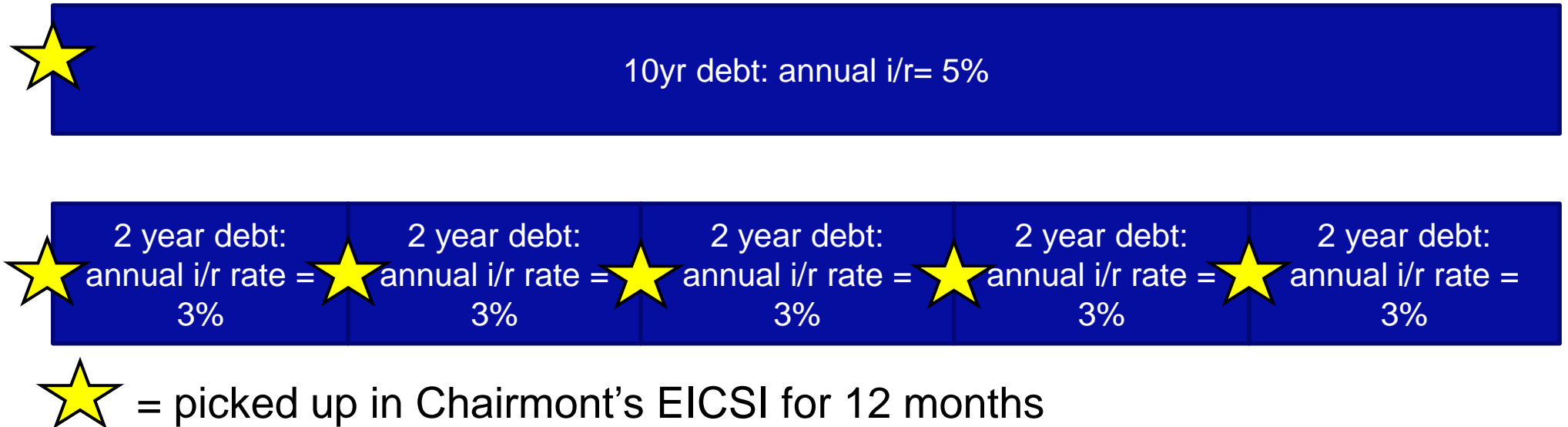
■ = Risk free rate averaging period

Only compare benchmark with cost on days when debt was issued

- Averaging periods, and therefore (you would expect) debt issuances are clustered around lower end.
- This chart visually overstates the gap between debt costs and the benchmark. The AER's benchmark may be high on days where debt is not issued – meaningless to compare with the costs of debt issued on a different day.
- Would expect a larger gap between the benchmark and the rolling average cost of debt issuances given few averaging periods fell during times of higher market rates.
- While the previous chart shows equity averaging periods, they are likely to occur relatively close to debt averaging periods (but the timing of debt averaging periods is not publically available).

