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Sent by email:

Rate of Return
Energy network debt data
Draft Working Paper

Major Energy Users Inc (MEU) is pleased to provide its thoughts on the issues raised in the AER Draft Working Paper relating to debt data.

The MEU was established by very large energy using firms to represent their interests in the energy markets. With regard to all of the energy supplies they need to continue their operations and so supply to their customers, MEU members are vitally interested in four key aspects – the cost of the energy supplies, the reliability of delivery for those supplies, the quality of the delivered supplies and the long term security for the continuation of those supplies.

Many of the MEU members, being regionally based, are heavily dependent on local staff, suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those interests of smaller power and gas users, and even at the residences used by their workforces that live in the regions where the members operate.

It is on this basis the MEU and its regional affiliates have been advocating in the interests of energy consumers for over 20 years and it has a high recognition as providing informed comment on energy issues from a consumer viewpoint with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

Overview of the market from a consumer viewpoint

Overall, while the MEU considers that the AER Draft Working Paper outlines the issues related to assessing the data to set the network debt allowance, the MEU is of the view that the current AER approach delivers the networks a benchmark cost of debt higher than the actual cost of debt incurred by networks; this can be directly derived from the work carried out by AER consultant, Chairmont[1] but also indirectly from the work by the AER on network performance.

The MEU considers that it is important to see the issue of debt cost allowance in context of how consumers see the overall electricity and gas markets. With this in mind, the MEU makes the following observations:

- The regulatory bargain between consumers and network service providers is based on allocating risk to the party best able to manage the risk. In the case of accessing debt, it has been accepted that networks are best placed to manage this risk and minimise the cost
- Networks have, on average, received a higher rate of return than the rate of return the regulator set at the commencement of each regulatory period[2]
- Networks are continuing to invest in their network assets and proposing significant future investments and large augmentations, implying the returns they get are not only high enough to continue operations but to continue to invest to ensure that network performance will exhibit continuous improvement[3].

In addition to these points, the MEU highlights that in developing an approach to setting the debt allowance the AER:

- Asserts that the approach they use is to provide incentives for the networks to reduce the costs of debt[4]
- Uses a credit rating process that assumes all acquirers of debt on the same credit rating will pay the same cost – and assumption that is not true[5]
- Uses corporate bonds as the basis for setting the cost of debt, even though this form of debt is not necessarily the lowest cost source of debt that the networks can acquire

[1] Using this actual cost of debt data, Chairmont has developed an assessment tool Energy Infrastructure Credit Spread Index – EICSI – which provides a guide to the actual cost of debt acquired by energy networks
[2] See AER Electricity distribution network service provider data report – 27 August 2019 (page 12)
[3] See AER Electricity distribution network service provider data report – 27 August 2019 (pages 5 and 6)
[4] Despite this incentive, the MEU observes that the savings the networks make from being incentivised are not shared with consumers and no longer-term benefits flow to consumers from networks achieving lower costs of debt
[5] For example, Australia and the US are both rated AAA, but Australian bonds of the same tenor pay a higher rate

- Assumes that the tenor of debt acquired is 10 years even though network data provides a view that the average tenor of acquired by the networks is shorter than 10 years.

What is important to establish is that the Chairmont work confirms that the current AER approach to setting the benchmark cost of debt, overall, provides a greater allowance than the cost the networks incur, thereby imposing a cost on consumers than is greater than necessary. Effectively, the AER is providing headroom between allowance and cost that is inefficient.

It is with these observations in mind that the MEU provides the following commentary on the AER Draft Working Paper on establishing a benchmark cost of debt for setting network revenue allowances.

What is the problem?

Consumers see that the acquisition of debt is a cost to the network and should be treated in a similar fashion to other costs the networks incur in providing the services. In contrast, the AER seems to view the acquisition of debt is not a cost of doing business and should be treated along with the cost of equity through the use of the weighted average cost of capital. This shift in emphasis removes the cost of debt from being managed through an incentive scheme where consumers share in the benefit of if networks reduce the cost of debt.

In recent years, the AER has been able to access actual debt data from the networks and to compare this actual data with the amount allowed by the AER for each year of a regulatory period. This comparison carried out by Chairmont has identified that the AER allowance for the cost of debt is higher than the actual debt that the networks pay, and that there are a number of causes of this – the tenor of debt assumed by the AER is too long and the credit rating used is too low. This is clearly identified by the calculation of the Energy Infrastructure Credit Spread Index (EICSI) developed by Chairmont (using actual network debt data) and highlights that the current AER approach is not efficient.