Weight by Term

\$80m debt
issuance:
2 paths



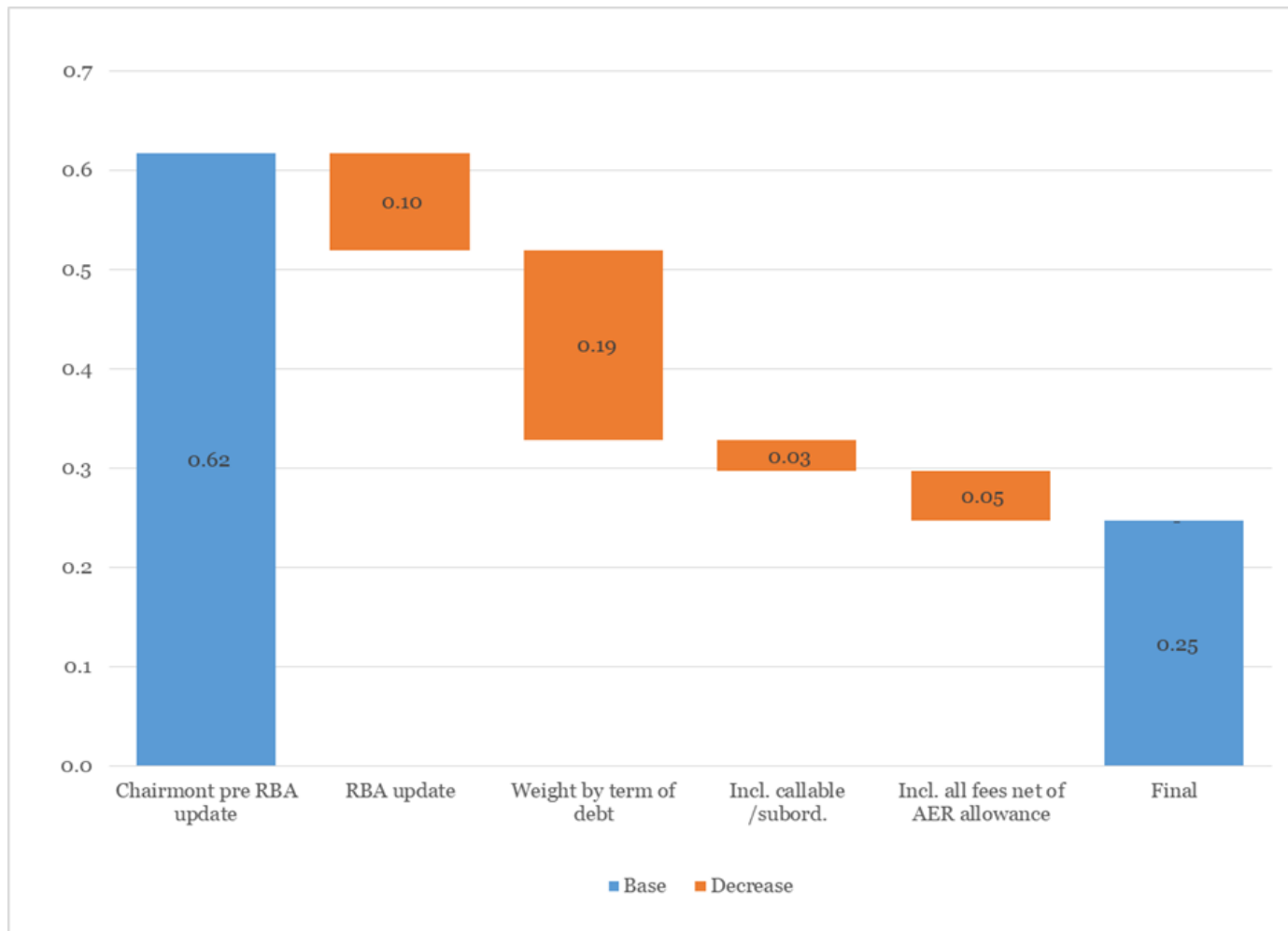
- Under both paths networks pay interest costs over 10 years.
- Chairmont's analysis only captures issuances, not ongoing costs. Therefore the 10 year debt issuance will be included once for 12 months , while the shorter term (cheaper) debt issuances will be picked up 5 times for 12 months each.
- Can fix bias by weighting by term.

Include Callable and Subordinated Debt

EICSI seeks to include only senior vanilla debt, similar to the structural restrictions of market data indices. Special case debt, involving credit-adjustment criteria or special purpose conditions, is removed. This includes working capital, bridging loans, leases and subordinated debt. – Chairmont, April 2018

- Unclear why bank debt is included (not like the benchmark) while callable and subordinated debt is excluded (also unlike the benchmark).
- Including one type (lower cost) but not the other (higher cost) biases the results.
- If objective of analysis is to measure total actual cost of debt compared to allowance, need to include all debt.