As an alternative approach to the current arrangements but reflecting the regulatory incentive regime used for other network costs, the networks could declare their costs of debt and any difference between the allowance and the actual cost would be shared with consumers following the same pattern with the differences between actual and expected/allowed reliability (through the STPIS), opex (EBSS) and capex (CESS). Such an approach would be consistent with the incentive regulatory regime as networks would be incentivise (as they are now) to reduce the cost of debt as they would receive a share of the benefit.

Another alternative could be to establish a cost pass through process for the cost of debt provision. The main drawback of such an approach is that this would remove any need for the network to minimise its costs. The MEU does not support a cost pass through arrangement for the same reasons it does not accept cost pass

through for opex or capex and supports the incentive approach, as an incentive program is more likely to minimise consumer prices over the long term.

What tools are there available for setting better debt allowances?

The MEU sees there two basic approaches that the AER could use to generate a more equitable allowance for debt in the allowed revenue.

The AER could continue with its current approach but this does not resolve the fact that networks have actual debt costs lower than this benchmark. The bring the two closer together would require the AER to refine the tenor of the debt to be more typical of actual performance and adjusting the credit rating to deliver an outcome closer to the actual costs of debt[6]. A further refinement would be to allow consumers to share in the difference between the actual cost of debt and the allowance (similar to the way opex is incentivised). This approach would retain the incentive on the networks to minimise the cost of debt and make any AER errors in setting the debt a little less critical.

While the MEU accepts that the EICSI developed by Chairmont is effectively an ex post assessment, it could also be used to forecast the cost of debt for the next 12-month period. This approach has some appeal as the AER could directly use the EICSI as the debt cost benchmark as it reflects the average actual cost of debt across all networks. Its use would still provide an incentive to the networks to "beat" the debt cost benchmark but would more closely reflect the actual cost of debt thereby minimising the premium the current AER approach to debt imposes on consumers. Over time, use of the EICSI would incorporate the improved practices used by the networks to minimise debt costs and so provide a long-term benefit to consumers.

The MEU observes that, as the EICSI is an ex post assessment, it does present some challenges in directly using the information to set the debt benchmark for the next 12 month period but equally, it does identify that the current AER approach is not delivering an accurate assessment of the likely cost for debt ex ante.

However, the MEU considers that the EICSI could be used to provide the benchmark cost of debt and agrees with the benefits observed by the AER through using the approach. Errors introduced by using an ex ante EICSI basis as a forecast could be removed with an ex post adjustment.

Equally, there are some drawbacks expressed by the AER about the use of the EICSI.

In this regard the MEU observes that the AER sets a benchmark cost of debt to develop the revenue allowance, similar to the way it sets the benchmark for opex and capex. Networks are permitted to use more or less opex and capex and allocate

[6] These improvements are drawn from the Chairmont report on tenor and credit rating to deliver outcomes closer to the EICSI

the allowances in any way they see fit as long as the benefits of making these choices are measured against the outturn performance of the networks. The MEU does not see that raising debt needs to be treated differently, with the networks being able to acquire their debt in whatever manner they consider appropriate for their needs.

With this in mind, the MEU considers that networks should not be able to set any elements for the establishment of the benchmark (eg what averaging periods should apply) just as they are not able to determine tenor or credit rating used in the establishing the benchmark. The networks should then be allowed flexibility to acquire their debt on any basis they consider meets their needs, presumably with the target of "beating" the benchmark allowance.

The MEU recognises that the acquisition of the data to develop the EICSI will require some additional controls to be imposed on networks, but we consider that the costs of this are far outweighed by the benefits that consumers will get from lower costs for providing the network services. The MEU points out that already the networks have benefitted from a reduction in risk by moving to a rolling annual reset of debt costs (the trailing average approach) and that moving to an EICSI based approach (more closely reflects the actual costs of debt) is a move which reduces consumer risk.

The MEU notes the request for input into refinements of the EICSI approach (eg including subordinated debt in the measure). The MEU does not have the data to be able to provide detailed input to the queries raised but, as a general observation, the MEU considers that such refinements need to be assessed to identify if they make any significant impact on the outturn value of the EICSI. These impact assessments need to be balanced against the increase in complexity – if, as the AER asserts, the impacts are minimal then the MEU would agree they need not be introduced.

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned a [redacted] or [redacted]

Yours faithfully

[redacted]

[redacted]
Public Officer