Impact of Suggested Changes

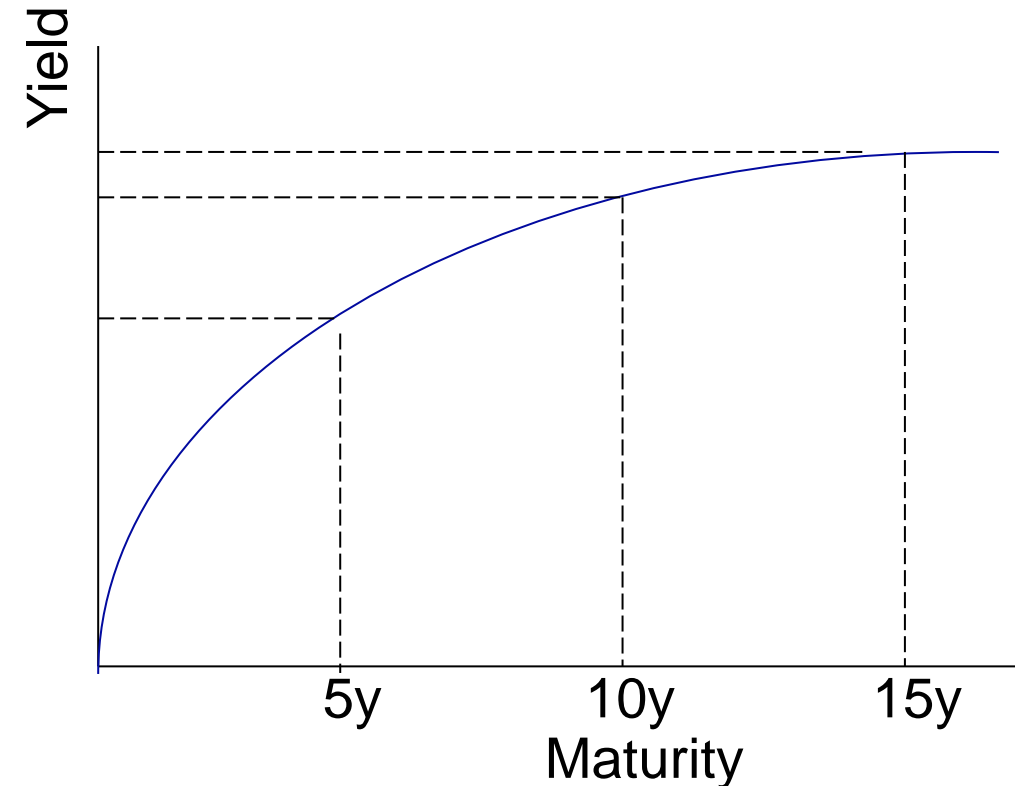


Actual value of fees is unclear – more analysis is required here to be confident in the conclusions.

Drivers of the Gap between Cost and Benchmark

Applying these adjustments in the AER's term matched analysis, it is clear that the majority of the gap is due to issuing varying terms of debt.

- » Overall, term at issuance averages 10 years but constituted of very short term (ie bank) debt, and longer term (i.e. 15 year) debt
- » The gap between debt costs and the benchmark is due to shape of yield curve ie greater difference between 5 year debt and 10 year debt (greater positive difference) than between 10 year debt and 15 year debt (less negative difference)
- » Different (higher) risk profile to assumed BEE



Fees and Debt Raising Costs

- » Need to get this right as materially impacts conclusions, particularly when short term debt is issued (lower yield but higher fees)
- » Chairmont analysis only includes some ongoing, not upfront fees.
- » Should include total fees, less those funded via opex
- » AER uses complementary approaches to the cost of debt and debt raising costs:

Our approach should be internally consistent and this is best achieved by ensuring that complementary benchmark approaches are used in both assessing debt raising costs in opex and the cost of debt in the rate of return. (AER, AusNet Services' 2016-20 Final Decision)

- » Therefore when comparing actual costs to benchmarks, need to look across both.
- » Suggest ask businesses to provide consistent data as a next step.

RBA Data Restatement

- » Acknowledge third parties may update their data series from time to time.
- » Under a 10 year debt benchmark, any updates should only be applied on a forward-looking basis. This is consistent with AER decisions:

'we will not revisit the return on debt set for prior regulatory years (that is for 2014/15 through 2017/18).' **AER, TransGrid's 2018-23 Final Decision**

...if Bloomberg or the RBA backcasts or replaces data using a revised or updated methodology we will not use the backcasted data to re-estimate our estimates of the prevailing return on debt for previous years. This would be impractical and would create regulatory uncertainty over whether the allowed return on debt would at some point in the future be re-opened.' **AER, Vic DBs' 2016-20 Final Decision**